Financial Reporting Advisory Board Paper

IFRS 16 *Leases* – Progress Update

Issue:	The IASB has issued IFRS 16 *Leases* which will replace IAS 17 *Leases* for annual periods beginning on or after 1 January 2019. This paper summarises the discussions of the technical working group and the initial conclusions drawn on the impact on the public sector and accounting policy choices available in the Standard, particularly in relation to transition.
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 IFRIC and SIC apply 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 project on leases to consider the impacts of IFRS 16.
Interpretation for the public sector context?	Interpretations are considered for the definition of a contract, mandating accounting policy choices for short term leases and mandating options available on transition. Other interpretations will be considered in a later paper to the Board.
Impact on budgetary/ Estimates regime?	Existing policy is that budgets/Estimates follow the National Accounts framework, which is not understood to changing in respect of leases. Application of IFRS 16 without adaptation would create a misalignment.
Alignment with National Accounts	Application of IFRS 16 without adaptation would create a misalignment.
Recommendation:	HM Treasury ask that the Board to note the progress made, to provide any comments on the issues identified and agree the next steps.
Timing:	No changes are to be made to the FReM until the 2019-20 financial year.

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. Whilst early 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, this is not expected to be used in the public sector. IFRS 16 is therefore expected to be effective from 2019-20. Endorsement by the European Financial Reporting Advisory Group (EFRAG) is expected in Q4 2017.

2. Previous HM Treasury's papers have provided the Board with an initial overview of the new Standard, a review of existing leases within the Whole of Government Accounts, initial consideration of the main challenges the new Standard presents and the high level work plan towards potential implementation in 2019-20.

3. This paper summarises the discussions of the technical working group and the initial conclusions drawn on the impact on the public sector and accounting policy choices available in the Standard, particularly in relation to transition.

Summary of Discussions from the Technical Working Group

4. The technical working groups have met monthly from February to June. The objectives of the group were focussed on thinking through unforeseen implications and potential issues, which may have genuine public sector impacts, and to help shape the initial public sector consultation. The membership of the technical working group is cross-governmental and comprises of representatives from relevant authorities, central government, health sector and public corporations.

5. Interpretations have been proposed for:
- Mandating accounting policy choices for short term leases (para 7)
- Mandating options available on transition (para 10, 13, 14)
- The definition of a contract for Crown bodies (para 22)

6. Further interpretations may be proposed following the feedback from the initial impact consultation.

7. Short Term Leases
- 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.
- There would be a link with the choice to not apply IFRS 16 to leases with less than 12 months remaining on transition and a similar mandated approach should apply.
- 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 particular exhibitions. The initial impact consultation will ask entities to provide details of short-term leases where applicable.

8. Low Value Leases
- The TWG found it 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. The initial impact consultation will aim to draw out the nature and type of leased assets.

- IT assets could be an area where judgement would be required to assess the highly dependent/highly interrelated criteria; especially as packaged IT solutions were increasing in prevalence and the individual elements could be difficult to separate out.
- Attributing a value in GBP was not recommended for application in the public sector as this could lead to perverse leasing practices.
- To aid consistency and comparability in the public sector guidance should be considered on how to determine low value assets.

Transition Arrangements

9. Definition of a lease

- There was 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.
- The TWG thought IFRS 16 implementation could provide an opportunity to undertake a review of all existing leases, perhaps with the assistance of the internal audit function. However, mandating reassessment of all leases would be considered excessively burdensome.
- There was a recognition of the impact of choosing this practical expedient in that the IFRS 16 definition of a lease would only apply to contracts entered into (or changed) on or after the date of initial application

Lessee Transition

10. Transition Method

- For lessees, IFRS 16 is to be applied retrospectively, subject to some practical expedients in particular circumstances. There are two transition options identified in IFRS 16 of which the election 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).

- There was a strong preference for option two as it would be the same transition method as IFRS 9 and IFRS 15. This was seen as 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.
- 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 will mandate one transition methodology across the public sector.

11. If option two 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

12. Liability Measurement
- The appropriate discount rate to use on initial application was considered the most pressing issue and relates to similar concerns about identifying the internal rate of borrowing for new leases. These are discussed further in paragraph 17. In order to maintain consistency between existing and new leases, it was considered that a similar approach to determine the internal rate of borrowing should be used.
- In the run up to implementation, the TWG recognised that entities should ensure their operating lease disclosures were as accurate as possible, as this would be the basis for liabilities to be recognised on the SoFP.

13. Asset Measurement
- IFRS 16 requires the lessee to choose, <u>on a lease-by-lease basis</u>, 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.

- The TWG recognised 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 in future years. As assets were reviewed as part of the IFRS adoption and therefore information about the contracts should, in theory, be available.
- Option 2 was considered beneficial from a cost/benefit perspective. It was seen to balance the reduced transparency against concerns over the availability of information and the costs of ascertaining the carrying amount at commencement date, particularly where an entity had a significant number of leases. This was considered to be the preferred option by the working group.

14. Further practical expedients
- There are a number of other practical expedients available on transition. Where these expedients related to choices made for new leases such as short term or low value, its use ought to be mandated in the public sector to provide consistency between existing and new leases.

- Other expedients were considered relevant on an individual entity basis as they were lease specific or unlikely to be material application across the public sector.

15. Leases previously classified as finance leases/lessor accounting
- No issues for the public sector were identified when considering the transition requirements in relation to finance leases or lessor accounting (including that of intermediate lessors).

New Leases – Lessee Accounting

16. Recognition
- Overall, there were no specific public sector issues with applying the IFRS 16 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.
- The requirements for identifying 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.
- 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.

18. Measurement – Lease Liability
- The group discussed the types of variable payments that existed –those by index or rate were 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. For the UK public sector the working group considered this was not necessary as no such mandation had not been in operation undertaken for IAS 17 and entities were already 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 increases 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 considered that departments do not "borrow" externally but from the Treasury 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 necessary reflect the requirements of the Standard when applied to those entities that were able to borrow externally.
- Any discussions on 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 on how the discount rate is reflected in the contracts and therefore whether their lessees will be readily able to identify the rate implicit in the lease.
- Entities would need to review their IT systems to consider whether it was suitable to handle the various accounting considerations when identifying lease payments and applying the appropriate discount rate.

18. Subsequent Measurement – Right of Use Asset

- IFRS 16 requires the subsequent measurement of the asset should be at cost less any accumulated depreciation (IAS 16), impairment losses (IAS 36) and any adjustments for the re-measurement of the lease liability. However 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 to use assets in that class.
- As per the FReM interpretation on IAS 16, the cost model has been withdrawn. All assets should be measured using the revaluation model which is interpreted as market value in existing use/present value of remaining service potential depending on whether the assets are specialised or not.
- By valuing leased assets at cost, this may cause inconsistencies in the measurement of assets on the SoFP. The TWG acknowledged that presentationally, it did not make sense to hold assets in the same class at different valuation methodologies just because one was leased and the other was freehold. This was especially the case for long 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 asset values in the SoFP. This was particularly the case for leases held for a short time compared to its useful economic life.
- It was considered 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.

19. New Leases - Lessor Accounting

- Lessor accounting has not substantially changed from IAS 17. The dual accounting model of finance and operating leases remain under IFRS 16 as does the criteria for assessing the classification.
- The working group identified no particular concerns with the lessor accounting model though noted the change in the classification method where the entity was an intermediate lessor (i.e. sub leased).

20. Disclosures

- Overall, the disclosure requirements for lessees and lessors were recognised as more extensive than those required under finance leases or operating lease commitments under IAS 17, increasing in both quantitative and qualitative disclosures.
- The TWG reminded themselves that per IAS 1 and the Simplifying and Streamlining agenda, information should only be disclosed if it material to the financial statements and need not duplicate information that is already presented elsewhere provided the information is incorporated by a cross reference to the relevant section.
- 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. However, the extent of the lessee disclosures may not be as significant where there were significant intra-group leasing.
- Whilst the disclosures would be very burdensome to prepare, there were not any specific public sector reasons why they should be adapted.

21. Outside the scope of IFRS 16

- There was significant discussion over the application of IFRS 16 to intangible assets where it was considered particularly challenging to identify what the asset actually was and whether there were substantive substitution rights. Examples discussion surrounded IT intangibles and cloud computing.
- 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, IFRS 16 to leases of intangible assets.
- The initial impact consultation will ask about the prevalence of intangible leased assets, whether there are concerns on the application and if the option to exclude all leases of intangible assets would be considered by the entity.

Group Consolidation/Whole of Government Accounts

22. Definition of a contract

- IFRS 16 identifies the definition of a contract as an agreement between two or more parties that creates enforceable rights and obligations. IAS 17 did not include similar wording because a lease was considered 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.
- Applying a strict definition of a contract poses issues for the public sector, specifically for those bodies underneath the Crown. There is technically no enforceability between crown bodies because the Crown is not divisible. In practice, the view is that the lack of enforceability between government organisations is not an issue as government bodies are expected treat agreements between themselves as if the agreement were akin to an enforceable contract.
- There was consensus was that the definition of the contract should be interpreted so that it included intra government agreements that were not technically legally enforceable. This would enable intra government agreements such as MOTOs, MOUs, licences etc. to be considered akin to a contract, as is currently the case under IAS 17.
- A similar interpretation on the definition of a contract was likely not considered necessary for local government, as they do not have the same issues with enforceability of contracts.

23. Intra Government Balances

- 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 valuations. This in turn will increase the number of eliminations required at a group consolidation and Whole of Government Accounts level.

- 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[1].
- The technical working group acknowledged the asymmetry in public sector accounting and agreed to work through potential proposals for managing the elimination process. No adaptations are proposed to the lessee or lessor accounting model to address the asymmetry in the public sector.
- The initial impact consultation will aim to identify the true extent of intra government leasing compared with that to the private sector.

Next Steps

24. Initial impact consultation over the summer to assess the wider landscape and test the early conclusions drawn in this paper, particularly around transition arrangements. The initial consultation will aim to collate additional information and comments on the areas of the Standard where firm conclusions have not yet been drawn. These will include:

- Type and nature of low value leased assets
- Subsequent valuation of asset valuations
- Internal rate of borrowing discount rate
- IFRS 16 applicability to intangible assets.

25. The working group will continue with their deliberations on the public sector impacts, focusing over the coming months on consolidation issues, business implications and audit considerations.

26. The outcome of the initial consultation is expected to be circulated to the Board as an out of committee paper for comment. Per the timetable, an Exposure Draft is expected to be circulated to the Board at the next meeting for a December 2017-February 2018 consultation period.

Recommendation

27. HM Treasury ask that the Board note the progress made, to provide any comments on the issues identified and agree the next steps.

HM Treasury

15 June 2017

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