IFRS 16: Leases

Frequently Asked Questions

Version: 9 December 2022

Change log

Date	Updates
9 December 2022	The following questions have been added: • Question B3 – when to apply the updates to the HM Treasury discount rate • Question B4 – measuring lease liabilities at year end • Question H4 – dealing with subsidiaries who implemented IFRS 16 in a previous year
7 January 2022	We have renumbered the questions based on section headers to make referencing easier. Updated HMT incremental borrowing rate in question (B1) A number of new questions have been added: • Question (A2) – grandfathering of leases without contracts, such as NHS Property Services • Question (B2) – dealing with changes in inflation • Questions in Sections I) Leasehold Improvements, J) Dilapidation provisions and K) Other transition issues.
15 October 2021	Reissued to reflect two-year implementation deferral – no new content (changes not marked)

Introduction

This document answers frequently asked questions on the application of IFRS 16 by NHS bodies. It does not form part of any accounts direction to providers or commissioners. If there is any doubt, a reading of IFRS 16 and the Department of Health and Social Care (DHSC) Group Accounting Manual (GAM) when issued for 2022/23 should take precedence.

Where this document refers to interpretations and adaptations made by HM Treasury in adopting IFRS 16, these are explained in HM Treasury's application guidance and are also reflected in the DHSC GAM supplement: see our Implementation Guide for links.

IFRS 16 implementation guidance

Our IFRS 16 implementation guide together with other tools provided by DHSC are available on our IFRS 16 financial accounting webpage: https://www.england.nhs.uk/financial-accounting-and-reporting/ifrs-16/.

Contents

A) Defining a contract / lease term / lease payments

A1) We are occupying a building but do not have an agreed contract for the lease. Do we still need to apply IFRS 16?

Paragraphs B9-B31 of IFRS 16 give guidance on the assessment of whether a contract is, or contains, a lease. But this guidance is intended to ensure that <u>all contracts</u> are adequately considered to assess whether they are in essence a lease. The guidance in the standard does not envisage a scenario where an arrangement exists but there is no actual contract in place.

*Importantly, HM Treasury has made a public sector adaptation in adopting IFRS 16. This is seen in paragraph 2.10 of HM Treasury's IFRS 16 application guidance and is in the FReM: "*The definition of a contract (and therefore, of a lease) is expanded to include intra-UK government agreements that are not legally enforceable.*" This adaptation is intended to capture lease-like arrangements between Crown bodies, or other governmental bodies, that are not legally enforceable but are in substance akin to an enforceable contract.*

NHS Property Services is a governmental body and so arrangements with them are in the scope of this adaptation.

Our expectation is that most arrangements with NHS Property Services will meet the definition of a lease because it is likely that the customer will obtain substantially all of the economic benefit of use, have the right to direct use and the right to operate the asset throughout its period of use.

*But entities will also have to judge whether the arrangement constitutes a short term arrangement. The application guidance goes on, in paragraph 2.11: "*when applying paragraph B34 of IFRS 16 to lease-like arrangements between Crown Bodies, an entity should consider whether the lessee and lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, notwithstanding the fact that the agreement is not legally enforceable." *Where an NHS body is occupying a building in such circumstances without a documented agreement, it should consider what rights it has to continue to occupy the building. Paragraphs*

B34 to B41 of the Standard give important guidance on assessing the lease term. If each party (tenant and landlord) could terminate the arrangement with only an insignificant penalty, then there is not an enforceable lease. However for intra-government arrangements, application of the public sector adaptation quoted above is likely to override this, with HM Treasury's intention being to capture such arrangements that are "not legally enforceable" but resemble a lease in all other respects.

Assuming there is an arrangement that rolls over each year in the absence of a documented lease agreement, the standard explains that a 12-month rolling arrangement may not constitute a short term lease: if the customer has the right to extend the arrangement, it must consider at the commencement date if it is reasonably certain to do so (paragraph B37).

Therefore if an NHS body has an annual licence/agreement but no documented lease agreement with NHS Property Services (for example), then the public sector adaptation overrides the 'is it enforceable' point, and the entity should consider whether it is reasonably certain to extend the lease beyond the current non-cancellable term. For example if the entity could technically vacate the property within a month but its business plan is based on delivering services from that property for the next ten years, and there is no information to suggest the lessor has a different view, then it would be logical to conclude that the lease term is reasonably certain to be longer than one month.

In such a scenario the lessee entity should estimate the lease terms based on the commercial reality and business plans. This will be an important local judgement and the entity will need to document its rationale. In the example above the lease term might be estimated at ten years. See also question (A3) for additional considerations in making this judgement: it's important that it the initial lease term judgement reflects current reality and expectation.

Once the length of the lease is established and the lease liability calculated, this is then used in accounting for each subsequent year with the lease term reducing by one year at each year end. After this, a lessee reassesses the lease term (per paragraph B41 of the standard) only when there is a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to extend the lease.

A2) We have an existing arrangement with NHS Property Services which we are not currently disclosing as a lease. Does this mean it will not be grandfathered in as a lease under IFRS 16?

IFRS 16 defines a lease as "A contract, or part of a contract that conveys the right to use an asset for a period of time in exchange for consideration". The FReM adapts this definition to include intra-government arrangements that may not be legally enforceable (ie may not be considered a 'contract'). IAS 17 defined a lease without reference to a contract: "A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time". An adaptation of IAS 17 was therefore not required for intra-

government arrangements that don't take the legal form of a lease to be considered a lease under that standard. This was also supported by interpretive guidance in IFRIC 4. While such an arrangement is likely considered 'cancellable' leading to no disclosure of future operating lease commitments under IAS 17, the arrangement is still considered a lease. All such existing arrangements are therefore expected to transition to IFRS 16 as an implementation adjustment on 1 April 2022. Entities should reconsider their assessment of these arrangements as leases under IAS 17 before transitioning to IFRS 16.

A3) We have an existing lease where we need to estimate a lease term as covered in question (A1). Are there any implications if we initially estimate this as too low and revise it (by increasing the lease term) in the future?

To comply with the standard it is important that an accurate estimate of the lease term is made at commencement (or IFRS 16 transition). Bringing existing leases on balance sheet on transition at 1 April 2022 will not score to national capital budgets (see question (F1)). But future lease modifications such as remeasuring the lease liability as a result of an increased lease term (per paragraph 40 of the standard) ***will*** *score to capital budgets upon remeasurement. Care must therefore be taken to accurately estimate the lease term for contracts that are coming on balance sheet for customers as part of IFRS 16 transition.*

A4) We have a historic lease-like agreement with a non-governmental body, eg a university, but neither we nor the other party cannot locate the historic agreement. Does this mean we have a lease or not?

The spirit of the HM Treasury adaptation is that such arrangements between public sector bodies could be considered a contract for evaluating as a lease. Relying on the fact that a university can be considered non-governmental is not in that spirit. Even if the other party is firmly a private sector commercial entity, we recommend that the entity now takes this opportunity to put an updated formal agreement in place with the other party, and ensures it is properly accounting for the arrangement under current standards before 1 April 2022. This will assist in transition to IFRS 16.

A5) How does IFRS 16 implementation work for existing contracts? And what does 'existing contracts' mean?

Paragraphs 7.4 and 7.5 of the HM Treasury application guidance makes clear that in the public sector, the transition expedient in paragraph C3 of IFRS 16 has been mandated. This means that the entity does not reassess whether an existing contract is, or contains, a lease at the date of initial application: this is carried forward from a previous assessment under IFRIC 4.

This is of course predicated on the assessment having been properly performed under IFRIC 4 previously. The implementation of IFRS 16 may identify items that the entity or its auditor will reconsider, and it is possible that a prior period error might be identified in some cases. If a contract is identified that was not previously properly assessed under IFRIC 4, correcting this is not an effect of IFRS 16 transition. Whether identified and corrected during the 2021/22 or 2022/23 years, usual practices in IAS 8 should *then be applied - starting with determining whether the impact of the prior error on previous and future periods is material or not – to determine if a prior period adjustment is required.*

*As to what 'existing' means - paragraphs 9 to 11 of IFRS 16, covering the assessment of a contract to identify a lease, says the assessment is made at <u>inception</u> of a contract. This is consistent with paragraph 10 of IFRIC 4. This is carried through the transition part of IFRS 16, where paragraph C4 says: "*the entity shall apply the requirements in paragraphs 9-11 only to contracts entered into (or changed) on or after the date of initial application.*"*

*While commencement (as referred to in question (F2) below) is the date on which the lessor makes the underlying asset available for use by the lessee, inception date is defined in IFRS 16 as "*the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease*". Therefore if an entity commits to a lease in 2021/22, the IFRIC 4 and IAS 17 assessment should be made at that point. The assessment of whether the contract contains a lease then carries through on transition to IFRS 16 as explained above.*

A6) Our employees can benefit from a centrally-operated lease car scheme. Does this mean we are the lessor in a lease arrangement?

Not necessarily. Whether this meets the definition of a lease for the employing entity will depend on the exact nature of the scheme. An illustrative example to explain this point is provided in paragraph 3.49 of DHSC's Group Accounting Manual IFRS 16 supplement: https://www.gov.uk/government/publications/dhsc-ifrs-16-implementation-guidance

A7) We have a contract where we obtain economic benefit from services provided through use of an asset. Does this mean it the arrangement will always meet the definition of a lease with us as the lessee?

Not necessarily. Paragraph 9 of the standard defines a lease as a contract which conveys the right to control the use of an identified asset for a period of time in exchange for consideration. 'Right to control' is expanded on in paragraph B9 – this means the right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use, and the right to direct the use of the identified asset throughout the period of use. Paragraph 3.49 of DHSC's Group Accounting Manual IFRS 16 supplement (https://www.gov.uk/government/publications/dhsc-ifrs-16-implementation-guidance) includes an example where it is assessed that the contract does not contain a lease because the customer does not have the right to direct the use of the identified asset. The example, for Continuing healthcare, is written for a commissioner but will be useful reading for all NHS bodies.

A8) We have a contract where we don't pay for the asset in itself but have to buy consumables from the supplier. How do we factor that into IFRS 16 considerations?

This does not affect the definition of whether there is a lease. Paragraph 9 of the standard defines a lease as a contract which conveys the right to control the use of an *identified asset for a period of time in exchange for consideration. The standard tests of whether there is an identified asset and so forth apply as normal. If the result of this is that it is assessed that the contract meets the definition of a lease with a right-of-use asset, then the lease payments need to be determined. These are amounts paid under the contract per paragraph 27 of the standard.*

If the customer is obliged to buy a certain minimum level of consumables then part of these payments are likely to be considered in-substance fixed lease payments as explained in paragraph B42 of the standard. The customer would need to estimate the fair value of the consumables (based on what the supplier or another supplier would charge for such consumables if no asset was being provided), with any amount paid above this being considered part of the lease payments for the leased asset. The amount determined as relating solely to the consumables would be expensed as the consumables are used. Any consumables purchased above this contracted minimum would be expensed as consumables (per paragraph 38(b) of the standard).

If there is no minimum purchase of consumables required by the contract and the purchases only depend on the use of the asset then such purchases, even if likely, will not be considered lease payments. Any consumables purchased would be accounted for separately and expensed when they are used. If the contract does not require a fixed minimum to be purchased, and the purchase of consumables is solely related to the future level of use of the asset, then the logic of BC169 of the standard is applied: "The IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset from the measurement of lease liabilities." *Continuing further, with the same paragraph says* "In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset." *Applying this logic means that such a contract would also not meet the definition of a peppercorn lease, as such arrangements still need to meet the definition of a lease in all other respects. Our expectation is that a contract like this where there are no fixed minimum payments for consumables will be one where it is assessed that the customer does not have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use - and as such there will be no right of use asset to account for.*

A9) We are the customer in an intra-government lease-like arrangement which we previously did not treat as a lease under IFRIC 4 on the basis that we considered it non-enforceable in the absence of a contract. Under IFRS 16 the HM Treasury adaptation expands the definition of a lease to include intra-UK government agreements that are not legally enforceable, but at the same time on transition we are not supposed to revisit assessment made under IFRIC 4?

Our experience is that these arrangements were usually treated as leases under IAS 17 and linked standards. The HM Treasury mandated practical expedient which says to not reassess judgements for existing contracts previously made under IFRIC 4 assumes that those judgements were correct. If there is any doubt, the HM Treasury adaptation under IFRS 16 for the definition of a lease should be applied, so we expect that the contract referred to here could now be considered a lease under IFRS 16, with the right of use asset recognised as part of 1 April 2022 transition. (Or via a prior *adjustment if it is considered that an error was made previously, it is material, and would have been a finance lease under IAS 17.)*

B) Discount rates and measurement of the lease liability

B1) What is the centrally provided incremental borrowing rate?

The FReM interprets IFRS 16 by requiring entities to use the HMT discount rate as their incremental borrowing rate[1]. This rate should be used in two circumstances:

- *On transition – for all existing leases not previously recognised as finance leases and not exempted under the short term or low value practical expedients. The lease liability should be calculated using the HMT specified discount rate in all cases, even where there is a rate implicit in the lease.*
- *For new leases commencing after transition to IFRS 16 – where there is no rate implicit in the lease, the incremental borrowing rate should be used.*

HM Treasury has confirmed that the discount rates will be applicable for a calendar year and will be published in the preceding December. The rate applicable to the 2022 calendar year is ***0.95%.***

This rate will apply to all existing operating leases transitioning on 1 April 2022 and all new leases commencing on or after 1 April 2022 where no rate is implicit in the lease. A rate applicable for the 2023 calendar year will be issued in December 2022. For the purposes of 2022/23 operational plans, entities should assume an incremental borrowing rate of 0.95% for the full financial year. Where leased additions are forecast in Jan - Mar 2023 and no rate is implicit in the lease, they should be discounted in capital plans at this rate.

B2) We have a lease where future lease payments are subject to increase in line with increases in CPI. Do we need to estimate future rates of inflation and this in our calculation of the lease liability?

Paragraph 27(b) of IFRS 16 requires variable lease payments that depend on an index or rate to be included in the lease liability, initially measured using the index or rate at the commencement date. This means where lease payments are linked to movements in an inflation index such as CPI, when calculating the lease liability, entities should assume that CPI remains unchanged (no inflation) in future years. Estimates of future inflation should not be made. This is further confirmed in the basis for conclusion paragraph BC166.

A remeasurement of the lease liability is triggered when the change in future lease payments actually occurs. This means that leases with payments linked to inflation will likely require remeasurement each year to reflect only the impact of the current year's movement in the index on future lease payments.

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[1] Per HM Treasury guidance, the HM Treasury rate should be used as the incremental borrowing rate unless the entity can demonstrate that another discount rate would more accurately represent their incremental borrowing rate (for example, if they undertake external borrowing independently of the Exchequer). This is unlikely to be the case for NHS providers and commissioners, so we expect the HM Treasury rate will be used.

B3) **Added 9 December 2022:** In December 2022 HM Treasury is expected to issue a new discount rate for the 2023 calendar year. Do I need to remeasure all my lease liabilities using the new discount rate on 1 January?

No. A lease liability is only remeasured if there is a reassessment of judgements used in measuring the lease liability (eg assessment of option to extend the lease term), a lease modification, or a change in in-substance fixed lease payments. When remeasuring a lease liability in these instances, a revised discount rate is only used in the following three circumstances:

1) *There is a change in the assessed lease term.*
2) *There is a change in the assessment of an option to purchase the underlying asset.*
3) *There is a lease modification that is assessed not to be a new lease.*

Where a lease liability is remeasured as a result of change in amount expected to be payable under a residual value guarantee or a change in future lease payments resulting from movement in an index or rate, the discount rate should not be updated.

B4) **Added 9 December 2022:** NHS Property Services usually issue annual charging schedules after the financial year commences. Do I need to estimate what the next year's charges will be for the new year to revalue my lease liability as at 31 March?

Remeasurement of lease liabilities for changes in in-substance fixed lease payments is only triggered when the change in contractual cash flows occurs. Remeasurement in this scenario is therefore not triggered until the new year. Remeasurement of lease liabilities is not an annual revaluation exercise. There is no specific requirement to remeasure lease liabilities at a year end, although assessment of options within the lease agreement should be reconsidered regularly to ensure they remain appropriate.

C) Accounting for the right-of-use asset

C1) The HM Treasury application guidance sets out two different ways: (i) using the cost measurement model in IFRS 16, and (ii) at current value in existing use. Are we likely to need to obtain valuations for leased assets as a lessee?

At the commencement of a lease, the lessee's initial measurement of the right-of-use asset is at cost. This is the same as the initial measurement of the lease liability, plus or minus the adjustments defined in paragraph 24 of the standard.

*For subsequent measurement of the right-of-use asset, HM Treasury has interpreted IFRS 16 such that (from paragraphs 3.14 to 3.18 of its application guidance): "*The subsequent measurement basis of all right-of-use assets shall be consistent with the principles for subsequent measurement of owned property, plant and equipment set out in the adaptations to IAS 16. Accordingly, right-of-use assets should be measured at either fair value or current value in existing use (ie that the revaluation model should be used, rather than the cost model). This will ensure that the measurement of right-of-use assets will be consistent with the measurement of owned assets in the public sector, and that the benefits of using a current value measurement be maintained for right-of-use assets. However, in practice, in most cases, the cost measurement model in IFRS 16 will be an appropriate proxy for current value in existing use or fair value.

This is because leases will often have provisions to update rental payments for market conditions, which will be captured in the IFRS 16 cost measurement provisions. Moreover, right-of-use assets generally have shorter useful lives and values than their respective underlying assets, and the FReM sets out, in the guidance on IAS 16, that cost can be used as a proxy for assets with shorter economic lives or lower values."

"However, for some right-of-use assets, the cost model in IFRS 16 will not be an appropriate proxy for current value in existing use or fair value. This is likely to be the case when both of the following conditions are met:

- A longer-term lease has no provisions to update lease payments for market conditions (such as rent reviews), or if there is a significant period of time between those updates; and
- The fair value or current value in existing use of the underlying asset is likely to fluctuate significantly due to changes in market prices. This is more likely to be the case with property assets."

While individual circumstances may differ and local bodies must complete proper local assessments, our indicative expectation for the NHS is as follows:

- *non-property leases – we expect that for the vast majority of leases, the IFRS 16 cost measurement provisions will be sufficient, because this will give a result that is a reasonable proxy for current value in existing use*

- *property leases with specialised asset – we expect that in some cases these will require regular valuations to ensure appropriate measurement. Where these are currently treated as finance leases under the old standards, this will probably already be the case. This will include PFI hospital contracts which are accounted for as leases. Such contracts tend to be for a relatively long period, tend not to have rent reviews, and the valuation measurement basis of such assets (depreciated replacement cost: modern equivalent asset) tends to be more volatile*

- *property leases with non-specialised asset – these will vary and local assessment will be required.*

Where it is judged that the IFRS 16 cost measurement provisions will give a result that is a reasonable proxy for current value in existing use, the lessee will continue to measure the asset at cost based on the lease liability, less accumulated depreciation and impairment losses, and adjusted for any remeasurement of the lease liability. This means that external valuations would not be necessary.

The lessee would need to consider obtaining a valuation where application of the cost model would not result in a fair approximation of the value of the right-of-use asset on a current value in existing use basis. As ever, materiality should be borne in mind when making this assessment. As guided by the application guidance extract above, this is likely to be the case with property assets where the lease has a longer term with no updates for market conditions or a significant period of time between those updates. Entities may find it useful to compare the period of time between rent updates against its policy for how often owned assets receive a formal revaluation: if they are *similar then the lease cost is being updated to market conditions sufficiently regularly that the cost model is more likely to be appropriate.*

A valuation approach may also be appropriate where it is known that lease rental payments are below market value.

C2) If we do have to use valuations, that's a matter of subsequent measurement rather than initial measurement (apart from peppercorn leases, covered below). So would we have to think about valuations as at 1 April 2022?

For leases that are currently classified as finance leases under IAS 17, on initial application of IFRS 16 at transition the carrying amount of the right-of-use asset and lease liability will be the same as those under IAS 17.

For leases that are currently classified as operating leases under IAS 17, HM Treasury's interpretation of IFRS 16 means that the approach in paragraphs C8(a) C8(b)(ii) is followed. Initial application of the Standard at 1 April 2022 means the right-of-use asset will be equal to the lease liability (per C8(a)), adjusted for any prepaid or accrued lease payments.

If the revaluation model is to be used for the leased asset, this applies to subsequent rather than initial measurement. For owned assets under IAS 16, it is usually self-evident when the principle of subsequent measurement should start to apply. HM Treasury's implementation of IFRS 16 is clear that the same principles are to be applied equally to right-of-use assets. Therefore it would normally be expected that 31 March 2023 would be the first point at which to apply the principles of subsequent measurement and consider whether a valuation is required.

However given the nature of measuring right-of-use assets, there may be (probably rare) scenarios where it would be appropriate to move to 'subsequent measurement' more quickly than 31 March 2023. This would be the case where it is obvious that maintaining an initial measurement of the right-of-use asset during 2022/23 equal to the lease liability (ie at cost) would be far away from the principle of current value in existing use, and thus affecting the I&E, for example where lease payments are artificially low (but do not meet the definition of peppercorn). In such a situation it may be appropriate to move to subsequent measurement at valuation sooner after initial recognition at 1 April 2022 in order to ensure the effect on the I&E in 2022/23 is not misstated.

The principles of revaluation in IAS 16 are applied to a class of asset. The judgement of whether the cost model under IFRS 16 can be used as a proxy for valuation of a right of use asset is made at the level of individual leased assets. Our view is that the judgement of moving an individual leased asset to subsequent measurement valuation 'early' in order to improve the accuracy of measurement can be made for an individual lease.

D) Nil consideration and peppercorn leases

D1) We have an arrangement that entitles us to use of an asset but we don't have to pay anything. Can we ignore IFRS 16?

No. As explained in paragraphs 2.13-2.14 of the HM Treasury application guidance: "The definition of a lease is expanded to include agreements that have nil consideration." *That means the principles of lease accounting continue to apply – and in particular the accounting for peppercorn leases.*

D2) What is a peppercorn lease for a lessee and do we have to do anything different?

Peppercorn leases are defined as leases for which the consideration paid is nil or nominal (that is, significantly below market value). HM Treasury recognises that the application of the IFRS 16 cost model for initial measurement of these leases would not result in an appropriate valuation for the right-of-use asset, as the lease liability would be substantially low or nil value for peppercorn leases.

The accounting to follow is explained in chapter 4 of the HM Treasury application guidance. In summary, the lessee recognises a right-of-use asset with initial measurement at current value in existing use. The lease liability is measured in accordance with IFRS 16 and the difference between the two is treated in the same way as donations and government grants in the FReM.

The depreciation charge and any impairments on such right-of-use assets will have specific treatment in national budgets so this is likely to require specific analysis in collection forms.

E) Managed Equipment Services

E1) How do we apply IFRS 16 to a new Managed Equipment Service (MES) we are considering?

Under IAS 17 and IFRIC 4, an MES would be evaluated to determine if the contract is, or contains, a lease. If it does, the implicit lease would then be evaluated to determine if an operating or finance lease. While new accounting standards mean the second part is not required (as on-SoFP accounting is always done for the lessee), the first part continues to apply.

Paragraphs B9 to B31 of IFRS 16 give guidance on determining whether a contract is, or contains, a lease. The basic principles are similar to those under IFRIC 4, but there is changed language relating to control. Any new MES should be evaluated under these paragraphs of IFRS 16.

E2) For our existing MES, what do we have to do for IFRS 16 implementation?

The principles here are the same as for any other contract: see question (A5) above. The concept of having the right to direct the use of the identified asset might also be relevant: see question (A7) above.

F) Government budgeting and effect on limits

F1) What impact will IFRS 16 have on capital resource limits? We are currently examining procurement options for a new asset, so how should we plan?

HM Treasury has released budgeting guidance for IFRS 16[2]*. At a high level, we expect IFRS 16 to impact budgets as follows:*

- *Capital: taking out a new lease as a lessee will score to capital budgets. Under previous standards, only leases categorised as finance leases scored in this way. There will be no CDEL impact for existing arrangements that transition on implementation of IFRS 16.*
- *Revenue: for a lessee, previously operating leases had their lease payment score to expenditure. Under IFRS 16, the depreciation and interest charges will score to expenditure. This will be profiled differently, with interest charges higher in the earlier part of the lease. We expect this will impact both new arrangements commencing in 2022/23 or later, and existing arrangements that transition into IFRS 16.*

We are currently seeking further clarity from HM Treasury and DHSC on the practical application of changes to Department level control totals, including the Capital Departmental Expenditure Limit (CDEL), as this will impact the formulation of guidance and policies for the NHS. However the budgeting treatment for leasing and purchasing assets will now be similar so procurement decisions should be made solely on value for money and other considerations in line with project appraisal guidance rather than being influenced by which different budget the arrangement will score to. HM Treasury's IFRS 16 budgeting guidance says "[Entities] should not sign short-term leases only to reduce CDEL, but should assess all options based on VfM and other relevant considerations*".*

F2) For a new lease entered into as a lessee, there may be a gap between signing the lease contract and the right-of-use asset(s) being made available for our use. At which of those dates is CDEL affected?

HM Treasury has covered this in paragraph 11a of its IFRS 16 budgeting guidance: the initial CDEL charge is incurred on commencement of the lease, ie the date on which the lessor makes the underlying asset available for use by the lessee – which should be the same as when the asset is recognised on the balance sheet by the lessee.

G) Data collection and forms

G1) What information will NHS England and NHS Improvement collect from us, and when?

More detail on this is provided in our IFRS 16 Implementation Guide – see https://www.england.nhs.uk/financial-accounting-and-reporting/ifrs-16/

[2] This is available at the bottom of this webpage: https://www.gov.uk/government/publications/government-financial-reporting-manual-application-guidance but it is primarily written for government departments, and does not contain all the detail necessary for us to operationalise this for the NHS.

G2) We’re working on what IFRS 16 implementation will mean for us as provider organisation. What should we be mindful of in terms of information NHS Improvement will want to collect from us, as it will affect our ledgers?

Please refer to our IFRS 16 implementation guide for details of the agreement of leases exercise, 2022/23 impact forecast in December 2021 to January 2022, and transition adjustment submission. Thinking ahead your preparations should also include data in the following areas. Note this list is not exhaustive.

- *Right-of-use assets will be a separate item on the statement of financial position in TAC forms in 2022/23: this means that leased assets for the lessee will move out of property, plant and equipment (PPE) and into this separate movements note. We’ve assessed this is the least cumbersome way of meeting the asset-related requirements of paragraph 53 of the standard which includes analysis by class of asset – we’ll probably use the same classes as the columns in the PPE note.*
- *Depreciation charges for right-of-use assets will need to be split by class of asset.*
- *The effect of remeasurement of lease liabilities will be separated from other movements in valuation for the right of use asset.*
- *Peppercorn leases will need to be separately identified, including depreciation charges for the right-of-use asset and non-cash income recognised as a result of the approach explained in question (D2).*
- *Separate disclosure information will be needed on expenditure relating to short-term leases, leases of low-value assets, and variable lease payments not included in the measurement of lease liabilities.*
- *Many existing income and expenditure items will need to be split between property and non-property leases to enable HM Treasury to make adjustments needed for National Accounts.*
- *Further, the collection of many elements (such as depreciation charges for right-of-use assets) is likely to be split by counterparty type (with other providers, with DHSC group bodies, etc) to facilitate the necessary consolidation adjustments.*

This is intended to provide an early indication of the sort of information we will need to collect relating to IFRS 16. Not all of this will feature in planning forms, which will be at a more summarised level than the detail that will be in TAC forms in 2022/23.

G3) What will we need for our 2021/22 year end accounts?

NHS bodies will need to make disclosures in accordance with IAS 8 on the impact of standards that have not yet been adopted. Given the material effect of IFRS 16 for many entities, this disclosure will be important in 2021/22. Information will be collected in the 2021/22 year end forms to enable us to make this disclosure in our consolidated accounts. But the emphasis of this data collection will be on that impact assessment disclosure, rather than collecting the detail of transition for accounts purposes. Given comparatives in the 2022/23 accounts will not be restated on an IFRS 16 basis, we won’t be collecting that level of detail in 2021/22 forms. At the same time, bodies are encouraged to start thinking about paragraph C12(b)(i) of the Standard for information on the effect of transition that will be disclosed in 2022/2 accounts.

H) Subsidiaries

H1) We consolidate a subsidiary into our accounts. Does that require special consideration before 2022/23?

The deferral of IFRS 16 until 2022/23 applies to the public sector as a result of HM Treasury implementation. If your trust has a subsidiary which accounts under full IFRS and has a 31 March year end, it will need to report under IFRS 16 from 2019/20 in its own accounts. When consolidating the subsidiary into the trust's group accounts, the trust's group accounting policies will continue to be on an IAS 17 basis in 2019/20 to 2021/22, so consolidation adjustments will be required. Please keep this in mind as part of your year end planning if you are affected by this. All reporting to NHS Improvement should include non-charity consolidated subsidiaries (as usual) but with consistent accounting policies, i.e. not on an IFRS 16 basis before 2022/23.

H2) Our subsidiary prepares accounts under IFRS, so will be applying IFRS 16 to its single entity accounts from 2019/20. Does the HM Treasury application guidance apply to the subsidiary?

Not directly. The HM Treasury application guidance contains adaptations and interpretations of IFRS 16 which are only applicable to the public sector. Subsidiary single entity accounts are prepared in accordance with the Companies Act and where prepared under IFRS, IFRS 16 should be applied in its original form. From 2022/23, the subsidiary will continue to apply IFRS 16 in its original form, but the trust will need to apply any public sector adaptations upon consolidation into its group accounts.

H3) Our subsidiary prepares accounts under FRS 102, so won't be doing 'IFRS 16 style' leasing accounting. What will we have to do in 2022/23?

When you consolidate your subsidiary into your 2022/23 accounts, the trust's group accounting policies will be on an IFRS 16 basis (as interpreted by the FReM), so consolidation adjustments will be required. The trust might be able to determine that the impact of the standard in the subsidiary is not material, but this would technically be an unadjusted error in the trust's group accounts, so should be discussed with your auditors. If there is a material lease between the trust and the subsidiary, remember that you will need to eliminate this transaction in the trust's group accounts – so ensure you prepare for this.

H4) **Added 9 December 2022:** We consolidate a subsidiary that has already applied IFRS 16 for 3 years. Do we need to reverse out 3 years of IFRS 16 accounting before consolidating the subsidiary?

The public sector IFRS 16 initial application date of 1 April 2022 should apply to all leases within the local group accounts. However, unwinding 3 years of IFRS 16 accounting on subsidiary leases is likely to be burdensome and the impact of this additional work will continue in future years until the leases expire. For most preparers of local group accounts, the impact of the difference in initial application date is unlikely to be material to the group accounts. To relieve considerable burden, entities should consider not aligning the initial application dates on consolidation and instead accept *an immaterial unadjusted error in the audit completion report (issued under ISA 260). Local bodies should estimate the impact of this and discuss with local audit.*

I) Leasehold Improvements

I1) Our trust has significant leasehold improvements already capitalised within PPE in relation to existing operating leases. How are these treated on transition?

Leasehold improvements paid for by the tenant (also referred to as tenant's works) are recognised and measured under IAS 16 and not IFRS 16. As such, they do not form part of the right of use asset and should be separately disclosed as PPE. Existing leasehold improvements capitalised prior to 1 April 2022 will remain within PPE and should not be reclassified to right of use assets.

Where leasehold improvements are made by the lessor instead of the tenant and the lease rental increased commensurate with the price of the improvements, this should be considered a lease modification and recognised as such under IFRS 16.

I2) Our valuation for the right of use asset includes the value of the leasehold improvements. How do we reflect this in our accounts?

Where leasehold improvements relate to a right of use asset held at valuation rather than cost under IFRS 16 (eg peppercorn leased assets), the valuation will need to be split between the right of use asset and the improvements. Where the valuer cannot easily distinguish between the two, entities should use an appropriate estimation basis to split this valuation. Where leasehold improvements are not significant, cost may be an appropriate proxy for the leasehold improvement portion. Any estimation basis used should be discussed with your auditor.

J) Dilapidation provisions

J1) IFRS 16 requires us to capitalise the expenditure as we build up a dilapidation provisions as part of the right use asset. However, we have existing dilapidation provisions in relation to existing operating leases. What adjustments, if any, do we make on transition?

The transition provisions of IFRS 16 are silent in relation to existing dilapidation provisions. Differing interpretations may have a significant impact on both revenue and capital budgets. We are therefore seeking clarification from HM Treasury for consistent application. In the interim, we are advising NHS bodies to assume <u>no adjustments</u> *to right of use asset values on transition for existing dilapidation provisions. Only new provisions arising after transition (or increases to existing amounts provided) should be capitalised during 2022/23 and beyond.*

In addition, new dilapidation provisions should not arise on transition. The requirement to recognise a liability arises under IAS 37 so where entities are obliged under existing lease agreements to restore assets to a specified condition, such costs should already be provided for prior to IFRS 16 implementation. For many entities, such obligations arise as the asset is used rather than on commencement of the lease.

J2) How do we account for subsequent changes in capitalised dilapidation provisions or unwinding of the discount rate?

IFRIC 1 provides clarity on the treatment of subsequent changes in decommissioning, restoration and similar (capitalised) liabilities. This applies to dilapidation provisions capitalised under IFRS 16. Paragraphs 4 to 6 of IFRIC 1 confirm that remeasurements of the liability arising from changes in the amount or timing of the expected outflows or from a change in the discount rate should be added to or deducted from the cost of the asset. Separately, paragraph 8 confirms that the periodic unwinding of the discount should be recognised as a finance cost when it occurs.

K) Other transition issues

K1) We have lease incentives in relation to existing operating leases deferred as a liability on our balance sheet. How should we treat these balances on transition to IFRS 16?

The transition provisions of IFRS 16 do not directly address existing deferred lease incentive balances. However, as lease incentives previously deferred are released on a straight-line basis, the balance on the SoFP relates to the remaining lease term (where lease payments are artificially higher due to the up-front benefit). It is therefore appropriate to reclassify the lease incentive balance as a reduction in the right of use asset value on transition. The lease liability will reflect the future lease payments, with the right-of-use asset measurement adjusted for this lease incentive balance, in line with paragraph 24 of the Standard. This achieves a true and fair 'cumulative catch up' position and is consistent with the treatment of prepaid or accrued lease payments.

K2) Our entity will have signed a lease contract prior to commencement of IFRS 16, however the right of use asset will not be made available to us until later in the 2022/23 financial year. Do we need to make any transition adjustments for this lease on 1 April 2022?

Where a lease has passed inception (e.g contract signed) but the lease term has not yet commenced (right of use asset not yet available for use), an entity has a disclosable commitment (IFRS 16 para 59(b)(iv)) but no obligation yet to pay, therefore no liability to recognise. On transition, for such leases, the assessment of the contract as a lease <u>commitment</u> will be grandfathered in on 1 April 2022, but there are no accounting entries to make at that time. When the lease term commences the right of use asset and lease liability will be recognised as a lease addition in-year in 2022/23 generating a CDEL charge.

K3) We understand that the HM Treasury interpretation relating to irrecoverable VAT means that lease liabilities should be calculated excluding VAT. We have existing finance leases for which we historically included VAT when calculating our lease liability. Do we need to adjust these liabilities on transition to IFRS 16?

Public sector bodies are applying IFRS 16 on transition in accordance with paragraph C5(b)(ii). Accordingly, paragraph C11 specifies that no adjustments should be made the right of use asset or lease liability carrying values for existing finance leases on transition. This continues to apply even where it is known that the liability under IAS 17 includes VAT. Should the liability be subject to remeasurement at a later date, only at *that point should the liability be recalculated exclusive of irrecoverable VAT. The same applies to any subsequent revaluations of the right of use asset.*

The HMT interpretation for irrecoverable VAT on lease payments is based on interpretive guidance in IFRIC 21, an interpretation that is already applied in the public sector. Entities may wish to discuss with their auditors whether they feel the HMT interpretation should be applied retrospectively to lease payments under IAS 17. Where that is the case, any amendments to lease liabilities and lease asset carrying values under IAS 17 should be made prior to IFRS 16 transition.