CIPFA The Chartered Institute of Public Finance & Accountancy

report

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Subject	IFRS 16 Leases – Approach to Adoption in the 2019/20 Code

To consider the issues that might arise for local authorities and the public sector on adoption of the Standard in the Code

1 Introduction and Background

1.1 This report provides an overview of IFRS 16 *Leases* and seeks to identify the potential impact on local authorities of the adoption of the new Standard. The International Accounting Standards Board (IASB) issued IFRS 16 in January 2016. It supersedes IAS 17 *Leases* and its associated interpretations[1]. The effective date of IFRS 16 is for reporting periods commencing on or after 1 January 2019. An entity can decide to apply IFRS 16 before that date but only if it also applies IFRS 15 *Revenue from Contracts with Customers*. Subject to CIPFA/LASAAAC decisions and European Union adoption the standard will apply in the 2019/20 Code.

1.2 IFRS 16 specifies the principles for recognition (including providing a new definition of a lease), measurement, presentation and disclosure of leases both for the lessee and for the lessor. The Standard was developed as a joint project between the IASB and the American Financial Accounting Standards Board (FASB), although there are divergences in the lessee accounting model.

1.3 The IASB focus on the leasing project was to respond to concerns about the lack of transparency of information. The central feature of the current standard for leases (IAS 17) is that classification as a finance lease is determined by whether a lease is economically similar to purchasing the asset being leased. If so an asset and related liability are recognised on an entities balance sheet. All other leases are classified as operating leases and no assets or liabilities are recognised. The existence of two different accounting models for leases means that transactions that are economically similar could be accounted for very differently. This meant that investors had to make adjustments to financial statements to compare economically similar entities.

1.4 The Secretariat would note that the IASB allowed private sector entities three years to implement the standard. It will be important therefore that local

[1] IFRIC 4 *Determining whether an Arrangement contains a Lease,* SIC 15 *Operating Leases—Incentives* and SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

authorities understand the reporting implications and have adequate preparation time to apply the Standard.

2 Initial Recognition

Introduction

2.1 IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

Identifying a Lease

2.2 Under IFRS 16 a lease is a contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration (whether or not it has the legal status of a lease). A contract is or contains a lease on the basis of whether the customer has the right to control the use of an identified asset for a period of time. A contract conveys the control of the right to use of an identified asset if throughout the contract period the customer has the right:

- to obtain substantially all of the economic benefits from use of the identified asset, and
- to direct the use of the identified asset.

2.3 The scope of IFRS 16 is similar to that of IAS 17. Importantly for local authorities it excludes service concession arrangements. A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than licensing agreements that are already excluded from the scope of the Standard.

2.4 Short-term (less than 12 months) and low value leases for items such as, office furniture, laptops, ipads are exempt from the recognition requirements (the basis of conclusions for IFRS 16 provides a monetary value of $5,000). However, this means that material leased cars, fleet items, plant and machinery and property items currently used under operating leases will need to be recognised on local authority balance sheets as right-of-use assets. The volume of transactions to be considered is likely to be an important consideration for local authorities preparing to adopt the Standard. In addition, CIPFA/LASAAC might want to consider whether it includes more explicit guidance in the Code on the application on the low value short-term exemption.

2.5 The definition of a lease is similar to that contained in IAS 17 and IFRIC 4. The Secretariat is not clear how many contracts held by local authorities contained leases which were identified under IFRIC 4. IFRS 16 includes detailed guidance to help entities assess whether a contract contains a lease or a service, or both. The entity needs to determine if a contract meets the definition of a lease. This means that the customer has the right to control the use of an identifiable asset for a period of time in exchange for consideration under the definition of a lease. Judgement will be required to make this decision areas of difficulty might be service contracts for IT eg network equipment and the use of data and storage facilities, as well as shared use of fibre optic cables but could also apply to property leases.

2.6 Where a contract was deemed to contain an operating lease separating the lease element would previously have little practical effect. Under IFRS 16 separation and identification of assets and liabilities is more likely to make a material difference. Contract analysis will therefore have a higher priority. The Secretariat would note that the definition of a lease is the area of the Standard where the most application guidance has been produced. The distinction between leases and services is now more important because accounting for operating leases used to be akin to accounting for services so potentially the identification of operating leases previously was not a priority. However, it is likely that for the vast majority of contracts the identification of leases will be straightforward but on the margins there will be areas which will require judgement. But local authorities will need to ensure that they have the relevant information to make these judgements.

3 Initial Measurement

Lease Liability

3.1 The lease liability is initially measured at the present value of the lease payments payable over the lease term. This is discounted at the rate implicit in the lease. If the rate implicit in the lease cannot be readily determined, the lessee is required to use their incremental borrowing rate.

3.2 A recent IASB article[2] identified that it is likely that in many cases lessees will not currently have sufficient information about how the lessor priced the contract to determine the rate implicit in the lease. If this is the case for local authorities then they will need to use their incremental borrowing rate. In theory this is not a new issue as this is the same as the accounting requirements for finance leases in IAS 17. However, a relevant incremental borrowing rate will be based on a rate that would have to be to be paid in borrowing funds over a similar term and with a similar security to acquire an asset of a similar value in a comparable economic environment. This will therefore vary across the different types of assets that local authorities hold under operating leases.

Right of Use Asset

3.3 The right-of-use asset is initially measured at cost. The cost of the right-of-use asset comprises: the initial measurement of the lease liability, lease payments made at or before lease commencement less any lease incentives received, the lessee’s initial direct costs and an estimate of restoration, removal and dismantling costs taking into account the lease term as determined under the IFRS 16. Determining the lease term will therefore be an important task under the Standard.

4 Subsequent Measurement

Lease Liability

4.1 Subsequent measurement of the lease liability requires that a lessee:

- increases the carrying amount to reflect interest on the lease liability
- reduces the carrying amount to reflect the lease payments made, and

[2] Leases one year on—putting IFRS 16 into practice, IASB January 2017

- remeasures the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.

Right of Use Asset

4.2 For subsequent measurement of leased assets, a lessee is required to measure the right-of-use asset using the cost model, unless:

- the right-of-use asset is an investment property and the lessee applies the fair value model to its investment property under IAS 40 *Investment Property*, or

- the right-of-use asset relates to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment*; in such circumstances a lessee may *elect* to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

4.3 One of the decisions that CIPFA/LASAAC will need to consider is whether it will permit the use of the cost model under the standard. It will need to consider whether this is consistent with its approach to current value for (the majority of) property, plant and equipment assets. Assets acquired under finance leases are presently carried at current value in line with CIPFA/LASAAC's view that current value best measures the worth of local authority assets. Consistent use of the cost model for right-of-use assets would allow an authority to end this policy. The Secretariat would note that there is a transitional option which permits the right-of-use asset and the lease liability at the date of initial application to be the carrying amount of the lease asset and lease liability immediately before that date measured applying IAS 17. This would leave finance lease assets at a suspended current value.

4.4 If CIPFA/LASAAC wishes to disallow the cost option it will need to make a decision whether to:

- allow materiality to determine whether current values are actually applied in particular instances (as it currently does in the Code by allowing a proxy to be use for short-life/low value assets)

- specify the lease term under which valuations are not required to avoid onerous requirements for shorter term leases

- specify asset classes or categories for which valuations would not be required.

Whichever approach is taken will also subject to any statutory requirements being maintained or extended impact on the General Fund as under IFRS 16 depreciation on the right-of-use asset will be charged to the Surplus or Deficit on the Provision of Services.

CIPFA/LASAAC is invited to consider whether it has any initial views on the subsequent measurement of the right-of-use asset.

5 Impact on the Financial Statements

Balance Sheet

5.1 The most significant effect of the new requirements in IFRS 16 will be an increase in lease assets and lease liabilities. For lessees all leases (with the exception of those short or low value leases discussed above) will be accounted for in a similar way to the current IAS 17 treatment for finance leases ie the recognition of a right-of-use asset and the liability for the obligation to make lease payments. Local authorities that currently have operating leases will appear to be more asset rich but this will be accompanied by a commensurate increase in indebtedness.

Impact on the Surplus or Deficit on the Provision of Services

5.2 IFRS 16 changes the nature of expenses for those local authorities with substantial operating leases. Under IAS 17 expenditure was normally incurred as a straight line expense for operating leases and for finance leases a charge for depreciation for finance lease assets and an interest expense in financing and investment income and expenditure. For local authorities currently the Minimum Revenue Provision (MRP) guidance for England and Wales and loans fund for Scotland stipulates the statutory charge for finance leases should be the lease payment. This will need to be considered by the relevant administrations because there will no longer be a distinction between finance and operating leases in local authority financial statements. Administrations in these jurisdictions will have to decide whether these provisions will be extended to all leases with a right of use asset.

5.3 Considerations for government bodies might be consistency with the previous statutory guidance and the impact of CIPFA/LASAAC decisions on subsequent measurement ie whether depreciation for subsequent measurement of the right-of -use asset is current value depreciation or historical cost depreciation.

Impact on the Cash Flow Statement

5.4 The introduction of IFRS 16 will not impact on the total cash flows in the cash flow statement. The accounting requirements will not change the payments made to lessors. It will have an impact on the presentation of the cash flows in the statement. On the application of the new requirements principal repayments on all lease liabilities are included within financing activities. Interest payments may also be included within financing activities applying IFRS 16. In comparison with the amounts reported under IAS 17 this is likely to mean operating cash flows will decrease with a corresponding increase in financing cash flows.

6 Transition

Definition of a Lease on Transition

6.1 As a practical expedient an entity is not required to reassess whether a contract is or contains a lease at the date of initial application instead an entity is permitted to:

- to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 and IFRIC 4.
- not to apply this Standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

Transition Approach

6.2 IFRS 16 provides two approaches to transition. The first is full retrospective restatement and the second is modified retrospective approach. The approach chosen by an entity has to be applied to the entire lease portfolio. Under this approach, a lessee is not required to restate preceding year information. Under the modified approach, at the date of initial application of IFRS 16 lessees are required to recognise the cumulative effect of initial application as an adjustment to the opening balance of equity (reserves).

6.3 Under the modified retrospective approach for leases that were previously operating leases at the date of initial application an entity is able to choose on a lease by lease basis to measure the right of its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application. The lease liability is measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.

6.4 As noted in paragraph 4.3 above, for assets which were previously recognised as finance leases lessees are permitted to measure the right-of- use asset and the lease liability as the previous carrying amount.

6.5 There are also a number of practical expedients for measurement. Under the modified approach to transition a lessee may:

- apply a single discount rate to a portfolio of leases with reasonably similar characteristics
- rely on its assessment of whether leases are onerous applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review
- account for leases for which the lease term ends within 12 months of the date of initial application as short-term leases
- exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application
- use hindsight, such as in determining the lease term.

7 Disclosure Requirements

7.1 Overall the disclosure requirements have increased under IFRS 16. The Standard has also introduced a disclosure objective which gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee and lessor. This includes additions for the right-of-use asset, depreciation charges and interest expense on the lease liabilities and disclosures on the exemptions for recognition (ie low value and short-term leases).

8 Lessor Accounting

8.1 The lessor accounting model is essentially the same as is in IAS 17 ie leases are accounted for as finance or operating leases. There are some changes in detail and those most likely to impact on local authorities are that the definition of a lease has changed and there are also more disclosures. IFRS 16 requires a lessor to provide some additional disclosures to enable users of financial statements to better evaluate the uncertainty of cash flows associated with the lessor's leasing activities.

9 HM Treasury Technical Working Group on the Adoption of IFRS 16

9.1 As noted in the developments report to CIPFA/LASAAC in November 2016 the Treasury has established a Technical Working Group on IFRS 16. It met on 20 February 2017 and has further meetings scheduled until November 2017. The Secretariat is a member of the Technical Working Group.

9.2 As noted previously HM Treasury has undertaken initial work on the assessment of the impact of IFRS 16 on estimates and budgets. The paper that was discussed at the June Government's Financial Reporting Advisory Board (FRAB) meeting is available by means of the following link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/542846/FRAB_127__04__IFRS_16.pdf .

9.3 The HM Treasury Paper also considered the differences between IFRS and National Accounts stating that the "*National Accounts framework, currently European System of Accounts 2010 (ESA10) is not understood to be changing in respect of leases. The distinction between finance and operating leases will remain*'. The report continued that '*if IFRS 16 is to be applied without adaptation for central government then this will create a misalignment on operating leases between departmental accounts and departmental Estimates and budgets'*.

9.4 The report also outlined the current Whole of Government Accounts breakdown of finance and operating leases across the public sector. It is noteworthy that the Appendices to the report highlight that three local authorities have substantial amounts of operating leases ie Transport for London, Westminster City Council and the London Borough of Hackney.

9.5 The HM Treasury report to the November 2017 FRAB meeting on the Workplan for implementation of the Standard anticipates a consultation in December 2017. This is outside the normal consultation period with local authorities which is during the summer. The Secretariat would recommend that the consultation on the Code's adoption of IFRS 16 is issued at the same time as the HM Treasury consultation.

CIPFA/LASAAC's views are sought on the approach to the consultation process for the Code's adoption of IFRS 16.

10 CIPFA/LASAAC Working Group

10.1 CIPFA/LASAAC has already agreed to set up a sub-group of its own on the implementation of IFRS 16 and decided to seek volunteers in last year's consultation. Only one authority applied. Two CIPFA/LASAAC Members have volunteered: Martin Stevens and Greg McIntosh. LASAAC has also volunteered a member for the Group. The Secretariat has also sought volunteers from the Local Authority Accounting Panel and via the FAN year-end workshops one volunteer has come forward so far as a result of this process. The Secretariat is also in the process of seeking volunteers from the London authorities with substantial operating leases listed in paragraph 9.4.

10.2 Once the membership of the group has been established the Secretariat will set out a terms of reference for the working group to be agreed by the Board. The Secretariat would seek the Board's initial views on the issues it would like the working group to cover.

Recommendation

CIPFA/LASAAC is asked to consider the above report and provide its initial views on the issues that need to be considered by the CIPFA/LASAAC's working group.