HM TREASURY

FRAB (126) 01
17 MARCH 2016

Financial Reporting Advisory Board Paper

IFRS 16 Leases

Issue:	The IASB has issued the final version of IFRS 16 which will replace IAS 17 for annual periods beginning on or after 1 January 2019, with early adoption permitted if IFRS 15 Revenue from Contracts with Customers is applied. This paper summarises the key requirements of IFRS 16, gives initial consideration to the main challenges that it presents and sets out the high level work plan. HM Treasury ask that the Board note the contents of the new Standard and seek their early views on the potential public sector implications.
Impact on guidance:	No impact at this stage
IAS/IFRS adaptation?	None proposed at this stage. This will be considered in a later paper to the Board. IAS 17 applies without interpretation in the FReM.
Impact on WGA?	Not at this stage
IPSAS compliant?	No – IPSAS 13 based on IAS 17
Interpretation for the public sector context?	This will be revisited nearer implementation date and in a later paper to the Board.
Impact on budgetary regime?	Existing policy is that budgets follow the National Accounts framework, which is unchanged by this new Standard. Therefore the application of IFRS 16 without adaptation would create a misalignment between accounts and budgets.
Alignment with National Accounts	IFRS 16 does not align with ESA 10 framework for National Accounts.
Impact on Estimates?	Existing policy is that Estimates follow budgets. Therefore the application of IFRS 16 without adaptation would create a misalignment between accounts and Estimates.
Recommendation:	That the Board; • note the finalisation of IFRS 16 • give early views on the potential public sector implications • consider the draft high level work plan in light of the theoretical option of early adoption.

Timing:	No changes are expected to be made to the FReM until the 2019/20 financial year.

DETAIL

Background

1. IFRS 16 has been developed by the IASB with the aim of improving the financial reporting of leasing activities in light of criticisms that the previous accounting model for leases failed to meet the needs of users of financial statements. In particular it was felt that information reported around operating leases lacked transparency and that the existence of two different accounting models for leases, whereby assets and liabilities associated with leases were not recognised for operating leases but were recognised for finance leases, meant that transactions that were economically similar could be accounted for very differently.

2. The current leasing standard, IAS 17, focusses on identifying when a lease is economically similar to purchasing the asset being leased i.e. the 'underlying asset'. When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and reported on an entity's statement of financial position. All other leases are categorised as operating leases and are not reported on the statement of financial position, with an annual amount charged to the income statement or equivalent, similar to the accounting arrangements for service contracts.

3. IFRS 16 largely removes the distinction between operating and finance leases for lessees by introducing a single lessee accounting model that requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. This is a significant change in lessee accounting.

4. IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply IFRS 15 Revenue from Contracts with Customers at or before the date of initial application of IFRS 16.

5. As well as superseding IAS 17 Leases, IFRS 16 also supersedes the following interpretations:

   (a) IFRIC 4 Determining whether an Arrangement contains a Lease;

   (b) SIC-15 Operating Leases-Incentives; and

   (c) SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

6. The Standard has not been endorsed by the European Union to date. The European Financial Reporting Advisory Group (EFRAG) draft endorsement advice is still 'to be determined'.

Overview of Standard

Identification

7. IFRS 16 defines a lease as a contract that conveys to the customer (the 'lessee') the right to control the use of an identified asset for a period of time in exchange for consideration.

8. IFRS 16 applies to all leases, including subleases, with the exception of:

   (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

   (b) leases of biological assets held by a lessee (see IAS 41 Agriculture);

   (c) service concession arrangements (see IFRIC 12 Service Concession Arrangements);

   (d) licences of intellectual property granted by a lessor (see IFRS 15 Revenue from Contracts with Customers); and

   (e) rights held by a lessee under licensing agreements for items such as films, videos, plays, manuscripts, patents and copyrights within the scope of IAS 38 Intangible Assets.

9. A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

10. Lessees may elect not to apply IFRS 16 to short term leases and leases for which the underlying asset is of low value. In these cases the lessee should account for the lease payments as an expense on a straight-line basis over the lease term or another systematic basis, as per operating leases in IAS 17. The Standard defines a short-term lease as a lease that has a lease term of 12 months or less at the commencement date, and does not contain a purchase or extension option.

11. The Standard itself does not define what is meant by low value, but accompanying guidance suggests that this would mean when new, an asset with a value in the order of magnitude of US $5,000 or less. This applies regardless of the quantity of assets being leased. Therefore high volume low value leases, such as those relating to some IT or office equipment, are excluded from an entity's balance sheet.

12. The Standard also contains new guidance on identifying leases. Lessees should distinguish a lease from a service if it has the right to control use of the asset. This is based on the right to obtain substantially all of the economic benefits from use of the asset and the right to direct its use. Therefore, for contracts that contain leases, the lease and non-lease components must be separately identified and accounted for. If prices are not readily observable for components, they can be estimated. Alternatively, lessees may elect, by class of underlying asset, not to separate non-lease and lease components and account for all components as a lease.

13. The lease term is defined as the non-cancellable period for which a lessee has the right to use an underlying asset. Extension options and cancellation options in leases should be considered dependent on whether they are reasonably certain to be exercised.

14. The requirements relating to the definition and identification of a lease in IFRS 16 have been changed somewhat from those in IAS 17. However, it is expected that the vast majority of contracts defined as leases in IAS 17 will also be defined as leases in IFRS 16.

Impact on Lessee's Financial Statements

Consolidated Statement of Financial Position

15. The major change in IFRS 16 is the removal of the classification of operating leases or finance leases for a lessee. Instead, all leases are treated in a similar way to finance leases under IAS 17, recognised as right-of-use assets and lease liabilities on the balance sheet. Assets are valued at cost, which comprises the present value of the lease payments including any direct costs incurred by the lessee. Leases should be presented on the balance sheet as either separate right-of-use assets, or within the line relevant to the underlying asset with disclosure of this line.

16. Subsequent measurement should use a cost model, whereby a right-of-use asset is measured at cost less accumulated depreciation and impairment, adjusted for any remeasurement of the lease liability unless:

    (a) The right-of-use asset is an investment property and the lessee applies the fair value model to its investment property as per IAS 40.

    (b) The right-of–use asset relates to a class of PPE to which the lessee applies the revaluation model in IAS 16, in which case all right-of-use assets relating to that class of PPE can be revalued.

17. Lease liabilities are measured at the present value of future lease payments, discounted using the interest rate implicit in the lease, if that rate can be readily determined. If the rate cannot be readily determined, the lessee should use their incremental borrowing rate. Subsequent measurement should reflect interest on the lease liability and payments made, as well as any reassessment or lease modifications. Lease liabilities should be shown separately from other liabilities, or the line that contains lease liabilities should be disclosed.

18. The most significant effect of the new requirements will be an increase in lease assets and liabilities on the statement of financial position. Those public sector entities with high number of operating leases under IAS 17 will be affected most by IFRS 16. Furthermore, those entities such as Trading Funds where financial ratios are relevant will be affected by the new Standard if they have material operating leases.

Consolidated Statement of Comprehensive Net Expenditure

19. IFRS 16 changes the nature of expenses related to leases. Under IAS 17 a typical straight-line operating lease expense would be shown in profit or loss. The new Standard replaces this with a depreciation charge under operating expenditure and an interest expense which is shown under finance expenditure. This change therefore aligns the lease expense treatment for all leases.

20. Whilst the depreciation charge would be expected to be typically even, the interest expense reduces over the life of the lease as the lease payments are made. This results in a reducing total expense as an individual lease matures. The difference in the profile of expenses between IAS 17 and IFRS 16 is not expected to be significant for most lessees as they are likely to hold a number of leases that commence and terminate in different reporting periods.

Consolidated Statement of Cash Flows

21. Changes in the accounting requirements for leases in IFRS 16 do not change the amount of cash being transferred between lessees and lessors, and therefore won't change the total amount of cash flows reported. However, the new Standard will have an effect on the presentation of cash flows related to leases shown as operating leases under IAS 17. Cash outflows for former operating leases were shown as cash flows from operating activities, whilst under IFRS 16 principal repayments on all lease liabilities and interest payments are shown under cash flows from financing activities. IFRS 16 will therefore lead to a reduction in cash flows from operating activities, and a corresponding increase in cash flows from financing activities.

Impact on Lessor's Financial Statements

22. The lessor accounting requirements of the IFRS 16 are largely as per IAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for the two types of leases separately. However, the new Standard does require enhanced disclosures to be provided by lessors in relation to their risk exposure.

Sale and Leaseback Transactions

23. IFRS 16 introduces new accounting requirements for sale and leaseback arrangements. An entity applies the requirements for determining when a performance obligation is satisfied in IFRS 15 Revenue from Contracts and Customers to determine whether the transfer of an asset is accounted for as a sale. If an asset transfer satisfies the IFRS requirements to be accounted for a sale, the selling entity measures the right-of-use asset as at the proportion of the previous carrying amount that relates to the right of use retained. The selling entity only recognises the amount of gain or loss that relates to the rights transferred to the buyer.

24. If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the lease payments are not at market rates, the sale proceeds are adjusted to fair value, either by accounting for prepayment of lease payments or additional financing.

High Level Work Plan

25. The proposed work plan for the introduction of IFRS 16 in the public sector follows a similar timetable and format to those for IFRS 9 and 15. This approach has worked well to date, and the draft high level work plan is set out as an annex to this paper. Technical working groups will be convened over summer 2016 and an exposure draft consultation begun in summer 2017. Responses would be considered and the FRAB meeting in November 2017 would provisionally agree adoption of the standard in the public sector for 2019/20.

26. The indicative timetable allows for the possibility of early adoption of the new Standard in 2018/19. HM Treasury ask that the Board give their views on the proposed work plan and timetable, and give any feedback as necessary. The Board are also asked to give consideration to whether early adoption of the Standard would be realistic or desirable for the public sector.

Initial Considerations for the impact on Central Government

27. It is expected that the introduction of IFRS 16 will have a significant effect on all departments, as high numbers operating leases as classified under IAS 17 are widely held. The 2013-14 WGA notes to the accounts shows total future minimum lease payments under operating leases of c£18bn, reduced from £21bn in 2014-15. Roughly 80% of operating leases related to buildings. The finalisation of the 2014-15 WGA will provide the opportunity for further analysis.

28. The scope of impact may go beyond those operating lease currently reported in the financial statements. IFRS 16 forces entities to account for leases as assets, and therefore will be required to improve the way that they hold information on operating leases. This is likely to be a significant cultural change for many entities and result in additional data requirements and increased administrative costs.

29. If IFRS 16 is applied without adaptation for central government then this will create a misalignment between resource accounts and departmental budgets. This would be a concern for the Treasury given the significant amount of work that has gone into aligning accounts and budgets.

30. HM Treasury ask that the Board give their views on these and other potential issues in relation to IFRS 16 that are likely to be significant for the Relevant Authorities.

Proposed text for the Government Financial Reporting Manual

31. At this stage no text is proposed for the FReM. However, any interpretations and adaptations will need to be considered for the 2019/20 version.

Recommendation

32. That the Board;

- note the finalisation of IFRS 16
- give early views on the potential public sector implications
- consider the draft high level work plan in light of the theoretical option of early adoption.

HM Treasury

17 March 2016

Annex

Draft IFRS 16 High Level Work Plan

Feb/March 2016	FRAB	FRAB Paper Stakeholder Engagement
June 2016	FRAB	Verbal update to the FRAB
Summer 2016	Technical Working Groups	To understand the application and risk profile across the public sector Informal public sector consultation if deemed required
November 2016	FRAB	FRAB Paper - Update on Technical Working Group discussions including transition arrangements
March 2017	FRAB	FRAB Paper - Update including interpretations/adaptations for the public sector
June 2017	FRAB	Exposure Draft for approval for consultation
Summer 2017 (July-Sept)	Exposure Draft Consultation	Issue exposure draft inviting comment from stakeholders
Autumn 2017 (Sept-Oct)	Exposure Draft Responses	Consider responses to exposure draft
Nov 2017	FRAB	FRAB meeting to agree adoption of the standard based on the exposure draft and response
Spring 2018	Further opportunity to consider any other adaptations or interpretations	
June 2018	FRAB	FRAB meeting for further consideration if needed Consider 17-18 FReM
Summer 2018	Opportunity to amend FReM extract if needed	
November 2018	FRAB	Approve 2018-19 FReM
December 2018	2017-18 FReM Published	
January 2019	IFRS Implementation Date	
2019/20	UK public sector implementation of IFRS 16	