Financial Reporting Advisory Board Paper

IFRS 16 *Leases*

Issue:	The IASB has issued IFRS 16 *Leases* which will replace IAS 17 *Leases* 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 analyses the existing finance and operating leases using Whole of Government Accounts data and including the impacts upon transition and provides brief discussion of the effects on Estimates and budgets.
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 and related interpretations applies without adaptation in the FReM.
Impact on WGA?	Not at this stage
IPSAS compliant?	IFRS 16 is not IPSAS compliant. IPSAS 13 based on IAS 17. IPSASB have launched a leases project to consider the impacts of IFRS 16.
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 not expected change in the near term in respect of leases. Application of IFRS 16 without adaptation would create a misalignment between accounts and budgets.
Alignment with National Accounts	Application of IFRS 16 without adaptation would create a misalignment between accounts and National Accounts.
Impact on Estimates?	Existing policy is that Estimates follow the National Accounts framework. Application of IFRS 16 without adaptation would create a misalignment between accounts and Estimates.
Recommendation:	HM Treasury ask that the Board consider the existing leases disclosed in the whole of government accounts, initial considerations of impact upon transition and proposed next steps.
Timing:	No changes are to be made to the FReM until the 2019-20 financial year.

DETAIL

Background

1. The International Accounting Standards Board (IASB) has issued IFRS 16 *Leases* which replaces IAS 17 Leases and related interpretations. IFRS 16 has an effective date of 1st 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. Endorsement by the European Financial Reporting Advisory Group (EFRAG) is expected in 2017.

2. HM Treasury's paper of March 2016 (FRAB 126) provided the Board with an initial overview of the new Standard, initial consideration of the main challenges that it presents and set out the high level work plan towards potential implementation in 2019-20.

3. At the last meeting, the Board specified further exploratory work was needed on the impact of the Standard in order for the Board to take a neutral and balanced view of whether IFRS 16 should be adopted, and what the regime would look like if the Standard was not.

4. This paper provides an analysis of the existing leases disclosed, based on the recently published 2014-15 Whole of Government Accounts (WGA)[1] including the impacts upon transition and provides brief discussion of the effects on Estimates and budgets.

Analysis using Whole of Government Accounts 2014-15

5. The following analysis refers to those leases where government is a lessee. Lessor accounting is not material for the Whole of Government Accounts. In any case, the requirements have not significantly changed between IFRS 16 and IAS 17 for lessor accounting.

6. Tables and charts to support the narrative can be found in Annex A.

Finance Leases

7. Finance leases which are shown on the WGA Statement of Financial Position as at 31 March 2015 can be found in Table 1. Future obligations (including interest) amount to £24 billion (2013-14: £24 billion). Of the finance leases:

- 98% of the land and 65% of the building finance leases are found in the Ministry of Defence – Annington Homes Ltd for homes for service personnel and their families.
- 15% of the building leases are found in the BBC (e.g. Broadcasting House, Pacific Quay and White City).
- The remainder is split amongst several central government, local government and public corporations.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525617/WEB_whole_of_gov_accounts_2015.pdf

- The assets that are capitalised in relation to these finance leases amount to:

    - £12.6 billion out of £847 billion of property plant and equipment (2014-15)
    - £10.5 billion out of £812 billion of property plant and equipment (2013-14)

8. Under IFRS 16, if a lessee elects to apply this Standard retrospectively without restatement, 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. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.

Operating Leases

9. The operating leases which are shown on the WGA Statement of Financial Position as at 31 March 2015 can be found in Table 2. There are £19.2 billion (2013-14: £17.8 billion) of future minimum lease payments recorded across the whole of government. 76% of these leases are for buildings.

10. A breakdown by organisation, type and length can be found in Chart 1. The majority of operating leases are found in Central Government and English Local Authorities. There are a very small number of local authorities that hold significant leases from a WGA perspective but for individual authorities, these leases are likely to be material and would therefore be required to apply the Standard if adopted.

11. There is in general, little narrative disclosure published in annual report and accounts about the nature of the assets. In particular where operating leases are for “other”, as a result of the lack of disclosures it is not clear whether these leases would qualify for any exemptions or practical expedients under the Standard such as the small lease exemption ($5,000 – an alternative for the UK may be £5,000 to prevent unnecessary issues with exchange rates).

12. There are two transition approaches permitted under IFRS 16:

- Option 1 - retrospectively to each prior reporting period presented applying IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; or

- Option 2 - retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application

13. If option one was chosen, entities will need to ensure they hold the required information in order to retrospectively apply the standard to all its leases. For some organisations this may be challenging, for example where their operating leases are older, data may not be available or if there have been complex lease changes to process.

14. HM Treasury have already strongly recommended to preparers (via RASIG) that they should create a leases register for all new leases as they are entered into from now, and when able, to add existing leases so that they have a comprehensive list of all leases putting them in a favourable position prior to the new standard taking effect.

15. IFRS 16 provides the following guidance on how to account for existing leases if option two was chosen as the transition method.

16. For existing leases, a practical expedient is available where 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 IFRS 16 to contracts previously identified as leases applying IAS 17 and IFRIC 4 and not to apply this Standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

Liabilities

17. The lessee is required 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.

18. If the standard was to apply from 1 April 2015 this would result in £19.2 billion of undiscounted liabilities that would need to be recognised. Consideration would be needed on what is the most appropriate discount rate to use. A practical expedient is permitted where a single discount rate could be applied to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

Assets

19. The right-of-use asset will need to be measured at either:

a) 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

b) 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.

20. It is not possible to ascertain what the value of the assets could be under option a, as the information is not available under present disclosures. Entities would need to review historical data to ascertain the carrying amount of their assets. Under option a, there may also be a discrepancy between the valuation of the assets and liabilities that may be shown on the statement of financial position. The difference is expected to be significantly smaller under option b.

21. Lessees are also required to apply IAS 36 Impairment of Assets to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient which enables the lessee to rely on its assessment of whether leases are onerous applying IAS 37 Provisions, Contingent Liabilities and Contingent Assets immediately before the date of initial application as an alternative to performing an impairment review.

22. Other practical expedients that are permitted under IFRS 16 on a lease-by-lease basis include:

- Electing not to apply the requirements to determine the liability and asset valuations to leases for which the lease term ends within 12 months of the date of initial application.
- Excluding initial direct costs from the measurement of the right-of-use asset at the date of initial application.
- The use in hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

IFRS vs. National Accounts

23. The existing policy is that Estimates and budgets follow the National Accounts framework. The National Accounts framework, currently European System of Accounts 2010 (ESA10) is not

understood to be changing in respect of leases. The distinction between finance and operating leases will remain.

24. Therefore, if IFRS 16 is to be applied without adaptation for central government then this will create a misalignment on operating leases between departmental accounts and departmental Estimates and budgets. Whilst the departmental accounts will recognise assets and liabilities associated with the leases, Estimates and budgets would only recognise operating leases, the lease payment due for the year in resource expenditure.

25. A comparative misalignment is currently that of private finance initiatives (PFI) which are predominately recognised in the Statement of Financial Position under IFRS but not recognised under the National Accounts Framework. Departments have to maintain two datasets in order to account for PFIs under the two frameworks.

26. Any misalignment would be a concern given the significant amount of work that has gone into aligning accounts and budgets. Any misalignments would need to be agreed by the Alignment Review Committee (ARC).

Next Steps

27. Surveying the departmental and sector landscape will play an important part of an initial impact assessment of IFRS 16 and is considered to be the logical next step. Analysis of WGA has identified the key players for whom the Standard is likely to have the most significant impact, but what it does mask are intra government lease (type) arrangements which will have been eliminated. It is proposed that a technical working group is set up to more fully understand the current scope of leases that are recognised, any future significant leases that are on the horizon and the impacts on adopting or not adopting the Standard.

Recommendation

28. HM Treasury ask that the Board consider the existing leases disclosed in the Whole of Government Accounts, initial considerations of impact upon transition and proposed next steps.

HM Treasury

23 June 2016

Annex A:

Table 1: Finance Leases

	Land £bn	Buildings £bn	Other leases £bn	2014-15 Total £bn	2013-14 Total £bn
Obligations under finance leases comprised:					
Total payments within 1 year	0.1	0.3	0.2	0.6	0.6
Total payments between 1 and 5 years	0.2	1.1	0.7	2.0	1.9
Total payments thereafter	8.7	12.1	0.6	21.4	21.5
Total	9.0	13.5	1.5	24.0	24.0
Less interest element	(8.1)	(10.5)	(0.3)	(18.9)	(19.0)
Total future minimum lease payments under finance leases	0.9	3.0	1.2	5.1	5.0

Table 2: Operating Leases

	Land £bn	Buildings £bn	Other leases £bn	2014-15 Total £bn	2013-14 Total £bn
Total future minimum lease payments under operating leases	1.5	14.5	3.2	19.2	17.8

Chart 1: Breakdown by organisation, type and length

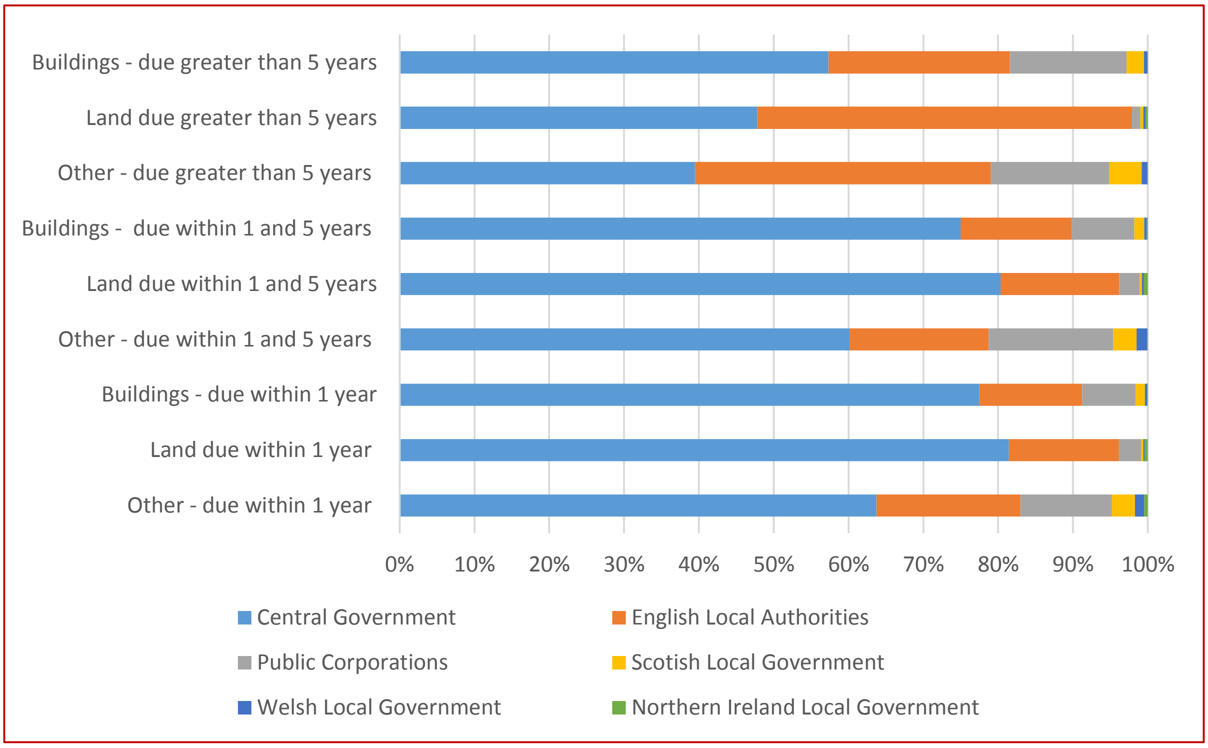

Table 3. Breakdown of organisations that hold significant operating leases (£'000)

Entity	Land	Buildings	Other	Most significant leases relate to:
Department for Health	33,199	2,465,609	486,068	No description in group accounts
Ministry of Justice		1,765,929	2,039	Court facilities
Hackney London Borough Council	428,022			Sherry's Wharf
Department for Culture Media and Sport		908,930		Royal Armouries Museum (£676m)
Westminster City Council		663,363		Properties
HM Revenue and Customs		542,855	16,994	No description in group accounts
Transport for London		600,373		Office space
Ministry of Defence	204,555	281,591	411,270	Training Schools, Accommodation and Airfield and Operational Support Vehicles
British Broadcasting Corporation		661,902	365,267	Office space, land, computers and other IT equipment.
London and Continental Railways		518,400		Office Premises
Department for Transport	1,199	195,954	542,911	No description in group accounts
Total	**666,975**	**8,604,906**	**1,824,549**	