HM Treasury

IFRS 16 Leases

Supplementary budgeting guidance

December 2020

Background

1. IFRS 16 *Leases*, issued by the International Accounting Standards Board (IASB) in 2016, will be adopted by the UK Public Sector from 1 April 2022.

2. Early adoption is available for some central government entities who meet particular criteria, from 1 April 2019 or 1 April 2021. Please refer to the Financial Reporting Manual (FReM) for more details, including the criteria.

3. HM Treasury is issuing this guidance to provide clarity on the budgeting treatment to apply to leases on implementation of IFRS 16. On-balance sheet leases will become more common under the new standard, affecting control totals, although the actual budgeting treatment of an on-balance or off-balance lease is not in itself changing substantially.

4. The guiding principle to apply is the budgeting for leases aligns to the accounting. This paper complements the lease budgeting guidance contained within chapter 13 of the CBG.

5. The below guidance pertains to budgeting. For accounting guidance, refer to the FReM, IFRS 16 and HM Treasury IFRS 16 application guidance on (gov.uk).

6. While the appendices outline budgeting in DEL, please note AME bodies would also follow the treatments prescribed below, but budgeting against AME instead of DEL.

Budgeting

7. For lessees, the budgetary and accounting impact of IFRS 16 means that most leases come on-balance sheet, with the recognition of an asset, for the right to use the underlying asset in the lease, and a liability, for future payments to be made on the lease. An on-balance sheet lease has three impacts on resource and capital:
   i) capital expenditure at lease commencement, for the asset recognised on-balance sheet;
   ii) ringfenced depreciation, due to depreciation on the leased asset over the life of the lease; and
   iii) non-ringfenced resource expenditure for the interest incurred over the life of the lease (as annual cash payments on the lease now score as working capital movements).

8. Appendix A outlines the budgeting treatment to be applied to leases, *as a lessee*. The appendix shows the treatment for i) leases that will be recognised on-balance sheet under the standard and ii) contracts that will be recognised off-balance sheet (such as, service contracts or leases that are short term or low value)[1]. Note the working capital column is an adjustment to creditors (required to balance the net cash requirement).

9. Appendix B outlines the budgeting treatment to be applied to leases, *as a lessor*. IFRS 16 is not changing lessor accounting substantially, retaining the distinction between a finance and operating lease, and the table only offers clarification on the treatments that should already be applied. Note the working capital column is an adjustment to debtors (required to balance the net cash requirement).

Transition

10. On transition to IFRS 16, it is mandated that all FReM bodies retrospectively apply the standard with the cumulative effect recognised as an adjustment to opening balances

[1] Refer to HM Treasury IFRS 16 application guidance for detail on the low value exemption.

(cumulative catch up). No budget entry should be made for the cumulative catch up adjustment to accounts. Instead, for budgeting, the cumulative catch up is ignored and no Prior Period Adjustment (PPA) is required. Existing leases should then follow the IFRS 16 budgeting treatment from implementation. Appendix C clarifies this treatment.

Further budgeting clarifications

11. As above, the guiding principle to apply when budgeting for leases, is that the budgeting treatment should align to the accounting. However, please note the following:

a. Capital recognised on commencement – The capital hit incurred on commencement of the lease, i.e. the date on which the lessor makes the underlying asset available for use by the lessee, should be equivalent to the asset recognised on-balance sheet (or de-recognised if a lessor). For example, the capital hit should allow for any prepayments, which, on an accruals basis, should score on lease commencement. Appendix E clarifies this treatment.
b. Revaluation, re-measurement or lease modification – The budgeting for these items in consistent with the principles outlined in the CBG. However, to clarify, the creation of a fixed asset revaluation reserve (for example, if the asset is subsequently measured at fair value) has no budget impact (see guidance on revaluations in CBG Chapter 3). However, a re-measurement or lease modification that results in either a reduction or increase in both the leased asset and liability will have a CDEL impact. Appendix E clarifies this treatment.
c. Impairment or early termination – Again, the budgeting for these items is consistent with the principles outlined in the CBG. For example, whether an impairment is first offset against a revaluation reserve or is DEL or AME will depend on the standard application of the CBG (see guidance on impairments in CBG Chapter 3). Appendix E clarifies this treatment.
d. Peppercorn leases – The treatment for a peppercorn lease (a lease with nil or nominal consideration) is identical to that of a donated asset/capital grant-in-kind (see guidance on donated assets in CBG Chapters 4, 6 and 7). Appendix D clarifies this treatment. Modifications and early terminations of peppercorn leases will be treated as extensions or reversals of capital grants-in-kind (and will therefore be budget-neutral).
e. Sale and leaseback – The budgeting for any sale and leaseback arrangement should follow the accounting (IFRS 16, 98 – 103). Any gain or loss on the rights transferred from the seller-lessee to the buyer-lessor should be treated as any gain or loss on the sale of a fixed asset (see guidance on these gains or losses in CBG Chapter 4). Appendix F clarifies this treatment.
f. Barter transactions – There is specific budgeting guidance on sale and leaseback transactions where the sale and leaseback elements are bartered. Note, for transactions such as these, the accounting treatment for such a transaction may not align to the budgeting treatment. See guidance on barter transactions in CBG Chapter 13 for further detail.)
g. Dilapidation provisions – IFRS 16 requires dilapidation provisions to be capitalised as part of the cost of the right-of-use asset (IFRS 16, 24(d)). These dilapidation provisions should be treated as provisions in respect of capital expenditure for budgeting purposes, consistent with normal CBG principles (see guidance on capitalised provisions in CBG Chapter 6). Appendix G clarifies this treatment.

National Accounts

12. The ONS will change the treatment of *property leases* in national accounts from 1 April 2022. For *property leases* (land and/or buildings), National Accounts are aligned to budgets (PSND/PSNB impacts are in line with CDEL and non-ringfenced RDEL).

13. For *non-property leases*, as a lessee, National Accounts are not aligned to budgets. Instead, non-property leases will follow the same treatment as applied under IAS 17, with PSND/PSNB impacts incurred over the life of the lease equivalent to what would have been the operating expense. Departments and spending teams should, therefore, note that the fiscal impact of a non-property lease, when a lessee, is not aligned to the budgeting impact.

14. For any departments early adopting IFRS 16 before 1 April 2022, a central adjustment will be carried out to adjust IFRS 16 lease budget data to an IAS 17 position, which does not require any input from departments, other than correct OSCAR coding (see 22 below). After 1 April 2022, a similar central adjustment will be carried out to adjust IFRS 16 *non-property* lease data to an IAS 17 position.

Adjusting budgets for IFRS 16 and best practice

15. The change to control totals caused by IFRS 16 is treated as a classification change. For departments implementing IFRS 16 from 1 April 2021, budget control totals will be changed as part of Main Estimates FY21/22. For departments implementing IFRS 16 from 1 April 2022, the timing of changes to budget control totals will be confirmed in due course.

16. Departments should follow the Green Book, Business Case and other relevant guidance when assessing how to acquire new assets. Departments should not sign short-term leases only to reduce CDEL, but should assess all options based on VfM and other relevant considerations.

17. A benefit of IFRS 16 is that the budget impact of leasing or purchasing an asset will be similar and for property assets the fiscal effect of leasing or purchasing will also be similar. This should allow for fairer comparisons between these two options, which departments should consider. If future plans are affected by this, please engage with your spending teams.

Coding

18. HM Treasury requires that budget data in OSCAR is kept up to date in year, as lease data in OSCAR will feed through to the ONS and so impact on fiscal results and projections.

19. HM Treasury will introduce new codes that should be used to record IFRS 16 information for FY21/22 (for any departments that are implementing IFRS 16 from this date). IFRS 16 requires a substantial number of new codes to be created—both in Plans and Outturn. These codes will be communicated in due course ahead of Main Estimates FY21/22.

Intra-public sector leasing

20. Operating *intra-public sector* leases will not eliminate out across the public sector, due to the asymmetric lessor and lessee accounting in IFRS 16 (as the lease itself will be on-balance sheet for the lessee and but the underlying asset will be on-balance sheet for the lessor).

21. To ensure that operating *intra-public sector* leases are eliminated at a National Accounts level, all *intra-public sector* leases must be coded to separate *intra-public sector* leasing accounts in OSCAR (note if this is not done, *intra-public sector* arrangements will have a fiscal effect, which will reflect detrimentally on the department that miscodes). Again, new codes for IFRS 16 for FY21/22 will be communicated to departments ahead of Main Estimates FY21/22.

22. Departments must note, any asymmetric *intra-departmental* arrangements must be eliminated out. OSCAR entries should therefore mirror the consolidated balances that departments present in their Annual Reports and Accounts, with the reconciliation between budgets and accounts audited by the NAO.

Coding property vs non-property leases

23. Given the different treatment of property vs non-property in National Accounts, it is vital that leases are appropriately coded as either property or non-property in OSCAR once new leasing codes are established.

This guidance is not exhaustive and further budgeting queries may arise on IFRS 16 implementation. If this occurs, please contact resource.accounts@hmtreasury.gov.uk.

Appendix A – Budgeting treatment for leases (lessee)

			Accounting						Budgeting			
			P&L		BS				Asset (CDEL)	Depreciation (Ringfenced RDEL)	Working capital (non budget)	Interest (RDEL)
			Income	Expense	Assets	Cash	Liab	Equity				
Lease (recognised on balance sheet)		Recognise asset			54		(54)		54		(54)	
	Yr 1	Depreciate asset		13.5	(13.5)					13.5		
		Interest		0.8			(0.8)					0.8
		Cash paid				(14)	14				13.2	
	Yr 2	Depreciate asset		13.5	(13.5)					13.5		
		Interest		0.6			(0.6)					0.6
		Cash paid				(14)	14				13.4	
	Yr 3	Depreciate asset		13.5	(13.5)					13.5		
		Interest		0.4			(0.4)					0.4
		Cash paid				(14)	14				13.6	
	Yr 4	Depreciate asset		13.5	(13.5)					13.5		
		Interest		0.2			(0.2)					0.2
		Cash paid				(14)	14				13.8	
Totals			0	56	0.0	(56)	0	0	54	54	0	2.0

			Accounting						Budgeting			
			P&L		BS				Asset (CDEL)	Depreciation (Ringfenced RDEL)	Working capital (non budget)	Operating payments (RDEL)
			Income	Expense	Assets	Cash	Liab	Equity				
Lease exempt from provisions of standard/ service contract		Recognise asset										
	Yr 1	Depreciate asset										
		Interest										
		Cash paid		14		(14)						14
	Yr 2	Depreciate asset										
		Interest										
		Cash paid		14		(14)						14
	Yr 3	Depreciate asset										
		Interest										
		Cash paid		14		(14)						14
	Yr 4	Depreciate asset										
		Interest										
		Cash paid		14		(14)						14
Totals			0	56	0	(56)	0	0	0	0	0	56

Appendix B – Budgeting treatment for leases (lessor)

			Accounting						Budgeting			
			P&L		BS				Asset (CDEL)	Depreciation (Ringfenced RDEL)	Working capital (non budget)	Interest (RDEL)
			Income	Expense	Assets	Receivable	Cash	Equity				
Lessor lease - finance under IFRS 16	Derecognise asset & set up receivable				(54)	54			(54)		54	
	Yr 1	Depreciate asset								0		
		Interest	(0.8)			0.8						(0.8)
		Cash received				(14)	14				(13.2)	
	Yr 2	Depreciate asset								0		
		Interest	(0.6)			0.6						(0.6)
		Cash received				(14)	14				(13.4)	
	Yr 3	Depreciate asset								0		
		Interest	(0.4)			0.4						(0.4)
		Cash received				(14)	14				(13.6)	
	Yr 4	Depreciate asset								0		
		Interest	(0.2)			0.2						(0.2)
		Cash received				(14)	14				(13.8)	
Totals			(2)	0	(54)	0	56	0	(54)	0	0	(2)

			Accounting						Budgeting			
			P&L		BS				Asset (CDEL)	Depreciation (Ringfenced RDEL)	Working capital (non budget)	Operating payments (RDEL)
			Income	Expense	Assets	Receivable	Cash	Equity				
Lessor lease - operating under IFRS 16	Retain asset											
	Yr 1	Depreciate asset										
		Interest										
		Cash received	(14)				14					(14)
	Yr 2	Depreciate asset										
		Interest										
		Cash received	(14)				14					(14)
	Yr 3	Depreciate asset										
		Interest										
		Cash received	(14)				14					(14)
	Yr 4	Depreciate asset										
		Interest										
		Cash received	(14)				14					(14)
Totals			(56)	0	0		56	0	0	0	0	(56)

Appendix C – Budgeting treatment for cumulative catch up approach

Based on a lease with a remaining liability of 16, over two years, at transition:

			Accounting						Budgeting			
			P&L		BS				Asset	Depreciation	Working capital	Interest/other
			Income	Expense	Assets	Cash	Liab	Equity	(CDEL)	(Ringfenced RDEL)	(non budget)	(RDEL)
Cumulative	Recognise asset				16		(16.0)					
IFRS 16 - on balance sheet lease	**Yr 3**	Depreciate asset		8	(8)					8		
		Interest		0.2			(0.2)					0.2
		Cash paid				(8.15)	8.15				7.95	
	Yr 4	Depreciate asset		8	(8)					8		
		Interest		0.1			(0.1)					0.1
		Cash paid				(8.15)	8.15				8.05	
			0	16.3	0	(16.3)	0	0	0	16	16	0.3

Note – On transition, in accounts, an asset and liability would be recognised. No corresponding budgeting entries should be made, either in the year of implementation or as a PPA.

Subsequent to that, the treatment to apply is as outlined in appendix A and existing leases should still follow the IFRS 16 budgeting treatment.

Appendix D – Peppercorn leases

Based on a lease with an asset valued at 20, but with nominal consideration (i.e. 1 peppercorn) provided:

			Accounting						Budgeting		
			Grant		BS				Asset	Asset	Depreciation
				P&L - Expense	Assets	Cash	Liab	Equity	(CDEL)	(CDEL)	(AME)
Peppercorn lease	Recognise asset		(20)		20		*Nominal*		20	(20)	
	Yr 1	Depreciate asset		10	(10)						10
		Interest		*Nominal*							
		Cash paid				*Nominal*					
	Yr 2	Depreciate asset		10	(10)						10
		Interest		*Nominal*							
		Cash paid				*Nominal*					
Totals			(20)	20	0	0	0	0	20	(20)	20

Appendix E – Prepayment, revaluation, impairment, re-measurement, modification or early termination

			Accounting						Budgeting			
			P&L		BS							
			Income	Expense	Assets	Cash	Liab	Equity	Asset (CDEL)	Deprec./impairment (Ringfenced RDEL)	Working capital (non budget)	Interest/other (RDEL)
Lessee lease - under IFRS 16		Prepayment			6	(6)					6	
		Transfer prepayment and recognise as part of ROU asset			6 & (6)				6		(6)	
	1	Recognise remainder of asset and liability			**54**		**(54)**		**54**		**(54)**	
	Yr 1	*Depreciate asset*		*12*	*(12)*					*12*		
		Interest		*0.8*			*(0.8)*					*0.8*
		Cash paid				*(11.3)*	*11.3*				*10.5*	
	2	FV subsequent ROU measurement, upwards reval			**14**			**(14)**				
	Yr 2	*Depreciate asset*		*14*	*(14)*					*14*		
		Interest		*0.7*			*(0.7)*					*0.7*
		Cash paid				*(11.3)*	*11.3*				*10.6*	
	3	Impairment due to change in market price		**16**	**(30)**			**14**		**16 (AME)**		
	Yr 3	*Depreciate asset*		*4*	*(4)*					*4*		
		Interest		*0.5*			*(0.5)*					*0.5*
		Cash paid				*(11.3)*	*11.3*				*10.8*	
	4	Remeasure lease liability			**5**		**(5)**		**5**		**(5)**	
	Yr 4	*Depreciate asset*		*6.5*	*(6.5)*					*6.5*		
		Interest		*0.4*			*(0.4)*					*0.4*
		Cash paid				*(13.8)*	*13.8*				*13.4*	
	5	Lease modified at year 4 close (area leased reduced)			**(5)**		**5**		**(5)**		**5**	
	Terminate lease early (fee of 20) 6	Clear asset		**7.5**	**(7.5)**				**(7.5)**			
		Clear liability		**(8.7)**			**8.7**				**8.7**	**(1.2)**
		Termination fee		**20**		**(20)**						**20**
Totals			0.0	73.7	0.0	(73.7)	0.0	0.0	52.5	52.5	0.0	21.2

1 *The prepayment hits budgets on an accruals basis, i.e. when the prepayment is realised on asset recognition.*

2 *Upwards revaluation that goes through OCI has no budget impact (a revalution would only be applicable if the asset is measured at fair value).*

3 *An impairment due to a change in market price, which occurs in this example, utilises the revaluation reserve with no budget impact and scores to ringfenced AME. Other types of impairment may have a budget impact even though they utilise the revaluation reserve (and can be AME or DEL). Refer to CBG 3.49 to 3.52 for further detail.*

4 *The remeasurement of the liability, in this example an increase, has a corresponding CDEL impact.*

5 *A lease modification that doesn't result in a new lease, in this example a reduction in the area leased results in a reduction in liability, has a corresponding CDEL impact.*

6 *Early termination should be treated in budgets using the same principles as for asset disposal, i.e. with a CDEL benefit equivalent to the NBV of the asset and termination fees, along with any difference between the asset and liability, scoring to RDEL.*

Appendix F – Sale and leaseback

			Accounting						Budgeting			
			P&L		BS							
			Income	Expense	Assets	Cash	Liab	Equity	Asset (CDEL)	Depreciation (Ringfenced RDEL)	Working capital (non budget)	Interest/ impairment /other (RDEL)
Transfer is a sale	At commencement, derecognise:				(44)	50			(44)			
	Then recognise leaseback:		(2)		36		(40)		36			(2)
	Yr 1	Depreciate asset		9	(9)					9		
		Interest		0.6			(0.6)					0.6
		Cash paid				(10.38)	10.38				9.8	
	Yr 2	Depreciate asset		9	(9)					9		
		Interest		0.4			(0.4)					0.4
		Cash paid				(10.38)	10.38				9.9	
	Yr 3	Depreciate asset		9	(9)					9		
		Interest		0.3			(0.3)					0.3
		Cash paid				(10.38)	10.38				10.1	
	Yr 4	Depreciate asset		9	(9)					9		
		Interest		0.2			(0.2)					0.2
		Cash paid				(10.38)	10.38				10.2	
	Totals		(2.0)	37.5	(44)	8.5	0	0	(8)	36	40	(0.5)
Transfer is not a sale	No change to asset, transaction recognised as financing provided		(10)			50	(40)		(10)		(40)	
	Yr 1	Depreciate asset		11	(11)					11		
		Interest		0.6			(0.6)					0.6
		Cash paid				(10.38)	10.38				9.8	
	Yr 2	Depreciate asset		11	(11)					11		
		Interest		0.4			(0.4)					0.4
		Cash paid				(10.38)	10.38				9.9	
	Yr 3	Depreciate asset		11	(11)					11		
		Interest		0.3			(0.3)					0.3
		Cash paid				(10.38)	10.38				10.1	
	Yr 4	Depreciate asset		11	(11)					11		
		Interest		0.2			(0.2)					0.2
		Cash paid				(10.38)	10.38				10.2	
	Totals		(10)	45.5	(44)	8.5	0	0	(10)	44	0	1.5

This table outlines the accounting and budgeting treatment for a sale and leaseback transaction where there is a transfer of assets under IFRS 15 and where there is no transfer of assets.

The transfer of assets table is based on the following scenario:
Carrying asset of 44, asset FV of 50, cash consideration on transfer of 50, lease payments of 10.4m per annum, present value of all payments of 40.
Under IFRS 16, the ROU asset is capped as the proportion of the previous carrying amount retained for use by the entity. This is worked out as follows:
Present value of lease/ fair value of asset = 40/50 = 80%.
*80% * carrying amount (of 44) = 36.*
The entries at the start of the sale and leaseback based on this scenario would be as follows:

Dr Cash	*50*	
Dr ROU asset	*36*	
CR PPE		*(44)*
Cr lease liability		*(40)*
CR gain on disposal		*(2)*

As the gain on disposal is 2, it passes the lower of 5% of NBV or £20m rule (CBG 7.2 and 7.3) and so can all be treated as RDEL. The treatment for any gain on disposal that exceeds the lower 5% of NBV or £20m should be discussed with Treasury (CBG 7.3).

Note, under IFRS 16, where the consideration on sale is above/below market terms the accounting treatment is slightly different, however budgets will still follow accounts. Refer to IFRS 16 for further guidance.

Appendix G—Dilapidation provisions

			Accounting							Budgeting				
			P&L		BS									
			Income	Expense	Assets	Cash	Liab (lease)	Liab (provision)	Equity	Asset (CDEL)	Deprec./impairment (Ringfenced RDEL)	Working capital (non budget)	Interest/other (RDEL)	CAME
Lessee lease - under IFRS 16		Dilapidation provision			6			(6)						6
		Recognise asset and liability			48		(48)			48		(48)		
	Yr 1	*Depreciate asset*		13.5	(13.5)						*13.5*			
		Interest		0.8			(0.8)						*0.8*	
		Cash paid				(12.5)	12.5					*11.7*		
	Yr 2	*Depreciate asset*		13.5	(13.5)						*13.5*			
		Interest		0.6			(0.6)						*0.6*	
		Cash paid				(12.5)	12.5					*11.9*		
	Yr 3	*Depreciate asset*		13.5	(13.5)						*13.5*			
		Interest		0.4			(0.4)						*0.4*	
		Cash paid				(12.5)	12.5					*12.1*		
		Change in dilapidation provision			2.0			(2)						*2*
	Yr 4	*Depreciate asset*		15.5	(15.5)						*15.5*			
		Interest		0.2			(0.2)						*0.2*	
		Cash paid				(12.5)	12.5					*12.3*		
		Pay out dilapidation provision				(8)		8		*8.0*				*(8)*
Totals			0	58	0	(58)	0	0	0	56	56	0	2	0