19th November 2020

HM Treasury

Financial Reporting Advisory Board Paper

IFRS 16 *Leases*: Discount Rates

Issue:	Whether there should be a change to the methodology used to determine the 'lessee's incremental borrowing rate' used as a practical expedient to measure lease liabilities and right-of-use assets when the rate implicit in the lease is not readily available.
Impact on guidance:	Yes, if approved by the FRAB.
IAS/IFRS adaptation or interpretation?	Possibly, depending on FRAB's decision.
Impact on WGA?	Yes, the FRAB's decision may have an impact on WGA.
IPSAS compliant?	Prior to IFRS 16, IPSAS and IFRS were broadly consistent for lease accounting. IPSASB are developing a new IPSAS on lease accounting.
Impact on budgetary regime?	Yes, any change in discount rate will impact the carrying amount of the right-of-use asset and lease liability, with corresponding budgetary impacts.
Alignment with National Accounts (ESA10):	No, ESA10 does not allow an 'incremental borrowing rate' practical expedient to be used when calculating interest on a finance lease. Broadly, ESA10 and IFRS 16 are not aligned in the measurement of lease assets and liabilities.
Impact on Estimates?	Yes, any change in discount rate will impact the carrying amount of the right-of-use asset and lease liability, with corresponding budgetary impacts.
Recommendation:	Option 2b: Use the new methodology for leases coming onto the balance sheet for the first time on transition to IFRS 16 in 2021/22 and remeasure leases which came onto the balance sheet on transition in 2019/20 for early adopters.
Timing:	Any changes approved could be implemented for FY20/21 accounts (for early adopters) or FY 21/22 accounts (for remaining entities).

Introduction

1. Paper 141 (05) was presented to FRAB at the June 2020 meeting. The paper asked that FRAB provide advice on whether the HM Treasury IFRS 16 discount rate methodology should be updated for the FY19/20 annual reports and accounts. This was due to an issue encountered on implementation by early adopters which is outlined in Annex 1. The HM Treasury rate is used for initial measurement of IFRS 16 lease liabilities when the rate implicit in the lease cannot be readily determined.

2. The paper provided two feasible options: maintain the existing discount rate methodology based on government gilt yields, or change this to use an average corporate borrowing rate.

3. FRAB did not support the use of a corporate borrowing rate methodology. FRAB agreed that there should be no mandatory change to the methodology for 2019/20, but requested HM Treasury undertake further analysis on a way forward and return to FRAB with another paper on the issue in the future.

4. HM Treasury have undertaken further analysis and discussions with departments, and are presenting this paper to FRAB to agree a forward approach, both for those who adopted IFRS 16 in 2019/20 and for remaining entities due to adopt IFRS 16 for 2021/22.

Background

5. Government entities need to use a discount rate for initial measurement of lease liabilities and right of use assets under IFRS 16. IFRS 16 requires that lessees use the rate implicit in the lease, or where this cannot be readily determined, their incremental borrowing rate.

6. The FReM contains an interpretation to IFRS 16 stating that a specific HM Treasury issued rate (promulgated in PES papers) should be used where the rate implicit in the lease is not readily available, unless the entity can demonstrate that another discount rate would more accurately represent their incremental borrowing rate. This HM Treasury rate is based on government gilt yields, reflecting that nearly all central government borrowing happens centrally through the Exchequer.

7. For 2019/20, the only central government departments who adopted IFRS 16 for their group accounts were the Department for Digital Culture Media and Sport (DCMS) and the Department for Transport (DfT).

8. DCMS encountered an issue after applying this rate to certain right of use assets on transition at the start of 2019/20, which then needed to be impaired at the end of 2019/20. Further details of this issue (which was also described in Paper 141 (05)) are given in Annex 1. The issue indicated there was a significant difference between the HM Treasury rate, which reflects lower government borrowing costs, and higher market rates. This is likely to result in discounting lease liabilities and right of use assets at a lower rate than the rate implicit in the lease, which results in a higher initial carrying value ('overvaluation').

9. Whilst the issue of implicit rates and incremental borrowing rates differing from each other is not unique to the public sector, lower government borrowing rates in comparison to commercial borrowing rates exacerbate the issue. In addition, in the private sector the cost model is mainly used, rather than the revaluation model. This is relevant as the 'overvaluation' issue comes to light when a right-of-use asset is either impaired or revalued.

10. Three options for 2019/20 were discussed in the paper presented to FRAB in June 2020 to address the matter: use an 'average' market yield rate (not felt to be feasible due to the wide range in yields), use an 'average' corporate borrowing rate, or maintain the current methodology. No change was made to the methodology for 2019/20. FRAB members noted that any alternative rate should be a practical expedient with an appropriate justification (relevant to the public sector).

Consultation with departments

Views of departments

11. To explore the impact of the methodology, HM Treasury held an IFRS 16 Technical Working Group meeting to gain feedback on:

- whether it was desirable to change the discount rate methodology
- could they propose a more appropriate discount rate methodology

12. There were a range of views amongst the group on whether it is desirable to change the discount rate. If a change was to be made, it was felt that simplicity of application is important and that a single rate would best achieve this.

13. Points in favour of using the existing rate methodology included its value to asset financing decisions (if the gilt yield rate is lower than the implicit rate of a lease, this can provide information about value for money), its simplicity, its adherence to IFRS 16 requirements, its reflection of risk exposure to government, and comparability with purchasing for some bespoke assets which need to be impaired soon after they are added to the balance sheet.

14. Points which were not in favour of using the existing rate methodology included a tendency to produce 'overvaluation' of assets, and the lack of perceived compliance with the IFRS 16 Basis for Conclusions which implies an incremental borrowing rate should approximate implicit lease rates. It was also observed that the benefit to asset financing decisions may be less significant because investment appraisal processes use different rates.

15. Further detail on departmental views is provided in Annex 1, along with an excerpt from the IFRS 16 Basis for Conclusions.

Potential alternative rates proposed

16. The Group explored two proposals considered as part of the review:

- **average of market yields on property**, however it was agreed that this is unlikely to be feasible due to the significant range in market yields, and
- **Green Book appraisal rate (social time preference rate)** - there was hesitation due to the rate being developed for investment appraisal purposes rather than accounting purposes and the loss of the separation between accounting and investment appraisal rates which may be beneficial to maintain. The Social Time Preference Rate, used for investment appraisal purposes in the Green Book, is not meant to reflect an accounting discount rate—rather to reflect the rate at which society, as a whole, values the present, rather than the future.

Summary of Technical Working Group meeting outcome

17. The working group recognised the inherent limitations of the existing methodology where the rate is applied to an asset which may then be impaired, but on balance, considered it to be the best application in lieu of any other methodology not yet identified.

A new methodology option

New methodology option – outline

18. An alternative methodology option has been developed by HM Treasury. This new methodology is used to calculate a revised version of an incremental borrowing rate based on government gilt yields. It would be used for leases previously classified as operating leases, but which come onto the balance sheet on transition to IFRS 16.

19. The methodology involves determining a rate using an average of government gilt yields over the past 10 years for a 20-year maturity. The 20-year maturity was selected to reflect the approximate average life of the government lease portfolio.[1] Using an average of gilt yields over the past 10 years is intended to reflect that borrowing costs to government have fluctuated over the time period during which these leases were originally taken out, whilst avoiding the complexities of applying different rates to leases based on the exact date each lease was entered into. Government gilt yields are currently at historic lows, whereas rates were higher in the past when leases were entered into, which was not reflected in the existing methodology.

20. The aim of this new methodology is to identify a rate to use on transition which:

- has its roots in government specific incremental borrowing rates,
- provides a better approximation of rates likely to be implicit in leases, and
- is reflective that existing leases signed before implementation of IFRS 16 were originally taken out over a period of time during which the cost to government of borrowing has fluctuated.

21. HM Treasury would not propose applying this rate to newly signed leases, which instead would be discounted using a rate based on the existing methodology.

22. If this methodology were adopted, the rate which entities would apply on transition at 1 April 2021 would be the rate for calendar year 2021, measured as at 30 November 2020. It would be calculated using an average of government gilt rates for a 20-year maturity between December 2010-November 2020.

23. The data for November 2020 is not yet available so a final rate cannot be calculated. An indicative rate is calculated using data from November 2010-October 2020, the indicative rate is 2.48%.

[1] To note, this is a similar maturity term to that used in the current discount rate methodology, which uses a 25-year term to line up with the long-term provision rate. Using a 25-year term for the new methodology would not significantly affect the rate, for example increasing it by 0.10% when calculating an indicative rate for calendar year 2021.

24. Early adopters who applied IFRS 16 on 1 April 2019 used the existing methodology rate for calendar year 2019 for leases on transition. This was 1.99%. The equivalent 2019 rate calculated using the new methodology would be 3.10%.

25. Further information on how the rate was calculated is contained in Annex 2.

New methodology option – impact on early adopters

26. The impact of how such a change of methodology would affect IFRS 16 early adopters who implemented IFRS 16 in 2019/20 was considered.

27. If the methodology for 2021/22 adopters is revised, this leaves two choices: remeasure leases which came on balance sheet in 2019/20 with transition to IFRS 16 for early adopters in their FY20/21 accounts, or choose not to remeasure them.

28. Remeasuring these leases would require work by early adopters, and there would also be wider considerations for budgets and Estimates. HM Treasury would propose any change in discount rate is accounted for prospectively. HM Treasury would also work with early adopters to ensure any budgets and Estimates consequences are clear and reflected in the upcoming Supplementary Estimates process.

29. The exact circumstance of changing the incremental borrowing rate methodology after implementation is not one covered by the standard. IFRS16 only directs a re-discounting of the liability where there is a change in the lease term or assessment of option to purchase the underlying asset (neither of which is the case here). IAS 8 directs adjustments in the case of changes of accounting policy or prior period errors, but it is not clear that this circumstance would fit either of these cases. Therefore, a decision on remeasurement is not clearly directed by accounting standards, and would rather be at the discretion of HM Treasury as advised by the FRAB.

30. The benefit of remeasurement would be consistency in approach across government. The disadvantage would be the additional work required by early adopters for what is unlikely to be a material change at group level. It may also be relevant to note that although early adoption at group account level is limited to two departments, there are a number of other public sector entities who have adopted IFRS 16 and use the HM Treasury rate (such as public sector companies who don’t borrow externally). They would also be impacted by a requirement to remeasure.

Further consideration

31. Feedback received noted that this does not provide full amelioration of the original issue but does soften the effect on transition with some incomparability between government borrowing rates and rates implicit in the leases remaining.

Options for how to proceed

32. We would retain the existing methodology for newly signed leases. The new methodology if agreed would only apply for leases which were previously classified as operating leases under IAS 17 and newly came onto the balance sheet on transition to IFRS 16. Therefore the options to for how to proceed are:

- Option 1 – Keep existing methodology for leases coming onto the balance sheet for the first time on transition to IFRS 16 in 2021/22

- Option 2a – Use the new methodology for leases coming onto the balance sheet for the first time on transition to IFRS 16 in 2021/22 **and** do not remeasure leases which came into the balance sheet on transition in 2019/20 for early adopters

- Option 2b - Use the new methodology for leases coming onto the balance sheet for the first time on transition to IFRS 16 in 2021/22 **and** remeasure leases which came onto the balance sheet on transition in 2019/20 for early adopters

Recommendation

33. HM Treasury **recommends Option 2b**: Use the new methodology for leases coming onto the balance sheet for the first time on transition to IFRS 16 in 2021/22 **and** remeasure leases which came onto the balance sheet on transition in 2019/20 for early adopters.

34. This recommendation offers a relevant public sector rate which better approximates implicit rates in leases and reflects the fact that former operating leases were taken out over a period of time during which the cost of government borrowing has fluctuated. It is a single rate which would be easy to apply, and is in accordance with the IFRS 16 principle of using an entity specific incremental borrowing rate.

35. The recommendation retains a consistent approach on transition although there would be some additional work for the early adopters as they would need to remeasure those leases that came on balance sheet in 2019/20.

Does the Board agree with this approach?

Annex 1

DCMS issue for FY 19/20

The issue arose because DCMS identified some right-of-use assets that were initially measured using the HM Treasury rate on transition to IFRS 16, and were impaired or needed to be revalued as at 31 March 2020. It therefore obtained valuations for the current values of these assets, which determined the impairment or revaluation it needs to recognise. This amount was comprised of two elements:

a) the difference between the contractual rents they were paying under the lease, and market rents, and;

b) the difference between measuring the right-of-use asset using the HM Treasury discount rate and a market discount rate (for example, for one asset this is a difference between the 1.99% HM Treasury rate and a 6% market rate—this comprises about 30% of the overall impairment recognised for that asset).

This second element is also present on 'day one' of entering into a lease, resulting in a difference between initial cost (discounted at the HM Treasury rate) and market value (discounted at the market rate) at lease commencement.

While DCMS had anticipated the need to impair or revalue these assets, it had not realised that a significant element of the change in carrying amount would be driven by the difference between the HM Treasury discount rate and a market discount rate. DfT, as the other central government department to adopt IFRS 16 early for their group accounts, did not encountered this issue as they are measuring their right-of-use assets at cost and have not identified the need to impair or revalue any right-of-use assets.

IFRS 16 Basis for Conclusions excerpt

The IFRS 16 Basis for Conclusions (BC161) offers the following rationale for the use of an incremental borrowing rate where the rate implicit in the lease cannot be readily determined:

> "**The interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases**. This is because both rates, as they have been defined in IFRS 16, take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor. Consequently, the IASB noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease"

Detail on departmental views

Advantages of keeping the existing rate – departmental views

- using the government borrowing rate has value when making asset financing decisions: if the gilt yield rate is lower than the implicit rate of a lease, this provides information about whether borrowing or leasing provide best value for money
- using the government borrowing rate adheres to the IFRS 16 requirement to use an entity specific incremental borrowing rate
- using the government borrowing rate reflects the risk exposure to government in taking on the lease
- there is a preference for simplicity and the existing rate offers this
- some bespoke assets need to be impaired soon after being brought onto the balance sheet, so if this is occurring for leased assets this may provide some comparability between owned and leased assets

Disadvantages of keeping the existing rate- departmental views

- using the government borrowing rate can tend to lead to 'overvaluation' of assets
- it seems counterintuitive to bring an asset on balance sheet at a value you shortly expect to impair (note – the difference between HM Treasury rates and implicit lease rates would not trigger an impairment review in isolation, and would **only** arise if a separate trigger causes an impairment review)
- using the government borrowing rate may not have as much value in making asset financing decisions, because of the fact that the investment appraisal process uses different rates
- The IFRS 16 Basis for Conclusions (see excerpt above) implies that the incremental borrowing rate should best approximate the rate implicit in the lease, which does not appear to be the case with the current methodology

Annex 2

New rate methodology

The methodology for the rate involves calculating the mean of government gilt yields over the past 10 years for a 20-year maturity.

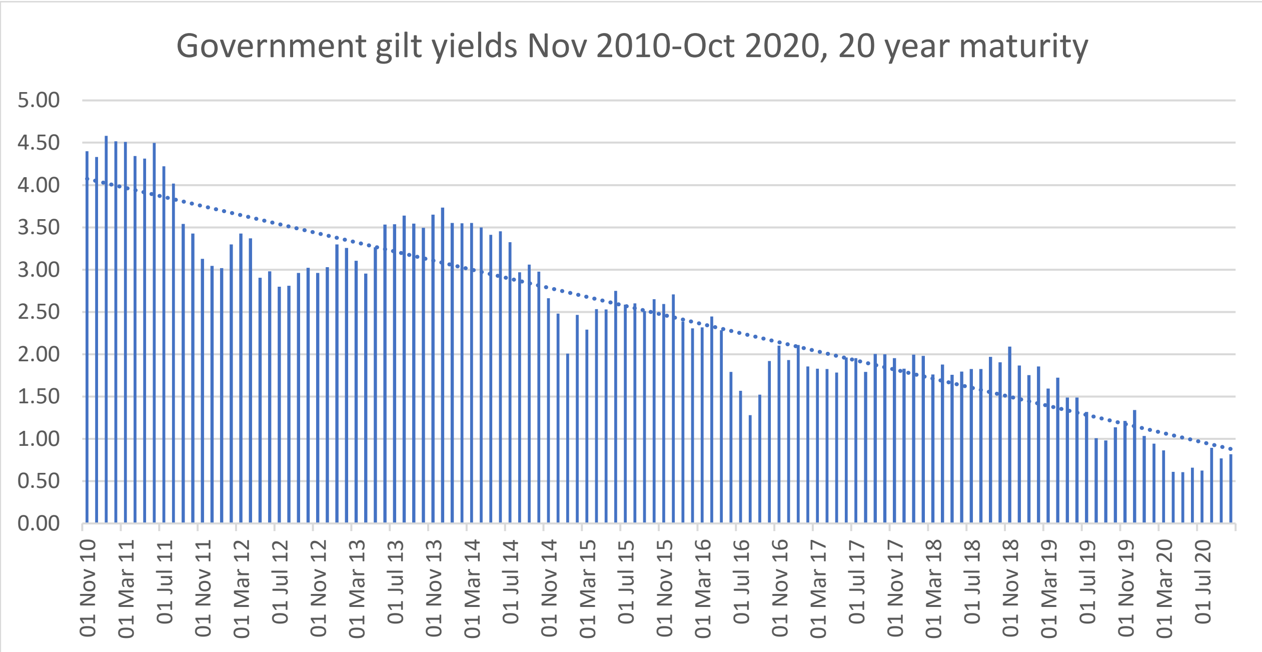
Date Lease Discount Rates determined	Date Range Lease Discount Rate applicable for	Rate using existing methodology	Rate using new methodology for leases on transition
As at 30 Nov 2018	1 Jan 2019 – 31st Dec 2019	1.99%	3.10%
As at 30 Nov 2019	1 Jan 2020 – 31st Dec 2020	1.27%	Not applicable
As at 30 Nov 2020	1 Jan 2021 – 31st Dec 2021	tbc	Rate would be close to 2.48%
As at 30 Nov 2021	1 Jan 2022 – 31st Dec 2022	tbc	Not applicable

Indicator of potential 2021 calendar year rate, using data from November 2010-October 2020

The rate which entities would apply on transition to IFRS 16 in April 2021 would be the calendar year 2021 rate, based on data as at 30 November 2020. This would average government gilt yields for a 20-year maturity between December 2010-November 2020.

The data for November 2020 is not yet available so a final 2021 rate cannot be calculated. An indicative rate is calculated using data from November 2010-October 2020, this is shown below.

Indicative 2021 rate	2.48

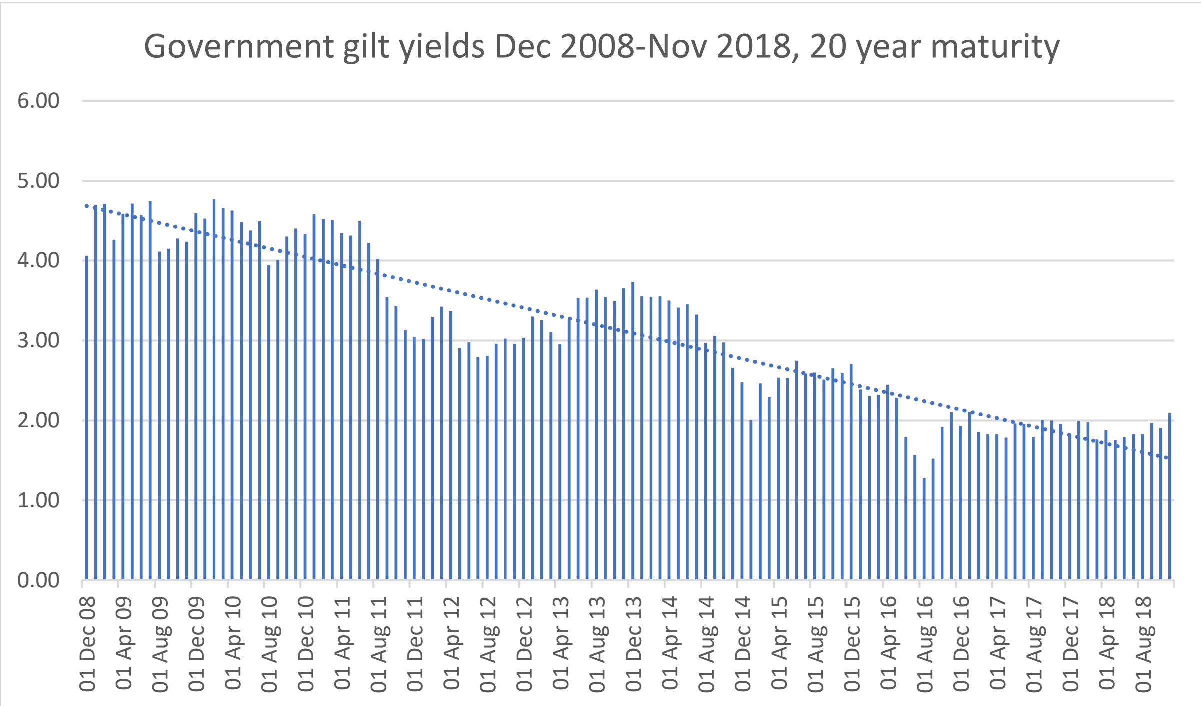


2019 calendar year rate, using data from December 2008-November 2018

The rate which early adopter entities applied on transition to IFRS 16 in April 2019 was the calendar year 2019 rate using the existing methodology. This would have been based on data as at November 2018.

An equivalent 2019 rate has been calculated using the new methodology. This uses data from December 2008 – November 2018, this is shown below.

2019 rate	3.10



Rates which may provide a useful comparison:

Comparators	%
PES 2019 rate (using existing methodology)	1.99
PES 2020 rate (using existing methodology)	1.27
Average corporate borrowing 2020 rate	2.73

The data is taken from https://www.bankofengland.co.uk/statistics/yield-curves Archive yield curve data – monthly, Monthly government liability curve (nominal): archive data