HM TREASURY

FRAB 134 (02)
22nd November 2018

# Financial Reporting Advisory Board paper

## IFRS 16 *Leases*

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| Issue: | HM Treasury published an Exposure Draft on IFRS 16 in May 2018. The FRAB received out-of-meeting papers on IFRS 16 on 20 September and 26 October providing summaries of the feedback received on the Exposure Draft and HM Treasury proposals on what the final FReM guidance on IFRS 16 should be. This paper provides a final summary of HM Treasury recommendations for FReM guidance on IFRS 16. |
| Impact on guidance: | The FReM will be updated for FY19/20 for any entities applying IFRS 16 as of 1 April 2019. |
| IAS/IFRS adaptation? | Adaptations are proposed for the definition of a lease, and accounting for peppercorn leases. Both adaptations address public sector-specific aspects of leasing. |
| Impact on WGA? | The adoption of IFRS 16 may affect how lease accounting is applied for the 2019-20 WGA (depending on the final decisions on effective date and early adoption). |
| IPSAS compliant? | Prior to IFRS 16, IPSAS and IFRS were broadly consistent. IPSASB are consulting on a new IPSAS on lease accounting. The most significant difference with IFRS is the IPSASB's proposal to align lessor and lessee accounting. IPSASB's proposal regarding concessionary leases (including peppercorn leases) also contains some differences from the FReM proposals. |
| Interpretation for the public sector context? | Interpretations are proposed for the public sector context for short-term leases; discount rate; subsequent measurement of the right-of-use asset; and transition. |
| Impact on budgetary regime and Estimates? | Yes, although a formal decision for budgets has not yet been made. |
| Alignment with National Accounts | Prior to IFRS 16, the ONS accepted IAS 17 as a suitable proxy for national accounts requirements. IFRS 16 recognises more leases on balance sheet than required by national accounts. HM Treasury are working closely with ONS to manage this misalignment. |
| Recommendation: | The Board considers and provides views on the issues discussed in this paper. |
| Timing: | Amendments to the FReM confirmed at this meeting will be published in December 2018. |

DETAIL

## *Background*

1. The International Accounting Standards Board (IASB) has issued IFRS 16 *Leases*, which replaces IAS 17 *Leases*; IFRIC 4 *Determining whether an Arrangement contains a Lease;* SIC-15 *Operating Leases—Incentives*; and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. IFRS 16 has been approved by the European Commission and published in the Official Journal in November 2017.

2. HM Treasury issued an Exposure Draft in May 2018 proposing changes to the FReM for IFRS 16. The consultation period for the Exposure Draft ended in August 2018. Out-of-meeting papers were distributed to the Board on 20 September 2018 and 26 October 2018. These papers provided the Board with an update of the responses to the Exposure Draft; early sight of the proposed amendments to the FReM for IFRS 16; and analysis of whether the proposed 1 April 2019 effective date should be confirmed, and whether early adoption should be allowed if the effective date is deferred. Board members provided feedback to those papers.

## *Purpose of this paper and Board feedback*

3. The main purposes of this paper are to:

- provide the Board with analysis and recommendations regarding IFRS 16 effective date and early adoption.
- summarise HM Treasury's proposals regarding FReM adaptations and interpretations to IFRS 16.

Most of the analysis and recommendations in this paper should not be new to the Board and have been previously discussed in the two out-of-meeting papers. This paper will highlight where any analysis or recommendations have changed from the September or October out-of-meeting papers. HM Treasury would like to take this opportunity to thank Board members for their engagement with the project over the last few months; the feedback received on both out-of-meeting papers was extremely helpful in further refining HM Treasury recommendations.

## *Effective date of IFRS 16*

### *Background and information gathered since September*

4. The 20 September 2018 out of meeting paper summarised the feedback received at that time regarding the effective date of IFRS 16, and asked Board members for their views on whether the 1 April 2019 effective date should be confirmed. To summarise the feedback received at that date at a high level, the majority of respondents to the Exposure Draft were supportive of a 1 April 2019 effective date, although some did so on the condition that final budgeting and accounting guidance was made available as soon as possible. A minority advocated for a deferral. There were subsequent concerns expressed by the Finance Leadership Group (senior finance directors) about a 1 April 2019 effective date.

5. Subsequent to the 20 September paper, new information has been gathered about the effective date through:

- feedback from Board members (to the out-of-meeting paper);

- feedback from the Resource Accounts Special Interest Group and selected departments (to specific questions posed about effective date and the feasibility of dual reporting); and
- discussions with the ONS (to specific questions posed about the national accounts treatment in FY19/20 and future years).

6. Subsequent to the 26 October paper, there was one further update regarding the effective date. After debate and considering HM Treasury's recommendations in this paper, as well as implications on the Whole of Government Accounts, CIPFA/LASAAC has agreed to defer the effective date of IFRS 16 to 1 April 2020, if the FRAB also decide to do so in this meeting (see discussion in FRAB 134(04)).

*HM Treasury analysis and recommendation*

7. <u>HM Treasury recommend that the effective date of IFRS 16 be deferred until 1 April 2020.</u>

8. The primary reason that HM Treasury recommends deferral is because of the budgetary complications. In summary:

- ONS has confirmed that it requires HM Treasury to provide data for national accounts on an IAS 17 basis for FY19/20.
- Time constraints, and the requirement to provide ONS with IAS 17 data, mean that it is not practical to implement IFRS 16 in budgets in FY19/20.
- A single-year deferral maintains alignment between the resource accounts, budgets and national accounts whilst a long-term solution is agreed with the ONS.

Further detail on HM Treasury's analysis is included below.

*National accounts framework*

9. ONS have always been consistent that leases should be classified for national accounts purposes using ESA 10, and have used IAS 17 as a proxy for this. As discussed in the June 2018 FRAB meeting (refer to paper 133(07)), the ONS have recently investigated whether IAS 17 is an appropriate proxy to classify full repair and insure (FRI) leases for national accounts purposes, and initially concluded that these FRI leases should be classified as finance leases for national accounts purposes (which would not necessarily be the case using IAS 17 but would be under IFRS 16).

10. On 9 October 2018, the ONS confirmed that leases classification will not change in the national accounts for FY19/20 (and that, therefore, the ONS will need IAS 17 leases data for FY19/20). HM Treasury welcomes this confirmation, as it provides a concrete basis to determine what information about leases HM Treasury needs to provide to the ONS. However, given the timeframe, HM Treasury would be concerned about the feasibility of providing data for the national accounts on an IAS 17 basis for FY19/20 if budgets are prepared using IFRS 16 (as the ONS generally uses budgeting-based data to populate the national accounts).

11. HM Treasury notes that the ONS will have to adjust IFRS 16 data to arrive at IAS 17 information in the private sector (although the ONS has not yet finalised its methodology for doing so). However, the ONS has communicated to HM Treasury that the methods used to make adjustments to arrive at IAS 17 information in the private sector may not be acceptable in the public sector, as there is higher scrutiny and a lower tolerance for error in the public sector (because public sector national accounts information is used to produce fiscal statistics).

12. Bearing this in mind, while we are actively working to agree a methodology with the ONS to ensure that national accounts are still ESA 10-compliant even with the provision of IFRS 16

information, there is no guarantee that this methodology will be agreed and implemented by 1 April 2019.

13. It is important to note, however, that HM Treasury and the ONS have agreed a joint work plan to work together to address the data and classifications issues surrounding the treatment of leases in national accounts, in order to arrive at a more permanent solution in FY20/21 and beyond.

14. The first stage of the work plan is already in progress and includes HM Treasury assessing a sample of leases using ESA 10 and comparing those results to an IAS 17 and IFRS 16 treatment. The work plan additionally includes ONS collaboration with other international standard-setters and preparers of national accounts to see what the best practice will be for the treatment of leases in the public sector. This joint work plan should ensure that the delays that happened this year will be avoided in the future.

*Budgeting framework*

15. HM Treasury believes that it is inadvisable to pursue an IFRS 16-based budget framework for FY19/20. ONS require IAS 17 data for FY19/20 national accounts, and generally populate the national accounts with the budgeting-based data provided by HM Treasury. There would be significant issues in agreeing a methodology for adjusting IFRS 16 budget data across government back to IAS 17 data for FY19/20. Additionally, there will be a significant fiscal risk if budgeting and national accounts are misaligned.

16. Moreover, there are multiple practical difficulties in implementing an updated IFRS 16-based budget framework for FY19/20, given the time pressures that now exist. These practical difficulties include cross-government consultation; training on any changes to budgeting guidance; creation of and implementation of new budgeting codes; and the consequences of the shift from resource expenditure to capital expenditure, such as preparing information based on the new budgeting guidance for Main Estimates in early 2019 and the impact on control mechanisms.

*Alignment considerations*

17. If it is accepted that an IFRS 16-based budget in FY19/20 is not practically feasible, there is then a question whether using IAS 17 for budgets, but IFRS 16 for accounts is an appropriate solution. One obvious disadvantage of any misalignment between budgets and accounts is the significant practical difficulties of the dual reporting it would require, given the substantial number and value of leases that are entered into across government. Discussions have been held with a number of departments, and there was a consistent concern that the dual reporting required by a misalignment between budgets and accounts would have a significant resource requirement. Some of those departments with the largest number of leases indicated that dual reporting was not practically feasible for FY19/20. There is no longer time to set up a systems-based solution for dual reporting for leases in FY19/20 in a manner that represents value for money, and a manual spreadsheet-based solution is also not practical for these departments, given the number of leases they enter into.

18.In addition to the practical difficulties, providing different frameworks on lease accounting for accounts and budgets would go against the Clear Line of Sight project, thereby undermining accountability and adding complexity. Different lease accounting frameworks would require departments to manage against various controls and increase the difficulty of tracking spending, therefore limiting the scope of Parliamentary scrutiny and making it more difficult to manage public money. Maintaining a single framework for leases will promote transparency, accountability and efficiency. HM Treasury has committed to meeting Clear Line of Sight objectives and would not recommend dual frameworks for lease accounting unless all other options are exhausted.

19. The combination of these factors leads to HM Treasury's conclusion that preparing accounts and budgets on an IAS 17 basis for FY19/20 and on an IFRS 16 basis from FY20/21 onwards is our preferred approach. We are working with the ONS on options for FY20/21 onwards and believe that alignment on an IFRS 16 basis may be feasible.

*Other considerations*

20. HM Treasury is sympathetic to concerns raised about resource and the efforts involved in IFRS 16 implementation. EU Exit and the 2019 Spending Review are one-off events that will involve significant commitment from departments. Moreover, IFRS 16 generally will require significant effort to implement across government, given the high number and value of leases in the public sector. HM Treasury appreciate that the delay in providing final guidance, especially around the budgeting treatment, has inhibited departments' ability to implement IFRS 16 in the most cost-effective manner.

21. HM Treasury consider it important to limit the deferral of IFRS 16 for just one year, to 1 April 2020, for a number of reasons:

- As discussed above, HM Treasury and the ONS have created a joint work plan to arrive at a more permanent solution for how leases will be treated in national accounts from FY20/21 and afterwards.
- HM Treasury plan to publish IFRS 16 application guidance in December 2018, and leases budgeting guidance in March 2019; departments will have a long lead time, with certainty over what the accounts and budget requirements will be, to implement the Standard. HM Treasury will also continue our work with the Technical Working Group, the Technical Accounting Centre of Excellence, One Finance, the Government Financial Academy and the Resource Accounts Special Interest Group to ensure that all resources available to support implementation are being fully utilised over the next year.
- By 1 April 2020, there should be more certainty over EU Exit and the 2019 Spending Review and correspondingly less departmental resource needed for these areas.
- The Spending Review provides an opportunity to update departments' baseline budgets for the changes to IFRS 16.
- Many of the respondents to the Exposure Draft supported a 1 April 2019 effective date.

22. HM Treasury would also like to confirm that recommending deferral of IFRS 16 for one year should in no way be treated as a precedent for other standards and that HM Treasury remains committed to the on-time adoption of new IFRS.

***Q. Does the Board agree with the HM Treasury recommendation to defer the effective date of IFRS 16 until 1 April 2020?***

## *Early adoption of IFRS 16*

### *Background*

23. If the deferral of IFRS 16 to 1 April 2020 is confirmed, a serious issue will be created for departments with material subsidiaries which, under the Companies Act, are required to follow

IFRS as adopted by the EU (rather than the FReM) and where those subsidiaries hold leases that are material in aggregate at the group level. Those subsidiaries will be forced to apply IFRS 16, but at the group level IFRS 16 treatment will need to be unwound and IAS 17 information will be needed. Moreover, national accounts reporting will continue to be on an IAS 17 basis in FY19/20.

24. HM Treasury has had extensive conversations with two departments who will be affected by this issue, the Department for Culture, Media and Sport (where the BBC will be adopting IFRS 16 from 1 January 2019) and the Department for Transport (where Network Rail and HS2 will be adopting IFRS 16 from 1 January 2019). Both DCMS and DfT have significant concerns about deferral of IFRS 16 and have warned that a deferral would jeopardise their ability to lay their accounts on time and would be risking a qualification and the general quality of the accounts. Moreover, they have invested significantly in implementation systems for IFRS 16 which would be difficult to reverse at this point.

25. Subsequent to the October out-of-meeting paper, HM Treasury has also had conversations with the Resource Accounts Special Interest Group, and the Technical Working Group, testing potential criteria for early adoption. This outreach has caused us to propose a slight revision to our recommendations regarding criteria for early adoption (as explained below).

26. Finally, subsequent to the October out-of-meeting paper, HM Treasury held an Alignment Review Committee meeting discussing early adoption and the associated potential budgetary changes that would impact the budgetary classification of lease expenses and voted budget totals. The Alignment Review Committee agreed with HM Treasury proposals in this area (as summarised below), noting that they were consistent with the Clear Line of Sight principles.

*HM Treasury analysis and recommendation*

27. HM Treasury is concerned about the difficulties faced by DCMS and DfT that would result from deferral of IFRS 16. These would be unavoidable, as the basis of reporting for entities like the BBC and Network Rail is out of HM Treasury's control.

28. In order to address these issues, HM Treasury recommend that the FReM contain an option to allow early adoption of IFRS 16 from 1 April 2019 for entities where the following criteria are met:

a) the entity has at least one subsidiary that, under the Companies Act, is required to follow EU-adopted IFRS and the total assets of the subsidiary comprise at least 10% of the total assets at the group level;

b) the subsidiary (or subsidiaries) described above have operating lease commitments that comprise at least 10% of the operating lease commitments at the group level; and

c) approval to early adopt has been received from HM Treasury.

29. Board members may note that the above criteria are slightly different from the criteria proposed in the October out-of-meeting paper (the criteria focused on materiality rather than the 10% thresholds above, and did not contain the HM Treasury approval requirement). Based on conversations with different government departments in October and November, HM Treasury determined it was necessary to further strengthen the criteria. HM Treasury believes that the amended criteria should capture DCMS and DfT, but would not encompass any other entities. HM Treasury would also create IFRS 16-based budgeting for leases for these entities to follow from 1 April 2019 (and would plan to publish that guidance by March 2019).

30. Although allowing early adoption in these limited circumstances should address the issues caused by deferral laid out above, it will create its own set of practical difficulties. These include the necessity of IAS 17 information for WGA consolidation adjustments and for national accounts. However, HM Treasury is in conversation with the WGA team and ONS to address these practical difficulties and, so long as early adoption is limited to as few entities as possible, think they are surmountable through data collection of transition adjustments and, for national accounts, a one-year roll-forward of IAS 17 data.

31. In response to the October out-of-meeting paper, some Board members asked whether early adoption would require any additional work for non-adopters (ie those entities who continue to apply IAS 17 in FY19/20). To clarify, HM Treasury does not propose any extra work for non-early adopters for the purposes of WGA or national accounts. Entities may, of course, require their own consolidation adjustments for consistent application of accounting policies at group level where the parent judges these to be material. Early adopters, on the other hand, will be required to submit an additional return to the WGA team with information to enable the provision of IAS 17 level at the WGA level.

***Q. Does the Board agree with the HM Treasury recommendation to offer early adoption of IFRS 16 if entities meet a set of limited criteria?***

## *FReM adaptations and interpretations to IFRS 16*

32. The September and October out-of-meeting papers summarised the feedback received[1] on the proposals made in the Exposure Draft regarding IFRS 16, and HM Treasury's recommendations for the final guidance on IFRS 16. The body of this paper will summarise HM Treasury's recommendations; Appendix B contains the analysis underlying these recommendations (this analysis was also presented in the September and October papers). The body of this paper also has further analysis on the subsequent measurement of the right-of-use asset; peppercorn leases; and a summary of differences between the FReM guidance on IFRS 16, and similar guidance developed by CIPFA/LASAAC and IPSASB.

### *Summary of adaptations and interpretations*

33. HM Treasury recommends the following adaptations of IFRS 16:

- An expansion to the definition of a lease to allow intra-UK government agreements that are not legally enforceable to qualify as leases.
- Specific recognition, measurement and transition provisions for peppercorn leases, along with a definition of a peppercorn lease.

34. In order to promote comparability of reporting between entities and consistent application of accounting policies for WGA, HM Treasury recommends the following interpretations of IFRS 16:

- Mandating the short-term recognition and measurement exemption.
- Introducing a presumption that, where entities cannot readily determine the interest rate implicit in the lease, the HM Treasury discount rate promulgated in PES papers should be applied (subject to an exception if another rate is more appropriate).
- Mandating cost measurement for right-of-use assets.

[1] The comment letters received on the consultation are replicated in the September out-of-meeting paper.

- Mandating specific transition provisions.

35. HM Treasury has also proposed application guidance to accompany the FReM, providing further guidance in respect of:

- The short-term and low-value asset recognition exemptions;
- The definition of a lease;
- Lessee accounting requirements;
- Lessee disclosure requirements;
- Lessee transition requirements;
- Lessor accounting requirements;
- Whole of Government Accounts implications; and
- Budgets and Estimates implications.

Appendix A contains the draft FReM interpretations and adaptations, and the proposed application guidance.

***Q. Does the Board agree with the HM Treasury recommendations regarding interpetations, adaptations and application guidance for IFRS 16 (aside from the technical points discussed below)?***

*Technical points to highlight*

36. Board member feedback received and further work done subsequent to the October out-of-meeting paper led HM Treasury to clarify its analysis around the subsequent measurement of right-of-use assets, and to change its recommendation regarding one aspect of peppercorn lease accounting. These areas are summarised below.

*Subsequent measurement of right-of-use assets*

37. Board members continue to be concerned that mandating the IFRS 16 cost model for right-of-use assets prohibits entities from using the revaluation model when it would provide a better reflection of the right-of-use asset value.

38. HM Treasury can understand this concern; there are cases where the revaluation model may result in a better reflection of the value of the right-of-use asset as compared to the cost model.

39. To give context, HM Treasury does not expect the revaluation model to be used widely for right-of-use assets in the private sector, given that a) the revaluation model is not widely used for owned assets; and b) revaluing right-of-use assets will be potentially more complicated and costly than revaluing owned assets. Right-of-use assets have a number of features, such as options, variable lease payments, residual value guarantees and restrictions upon use of the asset, that will complicate the process of revaluation. This was confirmed in the responses to the Exposure Draft.

40. In terms of current public sector treatment, HM Treasury, with the agreement of the FRAB, has mandated revaluation for owned fixed assets for the following reasons:

- When resource accounting was introduced in the public sector, historical cost accounting presented difficulties (because not all entities had records of historic costs) and did not result in useful information (because of inflation and different acquisition profiles);
- revaluation provided more useful information for asset management, and provided a better reflection of the value of assets and cost of using assets; and

- revaluation increased comparability between and within bodies in the public sector over time.

41. Given the feedback received on the Exposure Draft, HM Treasury do not feel comfortable mandating the revaluation model for all right-of-use assets. Significant concerns were raised by respondents to the Exposure Draft about the cost and complexity of measuring right-of-use assets at fair value.

42. HM Treasury considered providing different subsequent measurement methods for different types of right-of-use assets (for example, to allow for revaluation of longer-term right-of-use assets in property leases), but has not recommended this. It would be difficult to draw a line to define which types of assets would be suitable for which treatment. Such an approach could, for example, result in a different accounting treatment for two similar leases with, such as, a difference of just one year in the lease term.

43. Finally, HM Treasury considered providing an option to allow revaluation for right-of-use assets. This would help to address Board members' concerns that we are being unnecessarily prescriptive in banning revaluation for right-of-use assets. It would also allow revaluation to be used in cases where it provides a better reflection of the value of a right-of-use asset.

44. However, this approach would impair comparability amongst right-of-use assets and across government, and would impact on the Whole of Government Accounts preparation. Moreover, HM Treasury think that some of the arguments originally used to mandate revaluation for owned assets are no longer relevant in this case, such as the difficulty in obtaining historical cost figures, and the increase in comparability across government. There is also a question of whether any entities would actively elect to revalue their right-of-use assets, which was not suggested from the Exposure Draft responses. Bearing all of this in mind, HM Treasury do not recommend that an option for revaluation of right-of-use assets be allowed.

45. HM Treasury continues to be confident in its recommendation to mandate cost measurement for the right-of-use asset. Whilst there are benefits to requiring or allowing revaluation for all or some right-of-use assets, HM Treasury do not believe the benefits of revaluation would outweigh the cost. Revaluation of a right-of-use asset is likely to be costly and complex (and significantly more complex than revaluation of an owned asset, given the characteristics of right-of-use assets described in paragraph 39).

46. There may be benefits to revaluation in terms of asset management and better-quality information, although the incremental benefits of revaluation as compared to the IFRS 16 cost model are limited. In some cases (particularly for non-property leases, leases with shorter terms, and leases with rent reviews) there should not be a significant difference between IFRS 16 cost and revaluation, given the remeasurement provisions in IFRS 16. In the case of property leases it is worth highlighting that there are a number of initiatives to reduce the cost of government's estate, including the creation of the Government Property Agency to manage central government property.

*Q. Does the Board agree with the HM Treasury recommendation to require cost measurement for right-of-use assets?*

*Peppercorn leases*

47. In the September out-of-meeting paper, HM Treasury proposed adapting the definition of a lease to remove the requirement for consideration, to cover lease-like arrangements that are for nil consideration. Board members raised a concern that there could be unintended consequences for this adaptation. HM Treasury recognises this may be the case for Church-donated assets and as a result propose to defer the adaptation regarding nil consideration. Further analysis on this issue will be undertaken and any further adaptation on nil consideration, if necessary, will be proposed in 2019.

***Q. Does the Board agree with the HM Treasury recommendation to defer a decision on no-consideration lease-like arrangements to 2019?***

*IPSASB and CIPFA/LASAAC consultations*

48. IPSASB and CIPFA/LASAAC also ran consultations on IFRS 16. The IPSASB consultation contained multiple differences from the FReM proposals; the two most significant were a new lessor accounting model, and a different model for below-market leases as compared to the FReM's proposals on peppercorn leases. The IPSASB received mixed feedback on both of these proposals and is in the process of considering next steps on the project. It is unlikely that final guidance on either lessor accounting or below-market leases will be finalised in 2019.

49. CIPFA/LASAAC's consultation on IFRS 16 concluded in September 2018. CIPFA/LASAAC held a meeting on 6 November to discuss the results of the consultation. Please refer to FRAB 134(04) for more details regarding the consultation. At a high level, the only difference between the final Code guidance and the FReM proposals (that are not due to fundamental differences between local and central government) is the subsequent measurement of the right-of-use asset. The Code will require revaluation for property leases longer than 25 years, and allow an option for revaluation for other right-of-use assets. CIPFA proposed this treatment in their consultation, and received majority positive feedback (as compared to the FReM consultation, where a large majority of respondents opposed revaluation).

50. This does not change HM Treasury recommendations. Whilst ideally there would be alignment between the Code and the FReM for IFRS 16, HM Treasury believes that the costs of adopting the Code's subsequent measurement provisions described above would outweigh the benefits. CIPFA staff have been working with HM Treasury, including the WGA team, to ensure that the WGA consequences of any differences between the Code and the FReM are properly considered.

***Q. Does the Board agree with the HM Treasury recommendation to not change the FReM IFRS 16 guidance in response to either the IPSASB or CIPFA/LASAAC consultations?***

## *Next Steps*

51. HM Treasury plan to publish IFRS 16 adaptations, interpretations and application guidance in December 2018 (pending FRAB approval).

**22nd November 2018**