HFMA briefing
Updated July 2019

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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 applying the HM Treasury's Financial reporting manual (FReM) or the Department of Health and Social Care's (DHSC) Group accounting manual (GAM) the application of the standard has been deferred to 1 April 2020 (the 2020/21 financial year). For NHS bodies which are also companies applying EU adopted IFRS, such as NHS Property Services Ltd, the standard is still applicable in 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]

[1] Financial Reporting Advisory Board (FRAB) meeting minutes November 2017, 2017

- April 2018 – to add a second worked example
- June 2018 – following the publication of HM Treasury's Exposure Draft[2] (the ED)
- February 2019 – following the publication of HM Treasury's application guidance[3] (the AG) on IFRS 16 and the consultation draft of the IFRS 16 supplement to the 2019/20 GAM[4] ('the DHSC guidance'). This also follows the HFMA webinar on leases and the 2019 pre accounts planning conferences at which leases were discussed
- ***July 2019 – following the publication of HM Treasury's budgeting guidance[5] for the application of IFRS 16. This also follows the second HFMA webinar on leases – the briefing has not been updated for the questions raised during that webinar. Instead a second briefing will be prepared over the summer to respond to those questions***.

Changes to the briefing made in the July 2019 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.

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.

[2] HM Treasury, IFRS 16 leases: exposure draft 18(01), 2018
[3] HM Treasury, IFRS 16 leases: application guidance, 2018 (updated April 2109)
[4] DHSC, Group accounting manual: IFRS 16 supplement , 2019
[5] HM Treasury, IFRS 16 Leases: supplementary budgeting guidance, 2019

Contents of this briefing

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 standards6 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 in the public sector HM Treasury has amended 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[7], by having use of its output or by sub-letting the asset and
  - the right to direct how and for what purpose the identified asset is used. 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.

The differences between IFRS 16 and IAS 17

The new standard, IFRS 16 replaces IAS 17 and its related interpretations[8]. 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.

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[6] 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.

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

[8] 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.

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).

In November 2018, FRAB agreed that IFRS 16 would be effective in the public sector from 1 April 2020. Public sector companies that are required to report in accordance with the Companies Act and EU adopted IFRS will continue to apply the standard from 1 April 2019.

In April 2019, HM Treasury amended the AG to reflect:

- guidance on how right of use assets will be subsequently measured – ***mandating the valuation model in the public sector***
- guidance on accounting for lease-like arrangements with nil consideration
- ***guidance on discount rates***.

In July 2019, they issued guidance on the implications of IFRS 16 on national budgets and accounts.

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.

The ED acknowledged the problem, and this is the reason that application of the standard has been deferred for a year. ***HM Treasury planned to issue guidance on the implications for national budgets and accounts in March 2019 – it was finally issued in July.***

In summary, the budgeting will reflect the accounting and any adjustments to reflect ESA10 will be done at the national level. For NHS bodies, the application of IFRS 16 will not impact on capital resource. However, from 1 April 2020, the value of the right of use asset will score against CDEL when a new lease commences. It is expected that there will be an adjustment to CDEL to reflect the impact of the new standard.

The focus of this briefing is on applying the accounting standard as it stands to individual NHS bodies’ accounts.

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 it 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 AG mandates that public sector bodies carry forward their existing lease classifications rather than re-assessing all leases. However, the DHSC guidance makes it clear that this is based on a presumption that the guidance in IAS 17 and IFRIC 4 has been appropriately applied in the past. Any misapplication of the definition of a lease should be corrected as a prior period error in accordance with IAS 8 before the application of the new standard.

The practical impact will be that NHS bodies, ***that are satisfied with their current IAS 17 and IFRIC 4 assessments,*** 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.

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. ***In 2018/19, the adjustments in relation to the application IFRS 9 and 15 in the NHS tended to be undertaken by finance teams without changes being made to systems and wider departmental processes. This approach will not work in relation to leases as finance teams will need to be informed of all contracts which could contain a lease at the earliest possible stage – ideally before it is signed.***

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

For those contracts being signed now, and those which have not been reviewed in accordance with IAS 17 and IFRC 4, 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.

This assessment will require a detailed understanding of the standard's requirements. The standard contains a useful flow chart for assessing whether a contract is a lease or not in paragraph B31.

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.

Lease registers

All NHS bodies will maintain a lease register. In our last two year-end surveys[9], between 50 and 60% of respondents indicated that they do maintain a lease register. However, the completeness of that register was a concern in some cases.

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 2020 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. The DHSC guidance indicates that this option is open to NHS bodies.

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 ***DHSC guidance indicates*** 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 ***and the necessary disclosures made*** 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 meet the definition of a lease they should be included in the lease/ contract register.

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.

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.

[9] HFMA, 2016/7 year-end survey, 2017 and HFMA, 2017/18 year-end survey, 2018

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. Any lease with a purchase option cannot qualify as a short-term lease.

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 FReM will mandate that IFRS 16 will not be applied to short-term leases – this will be a public sector adaptation to the standard.

The disclosure requirements in relation to short term leases will be fully adopted – this means that, where material, 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

Other than on transition, there will be no public sector adaptation made for the low value asset exemption. This decision will therefore be made by the NHS body on a lease by lease basis.

On transition to IFRS 16, NHS bodies are required to take the leases of low value assets exemption. It is then for them to determine whether they continue to take that exemption for leases entered into after 1 April 2020.

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'.

The assessment of whether an asset is based on the value of the asset when it is new regardless of the age of the asset being leased. Paragraph B4 of the standard says:

> 'The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the accounting treatment in paragraph 6 regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.'

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 AG 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. It confirms that ***paragraph B6 of*** IFRS 16 explicitly states that a car would not qualify as a lease of a low value asset.

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. ***The assessment of whether leased assets are highly dependent or highly interrelated should be consistent with the assessment made in relation to purchased grouped assets.***

HM Treasury 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 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 material 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

HM Treasury will develop a central internal rate of borrowing for NHS bodies to apply. This rate can be applied to all leases where the NHS bodies cannot determine the interest rate implicit in the lease. Those bodies, such as subsidiaries, which follow EU adopted IFRS will not be able to use the HM Treasury rate.

HM Treasury will publish the discount rate each January in a PES paper. The Treasury application guidance includes a worked example on how the discount rate should be applied.

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

The issues raised in this section were identified early as issues that NHS bodies would have to consider. Following the webinar hosted by the HFMA in November 2018, a number of detailed issues were raised, these issues and an initial response are set out in appendix 3 to this briefing. ***The webinar in July 2019 raised further issues – a new briefing addressing these is being developed.***

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. ***In the absence of documentation, NHS bodies will need to make judgements around these leases. These judgements should be fully documented and will probably need to be revised annually.***

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. ***In other words, spending time constructing an argument that substitution exists may well demonstrate that those rights are not substantive!***

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.

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 expedient for leases for items of low value is applied, IFRS 16 requires that all leases which do not meet the definition of a short-term lease 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 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 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.

Treasury have determined that the right of use asset will be subsequently measured on a valuation basis as this is consistent with the principles applied to property, plant and equipment.

In practice, in most cases, depreciated historic cost will be an appropriate proxy for current value in existing use or fair value. This will be the case where the lease has provisions to amend the rental payments for market conditions. Also, right of use assets generally have shorter useful lives and values than the underlying asset so the Treasury guidance on IAS 16 around using cost as a proxy can be applied.

A three-stage approach can be applied to revaluation:

Stage 1 – expensing leases	***Stage 2 – depreciated historic cost***	***Stage 3 – revaluation***
Short-term leases are expensed (mandated by HM Treasury) ***Low value assets are expensed (mandated by HM Treasury on adoption, applied at the NHS body's discretion thereafter)***	***Apply the same tests as set out in the HM Treasury guidance on IAS 16:*** ***Lower value assets excluding those that could incur a significant fluctuation in their fair value.*** ***Assets with a shorter economic life. That is, shorter than the full cycle of the revaluation policy under IAS 16***	***For assets where there is no provision to regularly update the terms to reflect market conditions or where there is a risk that the fair value of the asst will fluctuate.*** ***The example given is a property lease of 30 years where there is only one rent review at the mid-point.*** ***It is expected that there will be a small number of mainly property leases where cost will not be an appropriate proxy and a valuation will have to be sought. The DHSC is in discussion with RICS to ensure that valuers are given appropriate guidance.***

Leases for a peppercorn rent

The FReM also includes an adaptation to the standard in relation to leases on a peppercorn rent basis. These leases will be measured using the following approach:

- recognise a right of use asset and measure it at current value in existing use or fair value (for right of use assets held for its service potential. For right of use assets meeting the definition of a heritage asset, the initial measurement will be in accordance with the FReM guidance on heritage assets
- 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 income in accordance with IAS 20 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 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 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 second option is mandated for public sector bodies.

Worked example 2

A trust entered into a 10-year operating lease on 1 April 2017. 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, the 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

	2017/18	2018/19	2019/20
	£	£	£
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 2018	31 March 2019	31 March 20209
	£	£	£
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 2020. 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 2020	31 March 2021	31 March 2025	31 March 2026	31 March 2027	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 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 2018. 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 2020.	
On 1 April 2020 (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 2020	31 March 2021	31 March 2022	31 March 2023	31 March 2024	31 March 2025	31 March 2026	31 March 2027	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[10]

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

Appendix 3: questions asked as a result of the HFMA's webinar on leases

Please note that while we are happy to help NHS organisations where we can, we will not be in possession of all the relevant facts and the local circumstances, so you should not place any reliance on our views or provide them to a third party. Your organisation needs to satisfy itself that the relevant legislation and guidance has been complied with.

General

If an NHS trust takes on a head lease and has to account for it under IFRS 16, do subsequent subleases with other NHS trust tenants also need to be accounted for under IFRS 16 by the sub tenants?

Probably, yes. That is assuming that each lease and sub-lease meets the definition of a lease set out in IFRS 16. Paragraph 3 of the standard says, 'An entity shall apply this Standard to all leases, including leases of right-of-use assets in a sublease,'

The NHS trust will account for the head lease as a lessee and the subleases as a lessor. Paragraph B58 sets out how the sublease should be classified as a finance or operating lease.

There is a consolidation issue here for NHS Improvement/DHSC to remove transactions between NHS bodies from the group accounts. It is likely that additional information will be required for all leases between NHS bodies to allow for the necessary consolidation adjustments to be made.

As these assets are right to use assets and not the asset themselves will they be classed as an intangible asset?

No, paragraph 47a of the standard states:

> 'A lessee shall either present in the statement of financial position, or disclose in the notes:
>
> - right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
>   - include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
>   - disclose which line items in the statement of financial position include those right-of-use assets.'

Does this include intangible "assets" such as use of software which are sometimes classed as operating leases?

Paragraph 4 of the standard says that it may be applied to intangibles (except those specifically excluded) but it is not a requirement. In their exposure draft on the application of IFRS 16 to the public sector, HM Treasury indicated that the standard would not be applied to intangibles in the public sector.

Paragraph 3e specifically excludes some intangibles from the scope of the standard – those are '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.'

NHS bodies will need to consider whether they will apply this standard to intangible assets such as cloud computing.

NHS VAT rules on leases used to be continually changing as there was a perception by HMRC that NHS trusts were exploiting tax loopholes. Are there any plans to standardise rules to the private sector or to provide some kind of long term view?

Not that we are aware of. HMRC has consulted[11] on the tax implications of IFRS 16 but VAT is not mentioned. We will raise this question with the HFMA's VAT sub-committee.

The big issue for the NHS is the capital resource limit, is there any steer yet on how this is going to be increased to account for all the extra capital on the balance sheet?

Not yet, this is the reason that the application of the standard has been delayed for a year. HM Treasury and the Office of National Statistics are working together to resolve the problem. It is expected that they will issue guidance in April 2019 which will allow time for public sector bodies to work through the impact of the standard on their budgets and forecasts.

CDEL is clearly a big issue here. What will happen to leases entered pre implementation of IFRS 16?

That is being worked on by HM Treasury and the Office of National Statistics and will become clearer during 2019.

What is clear is that all contracts which meet the definition of a lease will need to be accounted for in accordance with IFRS 16 no matter when they are entered into.

Are there worked examples?

The standard is accompanied by 24 illustrative examples. Some of these have been used in our briefing[12] and tailored for NHS specific circumstances.

We will develop other examples as implementation of the standard progresses and this FAQ contains the first of these.

Interested to know which software those that have opted to purchase a software solution chose, in order to explore this avenue?

We surveyed our members and those who attended the webinar to try to identify what solutions are being used.

The standard states we can elect to apply the short-term lease and low value exemptions. What form does this election take?

HM Treasury will mandate that all NHS bodies apply the short-term lease exemption, so NHS bodies will not have to make this decision. The fact that the exemption has been taken will be disclosed in the accounting policies. The amount expensed on short-term leases will need to be disclosed, where material so these leases still need to be identified.

It is expected that the decision to exclude low value assets from the standard will not be mandated. NHS bodies will therefore have to discuss their decision with their audit committees and determine their own policy. The low value exemption is applied on a lease by lease basis so it should be considered whenever a lease of low value items is entered into. However, on a practical basis, each NHS body should determine its own policy so that leases of low value items can be identified, discussed and a decision taken for each one.

The fact that the low value asset exemption has been taken needs to be disclosed in the accounts and the amount expensed on such items also needs to be disclosed, where material. Again, this means that these leases will have to be identified and the necessary information will need to be recorded.

Slide 8 stated leases are excluded if short life AND low value so it's not short life OR low value?

This was a typo on the slide and has been corrected in the version emailed to all attendees of the webinar.

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[11] HMRC, Income tax and corporation tax: response to accounting changes for leasing, July 2018
[12] HFMA, Accounting for leases – application of IFRS 16, June 2018

The exclusion applies to short life leases as well as leases of low value assets.

For clarity, paragraphs 5 and 6 of the standard say:

> 'A lessee may elect not to apply the requirements in paragraphs 22–49 to:
>
> - short-term leases and
> - leases for which the underlying asset is of low value (as described in paragraphs B3–B8).
>
> If a lessee elects not to apply the requirements in paragraphs 22–49 to either short-term leases or leases for which the underlying asset is of low value, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.'

The disclosures in 2018/19 and 2019/20 require a lot of the new standard to be worked through now to enable the financial impact to be understood and reported in this year's accounts?

Paragraphs 30 and 31 of IAS 8 *accounting policies, changes in accounting estimates and errors* state:

> When an entity has not applied a new IFRS that has been issued but is not yet effective, the entity shall disclose:
>
> - this fact and
> - known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application.
>
> In complying with paragraph 30, an entity considers disclosing:
>
> - the title of the new IFRS
> - the nature of the impending change or changes in accounting policy
> - the date by which application of the IFRS is required
> - the date as at which it plans to apply the IFRS initially and
> - either:
>   - a discussion of the impact that initial application of the IFRS is expected to have on the entity's financial statements or
>   - if that impact is not known or reasonably estimable, a statement to that effect.'
>
> So, it is not necessary to be ready to comply with the standard to make these disclosures. However, the disclosure should make reflect the best estimate of the impact at the time of preparing the accounts or a statement that it is not yet possible to tell and the reasons why.
>
> If, by the time of preparing the accounts, the impact of the standard on national accounts and CDEL is not known then this should be disclosed because it means that the full impact of the standard is not reasonably estimable.

Lease terms

Where property is leased but lease term is not clear - e.g. three months notice by lessor or lessee - how is term arrived at?

NHS Property services generally have annual contracts for buildings but are expected to be rolled over unless the NHS bodies wishes to move out of the property. Presume these fall into the new standard?

Paragraphs 18 and 19 of the standard say:

> 'An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

- 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.

In assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease, as described in paragraphs B37–B40.'

The non-cancellable period of a lease is the period for which the contract is enforceable. If either party has the right to terminate the lease without permission from the other party (with no more than an insignificant penalty) then the contract is no longer enforceable.

In assessing whether an option to extend a lease is reasonably certain, the following factors are highlighted in paragraphs B37-B40 of the standard:

- whether the optional periods are at market rates – if they are below market rates then it is more likely that they will be taken up
- whether significant leasehold improvements have been undertaken – it would make extending the lease more likely
- what the costs of terminating the lease are
- how important the underlying asset is to the lessee's operations. This is likely to be key to NHS lessees, as assets may well be specialised or in a specific location. The availability or not of suitable alternatives should also be considered – again, for NHS bodies this may be a key consideration
- whether there are conditions attached to extending the lease and whether those conditions are likely to exist.
- how short the initial non-cancellable period of the lease is – if it is short then it is more likely the lease will be extended because the costs of a replacement asset are likely to be proportionally higher
- the custom and practice of the lessee in relation to the period it has typically used particular types of asset.

Is it a lease?

Several of the questions below relate to whether or not an arrangement is a lease.

Paragraph 9 of IFRS 16 states:

> '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.'

Paragraph B31 of the standard contains a flow chart which is useful to consult when determining whether a contract is a lease. However, using paragraphs B9 to B31 of the standard, the responses below are based on the following questions:

1. Is there a legally enforceable contract? Or is there a contract/arrangement between two public sector bodies?
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?
3. Is there an exchange of consideration?
4. Does the contract convey the right to:
    - obtain substantially all of the economic benefits from use of the identified asset and
    - direct the use of the identified asset?

If the answers to all of these questions is yes, then the contract is a lease.

Will a current licence to occupy between two public sector organisations be captured under IFRS16? I assume it will be?

If it meets the definition of a lease, then it is a lease even if it is called something else. As the licence to occupy will relate to a specified asset, the licence should be reviewed against the standard starting with the questions above.

Contracts between two public sector organisations may not be legally enforceable but will be brought into the scope of the standard by the HM Treasury amendment to include arrangements between Crown bodies.

The NHS standard contract

Is the standard NHS contract with acute provider likely to include a lease - all have property and can't substitute, move elsewhere?

Are we confident that for CCGs none of the contracts we hold with say acute providers under the NHS standard contract do not fall within IFRS 16 i.e. they involve assets and could not be easily substituted by the provider? Is there an easy answer that allows us to exclude all such contracts?

Community contracts could also be a problem. Does each organisation have to review every contract or is there a way of reviewing the NHS Standard contract once, centrally and issuing national guidance?

Would the CCG contract with the CSU be a managed service contract? National guidance would be useful for expected treatment by CCG of assets used/contracted by the CSU in order to deliver a service to the CCG – could be buildings, lease cars and IT/GPIT.

What about secondary commissioning arrangements for inpatient stays (e.g. an arrangement to have use of a bed for 6 months)? Does this have implicit use of the building? Or is this similar to the fibre optic example where it is too difficult to quantify part of an asset?

Even if a nationally agreed approach to standard contracts is determined, each NHS body will have to consider whether there are local amendments to the standard contract that may result in a different outcome.

However, we will discuss these issues with the DHSC, NHS Improvement and NHS England to try to ensure that a consistent approach is taken across the NHS.

To start that debate, working through the questions above results in the following assessment:

1. Is there a legally enforceable contract?
   The answer to this question is yes, there is a contract.
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?
   The asset (hospital, clinical, care home) may not be explicitly identified but it is likely to be implicit in the contract that care will be delivered from a particular NHS site. It is unlikely that the NHS provider body could practically change the site from which they deliver healthcare services.

   Having said that, it may not always be the case for all healthcare services. Some will not require specialised assets and could be delivered from alternative sites.

   The answer to this question is probably yes.
3. Is there an exchange of consideration?
   The answer to this question is yes, there is an exchange of consideration.
4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

   It is the question of control which will determine whether there is a lease or not. Paragraph B21 of the basis of conclusions states ‘To control the use of an identified asset, a customer is required to have the right to obtain **substantially all** of the economic benefits from use of the asset throughout the period of use'. The bold has been added as this seems to be key to this assessment – it is unlikely that a single CCG will commission all of the services being provided from an NHS site, or event part of that site.

On that basis, the answer to this question is no.

Therefore, the NHS standard contract does not contain a lease.

However, in some cases there may a separate asset, or physically distinct part of an asset – for example, a particular floor/clinic that is used purely for the provision of a service that is commissioned by only one CCG (or NHS England in the case of specialised services) then there may be a lease for that asset or part of an asset. This could be the case where a CCG has a contract for a room or bed in a care home to be used for continuing care or step down care. In that case, consideration needs to be given as to whether the commissioning body has the right to direct how and for what purpose the use of that asset. Paragraphs B24 to B27 of the standard provide more guidance.

If a tenant occupies space in a property but no lease (undocumented) exist will this be treated as a lease for this IFRS16?

Yes, if it meets definition of a lease under IFRS 16 as set out above. The fact that there is no documentation makes that assessment harder as it will have to be based on custom and practice.

It is suggested that custom and practice and the assumptions that have been made in the assessment are clearly documented at an early stage. Ideally, these will be agreed by the other party to the arrangement and can then form the 'lease documentation'.

It should be noted that the standard is quite clear that when assessing whether an arrangement contains a lease or not, entities should consider what is reasonably certain to happen when considering the terms of the arrangement, in particular, options included in the contract. The standard, and the associated illustrations and basis of conclusions, are clear that what is expected to happen takes precedence over terms and conditions when applying the standard.

Managed service contracts/equipment

Would equipment provided free as part of a consumable deal need to be included?

What about contracts where we pay for consumables and get an asset "free of charge" will they be captured as part of this?

What about a managed service agreement whereby the supplier is signing a contract that guarantees an output, they provide equipment, not necessarily named, itemised equipment, that is used in order for the supplier to "sell" the output of that equipment, the supplier controls what assets are deployed, and the right to use the equipment is granted as part of the unitary charge?

Paragraph 12 of the standard requires the lease component of contracts to be accounted for separately to the non-lease (service) components. As a practical expedient, lessees may elect not to separate contracts into lease and non-lease components – this is done for a class of assets which are of a similar nature and use in an entity's operations. It is not done on a lease by lease basis.

For these contracts, the service element should therefore be separately identified. This will mean identifying the stand-alone price for this element of the contract on the basis of the price that would be paid for a similar service without the associated asset.

In relation to the asset, these contracts will need to be looked at individually because the detailed terms will be different. The following might be useful when considering whether there is a lease:

1. Is there a legally enforceable contract?
   Yes, there is likely to be a contract.
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?

The asset may be explicitly identified but it may be implicit in the contract. Substantive substitution rights will be key – whether the supplier has the practical ability to substitute alternative assets it would be commercially beneficial for them to do so. It is worth noting that paragraph B17 indicates that an asset located at the customers location generally costs more to substitute and these costs are likely to outweigh the benefits of substitution.

3. Is there an exchange of consideration?

   If the service or consumables are genuinely provided for free, then the answer to this question is no. However, in order to determine whether this is actually the case, some work may well need to be undertaken to identify how much it would cost to purchase the service or consumables alone.

4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

   This will need to be determined on a case by case basis but if the NHS bodies has exclusive use of the asset, this would indicate that the answer to these questions will be yes. Equally, if the equipment is specifically calibrated or designed to the NHS body's specification then the answer is likely to be yes.

   In terms of the right to direct the use of the asset, the key consideration set out in paragraphs B24 to B30 of the standard is the right to determine how and for what purpose the asset is used. Paragraph B26 sets out the following examples:

   - rights to change the type of output produced by the asset
   - rights to change when the asset is used
   - rights to change where the output is produced
   - rights to change whether output is produced and the quantity of the output.

   Consideration needs to be given to who decides when, and whether, the equipment is used and how much it is used. If the contract contains clauses that require a certain amount of throughput, then it is more likely that the NHS body will not have the right the direct the use of the asset.

   The fact that the supplier has the right to maintain an asset does not, in itself, mean that the NHS body does not have the right to direct its use. The standard recognises that the supplier will want to ensure that its asset is maintained appropriately.

   Illustrative examples 1, 5, 8 and 9 in the standard may be useful when considering managed service contracts.

As a CCG we are held financially responsible for NHSPS vacant/ void space. We do not hold a lease so would this fall within IFRS 16?

Answering the questions above:

1. Is there a legally enforceable contract?

   Yes, there is a contract, albeit not necessarily a written one

2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?

   There is likely to an explicitly identified asset although this will need to be reviewed on a case by case basis. Paragraph B20 of the standard provides additional guidance on portions of assets. The asset needs to be physically distinct (for example, a floor of a building) – this may not necessarily be the case for void space.

3. Is there an exchange of consideration?

   Yes, there is an exchange of consideration – the CCG makes a payment for the space.

4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

Whether the CCG has control of the asset is the question which needs to be answered. The considerations here are around the benefit the CCG gets from the space and the ability of the CCG to direct how the space is used. This will depend on the arrangement in place but where the CCG cannot determine how the void space is used, by whom and at what cost then it is unlikely that this test is met.

Are payments made by CCGs to GP practices for premises costs subject to IFRS 16? If so, why? Asset would usually be identified, period of time questionable for ongoing contract, exchange of consideration is present but right of control is weak.

We are discussing this question with NHS England at the moment. We think that it is a matter of whether the CCG has the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.

Lease car arrangements

Many trusts operate salary sacrifice car employee benefit schemes for employees. Employee may use car just for private use, employer charged lease. How will the rules change for these regarding the IFRS pls?

When it comes to leases for cars our understanding is that the cars with business use would need to come on to the balance sheet but when it comes to any car leased by staff through salary sacrifice and salary deduction, we understand these would not be brought onto the balance sheet. Would you agree?

The precise arrangements in relation to lease cars needs to be determined.

Where the leased cars are for business use only, then they will be leases.

Where leased cars are for business use and personal use then the terms of the arrangement will need to be considered. We are aware of some situations where the NHS body effectively acts as a broker between the lease company and the employer and, beyond the introduction, has no role/liability in relation to the lease car. The payment of expenses for business use is the same as if the employee owned their car. In these cases, it is unlikely that the NHS body would have a lease in relation to the car.

In other examples, the NHS body is a signatory to the lease along with the employee and has some liabilities relating to the contract. In these cases, the NHS body would have to consider the questions set out above:

1. Is there a legally enforceable contract?
   Yes, there is a contract.
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?
   Yes, there is an explicitly identified vehicle.
3. Is there an exchange of consideration?
   Yes, there is an exchange of consideration.
4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

This will depend on the terms of the contract and the arrangement entered into. If the personal use of the vehicle is incidental, then the NHS body may have a lease. If the employee can use the vehicle for their own personal use without restriction, then the NHS body is unlikely to be party to a lease as it does not get *substantially all* of the economic benefits from the vehicle or direct its use.

It is highly unlikely that any vehicles would be considered low value assets other than, perhaps, bicycles.

If I have an asset, funded by a local authority with leases for <30% floor space taken by GPs and 2 NHS Trusts. The CCG is providing a guarantee that it will commission health services in the space taken by GPs and trusts. The local authority is going to maintain the asset and will retain control of the asset. Leases with GPs/trusts will be 25-year leases.

1) does the CCG that provides a guarantee have to recognise or disclose anything under IFRS16?

2) will the trusts' contracts be considered leases?

The questions above will need to be considered by both the CCG and the trusts as well as the GPs. However, the GPs will have to make their decision based on the accounting treatment they adopt for their accounts – if they are following FRS 102 then they will have to determine whether they have an operating or finance lease, if they are following IFRS then they will have to make an IFRS 16 determination for 2019/20.

For the CCG, the assessment may be as follows:

1. Is there a legally enforceable contract?
   Yes, there is a guarantee which is a contract.
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?
   Probably, but see the trust assessment below.
3. Is there an exchange of consideration?
   Possibly, but presumably only if the trust or the GP pulls out of the site.
4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

   This is unlikely if the CCG is simply acting as guarantor. The decision to use or not to use the asset will lie with the GP or the trust and the CCG is acting as backstop.

   However, if the arrangement is that the CCG is part of the decision-making process around the use of the asset and the asset is used for services it commissions from the site then this may not be the case. As always, the assessment will depend on the exact terms of the agreement.

For the trust, the assessment is likely to be different:

1. Is there a legally enforceable contract?
   Yes, with the local authority.
2. Is there an explicitly identified asset? If not, is there an implicitly identified asset?
   Probably, assuming that the trusts are using a physically distinct of the building. If they have a defined floor/clinic/consulting rooms then this is the case. If they have access to a number of different consulting rooms but the local authority determines which of them the trust can use, then this may not be the case. Illustrative example 4 may be useful in this case.
3. Is there an exchange of consideration?
   Yes.
4. Does the contract convey the right to:
   - obtain substantially all of the economic benefits from use of the identified asset and
   - direct the use of the identified asset?

   This is the key question and it will depend on what '… will retain control of the asset' means in reality. The fact that the local authority is responsible for maintaining the asset does not mean that the trusts and GPs do not have these rights. However, issues such determining what services are provided from the asset, when they are provided and to who are likely to mean that the trusts have these rights.

Transition issues

Is it expected that where we currently have a dilapidation provision, that this should be included as part of the lease liability - or would they continue to remain separate? If it should be part of the liability - we'd then have questions around the first year transition.

This will continue to be treated as a separate provision.

On transition to the new standard, in relation to leases previously classified as operating leases the lessee will recognise:

- a lease liability at the date of initial application of IFRS 16 as the present value of the remaining lease payments discounted using the applicable rate at the date of initial application
- a right of use asset equal to the lease liability adjusted by any prepaid or accrued lease payments (assuming that HM Treasury mandate this transition option).

Any provisions relating to the end of the lease period will continue to be recognised.

For leases previously classified as finance leases, the right of use asset and lease liability will have the same carrying amount as the lease asset and liability recognised immediately before transition.

We have occupied a number of CHP properties for perhaps ten years now without a formal lease in place. For various reasons, we are now looking to sign up to a lease agreement for a fixed term. For the purposes of calculating the impact on transition to IFRS16, should we be treating 1/1/2019 (for example) as the lease commencement date (because we signed a document then) or 1/1/2009 (for example) because that is when we started to occupy the property and pay rent on it? Thinking of the chart you included showing the front-loaded I&E charge under IFRS16, the choice of this date is probably the difference between it being a cost pressure and a cost benefit to us in the first year of IFRS 16 applying.

If the terms and conditions of the arrangement do not change then simply signing the lease will not make any difference to the accounting. The standard applies to all leases whether there is a signed contract or not, although a signed contract makes everything easier to assess.

If the terms and conditions are substantially amended, then the lease would most likely be deemed to start on the date that the arrangement is signed.

The transition arrangements, and the options selected by HM Treasury, for leases previously deemed to be operating leases effectively mean that they will be brought onto the balance sheet as if they had been entered into on the date of transition.