



LEASES

Issued 2 August 2018

ICAEW welcomes the opportunity to comment on HM Treasury's *IFRS 16 Leases: Exposure Draft 18 (01)* published by HM Treasury in May 2018, a copy of which is available from this [link](#).

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MAJOR POINTS

Support for the exposure draft

1. We welcome the opportunity to comment on HM Treasury's Exposure Draft (ED) *Leases*. We commend HM Treasury's approach that only minor adaptations to IFRS 16 *Leases* are proposed but have some reservations about the ED's proposal of a single internal rate of borrowing and mandating the grandfathering arrangements.
2. The proposed implementation timetable should not pose significant difficulties for those entities already applying IFRIC 4. However, departments such as the Ministry of Defence could find the adoption of this standard more challenging, given that the Department's latest accounts available at the time of this response (2016-17) were qualified for not holding sufficient records to enable it to comply with IAS 17 *Leases*.

Applying the definition of a lease

3. There is concern that entities may argue that a contract does not meet the definition of a lease by not conveying the right to direct the use of the asset. There may be a drive towards classifying contracts as service arrangements with the asset and liability effectively remaining off balance sheet. A backstop position may need to be considered to ensure that substance over form prevails and that leases are being correctly classified.
4. The application of the definition of a lease is an area of considerable judgement which HM Treasury should monitor to ensure that leases are being accurately identified. Further guidance may be required in this area.

A single internal rate of borrowing

5. Setting a single internal rate of borrowing centrally is practically attractive, but the ED does not provide any information on how this rate would be calculated, which makes it difficult to comment in much detail. We recommend that HM Treasury publish a draft basis of calculation, which should be open to comment and which should be field tested for over/understatement effect on a range of entities within government. If it could be demonstrated that there would be insignificant misstatement because of similarities in inputs for all leases, then we could accept a single rate. However, should the single rate not reflect an entity's internal rate of borrowing, then significant over or understatement of assets and liabilities are possible, potentially resulting in financial statements that do not provide a true and fair view.
6. Entities should in first instance be calculating the rate implicit in the lease and only when this is proven not to be feasible should an internal rate of borrowing be applied. HM Treasury should be providing the necessary guidance to facilitate the calculation of the rate implicit in the lease as better outcomes may be achieved if entities apply a local rate specific to their circumstances.

Grandfathering existing lease classifications

7. The ED proposes to mandate the practical expedient that an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. We are concerned that some entity accounts will be inconsistent following IFRS 16 adoption. There may be circumstances where lease contracts were not recognised under IFRIC 4 yet they would be recognised under IFRS 16. To grandfather the previous non-recognition of the

lease only to recognise a lease under IFRS 16 could be problematic. We recognise that these inconsistencies would diminish over time as arrangements that existed under the old model come to an end.

8. The proposals to grandfather existing lease classifications are reasonable for those entities that were able to apply IFRIC 4 without any issues. However, for entities such as the Ministry of Defence, who were not able to apply the old leasing standard without qualification in the Department's financial statements, there is a risk that past errors would be transposed to the new leasing model. Entities should use this opportunity to improve their contract and asset management systems rather than import past errors and continue with the status quo.

RESPONSES TO SPECIFIC QUESTIONS FOR COMMENT

Question 1:

Do you agree with the adaptation for the definition of a contract? If so why? If not, why not and what alternatives do you propose?

9. We agree with the expansion of the definition of a contract to bring into scope intra-UK government lease agreements. Intra-government lease arrangements are material and failure to account for these appropriately could lead to the underlying transaction not being faithfully represented in the financial statements.
10. The ED does not, however, provide the revised definition of a contract. On page 33, the first paragraph in the 'Adaptations' section states that '*The definition of a contract is expanded to include intra-UK government agreements where non-performance may not be enforceable by law*'. We recommend that the revised government financial reporting manual (FReM) includes the definition of a contract which is to be applied.
11. One of the most challenging areas of this standard will be the application of the definition of a lease - in particular whether the lessee has the right to direct the use of the asset. This is an area of considerable judgement and HM Treasury should review how entities are identifying leases to ensure consistency. A backstop position may need to be considered to ensure that substance over form prevails and that leases are being correctly identified.

Question 2:

Do you agree with the public sector interpretation for short term leases? If so, why? If not, why not and what alternatives do you propose?

12. We agree with the proposal to mandate the election not to apply the IFRS 16 requirements in paragraphs 22-49 to short term leases on cost-benefit grounds. HM Treasury should ensure that sufficient guidance is available so that entities identify short term leases accurately and consistently. For example, an embedded purchase option would immediately prohibit the lease being classified as short term.
13. The FReM should make it clear that, if the election in IFRS 16 paragraph 5 is enforced, then public entities must apply the requirements in IFRS 16 paragraphs 6 and 7 for short term leases.

Question 3:

Do you agree with the proposals for low value leases. If so why? If not, why not and what alternatives do you propose?

14. We agree with the proposals for low value leases. The FReM should not seek to remove judgement from applying the standard.

Question 4:

Do you agree HM Treasury should set an internal rate of borrowing centrally, for entities to use when they cannot obtain the rate implicit in the lease? If so why? If not, why not and what alternative do you propose?

15. It is widely recognised that determining the rate implicit in the lease can be challenging. The FReM should provide suitable guidance to enable entities to calculate the interest rate implicit in the lease and make it clear that only when this is not feasible should the internal rate of borrowing be applied. There should not be a presumption that the internal rate of borrowing is the only viable option.
16. Setting a single rate centrally is certainly practically attractive and may be acceptable if the variance of factors that determine the internal rate of borrowing is low across all affected entities. Factors that determine the internal rate include credit worthiness of the entity, term of the arrangement, amount of funds 'borrowed', the nature and quality of the underlying asset and the economic environment. It should be the rate at which an entity would borrow to acquire an asset of similar value to the right-of-use asset, rather than to acquire the entire underlying asset. HM Treasury may wish to consider a matrix of different rates to reflect variances of lease contracts across government.
17. In order to make further comments on the viability of setting a single internal rate of borrowing centrally, we would need to have more detail on how HM Treasury intend to calculate that rate. We suggest that HM Treasury publish a draft basis of calculation, which should be open to comment, and which should be field tested for over/understatement effects on a range of entities within government. If it could be demonstrated that there would be insignificant misstatement because of similarities in inputs for all leases, then we could accept a single rate. HM Treasury need be clear on how the rate will be set and what the potential misstatement is before proceeding.
18. The effect of applying a single internal rate of borrowing that does not reflect an entity's internal rate risks significant over- or understatement of assets and liabilities, potentially resulting in financial statements that do not provide a true and fair view. The risks of setting the wrong rate are obvious. Better outcomes may be achieved if HM Treasury were to provide guidance on how to sensibly derive a rate locally, including setting a starting point and then indicating how different factors should be brought into account on a systematic basis. Only further testing of a single rate will provide the insight necessary.

Question 5:

Do you agree that the internal rate of borrowing should be set irrespective of the type of underlying asset? If so why? If not, why not and what alternatives do you propose?

19. Where a lessee's incremental borrowing rate is used, IFRS 16 requires that rate to reflect, inter alia, the nature and quality of the underlying asset and the value of the right of use asset that arises from the lease contract. There are many factors to consider when calculating the internal rate of borrowing but the type of underlying asset is most likely to play a factor.
20. However, as per our response above, HM Treasury should publish the calculation methodology and test it rigorously to ensure assets and liabilities in relation to leases are not materially over or understated. Furthermore, empirical evidence should be gathered to test whether the underlying asset has a material impact on the internal rate or whether other factors, such as credit risk, play a more important role.

Question 6:

How would you undertake revaluations of right of use assets under IFRS 16? Please provide explanations based on both property and non-property assets.

Question 7:

What valuation methodology do you believe HM Treasury should mandate for the public sector and why? Does your answer change depending on the asset type? If so why? If not, why not?

21. In our view the right of use assets under IFRS 16 should not be revalued, which would solve what otherwise might be a costly and difficult approach to application of the standard. Instead the IFRS 16 cost model should be applied on cost-benefit grounds, as the vast majority of private sector preparers will do in practice. In particular, we query what value would be delivered in a public sector context by revaluing the right of use assets to current market value since the asset is not for sale; changes in fair value would not impact the operational or financial capacity of the entity since it is locked into a lease contract.
22. It is not straightforward to fair value right of use assets. Given that the fair value of right of use assets cannot be (easily) ascertained, we do not think that the cost model can be said to be a proxy for the revaluation model because the fair value is not known. For example, long term leases of property could have material differences between historical cost and fair value quite quickly (without regular rent reviews). We believe that HM Treasury should keep the situation under review whilst mandating the cost model for leased assets for now.
23. If HM Treasury decide to follow the fair value model, it can look to the type of valuations carried out under IAS 40's requirements in relation to right of use assets where the fair value model is used.

Question 8:

Do you agree with the public sector adaptation for peppercorn leases? If so why? If not, why not and what alternatives do you propose?

24. We agree with the suggested treatment of peppercorn leases. In effect the asset would be treated like a donated asset with the right of use asset measured at fair value or current value in existing use (which would then be considered deemed cost) and the liability measured in line with IFRS 16. Any difference between the carrying amount of the asset and liability would be a gain in the statement of comprehensive income.

Question 9:

Are there any disclosure requirements for lessee accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

25. We do not believe that there are any disclosure requirements for lessee accounting which are not applicable to the public sector.

Question 10:

Do you agree with the proposals for lessor accounting? If so why? If not, why not and what alternative do you propose?

26. We agree with the proposals for lessor accounting. During the IASB's consultation on IFRS 16, some alternative methodologies for lessor accounting were proposed and were ultimately rejected on cost/benefit grounds.
27. IPSASB proposed an alternative lessor accounting model in their January 2018 exposure draft on leases whereby the lessor would continue to recognise the entire underlying asset, as well as creating a new lease receivable. We do not agree with this approach since we believe that this would inflate the lessor's gross assets. A key driver behind this proposal was the perceived difficulties of having asymmetry between lessor and lessee accounting for group accounts consolidation. We do not share these concerns: please see our response to question 19 for more detail.

Question 11:

Are there any disclosure requirements for lessor accounting which you believe are not applicable to the public sector? If so why and what alternatives do you propose? If not, why not?

28. We do not believe that there are any disclosure requirements for lessor accounting which are not applicable to the public sector.

Question 12:

Do you agree no adaptations or interpretations for the public-sector context is required for sale and leaseback? If so why? If not, why not and what alternatives do you propose?

29. We agree that no adaptations or interpretations for the public sector context are required for sale and leaseback.

Question 13:

Do you agree with the public-sector interpretation on grandfathering existing lease classifications? If so why? If not, why not and what alternatives do you propose?

30. We have some concerns regarding the grandfathering of existing lease classifications, which the ED proposes to make mandatory. In circumstances where leases were not recognised under IFRIC 4 yet similar new lease arrangements under IFRS 16 would be, the grandfathering arrangements would provide inconsistent outcomes. These would be removed over time, but could lead to anomalies for a number of years, depending on the length of contracts.
31. We are also concerned that past errors will be transposed to the new leasing model. In theory the proposals are reasonable for those entities that applied IFRIC 4 without any issues, but for those that did not, the proposals do not seem appropriate. For example, the Ministry of Defence should use the adoption of IFRS 16 to remove the qualification from the Department's financial statements in relation to leases, rather than carry over the status quo.
32. HM Treasury should monitor lease recognition under IFRS 16 as some entities may argue that contracts are service arrangements rather than leases, especially if they claim that they cannot direct the use of the asset.

Question 14:

Do you agree with the transition approach for the proposed amendments? If so why? If not, why not and what alternatives do you propose?

33. We agree with the transition approach for the proposed amendments.

Question 15:

Do you agree with the public-sector interpretation for asset measurement upon transition? If so, why? If not, why not and what alternatives do you propose?

34. Yes, we agree.

Question 16:

Do you agree with the public sector interpretation on practical expedients when applying IFRS 16 upon transition? If so why? If not, why not and what alternatives do you propose?

35. Yes, we agree.

Question 17:

Do you agree with the transition proposals for lessee accounting and disclosures? If so why, if not why not and what alternatives do you propose?

36. Yes, we agree.

Question 18:

Do you agree with the transition proposal for lessor accounting? If so why, if not why not and what alternatives do you propose?

37. Yes, we agree.

Question 19:

Do you have any comments on the impacts IFRS 16 will have on consolidation? Please explain any comments, including providing alternatives HM Treasury should consider.

38. We believe that potential impacts on consolidation are overstated. Similar consolidation adjustments that will be required under IFRS 16 already exist for property, plant and equipment and investment properties which are transacted within a group. There are also other examples where entities within government apply different accounting policies in relation to the same underlying transaction, such as gilts. Gilts will be a liability for the issuer and accounted for at amortised cost yet will be an asset for the gilt holder and accounted for at fair value. These transactions already require manual intervention in the consolidation process.
39. We believe that a group level journal is required to reverse out the relevant entries for the leasing transactions, so that only the underlying asset, together with any related depreciation, impairment etc., are left in the group accounts. Should HM Treasury require assistance with this matter, we would be pleased to offer our advice.

Question 20:

Do you agree with the proposals for aligning the accounting of service concession arrangements that contain a lease with IFRS 16? If so why? If not why not, and what alternatives do you propose?

40. Yes, we agree.

Question 21:

Do you agree with the proposed effective date for the public-sector implementation of IFRS 16? If so why? If not, why not and what alternatives do you propose?

41. Yes, we agree.

Question 22:

Are there any other areas not covered by the questions which you would like to comment on? Please explain any comments, including providing alternatives HM Treasury should consider.

42. There are no other areas we would like to comment on.

Question 23:

Are there any options available in IFRS 16 that your entity would be significantly concerned about adopting, were HM Treasury try to align with ESA 10? Please explain any comments, including providing alternatives HM Treasury should consider.

43. In our view it will be some time before ESA 10 is updated to reflect the latest accounting standards and once IFRS 16 is adopted, there will be fundamental differences between the underlying IFRS based accounts and National Accounts (which underpin budgets and estimates) as described in table 6.A. We cannot see how HM Treasury intends to align with ESA 10 and in our opinion, entities will need to keep separate accounting records to adhere to both IFRS 16 and the requirements of ESA 10.
44. Divergence between the two frameworks is regrettable and pressure should be exerted on Eurostat to ensure ESA 10 is updated more regularly than is currently the case. We appreciate that ESA 10 is consistent with the worldwide guidelines on national accounting, set out in the System of National Accounts 2008 (2008 SNA). Nevertheless, national accounting needs to keep up with the accruals-based data on which it relies, much of which is produced using IFRS.