HFMA briefing
Updated June 2018

Accounting for leases

Application of IFRS 16 (updated briefing)

Background

International Financial Reporting Standard 16 *Leases* (IFRS 16) was published by the International Accounting Standards Board (IASB) in January 2016. It will radically change how lessees account for leases as it removes the distinction between operating and finance leases. For lessors, this distinction will remain and IFRS 16 is not expected to change their accounting.

IFRS 16 is applicable for accounting periods beginning on or after 1 January 2019. For NHS bodies this will be 2019/20. It is widely expected that the application of this standard will be time consuming for lessees, so NHS bodies cannot postpone work until HM Treasury and then the Department of Health and Social Care (DHSC) produce their guidance.

This briefing sets out the practical steps NHS bodies should be taking now as well as highlighting the issues that will need to be considered when applying the standard for the first time. As there is not expected to be any impact on lessors, this briefing only considers the new standard from the perspective of the lessee. ***The briefing was first published in October 2017 and has been updated as follows:***

- ***February 2018 - following the pre accounts planning conferences and the publication of the November 2017 Financial Reporting Advisory Board (FRAB) papers[1]***
- ***April 2018 – to add a second worked example***
- ***June 2018 – following the publication of HM Treasury's Exposure Draft[2] (the ED).***

Changes to the briefing made in the April/June update have been highlighted in bold italic so they are easy to identify. The briefing will be updated again when HM Treasury and/ or DHSC issue further guidance.

[1] www.gov.uk/government/publications/financial-reporting-advisory-board-minutes-and-associated-papers-16-november-2017
[2] www.gov.uk/government/consultations/ifrs-16-leases-exposure-draft-1801

While every care had been taken in the preparation of this briefing, the HFMA cannot in any circumstances accept responsibility for errors or omissions and are not responsible for any loss occasioned to any person or organisation acting or refraining from action as a result of any material in it.

This briefing has been developed under the direction of the HFMA's Accounting and Standards Committee and Provider Faculty Technical Issues Group – we are grateful to all committee members and to Grant Thornton who provided comments as it was developed.

Summary of IFRS 16

The definition of a lease

Paragraph 9 of IFRS 16 defines a lease as a contract, or part of a contract, which conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration. All leases fall under this standard except for very specific leases covered by other standards[3] which NHS bodies are unlikely to enter into.

Unpicking this definition means understanding what the standard means in relation to the following:

- **a contract** – this is an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral or implied. In most instances, a lease will be a written contract – which makes the rights and obligations clearer. ***Technically, the following arrangements are not legally enforceable:***
  - ***between Crown bodies (public sector bodies)***
  - ***memorandum of understanding (MoU), memorandum of terms of occupancy (MOTO) and licences***

  but HM Treasury propose to amend the definition of a contract to include intra-government agreements so arrangements between NHS bodies and between NHS bodies and other public sector bodies will be treated in the same way as commercial contracts
- **the right to control** – this is explained in the standard (paragraph B9) as being when the customer has both of the following:
  - the right to obtain substantially all of the economic benefits from use of the identified asset, for example by having exclusive use of the asset over the period of the lease[4], by having use of its output or by sub-letting the asset and
  - the right to direct the use of the identified asset. ***This assessment is made on the basis of the most relevant decision making rights which will affect the how the asset is used and for what purpose during the period of use***
- **an identified asset** – usually the asset is explicitly identified in the contract. However, a specified asset can be identified implicitly specified at the time when it is made available for use by the customer. Part of an asset can also be the subject of a lease – for example, a room in an office building, ***but it does need to be physically distinct***.

Other than the amendment in relation to the contract, HM Treasury do not propose any amendments to the standard in relation to identification of leases.

[3] Leases to explore or use non-regenerative resources such as minerals and oil, leases for biological assets in the scope of IAS 41, service concessions under IFRIC 12, licences of intellectual property in the scope of IFRS 15 and rights in relation to licences within the scope of IAS 38 such as those for films, patents and copyrights are all excluded from IFRS 16.

[4] This is not necessarily the life of the asset – the right to control us assessed over the period of use of the asset.

The differences between IFRS 16 and IAS 17

The new standard, IFRS 16 replaces IAS 17 and its related interpretations[5]. In general, the definitions of leases in the two standards are quite similar although the new standard contains much more guidance and interpretation on identification of leases than IAS 17. It is not expected that leases previously classified as finance leases under IAS 17 will be outside of the scope of the new standard.

However, it is possible that under the new standard, a lease identified and accounted for as an operating lease under IAS 17 could instead be classified as a contract for services under the new standard and would, therefore, fall outside of its scope.

It is also more important that all leases are identified under the new standard as under IAS 17 the accounting for an operating lease and a service contract was similar whereas under IFRS 16 the accounting for a lease and a service contract is very different, so misclassification could result in material misstatements in the accounts.

The new standard replaces the key question under IAS 17 of 'is it an operating or a finance lease?' with 'is it a lease?'

Application of the standard to the public sector

HM Treasury workplan

IFRS 16 will not be adopted in the public sector until HM Treasury determine whether the standard needs to be adapted or explained before it is included in the *Financial reporting manual* (FReM).

HM Treasury have set out their work plan[6] in relation to IFRS 16 as follows:

- ***December 2017 to February 2018 – issue an ED on the application of the standard in the public sector – this was published in May 2018***
- ***February to March 2018 – consider responses to the ED. As the closing date for comments is 31 July, the ED says that over the summer the responses will be reviewed, and application guidance will be drafted***
- ***November 2018 – FRAB meeting to approve the 2019/20 FReM***
- December 2018 – issue 2019/20 FReM
- 1 April 2019 – standard applies in the public sector.

NHS bodies will not be able to wait until December 2018 to start work on the application of this standard. Therefore, this briefing will be updated as HM Treasury issue their documentation.

National accounts, budgets and estimates

IFRS 16 does not align with European System of Accounts 2010 (ESA 10) which is used to prepare the national accounts. This is currently the case for private finance initiative (PFI) schemes. Bodies with PFI schemes are required to maintain dual accounting records and submit financial information on an ESA 10 basis along with their accounts submission to enable the national accounts to be prepared. HM Treasury is working alongside the Office of National Statistics (ONS) to consider the impact of this standard on public sector finances.

We expect that part of this work will be to consider the practical implications of financing capital expenditure and managing capital expenditure limits.

[5] 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* are all superseded by IFRS 16.

[6] www.gov.uk/government/uploads/system/uploads/attachment_data/file/603024/IFRS_16_-_leases_workplan.pdf

The ED acknowledges the problem. It says a separate work programme has been established with the ONS to assess the extent of the differences and options for obtaining the data necessary for the national accounts, but that work has not been concluded.

The ED does include a table of potential alignment issues between EAS 10 and IFRS 16 and asks for comments what concerns public sector bodies would have if the FReM was aligned with ESA 10.

The focus of this briefing will be on applying the accounting standard as it stands to individual NHS bodies' accounts. However, the HFMA will raise any issues relating to the wider national accounts or budget implications of the in any responses to HM Treasury or the DHSC, or with the arm's length bodies as appropriate.

The standard is also likely to affect metrics currently used by NHS Improvement when assessing the financial performance of NHS provider bodies.

Practical implementation of the new standard

There are many issues NHS bodies will need to consider at an early stage.

Identification of leases

The application of a new standard usually increases the focus of the preparers of accounts, their auditors as well as regulatory bodies on a particular area of the accounts. In this case, the focus will be on all leases and those contracts which could contain a lease.

IFRS 16 sets out a variety of options on implementing IFRS 16 for the first time. These transitional arrangements are set out in appendix C to IFRS 16. One of the options allows for entities to apply the new standard to contracts which were previously identified as leases under IAS 17 *Leases* and IFRIC 4 *Determining whether an arrangement contains a lease* without reassessing without reviewing whether this would continue to be the case under IFRS 16. ***Equally, where a contract has been determined not to contain a lease under IAS 17 and IFRIC 4, this assessment will also stand.***

The ED proposes that the FReM will mandate that public sector bodies carry forward their existing lease classifications rather than re-assessing all leases.

Assuming this proposal is adopted, then the practical impact will be that NHS bodies will only have to apply the IFRS 16 definition only to contracts entered into (or modified) on or after the date of initial application of the new standard. This does not mean that operating leases which are in existence on 31 March 2019 will not have to be brought onto the statement of financial position (SOFP) when this standard is adopted on 1 April 2019. It simply means that existing contracts will not have to be reviewed against the new definition of a lease.

According to the progress update paper presented to the FRAB meeting in November 2017 this preference is based on the assumption that all leases were reviewed in detail when IFRS was adopted 10 years ago and that IAS 17 and IFRIC 4 have been applied since that date. The standard also assumes that a full assessment of contracts will have been undertaken in accordance with IAS 17 and IFRIC 4 when the contract was entered into. If this is not the case, then NHS bodies may have to consider whether their existing contracts need to be reviewed and should discuss this with their auditors.

The November 2017 FRAB paper ***and the ED*** note that it will be important that staff outside of the finance function – those in procurement, legal and estates departments, are briefed on the new standard so they can identify contracts which may contain a lease and inform finance colleagues. Contracting practices need to be aligned to accounting requirements.

Going forward, all contracts should be assessed to see if they are lease contracts. This includes contracts which are short term or for low value assets. Even if these contracts are not accounted for as leases under the new standard, disclosures will need to be made.

Review of leases

In case FRAB does not mandate this transitional arrangement, and for those contracts being signed now, this section of the briefing considers what information will be required if all contracts do have to be reviewed in the light of the new standard.

An important early step to take will be to identify all contracts involving the use of an asset and to review them to determine whether they are lease contracts under IFRS 16. In some cases, judgements will be required, and this is where accountants will need to be involved. For contracts currently being negotiated, this assessment must be made at an early stage of the negotiation process, to assess the impact that the contract will have on the financial position of the organisation throughout its operation.

For existing contracts, this is likely to be the most time consuming part of applying the new standard and work should start on this project as soon as possible. It is perhaps telling that of the twenty-four examples appended to IFRS 16, ten relate to the determination of whether a contract contains a lease or not. Few of the examples seem to be immediately applicable to the NHS but this one may be useful:

Example 10—Contract for network services

Example 10A

Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level.

In order to provide the services, Supplier installs and configures servers at Customer's premises - Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

There is no need to assess whether the servers installed at Customer's premises are identified assets.

This assessment would not change the analysis of whether the contract contains a lease because Customer does not have the right to control the use of the servers.

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding upon the level of network services (the output of the servers) before the period of use - the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used.

Supplier is the only party that can make relevant decisions about the use of the servers during the period of use. Supplier has the right to decide how data is transported using the servers, whether to reconfigure the servers and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer.

Example 10B

Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions, and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

The contract contains a lease. Customer has the right to use the server for three years.

There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning (see paragraph B18). Customer has the right to control the use of the server throughout the three-year period of use because:

- Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.
- Customer has the right to direct the use of the server (because the conditions in paragraph B24(a) exist). Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

Lease registers

Ideally, NHS bodies will maintain a lease register. In our 2016/17 year-end survey[7], just under 60% of respondents indicated that they do maintain a lease register. However, the completeness of that register was a concern in some cases. Only one comment provided an indication of what was included in their register:

'All contracts are recorded in a register. The register is then split into leases (items involving an asset) and financial commitments. It is then further reviewed to ensure that only non-cancellable amounts are included within the financial statement disclosures.'

This is the ideal register because it will enable the organisation to review all of those contacts, including those currently treated as financial commitments, against the new standard.

Where lease registers are incomplete or non-existent, the first step is to identify all contracts which:

- are for more than 12 months duration
- will still be in operation on 1 April 2019 and
- involve an asset – even if the contract is for a service being provided by the use of an identified asset or assets.

At a minimum. these are the types of contracts which will need to be reviewed to determine whether they are lease contracts.

Intangible assets

Rights held by a lessee under licensing agreements within the scope of IAS 38 *intangible assets* for such items as motion picture films, video, recordings, plays, manuscripts, patents and copyrights are specifically scoped out of IFRS 16.

There is an option to apply IFRS 16 to all other intangible assets but this is not a requirement. ***In November, the HM Treasury proposal was to leave the option to assess leases of intangibles to the discretion of individual entities. Intangible assets are not mentioned in the ED so it is assumed that this remains the case.***

[7] www.hfma.org.uk/publications/details/2016-17-year-end-survey

It is not known at this stage whether the DHSC will mandate the treatment of leases of intangibles for NHS bodies but this option is something that individual bodies may want to consider.

PFI and similar contracts

IFRS 16 specifically excludes service concessions under IFRIC 12 from its scope. Therefore, PFI contracts and similar arrangements which are service concessions are not considered in this briefing.

However, the FReM refers entities to the requirements of IAS 17 and IFRIC 4 for accounting and disclosure requirements in relation to PFI schemes. ***The ED proposes that these references will be replaced with references to IFRS 16.***

In practice, this means that where a service concession contains a lease, it will need to be accounted for in accordance with IFRS 16.

Arrangements without contracts

In the NHS, there are often agreements between bodies but there is no supporting contract, or indeed, any documentation whatsoever. Where NHS bodies are aware of these arrangements and they involve the use of an identified asset they should be included in the lease/ contract register.

The proposal in ED is that IFRS 16 will be applicable to intra government arrangements such as memorandum of understanding and licenses even if there is no legally enforceable contract.

For the DHSC, intra-departmental leases are likely to cause a consolidation issue. They will need to be removed on consolidation of the DHSC accounts but the difference between lessee and lessor accounting may make this complicated. It is expected that the DHSC will have to issue agreement of balances type guidance in relation to leases between NHS bodies.

The ED does not propose to make any amendments to the adoption of the standard to address asymmetry issues.

Information required

Alongside identifying all lease arrangements, entities applying this standard will need to collect the information they will need to work out the new accounting entries and disclosure requirements when they apply this standard.

This list is not exhaustive but the following information should be collated and included in the lease register:

- the length of the lease – including any early termination dates or extension periods
  - the standard requires that the leases are accounted for over the period that they are reasonably expected to run – so if there is an early termination option or the possibility of extending the lease the decision needs to be made whether those options are likely to be taken
- the start and the most likely end date of the lease
- the asset – identified by its serial number or some other unique reference
  - this should cross reference to the fixed asset register
- the value of the asset at the start of the lease and at the date that IFRS 16 is adopted
- the implicit interest rate in the lease or the incremental borrowing rate
- any costs involved in setting up the lease
- any costs involved in terminating the lease
- variable terms in the lease – this will include an assessment of the likelihood that those terms will be taken up

- any substitution rights the lessor has – this could be a key requirement when determining whether a contract is a lease or not.

Short term leases and leases of low value assets

IFRS 16 allows entities to elect not to apply the standard to:

- leases which are for less than a year and/ or
- leases for which the underlying asset is of low value.

If either or both of these options are applied then the payments for such leases will be expensed on a straight-line basis over the life of the contract. ***Disclosures are still required in relation to these leases.***

Short term leases

A short term lease is defined in the standard as having a lease term of 12 months or less, after the assessment of any options.

The decision to apply the exemption for short-term leases is made on a 'class of lease' basis – this is a grouping of underlying assets of a similar nature and use in the entity's operations. ***The ED proposes that the FReM will mandate that short-term leases will not be assessed under IFRS 16.***

The disclosure requirements in relation to short term leases will be fully adopted – this means that the expense relating to short term leases must be disclosed. This does not need to include the expense relating to leases with a term of a month or less.

In practice, it means that contracts for less than a year will still need to be classified as leases (or not) so that the expense relating to those contracts which are leases can be disclosed.

Leases for low value assets

The ED indicates it will not mandate whether or not government bodies elect to apply the lease accounting standard to leases for which the underlying asset is of low value. This decision will therefore be made by the NHS body on a lease by lease basis.

The standard itself does not define low value but the basis for conclusions indicate that the preparers of the standard had in mind a value 'in the order of magnitude of US$5,000 or less'.

An underlying asset can only be of low value if:

- it can be used on its own or together with other resources readily available to the lessee and
- it is not highly dependent on or interrelated with other assets.

The IASB had in mind mobile phones, tablets and the like when they developed this exemption. ***The ED suggests that, for government bodies, such items will include laptops, water coolers, small items of medical equipment, photocopiers and franking machines, if they meet the criteria set out in IFRS 16.***

The decision to apply the exemption for low value lases is made on a 'lease by lease' basis. The decision is based on the value of the individual asset and not the value of the lease contract – a lease of lots of low value assets may be material but can be excluded under this exemption because each of the individual assets is of low value. The underlying asset can only be low value if it can be used on its own and it is not highly dependent or highly interrelated with other assets.

HM Treasury has identified this as one of the initial topics for their discussions. The minutes of the FRAB meetings in November 2016 and March 2017 highlight that:

- materiality is a separate consideration to treatment of low value items
- the identification of low value assets should take place regardless of an entities' capitalisation threshold.

The November 2017 FRAB paper identified that this was an area of misunderstanding and was an area where preparers of accounts were asking for more guidance.

The disclosure requirements in relation leases of low value items will be fully adopted – this means that the expense relating to these leases must be disclosed – unless it is a short term lease for low value items in which case it is disclosed as part of the short term lease expense.

In practice, it means that contracts for low value items will still need to be reviewed to see if they meet the definition of a lease or not so that the expense relating to leases can be disclosed.

Discount rates

As discussed in the accounting section below, the lease liability is calculated as the present value of lease rentals plus the present value of the expected payments at the end of the lease. The entity must apply the appropriate discount rate to the present value calculation. IFRS 16 (paragraph 26) says that the discount rate to be used is the interest rate implicit in the lease if that rate can be readily determined. If it cannot then the entity uses its incremental borrowing rate instead. The interest rate implicit in the lease is unlikely to be available to the lessee so the it is widely expected that the incremental borrowing rate will have to be used in practice.

The incremental borrowing rate used in the calculation needs to be the rate that the entity would have to pay if it was borrowing the funds to obtain a similar asset over a similar period to the length of the lease with similar security in a similar economic environment. For particularly long-term leases it might be difficult to identify an appropriate borrowing rate for such a long period

The ED proposes that HM Treasury will develop a central internal rate of borrowing for entities to apply. This rate will be applied to all leases irrespective of the underlying asset.

HM Treasury will agree the final methodology for this discount rate with FRAB before application.

The provision of a central rate will make the application of this standard simpler for public sector bodies. However, it does mean that NHS bodies will be reliant on HM Treasury for the publication of the rates which may impact on understanding the full financial impact of a lease arrangement.

NHS bodies will still have to consider whether they can determine the interest rate implicit in the lease before applying the centrally determined rate.

NHS specific issues

Managed service contracts

Many NHS bodies enter into managed service contracts. Currently these are either being accounted for as an operating lease or as a service contracts (i.e. not as leases at all).

As discussed above, one of the transitional options in IFRS 16 is to ‘grandfather’ the assessment as to whether a contract contains a lease or not from IFRIC 4 into the new arrangements. This means that those contracts which have been assessed under IFRIC 4 as leases will continue to be treated as leases and those which have been assessed under IFRIC 4 as service contracts will continue to be treated as service contracts outside of scope of IFRS 16.

The standard (paragraph B32 to B34) indicates that the difference between a service contact and a lease is that:

- in a service contract, the customer does not obtain an asset that it controls at the start of the contract and that asset does not have to be made available for use by that customer

throughout the contractual term. The customer obtains the service at the time that the service is performed and is only obliged to pay for services provided to date
- in a lease contract, the customer (lessee) obtains and controls the asset throughout the lease term and controls the asset over that period. The customer decides how the asset is going to be used and how it will generate future economic benefits.

NHS Property Services

Lack of formal lease documentation is a particular issue for arrangements with NHS Property Services. At this stage, these arrangements should be identified and all related documentation pulled together as far as possible.

At this stage, this should include those arrangements where a clinical commissioning group (CCG), or other NHS body, is not using the asset but is paying for it (void space). In the commercial world, an entity may seek to terminate such arrangements as they are onerous but this is not always the case in the public sector. An affected NHS body should identify such arrangements at an early stage.

This is a specific area where further debate and guidance will be required as consideration needs to be given to whether such arrangements meet the definition of a lease or are, in substance, a funding arrangement.

Substitution rights

One of the key considerations when determining whether a managed service contract or any other contract is a lease or not will be the identification of an identified asset and, in particular, whether there is a substantive right of substitution. In an arrangement where a supplier can substitute the asset at any time for its own benefit then it has substantive rights of substitution and the contract is not a lease contract. Where it can only provide a substitute asset in very specific circumstances, for example if the original asset breaks down, then it does not have substantive substitution rights and the contract is likely to be a lease.

Substitution rights will normally be specified in the contract and an assessment of whether the rights are substantive will be dependent on the facts and detail in the contract. It will therefore be important for accountants to have access to contracts to be able to assess any rights of substitution.

According to the ED, the IASB did not expect customers to 'exert undue effort to determine whether the supplier has any substitution rights'. Where substitution rights cannot be readily determined then it should be assumed that they are not substantive.

The following example is adapted from example 8 in the standard.

Contract for scans

Customer enters into a contract with Supplier to purchase a type, quality and quantity of scans for a three-year period. The type, quality and quantity of scans are specified in the contract.

Supplier has only one machine that can meet the needs of Customer. Supplier is unable to supply the scans from another machine or source the scans from a third party supplier. The capacity of the machine exceeds the output for which Customer has contracted (i.e. Customer has not contracted for substantially all of the capacity of the machine).

Supplier makes all decisions about the operations of the machine, including the production level at which to run the machine and which customer contracts to fulfil with the output of the machine that is not used to fulfil Customer's contract.

The contract does not contain a lease.

The machine is an identified asset. The machine is implicitly specified because Supplier can fulfil the contract only using this asset.

Customer does not control the use of the machine because it does not have the right to obtain substantially all of the economic benefits from use of the machine. This is because Supplier could decide to use the machine to fulfil other customer contracts during the period of use.

Customer also does not control the use of the machine because it does not have the right to direct the use of the machine. Customer does not have the right to direct how and for what purpose the machine is used during the three-year period of use. Customer's rights are limited to specifying output from the machine in the contract with Supplier. Customer has the same rights regarding the use of the machine as other customers purchasing scans from the machine. Supplier has the right to direct the use of the machine because Supplier can decide how and for what purpose the machine is used (i.e. Supplier has the right to decide the production level at which to run the machine and which customer contracts to fulfil with the output produced).

Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the machine, or that Customer does not have the right to direct the use of the machine, would be sufficient in isolation to conclude that Customer does not control the use of the machine.

Continuing healthcare (CHC) contracts held by CCGs

CCGs will need to review their CHC contracts to determine whether they contain a lease. Like the managed service contracts, such contracts may include the use of an identified asset – in this case a bed or a room.

As with the managed service contracts the difference between a service contract and a lease may well be the substitution rights and whether the CCG controls the identified bed/ room.

The following example is adapted from example 4 in the standard.

Example – room

Customer enters into a contract with a property owner (Supplier) to use room A for a five-year period. Room A is part of a larger residential building space with many rooms.

Customer is granted the right to use Room A. Supplier can require Customer to relocate to another room. In that case, Supplier is required to provide Customer with a room of similar quality and specifications to Room A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of residential space at a rate sufficiently favourable to cover the costs of relocating Customer and other tenants in the residential building. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

The contract requires Customer to use Room A whenever the residential building is open. Customer makes all of the decisions about the use of the room during the period of use. For example, Customer decides on the type of patient which uses the room and the services they require. Customer also controls physical access to the room throughout the five-year period of use.

The contract requires Customer to make fixed payments to Supplier, as well as variable payments that relate to the services provided to the patient in Room A.

Supplier provides cleaning, nursing and catering services as part of the contract.

The contract contains a lease of the room. Customer has the right to use Room A for five years.

Room A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the room but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise (see paragraph B16).

Customer has the right to control the use of Room A throughout the five-year period of use because: Customer has the right to obtain substantially all of the economic benefits from use of Room A over the five-year period of use. Customer has exclusive use of Room A throughout the period of use. Although a portion of the cash flows derived from services from Room A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Room A.

Customer has the right to direct how and for what purpose Room A is used because the conditions in paragraph B24(a) exist. The contractual restrictions on the activities that can be undertaken in Room A, and when Room A is open, define the scope of Customer's right to use Room A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Room A is used by being able to decide, for example, the mix of activities undertaken in Room A and the sale price, if any, for those activities. Customer has the right to change these decisions during the five-year period of use.

Although cleaning, nursing and catering services are essential to the efficient use of Room A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Room A is used. Consequently, Supplier does not control the use of Room A during the period of use and Supplier's decisions do not affect Customer's control of the use of Room A.

Consolidation issues and interaction with lessor accounting

In the NHS, it is not uncommon for bodies to lease assets to one another. Usually, this is done on an operating lease basis. Under IFRS 16, lessors will retain current requirement to classify leases as either operating or finance lease so will continue to show assets leased on an operating lease basis on their SOFP. However, under IFRS 16, the lessee will also show the right of use asset on its SOFP and a corresponding liability to the lessor for the lease payments due over the lease term.

As the accounts of all NHS bodies are consolidated, there will need to be additional consolidation adjustments to ensure that only one asset is recorded in the DHSC's SOFP and that all liabilities with NHS bodies are eliminated.

A similar issue will apply when NHS bodies consolidate their accounts with other entities which prepare their accounts on a UK GAAP – FRS 102 basis rather than IFRS. At this stage, the Financial Reporting Council (FRC) are not proposing to amend FRS 102 to align it with IFRS 16 (see below).

This will be one of the issues that the DHSC will consider as part of the assessment of the standard's impact but it is likely to result in additional disclosures to the consolidating bodies and will bring new transactions within the scope of the agreement of balances exercise.

Prior to the implementation of the standard, the arm's length bodies will need to review their ledger coding to ensure that leases are appropriately reflected in the consolidation accounts.

NHS charities

NHS charities are required to account for leases in accordance with FRS 102. Currently, FRS 102 continues to classify and account for operating and finance leases in the same way as IAS 17. It is not expected that this will change until 2022 at the earliest. This may cause consolidation issues where there are leases between NHS charities and NHS bodies or where NHS charities have entered into leases.

As part of the preparation for the implementation of IFRS 16, leases held by charities will need to be reviewed as well.

Accounting by lessees

Unless the practical expedients for short-term leases and/ or leases for items of low value are applied, IFRS 16[8] requires that all leases will be accounted for on the SOFP from the inception of the contract or the date that the standard is applied (whichever is the earlier).

Leases will be shown on the SOFP as:

- an asset which reflects the right to use the underlying leased asset (the right of use asset) and
- a lease liability representing the obligation to make lease payments.

It is worth noting that IFRS 16 brings onto the SOFP a right of use asset. This is not to be confused with the actual underlying asset itself.

Lease liability

The lease liability will be the present value of the lease payments not paid on the date the contract starts over the lease term. This will be calculated using the interest rate implicit in the lease or, if that is not known, the lessee's incremental borrowing rate.

Lease payments

The lease payments included in the calculation are:

- any fixed payments less any lease incentives receivable. This includes any payments which are 'in-substance' fixed payments – those payments which may be variable, but which are, in reality, unavoidable. One example is a payment which will only made if a particular event occurs when there is no possibility of that event not occurring – this is in-substance a fixed payment
- those variable lease payments that depend on an index or a rate - for example the consumer price index or a benchmark interest payment such as LIBOR
- amounts expected to be payable by the lessee under residual value guarantees
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option. Whether the option is reasonably certain should be assessed considering all relevant facts and circumstances which might create an economic incentive for the lessee to exercise, or not to exercise, the option such as the contractual terms, improvements made to the asset and the importance of the asset to the entity's business
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Variable lease payments which are not included in this calculation are expensed as incurred.

Lease term

The standard defines the lease term as the:

non-cancellable period for which the lessee has the right to use the underlying asset

and periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option

and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

An entity first performs the assessment of whether it is reasonably certain that an entity will exercise an option at the date when the lessor makes the underlying asset available for use to the lessee (the commencement date of the lease). The assessment of whether an option is reasonably certain to be

[8] At this stage, this briefing summarises the requirements of the standard without adaptation. Once adopted into the FReM, the standard may be subject to adaptation or explanation. The briefing will be updated once the FReM requirements are known.

exercised must be made considering all of the facts and circumstances that create an economic incentive to make that decision. These will include contract terms and conditions compared with market rates for the optional periods, any significant leasehold improvements undertaken, any costs associated with termination, the importance of the asset to the entity's operations and any conditions associated with the option and the likelihood of those conditions existing. As well as the specific terms and conditions of the lease under consideration, the entity's past practice should be taken into account.

Incremental borrowing rate

The incremental borrowing rate is the amount that the lessee would have had to pay to borrow over a similar term an asset of similar value in a similar economic environment. This rate will therefore be specific to the lease being considered – it is made on a lease by lease basis. ***As discussed above, HM Treasury are proposing that they will set a central rate to be used when the rate implicit in each lease cannot be obtained. There will not be separate interest rates for different types of asset.***

Reassessment of the lease liability

It might be necessary to re-assess the lease liability after the commencement date if there is a change to the estimate of the lease payments. Re-assessment will also be required where there a change to the lease term or a change in the assessment in relation to the exercise of options.

Right of use asset

Initial measurement

The right of use asset will be measured at the date that the contract starts as:

	the amount of the initial measurement of the liability	This is the double entry for the right of use lease liability
plus	any lease payments made on or before the commencement date	The double entry will be to cash
less	any lease incentives received	The double entry will be to cash
plus	any direct costs incurred	The double entry will be to cash
plus	an estimate of any costs which will be incurred by the lessee at the end of the lease for dismantling and removing the asset.	The double entry will be a provision

Subsequent measurement

Where the underlying asset is property, plant or equipment IFRS 16 allows for right of use assets to be measured on a cost or valuation basis. An entity makes this accounting policy choice on a class of asset.

The ED proposes that public sector bodies will be mandated to apply the IFRS 16 cost model. This is because:

- ***there is little or no guidance on how the revaluation model should be applied to right of use assets***
- ***leases provided by the private sector are generally constructed on market terms and contain regular rent reviews so both asset and liability are subject to regular re-measurement.***

Leases for a peppercorn rent

It is proposed that the FReM would also include an adaptation to the standard in relation to leases on a peppercorn rent basis. The proposal is that these leases will be measured using the following approach:

- ***recognise a right of use asset and measure it using the initial measurement criteria under IAS 16 Property, plant and equipment 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.***

Worked example 1

A trust enters into a 10-year lease on 1 April. Lease payments of £50,000 are payable each year at the start of the year.

The direct costs incurred in arranging the lease are £20,000 and the trust has received a lease incentive of £5,000.

The interest rate implicit in the lease is unknown but the trust has determined that its incremental borrowing rate is 5%.

On 1 April, the lease liability is the net present value of the lease payments not made on that date. This is the net present value (NPV) of £450,000 calculated at 5% using a spreadsheet calculation. Appendix 1 sets out the NPV calculation in more detail.

	£
Net present value of lease payments	355,391
On 1 April, the right to use the asset is:	£
The amount of the initial measurement of the liability	355,391
Plus, any lease payments made on or before 1 April	50,000
Plus, any direct costs incurred	20,000
Less, any lease incentives	(5,000)
	420,391
For the full calculation, please see appendix 1	

	1 April Year 1	31 March Year 1	31 March Year 8	31 March Year 9	31 March Year 10	Total
Net book value of the asset	420,391	378,352	84,078	42,039	0	
Depreciation		42,039	42,039	42,039	42,039	420,391
Lease liability	355,391	373,161	97,619	50,000	-0	

Interest charge		17,770	4,649	2,381		94,609
Cash paid out	65,000		50,000	50,000	50,000	515,000

Impact on the financial statements

The new standard will affect the statement of comprehensive income (SOCI)/ statement of comprehensive net expenditure (SOCNE) and the cash flow statement. Under the current arrangements, operating lease rentals are an operating expense but under IFRS 16 the lease expense consists of depreciation and interest charges. In the cash flow statement, payments under lease arrangements are financing activities rather than operating costs.

Metrics such as EBITDA will also be affected as, currently, operating lease rentals are included in this calculation but under the new standard they will be excluded

For operating leases, the total cost of the lease over its life will not change as it will be the total amount paid to the lessor but rather than the current straight-line rental charge the new interest costs will be higher at the start of the lease period than the end. Depreciation will probably continue to be calculated on a straight-line basis but, overall, the impact of lease arrangements will be higher at the start of the lease period than at the end.

Transition to the new standard

IFRS 16 is to be applied retrospectively by lessees. However, the standard does contain a number of choices to be made in relation to transition – these are set out in Appendix C to the standard.

The first is around the definition of a lease. Paragraph C3 of the standard says, as a practical expedient, entities do not have to reassess whether a contract contains a lease. Instead it can apply the standard to contracts previously determined to be (or contain) a lease under IAS 17 and IFRIC 4. As stated above, HM Treasury are proposing that they will mandate this option.

Then there is a choice is between applying the standard retrospectively:

- to each prior reporting period in accordance with IAS 8 or
- by taking the cumulative effect at the date of application as an adjustment to the opening balance of retained earnings and not restating comparative information (the cumulative catch up approach).

The ED proposes that the second option will be mandated for the public sector as it is seen as more cost effective.

Transition for leases previously determined to be operating leases

For leases previously classified as operating leases, the lessee must:

- ***recognise a lease liability at the date of initial application. This is measured as the present value of the remaining lease payments using the lessee's incremental borrowing rate at that date***
- ***recognise a right of use asset at the date of initial application.***

There is a final choice to be made in relation to the measurement basis for the right of use asset:

- ***the carrying amount as if IFRS 16 had been applied since the commencement date of the lease (discounted using the incremental borrowing rate at the date of initial application of the standard) or***

- ***an amount equal to the lease liability adjusted by any prepaid or accrued lease payments relating to that lease recognised in the SOFP immediately before the date of initial application.***

The ED proposes that the second option is mandated.

Worked example 2

A trust entered into a 10-year operating lease on 1 April 2016. Lease payments of £50,000 are payable each year at the start of each year.

The direct costs incurred in arranging the lease are £20,000 and the trust has received a lease incentive of £5,000.

The interest rate implicit in the lease is unknown but the trust has determined that its incremental borrowing rate is 5%.

In this worked example, the arrangement was determined to be a lease under IAS 17, so it continues to be treated as lease under IFRS 16.

Under IAS 17, lease payments are expensed on a straight line basis over the life of the lease. Lease incentives are also spread over the life of the lease on the same basis. The direct cost of setting up the lease is expensed on 1 April 2017, that date of inception of the lease.

The accounts for the first three years that the lease is in operation look like this:

Statement of comprehensive income

	2016/17	2017/18	2018/19
	£	£	£
Operating costs			
- payment to lessor	(50,000)	(50,000)	(50,000)
- release of the incentive	500	500	500
-set up costs	(20,000)		
Surplus/(deficit)	(69,500)	(49,500)	(49,500)

Statement of financial position

	31 March 2017	31 March 2018	31 March 2019
	£	£	£
Assets			
- cash	(65,000)	(115,000)	(165,000)
Liabilities			
- incentive received in advance	(4,500)	(4,000)	(3,500)
	(69,500)	(119,000)	(168,500)
Taxpayers' equity	(69,500)	(119,000)	(168,500)

The new standard is applied on 1 April 2019. The lease liability is calculated on that date as the net present value of the remaining lease payments – this is 7 years' worth of payments at £50,000 each year.

The lease liability is therefore £289,319. The interest is calculated as 5% of the lease liability each year.

The right of use asset is the lease liability adjusted for the receipt in advance for the lease incentive. This is £285,819. This is depreciated on a straight line basis over the remaining 7 years of the lease which is £40,831 per year.

In summary, this is:

For the full calculation, please see appendix 2						
	1 April 2019	31 March 2020	31 March 2024	31 March 2025	31 March 2026	Total
Net book value of the asset	285,819	244,987	81,622	40,831	0	
Depreciation		40,831	40,831	40,831	40,831	285,819
Lease liability	289,319	253,785	92,971	47,619	0	
Interest charge		14,466	6,808	4,619	2,381	60,681
Cash paid out	50,000		50,000	50,000	50,000	515,000

The standard also requires the following disclosures in the year of implementation:

- *the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the SOFP at the date of initial application – as this is a simple example with only one rate, this is 5%*
- *an explanation of the difference between:*
  - *the operating lease commitments disclosed under IAS 17 at the end of 2018/19, discounted using the rate disclosed under the previous bullet point and*
  - *lease liabilities recognised at the SOFP at the date of initial application.*

In this case, there is no difference – the lease liabilities recognised at the start of the lease are the future lease payments (or lease commitments) discounted, in both cases, at 5%.

Leases previously determined to be 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.

Other transitional issues

IFRS 16 contains a number of other transition arrangements – the ED proposes that the following will be mandated:

- *there will be no adjustments for leases for low value underlying assets*

- ***there will be no transition for leases for which the lease term ends within 12 months of the date of initial application***
- ***entities must use hindsight, in determining the lease term if the contract contains options to extend or terminate the lease.***

This means that there are a number of transition arrangements that NHS bodies will to consider for themselves in relation to:

- ***leases of investment property accounted for IAS 40 Investment property – paragraphs C9(b) and (c) of IFRS 16 give more detail***
- ***leases which had been assessed as onerous under IAS 37 Provisions, contingent liabilities and contingent assets prior to the date of initial – see paragraph C10 (b)***
- ***excluding initial direct costs from the measurement of the right-of-use asset at the date of initial application – see paragraph C10 (d).***

Disclosures

IFRS 16 includes some new and challenging disclosure requirements. Some of these will require judgement because the standard requires disclosures to be made to provide users of the accounts sufficient information to assess the effect that leases have on the entity's financial position.

An entity must disclose the following in a table (unless another format is more appropriate) in the notes to the accounts:

- depreciation charge for right-of-use assets by class of underlying asset
- interest expense on lease liabilities
- the expense relating to short-term leases and leases of low-value assets which are not taken onto the SOFP
- the expense relating to variable lease payments not included in the measurement of lease liabilities
- income from subleasing right-of-use assets
- total cash outflow for leases
- additions to right of use assets
- gains or losses arising from sale and leaseback transactions
- the carrying amount of right of use assets at the end of the reporting period by class of underlying asset.

In addition, both qualitative and quantitative information about leasing activities must be disclosed which might include, but is not limited to, the following:

- the nature of the lessee's leasing activities
- future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:
  - variable lease payments
  - extension options and termination options
- residual value guarantees
  - leases not yet commenced to which the lessee is committed
  - restrictions or covenants imposed by leases
- sale and leaseback transactions.

As always, materiality needs to be considered when determining what disclosures are required.

Disclosures in the year of transition

Where the cumulative catch up approach is applied, the following disclosures must be made in the year of transition:

- ***where practical expedients have been used – this fact should be disclosed***
- ***the information required by paragraph 28 of IAS 8 (except for part (f)):***
  - ***the title of the new standard***
  - ***that the change in accounting policy is made in accordance with its transitional provisions***
  - ***the nature of the change in accounting policy***
  - ***a description of the transitional provisions***
  - ***the transitional provisions that might have an effect on future periods***
  - ***the amount of the adjustment relating to periods before those presented, to the extent practicable and***
  - ***if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied***
- ***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 difference between:***
  - ***operating lease commitments disclosed applying IAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application as described in and***
  - ***lease liabilities recognised in the statement of financial position at the date of initial application.***

Further reading

The standard (without the basis for conclusions and illustrative examples) is available to download free from the IASB's website.

The IASB has also issued an effects analysis, a project summary and fact sheet which are available free of charge from its website.

The ICEAW has issued a useful publication IFRS 16: putting leases into practice which contains articles about the practical application of this standard.

Appendix 1: worked example

Worked example	
A trust enters into a 10-year lease on 1 April. Lease payments of £50,000 are payable each year at the start of the year. The direct costs incurred in arranging the lease are £20,000 and the trust has received a lease incentive of £5,000. The interest rate implicit in the lease is unknown but the trust has determined that its incremental borrowing rate is 5%.	
On 1 April, the lease liability is the net present value of the lease payments not made on that date. This is the NPV of £450,000 calculated at 5%.	
	£
Total lease payment due is 10 x £50,000 but one payment is made on 1 April so the NPV calculation is based on the 9 payments made after the inception date. The formula for calculating the NPV is: $\sum_{i=1}^{T} \frac{C_i}{(1+r)^i}$ Where i= time, C= cash flow and r= discount rate. This calculation is therefore: $\frac{50{,}000}{(1+0.05)^1} + \frac{50{,}000}{(1+0.05)^2} + \frac{50{,}000}{(1+0.05)^3} + \frac{50{,}000}{(1+0.05)^4} + \frac{50{,}000}{(1+0.05)^5} + \frac{50{,}000}{(1+0.05)^6} + \frac{50{,}000}{(1+0.05)^7} + \frac{50{,}000}{(1+0.05)^8} + \frac{50{,}000}{(1+0.05)^9}$	355,391
On 1 April, the right to use the asset is:	£
The amount of the initial measurement of the liability	355,391
Plus, any lease payments made on or before 1 April	50,000
Plus, any direct costs incurred	20,000
Less, any lease incentives	(5,000)
	420,391

	1 April Year 1	31 March Year 1	31 March Year 2	31 March Year 3	31 March Year 4	31 March Year 5	31 March Year 6	31 March Year 7	31 March Year 8	31 March Year 9	31 March Year 10	Total
Net book value of the asset	420,391	378,352	336,313	294,274	252,235	210,196	168,156	126,117	84,078	42,039	0	
Depreciation		42,039	42,039	42,039	42,039	42,039	42,039	42,039	42,039	42,039	42,039	420,391
Lease liability	355,391	373,161	339,319	303,785	266,474	227,298	186,162	142,971	97,619	50,000	-0	
Interest charge		17,770	16,158	14,466	12,689	10,824	8,865	6,808	4,649	2,381		94,609
Cash paid out	65,000		50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	515,000

Appendix 2: worked example

Worked example	
A trust enters into a 10-year lease on 1 April 2017. Lease payments of £50,000 are payable each year. The direct costs incurred in arranging the lease are £20,000 and the trust has received a lease incentive of £5,000. The interest rate implicit in the lease is unknown but the trust has determined that its incremental borrowing rate is 5%. The lease is accounted for as an operating lease until 31 March 2019.	
On 1 April 2019 (the date of transition), the lease liability is the net present value of the lease payments not made on that date. This is the NPV of £350,000 calculated at 5%.	
	£
Total lease payment due is 7 x £50,000. The formula for calculating the NPV is: $$\sum_{i=1}^{T} \frac{C_i}{(1+r)^i}$$ Where i= time, C= cash flow and r= discount rate. This calculation is therefore: $$\frac{50{,}000}{(1+0.05)^1} + \frac{50{,}000}{(1+0.05)^2} + \frac{50{,}000}{(1+0.05)^3} + \frac{50{,}000}{(1+0.05)^4} + \frac{50{,}000}{(1+0.05)^5} + \frac{50{,}000}{(1+0.05)^6} + \frac{50{,}000}{(1+0.05)^7}$$	289,319
On 1 April, the right to use the asset is:	£
The amount of the initial measurement of the liability	289,319
Less, the remaining balance on the incentive received in advance	3,500
	285,819

	1 April 2019	31 March 2020	31 March 2021	31 March 2022	31 March 2023	31 March 2024	31 March 2025	31 March 2026	Total
Net book value of the asset	285,819	244,987	204,156	163,325	122,494	81,662	40,831		
Depreciation		40,831	40,831	40,831	40,831	40,831	40,831	40,831	285,819
Lease liability	289,319	253,785	216,474	177,298	136,162	92,971	47,619		
Interest charge		14,466	12,689	10,824	8,865	6,808	4,649	2,381	60,681
Cash paid out		50,000	50,000	50,000	50,000	50,000	50,000	50,000	515,000[9]

[9] This total includes the cash payments made before the implementation of the new accounting standard