HM Treasury

IFRS 16 Leases:

Exposure Draft 18(01)

Month 2018

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Chapter 1
Introduction

The Government Financial Reporting Team, HM Treasury, has published this exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) as part of the ongoing work in ensuring the FReM reflects the latest development in financial reporting.

The proposed amendments to the FReM are published by HM Treasury for comment only. The proposals may be modified in the light of comments received through the consultation process before being presented to the Financial Reporting Advisory Board (FRAB) for its approval. Final proposals approved by the FRAB will be published as amendments to the FReM from the proposed effective date.

Structure of exposure draft

The exposure draft provides details for each FReM chapter for which an amendment is proposed. Each section includes:

- An explanation of why the amendment is proposed
- When necessary any specific additional questions unique to that proposed amendment
- The paragraph of the FReM chapter that are affected by the proposed amendment
- The proposed effective date of each proposed amendment.

Initiation to comment

HM Treasury invites comments on the proposed amendments. Responses to the questions set out in Chapter 2 would be particularly welcomed. Comments are most helpful if they:

- Respond to the question as stated
- Indicate the specific paragraph or paragraphs to which they relate
- Contain a clear rationale
- Describe any alternatives HM Treasury should consider

Comments on this exposure draft should be submitted in writing so as to be received by XX XXX 2018. Respondents are asked to send their comments electronically to frem.consultation@hmtreasury.gsi.goc.uk

All responses will be published on the gov.uk website unless the respondent requests confidentiality.

HM Treasury will consider all comments received in writing by XX XXXX 2018. In considering the comments, HM Treasury will base its conclusions on the merits of the arguments for and against the alternative, not on the number of responses supporting each alternative.

Before responding to the consultation HM Treasury strongly advise respondents to read IFRS 16 as written by the IASB, including appendices, illustrative examples and Basis for Conclusions.

Chapter 2
Questions

Question 1:

Do you agree with the proposed amendments to the accounting for leases in the FReM to reflect the principles of IFRS 16? If so why, if not why not and what alternatives do you propose?

Question 2

Do you agree with the adaptation for the definition of a contract? If so why? If not, why not and what alternatives do you propose?

Question 3

Do you agree with the public-sector interpretation for short term leases? If so, why? If not, why not and what alternatives do you propose?

Question 4

Do you agree with the proposals for low value leases? If so why? If not, why not and what alternatives do you propose?

Question 5

Do you agree with the proposals for lessee accounting? If so why? If not, why not and what alternative do you propose?

- Do you agree HM Treasury should set an internal rate of borrowing centrally, for entities to use when they cannot obtain the rate implicit in the lease? If so why, if not why not and what alternative do you propose?
- Do you agree that the internal rate of borrowing should be set irrespective of the type of underlying asset? If so why? If not, why not and what alternatives do you propose?
- Do you agree with the public sector interpretation for subsequent valuation of assets? If so why, if not why not and what alternatives do you propose?
- Do you agree with the public sector adaptation for peppercorn leases? If so why? If not, why not and what alternatives do you propose?
- Are there any disclosure requirements for lessee accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

Question 6

Do you agree with the proposals for lessor accounting? If so why, if not why not and what alternatives do you propose?

- Are there any disclosure requirements for lessor accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

Question 7

Do you agree no adaptations or interpretations for the public-sector context is required for sale and leaseback? If so why? If not, why not and what alternatives do you propose?

Question 8

Do you agree with the transition proposals for lessee accounting and disclosures? If so why, if not why not and what alternatives do you propose?

- Do you agree with the public sector interpretation on grandfathering existing lease classifications? If so why? If not, why not and what alternatives do you propose?
- Do you agree with the transition approach for the proposed amendments? If so why? If not, why not and what alternatives do you propose?
- Do you agree with the public sector interpretation for asset measurement upon transition? If so, why? If not why not and what alternatives do you propose?
- Do you agree with the public sector interpretation on practical expedients when applying IFRS 16 upon transition? If so why? If not why not and what alternatives do you propose?

Question 9

Do you agree with the transition proposal for lessor accounting? If so why, if not why not and what alternatives do you propose?

Question 10

Do you have any comments on the impacts IFRS 16 will have on consolidation? Please explain any comments, including providing alternatives HM Treasury should consider.

Question 11

Do you agree with the proposals for aligning the accounting of service concession arrangements that contain a lease with IFRS 16? If so why? If not, why not and what alternative do you propose?

Question 12

Do you agree with the proposed effective date for the public sector implementation of IFRS 16? If so why? If not, why not and what alternatives do you propose?

Question 13

Are there any other areas not covered by the questions which you would like to comment on? Please explain any comments, including providing alternatives HM Treasury should consider.

Question 14

Are there any options available in IFRS 16 that you would be significantly concerned about adopting, were HM Treasury try to align with ESA 10? Please explain any comments, including providing alternatives HM Treasury should consider.

Chapter 3

Overview of IFRS 16

The International Accounting Standards Board (IASB) introduced IFRS 16 Leases in January 2016 replacing IAS 17 Leases and related Interpretations (IFRIC 4 Determining whether an arrangement contains a lease, SIC-15 Operating Leases-Incentives, SIC-27 Evaluating the substance of transactions involving the legal form of a lease).

The most notable aspects of IFRS 16 is that the lessee and lessor accounting models are asymmetrical. The IASB has retained the finance and operating lease distinction for lessors however, this distinction is no longer relevant for lessees.

For lessors, IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, except in respect of subleases. A lessor is not required to make any adjustments on transition however, additional requirements have been introduced for subleases, lease modification and disclosure requirements.

For lessees, IFRS 16 introduces a single lessee accounting model and 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. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. There are a number of aspects in the application of IFRS 16 which will require the exercise of judgement beyond what entities have had to experience under IAS 17.

IFRS 16 has an effective date of 1st January 2019. After the IASB has published a new Standard, the European Union (EU) has a formal process for adoption. The European Commission (EC) requests endorsement advice from the European Financial Reporting Advisory Group (EFRAG) and based on this advice the EC prepares a draft Endorsement Regulation. This Regulation is adopted only after a favourable vote of the Accounting Regulatory Committee (ARC) and favourable opinions of the European Parliament and the Council of the European Union. Following adoption, the Regulation is published in the Official Journal of the European Union, at which time it becomes effective. This process was concluded in December 2017 with IFRS 16 fully adopted by the EU.

The FReM applies EU adopted IFRS consistent with the requirements of the Government Resource Accounts Act 2000. This means HM Treasury currently expects the new Standard to be applied in central government from 2019-20.

Chapter 4

Applicability of IFRS 16 for public sector reporting entities

With £18.2 billion of future operating lease commitments disclosed in the 2015-16 whole of government accounts[1], leases are material within the public sector.

The Financial Reporting Advisory Board (FRAB) agreed the high level plan for the implementation of IFRS 16 in public sector entities in November 2016[2]. 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 landscape of the various sectors.

This section details the discussions of the FRAB, technical working group and initial impact assessment and from these, HM Treasury's proposals for the application of IFRS 16 in the public sector. HM Treasury will continue to review implementation issues in the private sector and consider any corresponding impacts in the public sector.

The structure of this section is as follows:

- Definition of a contract
- Exemptions from application
- Lessee accounting and disclosures
- Lessor accounting and disclosures
- Transition
- Impact on consolidation
- Implementation

Definition of a contract

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".

[1] https://www.gov.uk/government/publications/whole-of-government-accounts-2015-to-2016

[2] https://www.gov.uk/government/publications/financial-reporting-advisory-board-minutes-and-associated-papers-24-november-2016

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 (e.g. department to department or department to agency) would fall out of the scope of IFRS 16, as technically there is no legal enforceability because the Crown is not considered divisible.
- such as MOUs, MOTOs and licences between government entities may also not be enforceable by law and therefore excluded from IFRS 16 consideration.

In practice, it is recognised the lack of enforceability between government entities is not necessarily an issue, as government bodies are expected to treat agreements between themselves as if the agreement were akin to an enforceable contract.

Therefore, HM Treasury believes the definition of the contract should be adapted so that it includes such intra-government agreements that are not technically legally enforceable, but in substance would be considered a contract. This enables intra-government agreements to be considered akin to a contract and therefore assessed using IFRS 16, as they currently are now under IAS 17. This may not result in the intra government agreement being classified as a lease, but enables an IFRS 16 assessment to take place.

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, retaining transparency and understandability of transactions and balances within annual reports and accounts.

Entities should note that lease receivables between central core departments (including their executive agencies) would be exempted from recognising stage 1 and stage 2 impairments under the adaptation for IFRS 9 Financial Instruments. ALBs are excluded from the exemption unless they are explicitly covered by the guarantee given by their parent department.

Public Sector adaptation: The definition of a contract is expanded to include intra UK government agreements where non-performance may not be enforceable by law.

Question: Do you agree with the adaptation for the definition of a contract? If so why? If not, why not and what alternatives do you propose?

Exemptions from application

Short Term Leases

IFRS 16 allows an entity to elect to not apply the requirements of paragraph 22-49 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.

Short term leases are in existence across central government for property leases, software licences, specialised equipment and hire cars etc. These leases have a short term need, such as a national emergency or for a particular project, where longer leases or purchasing the asset would not constitute value for money.

To reduce the costs of applying IFRS 16 and ease the burden on preparers, HM Treasury proposes to mandate the election that all short term assets should not be assessed under IFRS 16 (22-49). Disclosures are still required for short term leases.

Public Sector Interpretation: The option to apply the election in IFRS 16 (5) has been withdrawn. All entities must apply the election in IFRS 16 (5) to not apply the requirements in paragraphs 22-49 to short term leases.

Question: Do you agree with the public-sector interpretation for short term leases? If so, why? If not, why not and what alternatives do you propose?

Low Value Leases

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. 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.

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

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.

Low value leases across government could include laptops, water coolers, small items of medical equipment, photocopiers and franking machines.

HM Treasury does not propose to provide a central value for low value leases. It is very challenging to provide a specific figure for comparison or a comprehensive list of low value asset types, as numerous financial circumstances, including inflation and the supply/demand relationship of certain assets, and value of underlying assets due to advancing technology is likely to fluctuate in the coming years. This would require any figures or lists to be continually revised and impede on the consistency in financial statements.

As this assessment is on a lease by lease basis, HM Treasury proposes to leave the decision to apply the exemption to individual entities.

Question: Do you agree with the proposals for low value leases. If so why? If not, why not and what alternatives do you propose?

New leases – lessee accounting

Identifying a lease

IFRS 16 requires an entity to assess whether a contract is considered a lease based on four main criteria:

- Identification of an asset

- Substantive substitution rights
- Right to obtain economic benefits from use
- Right to direct the use

Identification of an asset

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. 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 could use the cable. There is 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.

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.

Substantive Substitution rights

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

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 (B17)
- 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 (B14)
- 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 (B16)
- Substitution for repairs and maintenance does not preclude the customer from having right of use (B18)

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

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).

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

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.

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.

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.

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.

Public sector application

The impacts of these judgements are now more pronounced as it directly contributes to the assessment of whether there is a lease and therefore whether assets and liabilities are introduced on the Statement of Financial Position. Enhanced scrutiny will therefore be required when making these assessments under IFRS 16. Whilst discussions have raised issues with applying the identification of a lease criteria to individual contracts, they are not considered to be specific to the public sector, with private sector entities facing similar challenges.

Measurement – Lease Liability

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.

Lease Term

The lease term shall be the non-cancellable period of the lease together with both periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by the option to terminate the lease if the lessee is reasonably certain not to exercise that option

Whilst these requirements are very similar to IAS 17, IFRS 16 provides significantly more guidance on how to make these assessments (B34-B41).

Discount Rate

IFRS 16 requires the lease liability to be discounted using the rate implicit in the lease, or where this is not readily determined, the lessee's incremental rate of borrowing.

The incremental rate of borrowing is the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

The requirements to use the rate in the lease or the incremental rate of borrowing is not a new, concept as it was a requirement for finance leases under IAS 17. However, the impact of determining the rate becomes more substantial as it will directly impact the liability recorded on the Statement of Financial Position.

Public sector application

Within central government, entities are funded by Supply from the Exchequer (either directly or via grant in aid from their parent department). Whilst the Exchequer borrows externally as necessary to meet public sector finance requirements, there are only a limited number of circumstances where entities would borrow externally themselves. When Supply funding is passed to departments, there is no interest levied and the interest rates charged upon the Exchequer are irrespective of the reasons for the borrowing by the departments (or their agencies and arm's length bodies). It is therefore difficult for these entities to calculate the internal rate of borrowing for themselves.

In order to address this issue, HM Treasury proposes to introduce a central internal rate of borrowing for entities to apply, when they cannot obtain the rate implicit in the lease contract. In developing the central rate, HM Treasury proposes the application of the internal rate of borrowing to all leases irrespective of the type of underlying asset. The final methodology will be agreed with the Financial Reporting Advisory Board before application.

Public Sector Interpretation: Where entities cannot readily obtain the interest rate implicit in the lease, they should use the HM Treasury discount rate promulgated in PES papers

Question: Do you agree HM Treasury should set an internal rate of borrowing centrally, for entities to use when they cannot obtain the rate implicit in the lease? If so why? If not, why not and what alternative do you propose?

Question: Do you agree that the internal rate of borrowing should be set irrespective of the type of underlying asset? If so why? If not, why not and what alternatives do you propose?

Subsequent Measurement – Lease Liability

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

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 re-measurement 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 re-measurement in profit or loss.

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.

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 re-measurement only occurs when there is a change in the cash flows (i.e. when the adjustment to the lease payments takes effect).

Lease modifications

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.

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.

For a lease modification that is not accounted for as a separate lease, the lessee shall account for the re-measurement 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

Initial Measurement – Right of Use Asset

IFRS 16 requires the right of use asset to be measured the same as the lease liability adjusted for various items such as any payments made in advance, lease incentives, initial direct costs and dismantling/restoration costs.

Subsequent Measurement – Right-of-Use Asset

IFRS 16 states that the cost model should be used to determine the subsequent measurement of the right of use asset; i.e. cost less any accumulated depreciation

(IAS 16) and impairment losses (IAS 36), and any adjustments for the re-measurement of the lease liability.

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 right of use asset relates 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 may want 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.

Public sector application

Within the FReM, the cost model under IAS 16 had been withdrawn. All tangible assets shall be carried at either current value in existing use or fair value at the reporting date. A breakdown can be found in table 4.A.

Table 4.A: Measurement basis of Property, Plant and Equipment

Why the asset is held	Measurement Basis
For their service potential	• Non-specialised assets – market value in existing use • Specialised assets – present value of remaining service potential
Not for their service potential	• Lower of carrying amount and fair value less costs to sell (IFRS 5 *Assets held for sale and Discontinued Operations*) • Fair value per IAS 40 *Investment Properties* • Fair Value per IFRS 13 *Fair Value Measurement*
Entities may also elect to adopt a depreciated historical cost basis as a proxy for current value in exist use or fair value for assets that have short useful lives or low values (or both).	

Source: Government Financial Reporting Manual, Chapter 7

To maintain consistency with other assets recognised on the Statement of Financial Position, the default assumption would be to apply the revaluation model for all classes of right of use assets within the public sector.

There is very little guidance in IFRS 16 about how the revaluation model could work. In the Basis for Conclusions the IASB refers entities to the principles of IFRS 13 *Fair Value Measurement* and IAS 40 *Investment Properties* to help lessees measure the fair value of right to use assets. Whilst this would be applicable for right to use assets not held for their service potential, it does may not help for assets which are held for their service potential.

In order to ascertain the valuation for these right to use assets, entities could consider the following valuation approaches:

- Valuation at the current market rate for rent of a similar right to use asset
- Valuation at exit – what someone in the market would pay to take on the lease

As assets are being held for their service potential it is not considered appropriate to value the assets based on what someone would pay to take on the lease as there would be no intention to sell the lease.

Discussions have found that most leases are constructed on market terms and contain rent reviews during the lease term, which would affect the underlying cash flows a lessee would need to pay. In such circumstances IFRS 16 would require a remeasurement of the liability with a corresponding adjustment made to the asset. It is not known whether these adjustments, in all circumstances, be equivalent to the actual current market value of the rentals, and therefore be considered true equivalent for market value in existing use.

An alternative approach would be to require lessees to perform an evaluation of their current rental payments against the market rates, in order to make adjustments to the valuation of the asset (with increases and decreases being scored in a revaluation reserve as appropriate). This would result in increased costs for preparers to obtain the valuations for their right of use assets. In addition, whilst this may be possible for property leases, it is considered significantly complex for both preparers and valuers to undertake such reviews for non-property leases without disproportionate cost and effort.

In order to reduce the costs and the complexity for preparers and valuers, HM Treasury proposes to adopt the IFRS 16 cost model for lessees as a proxy for the revaluation model adapted in the FReM under IAS 16.

Public Sector Interpretation: All entities using the FReM shall apply the cost model to determine the subsequent measurement of the right of use asset (IFRS 16 (30-33)) or if applicable, the fair value model for right of use assets classified as investment properties under IAS 40 *Investment Properties* (IFRS 16 (34)).

Question: Do you agree with the public-sector interpretation for subsequent valuation of assets? If so why? If not, why not and what alternatives do you propose?

Peppercorn Leases

Within the public sector there are a number of leases which are provided on a peppercorn basis (i.e. nominal consideration). At present, such assets are treated as finance leases under IAS 17 *Leases* by both the lessee and the lessor. This results in the lessor de-recognising the asset and the lessee treated the asset as if it were owner occupied.

Under IFRS 16, the measurement of the asset is based on the lease liability. However, this would result in a substantially low or nil value for peppercorn leases. this does not conform to the principles in the FReM that assets shall be carried at their current value in existing use or fair value at the reporting date.

In order to address this, HM Treasury proposes the following measurement criteria for peppercorn leases for lessees:

Public sector adaptation: All lessees shall measure peppercorn leases using the following criteria:

- Recognise a right of use asset and measure it using the initial measurement criteria under IAS 16 as adapted and interpreted in the FReM

- Recognise a lease liability measured in accordance with IFRS 16
- Recognise any difference between the carrying amount of the right of use asset and the lease liability as non-operating income in the Statement of Comprehensive Net Expenditure (or equivalent)
- Subsequent measurement of the right of use asset should follow the principles of IAS 16 as adapted and interpreted in the FReM

Question: Do you agree with the public sector adaptation for peppercorn leases? If so why? If not, why not and what alternatives do you propose?

Lessee Disclosures

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.

As per IAS 1 Presentation of Financial Statements and the Simplifying and Streamlining agenda, information should only be disclosed if it is 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.

Lessees are required to disclose a variety of quantitative and qualitative information. 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 These are summarised in Table 4.A.

Table 4.B: Lessee Disclosure Requirements

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

Source: IFRS 16 (51-60)

The concept of materiality, as it applies to disclosures, is fundamental. It is not appropriate to simply apply the disclosure requirements in IFRS 16 without considering materiality. Specific disclosures are not required under IFRS if the information resulting from that disclosure is not material. Care should be taken to not reduce the understandability of the financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures and functions. The materiality concept should also be applied on a disclosure-by-disclosure basis.

HM Treasury considers it appropriate to retain the disclosure requirements in full but to emphasise the materiality considerations that entities are expected to undertake in determining whether they are required to provide particular disclosures

HM Treasury will engage with preparers and issue additional application guidance to improve understanding of the disclosure requirements in advance of the effective date to support implementation of the Standard in the public sector.

Question: Are there any disclosure requirements for lessee accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

New leases - lessor accounting

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

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.

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

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.

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 (lessors who sublease)

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

Lessor disclosures

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.).

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. Table 4.B. includes some of the disclosure requirements lessors are required to include as a minimum to meet the disclosure objective.

Table 4.C: Lessor Disclosure Requirements

Quantitative	Qualitative
• Fixed and variable payments for operating leases • Selling profit or loss, finance income and variable lease payments for finance leases • 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

Source: IFRS 16 (89-97)

Similar to lessee disclosures, HM Treasury considers it appropriate to retain the disclosure requirements in full but to emphasise the materiality considerations that entities are expected to undertake in determining whether they are required to provide particular disclosures.

Question: Do you agree with the proposals for lessee accounting? If so why? If not, why not and what alternative do you propose?

Question: Are there any disclosure requirements for lessor accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

Sale and Leaseback

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.

No adaptations or interpretations are proposed to the accounting for sale and leaseback transactions.

Do you agree no adaptations or interpretations for the public-sector context is required for sale and leaseback? If so why? If not, why not and what alternatives do you propose?

Transition

Definition of a lease

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.

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 identification of a lease using IFRS 16 will only apply to contracts entered into (or changed) on or after the date of initial application.

In order to improve consistency across the public sector and reduce the burden on preparers on the application of IFRS 16, HM Treasury proposes to mandate this practical expedient.

Public Sector Interpretation: The option to reassess whether a contract is, or contains, a lease at the date of initial application has been withdrawn. All entities should use the practical expedient detailed in IFRS 16 (C3) unless they have the explicit approval from the relevant authority otherwise.

Question: Do you agree with the public-sector interpretation on grandfathering existing lease classifications? If so why? If not, why not and what alternatives do you propose?

Transition for Lessees

Lessee Transition Method

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).

To reduce the burden for preparers and in order to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the Whole of Government Accounts (WGA), HM Treasury proposes the following transition approach to be applied across the public sector in relation to transition: **Option 2 Cumulative Catch Up Approach.**

Public Sector Interpretation: Upon transition, the accounting policy choice to retrospectively restate in accordance with IAS 8 has been withdrawn. All entities applying the FReM shall recognise the cumulative effects of initially applying the Standard recognised at the date of initial application as an adjustment to the opening balances of taxpayer's equity (or other component of equity, as appropriate) per IFRS 16 C5(b).

Question: Do you agree with the transition approach for the proposed amendments? If so why? If not, why not and what alternatives do you propose?

If the Option Two (cumulative catch up approach) transition approach is chosen, there are a number of transition options and practical expedients detailed that would be available to reporting entities. These are discussed further below.

Leases previously classified as operating leases

Liability Measurement

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.

To align with the public sector interpretation for new leases, the incremental rate of borrowing is proposed to be determined centrally by HM Treasury.

Asset Measurement

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.

In order to reduce the burden on preparers and to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the Whole of Government Accounts (WGA), HM Treasury proposes to apply **Option 2**.

Public Sector Interpretation: Upon transition, entities should measure the right of use asset per IFRS 16 (C8 (b)(ii)); 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.

Question: Do you agree with the public-sector interpretation for asset measurement upon transition? If so, why? If not, why not and what alternatives do you propose?

Further transition options, reliefs, practical expedients

Notwithstanding the requirements above, IFRS 16 allows a number of further transition options, reliefs and practical expedients. These are:

- No requirement to make adjustments for leases for which the underlying asset is of low value that will be accounted for applying IFRS 16 (6). (IFRS 16 C9 (a))
- No requirement to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40 Investment Property. (IFRS 16 C9(b))
- Lessees shall measure the right of use asset at fair value at the date of initial application for leases previously accounted for as operating leases applying IAS 17 and that will be accounted for as investment property using the fair value model in IAS 40 from the date of initial application. (IFRS 16 C9 (c)).
- A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics. (IFRS 16 C10(a))
- 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. (C10 (b))

- 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. (C10 (c))
- A lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application (C10 (d))
- A lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease (C10 (e))

With regard to the application of the discount rate, per the interpretation for new leases, the incremental rate of borrowing discount rate will be set irrespective of characteristics of the leases (such as lease term or type of underlying asset).

For the remaining options detailed above, HM Treasury propose to mandate certain options across the public sector to align with the proposals for new leases in these categories or to ease the burden on preparers. Where options are left to the discretion of each entity, these are in areas where the application is on a lease by lease basis. There is no strong reason to withdraw flexibility for entities to apply the expedients. The IASB determined that applying all of these practical expedients would not significantly impact on the reported figures.

Public Sector Interpretation: The option available for the following transition options has been withdrawn. All entities must apply the following transition options in IFRS 16:

- No requirement to make adjustments for leases for which the underlying asset is of low value that will be accounted for applying IFRS 16 (6). (IFRS 16 C9 (a))
- A lessee may elect not to transition to leases for which the lease terms ends within 12 months of the initial date of application (C10 (d)).
- A lessee may use hindsight, such as determining the lease term if the contract contains options to extend or terminate the lease (C10 (e))

Question: do you agree with the public sector interpretation on practical expedients when applying IFRS 16 upon transition? If so why? If not, why not and what alternatives do you propose?

Leases previously classified as finance leases

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.

No adaptations or interpretations are proposed for leases previously classified as finance leases.

Disclosures on Transition

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.

No adaptations or interpretations are proposed on the disclosures required for transition.

Question: do you agree with the transition proposals for lessee accounting and disclosures? If so why, if not why not and what alternatives do you propose?

Transition for Lessors

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:

- 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.
- 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.
- No adaptations or interpretations are proposed for transition for lessors.

Question: Do you agree with the transition proposal for lessor accounting? If so why, if not why not and what alternatives do you propose?

Impacts on consolidation

Asymmetry

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 Statement of Financial Positions and at different values. This in turn will increase the number of eliminations required in group consolidation and the Whole of Government Accounts (WGA).

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.

HM Treasury does not propose to change the lessor accounting in IFRS 16 to address the asymmetry issues.

Other accounting frameworks

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.

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)).

Whole of Government Accounts

Consistency of reporting methodology and disclosure requirements is preferable from a WGA perspective. However, it is recognised that given the individual nature of each public sector body, it is unlikely to be appropriate to mandate the same disclosures in every account, especially where it would not be material for the organisation.

WGA will need to ensure the right data is collected from public sector entities to facilitate the WGA consolidation process. This process and the requirements from entities will need to be considered in advance of the data collection tool being issued. The concept of materiality from a WGA perspective will be important when assessing the impact of the Standard across government and the relevant sectors.

The WGA team will need to consider these challenges as they develop their implementation plan for IFRS 16. Subject to responses from this consultation, HM Treasury proposes that IFRS 16 will be applied in full to WGA.

Question: Do you have any comments on the impacts IFRS 16 will have on consolidation? Please explain any comments, including providing alternatives HM Treasury should consider.

Accounting for service concession arrangements

Per the FReM[3], entities are required to assess whether service concession arrangements contain a lease under IFRIC 4. If the arrangement does contain a lease, then this would need to be accounted for under IAS 17.

[3] Government Financial Reporting Manual, Chapter 7, Accounting for PPP arrangements, including PFI contracts, under IFRS

As IFRIC 4 is being superseded by IFRS 16 the references in the FReM will need to change. For arrangements that contain a finance lease recognised on the Statement of Financial Position for accounting purposes, this should not result in significant changes. However, where arrangements contain an operating lease, the introduction of IFRS 16 will result in assets and liabilities relating to that lease being recognised on the Statement of Financial Position.

To align the accounting of leases across all elements of the financial statements, HM Treasury propose to change the respective references in FReM to IFRS 16. Chapter 5 contains details of the proposed FReM amendments.

Question: Do you agree with the proposals for aligning the accounting of service concession arrangements that contain a lease with IFRS 16? If so why? If not why not, and what alternatives do you propose?

Implementation

Timetable

The effective date of IFRS 16 is from 1 January 2019. HM Treasury proposes to apply IFRS 16 effective from 1 April 2019 for the public sector. The implementation timetable HM Treasury is working towards can be found on Box 4.A.

Box 4.A: IFRS 16 Implementation Timetable

Spring 2018	Exposure Draft for consultation
Summer 2018	Review responses and prepare Application Guidance
November 2018	FRAB meeting to approve the 2019-20 FReM
December 2018	2019-20 FReM and Application Guidance published
January 2019	IFRS 16 implementation date
April 2019	UK public sector implementation of IFRS 16

Question: do you agree with the proposed effective date for the public-sector implementation of IFRS 16? If so why? If not, why not and what alternatives do you propose?

Other business considerations

There are a number of areas where the introduction of IFRS 16 may impact on other business activities. These include:

- In planning for the adoption of IFRS 16, it is important that preparers have a good understanding of how IFES 16 will impact them on transition and business thereafter. As IFRS 16 requires a detailed analysis of individual or portfolio of leases, it is important that commercial colleagues have a good understanding of the impacts when writing or negotiating leases.

- IFRS 16 introduces the need for additional data, to support the methodology and disclosure requirements and infrastructure for developing new processes systems and controls to ensure entities are able to implement IFRS 16 successfully.

- Certain entities have or impose restrictions on others for assets and liabilities that are brought onto the Statement of Financial Position. These entities may need to consider whether changes are required to be made as a result of the introduction of IFRS 16.

- There may be tax implications following the introduction of IFRS 16. HMRC's consultation[4] on tax implications for plant and machinery leases has recently closed and responses are being considered.

Question: Are there any other areas not covered by the questions which you would like to comment on? Please explain any comments, including providing alternatives HM Treasury should consider.

[4] https://www.gov.uk/government/consultations/plant-and-machinery-lease-accounting-changes

Chapter 5

Proposed amendments to the Government Financial Reporting

Introduction

An amendment to each of the following chapters is proposed:

- Chapter 5, Form and content of the annual report and accounts
- Chapter 6, Applicability of accounting standards
- Chapter 7, Further guidance on accounting for assets and liabilities

Why the amendments are proposed

The amends proposed in this exposure draft seek to amend the FReM to incorporate the financial reporting principles contained in IFRS 16 where it is appropriate for them to be applied.

Effective date of amendments

The effective date for the proposed amendments is 1 April 2019

Proposed amendments

FReM amendments are proposed to reflect IFRS 16 being adopted for the first time.

Box 5.A: Draft FReM Extract

5 Form and content of the annual report and accounts

5.4 The Financial Statements

Notes to the accounts

5.4.26 Commitments under PFI contracts – For 'off-balance sheet' service concessions entities should disclose the total payments to which they are committed distinguishing between those that are due to be made within one year, between one and five years, and later than five years. For 'on-balance sheet' service concession arrangements the relevant IAS 17 and SIC 29 disclosures should be made. In addition, entities should ensure they disclose the total commitments due within one year, between one and five years and later than five years.

5.4.26 Commitments under PFI contracts – Entities should ensure the relevant IFRS 16 and SIC 29 disclosures should be made. In addition, entities should ensure they disclose at a minimum, total commitments due in each of the first five years, between five and ten years and later than 10 years.

6 Applicability of accounting standards

6.1 EU adopted IFRS

6.1.1 A list of EU adopted IFRS is shown in Table 6.1, together with a record of whether they have been adapted or interpreted for the public sector context in this Manual. All standards apply to all reportable activities and reporting entities applying this Manual to the extent that each standard is relevant to those activities and in the light of any statutory requirements or other pronouncements that might from time to time be made by the relevant authorities. Where adaptations or interpretations are different for ALBs this is identified below.

Table 6.1

International Standard	Applies without adaptation	Applies as interpreted for public sector	Applies as adapted for public sector	Different adaptations or interpretation for ALBs
IAS 17 Leases	•	•	•	
IFRS 16 Leases		•	•	

6.2 Interpretations and adaptations for the public sector context

6.2.1 Table 6.2 provides details of those adaptations and interpretations for the public sector context. Where an adaptation or interpretation to a standard results in an inconsistency with a relation interpretation issued by the

IFRS Interpretations Committee (IFRIC) or Standards Interpretation Committee (SIC), that interpretation is similarly adapted or interpreted. In all other cases, IFRIC and SIC Interpretations will apply in full.

6.2.3 Chapter 10 of this Manual provides additional guidance on adaptations and interpretations for the Whole of Government Accounts

Table 6.2

IFRS 16 Leases	
Interpretations	1. The option to apply the election in IFRS 16 (5) has been withdrawn. All entities must apply the election in IFRS 16 (5) to not apply the requirements in paragraphs 22-49 to short term leases. 2. Where entities cannot readily obtain the interest rate implicit in the lease, they should use the HM Treasury discount rate promulgated in PES papers 3. All entities using the FReM shall apply the cost model to determine the subsequent measurement of the right of use asset (IFRS 16 (30-33)) or if applicable, the fair value model for right of use assets classified as investment properties under IAS 40 Investment Properties (IFRS 16 (34)) 4. The option to reassess whether a contract is, or contains, a lease at the date of initial application has been withdrawn. All entities should use the practical expedient detailed in IFRS 16 (C3) unless they have the explicit approval from the relevant authority otherwise. 5. Upon transition, the accounting policy choice to retrospectively restate in accordance with IAS 8 has been withdrawn. All entities applying the FReM shall recognise the cumulative effects of initially applying the Standard recognised at the date of initial application as an adjustment to the opening balances of taxpayer's equity (or other component of equity, as appropriate) per IFRS 16 C5(b). 6. Upon transition, entities should measure the right of use asset per IFRS 16 (C8 (b)(ii)); 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. 7. Upon transition, the option available for the following transition options has been withdrawn. All entities applying the FReM must apply the following options:

	• No adjustments for leases for which the underlying asset is of low value that will be accounted for applying IFRS 16 (6). (IFRS 16 C9 (a)) • No transition for leases for which the lease term ends within 12 months of the date of initial application. (C10 (d)) • Use hindsight, in determining the lease term if the contract contains options to extend or terminate the lease (C10 (e))
Adaptations	1. The definition of a contract is expanded to include intra UK government agreements where non-performance may not be enforceable by law. 2. All lessees shall measure peppercorn leases using the following criteria: • Recognise a right of use asset and measure it using the initial measurement criteria under IAS 16 as adapted and interpreted in the FReM • Recognise a lease liability measured in accordance with IFRS 16 • Recognise any difference between the carrying amount of the right of use asset and the lease liability as non-operating income in the Statement of Comprehensive Net Expenditure (or equivalent). • Subsequent measurement of the right of use asset should follow the principles of IAS 16 as adapted and interpreted in the FReM.

7 Accounting for PPP arrangements, including PFI contracts, under IFRS

7.1.49 This section of the Manual deals with the accounting treatment of PPP arrangements, including PFI contracts, that meet the definition of service concession arrangements in IFRIC 12 Service Concession Arrangements. To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor (the public sector) (IFRIC 12.3). Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public. Examples of infrastructure for public services are: roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, telecommunication networks, permanent installations for military etc. operations, and non-current assets used for administrative purposes in delivering services to the public.

7.1.50 The private sector operator will apply IFRIC 12 to those arrangements where:

a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

b) the grantor controls – through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.

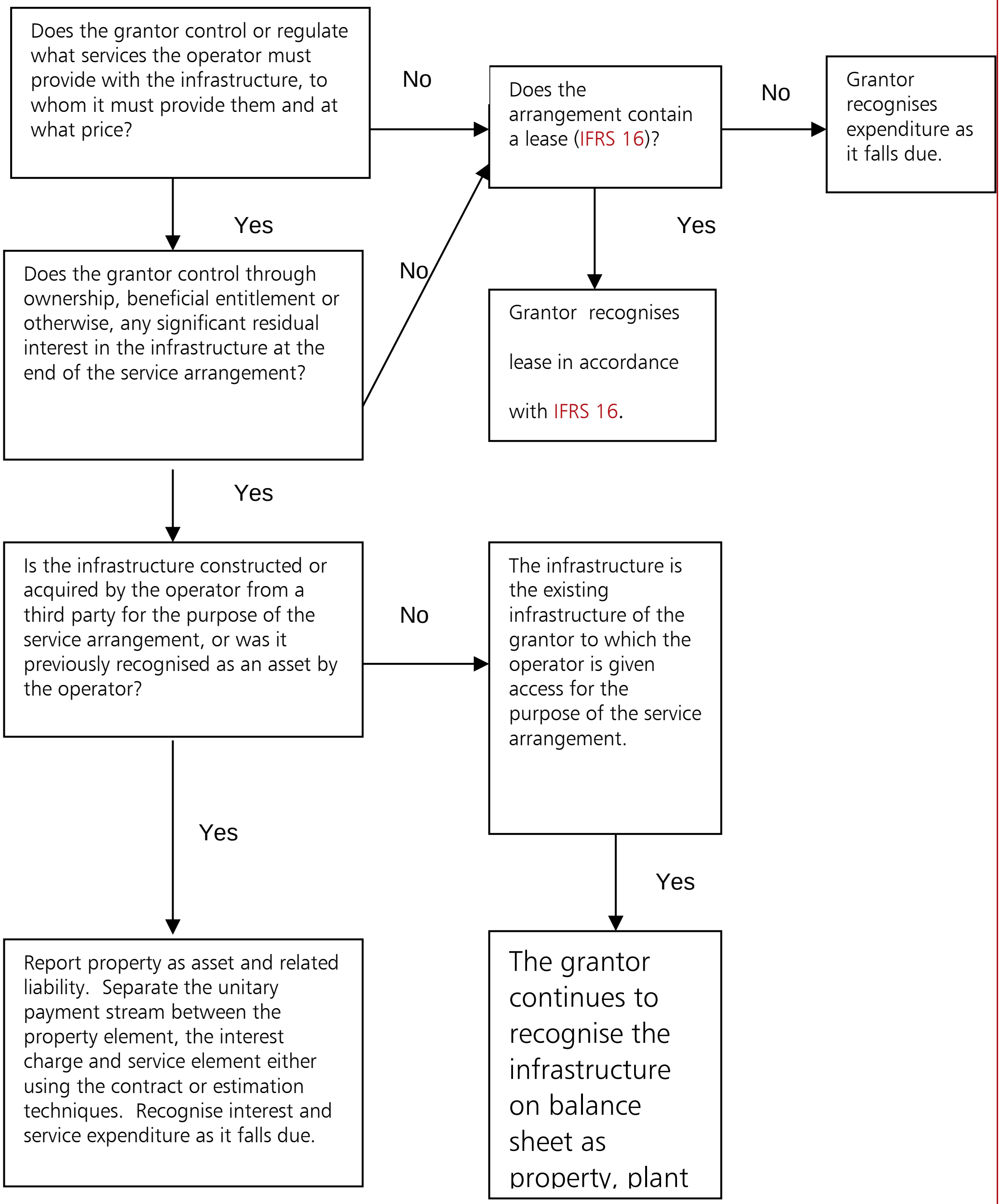
7.1.51 IFRIC 12 (Application Guidance paragraph 3) notes that, in determining the applicability of the first condition, non-substantive features (such as price capping that would apply only in remote circumstances) should be ignored and the substance of the arrangement considered.

7.1.52 IFRIC 12, including the Appendices, Information Notes, Illustrative Examples and Basis for Conclusions, provides guidance on how to apply IFRS to service concession arrangements. IFRIC 12 does not create exceptions from other IFRS for transactions that are within service concession arrangements, other than as specifically stated in IFRIC 12. Issues not addressed explicitly in this section of the Manual should be resolved by reference to other IFRS. IFRIC 12 applies to:

- arrangements where the infrastructure is used for its entire useful life;
- infrastructure that the operator constructs or acquires from a third party; and
- infrastructure that the grantor provides to the operator for the purpose of the concession.

IFRIC 12 does not specify the accounting for infrastructure that was held and recognised as an asset by the operator prior to entering the arrangement (IFRIC 12.6-8). This is because the operator would de-recognise the asset under IAS 16. Paragraph 7.1.48 interprets IFRIC 12 for the public sector by including an asset previously owned by the operator within the criteria for recognising the arrangement as a service concession. The flowchart overleaf will assist in determining the appropriate accounting treatment of PPP arrangements, including PFI contracts by public sector grantors.

Flowchart of accounting for PPP arrangements



Initial recognition and measurement of assets and liabilities in new arrangements and contracts

7.1.53 Where there is infrastructure, whether previously owned by the contractor or the grantor, or constructed or acquired from a third party for the purpose of the service arrangement, and the grantor:

a) Controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

b) Controls through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement (or there is no residual interest).

Then the PPP arrangement or PFI contract is a service concession within the meaning of IFRIC 12 from the grantor's viewpoint.

7.1.54 The grantor should recognise the infrastructure as a non-current asset and value it in the same way as other non-current assets of that generic type. The asset will be recognised when:

a) it is probable that future economic benefits associated with the asset will flow to the organisation; and

b) the cost of the asset can be measured reliably.

The grantor should consider the asset recognition criteria, together with the specific terms and conditions of the binding arrangement, when determining whether to recognise the service concession asset during the period in which the asset is constructed or developed. If the asset recognition criteria have been met a work-in-progress service concession asset and associated liability should be recognised. If not and the grantor makes contributions to the operator in advance of the asset coming into use, the grantor should account for those payments as prepayments.

Subsequent measurement

7.1.55 The asset will be measured in one of two ways:

a) where the contract is separable between the service element, the interest charge and the infrastructure asset (see also paragraph 7.1.51), the asset will be initially measured following the guidance in IFRS 16, with the service element and the interest charge recognised as incurred over the term of the concession arrangement (the subsequent measurement should be subject to the guidance of IAS 16); or

b) where there is a unitary payment stream that includes infrastructure and service elements that cannot be separated, the various elements will be separated using estimation techniques as set out in paragraph 7.1.52.

7.1.56 The grantor should separate out the service, interest and infrastructure elements. A contract may be separable in a variety of circumstances, including but not limited to the following:

a) the contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services;

b) different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract; or

c) different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.

7.1.57 In situations where it is not possible to separate the contract due to commercial reality, the service element of the payments must be estimated, which could be achieved by obtaining information from the operator or by using the fair value approach. The fair value of the asset determines the amount to be recorded as an asset with an offsetting liability. The total unitary payment is then divided into three: the service charge element, repayment of the capital element of the contract obligation and the interest expense on it (using the interest rate implicit in the contract).

7.1.58 For both existing and new contracts, where it is not practicable to determine the interest rate implicit in the contract, the grantor shall use its cost of capital rate (including inflation). It is expected that this situation would be rare. The rate should not be changed unless the infrastructure element or the whole of the contract is renegotiated.

7.1.59 Entities covered by the requirements of this manual should use the Treasury discount rate for investment appraisal purposes (currently 3.5%) as their cost of capital rate. This rate is stated in real terms and must be adjusted for the inflation rate to arrive at the nominal rate. The nominal rate can be calculated using inflation rates given in the table 16 of the Treasury's Pocket Data Bank. The Pocket Data Bank can be found at on the gov.uk website.

7.1.60 Under either approach, the grantor will recognise a liability for the capital value of the contract. That liability does not include the interest charge and service elements, which are expensed annually to the Statement of Comprehensive Net Expenditure.

7.1.61 Reporting entities should adopt an appropriate asset revaluation approach as set out earlier in this chapter. Liabilities will be measured using the appropriate discount rate, taking account of the reduction arising from the capital payments included in the unitary payment stream.

7.1.62 Revenue received under any revenue sharing provision in the service concession arrangement should be recognised when all the conditions as laid down in IFRS 15 have been satisfied.

7.1.63 The grantor should recognise any guarantees to the operator that it will meet any shortfalls in revenue or repay the debt if the operator defaults in line with the requirements of IAS 32 and IFRS 9.

7.1.64 The grantor should derecognise a non-current asset provided to the operator (and not used in the arrangement) and recognise any consideration received at fair value. If the consideration received is in the form of a reduction in future payments, this should be recognised as an asset representing a reduction in the future liability (normally as a prepayment).

Disclosure

7.1.65 The disclosure requirements in respect of PPP arrangements, including PFI contracts, are set out in chapter 5 of this manual.

Chapter 6

National Accounts

The Clear Line of Sight alignment project aims 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).

The recording for leases under ESA 10 may no longer be aligned with the principles for recording leases proposed in IFRS 16 because the distinction of finance and operating leases for lessees remain in ESA10 but has been removed in IFRS 16. A separate work programme has been established with the Office of National Statistics 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 remains conscious of the impacts any misalignments in accounting, budgeting and Estimates frameworks would cause within the public sector.

Using the principles of ESA 10, we have analysed the options chosen for IFRS 16 and have highlighted potential areas where they may not align. Table 6.A provides details of the significant areas.

Table 6.A: Potential alignment issues between ESA 10 and IFRS 16

Options	Potential alignment issues
Transition approach	When transactions and balances are restated for the National Accounts, they are fully retrospectively restated to prevent a step change in the data. This is different to the cumulative catch up approach proposed
Asset measurement on transition	As ESA 10 prefers retrospective restatement, the valuation basis of assets is its fair value at inception. This is different to the preferred option of the asset being valued the same as the liability (subject to some adjustments) and the alternative option of the carrying amount at inception discounted using the incremental rate of borrowing
Valuation of assets	ESA10 requires the underlying assets to be subsequently valued at current value. This is different to the proposal to use the cost model for the right of use assets which

	comprises of the cost (initial measurement of the lease liability (subject to certain adjustments)) less any accumulated depreciation and impairment losses and adjustment for certain re-measurement of the lease liability
Land Leases	Within ESA 10 land is always deemed to be an operating lease, unless it cannot be reasonably segregated from other leased assets. IFRS 16 requires land to be capitalised as a right of use asset

Question: Are there any options available in IFRS 16 that your entity would be significantly concerned about adopting, were HM Treasury try to align with ESA 10? Please explain any comments, including providing alternatives HM Treasury should consider.