HM Treasury

Financial Reporting Advisory Board paper

IFRS 16 *Leases*: Discount Rates

Issue:	Whether there should be a change to the methodology used to determine the 'lessee's incremental borrowing rate' that is used as a practical expedient to measure lease liabilities and right-of-use assets when the rate implicit in the lease is not readily available.
Impact on guidance:	Yes, if approved by the FRAB.
IAS/IFRS adaptation or interpretation?	Possibly, depending on FRAB's decision
Impact on WGA?	Yes, the FRAB's decision may have an impact on the 2021-22 WGA (as the first year of full public sector adoption).
IPSAS compliant?	Prior to IFRS 16, IPSAS and IFRS were broadly consistent for lease accounting. IPSASB are developing a new IPSAS on lease accounting.
Impact on budgetary regime?	Yes, any change in discount rate will impact the carrying amount of the right-of-use asset and lease liability, with corresponding budgetary impacts
Alignment with National Accounts (ESA10):	No, ESA10 does not allow an 'incremental borrowing rate' practical expedient to be used when calculating interest on a finance lease. Broadly, ESA10 and IFRS 16 are not aligned in the measurement of lease assets and liabilities.
Impact on Estimates?	Yes, any change in discount rate will impact the carrying amount of the right-of-use asset and lease liability, with corresponding budgetary impacts
Recommendation:	That FRAB provide advice on whether the discount rate methodology should be updated for the FY19/20 annual reports and accounts.
Timing:	Any changes approved could be immediately implemented for FY19/20 annual reports and accounts.

DETAIL

Introduction

1. In the course of finalising the FY19/20 accounts, the Department for Digital, Culture, Media and Sport has identified an issue with the PES discount rate used to measure lease assets and lease liabilities that we would like to bring to FRAB's attention.

2. The issue is described in more detail below but can briefly be summarised as whether a government borrowing rate should be used by central government as the 'lessee's incremental borrowing rate' in applying IFRS 16 (as previously agreed by the FRAB and set out in PES guidance).

3. The lessee's incremental borrowing rate is meant to serve as a proxy for the rate implicit in a lease. A government borrowing rate will likely not be the most accurate proxy in this regard as government borrowing rates are lower than corporate borrowing rates and more likely to be significantly different from the rate implicit in a lease.

4. As early adopters of IFRS 16, DCMS and DfT need confirmation of the appropriate discount rates to use for their FY19/20 annual reports and accounts.

Overview of the Issue

IFRS Guidance

5. IFRS 16 requires that the lessees should use the rate implicit in the lease as the discount rate in the initial measurement of the lease liability (and therefore right-of-use asset). If that rate cannot be readily determined, the lessee should use its incremental borrowing rate.

6. The Basis for Conclusions to IFRS 16 (BC161) offers the following rationale for this requirement:

> The interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases. This is because both rates, as they have been defined in IFRS 16, take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor. Consequently, the IASB noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease.

7. IAS 17 contained a similar requirement for finance leases.

Central government guidance

8. The FReM contains an interpretation to IFRS 16 stating that, where lessees cannot readily determine the rate implicit in the lease, they should use the HMT discount rate promulgated in PES papers as their incremental borrowing rate, unless they can demonstrate that another discount rate would more accurately represent their incremental borrowing rate.

9. The HMT PES discount rate is based on government gilt yields. FRAB agreed this was appropriate as central government bodies mainly do not borrow themselves; borrowing is done centrally through the Exchequer, and government gilt yields provide the best estimate of incremental borrowing rates.

10. The FReM also contains an interpretation that right-of-use assets should be subsequently measured using principles consistent with IAS 16 (i.e. generally at current value in existing use). FReM guidance clarifies that, in most cases, cost should be an appropriate proxy for fair value or current value in existing use.

Implementation Issue

11. In finalising the FY19/20 accounts, the Department for Digital, Culture, Media and Sport has identified an implementation issue with the IFRS 16 and FReM requirements summarised above.

12. This issue arises because of the difference between the HMT PES discount rate, and the rate implicit in leases.

13. As the HMT PES discount rate is based on government borrowing, it is quite low; 1.99% for calendar year 2019 and 1.27% for calendar year 2020. The rate implicit in a lease would typically be significantly higher than this; a VOA colleague has provided information which indicates that market yields for leases can range from approximately 3.75-11.5% (all given in nominal terms).

14. This means that, in a sense, lease liabilities and right-of-use assets are 'overvalued' on initial measurement when they are measured using the lower HMT PES discount rate. If they were measured using the higher rate implicit in the lease, they would have a lower carrying amount. It also means that the rationale in the Basis of Conclusion for using an incremental borrowing rate as a proxy for the rate implicit in the lease doesn't hold true when applied to central government. Although the rate implicit in the lease will take government's credit rating into consideration, it will also cover the lessor's higher cost of capital.

15. This issue has arisen because DCMS have identified some right-of-use assets that were initially measured using the HMT PES rate on transition to IFRS 16 and are impaired or need to be revalued as of 31 March 2020. They therefore obtained valuations for the current values of these assets, which determined the impairment or revaluation they need to recognise. This amount is comprised of two elements:

a) the difference between the contractual rents they are paying under the lease, and market rents

b) the difference between measuring the right-of-use asset using the HMT PES discount rate and a market discount rate (for example, for one asset this is a difference between the 1.99% PES rate and a 6% market rate—this comprises about 30% of the overall impairment recognised for that asset).

This second element is also present on 'day one' of entering into a lease, resulting in a difference between initial cost (discounted at the PES rate) and market value (discounted at the market rate) at lease commencement.

16. While DCMS had anticipated the need to impair or revalue these assets, they had not realised that a significant element of the change in carrying amount would be driven by the difference between the HMT PES discount rate and a market discount rate.

17. DCMS point out that this issue could also cause counterintuitive answers when lessees are paying below-market rents for assets, and therefore need to revalue those right-of-use assets. While intuitively one would expect the carrying amount of the right-of-use asset to increase in this instance (since market rents are higher than the actual rents being paid), it might actually decrease if the downward movement from switching from the HMT PES rate to a market rate would be greater than the upward movement from using market rents in the revaluation.

18. DfT, as the other central government early adopter, has not encountered this issue as they are measuring their right-of-use assets at cost and have not identified the need to impair or revalue any right-of-use assets.

Comparison to private sector/IAS 17

19. This issue is not unique to the public sector. Whenever a lessee measures a right-of-use asset using its incremental borrowing rate instead of the rate implicit in the lease, there is a risk that there could be a significant difference between the two rates and therefore, a significant difference in the measurement of right-of-use assets and lease liabilities depending on which rate is used.

20. This issue is also not a new issue; it existed under the requirements of IAS 17 for finance leases.

21. However, this issue will be exacerbated for central government on implementation to IFRS 16 for the following reasons:

- Government borrowing rates are lower than corporate borrowing rates and so the difference between the incremental borrowing rate and the rate implicit in the lease will be wider.
- In the private sector the cost model is mainly used, rather than the revaluation model.
- The scope of the problem will be wider as compared to IAS 17; operating leases are required to be measured using the lessee's incremental borrowing rate on transition to IFRS 16.

Potential response to the issue

23. One possible response identified that would at least partially address this issue, and be feasible for DCMS and DfT to implement in FY19/20, would be to update the HMT PES discount rate used for leases. DCMS and DfT have both confirmed that, although this would entail extra resource, they could implement a new HMT PES rate without a significant delay to their laying timetables.

24. HM Treasury has identified two different methodologies to use to update the discount rate:

- Use an 'average' market yield
- Use an 'average' corporate borrowing rate

25. After discussions with VOA, we do not consider it feasible to calculate an 'average' market yield for use in FY19/20 accounts. Market yields on leases vary widely (again, from approximately 3.75-11.5%) and depend on a number of factors individual to each lease.

26. It would be possible to calculate an 'average' corporate borrowing rate by using the yield from an index of corporate bonds[1]. This would result in a discount rate of 3.99% for calendar year 2019, and 2.73% for calendar year 2020 (as compared to the current HMT PES rates of 1.99% for 2019 and 1.27% for 2020).

27. The use of a corporate borrowing rate would still run the risk of being significantly different from the rate implicit in a lease; however, this difference would likely be lower as the corporate bond rate is higher.

28. The advantages and disadvantages of updating the HMT PES discount rate to use a corporate borrowing rate, rather than the central government borrowing rate, are discussed below.

Advantages of updating the HMT PES rate

29. The main advantage of updating the HMT PES rate is that it would lessen the risk of a significant difference between the HMT PES rate and the rate implicit in a lease and would therefore avoid the issues discussed in paragraphs 13-18 above.

30. This approach could be seen as following the 'spirit', rather than the 'letter' of IFRS 16, in the sense that IFRS 16 allows the lessee's incremental borrowing rate to be used as a proxy for the rate implicit in a lease under the assumption that these two rates are similar and this approach would use a more suitable proxy.

31. The current guidance follows the 'letter' of IFRS 16 and uses government gilt yields as the lessee's incremental borrowing rate on the basis that this is the best approximation of a central government body's borrowing rate. However, following the 'spirit' of IFRS 16 could justify using corporate borrowing rates, rather than government borrowing rates, following the rationale that corporate borrowing rates would better approximate a typical rate implicit in a lease.

Disadvantages of updating the HMT PES rate

32. The main disadvantages of updating the HMT PES rate to use a corporate borrowing rate can be summarised as follows:

- Using a corporate borrowing rate breaks with the articulation in IFRS 16 of choosing a discount rate that is unique to the lessee.
- One could argue that recognising an impairment on a right-of-use asset due to the difference between government borrowing rates, and a higher market yield, is meaningful as it demonstrates that a department, and government as a whole, could have made

[1] We have used the ICE Bank of America 15+ Year Corporate Bond Index, adjusted to reflect the fact that the average lease term in central government is approximately 20 years.

better-value asset finance decisions (although to note IFRS 16 does not report on the differential borrowing rates of lessees and lessors).

- As described above, using a corporate borrowing rate would not completely solve the risk of a significant difference between the HMT PES rate and the rate implicit in a lease; it would only lessen it.
- As described above, this is not a new issue and the FRAB had not previously decided that this issue merited an adaptation to IAS17 or public sector specific guidance. This issue theoretically existed for finance leases under IAS 17 requirements and was accepted in central government; the implementation of IFRS 16 simply means the scope of the issue has widened.
- Given that this issue was raised late in the FY19/20 reporting cycle, HM Treasury has only been able to perform limited outreach on this issue and there may be unintended consequences that we have been unable to identify.

Recommendation

33. HM Treasury have not been able to reach a definitive view on this issue, as the arguments are finely balanced. We recognise that a central government borrowing rate is not likely to serve as an appropriate proxy for the rate implicit in a lease, which undermines the basis for using this rate in initial measurement of the right-of-use asset and lease liability.

34. However, as stated earlier in this paper, the issue is not a new one, nor is it unique to the public sector (although it is exacerbated in the public sector). We are conscious of making a significant change to the discount rate methodology at this point in the FY19/20 reporting cycle without being able to perform wider consultation.

35. DfT and DCMS have provided us with their views on this issue. DCMS are supportive of changing the HMT PES rate in FY19/20 to use corporate borrowing rates, primarily on the basis that these rates are a better proxy of the rate implicit in a lease. They believe the current methodology produces an artificially low discount rate. They are also concerned about the counterintuitive results discussed earlier in this paper where revaluations due to a lessee paying below-market rentals could actually lead to downward movements in the carrying amount of right-of-use assets, solely due to the difference between the HMT PES rate and market discount rates.

36. DfT, on balance, support leaving the HMT PES rate unchanged for FY19/20 and exploring a change in methodology for FY20/21. They are not convinced that use of corporate borrowing rates represents an improvement from the current methodology, as it moves away from using a borrowing rate that reflects the specific circumstances of the lessee, and still runs the risk of being significantly different from the rate implicit in the lease (so does not completely solve the underlying issue).

37. Regardless of the decision reached on updating the HMT PES discount rate for FY19/20, HM Treasury would want to confirm to DCMS and DfT that a difference between the HMT PES rate and market rates, in isolation, would not trigger revaluation of right-of-use assets in FY19/20. DCMS and DfT would not have the resource to revalue the entirety of their right-of-use asset stock at this point in the FY19/20 reporting cycle.

Q. Can FRAB provide HM Treasury with advice on this issue?