RICS PRACTICE INFORMATION

IFRS 16: Principles for UK real estate professionals

Accounting for leases on the balance sheet

UK

March 2022

RICS®

IFRS 16: Principles for uk real estate professionals: accounting for leases on the balance sheet

RICS practice information, UK

1st edition, March 2022

Effective from publication

Published by the Royal Institution of Chartered Surveyors (RICS)

Parliament Square

London

SW1P 3AD

www.rics.org

This document was originally published in March 2022 as an RICS insight paper and reissued in October 2022 as RICS practice information.

ISBN 978 1 78321 462 4

Typeset using Typefi

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RICS standards framework

RICS' standards setting is governed and overseen by the Standards and Regulation Board (SRB). The SRB's aims are to operate in the public interest, and to develop the technical and ethical competence of the profession and its ability to deliver ethical practice to high standards globally.

The RICS Rules of Conduct set high-level professional requirements for the global chartered surveying profession. These are supported by more detailed standards and information relating to professional conduct and technical competency.

The SRB focuses on the conduct and competence of RICS members, to set standards that are proportionate, in the public interest and based on risk. Its approach is to foster a supportive atmosphere that encourages a strong, diverse, inclusive, effective and sustainable surveying profession.

As well as developing its own standards, RICS works collaboratively with other bodies at a national and international level to develop documents relevant to professional practice, such as cross-sector guidance, codes and standards. The application of these collaborative documents by RICS members will be defined either within the document itself or in associated RICS-published documents.

Document definitions

Document type	Definition
RICS professional standards	**Set requirements or expectations for RICS members and regulated firms about how they provide services or the outcomes of their actions.** RICS professional standards are principles-based and focused on outcomes and good practice. Any requirements included set a baseline expectation for competent delivery or ethical behaviour. They include practices and behaviours intended to protect clients and other stakeholders, as well as ensuring their reasonable expectations of ethics, integrity, technical competence and diligence are met. Members must comply with an RICS professional standard. They may include: • mandatory requirements, which use the word 'must' and must be complied with, and/or • recommended best practice, which uses the word 'should'. It is recognised that there may be acceptable alternatives to best practice that achieve the same or a better outcome. In regulatory or disciplinary proceedings, RICS will take into account relevant professional standards when deciding whether an RICS member or regulated firm acted appropriately and with reasonable competence. It is also likely that during any legal proceedings a judge, adjudicator or equivalent will take RICS professional standards into account.
RICS practice information	**Information to support the practice, knowledge and performance of RICS members and regulated firms, and the demand for professional services.** Practice information includes definitions, processes, toolkits, checklists, insights, research and technical information or advice. It also includes documents that aim to provide common benchmarks or approaches across a sector to help build efficient and consistent practice. This information is not mandatory and does not set requirements for RICS members or make explicit recommendations.

Glossary

Definition	Term
Commencement date	Under IFRS 16, the date on which a lessor makes an underlying asset available to use by a lessee.
Cumulative catch-up	This 'modified retrospective' transition approach to IFRS 16 requires that comparative information presented is not restated but instead the cumulative effect of initially applying the standard is recognised as an adjustment to opening retained earnings at the date of initial application. As a result, current information is provided on an IFRS 16 basis whereas comparative information remains presented on an IAS 17 basis. This approach only takes into account lease payments after the date of transition to IFRS 16 and does not retrospectively go back to lease commencement.
Decapitalisation	Calculates the rental equivalent of a capital value through applying a yield to the value.
Depreciated Replacement Cost (DRC)	The DRC or 'Contractors' valuation method is a form of cost approach to valuation that is defined in the RICS Valuation – Global Standards Glossary as: 'The current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation'.
Discount rate	The percentage interest rate used in DCF analysis to determine the present value of future cash flows.
Discounted Cash Flow (DCF)	A valuation method used to estimate the value of an investment based on its expected future cash flows. DCF analysis attempts to establish the value of an investment today, based on projections of how much money it will generate in the future.
Economic life	The number of years in which the asset returns more value to the owner (or successor for the same purpose) than it costs to own, operate and maintain.

Definition	Term
Existing Use Value (as defined in Red Book Global Standards UK national supplement UK VPGA 6 Local authority and central government accounting)	The estimated amount for which a property should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion, assuming that the buyer is granted vacant possession of all parts of the asset required by the business, and disregarding potential alternative uses and any other characteristics of the asset that would cause its market value to differ from that needed to replace the remaining service potential at least cost.
Fair value	Defined in IFRS 13 as, 'The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date'.
Finance lease	Under IAS 17 a finance lease is where the value of the lease is the substantial majority of the value of the leased asset including the value on reversion. Along the same principles, IFRS 16 defines a finance lease as, 'A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset'.
Financial Reporting Manual (FreM)	The Government Financial Reporting Manual sets out core guidance for preparing central government annual reports and accounts in the UK.
Fixed payments	Payments made by a lessee to a lessor for the right to use an underlying during the lease term, excluding variable lease payments
FRS	Financial Reporting Standard.
FRS 102	A single financial reporting standard that applies to the financial statements of entities that are not applying adopted IFRS, FRS 101 or FRS 105. It replaces the old UK GAAP. A periodic review of FRS 102 commenced in March 2021 and resulting amendments are expected to be effective no earlier than 1 January 2024.
Group Accounting Manual (GAM)	Mandatory accounting guidance for DHSC group bodies including clinical commissioning groups, NHS trusts, NHS foundation trusts and arm's length bodies.

Definition	Term
Heritage Asset (under FreM principles)	A heritage asset is a tangible asset with historical, artistic, scientific, technological, geophysical or environmental qualities that is held and maintained principally for its contribution to knowledge and culture. Heritage assets are those assets that are intended to be preserved in trust for future generations because of their cultural, environmental or historical associations.
HM Treasury Consolidated Budgeting Guidance (CBG)	Provides guidance for government departments on their budgeting framework.
IAS	International Accounting Standards.
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors	Determines how entities handle changes in accounting policies and corrections of errors in reported accounts.
IAS 16 Property, Plant and Equipment	Under IAS 16 property, plant and equipment is initially measured at its cost and subsequently measured either using a cost or revaluation model and depreciated on a systematic basis over its useful life.
IAS 17 Leases	Predecessor to IFRS 16. Classifies leases as either 'finance' leases or 'operating' leases.
IAS 36 Impairment of Leases	'Seeks to ensure that an entity's assets are not carried at more than their recoverable amount (i.e., the higher of fair value less costs of disposal and value in use)'.
IAS 38 Intangible Assets	Covers the accounting treatment for intangible assets (non-monetary assets which are without physical substance and identifiable).
IAS 40 Investment Property	Initially measures investment properties at cost and subsequently. measures using a cost model or fair value model.
IAS 41 Agriculture	Sets out the accounting for agricultural activity.
IASB	International Accounting Standards Board – sets the IFRS.
International Financial Reporting Standards (IFRS)	A set of accounting rules for the financial statements of public companies.

Definition	Term
IFRS 16 cost model	Refers to how the right of use asset is quantified at lease inception by reference to the lease liability (as opposed to the DRC cost model). As per IFRS 16 paragraph 23, the initial measurement of the right of use asset is calculated as: the initial lease liability adjusted for payments made and incentives received before the commencement date of the lease, initial direct costs incurred by the lessee, and estimated costs for dismantling, removing and restoring the asset. The right of use asset is subsequently measured at cost less accumulated depreciation and any impairment, and is adjusted for specified lease liability remeasurements.
IFRS 16 peppercorn lease	Leases for which the consideration paid is nil or nominal (that is, significantly below Market Value) and for which the rent paid is nil or nominal (that is significantly below Market Rent).
IFRS 16 Market Rent	Refers to the capitalised rent used to re-value a non-specialist RoU asset.
Impairment	The reduction in the value of an asset to reflect a decline in the quality, quantity, or market value of the asset.
Initial direct costs	The incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained (e.g. legal costs).
Interest rate implicit in the lease	Defined in IFRS 16 as, 'the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor'.
Internal rate of return (IRR)	The discount rate that makes the present value of all future cashflows equal to zero including the initial cost of the investment.
Investment property	Property (land and/or buildings) held to earn rentals and/or for capital appreciation.
Lease	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time (in exchange for consideration in private sector but not public sector).
Lease liability	Under IFRS 16 the lease liability equates to the present value of the minimum lease payments over the likely remaining lease term.

Definition	Term
Lease term	Under IFRS 16 the lease term is the non-cancellable period for which a lessee has the right to use an underlying asset, together with both: a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
Lessee's incremental borrowing rate (IBR)	The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.
Memorandum of Terms of Occupation (MOTO)	Sometimes used in place of leases in central government.
Modern Equivalent Asset	A hypothetical comparative substitute used in DRC valuation against which depreciation adjustments are applied to the gross replacement cost to reflect the differences between the MEA and the actual asset.
Net Book Value (NBV)	Usually applied in Historic Cost Accounting for assets where the asset is recorded in the Balance Sheet at historic cost then depreciated over a number of years. The land element (if any) is not usually depreciated for freehold properties and long leasehold properties with over c.100 years expired.
Non-specialised property	Property classes such as offices, retail and industrial which are regularly traded in the open market for their use.
Operating lease	Defined in IFRS 16 as, 'a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.' This is in contrast to a finance lease, which is a lease that does transfer substantially all the risks and rewards incidental to ownership. The distinction between operating leases and finance leases is removed for lessees when applying IFRS 16.
Present value	The current value of a future sum of money or stream of cash flows given a specified discount rate.
Public Works Loan Board (PWLB)	Major local authorities (e.g. metropolitan, borough, county, city and combined authorities) may take out PWLB loans operated by the UK Debt Management Office (DMO) on behalf of HM Treasury.

Definition	Term
Residual value guarantees	A guarantee made to the lessor that part or all of the value of the Underlying Asset will be at least a specified amount at the end of the lease.
RICS Valuation – Global Standards	The latest edition of *RICS Valuation – Global Standards* (Red Book Global Standards) took effect on 31 January 2022. *The RICS Valuation – Global Standards 2017: UK national supplement* augments the global standards for valuations that are subject to UK jurisdiction.
Right of Use Asset	An asset that represents a lessee's right to use an underlying asset for the lease term.
Specialised property	Defined within the *RICS Valuation – Global Standards* as, 'A property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise.'
Tenant/Capital incentives	Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.
Turnover rent	A lease where the tenant pays a percentage of their turnover (or profit) to the landlord.
Underlying asset	An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.
Useful life	The life type over which an asset is depreciated for accounting purposes and is the period over which an asset is expected to be available for use by an entity.
Variable lease payments	Payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date.
Weighted Average Cost of Capital (WACC)	The blended/weighted cost of a firm's capital sources such as debt and equity.

1 Introduction

In January 2016 the International Accounting Standards Board (IASB) set out their new IFRS 16 Leases standard. IFRS 16 replaced the existing lease accounting standard (IAS 17) for accounting periods beginning on or after 1 January 2019, effective for companies reporting under International Financial Reporting Standards (IFRS). The adoption of the IFRS 16 Leases accounting standard has resulted in major changes to the recognition, measurement, presentation and disclosure of leases. The former IAS 17 standard permitted wide discretion in assessing whether a lease was an off-balance-sheet 'operating lease' or an on-balance-sheet 'finance lease'. IFRS 16 requires almost all leases to be treated as finance leases, effectively eliminating most off-balance-sheet accounting opportunities. This has significant implications for accounting methodologies, gearing, profitability, and, potentially, credit ratings and borrowing costs.

IFRS 16 has introduced the concept of the 'Right-of-Use' ('RoU') asset, which is the value of a lessee's right to use an underlying asset for the lease term. This new type of asset is recorded on the balance sheet along with a corresponding lease liability representing the discounted future lease payments.

The objective underpinning the introduction of this accounting standard was to increase visibility of lessee's lease commitments and to make it easier for users of financial statements to compare different entities. This is particularly the case when trying to establish the true leverage of entities that use leasing extensively, rather than owning tangible assets.

IFRS 16 is an accounting standard and as such is predominantly the domain of accountants and finance teams. However, it is beneficial if real estate professionals are aware of the high-level principles of IFRS 16 and where real estate expertise may be called upon. The high-level principles are relatively straightforward to understand but it is the practical implementation of this accounting standard that is the challenge.

IAS 17 is still the approach of UK entities reporting under FRS 102 with the next iteration of harmonisation between FRS 102 and IFRS expected to be effective from 1 January 2024. Therefore, the adoption of IFRS 16 principles by FRS 102 is currently under review as at the date of this information.

In the USA there has been the implementation of a lease standard called ASC 842, which is similar to IFRS 16 but not in the scope of this paper.

The specific details of IFRS 16 and the various transition arrangements are dealt with in detail in a variety of online sources, particularly from IASB and leading accountancy companies.

There is also an increasing amount of guidance online for UK public sector entities as the UK public sector is aiming to implement IFRS 16 principles from 1 April 2022 (although there have been a few early adopters and its implementation by UK local authorities has now been deferred until 1 April 2024, albeit with the ability to adopt in advance).

It is not the intention of this practice information to rephrase the extensive range of online material on IFRS 16 principles applicable to public and private sector entities. Instead, it focuses on real estate leases and those parts of IFRS 16 that are considered particularly relevant to real estate professionals practising in the UK. Following an explanation of the key IFRS 16 principles in section 2 and a review of UK Public Sector adaptations in section 3, this paper focuses on IFRS 16 discount rates in section 4, and revaluation models in sections 5 and 6.

This practice information was developed by a working group of expert valuers, accountants and other key stakeholders to explore the application of IFRS 16 Leases specifically from a UK based real estate professional's perspective, and in both its private sector and public sector application. As such it refers to the views and opinions of that group as insight into this topic and its common practice only.

2 Understanding the key concepts of IFRS 16

2.1 What is a right of use asset?

Under IFRS 16, where a lease is identified, a lessee recognises a right of use asset, representing its right to use the underlying asset for a non-cancellable lease term, and a lease liability representing its obligation to make lease payments. The lessee must be able to both direct the use of the asset and receive substantially all of the economic benefits of the asset.

The non-cancellable period of a lease should take into account the following:

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

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

Lessees cannot simply adopt the shortest time position to limit their IFRS 16 balance sheet impact; the assumptions regarding breaks and options should be based on operational requirements and likely scenarios. Note that a tenant may be giving up sensitive or confidential information if they show their expected treatment of the lease and could prejudice discussions with their landlord. However, in most cases, lessees will report on more than one lease, so it will be difficult for landlords to isolate a particular property.

IFRS 16 applies to all leases including real estate, vehicles and aircraft. There are the following key exceptions:

- leases to explore minerals, oil, gas and similar regenerative resources
- leases of biological assets as defined in IAS 41 Agriculture
- service concession arrangements, e.g. PFI arrangements
- rights held by a lessee under licensing agreements within scope of IAS 38 Intangible Assets and licenses of intellectual property granted by lessors under IFRS 15 Revenue from Contracts with Customers
- leases of 'low value' – IFRS 16 does not define 'low value' although it is generally accepted that the equivalent of $5,000 when new is a reasonable level. Ultimately the threshold is set at entity level
- lessees can opt to exclude short term leases, i.e. leases that at the commencement date have a term of 12 months or less. Leases with purchase options are not short-term leases. The UK public sector will exclude all leases under 12 months when it implements IFRS 16.

2.2 The IFRS 16 cost model

The 'IFRS 16 cost model' is not to be confused with the Depreciated Replacement Cost (DRC) 'cost' approach to valuation of specialised assets, as discussed in section 6 of this paper.

On transition to IFRS 16 or when entering into a new lease, IFRS 16 requires lessees to apply the IFRS 16 cost model unless the fair value model for investment property or the revaluation model for specific classes of property, plant and equipment is applied.

Some leases are part base rent (or 'fixed rent') and part turnover rent. In this case IFRS 16 only takes into account the base rent/fixed rent element whereas the variable element of the rent is recognised in the P&L as an operational expense unless the turnover rent is considered to be an in-substance fixed payment.

It is the responsibility of the entity to determine whether the IFRS 16 cost model is an appropriate accounting policy choice. We note that the IFRS 16 cost model is usually acceptable where:

- a market rent is being paid, or
- the term is short enough that material increases in value are unlikely to arise, or
- there are regular rent reviews to market rent and the property is not overrented.

We provide a worked example of the IFRS cost model in Appendix A. At initial measurement, the lessee measures the RoU asset at a cost that is at least the equal and opposite of the discounted lease liability. The initial measurement of the lease liability is based on the minimum rent payable under the terms of the lease and measured at the present value of the lease payments that are not paid at that date. Lease breaks and extensions should be taken into account if they are reasonably certain to be exercised. As well as minimum rent, additional components for the initial lease liability for real estate leases include:

- fixed rental changes and changes that depend on an index or a rate (for example, payments linked to CPI or RPI)
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease if the lease term reflects the lessee exercising a termination option.

In the case of new leases, initial direct costs are added to the RoU asset such as agency fees. Estimated costs to dismantle, remove or restore at lease expiry are also added to the RoU asset where a provision for those costs is required.

For leases that are currently classified as 'finance leases' under IAS 17, on transition to IFRS 16 the carrying amount of the RoU asset and lease liability will be the same as those under IAS 17.

2.3 Sale and leasebacks after transition to IFRS 16

Sale and leaseback transactions are subject to the requirements of IFRS 15 in determining whether the transfer of the asset is accounted for as a sale of that asset. The substance of the sales contract needs to be established.

For example, an 'income strip' sale and leaseback with a buyback provision at the end of the lease for £1 is unlikely to be deemed a true sale and leaseback of the asset. In this case, the seller-lessee continues to recognise the property asset and recognises a financial liability for the proceeds received.

If a sale and leaseback transaction is accounted for as a true sale of the asset, the seller-lessee derecognises the carrying amount of the asset and recognises a right of use asset arising from the leaseback. The right of use asset is measured at the proportion of the previous carrying amount of that asset that relates to the right of use retained by the seller-lessee. The seller-lessee also recognises a lease liability at the present value of the future lease payments to be made.

Any sale and leaseback proceeds in excess of the fair value of the asset are accounted for as additional financing provided by the buyer-lessor to the seller-lessee. Surveyors may have a role in appraising the fair value at the time of sale.

If the sale and leaseback proceeds are less than the fair value of the asset, the difference is accounted for as a prepayment of lease payments and as such is factored into the right of use asset.

Assuming that a sale and leaseback is at fair value, the upfront gain on sale equates to:

P – NBV + ROU – LL

Where:

P is the proceeds received on sale

NBV is the carrying amount of the property immediately prior to the sale

ROU is the right of use asset recognised and

LL is the lease liability recognised.

The remainder of the surplus over the NBV is spread over the leaseback length through a reduced right of use asset, and therefore a lower depreciation amount.

2.4 IFRS 16 'revaluation' model of RoU assets

As per the worked example in Appendix A, most RoU assets will not require a revaluation after initial measurement and are typically 'straight line' depreciated over the likely lease term.

When using the IFRS 16 cost model, this will be adjusted to reflect relevant events such as the following:

- change in the lease term
- change in assessments of an option to purchase
- change in amounts expected to be payable under a residual value guarantee
- change in future lease payments resulting from a change in an index or rate used to determine those payments
- changes in the estimated costs of dismantling, removal and restoration can also affect the cost model measurement of the right-of-use asset.

If the lease liability changes as a result of the above factors, a corresponding change must be made to the RoU asset, unless there is a partial or full termination of the lease. If this occurs, the RoU asset is decreased accordingly (RoU assets are subject to the impairment requirements of IAS 36) and any gain or loss is recognised as income/outgoings.

A detailed explanation of IAS 36 Impairment is outside the scope of this paper. However, impairment is relevant to 'cash generating units' in the private sector, which sometimes comprise more than one property.

With the exception of IFRS 16 peppercorn leases (discussed in the next section), the revaluation model applies to subsequent rather than initial measurement. In some rare cases, it may be appropriate to move to 'subsequent measurement' within the first year of implementation of IFRS 16, 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 in order to ensure the effect on the I&E/P&L is not misstated throughout the year.

The general revaluation principle is that RoU assets should be measured on the same basis that the underlying asset would be valued if owned by the tenant, while only reflecting the rights that the lessee has acquired, and not the full value of the item. These subsequent measurements (valuations) must be materially accurate as at the end of year balance sheet date.

The revaluation method for a non-specialised right-of-use asset is unlike valuing a typical long lease in other circumstances, where the profit rent is capitalised at an appropriate rate over the lease period during which the profit rent can be enjoyed. When valuing a right-of-use asset, one ascertains the full market rent at the valuation date and capitalises it, rather than having regard to any profit rent or the lessee's passing rent, whether that be a peppercorn, under-rented or over-rented figure; the passing rent is accounted for separately in the Lease Liability calculation. Therefore, all right-of-use asset valuations ignore any passing rent expense, which is accounted for separately in a lease liability calculation. Application of the revaluation model to non-specialised assets is covered in more detail in section 5 of this paper.

In most cases property leases of specialised assets will require regular valuations to ensure appropriate measurement. Where these are currently treated as finance leases under IAS 17 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 (DRC based on MEA) tends to be more volatile.

Leases of specialised properties are likely to require a DRC approach, particularly in the case of an 'IFRS 16 peppercorn lease', where it can be demonstrated that the passing rent is not representative of the right-of-use asset, or where the specialised asset is a tenant's improvement constructed under a ground lease. Application of the revaluation model to specialised assets is covered in more detail in section 6 of this paper.

If the right-of-use asset meets the definition of a heritage asset (refer to Glossary), it should be measured in accordance with guidance on heritage assets. For the public sector, see HMT's Financial Reporting Manual (FReM) for central government bodies, CIPFA's Code of Practice for local authorities (the Code), and by the NHS Group Accounting Manual for the NHS.

We note that fully sublet leases will not require a right-of-use asset re-valuation as they are not recognised on transition to IFRS 16. The right-of-use asset will be 'de-recognised' and replaced with a recognition of the sublease income – effectively the present value of projected rental income from the finance sublease. A lease liability is still recognised.

3 Overview of UK Public Sector implementation of IFRS 16

For most of the UK Public Sector, IFRS 16 is adopted 1 April 2022 (there were some earlier adopters). Real estate professionals should be aware that although the new international accounting standard for leases (IFRS 16) has been effective since 1 January 2019 and adopted by most of the UK public sector with effect from 1April 2022 (although there were some earlier adopters), its implementation by UK local authorities has now been deferred until 1 April 2024. However, local authorities are encouraged to adopt the standard before this date and this is permitted in the 2022/23 and 2023/24 Code, which allows for early adoption as of 1 April 2022 or 2023.

Public Sector guidance on financial reporting includes the following:

- HM Treasury: HMT's Financial Reporting Manual (FReM) for central government bodies. In addition to its FReM, HMT has published IFRS 16 Leases Application Guidance
- The Department of Health and Social Care's Group Accounting Manual
- Group Accounting Manual IFRS 16 Supplement
- Local Authority Scotland Accounts Advisory Committee (LASAAC)
- CIPFA/LASAAC's Code of Practice for Local Authority Accounting (the Code)
- The Welsh Government
- The Scottish Government
- The Executive Committee of the Northern Ireland Assembly

IFRS 16 defines a lease as a contract that, 'conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. In central government, the definition of a contract is expanded to include intra-UK government agreements where non-performance may not be enforceable by law. This could include MOTOs and other intra-government arrangements. Central government also interprets and adapts several areas of IFRS 16, including:

- Mandated use of 'cumulative catch up' approach (refer to Glossary) on transition (which will be on 1 April 2022 unless departments have adopted earlier).
- All entities must exclude short term leases (i.e. under 12 months) from IFRS 16 recognition.
- Where central government entities cannot readily determine the interest rate implicit in the lease, they are instead required to use a lessee's incremental borrowing rate based on the HM Treasury discount rate promulgated in PES papers. However, if an entity can demonstrate that another discount rate would more accurately represent their lessee's incremental borrowing rate then can use that discount rate as their IBR.

- Inclusion of leases for which nil consideration (or very limited) financial consideration is made, if they meet all aspects of the IFRS 16 lease definition other than containing consideration. The lack of an upfront market-based consideration distinguishes these IFRS 16 peppercorn leases from typical long leases. IFRS 16 peppercorn leases have already been identified as a potential challenge for UK Public Sector adoption of IFRS 16 and they are referred to at Chapter 4 of HMT's IFRS 16 guidance.

Adaptation for local authority accounting has been set out under draft accounting provisions in Appendix F of the 2021/22 CIPFA 'Code'. This substantially adopts the central government approach mentioned above.

- For the lease discount rate, local authorities may choose to use a lessee's incremental borrowing rate that is different from PES, instead using PWLB rates or another approach that better reflects their blended cost of capital.
- The initial Code commentary had adapted IFRS 16 Leases to remove Housing Revenue Account tenancy agreements from the requirements of the standard. This has now changed – such tenancies are no longer scoped out from IFRS 16 – and the proposal set out in the latest consultation is that the Code interprets the standard in a way that HRA tenancies are deemed operating leases (with no additional lessor disclosures) as per the consultation proposals.
- As with the HMT guidance, the Code interprets IFRS 16 to specify in more detail the accounting requirements for leases at peppercorn or nominal lease payments, or for nil consideration by following the principles in the Code for the treatment of donated assets.
- For lessors, nil consideration finance leases are required to be identified, with the asset provided to the third party required to be derecognised, and any unguaranteed residual value recognised, where applicable.

The NHS and health bodies are guided in their implementation of IFRS 16 by the Group Accounting Manual IFRS 16 Supplement. It also refers to additional guidance such as the DHSC IFRS 16 implementation summary, NHS England/NHS Improvement IFRS 16 Implementation Guidance and frequently asked questions document.

4 Discount rates

Under IFRS 16 the expected lease payments are discounted to present value at an appropriate discount rate.

The discount rate reflects the rate of interest that is charged by the lessor to the lessee as part of the rental payment. The rental payment compensates the lessor for both the property cost plus an additional rate of return. In the majority of cases, the lease agreement will not prescribe the implicit interest rate so this needs to be estimated based on available information.

IFRS 16 prescribes two methods of determining the appropriate discount rate:

- The interest rate implicit in the lease must be applied where it can be readily determined or
- the lessees incremental borrowing rate (IBR).

4.1 Interest rate implicit in the lease

The interest rate implicit in the lease (RIIL) is defined in IFRS 16 as:

> '...the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.'

The RIIL should be used where the information required to estimate it can be readily determined. The RIIL is equivalent to the lessor's internal rate of return (IRR) on the property lease. This requires an assessment of the following information for the calculation:

1. **The unguaranteed residual value:** In some markets, a property valuer may be able to estimate the unguaranteed residual value at the end of the lease based on an estimate of the property on the 'special assumption' that the property has been maintained in reasonable and tenantable repair and decoration but is exchanged with vacant possession. The estimate may reflect a degree of discount to reflect the age and obsolescence of the asset in the current market based on similarly aged assets.
2. **The fair value of the underlying asset:** In most circumstances the fair value concept is consistent with the IVS definition of Market Value, i.e. it is based on the hypothetical transaction between market participants at the inception date (lease start date), and not 'worth', which is a specific value to a known party, e.g. the actual lessor.
3. **Any initial direct costs to the landlord:** These tend to be relatively standardised in a mature property market.

Previously, when assessing the rate implicit in finance leases under IAS 17, surveyors will have assisted with similar assumptions to the above. However, under IFRS 16 the requirements for reasonably certain assumptions are more stringent.

- **Lessor's initial direct costs:** lessees will not know the actual amount of the cost incurred by the lessor in negotiating the lease **but** in a mature market a surveyor should be able to assume 'market participant' fee levels for lease costs/professional fees where these are observable in the market.
- **Fair value of the underlying asset and the lessor's expectation of unguaranteed residual value at the end of the lease:** along with likely rental cash flows, both these measures are required to create an IRR, which will equate to the interest rate implicit in the lease after direct costs are taken into account. A lessee is unlikely to have this specific information **but** in a mature market a reasonable estimate may be possible.

Fair value as per IASB's definition in IFRS 13 is a concept that is based on market participants and not an identified specific party. This means the fair value of the asset could be estimated by a property valuer, as at the date of the lease inception in mature and active market with appropriate levels of transactional evidence.

The lessor's expectation of residual value may be specific to an identified party. If this is the case, then the residual value (worth) is not likely to be calculable by the lessee (or anyone else other than the lessor).

Logically, the interpretation of the lessor's unguaranteed residual value should be in line with the fair value market participant assumption, therefore the residual value could be estimated by a property valuer having regard to the value of the asset on the special assumption that this equates to the current value of the property, with the special assumption of vacant possession and assuming the state, age and condition of the property at lease expiry (assuming it is maintained to a reasonable level).

A valuer should therefore have regard to the additional age of the property at the date of lease expiry, assuming no major capital expenditure, improvements or alterations but assuming the property is handed back to the landlord in accordance with the yielding up provisions of the lease, i.e. usually in good and tenantable repair and condition.

The surveyor should ensure that only actual lease payments are accounted for in the RIIL calculation and deduct tenant incentives/rent free payments or capital incentives provided to the tenant at inception of the lease. The surveyor should engage with the client and/or the client's accountant/auditor to ensure appropriate account has been made in relation to the actual payments to be made and benefits received under the lease.

In the below worked example, the IRR of 4.5% is the discount rate, which equals the present value of the future positive cash flows with the initial fair value plus lessor's costs.

Inputs						
Lease payments	10					
Payments	5					
Unguaranteed residual value	50					
Fair value of underlying asset	80					
Initial direct costs (5%)	4					
Year end	**Opening**	**1**	**2**	**3**	**4**	**5**
Lease payments		10	10	10	10	10
Unguaranteed residual value						50
Initial fair value + lessor's cost	-84					
Total cash flows	-84	10	10	10	10	60
Internal rate of return	4.5%					

In practice, many accountants and business valuers have not adopted the RIIL to estimate the discount rate due to the following reasons:

- IFRS 16 required the use of the IBR for application of IFRS 16 at transition under the modified retrospective approach to adoption, which many companies adopted.
- Early guidance from leading accountancy firms (including GT; KPMG; BDO; Deloitte; and EY podcast series) concluding that in most cases it is not easily determinable for lessees to estimate the interest rate implicit in the lease.
- Many companies have transitioned significant numbers of leases simultaneously necessitating the use of the IBR, which is more versatile and easier to apply to larger numbers of leases. Determining the RIIL may be more practical for smaller numbers of leases.

However, going forward the RIIL may still be relevant, given that it is required by the standard if readily available, and real estate valuers may be able to offer insight into the estimation of assumptions set out above.

4.2 Lessee's incremental borrowing rate

The lessee's incremental borrowing rate (IBR) is defined in IFRS 16 as:

> '...rate of interest that a lessee would have to pay to borrow over a similar term, and with similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment'.

IBR calculations have, to date, been primarily undertaken by business valuers and company management, as they require a specialist knowledge of debt markets, and the company's own borrowing rate, rather than real estate. As the IBR is focused primarily on rates of return

in debt markets, the calculations typically require access to specialist debt market data, i.e. Bloomberg, S&P, Factset, as well as a thorough understanding and analysis of the credit risk of the lessee.

It is important to note that real estate practitioners must exercise an appropriate degree of caution if asked to calculate the IBR and should only do so if they possess the necessary knowledge and skills required to estimate credit risk.

IFRS 16 does not prescribe a calculation methodology for the IBR. The general principles of the IBR calculations are discussed below, based on typical market practice.

The method that is generally adopted by business and debt valuers for IBR assumptions is a 'build-up' method. The build-up method considers:

- a 'risk-free' rate of return over a similar term
- a credit spread or margin to reflect the entity-specific credit risk of the lessee. This is the primary driver and typically the most material component of the IBR. It may be based on an independent assessment of the credit quality of the lessee, or with reference to existing debt financing of the lessee, as long as it meets the requirements of the IBR definition and
- adjustments for the term, security, funding amount, and the economic environment, as required by the definition of the IBR.

The extent to which the inputs and adjustments are required depends on the approach used by the valuer, the benchmark data available, and the market data available. Benchmark data may already address one or more of the requirements of the IBR definition.

4.2.1 Examples

Risk-free rate	**or**	**Benchmark borrowing rate for the lessee**
+ Credit spread		+/- Adjustment for similar term
+/- Adjustments		+/- Adjustment for security offered
		+/- Adjustment for amount of funding required
		+/- Adjustment for differences in economic environment at the valuation date
= Lessee's incremental borrowing rate		**= Lessee's incremental borrowing rate**

Some examples of benchmarks for the lessee's credit spread may include:

- **Existing borrowings:** credit spread on the lessee's existing borrowings.
- **Credit rating:** the lessee's credit rating, or an estimate of the credit rating.
- **Comparable bonds:** market data relating to comparable bonds or indices.

Care should be taken to determine the extent to which such benchmarks are relevant in determining the IBR, and which adjustments may be required. It is also important to consider structural factors, such as the extent to which benchmark loans issued by a parent/subsidiary/affiliate would be relevant to the lessee.

Adjustments that may be considered include:

- **Term:** Where the term of the benchmark instrument differs to the term of the lease, an adjustment may be appropriate, reflecting market yield curves. Note that the term of the lease is often adjusted to consider the weighted-average lease term, due to the amortising nature of the RoU asset.
- **Security:** In cases where the RoU asset is considered to offer security to the theoretical lender, this reduced risk may lead to a lower credit spread than comparable unsecured borrowing. It may also be appropriate to consider the loan-to-value ratio and the extent to which secured borrowing may be offered. A blended borrowing rate may be considered between secured funding and alternative funding for the remainder of the value.
- **Amount of funding:** Where the funding required to acquire the RoU asset substantially differs from the benchmark instrument, it may be considered whether this results in a difference in risk and credit spread.
- **Economic environment:** There are a number of factors that are relevant when considering the economic environment at the point in time of the IBR estimate.
  - Changes in market conditions between the issue of the benchmark instrument and the IBR assessment date.
  - Differences in country/currency of the leases and benchmark instruments may require different considerations. The appropriate rate of interest may be different for a lease in a developed market compared to a lease in a developing market, reflecting differences in currency and risk perception.

An alternative to the build-up approach is to start with a market-based investment yield for a similar asset, adjusting for purchasers' costs, specific covenant strength and lease term. The lessee's unsecured debt rate is then blended in at a reasonable debt financing rate. Previous accounting guidance considered the property yield as being a reasonable starting point for the determination of the IBR. However, there has been limited application of this approach in practice, due to the complexity of separating the debt component from the overall return implicit in a property yield. Where this has been adopted, it has been used as a cross-check to the build-up method above.

With regards to discount rates, the Weighted Average Cost of Capital (WACC) is not an appropriate benchmark for the IBR. This is because the IBR is specifically a 'borrowing' rate relating to debt financing whereas WACC is used by companies for financial reporting purposes representing the cost of capital for a whole business including **both** equity and debt financing.

As mentioned in section 3, UK public sector entities will apply a more restrictive approach to the IBR with standardised rates. However, if an entity can demonstrate that another discount rate would more accurately represent their IBR (for example, if they undertake external borrowing independently of the Exchequer), they shall use that discount rate as their IBR.

4.3 Grouping leases

IFRS 16 specifies the accounting for individual leases but does permit the use of a portfolio approach as a practical expedient.

That approach could involve the use of a single discount rate being applied to a portfolio of leases, but only where it is reasonably expected that there will be no material difference between this and individually calculated discount rates.

Surveyors may be required to assist with these groupings based on lease lengths, geography and market characteristics.

4.4 Discount rate conclusions

To date, the IBR has been the most popular approach for lessees in determining discount rates for IFRS 16 calculations. IBR is the easier and more pragmatic route requiring less effort and can be adopted easily on portfolios of leases. In practice, IBR is typically calculated by a business or debt valuation specialist using a build-up approach to the discount rate. IBR is more focused on understanding of debt markets and credit risk. It is necessary to have access to relevant debt market data in order to do this. An alternative to the build-up method is to use an adjusted property yield approach. This is mentioned in the literature, but we recommend this is only used as a cross check.

With the possible exception of the UK public sector, the interest rate implicit in the lease may become a more popular approach going forward following this original transition. Therefore, real estate valuers should be able to assist accountants' and entity managements' input with this process by providing estimates of fair value and residual values over lease periods.

If a reasonable assumption can be reached as to inputs, there is no reason why the interest rate implicit in the lease cannot be used. These calculations can be done by a real estate valuer based upon looking at a fair or market value of the underlying asset, which is calculable, an estimate of the residual value which a real estate valuer is capable of calculating, and alongside the accountant, who will look at the actual cash flows, there is an ability for real estate valuers to calculate the interest rate implicit in the lease.

5 IFRS 16 revaluation model – non-specialised property

5.1 Introduction

When valuing an IFRS 16 peppercorn lease or revaluing a RoU asset, the aim is to appraise what would be payable were the lessee to be deprived of the use of its lease and have to replace it with a similar asset under the same lease terms.

Therefore, the valuer does not use the rent passing but rather estimates the Market Rent of the asset as at the valuation date under the terms of the lease. We will call this the IFRS 16 Market Rent. This will be capitalised as at the valuation date over the remaining non-cancellable lease term to arrive at the RoU asset value.

For non-specialised property classes such as offices, retail and industrial that are regularly traded in the open market for their use, there will be market evidence available which can be used to inform the required IFRS 16 Market Rent and appropriate capitalisation yield to use to assess the value of the lessee's right. For specialised properties this is not the case; please refer to section 6.

5.2 Lease term

The period over which the full rental value is to be capitalised is the remaining non-cancellable period of the lease as discussed in section 2. The same timescale is used for the lease liability calculations.

While a valuer may be asked to provide assistance in the interpretation of property lease clauses, the valuer cannot determine the appropriate non-cancellable period as only the entity can decide whether it is likely to exercise an extension option or early termination clause. For legal interpretations, valuers should always defer to and be guided by the entity's finance teams.

Where a lease is not contracted out of the security of tenure provisions of the Landlord and Tenant Act 1954, only the entity can determine whether or not it may seek an extension under these provisions and whether it considers that be reflected in the non-cancellable period.

Challenges can arise where an occupancy arrangement is known to be long standing but is either informal in nature or not well documented. Such instances may include an 'evergreen' lease or 'mere licence', which may only be of 12 months duration but has for many years been effectively 'automatically renewed' every year, with this expected to continue into the future, although there is no legal guarantee of continuance being permitted.

In all such instances, it is for the entity having regards to their intentions, to instruct the valuer on what is the appropriate lease term period to be used in the valuation.

5.3 Assessing the IFRS 16 Market Rent for the right-of-use asset

When assessing the IFRS 16 Market Rent, all of the existing lease terms with the exception of the passing rent, rent review date and any existing rental concessions need to be reflected, including:

- security of tenure
- repairing and insuring provisions
- user and restrictive user clauses
- alienation, subletting and underletting rights
- other lessee restrictions
- tenant's improvements (where the lease provides for their value to be reflected in the rental figure; see section 5.5)
- alterations
- break clauses.

Appropriate care must be taken to analyse and adjust headline rents for any rent-free periods, discounted rents and stepped rent provisions that may artificially adjust a rent in the first few years of the lease.

5.4 Capitalising the IFRS 16 Market Rent

The IFRS 16 Market Rent can be capitalised using a single rate multiplier, which is a shortcut way of replicating the IFRS 16 cost based approach to calculating the RoU asset.

When a single rate multiplier is used, we recommend that it should be based on RIIL principles mentioned in section 4 and can be derived usually from freehold market evidence. We recommend starting with a freehold yield as they will not allow for any sinking funds, which will be implicit in any leasehold evidence. We would caution against using a 'dual rate' multiplier as it is starting to move away from the simplicity of the IFRS 16 cost based approach, which does not assume any sinking fund. This comes back to the principle of deprival value mentioned in the introduction of this section.

A valuer can alternatively choose to capitalise the IFRS 16 Market Rent using a DCF. In order to align with the IFRS 16 cost based approach we recommend that the DCF does not take into account market rent reviews but does reflect indexed rent reviews (e.g. based on CPI or RPI). Like the above-mentioned single rate, the valuer should replicate the RIIL approach mentioned in section 4 of this document. We do not recommend using the incremental borrowing rate as this is likely to lead to an over-valuation – particularly if using PES rates in the public sector.

When drawing on leasehold and freehold evidence, it is important to bear in mind that there are certain disadvantages to leasehold interests compared to freehold interests, which should be reflected.

- Leaseholds are a depreciating or 'wasting' asset, which by definition become less valuable as the term approaches its expiry date.
- At the end of a lease, the leaseholders may incur dilapidation costs if these are stipulated in the lease.
- Lease terms may place more restrictions on the use that can be made of an asset, compared to the position of a freeholder who will only be restricted by planning restrictions.
- Leaseholders may be constrained in realising any development potential or may have to pay a proportion of it to a lessor, unlike a freeholder.
- For leaseholds held as rental investments, a void or rent-free period will take up proportionally more of a property's income potential compared to that of a freehold investment. For example, for a leasehold with ten years remaining, a three-year combined void/incentive before receiving a subtenant's income will impact the profitability of the leasehold to a greater extent than an equivalent asset held freehold where the loss of initial income can be spread over a greater time horizon.
- Lenders may not be prepared to finance a leasehold acquisition where an investor wishes to dispose of the property before the lease ends. This can restrict the size of the disposal market and may increase disposal time, generating additional risk and impacting leasehold values.

5.5 Tenant's improvements

It is considered that any tenant's improvements that are encountered will usually not form part of the right-of-use asset, unless the lease stipulates that the tenant should pay for the improvements and that these improvements are then to form part of the demise whose value is to be reflected in future rent reviews. Where a lease appears to stipulate this, the matter should be drawn to the attention of the client for confirmation.

Tenant's improvements can range from minor works such as the addition of partitioning to an open plan office, to the construction of a mezzanine within an industrial warehouse, or the construction at the tenant's expense of a new building on a ground-rented long leasehold site. Typically, where an entity has incurred capital expenditure on a leasehold interest which it considers material, the entity will already hold such tenant's improvements separately on its balance sheet and it is anticipated this will continue with the valuer being required to provide a valuation of them, separate from the valuation of the right-of-use asset.

This approach to tenant's improvements minimises the risk of double counting and also aligns with the general principle under the *Landlord and Tenant Act* 1954, that tenant improvements that have taken place within the current tenancy are typically disregarded.

Dialogue with the entity is important to ascertain the status of any tenant's improvements that are present on leasehold property, including whether they were added in the current or a preceding tenancy, and to agree their treatment.

6 IFRS 16 revaluation model – specialised property

6.1 Introduction

This section discusses the recommended IFRS 16 revaluation model for specialised property leases, which are either held as a RoU asset or is a tenant's improvement provided in connection with a RoU asset.

Specialised property is defined in Red Book Global Standards as: 'A property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise.'

The most appropriate valuation method for specialised property is Depreciated Replacement Cost (DRC) because there is no useful or relevant evidence of recent sales transactions due to the specialised nature of the asset and it is therefore impractical to produce a reliable valuation using other methods.

Even where the weighted overall remaining life of the building is less than the remaining term certain, the impact of capital expenditure on specialist properties could create issues in the future (the impact of extending useful economic lives must be disregarded until it occurs).

Underpinning the DRC measurement method is the principle that a specialised asset's value to the entity is equivalent to the cost of replacing that asset's remaining service potential at least cost. That principle is applicable regardless of whether the asset is held freehold or leasehold.

For a long leasehold with an unexpired term of more than 100 years, the DRC method of valuation will not differ substantially with a freehold, so limited adjustment may be required to be made to the freehold DRC values to adjust for the long leasehold nature.

Depreciated replacement cost method of valuation for financial reporting, RICS professional standard, 'explains the application of DRC to freehold property although does not provide any details on the application of DRC to long leaseholds – particularly as their term reduces under c.100 years. In this document we will adapt the principles of the DRC professional standard to leasehold property under c.100 years term unexpired using a decapitalisation/recapitalisation approach.

6.2 Examples of specialised leases in the IFRS 16 context

Examples of specialised property leases in the IFRS 16 context that may require (re)valuations include:

- A lease comprising a specialised asset and associated land where the rent is set at a peppercorn or similar concessionary level for the full lease term and there was no consideration upfront for this concessionary rent. It is thought that where the revaluation approach is required for a public sector specialised asset, this IFRS 16 peppercorn lease may be found to be the most common scenario encountered.
- A lease where the property held by the lessee is either materially under or overrented, with there being no provision for regular rent reviews to rectify this position.
- A ground lease where the land qualifies as a right-of-use asset to be valued, and the lessee has constructed a specialised building on the land which constitutes a tenant's improvement not reflected in the lease rent. While valuations of both will be required, only the land is the right-of-use asset, and they will therefore require to be valued and stated separately for financial reporting purposes.

6.2.1 Recommended approach where the unexpired term is under c.100 years

Decapitalisation and recapitalisation

The preferred method is to mirror the revaluation approach for non-specialised leasehold assets under IFRS 16 of establishing a rental figure as at the valuation date – in this case a 'proxy DRC rental' – and then capitalising that figure for the remaining non-cancellable period of the lease – also known as the 'remaining lease term certain'.

However, rather than establishing and capitalising a single rental figure which combines both land and building, a twin track approach is proposed. This envisages a proxy DRC rental figure being established for the specialised asset and a separate rental figure being assessed for the land associated with the specialised asset. Each rental figure is then capitalised for the remaining lease term certain. The resulting capitalised figures can then be added together at the end of the calculation to arrive at the right-of-use asset valuation.

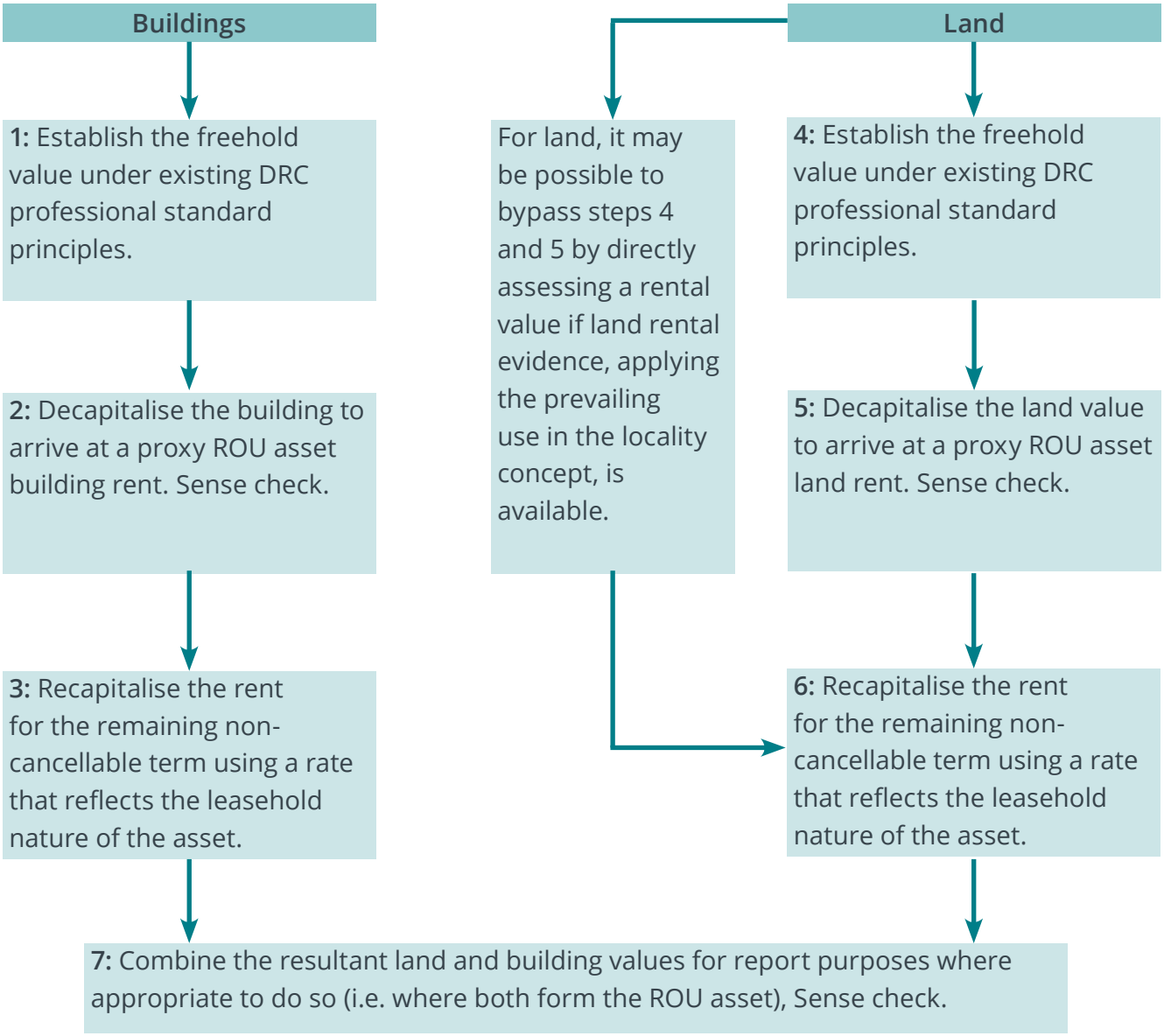
There are several benefits in adopting the twin track approach throughout the valuation calculation stages. By not prematurely combining DRC costs with the land's EUV (public sector) or fair value (private sector) derived figures during the calculation stage, doing so only at the end of the process, one is mirroring the approach taken in the valuation of DRC freehold cases.

The twin track approach enables the application of different rates to land and building when decapitalising and recapitalising, should the valuer consider that the circumstances of a particular case support that. Additionally, it allows the possibility of direct land rental values being assessed should rental evidence from 'prevailing uses in the locality' be available. It also facilitates addressing the anticipated common scenario (at least in the public sector) of accounting for a right-of-use ground lease under whose terms a specialised building has been

constructed as a tenant's improvement. This necessitates the RoU asset (the ground lease) and the tenant's improvement (the building) each being valued and stated separately.

The decapitalisation and recapitalisation method usefully recognises and enables the depreciating effect of a leasehold interest to be treated separately from the other matters that are considered when calculating a freehold DRC value, such as condition/physical depreciation.

A further benefit of the method is that in paralleling the approach applied to non-specialised right-of-use assets, it may help minimise the degree of value movement should a property ever be re-categorised from non-specialised to specialised, or vice-versa. While such a change would be unusual, it is not unknown, some properties sitting on the margins of either classification; for example, potentially a purpose-built lecture theatre in London, where there may be a semblance of educational market evidence. In these circumstances, dialogue with the entity is important and the valuer may wish to cross-check the outcomes of both the specialised and non-specialised approaches and reflect on the degree of divergence present.



The flow chart below shows the key steps when applying the decapitalisation and recapitalisation method.

Buildings

Step 1

- Establish the depreciated replacement cost of the specialised building on a modern equivalent asset basis as if held freehold.
- The remaining life (lives) applied in the valuation calculation will as usual be the lower of the remaining physical or remaining economic life of the asset, rather than, for example, adjusting (capping) the lives to reflect what may be a shorter remaining lease period.

Step 2

- The freehold DRC figure is decapitalised to obtain a proxy DRC rental value for the specialised building. The challenge in forming a judgement as to the appropriate decapitalisation rate to apply is that a specialised asset has no observable market from which to derive yields. The valuer should seek to identify, review, analyse and weight a broad range of evidential indicators and factors.
- Some assistance with yields may come from whatever may be considered the nearest similar asset class, helping to inform and also constrain the level of yield to apply and reducing the incidence of outliers. For example, for an NHS hospital, it may be useful to consider any rental or investment evidence from the private hospital market and healthcare market.
- Where relevant market evidence can be identified but is for land and buildings combined, valuers will wish to consider whether there is sufficient evidence to differentiate building-only and land-only yields or whether it is appropriate to equate them for decapitalisation purposes.
- The working group considered whether the IBR on its own could be used to decapitalise the DRC. The issue arises where borrowing rates are low (for example using PES rates in the public sector). The working group found in testing that the use of a very low IBR without any adjustment for a property premium leads to a significant under-valuation, as a very low proxy rent is produced which reduces the output of the capitalisation step. The testing suggests that when adopting a very low IBR as the yield, it may be appropriate to adjust this by a borrower's or property premium to cover the additional risk and reward that the lender would have lending on a property asset compared to the risk-free rate.
- A comparable decapitalisation process is present in the contractors method of valuation, which is applied to specialised assets in the UK for Non-Domestic Rating (NDR) purposes. Direct application of these NDR decapitalisation rates is not recommended as they are set by Statutory Instrument for a particular purpose and reflect the rating hypothesis. They are also set at a specific historic valuation date for the period of the rating list. However, in the absence of investment yield data, some assistance may be drawn from the underlying principles, where contractors method decapitalisation rates are intended to represent the cost of borrowing capital. The tenant (hypothetical in the NDR world) has an alternative to

leasing and paying rent because they can build similar premises; the 'tenant's alternative'. The hypothetical tenant would not pay more in rent, and may well pay somewhat less, than interest charged or foregone on the capital sum employed in providing the 'tenant's alternative'. The approach involves adopting the Bank of England Base Rate, adding a borrower's premium, and then deducting an allowance for the perceived net benefits of ownership as compared with tenancy. The borrower's premium is an addition to cover lender's risk and reward. Historically it has tended to be between 1% and 5%, reaching its highest point when the base rate was at its lowest, reflecting increased lender risk.

- Having calculated a proxy DRC rent for the specialised building, it may be helpful to carry out a sense check on the figure that has been produced. The valuer can compare the inferred rent produced from the freehold DRC and choice of decapitalisation rate with the inferred yield that would arise if the capital value was divided by the proxy rent. The valuer may then undertake an iterative process whereby the proxy DRC rent and proxy decapitalisation rate used are adjusted so that they both align with the freehold DRC figure and appear reasonable when contrasted with any weighted evidence that can be drawn from other sources, including other asset classes. This may be particularly helpful when valuing properties that sit on the margins of being either specialised or non-specialised.

Step 3

- The next step is to 'recapitalise' the specialised building's proxy DRC rent as at the valuation date for the remaining length of the non-cancellable lease term. This mirrors the approach for non-specialised right-of-use assets and just as for them, and as explained in section 5 it is for the entity to determine and advise the valuer how long that non-cancellable period is.
- Another point to bear in mind is that where a yield rate derived from a freehold asset was used for the decapitalisation step and it is intended to utilise this rate again for the recapitalisation step, consideration should be given as to whether an upwards adjustment to the freehold rate would be appropriate. In many cases an adjustment will be required to the capitalisation rate to reflect the riskier nature of leasehold assets compared to freehold assets (additional risk, restrictions, wasting asset, hassle factor, etc.).

Land

The land associated with the specialised use makes up the right-hand side of the flow diagram. The objective is to establish a rental figure for the right-of-use land that is associated with a specialised purpose and then capitalise it for the remaining length of the term certain. The basis of value is fair value or, for UK Public Sector Bodies subject to IFRS as adapted, existing use value to establish current value in existing use.

Steps 4 and 5

- Steps 4 and 5 relate to a rental assessment of the land. If there is any comparable rental evidence, the 'prevailing use in the locality' concept should be applied. Section 7 of *Depreciated replacement cost method of valuation for financial reporting*, RICS professional standard, provides guidance on assessing the freehold value of such specialised land by

applying the 'prevailing use in the locality' concept. The fundamental principle is that the hypothetical buyer (in our case **lessee**) is seeking to replace at least cost the site's existing service potential and would therefore purchase (in our case **lease**) the least expensive site that would realistically be suitable and appropriate for their operations. This may require consideration to be given by the valuer to the suitability of alternative sites, in consultation with the entity.

- Where direct rental assessment of the land is not possible, the valuer may:
  - first appraise the value of the land as if freehold, having regard to prevailing use in the locality (Step 4), then:
  - decapitalise the above figure to obtain a proxy rent (Step 5). This is a similar procedure to the Step 1 and 2 stages described for the assessment of the specialised building's DRC rent with a final 'sense check' of the output figure.
  - Note, however, that the use of freehold land values can present a challenge as it must be borne in mind that land held leasehold will be less valuable as it comprises a wasting asset, depreciating in value to lease expiry compared to freehold land which can be held indefinitely.

Step 6

The land rental figure, however assessed, will be capitalised for the 'remaining length of the term certain'. The comments below should be borne in mind when selecting the capitalisation approach.

Combining buildings and land values

Step 7

- The valuer will now have separate capitalised figures for the land rent and for the specialised building rent.
- These can now be added together if appropriate to give the total value of the right-of-use asset, for example, where both parts constitute the right-of-use asset.
- Alternatively, where for example the right-of-use asset is simply the land (a ground lease) and the building is a tenant's improvement, the figures will not be totalled but rather will require to be stated separately.
- The valuer should sense-check the final calculations; it may be useful to review the leasehold relativity of the right-of-use asset to ensure it seems sensible. Leasehold relativity is the ratio of the right-of-use asset against the freehold value, expressed as a percentage ratio. An analogous situation occurs in the specialist field of leasehold enfranchisement where, for residential leasehold assets, the leasehold relativities and their relationship with unexpired lease terms are well understood. A ratio of over 100% would indicate an error, while equally a very low relativity for a long lease would also suggest a potential problem.

6.2.2 Decapitalisation/recapitalisation method – illustrative worked example

- The assumed non-cancellable lease term in this illustrative example is 30 years.
- Theoretical FH value: We have adopted straight line depreciation of a £1,000,000 GRC building that is 35 years through its 60-year life, i.e. 25 years economic life remaining. The freehold DRC value of the building is therefore theoretically £416,667. The assumed land value for the freehold site is £250,000.
- Both the land and buildings are independently decapitalised by an appropriate yield, in this case 5%, to arrive at a proxy rental figure for both elements. The proxy rents are checked against rents for the nearest similar asset classes, and the decapitalisation yield may need to be reviewed if the rents cannot be understood. If no rental evidence is available, even for similar asset classes, this step may be skipped.
- The building and the land rents are then separately multiplied by the Single Rate Year Purchase, at a rate of 6%. The recapitalisation rate has been adjusted upwards to reflect the wasting nature of the leasehold asset.
- Combining the land and building elements produces the ROU asset value of £460,000, which for a 30-year lease represents 69% of the freehold value. All figures used are for illustrative purposes only.

Inputs	Building gross replacement cost	£1,000,000
	Land value (freehold)	£250,000
	Building as-new/design life	60 years
	Building's weighted remaining economic life	25 years
	Non-cancellable lease length	30 years
	Land decapitalisation rate	5.0%
	Land recapitalisation rate	6.0%
	Building decapitalisation rate	5.0%
	Building recapitalisation rate	6.0%
Land		
	Freehold land value	£250,000
	x land decap rate @ 5%	£12,500
	Recapitalise 30 years (Single rate YP @ 6%)	£172,060
Buildings		
	GRC	£1,000,000
	1 – depreciation (straight line)	41.67%
	Freehold DRC value	£416,667
	x building decap rate @ 5%	£20,833
	Recapitalise 30 years (Single rate YP @ 6%)	£286,767

Check		
	Proxy freehold rent (for sense check)	£33,333
	Proxy gross yield (for sense check)	5.00%
Land + buildings		
	ROU asset value	£458,828
	Say	£460,000
	Leasehold relativity (ROU asset value/ freehold value)	69%

6.2.3 Potential treatment of shorter life simple buildings where all constituent parts of a building will have no residual value before lease end

Notwithstanding the 100 years guidance given in section 6.2.1, there are certain circumstances where a lower threshold may be appropriate. For example, if the building's remaining life is 30 years or below, the threshold could be 80 years unexpired term as it would introduce no greater risk of material error than undertaking a decap/recap approach.

This alternative approach to the assessment of the specialised building part of a right-of-use asset presents itself where the physical or economic remaining life of all valuable parts of the building will expire well before that of the lease. Applying the lesser of the physical and economic remaining life in the normal way for building depreciation purposes to ascertain the freehold DRC building value would appear to provide not only the freehold building value but also its value to the lessee, removing the need to decapitalise the figure to obtain a proxy DRC rent and then recapitalise that rental. A scenario can be envisaged, for example, where a building constructed under a ground lease as a tenant's improvement might be 100% physically depreciated before the ground lease which constitutes the right-of-use asset expires. The greater the gap between the longer remaining non-cancellable period of the lease and the expiry of the building's physical or economic remaining life, the more likely this approach is to be appropriate. As a sense check on using this alternative, it is strongly recommended that it is not used where the gap between the remaining lease length and weighted economic life is less than 40 years.

As an illustration, if a specialised asset was a temporary building (for example simplicity, say treated as only one component and having a single remaining life of 40 years) and this was constructed on a leasehold title with 60 years remaining, then the building value of the asset could be taken as the freehold DRC value, and depreciated over the 40-year life. This would also be an effective approach to valuing a simple short life specialist addition to an otherwise valued building, such as a boiler addition, where at the end of its life the boiler would have negligible residual value. The test is whether there would be any residual value left at the end of the lease, where simply adopting the freehold DRC values would not be appropriate as it would risk over-valuing the ROU asset.

While this approach may appear straightforward and removes the need to assess and recapitalise a proxy DRC rent, considerable caution will be required for more complex

buildings. Care is needed not to conflate the calculations being used to arrive at the physical depreciation of a building's components with adjustments being made to try to reflect the asset being held leasehold, and in practice, complexities can arise as specialised buildings comprise multiple constituent parts / components, each with their own different lifespans and potentially differing rates at which they wear out. For example, while the weighted overall remaining life of the building may be less than the remaining term certain, and the impact of future capital expenditure in extending lives must be disregarded until it occurs, caution is still required over the treatment of certain longer life components as they may not in practice depreciate on a straight-line basis and may have an extended residual life, possible examples being the foundations, walls or frame.

For example, the weighted overall remaining life of a 1960s hospital building, may be judged to be 15 years, however, this may comprise of many shorter life constituent elements of 5 – 10 years remaining, with longer life constituent elements (walls, foundations, frame) of 50 years. At face value, if the remaining non-cancellable period of the lease was 15 years, and the weighted life was 15 years it may appear that no adjustment would be required, however, this would be ignoring the longer life constituent elements, which will still have valuable life remaining in them at lease expiry, and in practice many of the shorter life elements will also not have fully depreciated to nil as the depreciation rate will have slowed down on many of them. The hypothetical lessor of the specialised asset will therefore be handed back an older building with a material residual value when the right of use asset expires for the lessee. This could in theory be re-let to the lessee, or an alternative occupier.

Continuing this example, it follows that the freehold title of the 1960s hospital building will be more valuable than the same building held under a 15 year (or even a 25 year leasehold title), even though at the point of undertaking the right of use asset valuation the weighted life is only 15 years. Or put another way, the leasehold right of use asset will be worth less than the freehold interest of the same asset as the lessee only needs to pay for their use of the building for the 15-year period but does not need to pay for the residual value of the building. If this alternative approach were applied to buildings with multiple constituent parts of differing lifespans without any consideration, there would be the risk of over-valuing the specialised right of use asset. In this example, the preferred decapitalisation & recapitalisation approach could be used to determine how much less valuable the leasehold interest is from the freehold.

Where a practitioner considers that it may be appropriate to apply this approach to ascertain the building's value to the lessee in circumstances where its life appears shorter than the lease itself, it is recommended that they proceed with care and consider each constituent element or element grouping in turn to help avoid potential pitfalls and satisfy themselves that a 'true and fair' figure is produced.

6.2.4 Alternative RoU asset revaluation techniques considered but rejected where the building economic life is longer than the unexpired term

For the buildings, the temptation for the valuer is to simply shorten, or cap, the calculation of the DRC building depreciation by using the remaining 'non-cancellable lease term' rather than the asset's longer remaining physical or economic life. This approach is not recommended by the working group for the following reasons:

- impairment issues where the entity incurs capital expenditure on the asset expenditure will not result in any increase in the value of the right-of-use asset
- counter-intuitive results are produced where a new building subject to a ten-year lease has the same value as an old building with only ten years economic life.

Equally, a further temptation could be to artificially shorten the as new or design lives for a building or component to increase the rate of annual depreciation. For instance, if a new asset is built that would last 60 years but on a lease with a term of 20 years, to shorten the denominator used as an input into the physical depreciation calculation to just 20 years. This approach is not recommended by the working group because it will over-value the leasehold value of the asset initially as almost all the freehold value will be given to the asset despite the leasehold nature of the asset. The freehold of a new building with 60 years of economic life should intuitively be worth more than a 20-year lease of the same asset.

7 Conclusions

It is possible for accountancy professionals, business valuers and entity management to apply the majority of IFRS 16 without the assistance of real estate professionals. However, there are parts of IFRS 16 where surveying skills are required in the application of IFRS 16 to real estate leases (rather than other types of leased assets such as vehicles or aircraft).

As this paper shows, there are many parallels as well as some key differences between Private Sector and UK Public Sector proposed IFRS 16 adaptations.

Key areas for real estate professionals include:

- The appropriate discount rate used for lease liabilities, either on lease inception, transition to IFRS 16 or when the lease is substantially varied (e.g. floor area or term). In the public sector be aware that most clients are likely to use a PES rate / PWLB, and surveyors are only likely to be required where it is possible to calculate the interest rate implicit in the lease.
- The appropriate categorisation of leases where discount rates are applied to groups of leases. IFRS 16.B1 mentions that a portfolio approach is permitted to group leases with similar characteristics in determining the discount rate where there is unlikely to be a material difference between the effects of applying the standard to the portfolio and applying the standard to the individual leases within that portfolio. Surveyors may be required to assist with these groupings based on lease lengths, geography and market characteristics. Again, this is mainly to apply to the Private Sector.
- Appraising fair value for sale-and-leaseback transactions. Surveyors will need to appraise whether the consideration received equates to the asset's fair value and whether the lease payments are set at market rates. Where either of these is not the case then adjustments are required to measure the sale proceeds at fair value.
- Revaluation of both specialised and non-specialised Right of Use Assets including the appraisal of IFRS 16 peppercorn leases in the Public Sector using the IFRS 16 revaluation model. The valuation techniques recommended in this paper are similar to the appraisal of finance leases under IAS 17, particularly in the case of leases of non-specialised property. We have recommended a capitalised rent approach to the (re)valuation of RoU assets and have suggested that the RIIL (with reasonable assumptions) is the most appropriate capitalisation yield. The yield is applied to the 'IFRS 16 Market Rent' which is a term used in this paper to describe the rental value of the lease excluding passing rent.
- The key issue addressed in this paper is the (re)valuation of specialised RoU assets. The RICS DRC professional standard only deals with freeholds and long leaseholds akin to freeholds; on this basis, we assume that there is a fair degree of variance in the valuation profession when valuing existing specialised IAS 17 finance leases. It is important to create consistency in approach when valuing shorter lease terms on a specialised use basis. In summary we recommend that the leasehold nature of a ROU specialised asset is reflected. In most cases the decapitalisation/recapitalisation approach produces the most representative leasehold relativities more in keeping with the non-specialised approach, however, other approaches may be valid but must be justified and carefully applied.

Appendix A IFRS 16 cost model – worked example

The example illustrates the various steps required for a lessee to calculate the balance sheet, profit and loss and cash position, and is based on the following assumptions:

1 A 5-year lease without any breaks.

2 Rent is £10,000 pa payable annually in arrears with no fixed uplifts.

3 The discount rate is 5%.

4 There are no known additional cost components (in order to keep the calculations as simple as possible).

			Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	Cumulative time for calcs		0	1	2	3	4	5
	Discount and interest rate	5.00%		1	1	1	1	1
	Count periods			1	1	1	1	1
	Cumulative periods			1	2	3	4	5
	Discount in arrears		1.000	0.952	0.907	0.864	0.823	0.784
	Discount in advance			1.000	0.952	0.907	0.864	0.823
Calculate initial Liability		**Totals**	**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
	Rent	**£50,000**		£10,000	£10,000	£10,000	£10,000	£10,000
	Net Present Cost at 5.00%	**£43,295**		£9,524	£9,070	£8,638	£8,227	£7,835
	ase Liability period start			£43,295	£35,460	£27,232	£18,594	£9,524
Calculate interest & repayment	Interest at 5.00%	**£6,705**		+£2,165	+£1,773	+£1,362	+£930	+£476
	Repayment (rent)	**£50,000**		-£10,000	-£10,000	-£10,000	-£10,000	-£10,000
	ase Liability period end			£35,460	£27,232	£18,594	£9,524	£0
Calculate depreciation	epreciation (£43,295/5)	**£43,295**		£8,659	£8,659	£8,659	£8,659	£8,659
Insert Calculations into accounting categories								
1) Balance	**Right of Use Asset**		£43,295	£34,636	£25,977	£17,318	£8,659	£0
	Lease Liability		-£43,295	-£35,460	-£27,232	-£18,594	-£9,524	-£0
2) P&L	**Interest:** Presented in finance costs	**£6,705**		£2,165	£1,773	£1,362	£930	£476
	Depreciation:	**£43,295**		£8,659	£8,659	£8,659	£8,659	£8,659
	TOTAL combined P&L figure	**£50,000**		£10,824	£10,432	£10,021	£9,589	£9,135
3) Cash	**Principal repayment:** In financing	**£43,295**		£7,835	£8,227	£8,638	£9,070	£9,524
	Interest:	**£6,705**		£2,165	£1,773	£1,362	£930	£476
	TOTAL CASH:	**£50,000**		£10,000	£10,000	£10,000	£10,000	£10,000

The expected lease cash flows are discounted to present value at an appropriate discount rate discussed in section 4 of this paper. This creates an initial lease **liability** in this example of £43,295, compared to the £50,000 total rent over 5 years without discounting.

The corresponding right-of-use **asset** is equal to the lease liability and is therefore £43,295. This measurement, based on a discounted cash flow (DCF), is known as the cost model. It assumes that the DCF cost of the lease liability is equivalent to the value of the right to use the leased property.

Thereafter, the lease liability interest is added, and rental payments are deducted. For example, in Year 1 the lease liability increases by £2,165 (interest) and then reduces by £10,000 (rent). The net result is a lease liability of £35,460 carried forward to the next year.

The right-of-use asset is generally depreciated on a straight-line basis, which in most cases is the life of the lease (over the property's useful life) until the end of the lease. In this example the RoU asset reduces by £8,659 per annum, until it is £0 at the end of the final year.

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