



Financial Reporting Advisory Board paper IFRS 16: changes to FReM guidance

Issue:	This paper provides an overview of the updates that will be made to the 2020-21 FReM to reflect that IFRS 16 is applicable for all central government bodies from 1 April 2020. These updates are consistent with previous FRAB decisions on IFRS 16; we are bringing this paper to the FRAB so it can approve the exact drafting.
Impact on guidance:	We are proposing updates to the 2020-21 FReM, consistent with the decisions that the FRAB has made previously about IFRS 16.
IAS/IFRS adaptation?	No new adaptations or interpretations to IFRS 16 are proposed.
Impact on WGA?	None.
IPSAS compliant?	IPSASB are still deliberating on their leases project; it is too early to say whether this will be consistent with IFRS 16 and FReM guidance.
Interpretation for the public-sector context?	No new adaptations or interpretations to IFRS 16 are proposed.
Impact on budgetary regime and Estimates?	The budgeting for leases will align to the accounting. The updated guidance proposed in this paper does not substantially change the budgetary impact of IFRS 16.
Alignment with National Accounts	The ONS has decided that property leases will be on-balance sheet in the national accounts, while non-property leases will be classified as operating or finance leases. The updated guidance proposed in this paper does not substantially change the national accounts impact of leases.
Recommendation:	For the Board to approve the updated IFRS 16 guidance proposed for the 2020-21 FReM.
Timing:	We ask the Board to make a decision at this meeting to ensure that the draft 2020-21 FReM is able to be published in December 2019.



DETAIL

Overview

1. The Board has already made decisions on IFRS 16 interpretations and adaptations in previous meetings (namely the November 2018 and April 2019 meetings).
2. The effective date of IFRS 16 for most FReM-compliant central government bodies is 1 April 2020¹.
3. The draft 2019-20 FReM published in December 2018 was drafted to reflect that most FReM-compliant bodies would need to follow IAS 17 in FY19/20. The 2019-20 FReM, therefore, did not contain any detailed guidance on IFRS 16 other than a list of the interpretations and adaptations.
4. This paper highlights to the Board the amendments to the 2020-21 FReM (as compared to the 2019-20 FReM) that need to be made to reflect IFRS 16 implementation by all FReM-compliant bodies in FY20/21. These amendments fall into three main categories:
 - a. Removing references to IAS 17 and finance leases, and replacing them with IFRS 16-appropriate references
 - b. Reflecting the decisions on nil-consideration leases and subsequent measurement of the right-of-use asset that were made in April 2019 (since these decisions were made in April 2019, they were not reflected in the draft 2019-20 FReM published in December 2018)
 - c. Clarifications to the drafting
5. These amendments do not represent substantive changes to the decisions the FRAB reached at the November 2018 and April 2019 meetings and are limited to those described in paragraph 4 above. We have purposely limited the extent of changes around IFRS 16 to only those considered absolutely necessary as we appreciate it is not helpful to change the guidance so close to the effective date of IFRS 16.
6. Appendix 1 below is a table that summarises these changes and the underlying rationale. Appendix 2 reflects the changes made for IFRS 16 in the 2020-21 FReM, shown in track changes from the draft 2019-20 FReM published in December 2018.

Recommendation

7. We recommend that the Board approve the drafting changes proposed in this paper.

¹There is a limited exception for early adoption for the Department for Digital, Culture, Media and Sport and the Department for Transport.



Appendix 1: Summary of IFRS 16 in 2020-21 FReM as compared to 2019-20 FReM

Paragraph reference	Summary	Rationale
<i>Editorial changes</i>		
Paragraph 4.2.4	Remove reference to deferral of IFRS 16	No longer relevant for 2020-21
Paragraphs 7.4.2 and 7.4.4	Replace references to 'finance leases' with 'leases'	Finance leases no longer exist for lessees under IFRS 16.
Table 8.2: IFRS 9 interpretations	Replace reference to 'IAS 17' with 'IFRS 16'	Necessary on implementation of IFRS 16
Table 8.2: IFRS 16 adaptations	Remove adaptation for early adoption of IFRS 16.	No longer relevant for 2020-21
<i>Interaction between IFRIC 12, FReM PPP guidance and IFRS 16</i>		
Paragraph 7.6.15	Replace reference to 'IAS 17' with references to IFRS 7 and the relevant standards for the underlying infrastructure in service concession arrangements. Add a sentence clarifying that the disclosure of total minimum commitments should have a reconciliation back to present value	<p>Reference to IAS 17 is no longer appropriate. After consideration, we do not recommend replacing this with a reference to IFRS 16, because this could introduce new disclosure requirements for 'on-balance sheet' service concession arrangements.</p> <p>Instead, we recommend introducing references to IFRS 7 and the relevant standards for the underlying infrastructure (this is consistent with IAS 17, which included references to IFRS 7 and IAS 16, 36, 38, 40 and 41). We also propose providing language to clarify that the disclosure of total minimum commitments should have a reconciliation to present value, which is consistent with the requirements in IAS 17.</p> <p>This drafting should ensure that the existing disclosure requirements for 'on-balance sheet' service concession arrangements are carried forward.</p>
Paragraph 10.1.57	Reference to 'IAS 17' replaced with 'IFRS 16'	Necessary on implementation of IFRS 16; should not result in a substantive change in initial measurement of assets in 'on-balance sheet' service concession arrangements



Paragraph reference	Summary	Rationale
Flowchart of accounting for PPP arrangements (after paragraph 10.1.53)	References to 'IFRIC 4' and 'IAS 17' replaced with 'IFRS 16'; reference to 'leased assets' replaced with 'right-of-use assets'	Necessary on implementation of IFRS 16
General interaction between IFRIC 12, FReM PPP guidance and IFRS 16	No changes proposed	<p>We are aware that other relevant authorities are considering whether to provide additional guidance for the measurement of the liability in an 'on-balance sheet' service concession arrangement in their respective manuals following the obsolescence of IAS 17.</p> <p>No changes are proposed in this respect in the FReM given it does not currently directly reference IAS 17 or leases when discussing the measurement of 'on-balance sheet' service concession arrangement liabilities. Adding new guidance in this area would constitute a substantive change outside the scope of IFRS 16 implementation.</p> <p>Additionally, IFRS 16 contains a scope exclusion for IFRIC 12, but we are introducing a reference to IFRS 16 in the FReM for the initial measurement of 'on-balance sheet' service concession arrangements assets (to replace the existing reference to IAS 17). We do not consider this to override the scope exclusion in IFRS 16; instead, preparers are referred to IFRS 16 guidance <i>only</i> for the initial measurement of assets in 'on-balance sheet' service concession arrangements. Preparers should use the guidance in the FReM in every other aspect of accounting for these arrangements.</p> <p>In summary, no further changes to the FReM regarding the interaction between IFRIC 12, FReM PPP guidance and IFRS 16 are proposed apart from the ones summarised in the rows above. The existing guidance should be sufficient and should not introduce substantive changes to the accounting for PPPs.</p>
<i>Peppercorn leases: including nil consideration leases</i>		
Table 8.2: IFRS 16 adaptations	Expand definition of peppercorn leases to include nil-consideration leases	Consistent with FRAB decision from April 2019



Paragraph reference	Summary	Rationale
Table 8.2: IFRS 16 adaptations	Add statement that peppercorn leases are in scope of IFRS 16 if they meet the definition of a lease in every aspect apart from containing consideration	Clarification to be explicit that peppercorn leases are in scope of IFRS 16; also consistent with transition clarification below.
Table 8.2: IFRS 16 adaptations	Change wording and add footnote to clarify that all peppercorn leases, even those previously not considered in scope of IAS 17, should be brought on balance sheet on transition to IFRS 16.	<p>CIPFA requested clarification in this area; they had received questions asking whether nil-consideration leases should be brought onto the balance sheet on transition to IFRS 16 if they were not previously considered to be leases under IAS 17 because they did not contain a payment, or series of payments.</p> <p>After discussion with stakeholders we think it is beneficial to make this clarification to ensure that all peppercorn leases are capitalised on transition to IFRS 16, regardless of whether they were considered to be leases under IAS 17. This will ensure consistent treatment of peppercorn leases across central government.</p>
<i>Subsequent measurement of right-of-use assets</i>		
Table 8.2: IFRS 16 adaptations	Remove sentence in peppercorn lease transition guidance stating that 'The initial measurement of the right-of-use asset shall serve as its deemed cost for subsequent measurement purposes.'	No longer relevant as cost is no longer the required basis for subsequent measurement of the right-of-use asset (following April 2019 FRAB decision)
Table 8.2: IFRS 16 interpretations	Replace interpretation mandating that the cost model be used for subsequent measurement of right-of-use assets with interpretation stating that the principles in IAS 16 as adapted in the FReM should be used for the subsequent measurement of right-of-use assets	Consistent with FRAB decision from April 2019
Table 8.2: IFRS 16 interpretations	Remove statement that the revaluation reserve associated with any previous finance leases should be eliminated on transition to IFRS 16.	No longer appropriate, considering the April 2019 FRAB decision to mandate revaluation for all leases.
Section 10.2	Insert new section providing guidance on how FReM IAS 16 subsequent measurement principles apply to right-of-use assets	Consistent with FRAB decision from April 2019.
<i>Miscellaneous</i>		
Paragraph 10.1.32	Add a statement clarifying that right-of-use assets can qualify as heritage assets.	This is consistent with the decisions the FRAB has made around peppercorn leases; stakeholders, including DCMS, have provided examples of leases where the right-of-use



HM TREASURY

FRAB 138(06)
21 November 2019

Paragraph reference	Summary	Rationale
		asset would meet the definition of a heritage asset. We think it is therefore appropriate that such right-of-use assets should be subject to the heritage asset accounting requirements available for owned assets.



Appendix 2: IFRS 16 drafting changes in 2020-21 FReM (tracked changes from 2019-20 FReM)

Chapter 4 - The annual report and accounts

4.2 Accounting principles for government annual reports and accounts

4.2.4 This 2020-21 edition of the FReM applies EU adopted IFRS and Interpretations in effect for accounting periods commencing on or after 1 January 2020², ~~except for IFRS 16 Leases, which is deferred until 1 April 2020³.~~

Chapter 7 – The financial statements

7.4 Statement of Cash Flows

7.4.2. In reconciling the operating expenditure to operating cash flows, entities should exclude movements in debtors and creditors relating to items that do not pass through the Statement of Comprehensive Net Expenditure (balances with the Consolidated Fund; and debtors and creditors linked to loans from the National Loans Fund, capital expenditure, ~~finance~~ leases and PFI contracts);

7.4.4. In analysing financing, entities should adjust for debtors and creditors relating to the capital expenditure in respect of ~~finance~~ leases and on-balance sheet PFI contracts.

7.6 Notes to the accounts

7.6.15 For 'on-balance sheet' service concession arrangements the relevant ~~IAS 17 and~~ SIC 29 and IFRS 7 disclosures should be made, along with any relevant disclosures required under IFRS for the underlying infrastructure in the service concession arrangements. In addition, entities should ensure they disclose a reconciliation between the total minimum commitments and their present value, along with a maturity analysis of the total minimum commitments: due within one year, between one and five years, and later than five years.

Chapter 8 – Adopting and interpreting IASs and IFRSs

8.2 Interpretations and adaptations for the public sector context

IFRS 9 Financial Instruments	
Interpretations	<p>...</p> <p>(6) The accounting policy choice allowed under IFRS 9 for long term trade receivables, contract assets which do contain a significant financing component (in accordance with IFRS 15), and lease receivables within the scope of IFRS 16 IAS 17 has been withdrawn and entities should always recognise a loss allowance at an amount equal to lifetime Expected Credit Losses. All entities applying this Manual should utilise IFRS 9's simplified approach to impairment for relevant assets.</p> <p>...</p>
IFRS 16 Leases	
Adaptations	<p>1. IFRS 16, as adapted and interpreted by this Manual, will be effective from 1 April 2020, with one exception. Early adoption from 1 April 2019 is available for entities where the following criteria are met:</p>

² Early application of EU adopted IFRS before the effective date is permitted with the consent of the relevant authority

³ ~~Early application of IFRS 16 is permitted if the criteria described in Table 6.2 are met.~~



	<p>the entity has at least one subsidiary that, under the Companies Act, is required to follow IFRS as adopted by the EU, and the total assets of the subsidiary comprise at least 10% of the total assets at the group level;</p> <p>the subsidiary (or subsidiaries) described above have operating lease commitments that comprise at least 10% of the operating lease commitments at the group level; and</p> <p>approval to early adopt has been received from HM Treasury.</p> <p><u>21.</u> The definition of a contract is expanded to include intra-UK government agreements where non-performance may not be enforceable by law.</p> <p><u>32.</u> Peppercorn leases are defined as leases for which the consideration paid is <u>nil or nominal</u> (that is, significantly below market value). <u>Peppercorn leases are in the scope of IFRS 16 if they meet the definition of a lease in all aspects apart from containing consideration.</u> All lessees shall account for peppercorn leases using the following criteria:</p> <ul style="list-style-type: none"> • Recognise a right-of-use asset and initially measure it at current value in existing use or fair value, depending on whether the right-of-use asset will be held for its service potential and as set out in paragraphs 10.1.4-10.1.6. However, if the right-of-use asset meets the definition of a heritage asset, it should be initially measured in accordance with paragraphs 10.1.34-10.1.39. • Recognise a lease liability measured in accordance with IFRS 16. • Recognise any difference between the carrying amount of the right-of-use asset and the lease liability as income as required by IAS 20 as interpreted in this Manual. • Subsequently measure the right-of-use asset following the principles of IFRS 16 as adapted and interpreted in this Manual. The initial measurement of the right-of-use asset shall serve as its deemed cost for subsequent measurement purposes. • Upon transition, any peppercorn leases that were <u>not previously</u> classified as <u>operating finance</u> leases under IAS 17 shall be recognised as follows⁴: <ul style="list-style-type: none"> • The right-of-use asset shall be measured at current value in existing use or fair value, depending on whether the right-of-use asset will be held for its service potential and as set out in paragraphs 10.1.4-10.1.6. However, if the right-of-use asset meets the definition of a heritage asset, it should be initially measured in accordance with paragraphs 10.1.34-10.1.39. • The lease liability shall be measured at the present value of lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. • The difference between the carrying amount of the right-of-use asset and lease liability shall be included as part of the adjustment to the opening balances of taxpayers' equity (or other component of equity, as appropriate) per IFRS 16 (C5(b)).
Interpretations	<p>1. The option to apply the election in IFRS 16 (5) has been withdrawn. All entities must apply the recognition and measurement exemption for short-term leases in accordance with IFRS 16 (6-8).</p> <p>2. Where lessees cannot readily determine the interest rate implicit in the lease, they are instead required to use the HM Treasury discount rates</p>

⁴ This includes any peppercorn leases that previously were classified as operating leases under IAS 17, or were argued to be outside of the scope of IAS 17 because they did not include a payment, or series of payments.



promulgated in PES papers as their incremental borrowing rate. However, if an entity can demonstrate that another discount rate would more accurately represent their incremental borrowing rate (for example, if they undertake external borrowing independently of the Exchequer), they shall use that discount rate as their incremental borrowing rate.

3. The ~~subsequent measurement basis for right-of-use assets shall be consistent with the principles for subsequent measurement of property, plant and equipment set out in the adaptations to IAS 16 in this Manual. Paragraphs 10.2.1-10.2.6 of this Manual set out how these principles apply to right-of-use assets. option to use the revaluation model for subsequent measurement of right-of-use assets has been withdrawn. All entities using this Manual shall apply the cost model to determine the subsequent measurement of the right-of-use asset (IFRS 16(30-33)) or, if applicable, the fair value model for right-of-use assets classified as investment properties under IAS 40 Investment Properties (IFRS 16(34)).~~

4. The option to reassess whether a contract is, or contains, a lease at the date of initial application has been withdrawn. All entities shall use the practical expedient detailed in IFRS 16 (C3).^[1]

5. Upon transition, the accounting policy choice to apply IFRS 16 retrospectively to each prior period presented in accordance with IAS 8 has been withdrawn. All entities applying this Manual shall recognise the cumulative effects of initially applying IFRS 16 recognised at the date of initial application as an adjustment to the opening balances of taxpayers' equity (or other component of equity, as appropriate) per IFRS 16(C5(b)). ~~This should include the elimination of any revaluation reserve associated with existing finance leases.~~

6. Upon transition, entities shall measure the right-of-use asset for leases previously classified as operating leases per IFRS 16((C8 (b)(ii))): at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.

7. Upon transition, all entities applying this Manual shall apply the following options for leases previously classified as operating leases:

- No adjustments for leases for which the underlying asset is of low value that will be accounted for applying IFRS 16 (6). (IFRS 16 C9 (a))
- No adjustment for leases for which the lease term ends within 12 months of the date of initial application (with a requirement to include the cost associated with those leases in the short-term lease expense disclosure). (C10 (c))
- Use hindsight in determining the lease term if the contract contains options to extend or terminate the lease. (C10 (e))

^[1] This presumes that entities have been applying the guidance in IAS 17 and IFRIC 4 appropriately in the past. Any known misapplication of the definition of a lease guidance should be corrected as a prior period error in accordance with IAS 8 unless an entity has explicit approval from the relevant authority to do otherwise.



Chapter 10 - Further guidance on accounting for assets and liabilities *Property, plant and equipment (PPE)*

Heritage assets

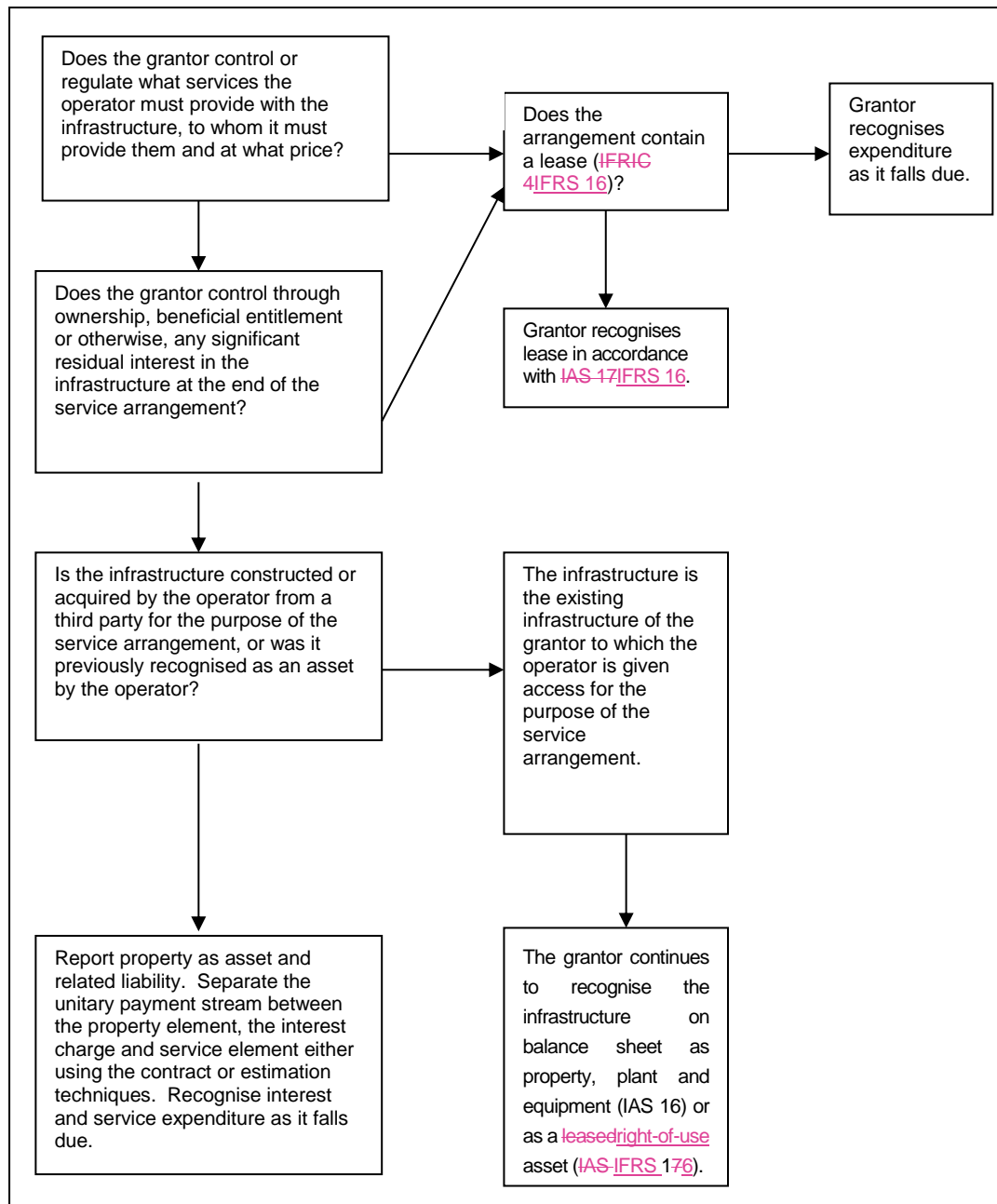
Definition

- 10.1.31 A heritage asset is a tangible asset with historical, artistic, scientific, technological, geophysical or environmental qualities that is held and maintained principally for its contribution to knowledge and culture. Heritage assets are those assets that are intended to be preserved in trust for future generations because of their cultural, environmental or historical associations. They are held by the reporting entity in pursuit of its overall objectives in relation to the maintenance of the heritage. Non-operational assets are those that are held primarily for this purpose. Operational heritage assets are those that, in addition to being held for their characteristics as part of the nation's heritage, are also used by the reporting entity for other activities or to provide other services (the most common example being buildings).
- 10.1.32 The reporting entity holding the asset should attest annually to the ongoing heritage credentials of its heritage assets. Heritage assets include historical buildings, archaeological sites, military and scientific equipment of historical importance, museum and gallery collections and works of art. [Right-of-use assets can qualify as heritage assets.](#)
- 10.1.33 In principle, heritage assets should be accounted for in the same way as any other asset under IAS 16. There are, however, certain characteristics associated with heritage assets that give rise to the need for interpretation of IAS 16:



Accounting for PPP arrangements, including PFI contracts, under IFRS

Flowchart of accounting for PPP arrangements



Subsequent measurement

10.1.54 The asset will be measured in one of two ways:

- a) where the contract is separable between the service element, the interest charge and the infrastructure asset (see also paragraph 10.1.53), the asset will be initially measured following the guidance in ~~IAS 17~~IFRS 16, with the service element and the interest charge recognised as incurred over the term of the concession arrangement (the subsequent measurement should be subject to the guidance of IAS 16); or



- b) where there is a unitary payment stream that includes infrastructure and service elements that cannot be separated, the various elements will be separated using estimation techniques as set out in paragraph 10.1.52.

10.2 Right-of-use assets

10.2.1 When determining a current value in existing use or fair value for right-of-use assets, entities should bear in mind that, in most cases, the cost model in IFRS 16 is an appropriate proxy for current value in existing use or fair value. This is because right-of-use assets generally have shorter useful lives and values than their respective underlying assets (see guidance in paragraph 10.1.14 regarding using cost as a proxy for owned assets with shorter economic lives or low values). Additionally, in many cases leases will have provisions to update rental payments for market conditions, which will be captured in the IFRS 16 cost measurement requirements.

10.2.2 However, for some right-of-use assets, the cost model in IFRS 16 will not be an appropriate proxy for current value in existing use or fair value. This is likely to be the case when both of the following conditions are met:

- a) A longer-term lease has no provisions to update lease payments for market conditions (such as rent reviews), or if there is a significant period of time between those updates
- b) The current value in existing use or fair value of the underlying asset is likely to fluctuate significantly due to changes in market prices. This is more likely to be the case with property assets.

10.2.3 Additionally, cost will not be an appropriate proxy for right-of-use assets for peppercorn leases.

10.2.4 To measure the current value in existing use of a right-of-use asset, a valuer should calculate the full replacement cost of the right-of-use asset by identifying the current market rental value that could be achieved for existing use of the right-of-use asset and capitalise it for the full remaining lease term from the valuation date. This valuation should reflect the terms and conditions of the lease giving rise to the right-of-use asset and should reflect an assumption that the entity requires the use the entire right-of-use asset. The Royal Institution of Chartered Surveyors (RICS) will publish guidance for valuers consistent with the above.

10.2.5 If the cost model in IFRS 16 is used as a proxy for current value in existing use or fair value then this fact should be disclosed, including the classes of right-of-use assets within which it has been used (where appropriate) and the reasons why.

10.2.6 Finally, entities should bear materiality in mind when applying this guidance, just as in other areas of financial reporting. Part of the reason that, in most cases, the cost model in IFRS 16 is an appropriate proxy for current value is that there is not a material difference between the valuation produced by the cost model or the valuation produced by the revaluation model.