IFRS 16 *Leases*

Summary and early impact assessment (February 2016)

Background

The IASB published IFRS 16 *leases* on 13 January 2016. The implementation date for the standard is accounting periods starting on or after 1 January 2019 but the standard will need to EU endorsement before then and, for NHS bodies, it will also need to be reviewed by HM Treasury and incorporated into the financial reporting manual (FReM).

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 new standard completely changes the way that lessees account for leases. It has very little impact on lessors. This briefing only considers the impact of the standard from the lessee's perspective.

Application date for NHS bodies

All accounting standards have to be endorsed by the EU and incorporated into the HM Treasury FReM before they can be adopted in the public sector.

Wherever possible, new accounting standards are applied in the public sector at the same time as they are applied in the commercial sector. However, as the standards are written for the commercial sector it can take time to consider their impact on public sector accounts and reporting requirements. A recent example is the adoption of IFRS 13 *fair value* which was adopted in the public sector a year after its commercial application due to considerations about its impact on the valuation of non-current assets.

IFRS 16 requires that all leases are reflected on the statement of financial position (SOFP) as assets reflecting the right to use an asset and a liability to pay for that right. Currently, only finance leases are reflected on the SOFP and these leases are counted as capital expenditure which scores against capital resource limits set by HM Treasury.

Clearly, a change in the classification of leases from off-SOFP to on-SOFP will have an impact on the level of capital resource limits and how expenditure is scored against those limits.

HM Treasury will therefore need to analyse the impact of this accounting standard on its system of funds allocation and budget management before it can be adopted in the public sector. NHS bodies will need to be aware of HM Treasury's review of this accounting standard and take part in any discussions relating to its application in the public sector.

Lease definition

The standard does not change the definition of a lease but makes changes to the guidance about how a lease is identified.

Definition of a lease as set out in the standard:

'A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.'

Definition of the underlying asset as set out in the standard:

'An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.'

Paragraph 9 of the standard says:

'At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.'

The standard says in paragraph B9 that:

'To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

a. the right to obtain substantially all of the economic benefits from use of the identified asset; and
b. the right to direct the use of the identified asset.'

The definition of control is the same as set out in IFRS 10.

It is possible that under the new standard, leases which would have been operating leases under IAS 17 will be classified as contracts for services under the new standard and would therefore fall outside of its scope.

Going forward, it will be important to identify all contracts which include the use of an asset and review them at an early stage to determine whether or not they are lease contracts under both IAS 17 and IFRS 16. It is expected that this will be one area where judgement will need to be applied and where accountants will need to be involved at an early stage to be able to assess the impact that the contract will have on the financial position of the organisation throughout its operation.

Accounting by lessees

As already stated, 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 and a lease liability representing the obligation to make lease payments. The only possible exceptions to this are leases of less than 12 months duration and leases for underlying assets of low value such as computers and tablets. The decision about whether to treat these exceptions as leases or not is for the entity applying the standard to make. In the NHS, this decision may be made by HM Treasury or the Department of Health.

The lease liability will be the present value of the lease payments not paid on the date the contract starts. This will be calculated using the interest rate implicit in the lease or, if that is not known, the lessee's 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. Past experience shows that it is unusual that the rate implicit in the lease is known so this is another area where judgement will need to be applied to all lease arrangements.

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

	the amount of the initial measurement of the liability
plus	any lease payments made on or before the commencement date
less	any lease incentives received
plus	any direct costs incurred
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.

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 payments due are 10 x £50,000 but one payment is made on 1 April.	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**

The new standard will affect both the statement of comprehensive income (SOCI) and the cash flow statement. Under the current arrangements, operating lease rentals are an operating expense but these will be replaced under IFRS 16 by depreciation and interest charges. In the cash flow statement the cost of leases will be shown as financing costs 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

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.

Leases between NHS bodies

In the NHS, it is not uncommon for bodies to lease assets to one another. Usually, this is done on an operating lease basis. Lessors will retain the operating/finance lease distinction so will continue to show assets leased on an operating lease basis on their SOFP. However, under the new standard, the lessee will also show the asset on its SOFP and will also record a payable to the lessor for the lease payments due over the life of the lease.

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 Department's SOFP and that all liabilities with NHS bodies are consolidated out of the SOFP. This will be one of the issues that the Department 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.

Transition to the new standard

The standard allows entity to adopt the practical expedient of not re-assessing all leases when applying this standard. This means that the new guidance on the definition of leases would only be applied to new contracts entered into after the date that the standard is adopted. All leases which have been identified as such under IAS 17 and IFRIC 4 would be treated as leases under this new standard.

There is also a choice to be made when accounting for the new standard. The 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.

It is expected that HM Treasury will determine which of these options will be applied in the NHS.

Disclosures

As always, the standard includes new 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.

A table will be included in the notes to the accounts which will include:

- 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.

This table will be supplemented by other information where specific circumstances apply.

In addition, qualitative and quantitative information about leasing activities will be disclosed which might include:

- 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.