# Financial Reporting Advisory Board Paper

## IFRS 16 *Leases* – Progress update and feedback from the initial impact assessment

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| Issue: | This paper provides a progress update on the IFRS 16 technical working group and feedback from the initial consultation exercise, including early views on the options for transition and possible interpretations and adaptations. |
| Impact on guidance: | None proposed at this stage. This will be considered in a later paper to the Board following an Exposure Draft. |
| IAS/IFRS adaptation or interpretations? | Adaptations and interpretations are proposed for IFRS 16. These will be refined in future papers to the Board. |
| Impact on WGA? | None at this stage, but decisions on transition and disclosure requirements will affect how IFRS 16 is applied in WGA. |
| IPSAS compliant? | IFRS 16 is not IPSAS compliant. IPSASB have a leases project with an Exposure Draft expected to agreed by the IPSASB in December 2017. |
| Impact on budgetary regime? | IFRS 16 currently does not align with the budgetary regime which is based on the National Accounts. |
| Alignment with National Accounts (ESA10)? | IFRS 16 does not align with the National Accounts which maintains the operating and finance lease distinction. |
| Impact on Estimates? | IFRS 16 will not align with the Estimates as this is based on the budgetary regime. |
| Recommendation: | HM Treasury ask the Board to note the progress made, to provide any comments on the issues identified, note the challenges with alignment and agree next steps. |
| Timing: | No changes are expected to be made to the FReM until the 2019-20 financial year. |

DETAIL

## Background

1. The International Accounting Standards Board (IASB) has issued International Financial Reporting Standards (IFRS): IFRS 16 Leases which replaces IAS 17 and related Interpretations. IFRS 16 is expected to be adopted by the EU at the end of 2017. The effective date of IFRS 16 is 1 January 2019.

2. As agreed by the Board at the November 2016 meeting (FRAB 128), when HM Treasury provided the Board with their high-level work plan for implementation, the timetable for implementation of IFRS 16 in the public sector is the 2019-20 financial year. The work plan included the creation of a cross-government technical working group and an initial impact assessment undertaken by the Relevant Authorities to scope the landscapes of the various sectors.

3. At the last meeting, the Board received an update of the discussions from the technical working group. This paper provides a further progress update to the Board on the technical working groups and feedback from the initial consultation exercise, including early views on the options for transition, adaptations and interpretations. It also highlights the alignment challenges between IFRS and the National Accounts.

## Consultation Responses

4. The HM Treasury consultation can be found in Annex A. This was used by all Relevant Authorities and the health sector[1] and highlighted key areas of discussion from the technical working group as well as the public-sector issues identified and the questions posed.

5. HM Treasury received 37 responses[2] to the consultation of which 3 responses were 'nil returns'. The responses were made up of:

a. 16 Ministerial Departments (most included a group return)

b. 9 Non-Ministerial Departments

c. 8 Agencies and Arm's Length Bodies (ALBs)

d. Relevant Authorities – Scotland, Wales (incl. Welsh NHS), Northern Ireland

e. Whole of Government Accounts

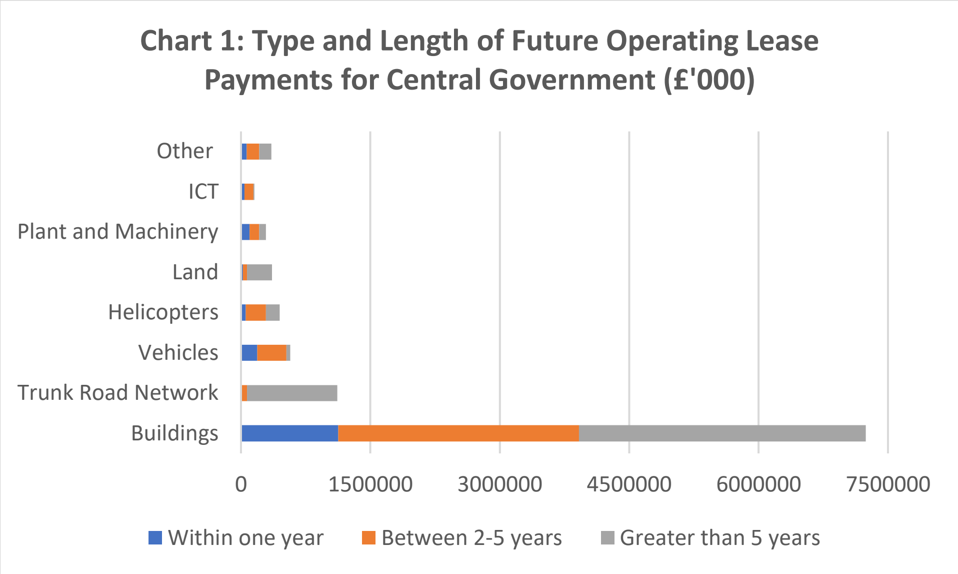
6. Quantitative figures on leases were also requested to put the application of IFRS 16 into the public-sector context, as disclosures on operating leases within annual reports and accounts (ARAs) tended to be limited. Responses for the quantitative analysis amounted to c.£10.5bn (uneliminated) of future lease payments out of a potential £11.5bn future lease payments (eliminated) from Whole of

[1] Entities within the remit of the Relevant Authorities (HM Treasury, Welsh Government, Scottish Government, The Executive Committee of the Northern Ireland Assembly) and the health sector will henceforth be referred to as central government entities within this paper.

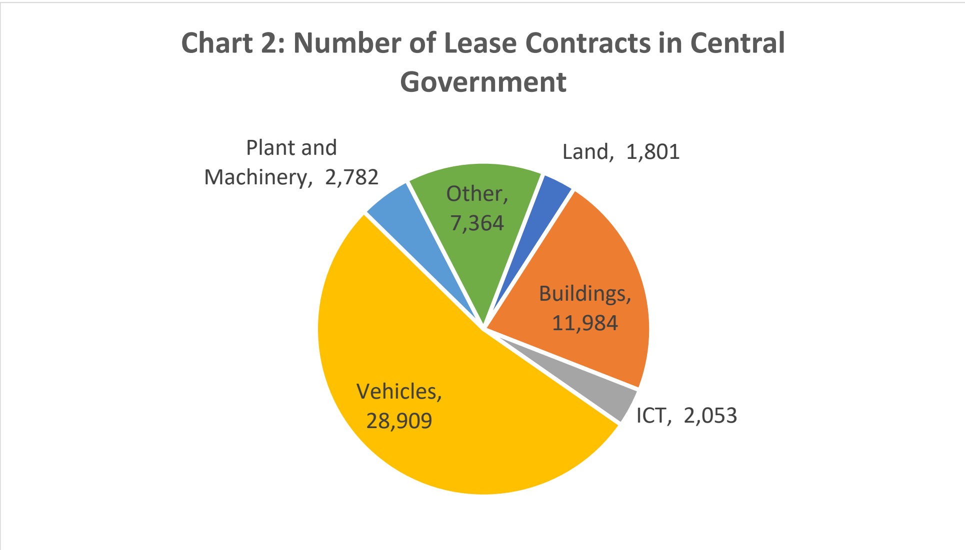
[2] The following public bodies responded to the HM Treasury consultation: BEIS, CO, DCLG, DCMS, DEFRA, DFE, DFID, DFT, DH (including NHS), DWP, FCO, HMRC, HMT, Home Office, MoJ, MoD, Competition and Markets Authority, Electoral Commission, OFQUAL, Office for National Statistics, National Savings & Investments, Food Standards Agency, National Archives, Security and Intelligence Agencies, Welsh Office, CC Water, Flood Re, Rural Payments Agency, Animal and Plant Health Agency, Forestry Commission, Agricultural and Horticulture Development Board, Natural England, Government Property Agency (Shadow), Scottish Government, Welsh Government (including Welsh NHS), The Executive Committee of the Northern Ireland Assembly and the Whole of Government Accounts.

Government Accounts data. With 25% of leases expected to be intra-government leases, the figures obtained through the initial impact consultation are sufficient to undertake credible analysis on the impacts on central government entities.

7. As can be seen in Chart 1, most leases held by central government entities are for buildings, as expected. The application of IFRS 16 is expected to be relatively straightforward for these building contracts. What the additional data has provided is the breakdown of other leases, not identifiable through ARAs. These include ICT, vehicles, helicopters, the trunk road network and plant and machinery. It is anticipated that applying IFRS 16 to these contracts that are low in value but high in volume is likely to be more challenging.




8. The number of lease contracts in central government, as identified by respondents, is shown in Chart 2. There are c.55,000 lease contracts identified which provide useful context when considering the options and practical expedients available in the Standard and the ability to maintain dual reporting frameworks. It should be noted that these figures exclude leases held by academies, public corporations and those central government bodies who did not respond to the consultation.



## Definition of a Contract

9. IAS 17 considered a lease to be "an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time". IFRS 16 identifies the definition of a lease as a contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration. A contract is "an agreement between two or more parties that creates enforceable rights and obligations".

10. The subtle change in wording for what is considered to be a lease, particularly the definition of a contract, will cause application issues within the public sector. By applying a strict definition of a contract under IFRS 16, lease like arrangements between Crown bodies would fall out of the scope of IFRS 16, as technically there is no enforceability because the Crown is not considered divisible.

11. In practice, it was recognised by the technical working group and respondents to the consultation that the lack of enforceability between government organisations was not necessarily an issue, as government bodies are expected treat agreements between themselves as if the agreement were akin to an enforceable contract.

12. Therefore, the definition of the contract should be adapted so that it includes such intra-government agreements that were not technically legally enforceable, but in substance were expected to be honoured and in all other aspects be considered a lease. This would enable intra-government agreements such as MOTOs, MOUs, licences etc. to be considered akin to a contract and therefore assessed using IFRS 16 as they currently are now under IAS 17.

13. In having this adaptation, public sector accounting would retain the understanding that these agreements are akin to a lay person's definition of a lease and retain transparency of transactions and balances in the individual annual reports and accounts. It also follows the substance over form principles within the conceptual framework.

14. **HM Treasury proposes to expand the definition of a contract to enable intra-government agreements to be assessed as leases if they meet all relevant criteria.**

## Intangible Assets

15. IFRS 16 allows the option for entities to assess intangible assets under IFRS 16. Most respondents indicated they would not apply IFRS 16 to intangible assts. The reasons were because it would be time consuming given the value of the intangibles, the assets were already capitalised (though the liability was not) and it would save time preparing the IFRS 16 disclosure requirements. Examples provided by respondents about the type of intangible leases they held (or were likely to) included software licences and cloud-based IT solutions.

16. Six respondents indicated they would assess leases of intangible assets under IFRS 16 as they did not feel it would be necessary to differentiate between asset classes and this would maintain consistency.

17. Given the value of non-property operating leases (c.£3 billion), of which the current intangible leases figure is substantially smaller, and the additions to intangible assets in the Whole of Government Accounts (£3.6 billion), leaving this accounting policy choice to the discretion of individual entities would not have a material impact on the Whole of Government Accounts. Parents in group consolidations indicated that they would mandate the accounting policy choice for their own group.

18. **HM Treasury proposes to leave the option to assess leases of intangible assets under IFRS 16 to the discretion of individual entities.**

## Short Term Assets

19. IFRS 16 allows an entity to elect to not apply the requirements in paragraphs 22-49 to short term leases. Short term leases are in existence across central government for property leases, software licences, specialised machinery, medical equipment and hire cars. Often these leases only have a short-term need, such as a national emergency or for a particular project.

20. No respondents indicated any concerns with HM Treasury mandating this accounting policy choice across government. In doing so, entities will need to be reminded they are still required to assess if there is a lease in the first place (IFRS 16 (9-21)). Some disclosures are required for short term leases so entities will need to continue to monitor spending on these leases.

21. **HM Treasury proposes to mandate the election that short term assets should not be assessed under IFRS 16 (22-49).**

## Low Value Assets

22. IFRS 16 allows an entity to elect to not apply the requirements in paragraphs 22-49 to leases for which the underlying asset is of low value. Low value leases across government is expected to include laptops, water coolers, small items of medical equipment, photocopiers and franking machines.

23. There were overwhelming number of respondents that stated that low value should be linked to the capitalisation threshold or that any threshold should be linked to materiality. Furthermore, there was a misconception that leases of land and buildings, where the payments were significantly below market value, would be classed as low value. However, the responses did not link to the requirements of low value as prescribed in B3-B8, in particular that the assessment was supposed to be undertaken on the value of the underlying asset (not the lease payments) and regardless of whether the leases are material to the lessee.

24. This exemption is to be undertaken on a lease by lease basis, with the IASB expecting different lessees to reach the same conclusions about whether a particular underlying asset is of low value, therefore questioning the need to provide any public sector interpretations. Respondents however preferred to have central guidance on what would be classified as low value, as well as a value threshold. One respondent went as far as asking if a value was prescribed, would this need to be increased by inflation each year.

25. **Does the Board have any examples of how the low value exemption is being applied in the private sector?**

26. **Does the Board have any guidance on how the low value threshold should be implemented in the public sector?**

## Transition

*Grandfathering*

27. IFRS 16 allows the option to not assess existing lease contracts under IFRS 16 but instead 'grandfather' the arrangement. The impact of this would be that only new leases will be assessed under IFRS 16.

28. The vast majority of respondents indicated they would use this option, as it was considered too time consuming and costly to review all existing leases; in some cases, this amounted to thousands of contracts. There was also a concern that existing lease contracts may not contain all of the necessary details to assess under IFRS 16. They also agreed that it should be mandated across the public sector.

29. Almost all respondents stated that they believed their existing leases would continue to be leases under IFRS 16, with only a few stating further work would need to be required.

30. Some ALBs stated their preference to assess all contracts to maintain consistency and transparency in their accounts. Some of these entities acknowledged that they only held a couple of leases and therefore this would not be an onerous requirement. Others saw this as an opportunity to review all their contracts.

31. There was a misconception about needing to justify to auditors about using this expedient without a central mandate in the FReM. This was naturally incorrect because this was an accounting policy choice allowed in the Standard and therefore additional approvals would not be required.

*Transition Approach*

32. IFRS 16 allowed two options for transition; retrospective application with full restatement under IAS 8 (option 1); or retrospective application with the cumulative effect of initially applying the Standard in reserves (option 2).

33. ALBs that operated on pure IFRS favoured full restatement for transparency reasons. However, most respondents favoured option 2 as this option:

- Minimised the administrative burden as the level of work required to fully restate would be significant, timely and costly.
- Is aligned with the transition approach for IFRS 9 and IFRS 15.
- Was also considered easier to explain the differences from the prior year than to fully restate.

34. Were option 2 to be mandated, the following options are available for lessees.

*Asset Measurement*

35. Upon transition, IFRS 16 allows assets to be measured at either:

- Their carrying amount as if the Standard had been applied since the commencement date but discounted using the lessee's incremental borrowing rate at the date of initial application; or
- At an amount, equal to the lease liability adjusted by any prepaid or accrued lease payments.

36. Overall, the respondents preferred the asset to be measured as equal to the lease liability, though it was recognised that transparency would be increased using the carrying amount method. The lease liability option was considered to be the most cost effective and information was deemed to be readily available. It was particularly favoured for historic leases where it was considered challenging to obtain the necessary information to inform the carrying amount. In addition, for some entities, leases were

not a material category in relation to other assets on the Statement of Financial Position and therefore transparency was not seen as a compelling reason.

37. The Board should note that, unlike the private sector, the public sector is not strongly motivated by the impacts each method would have on the future depreciation of the assets.

*Further practical expedients on transition*

38. Further practical expedients are available to lessees. The proposal in the consultation was to mandate that no adjustments would be made for assets of low value, those with a lease term that ends within 12 months of initial application, as well as permitting the use of hindsight when assessing options in the lease contract. However, it was proposed to leave to each entity's discretion whether to apply IAS 37 onerous leases rather than IAS 36 impairment of assets, and to exclude initial direct costs from the measurement of ROU assets.

39. Overall, all respondents agreed to this proposal, though some questioned why some of the expedients should be left to each entity's discretion instead of mandating them all. Mandating the first three practical expedients aligns with the proposed treatment for corresponding new leases, whereas there was no strong reason to withdraw flexibility for entities to apply the last two expedients on a case by case basis.

40. In any case, the IASB determined that applying all of these practical expedients would not significantly impact on the reported figures.

## New Leases

*Recognition: Identification of a lease*

41. Responses to questions on the criteria for the identification of a lease included:

- Recognition that the biggest challenge would be about data collection, especially where contracts were a mixture of assets and services.
- Enhanced understanding of the changes in the Standard would need to be required by those outside of the finance function, such as procurement and legal colleagues, in order to realign contracting practices with the accounting requirements.
- The majority of respondents expected assets to be explicitly specified in the lease contracts. However, a few large departments expected to have implicit leases.
- Some respondents did state they may need to revert to the assumption that rights held by the supplier were not substantive, as there would be a disproportionate amount of effort to obtain necessary information from suppliers themselves. This was predominately in relation to non-property leases. A pragmatic approach in terms assessing substantive rights was requested by auditors.
- Overall, it was expected that non-property leases would require more judgement in applying IFRS 16. For the majority of entities, these leases were high volume, low value transactions.

42. Overall, whilst issues have been raised, these are not considered to be particularly specific to the public sector as private sector organisations were facing similar challenges. As a result, no adaptations or interpretations are proposed for the identification of a lease.

*Liability Measurement*

43. There were no substantial issues identified with liability measurement, other than the challenges with identifying the lease term (i.e. assessing the options), given the judgements made would have a substantial impact on liability, and the discount rate.

*Discount Rates*

44. Most respondents indicated they would not be able to identify the discount rate implicit in the lease and therefore would be looking to use an internal rate of borrowing (IRB). Whilst respondents agreed that a central IRB should be mandated by HM Treasury, there was no consensus on how the IRB would be calculated.

45. Discount rates suggested by respondents were the Green Book rate, Government Bonds, National Loans Fund Interest Rate, and CPI + base rate. There was also variety in the expectation on when these rates should be updated - which included quarterly, annually, at each Spending Review or on a 5 year period irrespective of a Spending Review. However, there were no reasons provided on how choosing these rates would meet the requirements of IFRS 16.

46. The challenges for Supply-funded public sector entities is that any "borrowing" they undertake is through a request for Supply from the Exchequer. There are no interest rates levied to supply-funded bodies and the interest rates charged upon the Exchequer are irrespective of the reasons for the borrowing. It is therefore challenging to see how the exact application of the Standard would work in a public-sector context.

47. Whilst a centrally mandated rate was requested for supply-funded organisations, there was suggestions that those entities that borrowed with a mixture of supply and external borrowing may need to consider a weighted average cost of the various borrowing options to obtain their internal rate of borrowing. One respondent even suggested that adjustments may need to be made for regional variations in interest rates.

48. **Does the Board have any comments on the way in which the internal rate of borrowing could be applied in the public-sector context?**

*Asset Measurement*

49. The default valuation option for assets in IFRS 16 is the cost model, based on the value of the liability (with some adjustments). Though IFRS 16 does explicitly permit entities to elect the revaluation model on an asset class basis, as there was a recognition that some entities may wish to maintain consistency with their owned assets.

50. Within the public sector, the cost model has been withdrawn under IAS 16 and assets are measured at current value in existing use (i.e. market value in existing use for non-specialised assets and present value of the assets remaining service potential for specialised assets). Therefore, were the cost model to be used in the public sector, there would be an inconsistency in valuation methodology between owned and leasehold assets, which was highlighted by many respondents.

51. However, there were mixed opinions on whether a cost or revaluation model should be adopted for leased assets:

- Whilst the Whole of Government Accounts team preferred a consistent approach across the public sector, approximately half the entities requested the choice on whether a revaluation approach is adopted should be left to the discretion of individual entities. Based on the comments received, it was unclear whether entities fully acknowledged that the revaluation option needed to be by class of asset, as there were diverse opinions on short term vs. long term building leases which would be the same class of asset.

- For existing finance leases, responses indicated there was a mixture of both the cost and revaluation model for assets used under IAS 17. This lack of consistency at present does not present a significant issue, as finance leases within central government are not material compared to freehold assets.

- There was concern in identifying how to revalue assets that were a small part of a larger asset (e.g. a building) or an asset used for a significantly shorter period that the useful life of the underlying asset.

- There was also concern in applying the depreciated replacement cost methodology to leased assets, where there was no prospect of replacing the assets.

- Revaluing right of use assets to values much higher than the lease liability would inflate deprecation costs accordingly.

- Increases in the market value of a building leased for a short period do not result in any obvious additional economic benefits to the lessee and therefore artificially increase the value on the lessee's Statement of Financial Positon.

- The potential cost implications of needing to revalue leases in addition to freehold assets.

- There was a misconception that IFRS 13 disclosures would be required if the revaluation model would be adopted. As the revaluation model applied would be as per IAS 16 as adapted in the FReM, fair value disclosures under IFRS 13 were unlikely to be applicable unless the leases were considered surplus property or investment properties.

52. **Does the Board know of any private sector organisations that would consider using the revaluation model for leased assets and how they may address the valuation issues?**

53. **What does the Board believe was the IASB's intention for how the revaluation model would apply to right of use assets; i.e. whether there is an expectation that it is only the right of use over the lease term, or the overall value of the underlying asset, that is revalued?**

## *Lessor Accounting/Lease Modifications*

54. No significant issues were raised on the requirements for lessor accounting (including intermediate lessors) or lease modifications.

## *Disclosure requirements*

55. The disclosure requirements of IFRS 16, have increased compared with the disclosure requirements of operating leases under IAS 17.

56. Respondents recognised that whilst there was an increase, the disclosures were relevant for the public sector and therefore should not be adapted or interpreted. In particular, qualitative disclosures would only apply to those organisations who had complex lease arrangements, and therefore in a large number of cases would not be required on the grounds of materiality.

## *Group Consolidation/Whole of Government Accounts*

57. Overall, respondents did not identify any particular issues with group consolidation, though recognised the increased work required to perform the necessary eliminations. Based on the information provided by respondents, approximately 25% of leases within central government are intra- government transactions and predominately made up of building leases.

58. Some departments stated that they consolidated bodies who reported on different accounting frameworks, such as FRS 102. All but one of these respondents indicated these bodies would not be material and no adjustments would be necessary on consolidation. One body who consolidates a significant number of charities highlighted that making adjustments on consolidation would be material and challenging.

### *Wider consequences*

59. Currently, the FReM refers entities to the requirements of IAS 17 where public private partnership arrangements contains a lease (IFRIC 4) for both the accounting and disclosure requirements. In theory, these references would be replaced with IFRS 16, however further work needs to be undertaken to ensure that the grantor accounting (i.e. from the government perspective) does not unintentionally change.

60. The responses highlighted that there were debt or covenant arrangements, or financial metrics the respondents had or imposed on others that may be impacted by the introduction of IFRS 16, in accounting and budgeting. Some of these were within the control of the entity to amend whilst others may require HM Treasury approval or legislative changes.

### *Timetable*

61. Most respondents agreed with the implementation timetable, though noting there was not any explicit reference to the timetable for impacts on budgets. Some correspondents perceived issues with FRAB approval in Nov 2017 being too late; however, as with IFRS 9 and IFRS 15, the FRAB approvals on adaptations and interpretations are expected to have occurred well in advance of the November 2017 meeting.

62. Many agreed that early adoption was not sensible and that 2019-20 adoption was appropriate and feasible. A few entities preferred early adoption to align IFRS 15 and IFRS 16 accounting therefore reducing the need to assess contracts for two years running. One entity, with potentially material leases, raised concerns with having to change their lease accounting a year after coming into existence.

## *Impact on Budgets/Estimates and alignment with ESA 10*

63. As the Board is aware, IFRS 16 is not aligned with European System of Accounts 2010 (ESA10) which retains the finance vs. operating lease distinction for lessees. ESA10 provides the framework on which the government's fiscal mandate is based and it is used within the budgeting and Estimates regime. Under Clear Line of Sight project implemented in 2011, the public sector has worked towards maintaining alignment between the accounts, budget and Estimates in all but a small number of areas.

64. At present, there are no indications in the short to medium term that the statistical community will change ESA 10 (or the United Nations System of National Accounts 2008 on which ESA10 is based on). The Office of National Statistics has been working to understand the implications of changes made because of IFRS 16, which includes revisiting the definitions of a lease under ESA10, the impacts on data collection in both the public and the private sector and the feasibility of operating dual financial reporting systems.

65. One of the largest misalignments at present relates to private finance initiatives (PFIs) that are predominately off balance sheet for budgets and Estimates, but on balance sheet for accounts. When asked how entities maintain the financial information for this misalignment many respondents spoke of maintaining dual records predominately with the use of spreadsheets, or in some cases specific general ledger codes.

66. However, one of the biggest challenges raised by respondents on whether the methodologies used for PFIs would work for leases was the sheer quantity of leases. There is only c. 650 PFIs across the whole of the public sector compared with c55,000+ leases within central government alone.

67. Given the issues on the alignment between ESA 10 and IFRS has not yet concluded and the significant impacts this would have not only on financial reporting but the fiscal mandate, HM Treasury believes it would be premature to issue an Exposure Draft on the application of IFRS 16 if there were a possibility of further adaptations to improve alignment with ESA10 within the UK public sector context.

## *Next steps*

68. The Treasury plans to work closely with the ONS over the coming months to conclude the alignment issues on adopting IFRS 16. The Treasury will also work with the relevant authorities and the technical working group to finesse the potential adaptations and interpretations for IFRS 16.

69. Given the next FRAB meeting is March 2018, HM Treasury proposes to provide the Board with an out of committee update on the alignment issues along with an Exposure Draft for IFRS 16.

## *Recommendation*

70. HM Treasury ask the Board to:

- Note the progress made and analysis of comments following the initial impact consultation;
- Provide comments on the issues identified;
- Recognise the challenges in maintaining alignment between the accounting and fiscal frameworks and its impact on the timetable; and
- Agree the next steps.

HM Treasury
16 November 2017

Annex A – IFRS 16 Initial Impact Consultation

# Annex A: Initial Impact Consultation

## Summary

1. IFRS 16 Leases was published in January 2016 and is effective for annual periods beginning on or after 1 January 2019. HM Treasury expects IFRS 16 to be adopted in the public sector from 1 April 2019, subject to EU adoption.

2. IFRS 16 will supersede IAS 17 Leases and the following Interpretations:
    - IFRIC 4 Determining whether an Arrangement contains a Lease;
    - SIC-15 Operating Leases - Incentives; and
    - SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

3. IFRS 16 brings a significant change in lessee accounting by removing the distinction between operating and finance leases and introducing a single lessee accounting model. The model 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. The lessor accounting model remains largely unchanged as it retains the dual accounting model (finance and operating leases) and the transfer of risk and rewards criteria. Changes have been made relating to the interaction with IFRS 9 *Financial Instruments* and IFRS 15 *Revenue with Contracts with Customers* as well as enhanced disclosures requirements.

4. The aim of this consultation is to draw attention to the key aspects of the Standard, understand the public-sector leasing landscape and test some of the early conclusions drawn from the technical working group (TWG). The consultation does not address all aspects of the Standard but covers the material areas. Entities should read IFRS 16 in full before completing the consultation.

5. The contents of this consultation are as follows:
    - Public Sector Interpretations
    - Exemptions from application
        - Outside the scope
        - Short term leases
        - Low value leases
    - Transition
    - Lessee accounting and disclosures
    - Lessor accounting and disclosures
    - Group consolidation/Whole of Government Accounts
    - Budgets and Estimates
    - Implementation Timetable
    - Other relevant issues

6. The Technical Working Group (TWG) have identified three proposed interpretations for the public sector:
    - The definition of a contract for Crown bodies (para 9)
    - Mandating the accounting policy choice for short term leases (para 16)
    - Mandating certain options available on transition (para 28)

7. Further public sector adaptations and/or interpretations may be proposed following the feedback from the initial impact consultation as well as the normal due process involving a formal Exposure Draft of the Standard and the Financial Reporting Advisory Board.

8. Annex B requests a breakdown of existing operating leases. Please fill out the annex and return with the questionnaire so HM Treasury and the TWG are able to better understand the nature of the leases held across government.

## Public Sector Interpretation

### Definition of a contract

9. IAS 17 considered a lease to be "*an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time*". IFRS 16 identifies the definition of a contract as "*an agreement between two or more parties that creates enforceable rights and obligations*".

10. The subtle change in wording for what is considered to be a lease may cause issues in application for the public sector. The technical working group discussed:
    - Applying a strict definition of a contract under IFRS 16 poses issues for the public sector, specifically for those bodies underneath the Crown as there is technically no enforceability because the Crown is not considered divisible.
    - In practice, it was recognised that the lack of enforceability between government organisations was not necessarily an issue as government bodies are expected treat agreements between themselves as if the agreement were akin to an enforceable contract.
    - There was consensus that the definition of the contract should be interpreted so that it included such intra-government agreements that were not technically legally enforceable but in substance were expected to be honoured. This would enable intra-government agreements such as MOTOs, MOUs, licences etc. to be considered akin to a contract and therefore assessed using IFRS 16 as they currently are now under IAS 17.
    - In having this interpretation, public sector accounting would retain the understanding that these agreements are akin to a lay person's definition of a lease and retain transparency of transactions and balances in individual accounts.

11. **Do you agree that an interpretation is required for the definition of a contract? If so why, if not why not and what alternatives do you propose?**

# Exemptions from application

### Outside the scope of IFRS 16

12. As per IFRS 16 (3), an entity shall apply IFRS 16 to all contracts with customers, except the following:

    - Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
    - Leases of biological assets within the scope of IAS 41 Agriculture held by a lessee
    - Service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements
    - Licences of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers
    - Rights held by a lessee under licencing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

13. Similar to IAS 17, IFRS 16 has excluded licensing agreements from the scope of the Standard. IFRS 16 goes further to state that a lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described above.

14. **Does your entity have any leases of intangible assets or plan to procure any leases of intangible assets in the near future? If so, please provide details about the type and nature of these assets?**

15. **Would you consider using the option available in IFRS 16 to not apply the Standard to leases of intangible assets? If so why, if not then why not?**

### Short Term Leases

16. A lessee may elect not to apply the requirements of recognition and measurement to short term leases. A short-term lease is defined from commencement, as having a lease term of 12 months or less, after the assessment of any options. The election is made by class of asset.

17. When this election is made, the lessee shall recognise lease payments as an expense either, on a straight-line basis over the lease term or another systematic basis if it is more representative of the pattern of the lessee's benefit. Entities are required to state if this exemption is adopted alongside the disclosure requirements for lessees (see disclosure section below).

18. If a short-term lease is modified or there is a change to the lease term, then the lease will be considered to be a new lease from that point forward and reassessed under IFRS 16.

19. The technical working group discussed:
    - There was a strong preference to mandate the exemption of IFRS 16 for short term leases across the public sector on all asset classes because it was considered virtually certain that all entities would chose this election from a cost/benefit perspective.

- The choice made would also impact on leases with less than 12 months remaining upon transition to IFRS 16 (see transition section).
- Whilst short leases were not considered to be overly prevalent in the public sector, they may be in existence, for example in museums who may lease artwork for exhibitions.

**20. Do you regularly lease assets for a short term that would be eligible for the election to not apply IFRS 16? If yes, what are these assets and why do you only lease for a short period?**

**21. Do you have any concerns if HM Treasury were to mandate that all leases with terms less than 12 months should not be assessed under IFRS 16? If so why and what alternatives do you propose, if not why not?**

## Low Value Leases

22. IFRS 16 allows an exemption from applying the Standard if the underlying asset is of low value. An underlying asset can be of low value only if:
    - The lessee can benefit from the use of the underlying asset on its own or together with other resources readily available to the lessee; and
    - The underlying asset is not highly dependent on, or highly interrelated with, other assets

23. If, when the asset is new, the asset is typically not of low value (e.g. a car), and then the lease would not qualify as a low value asset. If the lessee expects to sublease the asset, the head lease does not qualify as a low value asset.

24. The election of low value leases is undertaken on a lease-by-lease basis. Entities should be aware that this assessment is undertaken regardless of whether, individually or in aggregate, the leases classed as low value would be material to the financial statements.

25. The technical working group discussed:
    - It was difficult to consider the types of assets this would cover and the extent to which the public sector held low value assets as currently annual reports and accounts did not provide a comprehensive picture of the types of non-property leases held by public sector entities. This consultation should aim to draw out the nature and type of leased assets.
    - IT assets were highlighted as an area where judgement would be required to assess the highly dependent/highly interrelated criteria; especially as packaged IT/cloud based solutions were increasing in prevalence and the individual elements may be difficult to separate.
    - Attributing a central threshold value in GBP was not recommended as this could lead to perverse leasing practices.
    - To aid consistency and comparability in the public sector, guidance would be required on how to determine low value assets.

**26. What leases and of what assets does your entity own that you consider would meet the criteria of low value assets? Please explain any examples.**

27. **How do you believe the low value lease exemption should be applied in the public sector? Please explain any comments made.**

## Transition Arrangements

### Definition of a lease

28. As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted:
    - to apply this Standard to contracts that were previously identified as leases applying IAS 17 and IFRIC 4
    - not to apply this Standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

29. The option chosen will be applied to all lease contracts, with disclosures requirements if this practical expedient is used. The impact of choosing this practical expedient is that the IFRS 16 definition of a lease will only apply to contracts entered into (or changed) on or after the date of initial application.

30. The technical working group identified:
    - A preference for mandating the option to carry forward the existing lease classifications rather than reassessing all the leases. This was on various grounds:
        - The time and costs associated with reviewing all the existing leases.
        - All leases were assessed less than 10 years ago, during the work for initial IFRS adoption. These assessments should have been updated for changes in leases and the IAS 17 criteria applying to new leases since IFRS adoption.
    - IFRS 16 implementation could provide be an opportunity to undertake a review of all existing leases. However, it was considered to mandate reassessing all leases was considered excessively burdensome.
    - Entities should consider whether there were opportunities for the internal audit function to undertake a review of the existing leases.

31. **Would your entity consider using the practical expedient to not assess existing contracts under IFRS 16? If so why, if not why not?**

32. **When considering your existing lease portfolio, how likely do you anticipate your existing IAS 17 leases would not be determined to be a lease under IFRS 16?**

33. **Do you believe the use of this practical expedient should be mandated across the public sector or left to each entity's discretion? Please explain your rationale.**

### Lessee Transition Method

34. For lessees, IFRS 16 is to be applied retrospectively, subject to some practical expedients. There are two transition options identified in IFRS 16. The election of the transition method should be applied consistently to all of the leases in which the entity is the lessee.

**Option One: Retrospection application with restatement** - IFRS 16 should be applied retrospectively to each prior reporting period presented applying IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

**Option Two: Retrospective application with no restatement** (cumulative catch up approach) - Retrospectively with the cumulative effects of initially applying the Standard recognised at the date of initial application as an adjustment to the opening balances of retained earnings (or equivalent).

35. The technical working group identified:
    - There was a strong preference for option two as it would be the same transition method as IFRS 9 and IFRS 15. This was considered the more cost effective transition approach given the number of transitional reliefs available and ease of preparation for large consolidations.
    - Leases were unlikely to be material to individual entities or to WGA in the context of owned assets recorded on the Statement of Financial Position. Any concerns around the comparability between years under option two would therefore be reduced.
    - Preparers should be considering the cost and time implications of introducing IFRS 16 as well as considering the level of preparatory work, systems and processes required.

36. If the Option Two (cumulative catch up approach) transition approach is chosen, the following practical expedients are available to the entity depending on whether the leases were previously classified as a finance or operating lease.

## Leases previously classified as operating leases

### Liability Measurement

37. IFRS 16 requires the lessee to measure the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. The Standard allows a lessee to apply a single discount rate to a portfolio of leases with reasonably similar characteristics.

38. The technical working group identified:
    - Questions raised on the use of the discount rate for new leases would need to be addressed for leases on transition as well (see para 74).
    - In the run up to implementation, entities should ensure their operating lease disclosures were as accurate as possible, as this would be the basis for liability to be recognised on the balance sheet.

39. **Are you satisfied that your entity has a complete picture of the value of the future lease commitments, particularly where these commitments are entered into by consolidating entities?**

### Asset Measurement

40. IFRS 16 requires the lessee to choose, on a lease-by-lease basis, to measure that right-of-use asset at either:

**Option 1** - its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or

**Option 2** - 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.

41. The technical working group identified that:
    - The option chosen would affect the size of the asset on initial recognition and SoCNE transactions in terms of the level of depreciation that would be recorded in future years.
    - Option 1 was considered more transparent in terms of ascertaining the best value of the right to use asset and consequently provided a better reflection of the depreciation associated with the asset in future years. As assets were reviewed as part of the IFRS adoption, information about the contracts should be discernible.
    - Option 2 was considered beneficial from a cost/benefit perspective balancing the reduced transparency against the availability of information and the costs of ascertaining the carrying amount at commencement date particular where an entity had a significant number of leases.

42. **Which asset measurement approach do you consider your entity would adopt when applying IFRS 16 on transition? Please explain your rationale.**

43. **Do you have a different view depending on the type or nature of the underlying asset? If so why, if not why not?**

## Further practical expedients

44. There are a number of other practical expedients available on transition. These are:

    - No adjustment is required or leases for which the underlying asset is of low value
    - A lessee may elect not to transition to leases for which the lease term ends within 12 months of the date of initial application. In this case, a lessee shall:
        - account for those leases in the same way as short-term leases; and
        - include the cost associated with those leases within the disclosure of short-term lease expenses.
    - A lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease
    - Rather than applying IAS 36 at the date of initial application, rely on its assessment of whether leases are onerous applying IAS 37 immediately before the date of initial application as an alternative to performing an impairment review.
    - A lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application

45. The first three expedients in paragraph 44 are proposed to be mandated for application across the public sector to align with the proposals for new leases in these categories. The last two expedients in paragraph 44 are proposed to be left to individual entities to consider whether to apply these expedients on a case-by-case basis.

46. **Do you agree with the proposal in para 45? If so why, if not why not?**

Leases previously classified as finance leases

47. For leases that were classified as finance leases applying IAS 17, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying IAS 17.

**48. Do you foresee any issues in accounting for leases previously classified as finance leases? If so why and what alternatives do you propose? If not why not?**

Disclosures

49. The following disclosures are required if Option 2 cumulative catch up transition approach was chosen:
    - Information required by IAS 8 (28) on initial application of a new standard except for part (f) which requires a line by line impact on the financial statements.
    - The weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the statement of financial position at the date of initial application
    - An explanation of any differences between the operating lease commitments disclosed applying IAS 17 at the of the reporting period immediately preceding IFRS 16 application discounted using the incremental borrowing rate at the date of initial application and lease liabilities recognised in the SoFP at the date of initial application
    - if the entity has used one or more of the practical expedients.

**50. Do you foresee any issues in the disclosures on transition for lessees? If so why and what alternatives do you propose? If not why not?**

51. In order to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within departmental group accounts and the Whole of Government Accounts (WGA), HM Treasury is expecting to mandate one transition methodology across the public sector.

**52. Which transition approach (option one – retrospective restatement or option two – cumulative catch up approach) would you choose for your entity and for the public sector. Please explain your choice.**

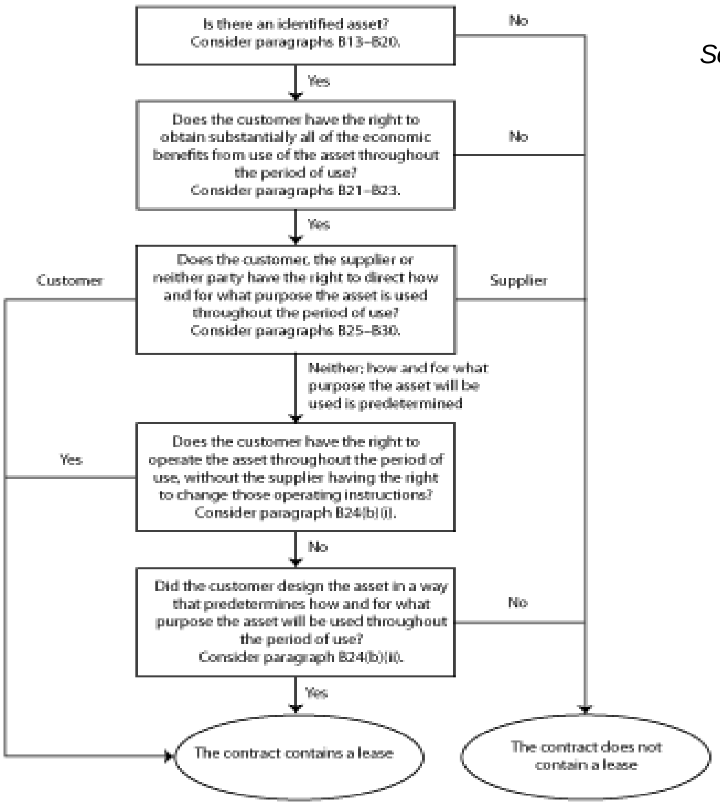
Transition for Lessors

53. A lessor is not required to make any adjustments on transition for leases in which it is a lessor except in the case where the lessor is an intermediate lessor (i.e. it subleases). In such cases the intermediate lessor shall:
54. reassess subleases that were previously classified as operating leases to determine whether each sublease should be classified as an operating lease or a finance lease applying IFRS 16. This assessment should be based on the remaining contractual terms and conditions of the head lease and sublease at initial date of application.
55. for subleases that were classified as operating leases applying IAS 17 but finance leases applying this Standard, account for the sublease as a new finance lease entered into at the date of initial application.

**56. Do you foresee any issues in accounting for leases as a lessor? If so why and what alternatives do you propose? If not why not?**

# New Leases – Lessee Accounting

57. IFRS 16 provides a flowchart that may assist in making the assessment of whether a contract is considered as, or contains a lease. These questions are discussed in turn in the following section.




*Source: IFRS 16 (B31)*

## Identification of an asset

58. An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time the asset is made available for use by the customer.

59. The asset can be a portion of a larger asset, however it needs to be physically distinct. For example, a floor of the building would be considered as physically distinct, whilst a portion of a fibre optic cable would not be considered as physically distinct as multiple customers would use the cable.

60. There is also a requirement to separate the lease from the non-lease components unless it is impractical to do so. In such cases, the whole contract is considered a lease.

61. The technical working group identified:
    - The requirements to identify an asset are broadly the same as IAS 17 and IFRIC 4 and therefore do not represent any significant changes from previous accounting practices. There may be particular challenges in identifying assets where they are implicit in a contract, although these would not necessarily be any more challenging than under IAS 17/IFRIC 4.

- The impacts of these judgements however would be more pronounced, as it will contribute to the assessment of whether there is a lease and therefore assets and liabilities introduced on the Statement of Financial Position (SoFP). Enhanced scrutiny will therefore be required when making these assessments under IFRS 16.

62. Do you foresee any issues with identifying an asset? If so why, if not why not?

63. On average, do you foresee the underlying assets will be explicitly specified or implicit in the contracts your entity enters into?

Substantive Substitution rights

64. IFRS 16 states that even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier has the substantive rights to substitute when they have the:

    - Practical ability to substitute alternative assets throughout the period of use; and
    - Benefit economically from the exercise of its right to substitute the asset

65. These rights as determined at contract inception need to be in place throughout the period of use. The Standard provides a number of examples of where substantive substitution rights are considered likely or not. These include:

    - If the asset is on the customer's premises, this increases likeliness that supplier does not have substantive rights as costs of substitution are more likely to exceed benefits.
    - If the supplier has more than one asset to deliver the terms of the contract, this increases the likeliness that the supplier does have substantive rights as it can easily substitute the asset.
    - Future events that, at contract inception, would not be considered likely to occur should be excluded from the evaluation. These include the introduction of new technology that is not substantially developed, or a substantial difference between the market price during the period of use compared with inception.
    - Substitution for repairs and maintenance does not preclude the customer from having right of use.

66. If the customer cannot readily determine whether the supplier has substantive substitution rights, the customer shall presume that any substitution rights are not substantive. The IASB did not expect customers to exert undue effort to determine whether the supplier has any substitution rights.

Rights to obtain economic benefits from use

67. To control the use of an identified asset, a customer is required to have the rights to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example by having exclusive use throughout the period of use).

68. Entities should be aware that these benefits may not be the same as the economic benefits obtained over the life of the asset, especially when the lease is for a short period compared to the useful economic life.

### Rights to direct the use

69. A customer has the right to direct the use of an identified asset throughout the period of use if either:
    - The customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
    - The relevant decisions about how and for what purpose the asset is used are predetermined and:
        - The customer has the right to operate the asset (or direct others to operate in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
        - The customer designed the asset (or specific parts) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

70. When making this assessment, the customer should only consider the most relevant decision making rights relevant to changing how and for what purpose the asset is used during the period of use. Decision making rights are relevant when they affect the economic benefits to be derived from the use and may vary from contract to contract.

71. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

72. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset. For example, a contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations.

73. The technical working group discussed:
    - Overall, there were no specific public sector issues with applying the IFRS 16 recognition criteria to identifying a lease in a contract. The impacts of the judgements were recognised as being more pronounced, as it directly contributes to the assessment of whether there is a lease and therefore assets and liabilities are introduced on the Statement of Financial Position (SoFP). Enhanced scrutiny will therefore be required when making these assessments under IFRS 16.
    - Notwithstanding that, the actual application in some cases could be challenging, especially where the contract contains lease and non-lease components or if the

identification of the asset is implicit. Contracts will need to be reviewed on a case-by-case basis with judgements made in conjunction with both finance and commercial colleagues.

- There could be some instances where on paper the asset was considered as being leased, but the supplier retained a varying degree of substitution rights or ability to direct the use. This may be particularly the case for IT and infrastructure assets.
- In some cases, entities may need to default on the areas in the Standard that states that a lessee is not expected to exert undue effort in order to evidence certain rights are substantive or present.

74. **What factors would you consider in your deliberations around whether rights were substantive or not? Do you foresee instances where you would conclude it was too difficult to identify the rights, and therefore need to assume, as per the Standard, that these were not substantive?**

75. **Do you foresee any particular issues with applying the recognition criteria in IFRS 16 in the public sector? If so why and what alternatives do you propose, if not why not?**

Measurement – Lease Liability

76. IFRS 16 requires the lessee to consider the following when determining the measurement of the lease liability:
    - **Determine the lease term** – taking into account any options available in the contract and the likelihood at contract inception that these options will be exercised.
    - **Identify the lease payments** – splitting what are fixed payments, those that are variable due to an index/rate and those that are genuinely variable. Payments relating to residual value guarantees, lease incentives and options also need to be considered in the calculations.
    - **Apply the discount rate** - using the rate implicit in the lease (if readily available) or the entity's internal rate of borrowing. Disproportionate effort is not expected to be exerted when trying to identify the rate implicit in the lease.

77. The technical working group discussed that:
    - There were a variety of variable payments that existed in public sector lease contracts, with those by index or rate prevalent. Genuine variable payments were likely to be in existence, for example in photocopiers or cars.
    - Drawing on the experience of international colleagues, it was noted that the US GASB had mandated that all options be considered as taken when assessing the lease liability. The working group considered this would not be necessary for the UK public sector, as no such mandating had been in operation for IAS 17 and entities were considered capable of assessing whether options were likely to be taken or not.
    - The requirements to use the rate in the lease or the incremental rate of borrowing is not new, as it was a requirement for finance leases under IAS 17. However, the impact of determining the rate is more significant as the number of leases being capitalised will increase substantially.
    - Feedback from the private sector indicated that entities were more likely to use their internal rate of borrowing as the rate implicit in the lease was considered to be harder to identify.

- When considering the internal rate of borrowing, the TWG discussed that departments are financed via supply when they wish to finance capital purchases. As a result, this commenced a discussion on whether a central rate for the government's cost of borrowing should be in place where the rate implicit in the lease could not be determined.
- Whist central rates may be appropriate for some public sector bodies, mandating rates across the public sector would not necessarily reflect the requirements of the Standard when applied to those entities that were able to borrow externally.
- Any discussions on setting centrally determined discount rates should be linked to the wider discount rates review currently being undertaken by Treasury.
- Where government entities are lessors and are "leasing" within the public sector, active consideration would need to be given by the lessor on how the discount rate is reflected in the contracts and therefore whether lessees will be readily able to identify the rate implicit in the lease.
- Entities would need to review the suitability of their IT systems to consider whether it they are able to handle the various accounting considerations when identifying lease payments and applying the appropriate discount rate.

78. **Do you foresee any issues in measuring the lease liability? If so why and what alternatives do you propose? If not, why not?**

79. **What discount rates are currently used in your entity's finance leases? Are these rates implicit in the lease or do you use a different rate? If so, how are they calculated?**

80. **If central discount rates were to be considered, on what should these be based upon and how often would you expect the rates to be updated? Please explain your comments.**

### Subsequent Measurement – Lease Liability

81. After the commencement date, a lessee shall measure the lease liability by:
    - Increasing the carrying amount to reflect interest
    - Reducing the carrying amount to reflect lease payments made
    - Re-measuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in substance fixed lease payments.

### Reassessment of the lease liability

82. After the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

83. A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate (either implicit in the lease for the remainder of the term or incremental borrowing rate at the date of reassessment), if either:
    - there is a change in the lease term; or
    - there is a change in the assessment of an option to purchase the underlying asset.

84. A lessee shall remeasure the lease liability by discounting the revised lease payments using an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates, if either:
    - there is a change in the amounts expected to be payable under a residual value guarantee.
    - there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The remeasurement only occurs when there is a change in the cash flows (i.e. when the adjustment to the lease payments takes effect).

### Lease modifications

85. A lessee shall account for a lease modification as a separate lease if both:
    - the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
    - the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

86. For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:
    - allocate the consideration in the modified contract
    - determine the lease term of the modified lease; and
    - remeasure the lease liability by discounting the revised lease payments using a revised discount rate.

87. For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:
    - decreasing the carrying amount of the ROU asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.
    - making a corresponding adjustment to the right-of-use asset for all other lease modifications

88. The technical working group identified entities should be aware that the requirements to re-measure lease liabilities on reassessment or modification of the lease has changed from the previous IAS 17 requirements. Furthermore, active consideration will need to be given on changes in index/rates throughout the lease period. There were however no specific public sector issues identified with the requirements of the Standards.

89. **Do you foresee any difficulties in the remeasurement or modifications of the lease liability? If so why, if not why not?**

### Initial Measurement – Right of Use Asset

90. IFRS 16 requires the right of use asset to be measured the same as the lease liability i.e. adjusted for various items such as any payments made in advance, lease incentives, initial direct costs and dismantling/restoration costs.
91. The technical working group did not identify any significant issues in the initial measurement of ROU assets. The challenges would arise in measuring the liability first.

Subsequent Measurement – Right-of-Use Asset

92. Subsequent measurement of the asset should be at cost less any accumulated depreciation (IAS 16) and impairment losses (IAS 36), and any adjustments for the re-measurement of the lease liability.

93. If the lessee applies IAS 40, the lessee shall also apply that fair value model to the right-of-use (ROU) assets that meet the IAS 40 definition of a property. If the ROU assets relate to a class of PPE to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets in that class. The IASB found entities might want to have a revaluation option for right-of-use assets to achieve consistency with their owned assets. Entities might view these assets in the same way and want to adopt the same accounting treatment for them.

94. Discussions of the technical working group discussed:

- As per the FReM interpretation, the cost model under IAS 16 had been withdrawn. All assets should be measured using the revaluation model.
- The TWG acknowledged that presentationally, it did not make sense to hold assets in the same asset class at different valuation methodologies just because one was leased and the other was freehold. This was especially the case for long term building leases or those acquired on a peppercorn rate.
- However, the counter argument was that the leased price contained the value of the asset the entity was entitled to, during its period of use, and a revaluation could be considered an artificial inflation of the SoFP. This was particularly the case for leases held for a short time compared to their useful economic life.
- It was considered that for specialised asset leases, revaluing the ROU asset using depreciated replacement cost was not appropriate because the lessee themselves would be highly unlikely to replace the asset. Challenges were likely to exist for revaluing on a freehold modern equivalent basis for an asset with a finite economic useful life (i.e. the lease term). However, under IAS 17 these assets would be considered as finance leases and therefore on balance sheet. Revaluation of assets held under finance leases is not explicitly permitted under IAS 17 (excluding IAS 40 leases) but it is widely acknowledged that it does occur in practice in both the public and private sector.

95. Does your entity use the revaluation or cost model for existing finance leases? Why have you chosen the approach you adopt?

96. Which option for subsequent valuation do you believe should be adopted in the public sector - the cost model, the revaluation model or preference to leave the decision at the discretion of each entity? Does your choice change depending on what the underlying asset is or the length of the lease? Please explain your rationale.

### Lessee Disclosures

97. Overall lessees are required to provide more extensive disclosures than those for finance leases or operating lease commitments under IAS 17. In addition, lessees need to assess whether additional information is necessary to meet the overall disclosure objective which requires disclosures to give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

98. As per IAS 1 *Presentation of Financial Statements* and the Simplifying and Streamlining agenda, information should only be disclosed if it material to the financial statements. Lessees need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

99. Lessees are required to disclose a variety of quantitative and qualitative information that includes:

| Quantitative | Qualitative |
|---|---|
| • Depreciation and interest charge;<br>• Expense relating to short-term and low value leases;<br>• Expense relating to variable lease payments not included in the measurement of lease liabilities;<br>• Income from subleasing;<br>• Additions;<br>• The carrying amount of ROU assets by class of underlying asset<br>• Leases not yet commenced but committed<br>• Magnitude of variable vs. fixed payments | • The nature of leasing activities<br>• Reasons for using variable payments, options, residual value guarantees etc., and their prevalence.<br>• Restrictions or covenants imposed<br>• Sensitivity of reported information and any associated operational or financial effects including risk exposure<br>• Deviations from industry practice |

100. The technical working group discussed:

- Overall the disclosure requirements for lessees in the new Standard is significantly more extensive than that required under finance leases or operating lease commitments under IAS 17, increasing both quantitative and qualitative disclosures.
- The TWG reminded themselves of the materiality considerations that would need to be applied across all the disclosure requirements and incorporating cross referencing in order to reduce duplication of information in the financial statements and notes.
- The disclosure requirements for lessees would require a large amount of understanding and coordination to collate and present the qualitative disclosure requirements. This was considered a particular challenge to those entities with a large consolidation. Though the extent of the lessee disclosures may not be as significant once intra-group leasing was eliminated on consolidation.
- In terms of presentation, the quantitative information could be consolidated into simple tables
- Whilst the disclosures were extensive, no specific reasons were identified on why they should be adapted for the public-sector context.

**101. Are there any disclosure requirements in the Standard which you believe are not applicable to the public sector? If so why? If not, why not and what alternatives do you propose?**

**102. Do you have any other comments on the lessee disclosure requirements from a public-sector perspective and the implications for reporting entities?**

## New Leases - Lessor Accounting

103. Lessor accounting has not substantially changed from IAS 17. The dual accounting model of finance and operating leases remains under IFRS 16 as does the criteria for assessing the classification. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Where these are not substantially transferred the lease is an operating lease.

### Finance Leases

104. At the commencement date, a lessor shall recognise assets held under a finance lease in its Statement of Financial Position (SoFP) and present them as a receivable at an amount equal to the net investment in the lease. The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease.

105. A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. The lessor shall apply the derecognition and impairment requirements in IFRS 9 to the net investment in the lease.

### Operating Leases

106. A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis, if that is deemed more representative of the pattern in which the benefit of the underlying asset diminishes.

107. A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense. Depreciation calculated should be consistent with the lessor's normal depreciation policy for similar assets and accounted for under IAS 16 and IAS 38. IAS 36 should be applied to consider if the underlying asset is impaired. Initial direct costs shall be added to the carrying value of the underlying asset and recognised as an expense over the lease term on the same basis as the lease income.

### Intermediate Lessor (lessees who sublease)

108. In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

- if the head lease is a short-term lease that the entity, as a lessee, has accounted for, the sublease shall be classified as an operating lease.
- otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset. For example,

referring to how long the sublease is in relation to the lease term of the head lease rather than the useful economic life of the underlying asset.

**109. Do you foresee any issues with the lessor accounting for finance or operating leases as a head lessor or an intermediate lessor? If so why, if not why not?**

### Lessor disclosures

110. Overall lessors are asked to provide more disclosures than IAS 17, though the requirements are far less extensive than those for lessees. When considering this, lessors are reminded that they are also required to follow the disclosure requirements related to the assets they hold but are subject to operating leases (e.g. IAS 16, IAS 38, IAS 40 etc.).

111. The disclosure objective for lessors remains the same as lessees, in that lessors are required to provide disclosures that give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. To meet this objective lessors are required to disclose at a minimum:

- Quantitative information in a tabular format depicting:
    - Fixed and variable payments for operating leases
    - Selling profit or loss, finance income and variable lease payments for finance leases

- Additional quantitative and qualitative information required:
    - Maturity analysis of lease payments on an annual basis for a minimum of the first 5 years and a total for the remaining years (discounted and reconciled to net investment for finance leases and undiscounted for operating leases)
    - the disclosures required by IAS 16 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor;
    - explanation of significant changes in the carrying amount of the net investment in finance leases
    - description of the nature of the lessor's leasing activities;
    - explanation of how the lessor manages the risk associated with any rights it retains in underlying assets, including its risk management strategy.

112. The technical working group discussed:

- Similar to lessee maturity analysis, additional breakdown by decade may be required for long leases to meet the disclosure objective.
- Intermediate lessors had the challenge of providing disclosures that related to both lessee and lessor requirements. This burden was reduced at a group level where there were intra group leasing which would be eliminated on consolidation.
- As there generally were not any differences between public and private sector leasing, the disclosure requirements remain valid for the public sector as well.

**113. Are there any disclosure requirements in the Standard which you believe are not applicable to the public sector? If so why, if not why not and what alternatives do you propose?**

**114. Do you have any other comments on the lessor disclosure requirements from a public sector perspective and the implications for reporting entities?**

## Sale and Leaseback

115. In assessing whether the transfer of the asset is a sale, entities will need to apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

116. A draft version of the IFRS 15 FReM extract was presented to the FRAB in November 2016[3]. There are no adaptations or interpretations for the IFRS 15 requirements to satisfy performance obligations for the public sector context. Respondents should therefore refer directly to the requirements of IFRS 15 when considering when performance obligations are satisfied.

117. Where the transfer is considered to be a sale

- The seller/lessee measures the ROU asset as the proportion of the previous carrying amount that is retained by the seller-lessee. Accordingly, the seller-lessee only recognises the gain or loss that relates to the rights transferred to the buyer-lessor.
- The buyer-lessor accounts for the purchase of the asset by applying the applicable Standards (e.g. IAS 16) and for the lease by applying the lessor accounting requirements in IFRS 16.
- Adjustments are also required if the fair value of the consideration does not equal the fair value of the asset or if the payments for the lease are not at market rates. Any below market terms shall be accounted for as a prepayment of lease payments and any above market terms accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

118. Where the transfer is not a sale, the seller/lessee shall continue to recognise the asset but also recognise a financial liability equal to the sales proceeds. The buyer/lessor shall not recognise the assets and recognise a financial asset equal to the sale proceeds. Both the financial assets and liabilities are accounted for under IFRS 9.

119. The technical working group identified:

- Whilst not common, there were instances where government entered into sale and leaseback transactions. These were often seen as novel engagements which required finance input, given the specific accounting requirements.
- The sale and leaseback accounting requirements were not perceived to be a significant issue in the public-sector context. The challenge arises from the identification of the transactions in the first place.
- In setting the standards there was acknowledgement of adaptations and interpretations made in other Standards (e.g. IFRS 9 discount rates or IAS16 fair value adaptation) which may impact on how specific requirements under IFRS 16 may needed to be assessed.

**120. Does your entity either regularly or in the near future expect to enter into sale and lease back transactions? If yes, how significantly do the changes in sale and leaseback accounting in IFRS 16 affect your entity?**

## Group Consolidation/Whole of Government Accounts

### Asymmetry

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/602400/FRAB_128__03__IFRS_15.pdf

121. IFRS 16 will increase the level of asymmetry between lessor and lessee accounting where both parties are within the public sector as the same or corresponding assets and liabilities are recorded on both SoFPs and at different values. This in turn will increase the number of eliminations required in a group consolidation and in whole of government accounts level.

122. Whilst there is asymmetry in the accounting, this is not a new phenomenon within IFRS. Examples include recognition of liabilities by the defendant in a legal case, while the claimant would not recognise an asset. The recent deliberations by the IASB on the Conceptual Framework acknowledges that in some cases income may need to be treated differently from expenses and assets differently from liabilities. Asymmetry may sometimes arise as a consequence of requiring the most useful information[4].

123. Whilst the technical working group recognised the additional work on consolidation, no adaptations or interpretations are proposed to the lessee or lessor accounting model to address the asymmetry in the public sector.

**124. What is the proportion of intra-group and/or intra-government leases compared with private sector leases for your entity?**

**125. Do you foresee significant issues because of the asymmetry between lessees and lessors? If so why and what alternatives do you propose? If not, why not?**

### Other accounting frameworks

126. Some public sector entities follow the requirements of other accounting frameworks such as FRS 102 and the charities SORP. The authorities responsible for these frameworks have indicated that the accounting for leases are unlikely to updated in time for the IFRS 16 effective date.

127. Entities who consolidate such bodies that prepare accounts under these frameworks will need to assess whether the leases they hold are material and whether they need to make adjustments to their group accounts in order to consolidate the bodies using uniform accounting policies (IFRS 10 (19).

**128. Is your entity likely to adjust for material leases held by ALBs under different accounting frameworks? Do you foresee any significant issues in making these adjustments? If so why, if not why not?**

## Budgets and Estimates

129. The Clear Line of Sight (CLoS) alignment project aimed to reduce the differences in budgetary controls, Parliamentary Supply Estimates and departmental accounts to those absolutely necessary for the proper management of spending and the presentation of data. Protocols have been put into place to ensure that alignment is maintained as far as possible when there are changes to underlying frameworks (IFRS for departmental accounts and European System of Accounts 2010 (ESA10) for the National Accounts which underpin budgets and Estimates).

[4] http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/March%202017/Summary-of-tentative-decisions-February.pdf

130. It has been recognised that the recording for leases under ESA 10 may no longer be aligned with the changes proposed in IFRS 16. A separate work programme has been established with the Office of National Statistics (ONS) to assess the extent of the differences and options for obtaining the data necessary for the National Accounts and the fiscal aggregates. This work has not been concluded, however HM Treasury is conscious of the impacts any misalignments in the accounting, budgeting and Estimates frameworks would cause within the public sector.

131. **If there were to be a misalignment between the accounting and the budgeting for leases, how significantly would this affect your entity? Please explain any comments.**

132. **Does your entity currently hold PPP/PFI/PF2 contracts that have a different treatment for accounting compared to the budgeting? If so, how do you currently maintain the information required for the different treatments? Do you believe this approach to maintaining dual data records could also be used for leases? If so why, if not why not and what alternatives do you propose?**

## Implementation timetable

133. HM Treasury is working to the following timetable for implementation of IFRS 16:

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|---|---|
| October 2017 | Out of committee paper to be presented to the FRAB on the progress and issues arising from the work of the technical working group and feedback from the initial public sector consultation exercise. |
| Dec 2017–Feb 2018 | Exposure Draft for wider consultation on the impact of this Standard |
| Spring/Summer 2018 | Further opportunity to consider any adaptations or other interpretations required for the 2019-20 FReM. If required, produce application guidance for preparers. |
| November 2018 | FRAB meeting to approve 2019-20 FReM |
| December 2018 | 2019-20 FReM published |
| April 2019 | UK public sector implementation of IFRS 16 for 2019-20 financial year |

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134. **Do you agree with the implementation timetable and effective date for IFRS 16? If so, why? If not, why not and what alternative do you propose?**

135. **As a result of this timetable, early application of IFRS 16 will not be permitted. Do you agree this is appropriate for the public sector? If so why, if not why not and what alternatives do you propose?**

## Other relevant issues

136. There are a number of areas where the introduction of IFRS 16 may impact on wider business activities. These are summarised below:

- **Debt** - It is understood that some public-sector entities are not permitted to take on debt. Finance leases under IAS 17 were considered to be a form of debt. As IFRS 16 brings liabilities onto the SoFP, leases under IFRS 16 may also be considered as a form of debt.
- **Taxation** – HMRC are considering the tax implications from the changes that arise in IFRS 16. A discussion document was published in August 2016 on the impacts of plant and machinery leasing. HMRC intends to maintain the current system of lease taxation by making legislative changes which enable the rules to continue to work as intended and will consult on this over the summer (2017).

137. **Would applying IFRS 16 (assuming no alignment issues in budgeting) affect any debt or covenant arrangements (legal or by agreement) or financial metrics your entity has or imposes on others? If so, please could you describe the arrangements and foreseeable consequences?**

138. **Are there any other issues not raised in any of the consultation questions above? If so, please describe the issues, the consequences and potential actions or alternative solutions HM Treasury should consider.**