CIPFA The Chartered Institute of Public Finance & Accountancy

report

Paper CL 09 03 18

Board	CIPFA/LASAAC
Venue	PwC Offices, Cardiff
Date	12 March 2018
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Subject	IFRS 16 Leases

Purpose

The purpose of this report is to agree amendments to the consultation papers on IFRS 16 *Leases* and approve them for issue

1 Introduction

1.1 CIPFA/LASAAC agreed the Invitation to Comment and Exposure Draft of the amendments to the Code for IFRS 16 *Leases* following its November 2017 meeting and following consideration of the Analysis of Responses to the Early Consultation on IFRS 16 Leases and Approval to Issue the Formal Consultation Paper. However, the Board will be aware that following the issues raised in relation to the impact of IFRS 9 *Financial Instruments* it was considered necessary for CIPFA to develop a formal impact assessment process to support the Board in its deliberations and local authority accounts preparers on the approach to adoption of new standards.

1.2 It is recognised that CIPFA/LASAAC has considered the impact of the changes to standards on local authorities in some detail by means of its extensive consultation processes. However, previously feedback has traditionally been more general and conceptual and it has been difficult to quantify the financial impact on local authorities. In the case of IFRS 9, this was despite frequent attempts to do so.

1.3 This report also considers additional issues that have arisen since the Board approved the consultation paper and provides an outline of CIPFA's proposals for the impact assessment.

1.4 Note that the proposed changes to the ITC are highlighted in grey for ease of reference and the proposed changes to the Exposure Draft are in tracked changes. Note also that the tracked changes in the other sections of the Code (with the exception of section 2.3) have already been agreed by CIPFA/LASAAC.

2 Impact Assessment

2.1 As noted above CIPFA/LASAAC has always been keen to consider and evaluate both the costs and the benefits of the introduction of any changes to the Code. The major standard setters, for example, the Financial Reporting Council and the IASB undertake impact assessments or effects analyses to formally make this assessment. CIPFA/LASAAC will be aware that governments across the UK undertake various impact assessments on changes in policy.

2.2 Against that background, CIPFA considers therefore that it is timely to consider how further and enhanced Secretariat support can be provided to CIPFA/LASAAC to fulfil its standard setting role. CIPFA proposes to develop a process to evaluate the impact of proposed new financial reporting standards on local authorities, the results of which will be beneficial to the Board and to wider stakeholders.

2.3 As IFRS 16 is a substantial new standard then the likely characteristics associated with its implementation provides a current and early opportunity to introduce the process. The outcome from the evaluation is summarised in tabular form below but in its widest sense, CIPFA anticipates that the process will result in a rich and practical dataset to be presented to the Board to inform its forward discussions.

2.4 The format and detail of the impact assessment is in the process of being developed into a project plan by CIPFA. However, initially the impact assessment is described in more detail in the table below.

Table1: Outline of the Process for the Impact Assessment of IFRS 16

Issue	Detail
Objectives	▪ provide empirical and practical evidence to CIPFA/LASAAC for its decision making as standard setter – including providing a full cost/benefit analysis ▪ facilitate the development of targeted application guidance by CIPFA ▪ support local authorities in their implementation of the Standard ▪ provide the basis for early communication of implementation to stakeholders
Scope	▪ Four UK nations within the scope of the Code – local authorities across the UK regions – England – all major types of authority adopting the Code.
Stakeholders anticipated to be involved/or informed:	▪ Chief Finance Officers (financial management impact) ▪ Local Authority Accounts Preparers ▪ Technical Finance Officers ▪ Government

Issue	Detail
	▪ CIPFA/LASAAC and its sub group on leases ▪ CIPFA Standards and Financial Reporting Board ▪ Leasing Advisors ▪ Treasury/Capital Management Advisors ▪ National Audit Bodies ▪ Audit Firms ▪ Other CIPFA Panels
Delivery	▪ CIPFA Policy and Technical - (project lead – Head of Policy and Technical) ▪ CIPFA/LASAAC Secretariat ▪ FAN Advisors
Coverage	▪ Financial impact: – Comprehensive Income and Expenditure Statement, – Balance Sheet – Cash Flow Statement and – the notes Are there any specific issues for the Group Accounts of Local Authorities? ▪ Capital financing implications across the four UK administrations (NB this is confirmed for English authorities) – other issues relating to the impact on the Prudential Framework ▪ Initial cost of compliance – eg systems, processes, training and information requirements ▪ Costs of transition including any changes in dilapidation recognition ▪ Ongoing cost of compliance, systems, processes and information requirements

Issue	Detail
	▪ Impact of timeline for implementation ▪ Benefits of adoption – transparency, more efficient decision making and comparability ▪ Other practical impacts, particularly on procurement and any other resource issues ▪ Impact on the leasing market for local authorities.
Methodology	▪ Review of leasing landscape for local authorities ▪ Use information in the readiness assessment questionnaire issued with the consultation papers ▪ Desktop research – including information available from Whole of Government Accounts, if available ▪ Sample of local authorities lessors and lessees interviewed – establish a model to make the assessment ▪ Fieldwork with sampled local authorities to compute the assessment ▪ Other feedback available as a part of the consultation process.
Timeline	▪ Commence April 2018 ▪ Fieldwork April 2018 to September 2018 ▪ Results of consultation analyses October 2018 to December 2018.

CIPFA/LASAAC is invited to comment on the outline of the review above.

3 IPSASB Exposure Draft 64 Leases

3.1 IPSASB issued Exposure Draft 64 Leases on 31 January 2018[1]. The consultation period is open until 30 June 2018. The project is an IPSASB convergence project therefore under the IPSASB 'Rules of the Road' the lessee model in IFRS 16 is followed by ED 64.

[1] **Exposure Draft 64, Leases**

3.2 Following the *Memorandum of Understanding between the Relevant Authorities*[2] an indication that an adaptation to IFRS may be necessary is the issue of different or additional guidance in a relevant International Public Sector Accounting Standard (IPSAS).There are two main areas where the IPSAS has diverged from IFRS 16 both of which are relevant to the local authority approach to adoption of the standard. The first issue was raised with the Board at its last meeting (ie the IPSASB approach to the lessor accounting model) and the second area is in relation to concessionary leases.

The Right-of-Use Model for Lessor Accounting

3.3 CIPFA/LASAAC will be aware that the lessor accounting model under IFRS 16 retained the risk and rewards approach in IAS 17 *Leases*. Also five respondents to the initial consultation on IFRS 16 raised concerns over the lack of symmetry between lessee and lessor accounting under IFRS 16 with one respondent commenting:

'*This concept may be difficult for users of the accounts to understand particularly in a group scenario where leases are made between the group*.'

The Secretariat is of the view that this might be an issue for users of the financial statements. However, this reflects the principles and approach in IFRS 16.

3.4 The IPSASB is of the view that when the lessor and the lessee are public sector entities in the same lease contract, the lack of consistency between lessor and lessee accounting in IFRS 16 will lead to:

- the underlying asset not being recognised by the lessor nor by the lessee if the lessor classifies the lease as a finance lease, and
- the lessor not recognising a lease receivable if the lease is classified as an operating lease, while the lessee always recognises a lease liability.

3.5 The IPSASB is of the view that this could give rise to a number of practical issues that it considers are more prevalent in the public sector:

- consolidation issues - ie where the lessor and lessee are part of the Group Accounts and separate records need to be maintained for the underlying asset and lease receivable
- understandability issues – ie due to different accounting models for the same transaction - it may be difficult for users of the financial statements to distinguish between a lease and the sale of an asset in lessor's financial statements (note this is similar to the view held by one of the respondents to last year's early consultation)
- asymmetrical information in the public sector – different recognition criteria for the same transaction distorts the analysis of the financial position of public sector entities. This may be particularly an issue in relation to Whole of Government Accounts and the asymmetry was an issue raised by the respondents.

[2] Note that the *Memorandum of Understanding Between the Relevant Authorities* is included as an Appendix to the Operational Framework in paper CL 10 03 18.

3.6 The IPSASB ED 64 proposes a single model for lease accounting based on the principle that lease contracts simultaneously:

- create an asset (the right-of-use asset) separate from the underlying asset ie it distinguishes between the two assets
- transfer the right to use an underlying asset (the right-of-use asset) from the lessor to the lessee, not the underlying asset itself, and
- finance the right to use an underlying asset.

A lease is, in substance, a sale of an unrecognised right-of-use asset, for which the lessor has a performance obligation to provide access to the underlying asset to the lessee, in exchange for cash. ED 64 also distinguishes between control of the underlying asset held by the lessor from the control of the right-of-use asset held by the lessee.

3.7 For the lessor ED 64 proposes:

- continuing to recognise the underlying asset in the balance sheet because the lessor continues to control the underlying asset and measuring this in accordance with the current requirements for that asset
- recognising a liability (unearned revenue) at the value of the lease receivable plus the amount of any lease payments received at or before the commencement date because the lessor sells an unrecognised right-of-use asset to the lessee and has a present obligation to provide access to the underlying asset to the lessee. Note that the IPSASB at a glance summary indicates that this is consistent with the approach to measurement of similar liabilities in IPSAS 32 *Service Concession Arrangements: Grantor*
- recognising a lease receivable because the lessor gains control of the right to receive payments. This is measured initially at the present value of the future lease payments.

3.8 The Secretariat would highlight that the second bullet in paragraph 3.7 should be considered carefully, the consistency with IPSAS 32 relates to the grant of the right of an operator model which was not included in the Code when CIPFA/LASAAC sought to adopt IPSAS 32 principles in the Code. This was because there was debate amongst standard setters on this issue as outlined in FRS 102[3] which sets out that:

'*the Accounting Council does not advise the application of this model because it appears to result in the recognition as liabilities of amounts that may not meet the definition of a liability'*.

The Secretary would personally note that if there is no control over some or all of the property, plant or equipment given up (which might properly be reflected in an adjustment to the carrying value of the underlying asset) the lessor would only be meeting its obligations over the life of the lease and not on entry into it.

3.9 As the lack of symmetry in the standard has been raised by respondents and is an issue of concern for IPSASB, the Secretariat considers that the Code consultation

[3] FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

documents should explore the use of the right-of-use model in the consultation papers and particularly seek the views of interested parties on whether the public sector issues raised by IPSASB will impact substantially on local authorities. The readiness assessment questionnaire will also seek views on whether local authorities have leases with other areas of the public sector to consider how much of an impact this might be. At this juncture the Code Exposure Draft will not include the relevant provisions as these are currently only at Exposure Draft stage for the IPSASB and may be subject to change.

CIPFA/LASAAC is invited to consider whether it agrees to include this issue in the Invitation to Comment.

Concessionary Leases

3.10 CIPFA/LASAAC Members will be aware that the Code currently includes provisions for leases either at nil, a peppercorn or nominal amount and that the Board has agreed to include those provisions for finance leases for lessors in the Exposure Draft (see paragraph 4.2.2.68) which requires that local authorities consider the substance of the lease transaction.

3.11 ED 64 includes proposals for public sector specific requirements to account for concessionary leases for both lessors and lessees based on the right-of-use model. The proposals include guidance for accounting for the subsidy which is consistent with IPSASB provisions on accounting for non-exchange transactions and concessionary loans. The IPSASB is of the view that the nature of the resource transferred does not affect the economic substance of a subsidy. Consequently, whether an entity grants a loan or transfers a right-of-use asset at below market terms the accounting for the subsidy should be the same. As this issue is consistent with approaches already in the Code the Secretariat would recommend that the Code consultation documents consider this issue. The Secretariat has therefore included the relevant provisions for concessionary leases into the lessees section of the Exposure Draft.

3.12 As the lessors' transactions in ED 64 are based on the right-of-use lessor model which the Code Exposure Draft doesn't adopt the Code Exposure Draft continues with the same approach for finance leases as the current edition of the Code which is to require a local authority to consider the substance of the transaction, which is essentially the approach of the IPSASB but on a principles basis.

CIPFA/LASAAC is invited to consider whether it wants to include the specific reference to concessionary leases for lessees in the ITC and Exposure Draft.

4 Date of Adoption

4.1 The basis of conclusions for IFRS 16 indicates that the IASB allowed companies three years from issue to the effective date of the standard because the majority of accounts preparers responding indicated that it would take three years from issue of the standard to implementation.

4.2 CIPFA/LASAAC consulted last year on its initial views on the approach to adoption of IFRS 16. The Board will be aware that the consultation documents were issued on a principles basis and did not include an Exposure Draft of the Code. The Board will also be aware that the responses to that consultation focused on the practical impacts and the information requirements anticipated to be necessary to adopt the Standard. CIPFA/LASAAC had anticipated these issues and had already requested that the sub group include a form of impact assessment. The consultation papers therefore already include the readiness questionnaire. The sub group also raised the issue that companies were allowed three years to implement the standard and was concerned that local authorities would also need three years.

4.3 CIPFA/LASAAC will also be aware that it was able to issue the agreed Code provisions in relation to the anticipated adoption of both IFRS 9 and IFRS 15 *Revenue from Contracts with Customers* alongside the 2017/18 Code thereby allowing local authority accounts preparers sufficient time to adopt the standard. The IFRS 16 consultation was previously planned for December 2017 to align with the anticipated issue of the HM Treasury consultation on IFRS 16. The CIPFA/LASAAC consultation was delayed so that CIPFA could develop its approach to the impact assessment. It should be noted that the HM Treasury consultation is also yet to be issued.

4.4 The Secretariat would also note that following the issue of the IPSAS Exposure Draft (ED) 64 *Leases,* particularly in relation to the lessor model, it may be prudent to await the outcomes of the consultation before finalising the Code's approach to the adoption of IFRS 16. Additionally, a prudent assessment of timescales to undertake an effective impact assessment is likely to mean that it may be difficult to reflect the outcomes in the final version of the Code.

4.5 The Secretariat considers therefore that:

- taking into account the implementation timescales the IASB offered to companies to adopt IFRS 16
- allowing CIPFA/LASAAC time to evaluate the final version of the IPSAS ED 64 lessor accounting model, and
- to ensure that the Board can effectively consider the outcomes of the formal impact assessment

It is recommended that the consultation papers seek views from accounts prepares and other interested parties on whether the implementation of the standard should be delayed until 2020/21.

5 **HM Treasury Proposals for the Governments Financial Reporting Manual**
(Note that this section of the Report should be treated in Confidence)

5.1 Since the last meeting of CIPFA/LASAAC the proposals for the Exposure Draft of the Government's Financial Reporting Manual (the FReM) have been issued to the Technical Working Group. CIPFA/LASAAC's approach has always been to align the approach to adoption with the FReM subject to the proposals being able to adequately reflect local authority circumstances. There are four areas where the Code currently differs from the proposed approach in the FReM.

Table 2: Areas of Difference from the Anticipated Approach in the FReM to the Proposed Approach for the Code

<table>
<tr><th>Anticipated Approach for HM Treasury in the FReM</th><th>Proposed Approach for the Code</th></tr>
<tr><td>Definition of a Lease Contract

HM Treasury believes the definition of the contract should be adapted so that it includes such intra-government agreements that were not technically legally enforceable, but in substance were expected to be honoured and in all other aspects be considered a lease.</td><td>This does not apply to local authorities therefore there are no proposals to adapt the Code for the definition of a lease contract.

The Secretariat does not recommend any change to the proposals in the ITC and Exposure Draft.</td></tr>
<tr><td>Transition - Definition of a Lease

HM Treasury proposes mandating the practical expedient to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 and IFRIC 4.</td><td>The sub group and the Board have considered this practical expedient and anticipate that local authorities will use it but have considered that local authorities are best placed to decide their needs in relation to this issue.

It is anticipated that as most authorities are likely to apply this approach there should not be too much of a difference between the FReM and the Code.

The Secretariat considers that the Board could maintain its current approach but would seek the Board's views.</td></tr>
<tr><td>Practical Expedients on Transition

The following practical expedients are anticipated to be mandated by the FReM:

▪ No adjustment is required for leases for which the underlying asset is of low value

▪ A lessee may elect not to transition for leases for which the lease term ends within 12 months of the date of initial application. In this case, a lessee shall:

– account for those leases in the same way as short-term leases, and

– include the cost associated with those leases within the disclosure of short-term lease expenses</td><td>CIPFA/LASAAC and the sub group had not anticipated mandating these three practical expedients on the basis again that local authorities would be best placed to decide how to use them. However, as this issue was not debated CIPFA/LASAAC is invited to consider whether it wishes to mandate the use of the first three practical expedients. It is arguable that from a consistency basis that the Code should mandate the second practical expedient.

The Secretariat would recommend that at least the second practical expedient be considered but also considers that it may be useful to also mandate the low value lease practical expedient and has currently reflected that position in the (draft) consultation papers.</td></tr>
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Anticipated Approach for HM Treasury in the FReM	Proposed Approach for the Code
▪ A lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. This is to align with the proposals for new leases in these categories.	
Incremental Rate of Borrowing As there are no interest rates levied to supply-funded bodies and the interest rates charged upon the Exchequer are irrespective of the reasons for the borrowing, HM Treasury proposes to introduce a central internal rate of borrowing for entities to apply, when they cannot obtain the rate implicit in the lease contract.	This is not an issue for local authorities and therefore the setting of a central rate has not been proposed. Note that HM Treasury sets a number of discount rates for central government and the Code has not followed this approach. **The Secretariat does not recommend any change to the proposals in the ITC and Exposure Draft.**

5.2 HM Treasury are also concerned with the impact on the cumulative catch-up approach to retrospective restatement if the Office for National Statistics agrees that leases come on balance sheet. Note that the early consultation on the Code already indicated that CIPFA/LASAAC's preferred approach would be to adopt the standard using the cumulative catch-up approach to reduce the application burden for local authorities but also to be consistent with the approach to IFRS 9 and IFRS 15.

CIPFA/LASAAC is invited to note this point.

Recommendation

CIPFA/LASAAC is asked to consider the above issues and agree to issue the Exposure Draft and ITC.