CIPFA The Chartered Institute of Public Finance & Accountancy

report

CL 08 11-17

Board	CIPFA/LASAAC Local Authority Accounting Code Board
Venue	CIPFA Scotland Edinburgh
Date	8 November 2017
Author	Sarah Sheen, Technical Manager, Local Government Financial Reporting
Subject	Analysis of Responses to the Early Consultation on IFRS 16 Leases and Approval to Issue the Formal Consultation Paper

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Purpose

To report on the responses to the consultation on the IFRS 16 *Leases* and agree the content of the consultation paper on the approach to the adoption of the Standard in the Code.

1 Introduction

1.1 CL 06 11-17 summarises the number of responses received to the 2018/19 *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code) consultation and analyses questions three to seven. This report deals with the separate set of investigatory questions relating to the Appendix on IFRS 16 *Leases*. It should be noted that as these were investigatory questions there was a more sporadic response rate to this set of questions and that a small number of the 49 respondents to the Code consultation did not make any response on the adoption of IFRS 16.

1.2 The responses received are summarised in the remainder of this report with more detailed analysis in Appendix A, section by section, followed by the Secretariat's comments and suggestions. Issues of principle are considered in the main body of the report. The statistical analysis of all the responses and individual comments are included in Appendix A. Minor issues are not included in this analysis but may be included in amendments to the Exposure Draft of the Code.

2 Overview

2.1 Generally the majority of respondents supported CIPFA/LASAAC's early views on the approach to the adoption of IFRS 16. However, one of the key messages from respondents was an early awareness of the amount of work which is likely to be required to prepare for the adoption of the standard. This was raised in relation to a number of areas, for example:

- the ability to obtain the relevant information to comply with the measurement requirements and to enable accounts preparers to make the correct decisions

- other practical difficulties eg identifying contracts particularly in areas such as schools

- a number of authorities were concerned about the cost of meeting the requirements with one citing the move to IFRS where reserves were used to meet the cost of reclassifying operating leases to finance leases.

One respondent was particularly concerned about the workload local authorities might be faced with and, to exemplify, referred to the amount of work required to bring PFI/PPP contracts onto local authority balance sheets for the 2008/09 financial year.

CIPFA/LASAAC is invited to note the comments above in relation to the preparation needed to be made by local authorities to adopt IFRS 16.

3 Initial Recognition and Measurement

3.1 A number of respondents raised issues about the requirements in IFRS 16 to identify a lease, particularly for those contracts that might have previously been identified under IFRIC 4 *Determining Whether an Arrangement Contains a Lease* and a number referred to outsourcing contracts that might contain identifiable assets. The Secretariat considers that this might be a part of IFRS 16 which will require particular resource input by accounts preparers despite the practical expedients in the standard.

3.2 A number of other detailed issues were raised by respondents. The Secretariat considers that these are largely matters of detail but where necessary has included appropriate clarification in the Exposure Draft of the Code (see Appendix A rows I1.1, I1.7, I1.8, I1.9 and I1.11).

CIPFA/LASAAC is invited to note the comments above in relation to initial recognition and measurement.

CIPFA/LASAAC is invited to agree the approach in the ITC and the Exposure Draft on initial recognition and measurement. (Note that the following sections 4, 5 and 6 consider separately individual issues relating to initial recognition and measurement.)

4 Low Value Lease Recognition Exemption

4.1 The majority of respondents were supportive of the approach proposed in the consultation paper in relation to the low value lease recognition exemption ie to include more explicit guidance on the application on the low value exemption for local authority circumstances in the body of the Code.

4.2 A number of respondents were keen to see the indicative value of $5,000 being included in the Code, with some commenting that they thought that this value was too low. A number of respondents also considered that the Code should specify (a higher) de minimis level for low value leases. The Secretariat would note that it is has not been previous practice to include thresholds in the Code. The Exposure Draft clarifies that the $5,000 is an indicative value that the IASB 'had in mind[1]' but that it does not form any part of the standard.

[1] See IFRS 16 basis of conclusions paragraph BC.100.

4.3 The respondents to the consultation were supportive of provisions being included in the Exposure Draft to provide clear guidance and thus encourage consistency between local authority accounts preparers. The Exposure Draft therefore includes relevant provisions provided by paragraphs B3 to B8 of the IFRS 16 application guidance. Note that the application guidance in IFRS 16 is seen as an integral part of the standard.

CIPFA/LASAAC is invited to agree the ITC and the provisions in the Exposure Draft of the Code in relation to the low value lease exemption.

5 Mandate the Short-Term Lease Recognition Exemption

5.1 The majority of respondents (32 (65%)) to the early consultation on IFRS 16 agreed with CIPFA/LASAAC's initial view that the short-term exemption should be mandated by means of an adaptation in the Code. The respondents echoed the rationale set out in the consultation ie that it would reduce the reporting burden and encourage consistency. Five (10%) respondents disagreed.

5.2 A small number of respondents considered either that authorities could take their own decisions on this issue or that it did not matter whether such an adaptation was included in the Code as most authorities would adopt this approach as a matter of course. The Secretariat considers that it would still be beneficial to retain this proposal as it would add certainty for accounts preparers and overall should reduce the reporting burden. The Exposure Draft therefore includes the adaptation.

5.3 A number of issues of application were raised by respondents – see rows I3.2 and I3.5, the Secretariat considers that these are issues of application which will be dealt with in the normal approach to application guidance issued by the Local Authority Accounting Panel.

CIPFA/LASAAC is invited to agree the proposed approach in the Exposure Draft to the adaptation to mandate the use of the short-term lease recognition exemption in the Code.

6. Discount Rates

Ability to Identify the Interest Rate Implicit in the Lease

6.1 Overall respondents considered that there were practical difficulties in identifying the interest rate implicit in the lease primarily due to the availability of the relevant information and documentation (see I4.1). A small number of authorities considered that they would be able to establish the rate. The Secretariat would note that this is also an issue for commercial entities.

CIPFA/LASAAC is invited to note the practical difficulties local authorities are anticipated to face in establishing the interest rate implicit in the lease.

Use of the Incremental Borrowing Rate

6.2 CIPFA/LASAAC will be aware that IFRS 16 requires that if the rate implicit in the lease cannot be readily determined the lessee is required to use its incremental borrowing rate. The majority of the respondents to the consultation referred to the potential use of the PWLB borrowing rates as these rates represent the cost of borrowing for local authorities. A number of respondents suggested that the Code should specify the use of the PWLB rate for the incremental borrowing rate.

6.3 Two of the firms that responded considered that use of the PWLB rate was '*reasonable and appropriate*' or '*borderline*' with another firm considering that '*it is not as simple as taking a borrowing rate like the PWLB … it is the rate that a lessee would be required to pay on a loan to acquire the same property that is being leased*'. However, CIPFA/LASAAC is reminded that a local authority's assets are not secured on a specific asset but on all the revenues of the authority.

6.4 The sub group has considered that PWLB rates might be able to be used and that PWLB rates do generally represent the cost of borrowing for local authorities. However, the sub group noted that as these rates are low this might inflate the lease liability for local authorities. The sub group is of the view that identification of the incremental borrowing rate is an issue for application guidance and not the Code.

6.5 The Secretariat does not consider that there is an argument to include specific provisions in the Code on the discount rates to be used and therefore the Exposure Draft of the Code and the ITC only reflect the provisions in IFRS 16 without adaptation or interpretation.

CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft in relation to discount rates.

7. Subsequent Measurement of the Right-of-Use Asset

7.1 The largest number of respondents (23 (47%)) supported CIPFA/LASAAC's early view that subsequent measurement of the right-of-use asset should be at current value in accordance with the measurement provisions of section 4.1 (Property, Plant and Equipment) of the Code. These supportive comments were on the basis this was consistent either with the approach to the measurement of property, plant and equipment or that for finance leases. Eight respondents (16%) did not agree with CIPFA/LASAAC's early view.

7.2 A number of respondents raised the practical difficulties (including the cost of this proposal). One respondent highlighted the technical issues that would arise for shorter term leases of property, plant and equipment querying '*Potentially it could be considered to be the value which could be obtained from subleasing the asset for the remaining lease term? Or the cost of leasing a building of the same capacity over the remaining lease term?*' Two respondents noted that for assets held for a short proportion of their economic life the cost model would be more appropriate.

7.3 The Secretariat met with the editor of the RICs Red Book (who is also the Chair of the RICS Public Sector Working Group) to discuss the approach to current value measurement of the right-of-use asset from a valuer's perspective. He gave an indication that it would be difficult to establish a current value for a 'traditional' operating lease unless there was a sublease (or an assumption that there was a sublease in place).

7.4 The sub group considered that there are also difficulties in establishing a land value for what would have previously been an operating lease for land as it would be difficult to measure an amount of the asset that would be consumed by the authority throughout the period of use. The sub group considered this issue and have suggested that a current value for the right-of-use asset may be estimated using a discounted cash flow of the rental streams and this suggestion has been included in the ITC.

7.4 The Secretariat is of the view that materiality and the nature of the right-of-use asset, particularly for shorter term property leases, are relevant considerations for local authorities. It would suggest an approach is needed which maintains CIPFA/LASAAC's principle that non-current assets should be measured at current value, but which is also proportionate and still meets the needs of the users of local authority financial statements. The Secretariat suggests that the Code would be able to adopt a methodology which is based on the materiality approach for low value/short life assets included in section 4.1 of the Code ie that depreciated historical cost is used as a 'proxy' for current value. The materiality approach would principally apply to leased property assets (as the Secretariat considers that the proxy would normally apply to plant and equipment assets).

7.5 The Secretariat's suggested approach is that longer-term property leases (which would have previously been finance leases) should (continue) to be measured at current value whilst short-term property leases could use the proxy approach in section 4.1 of the Code and be measured at depreciated historical cost. The Secretariat considers that the consultation should be able establish the length of those longer-term leases to be measured at current value. For example, the starting point might be property leases with a lease term of 25 years and above being measured at current value. Currently the consultation papers do not include this proposal as the Secretariat considered that this issue first needed to be debated by the CIPFA/LASAAC.

CIPFA/LASAAC is invited to consider the Secretariat's proposals for current value measurement of the right-of-use asset.

8. Capital Financing Requirements

8.1 The respondents to the consultation agreed with the impact assessment outlined in the ITC and referred to the possibility of the Guidance on the MRP in England and Wales being updated to extend the current provisions for finance leases to all leases for the right-of-use asset under IFRS 16. A number of the respondents were of the view that depreciation and impairment on the leased assets were no different to other items of property, plant and equipment and were of the view that in the absence of a specific statutory override that the general approach to depreciation and impairment charges would apply (ie that these are not proper charges to the General Fund).

8.2 The sub group has considered the issue at its meetings and a Local Authority Accounting Panel (LAAP) member Stephen Sheen and the original author of the practitioners guide to capital finance provided an informal analysis which is attached at Appendix B to this report.

8.3 The Appendix highlights that interpretation is needed to determine the statutory accounting (and financing) treatment for the operating leases in existence at the transition date and for new leases (which would have previously been recognised as operating leases) whose accounting treatment under proper practices in the Code require the recognition of the right-of-use asset in the following areas:

- whether the leases become credit arrangements under the Local Government Act 2003, and

- whether they are within the scope of the statutory definition of capital expenditure, or retain their revenue financing status.

8.4 The informal analysis concludes that there could be some debate about whether an operating lease on transition will meet the definition of a credit arrangement or capital expenditure because both definitions require that the liability and the expenditure arise when a transaction is entered into. It could be argued that the precedence has been established in the statutory guidance on the MRP which on the transition to the IFRS based Code treated the transactions as both capital expenditure and credit arrangements when operating leases were changed to finance leases and the transactions came 'on balance sheet'. However, this might usefully be explicitly clarified in the statutory guidance for the avoidance of doubt and it is suggested that the issue be raised by the Treasury and Capital Management Panel with the Department for Communities and Local Government.

8.5 The analysis in the Appendix does not identify any issues that need to be addressed by substantial amendments to the Code. However, there will be implications for capital financing in recognising the right-of-use asset for leases that are currently classified as operating leases. Some of these issues will be relatively easily accommodated into the Prudential Framework ie if an operating lease becomes a credit arrangement then a local authority will be able to accommodate recognition of the lease liability within the relevant prudential indicators, for example, the Authorised Borrowing limit.

8.6 The cost of leases that would previously have been defined as operating leases will be able to be met from capital resources. However, it should be noted that adding the cost of the leases that would have not been treated as capital expenditure to the Capital Financing Requirement might raise issues for the Housing Revenue Account for English authorities in relation to the Limits on Indebtedness Determination.

8.7 The informal analysis suggests that the MRP Framework in England (and Wales) is sufficiently robust to cope with the transition if no changes are made (perhaps with the exception of the treatment of operating leases on transition). However, to avoid any unintended consequences of interpretation DCLG and Welsh Government may wish to ensure that the status quo ie a payments based approach is maintained. This could easily be facilitated by extending the current statutory guidance in paragraph 20 of the English MRP guidance to all leases. Note that a number of responses to the consultation supported this approach.

8.8 The situation is different in Scotland Finance circular 6/2011 sets out that the "*'Statutory charge for the repayment of debt' shall be made for a finance lease. This statutory charge is equal to the annual lease charge after deducting those amounts which have been charged to the Income and Expenditure account for interest in accordance with proper accounting practices'.* Again as finance leases will no longer exist in financial accounting on the adoption of IFRS 16 these provisions will no longer apply. If no changes are made to this statutory guidance then depreciation will be chargeable to the General Fund.

8.9 As this is not an issue which the Code can resolve the Exposure Draft of the Code includes the current statutory accounting provisions with a small number of amendments for the provisions which can no longer apply. For ease of reference these changes are tracked.

CIPFA/LASAAC is invited to consider the statutory reporting/capital financing requirements and agree

i) the actions outlined above

ii) the approach in the ITC and the Exposure Draft of the Code.

9 Accounting for Lessors

9.1 The consultation papers set out that the lessor accounting provisions are largely unchanged in IAS 17 (with the exception of the classification of subleases and sale and leaseback arrangements). It noted that CIPFA/LASAAC's early view was that there were no local government circumstances requiring adaptation or interpretation. This was view agreed by 21 respondents (43%) with 6 (12%) respondents disagreeing.

9.2 Five respondents 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.

9.3 The Secretariat would note that in its approach to adopting IFRS 16 the IPSASB have addressed the asymmetry. The IPSASB in the current draft of ED64 *Leases* noted that:

'*This lack of symmetry in lease accounting leads to the following accounting situations:*

(a) If the lessor classifies the lease as a finance lease, the underlying asset is not recognized by the lessee nor by the lessor; and

(b) If the lessor classifies the lease as operating lease, the lease receivable is not recognized by the lessor, while the lessee always recognizes the lease liability.' (draft ED64 paragraph BC31).

The [draft] Exposure Draft sets out that the IPSASB concluded that the retention of the IFRS 16 lessor accounting model is not appropriate for public sector financial reporting. Appendix C includes an extract of the IPSASB's current rationale.

9.4 The current draft of the ED64 therefore proposes an approach where at the commencement date a lessor is required to recognise a lease receivable and a liability (unearned revenue). The current draft of the IPSASB ED64 requires a lessor not to derecognise the underlying asset.

9.5 The Secretariat would recommend that this issue is considered in more detail in the consultation. The ITC therefore highlights the IPSASB developments and requests interested parties views on the impact of the lack of symmetry in the standard on local authority's and the wider public sector.

CIPFA/LASAAC's views are sought on the approach in the consultation paper on the impact of the lack of symmetry between the lessor and lessee accounting models in IFRS 16.

9.6 The ITC and Exposure Draft have therefore been drafted without adaptations or interpretations for lessor accounting. However, the Exposure Draft has maintained the provisions in the Code in relation to leases where there is no or a nominal consideration. The ITC also discusses the accounting provisions for subleases and the Exposure Draft cross refers to the relevant paragraphs in the IFRS 16 application guidance on the classification. For sale and leaseback transactions the Exposure Draft includes the relevant provisions in an approach that is similar to the current provisions in the Code for those transactions.

CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft for lessor accounting.

10 Transitional Reporting Requirements

Approach to Identifying a Lease on Transition

10.1 The majority of respondents (32 (65%)) agreed with the approach to identifying lease on transition ie IFRS 16 permits local authorities to apply IFRS 16 to leases identified under IAS 17 and IFRIC 4 and not to apply IFRS 16 to contracts that were not identified under IAS 17 and IFRIC 4. These respondents noted that this would make the process more straightforward and reduce the reporting burden not to revisit their previous decisions. Three respondents (6%) disagreed.

10.2 An audit body noted that '*this meant that as a result, local authorities would apply the requirements in paragraphs 9–11 of the standard (in respect of identifying a lease) only to contracts entered into (or changed) on or after the date of initial application*'. The Secretariat concurs that this latter point is the case. However, this is permitted under IFRS 16 as a part of the transitional reporting arrangements. The Exposure Draft and the ITC therefore have retained the practical expedient in IFRS 16 in relation to identifying the lease.

CIPFA/LASAAC is invited to agree the approach to identifying a lease on transition.

General Approach to Retrospective Restatement on Transition

10.3 The majority of respondents (30 (61%)) agreed with CIPFA/LASAAC's early view that it would wish to adopt the cumulative catch-up retrospective approach to transition. Four respondents (8%) were against the use of the cumulative catch-up approach to retrospective restatement with one respondent (a treasury management adviser) stating '*We believe that local authorities should be permitted to make a full retrospective restatement where the information is readily available, such as from an options appraisal from a recent acquisition*.'

10.4 The Secretariat considers that the respondents have not cited any economic rationale to maintain both transitional options under the standard. It is likely that the FReM will use the cumulative catch-up model and therefore should support consistency from a Whole of Government Accounts perspective. This approach is also consistent with CIPFA/LASAAC's previous decisions on IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*. The ITC and Exposure Draft of the Code therefore mandate the use of the cumulative catch-up approach to retrospective transition.

CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft of the Code to mandate the cumulative catch-up approach to retrospective transition.

Measurement of the Right-of-use Asset for Leases Originally Classified as Operating Leases on Transition

10.5 The majority of respondents (31 (63%)) agreed with CIPFA/LASAAC's early view to mandate the transitional option for measuring the right-of-use asset for leases originally classified as operating leases on transition ie to use an amount equal to the lease liability adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the Balance Sheet before the date of initial application. There were no dissenting views. The ITC and the Exposure Draft of the Code therefore mandate this option.

CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft of the Code for measuring the right-of-use asset for leases originally classified as operating leases on transition.

10.6 CIPFA/LASAAC may also wish to note that the transitional disclosure requirements cross-refer to the reporting requirements in paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, as the transitional disclosures for the adoption of a new financial reporting standard are stipulated by the Code, under the Code's approach to the adoption of IAS 8, those reporting requirements in IAS 8 that are relevant to local authorities on the adoption of IFRS 16 have been included in paragraph 4.2.2.91 of the Exposure Draft.

CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft on the transitional reporting requirements.

11 Other Issues Raised in the Consultation

11.1 A number of technical issues were raised in relation to the final question on the ITC which sought interested parties views on whether there were any particular aspects that the sub group should consider these items are set out and listed in rows I11.1 and I11.2. The Secretariat would note that the majority of items listed have been included in the Exposure Draft and ITC. Two of the items in the list at I11.2 are issues either for application guidance or are issues which would need to be considered by an authority's professional advisors. One of the issues - the treatment of service concession arrangements is considered in the next section of this report.

CIPFA/LASAAC is invited to agree the list of adaptations and interpretations listed in paragraph 7.1.1.3 of the Code Draft.

12 Consequential Amendments for Service Concession Arrangements

12.1 CIPFA/LASAAC will be aware that the Code specifies that measurement of the service concession arrangement (PFI/PPP) liability follows the requirements for the measurement for finance leases in section 4.2 of the Code (and in accordance with IAS 17). As this is no longer an extant standard the consultation papers propose changing the service concession arrangement liability measurement to that of IFRS 16. This is a similar measurement approach ie the liability is measured on an amortised cost basis. However, the Secretariat and the sub group have noted that IFRS 16 requires that where there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments the lease liability is to be measured to reflect those revised lease payments when there is a change in the cash flows. This would mean where PFI contract payments are increased (annually), for example, by RPI that the liability would need to be remeasured.

12.2 CIPFA/LASAAC members may remember that when, in the consultation for the 2013/14 Code CIPFA/LASAAC proposed changing the measurement requirements to align with the approach of IPSAS 32 *Service Concession Arrangements: Grantor* and measure the liability as a financial liability a large number of local authority responses were concerned about the costs of changing the measurement requirements.

12.3 The Secretariat raised this issue with the sub group. The sub group considered that this was an issue of concern. Whilst noting that technically the better approach would be to follow a measurement approach in an extant standard the sub group noted that an alternative might be to continue with the IAS 17 measurement approach. A precedent for retaining provisions not in extant standards is already in place for the approach to current value measurement of property, plant and equipment where because the Code has not adopted IFRS 13 *Fair Value Measurement* a small number of provisions in IAS 16 *Property, Plant and Equipment* which were deleted by IFRS 13 have been maintained. The ITC and the Exposure Draft therefore include proposals to move to the new measurement requirements, note the issues that might arise but also set out the alternative ie to maintain the current measurement approach following the provisions in IAS 17.

CIPFA/LASAAC is invited to consider the approach in the Exposure Draft and ITC in relation to the consequential amendments to the measurement requirements for service concession arrangements and whether it agrees to the approach in the ITC.

13 Group Accounts

13.1 The terms of reference for the sub group required that it considered the group accounting implications of the adoption of IFRS 16. There are two areas where this will impact on local authority Group Accounts

- the alignment of the accounting policies where local authority subsidiaries follow FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland*
- the need to eliminate transactions where there is an intra group leasing arrangement.

13.2 The ITC sets out the accounting treatment for these two issues. However, it notes that these are issues for application guidance, they relate to the accounting provisions in other sections of the Code and there are therefore no explicit new provisions in the Code setting out the required treatment.

CIPFA/LASAAC is invited to agree the section in the ITC relating to the impact of the adoption of IFRS 16 on the Group Accounts of the authority.

14 Practical Issues and Impact Assessment

Practical Issues

14.1 As noted in section 2 of this report there will be substantial practical application issues facing local authorities. The sub group is of the view that these issues need to be covered in some detail in the ITC to ensure that local authorities are aware of the issues that need to be addressed. CIPFA/LASAAC is invited to consider whether there are any further issues that need to be included in the ITC.

CIPFA/LASAAC is invited to agree the approach in the Exposure Draft and the ITC in relation to the practical issues facing local authorities.

Impact Assessment

14.2 CIPFA/LASAAC requested that the Terms of Reference for the sub group include an impact assessment. The sub group decided that this assessment should take the form of a readiness assessment questionnaire. The readiness questionnaire is included as an Appendix to the ITC. However, the consultation documents will include a separate Word document in the form of the questionnaire for local authorities to completed and submit with their consultation responses.

14.3 The sub group noted that the IASB had given accounts preparers three years to prepare for the adoption of the standard. It also noted following its consideration in the ITC for Group Accounts issues that in September 2016 the FRC consulted on the UK GAAP approach to adoption of IFRS 16 in its Triennial Review. The original timetable in that consultation was for UK GAAP to incorporate the IFRS 16 requirements by 2022. However, the FRC Feedback Statement[2] now indicates that '*Further evidence-gathering and analysis needs to be undertaken before a decision can be made on the most appropriate timetable and approach for reflecting the principles of IFRS 16 in FRS 102, if at all*.'

14.4 The Secretariat therefore raised the issue of whether local authorities would find the timetable for adoption by 2019/20 achievable against a background of resource constraint, faster closing and following the adoption of two substantial standards in 2018/19. The sub group considered that the impact assessment should include an assessment of the workload facing local authorities on adoption of IFRS 16 and therefore the readiness assessment questionnaire is seeking views on the number and value of the leases held by local authorities. The Secretariat considers that in addition to the questions already included in the questionnaire it may be worthwhile seeking local authority views on whether adoption by 2019/20 is achievable.

CIPFA/LASAAC is invited to agree the questions included in the readiness assessment questionnaire.

CIPFA/LASAAC is invited to consider whether it wishes to add a question on the achievability of adoption of IFRS 16 by 2019/20.

15. Next Steps

15.1 In its early consultation on IFRS 16 CIPFA/LASAAC announced its intention to issue the formal consultation on IFRS 16 in December 2017 to align with the HM Treasury timetable for issuing its consultation on the standard. It is possible that

[2] Feedback Statement - Consultation Document Triennial Review of UK and Ireland Accounting Standards, Approach to Changes in IFRS, FRC June 2017

the Treasury consultation will now be issued in January. If CIPFA/LASAAC wants to maintain its alignment with HM Treasury timetable then the eight-week minimum consultation period will mean that the results of the consultation will not be available for its meeting on 28 February 2018. The Secretariat suggests that if CIPFA/LASAAC wants to maintain this approach that a shorter, single issue meeting be scheduled to consider the consultation responses.

15.2 Alternatively, CIPFA/LASAAC might want to maintain the December timetable to issue it with a consultation on the changes to the Comprehensive Income and Expenditure Statement and the Expenditure and Funding Analysis. Any issues where the HM Treasury consultation is substantially different from the approach in the Code consultation can be dealt with in the consultation to adopt the standard in the Code. The Secretariat would note that it has tried to keep the consultation differences to a minimum thus far.

CIPFA/LASAAC's views are sought on whether it wishes to consult in December or to whether it wants to wait to align the consultation publication with that of HM Treasury.

15.3 Following the consultation the Secretariat would recommend that CIPFA/LASAAC's agreed provisions for the adoption of IFRS 16 are issued prior to the relevant Code in which the provisions will be adopted. A member of the sub group considered that the agreed Code provisions on adoption of the Standard should be issued as soon as possible. Timescales are such that it will not be possible to issue the agreed provisions with the 2018/19 Code in a manner similar to the Board's approach on IFRSs 9 and 15.

15.4 The CIPFA local government faculty considers that subject to CIPFA/LASAAC's approach to adoption of IFRS 16 it would be beneficial to issue early application guidance on the standard. The Secretariat therefore suggests that the agreed provisions for the Code on IFRS 16 could be issued with this publication. As with the approach for IFRSs 9 and 15 it would be made clear that early adoption is not permitted and that that part of the publication did not have the authority of the Code.

CIPFA/LASAAC is invited to agree the Secretariat's suggested approach to issuing the agreed Code provisions for IFRS 16.

Recommendations

CIPFA/LASAAC is invited to consider the individual issues brought to its attention above in relation to the approach to adoption of IFRS 16 in the Exposure Draft of the Code and consider the consultation papers for approval to issue.

SUMMARY OF CONSULTATION RESPONSES – EARLY VIEWS ON THE ADOPTION OF IFRS 16 LEASES

Note – a group of interested parties best described as professional accounting firms that audit local authorities is abbreviated in this Appendix to ''firm'' or "firms"

Initial Recognition and Measurement

Question	
I1	Do interested parties have any views on the approach to initial recognition and measurement under the leasing standard? Please set out the reasoning for your response.
I2	Do interested parties consider that specific provisions should be included in the Code on the low value exemption from the recognition requirements of the leasing standard? Please set out the reasoning for your response.

Question		Yes	No	No Comment
I3	Do interested parties agree with CIPFA/LASAAC's preliminary view that the short-term exemption should be mandated in the Code (by adapting the accounting policy choice)? If yes, please provide the rationale for your response. If not why not? What alternatives do you suggest?	32 (65%)	5 (10%)	12 (25%)

Question	
I4	Do interested parties consider that local authorities will be able to measure the lease liability by using the interest rate implicit in the lease? Please set out the reasoning for your response.
I5	If interested parties consider that local authorities will have to instead use their incremental borrowing rate do you consider this will be able to be easily identified? Please set out the reasoning for your response.

	Issue	**Secretariat Response**
	Question I1– Approach to Initial Recognition and Measurement	
I1.1	A number of respondents discussed the practical difficulties of the identification of a lease under the standard,citing issues such as:	The practical difficulties should not be underestimated and will be stressed in the consultation documents along with the need for effective preparation for the

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<tr><th></th><th>Issue</th><th>Secretariat Response</th></tr>
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- how to assess whether it is economically advantageous for a supplier to substitute an asset
- the ability to identify the relevant contractual documentation and the practical difficulties in obtaining the relevant information
- what contracts meet the definition of a lease eg do licences, easements etc meet the definition
- what happens when there are contracts which are renewed on a rolling basis
- the need for clear provisions relating to whether a contract is or contains a lease
- the types of contract that might be involved (ie provision of managed services and outsourcing contracts for the use of and supply of assets including waste management, property and grounds maintenance, fleet and highways vehicles, IT and business equipment).

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adoption of the standard.

The evaluation of whether it is economically advantageous for a supplier to substitute an asset should only take place on information that is readily available to the lessee. This is evidenced by paragraph B19 which states that:

'*If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive*',

Contracts that meet the definition of a lease are covered by the normal application of the standard and the definition of a lease which states that

'*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*.'

For leases that are renewed on a rolling basis local authorities will be required to establish the lease term in accordance with the definition and provisions in IFRS 16 and assess whether it is reasonably certain to exercise the options under the contract.

The Exposure Draft of the Code includes cross reference to the relevant application guidance highlighting the main decisions for identifying a lease.

The consultation documents highlight the typical contract areas that will need to be considered.

Where relevant these issues have been considered in the ITC and/or Exposure Draft of the Code.

</td></tr>
<tr><td>I1.2</td><td>

A firm commented:

'*In our experience many of the*

</td><td>

There is detailed application guidance on identifying a lease in IFRS 16. The guidance is based on the ability of the

</td></tr>
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	Issue	Secretariat Response
	outsourced service contracts that local authorities enter into are likely to contain provisions that convey the right to control the use of an identifiable asset for a period of time in return for consideration. In many cases these assets are intangible (specially developed software, intellectual property rights etc) which would only become problematic in the unlikely event that an authority voluntarily applied IFRS 16 to intangibles. The assessment of control over tangible assets is also likely to be a difficult area, although many of these contracts provide for underlying assets to be transferred back to the authority, or to the new contractor, on termination or expiry of the contract which suggests control.	lessee to control through use the economic benefit (and for local authorities' service potential) inherent in the asset. **No further action in the ITC and Exposure Draft of the Code.**
I1.3	A number of the respondents referred to the volume and difficulty of identifying transactions for schools with one respondent referring to the identification of '*leases across hundreds of schools*'.	**For note.**
I1.4	A number of respondents referred to the workload involved in applying the requirements with one respondent referring to the work previously required to bring PFI/PPP assets on to local authority balance sheets.	**For note.**
I1.5	A number of respondents referred to the $5,000 indicative value referred to by the IASB in the basis of conclusions and appeared to think that this figure might be explicitly included in the Code. Respondents also seemed to think that this might be similar to a de minimis figure and/or request that a de minimis figure be set.	It was never the intention that the figure that the IASB 'had in mind' would be included in the Code. It is clear that this is an indicative figure only. It is not normal practice for the Code to set de minimis or any form of threshold. The Secretariat considers that it would not be appropriate to set one for low value leases. **No further action in the ITC and**

	Issue	Secretariat Response
		Exposure Draft of the Code.
I1.6	One respondent queried whether the asset could be initially recognised at a cost greater that the liability due to pre and post commissioning works. Another respondent queried whether the difference between the two be accounted for as a debit to the net cost of services, or via use of the reserves, and if the reserves, then would the revaluation reserve be the appropriate entry or will a new "leases adjustment account" reserve be required?	Yes the asset could be recognised at a cost which is greater than the liability. The cost of bringing the asset into use would be the same or similar costs that would be incurred if the asset were owned under IAS 16 *Property, Plant and Equipment*. Costs to restore the asset may be more onerous than IAS 16. However, it is a possibility that these might not be proper charges to the General Fund under the statutory financing framework. This is an issue relating to the application and interpretation of the statutory/ capital financing requirements – **no further action in the ITC and the Exposure Draft of the Code.**
I1.7	A respondent enquired about the intention of the standard to create a new asset class of "right-of-use assets".	This is not explicit in the Standard. However, the standard requires that the right-of-use asset is either reported separately on the face of the balance sheet or in the notes so substantially this is the case. **No further action in the ITC and Exposure Draft of the Code.**
I1.8	One authority was concerned that the right-of-use asset should not be classified with other property, plant and equipment due to the nature of the cost profiles.	See previous response (I1.7). **No further action in the ITC and Exposure Draft of the Code.**
I1.9	One respondent noted that '*the initial measurement now takes into account "variable lease payments that depend on an index or a rate" such as inflation, which are currently excluded and treated as contingent rents. This means that existing finance leases will need to be re-measured, not just existing operating leases*'.	The respondent is correct per IFRS 16 paragraph C11 and Exposure Draft 4.2.2.88. **No further action in the ITC and Exposure Draft of the Code.**

	Issue	Secretariat Response
I1.10	A confidential respondent commented that it was '*concerned about the cost of transition to new arrangements. When some operational leases were reclassified to finance leases some years ago the Council had to use reserves to cover the cost of adjusting past years with higher charges. Would it be possible to start with new leases only.'*	**For note.**
I1.11	A firm commented that with regard to the estimated restoration, removal and dismantling costs relating to the right-of-use asset: '*The Code should make it clear that a lessee should only recognise these costs as part of the cost of a right-of-use asset when it incurs an obligation for these costs'.*	The Exposure Draft of the Code has been drafted following the provisions of the standard which should be sufficient to demonstrate this point. **No further action in the ITC and Exposure Draft of the Code.**
	Question I2 – Approach to the low value recognition exemption	
I2.1	Most respondents appeared to agree that there should be specific provisions in the Code on the low value recognition exemption. One respondent was concerned that more explicit guidance should not be included.	The Exposure Draft of the Code includes some of the IFRS 16 application guidance paragraphs to assist local authorities in their decision making. The application guidance is clearly indicated as being a part of the Standard. **CIPFA/LASAAC is invited to agree the approach in the ITC and Exposure Draft of the Code.**
I2.2	A number of respondents considered that the indicative value amount of $5,000 that the IASB had in mind as set out in the basis of conclusions was too low. Other respondents as noted above requested that the Code set a de minimis level for low value assets.	As set out above (I1.4) the Code will not explicitly refer to a threshold. Authorities will be able to establish their own de minimis levels consistent with their other accounting policies on the de minimis threshold. **CIPFA/LASAAC is invited to agree with this approach**.
I2.3	A number of respondents were concerned about the application of high	IFRS 16 applies the low value exemption to individually low value items (even if

	Issue	Secretariat Response
	volume individually low value items.	there are high volumes of these items). Paragraph B4 of IFRS 16 states that: '*The assessment of whether an underlying asset is of low value is performed on an absolute basis.'* For information this issue was discussed at FRAB. **No further action in the ITC and Exposure Draft of the Code.**
	Question I3 – Mandate short-term recognition exemption?	
I3.1	The majority of respondents supported the proposal on the basis of consistency and noting that it would also reduce the reporting burden.	No further comments. **CIPFA/LASAAC is invited to agree the approach as set out in the ITC and the Exposure Draft of the Code.**
I3.2	A respondent noted that there might be issues if '*this short term is extended to exceed the 12 months and if this happens to occur at certain trigger dates*'. A number of other respondents commented on the treatment of extensions.	IFRS 16 is clear that the lease term would cover periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and therefore these leases would not meet the definition of a short-term lease. **No further action in the ITC and Exposure Draft of the Code.**
I3.3	A respondent considered that it would be preferable to allow authorities to reflect their own transactions. A small number of respondents considered that authorities would adopt this approach as a matter of course and therefore there was no need to adapt IFRS 16.	**CIPFA/LASAAC's views on this issue are sought.** The Secretariat considers that normally the short period of such leases should ensure that this reflects most circumstances. The Secretariat agrees that local authorities are very likely to utilise this option. However, it is of the view that this will provide certainty for local authority accounts preparers.
I3.4	A firm commented: '*Note that a lease cannot qualify if it contains a purchase option and/or the*	The Secretariat is not clear what the firm is referring to but the proposed approach in the Exposure Draft has not changed the definition of a short-term lease in

	Issue	Secretariat Response
	lease term excludes any optional extension periods unless the lessee is reasonably certain to exercise its option to terminate the lease. This additional gating question can cause unnecessary complexity. ‘	any way but has instead mandated the recognition exemption. **No further action in the ITC and Exposure Draft of the Code.**
I3.5	A confidential respondent commented ‘*I am unclear over how break clauses would affect recognition eg House rented from Private sector for 3 years but a clause allowing termination with 3 month notice would this would be a 3 month lease and therefore exempt?, further clarity on termination clauses would be useful*.’	This is also covered by the definition of the lease term which covers ‘*periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option*’. **No further action in the ITC and Exposure Draft of the Code.**
	Question I4 – Ability to Identify Interest Rate Implicit in the Lease	
I4.1	Respondents cited the difficulties in identifying the interest rate implicit in the lease including: ▪ the need to rely on third parties (referring to both leasing companies and schools) ▪ increased difficulties for contracts that contain leases ▪ availability of information including residual values and the fair value of the asset ▪ availability of documentation ▪ resource issues in relation to finding the relevant documentation.	The Secretariat and the sub group concur that these might be difficulties faced by local authorities. Again the Exposure Draft encourages early preparation for the adoption of the standard. **No further action in the ITC and Exposure Draft of the Code.**
I4.2	A small number of authorities thought that they would be able to identify the rate.	**For note.**
	QI5 – Use of Incremental Borrowing Rate	

	Issue	Secretariat Response
I5.1	A number or respondents referred to the use of a PWLB rate as this is the real cost of borrowing to the authority. A small number suggested that the Code should specify the use of the PWLB rate, with one authority suggesting that there should be a rebuttable assumption for that the PWLB rate should be used.	The Secretariat and the sub group are of the view that the PWLB rate might be able to be used by local authorities. However, the Secretariat does not concur that the rate should be specified in the Code because the rate should be specific to the authority, the type of asset leased or the property yield when determining the discount rate. **No further action in the ITC and Exposure Draft of the Code.**
I5.2	A number of authorities highlighted the difficulties they would have using the PWLB rate, for example: ▪ debt free authorities, ▪ shorter lease periods (where an authority's loans are for longer periods). One of the respondents noted that it may be helpful to use the PWLB new loan rate.	The authority would need instead to identify its incremental borrowing rate from information available. These are also issues for application guidance. See the body of the main report for the approach in the ITC and Exposure Draft of the Code. **No further action in the ITC and Exposure Draft of the Code.**
15.3	One respondent noted that the Loans Fund Rate could be used. Another authority stated that the capital interest rate should be used.	The Secretariat is not clear that this would be an appropriate rate to use. **No further action in the ITC and Exposure Draft of the Code.**
15.4	Three respondents noted that the comment in the ITC that 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. They noted that the point in the ITC that this will therefore vary across the different types of assets that local authorities hold under operating leases overlooks that under statute all of a local authority's borrowings are secured	The Secretariat concurs that a local authority's borrowings are secured equally over its revenue streams in accordance with section 13 of the Local Government Act 2003. The Secretariat concurs that a PWLB rate is likely to be the cost of borrowing for local authorities. See the body of the main report for the approach in the ITC and Exposure Draft of the Code.

	Issue	Secretariat Response
	equally over its revenue streams.	
15.5	A firm stated that '*We expect local authorities will turn to a PWLB rate for the relevant value and term of the lease. In theory this is contrary to the requirements of the standard to use a secured borrowing rate because PWLB is unsecured. Local authorities may find that secured borrowing is either unavailable for the particular type of asset or that it is more expensive than PWLB. In these circumstances it is our view that a PWLB rate would be reasonable and appropriate*.' Another firm commented: '*It is not as simple as taking a borrowing rate like PWLB, but it is the rate that a lessee would be required to pay on a loan to acquire the same property that is being leased. This could be a secured or unsecured loan or a mix'*. A third firm commented that the use of PWLB might be 'borderline' in terms of being consistent with the IFRS 16 definition of the incremental borrowing rate.	The Secretariat notes these comments in relation to the rate to be used. IFRS 16 requires that the rate used should be the one that a lessee has paid or would pay to borrow money for the type of asset being leased or the property yield when determining the discount rate. It should be noted also that the IASB decided to define the lessee's incremental borrowing rate to take into account the terms and conditions of the lease. The lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16 (see the basis of conclusions, BC162). See the body of the main report for the approach in the ITC and Exposure Draft of the Code.

Subsequent Measurement

Question		Agree	Disagree	No Comment
I6	Do interested parties agree with CIPFA/LASAAC's view on the approach to subsequent measurement of the right-of-use asset? If, not why not? What alternatives do you suggest?	23 (47%)	8 (16%)	18 (37%)

	Issue	Secretariat Response
	Question I6 – Subsequent Measurement of the Right-of-Use Asset	
I6.1	A number of supportive comments indicated that this was consistent either with the approach to the measurement of property, plant and equipment or that for finance leases currently and that '*its value needs to be that of current use in order to reflect the substance of the asset*.'	**For note.**
I6.2	A respondent commented '*The proposed approach would be acceptable for VPE assets … and for long term leases of land and property which are already recognised as assets under finance leases. However more consideration needs to be given to short term right of use assets for land and property. The consultation does not discuss what could be considered to be the current value of e.g. the right of use asset for a five year lease of a building. Clearly it is not the same as the current value of the building itself. Potentially it could be considered to be the value which could be obtained from subleasing the asset for the remaining lease term? Or the cost of leasing a building of the same capacity over the remaining lease term? … It is suggested that the most practical approach would be to introduce a new asset classification for right of use assets for land and buildings, which would be valued at cost rather than current value*.' A number of other respondents cited difficulties in measuring the current values of assets held for only a proportion of the economic life of an asset. Particularly for shorter term	The Secretariat would note that the principle established for the current value measurement of the right-of-use asset is correct. However, there are issues relating to the measurement of assets that were previously classified as held under operating leases. The measurement approach may need to be similar to the suggestions outlined in the respondents answer. Materiality will also be a key determinant for the approach. **See the Secretariat's proposals for measurement of the right-of-use asset where the underlying asset is an item of property, plant and equipment.**

	Issue	Secretariat Response
	leases.	
I6.3	A number of respondents noted or cited the cost of obtaining a valuation.	The Secretariat concurs there would be a cost to obtaining a valuation.
I6.4	A number of respondents noted that materiality would be a consideration, particularly for plant and equipment leases.	The Secretariat concurs with this response.
I6.5	Two respondents commented that: '*Many leased assets are only held for a short proportion of their useful life therefore a cost model would be more appropriate in many circumstances than current use'*	The Secretariat considers that this is a valid point. However, the standard offers no distinction between those assets previously held under finance leases and those held under operating leases to provide a mixed measurement approach. **See the Secretariat's proposals for measurement of the right-of-use asset where the underlying asset is an item of property, plant and equipment.**
I6.6	One respondent queried whether it was '*CIPFA/LASAAC's view that discounted minimum lease payments is the appropriate method to establish the current value of a leased asset, or would another method be mandated'*.	The consultation papers did not establish an approach to current value measurement or the appropriate measurement approach. This should be a decision for the authority under the requirements of section 4.1 of the Code. **No further action in the ITC and Exposure Draft of the Code.**
I6.7	An authority enquired '*The standard (para 21) states that "an entity shall revise the lease term if there is a change in the non-cancellable period of a lease"; in CIPFA/LASAAC's view, would this be treated as a new lease from the start of the additional period, or would the existing right-of-use asset and lease liability be revalued on the basis of the revised lease term. If the latter treatment, would this be accounted*	The change in the lease term does not create a new lease under the standard. This would require measurement of the lease liability under paragraph 40 of the standard. This would mean an adjustment to the right-of use asset but whether it would mean a change in the current value of the asset would depend on the nature of the valuation. **No further action in the ITC and Exposure Draft of the Code.**

	Issue	Secretariat Response
	in the same way as any other asset revaluation?'	
I6.8	A firm commented: '*We do not see that CIPFA/LASAAC has any choice but to state that the subsequent measurement of the right-of-use asset should be at current value. The key for local authorities will be the extent to which they are able to use depreciated historic cost as a proxy for the current value of short life/low value leased assets and this will depend to some extent on the materiality of the amounts involved and the attitude of auditors to this issue*.'	The Secretariat agrees with this comment in principle. **See the Secretariat's proposals for measurement of the right-of-use asset where the underlying asset is an item of property, plant and equipment.**

Impact on the Financial Statements and the General Fund

Question	
I7	Do interested parties have any commentary on the impact of the anticipated approach to adoption of the leasing standard on the Surplus or Deficit on the Provision of Services and therefore Council Tax? Please set out the reasoning for your response.

	Issue	Secretariat Response
	Question I7 – Impact on the Financial Statements and the General Fund	
I7.1	A number of the respondents were of the view that depreciation and impairment on the leased assets were no different to other items of property, plant and equipment and were of the view that in the absence of a specific statutory override the general approach to depreciation and impairment charges would apply (ie that these are not proper charges to the General Fund).	The Secretariat considers that this is a valid viewpoint. The right-of-use asset will be brought into the Prudential Framework. However, see also main report for more detail on the impact on the General Fund.

	Issue	**Secretariat Response**
I7.2	A number of authorities agreed with the impact assessment in the ITC and referred to the possibility of Guidance on MRP in England and Wales being updated to extend the current provisions for finance leases to all leases under IFRS 16.	The Secretariat recommends that this issue be brought to the attention of the devolved administrations but see also comments in the main report.
I7.3	A number of respondents queried whether the right of-use asset would feature as a part of the Prudential Framework eg would it be included in the Capital Financing Requirement (CFR).	The Secretariat considers that the right-of-use asset will be included in the CFR.
I7.4	One respondent commented that: '*it is suggested that for leases a simpler approach is adopted. Rather than MRP matching the principle element of the lease rental that it be based on a straight line split of principal and interest thereby eliminating annual adjustments and aiding budget monitoring'*.	The Secretariat considers that this option is available subject to it being a prudent approach in accordance with the statutory guidance on the MRP.

Accounting for Lessors

Question		Agree	Disagree	No Comment
I8	Do interested parties agree with CIPFA/LASAAC's early view on the provisions for accounting for lessors under IFRS 16? If not, why not? Please set out the reasoning for your response.	21 (43%)	6 (12%)	22 (45%)

Question 8 – Lessor Accounting		
	Issue	**Secretariat Response**
I8.1	The majority of respondents agreed with CIPFA/LASAAC's view that there was no need for adaptations for lessor accounting under IFRS 16.	**No further comments.**
I8.2	Four respondents 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. **CIPFA/LASAAC's views are sought on this issue.**
I8.3	One respondent commented '*We agree that in many circumstances there will be little change to the accounting for lessors. However, the inclusion of variable lease payment tied to an index (e.g. inflation) means that many leases need re-measuring*.'	The Secretariat concurs with this response and has included appropriate reference in the ITC. **No further action in the ITC and Exposure Draft of the Code.**

Transition

Question		Agree	Disagree	No Comment
I9	Do interested parties agree with CIPFA/LASAAC's early view on the approach to the practical expedients in relation to the identification of a lease on transition? If not, why not? What alternatives do you suggest?	32 (65%)	3 (6%)	14 (29%)
I10	Do interested parties agree with CIPFA/LASAAC's early view that it wishes to adopt the cumulative catch-up retrospective approach to transition? If not, why not? What alternatives do you suggest?	30 (61%)	4 (8%)	15 (31%)
I11	Do interested parties agree with CIPFA/LASAAC's early view for the approach on transition for measurement of	31	0	18

the right-of-use asset for leases originally classified as operating leases? If not, why not? What alternatives do you suggest?	(63%)	(0%)	(37%)

	Issue	Secretariat Response
	Question I9 – Approach to Identification of a Lease on Transition (the 'grandfathering' approach	
I9.1	The majority of respondents agreed with the approach to identification of a lease on transition noting that this would make the process more straightforward and reduce the reporting burden not to revisit their previous decisions.	**No further comments.**
I9.2	An audit body stated: '*This practical expedient is permitted by paragraph C3 of the standard, and we agree there are advantages in adopting it. It should be noted that paragraph C4 requires an entity, if it chooses the expedient, to disclose that fact and apply it to all of its contracts. As a result, local authorities would apply the requirements in paragraphs 9–11 of the standard (in respect of identifying a lease) only to contracts entered into (or changed) on or after the date of initial application*.'	The Secretariat concurs that this is the case under the Standard. **No further action in the ITC and Exposure Draft of the Code.**
	Question 10 - General Approach to Transition	
I10.1	The majority of respondents agreed with the cumulative catch-up approach to retrospective restatement an example of the types of comment being: '*A cumulative catch up with clear explanatory notes would probably be of more benefit to the reader. The level of work required for a restatement would probably outweigh the use to the reader, particularly since the opening equity will be appropriately restated in*	**No further comments.**

	Issue	Secretariat Response
	the cumulative catch up approach.'	
I10.2	One authority commented that '*Provided that there were no implications for revenue income for the General Fund (in terms of recognising adjustments in year) then the cumulative catch up would be acceptable*.'	The Secretariat considers that this issue should be discussed with the relevant administrations.
I10.3	Four respondents were against the use of the cumulative catch-up approach to retrospective restatement with one respondent (a treasury management adviser) stating '*We believe that local authorities should be permitted to make a full retrospective restatement where the information is readily available, such as from an options appraisal from a recent acquisition*.'	The majority of respondents supported the use of the cumulative catch-up approach which is a permitted option under IFRS 16. The respondents have not cited any economic rationale to maintain both transitional options under the standard. It is likely that the approach under the FReM will use the cumulative catch-up model. **No further action in the ITC and Exposure Draft of the Code.**
	Question 11 - Measurement of the Right-of-use Asset for Leases Originally Classified as Operating Leases on Transition	
I11.1	The majority of respondents supported the approach outlined in the consultation for the measurement of the right-of-use asset for leases originally classified as operating leases setting out that this is easier to calculate and understand. A firm commented: '*Of the two choices in IFRS 16, we believe that the second option is technically superior to the first, since discounting at the incremental borrowing rate on 1st April 2019 is likely to overstate the value of the asset, given that interest rates are much lower than they have been historically*.'	For note. Although there were three dissenting votes no economic arguments were put forward for the first transitional option under the standard (ie to measure the asset at 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). **No further action in the ITC and Exposure Draft of the Code.**

Areas for Further Guidance

Question	
I12	Are there any areas of the leasing standard in addition to the listing provided by the sub group that will require specific consideration for local government circumstances? Please set out the reasoning for your response.

	Issue	Secretariat Response
	Question 12 - Areas for Further Guidance	
I12.1	A respondent commented: '*Local authorities may have specific outsourcing contracts i.e. refuse service, social care and it may be beneficial for the code to be prescriptive in the accounting treatment of different scenarios to avoid time spent in reviewing and deciding on appropriate treatment and to ensure consistency'.*	The Secretariat considers that this is an issue for application guidance and not for the Code. **No further action in the ITC and Exposure Draft of the Code.**
I12.2	The following were issues were suggested by respondents as issues which should be considered by the sub group: 1. leases of low or nominal value 2. the impact on specific prudential indicators eg the authorised borrowing limit and the CFR 3. the group accounts where subsidiaries make significant use of leased assets but do not prepare IFRS-based accounts eg refuse collection/waste disposal contracts outsourced to a wholly owned company 4. the impact on service concession arrangements 5. the resources required to implement	The first five issues in this list have been covered in the ITC and/or the Exposure Draft of the Code. The Secretariat considers that the last two issues are matters for application guidance, or, where technically complex or detailed arrangements are in place, are matters for the authority's own professional advisors. **No further action in the ITC and Exposure Draft of the Code.**

	Issue	Secretariat Response
	the new standard should be emphasised 6. what contracts would be covered by the definition of a lease 7. complex sub lease or sale and leaseback arrangements.	

Stephen Sheen's thoughts on the Impact on the Prudential Framework of the Adoption of IFRS 16 Leases set out in an Email Received 04 October 2017 as Updated on 13 October 2017

Summary

- Interpretation is needed to determine whether operating leases in existence at the transition date and whose accounting treatment changes to require the recognition of a right-of use asset:
  - become credit arrangements, and
  - come within the scope of the capital expenditure definition, or
  - retain their existing revenue financing status
- If an operating lease becomes a credit arrangement, this will largely only be an administrative problem to ensure that the Authorised Borrowing Limit is increased to accommodate recognition of the lease liability.
- The cost of ex-operating leases entered into after the transition date will become eligible to be met from capital receipts and relevant capital grants.
- Adding the cost of leases that would not previously been treated as capital to the Capital Financing Requirement might be problematic for the Housing Revenue Account in relation to the Limits on Indebtedness Determination.
- The MRP framework is sufficiently robust to cope with the transition without any amendment. However, if DCLG wishes to preserve the status quo and legitimise a payments-based approach to MRP, it can straightforwardly extend the current Statutory Guidance to all leases.

Credit Arrangements

Leases are not featured specifically in the Local Government Act 2003, but are covered by the wider provisions relating to credit arrangements. Section 7 defines a credit arrangement as arising when an authority enters into a transaction which gives rise to a qualifying liability on its part, recognition of the liability being required either under proper accounting practices or by statutory direction.

Qualifying liabilities are defined to exclude:

- per section 7(3) of the 2003 Act:
  - a liability to repay money
  - a liability in respect of which the date for performance is less than 12 months after the date on which the transaction giving rise to the liability is entered into
- per regulation 3 of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 (SI 2003 No 3146):
  - a liability that does not arise from a transaction under which an authority recognises a non-current asset (excluding financial assets) in accordance with proper accounting practices

This will mean that a lease that would previously have been classified as an operating lease under the Code of Practice on Local Authority Accounting but will require the recognition of a right-of-use asset following the implementation of IFRS 16 *Leases* would be a credit arrangement because:

- the proper accounting practice will be to recognise a non-current asset and a liability to pay for that asset
- the liability will extend for more than 12 months, as short-term leases are excluded by the Code

There will be some debate about whether leases can become credit arrangements as a result of changes in accounting practice during their term. The definition in section 7 requires that a qualifying liability arises when the transaction is entered into. If the liability only arises subsequently as the accounting treatment changes, then there is a case for arguing that operating leases entered into before the IFRS 16 transition date will not be credit arrangements.

When a credit arrangement does arise, section 8 of the 2003 Act requires that the cost of the credit arrangement (ie, the amount of the liability) is added to the authority's borrowings when an assessment is made as to whether statutory borrowing limits have been exceeded. This is not generally a problem for an authority as (subject to due process) it can raise its Affordable Borrowing Limit to cover the newly recognised cost of the credit arrangement.

There are therefore no substantial implications for operating leases becoming credit arrangements.

Capital Expenditure

Leases covered by IFRS 16 will involve the incurring of capital expenditure, as defined in section 16 of the 2003 Act:

> "… expenditure of the authority which falls to be capitalised in accordance with proper practices …"

There is no definition of what comprises "capitalisation", but it is generally taken to mean the debiting of expenditure as an asset to the Balance Sheet rather than charging it to the Comprehensive Income and Expenditure Statement as an expense. Recognition of a right-of-use asset would meet this interpretation.

The same issues will apply to capital expenditure as they apply to credit arrangements – whether expenditure can become capital as a result of changes in accounting treatment for a past transaction or whether it retains the status that it had when originally entered into. Where the view is that the status of leases will change, the following discussion will relate to operating leases that were entered into before the transition date. Otherwise it will only apply to leases entered into after that date.

(This would not mean that operating leases will be unaffected by the changes. The charge against the Surplus/Deficit on the Provision of Services will switch to depreciation of the right-of-use asset, but there will be no statutory justification for reconciling the charge to the rentals payable for the year (or a straight-line adjustment thereof if required by IAS 17).)

As capital expenditure, the cost of a right-of-use asset will be eligible to be financed from capital receipts or a relevant capital grant that relies on the statutory definition of capital in determining qualifying expenditure. The accounting change will therefore extend the scope of an authority's expenditure that can be met from capital resources.

This will be recognised by an increase in the Capital Financing Requirement to accommodate the cost of right-of-use assets. This will not cause a direct problem for the General Fund, but may be an issue for the Housing Revenue Account, where the HRA CFR cannot exceed the borrowing cap specified for the authority in the Limits on Indebtedness Determination.

Where financing is not made from other capital resources or direct revenue financing, consideration will be given to meeting the cost from Minimum Revenue Provision (MRP).

The DCLG Guidance on MRP discusses leases only in the context of finance leases (paragraph 20). With the concept of finance leases disappearing under IFRS 16, the guidance will presumably become inapplicable to all leases at the date of implementation.

This is not necessarily problematic, as authorities will still need to consider the general recommendations for MRP in the Guidance and determine their own prudent policies.

The current guidance in paragraph 20 is effectively based on reconciling the charge against revenue to the payment made under the lease for the financial year. For a finance lease, annual rentals are accounted for by identifying a proportion each year that is allocated to writing down the lease liability held in the Balance Sheet, with the remainder being charged to revenue as an interest expense (or as running costs if there is a service element). The paragraph 20 recommendation to make a charge for MRP equal to the element of the rent/charge that goes to write down the balance sheet liability will therefore result in the gross charge to revenue being the annual rental.

As operating leases are generally accounted for on a "pay as you go" basis (subject to the possible smoothing of uneven payment profiles), the current approach means that all leases are financed in the same way.

However, if authorities move away from the current guidance or do not apply it to the operating leases that will now be within the scope of the capital expenditure definition, there is potential for an impact on council tax. Without the support of the Statutory Guidance, a payments-based MRP approach would have no legitimacy, being contrary to the logic of the new accounting arrangements, which are intended to shift the focus for expenditure from paying off the liability to the cost of consuming the right-of-use asset.

The reasonable basis for an MRP charge for leases would allocate the cost over the periods that benefit from the relevant assets: ie, not on the basis of the rate that the liability is written down but the rate that the right-of-use asset is being consumed. In the private sector (where financing is based on depreciation) it is anticipated that the IFRS 16 changes will lead to a rebalancing of the profile of charges for ex-operating leases over the lease term, so that more is debited in the earlier years and less in the later years, reflecting the relatively even pattern of benefits obtained from an asset compared to the skewing of principal payments towards the end of the term.

Authorities may be able to get close to a payments-based MRP by applying the annuity option in the Statutory Guidance, but will need to justify their use of this approach.

If there is an adverse impact on council tax, this would be because the new approach gives a more equitable outcome. There is a risk, though, that authorities might seek to be creative and manipulate the MRP profile to reduce early year charges even further. This risk is currently present, as authorities are not bound to follow the Statutory Guidance. However, it is less likely that an authority would devise such a policy if it were clearly contrary to extant guidance.

In summary, the arrangements for MRP will not be broken by the implementation of IFRS 16. If the Statutory Guidance is to be amended, this will be a policy decision for DCLG based on an intention to maintain the status quo and reduce the risk of council tax impacts.

Paragraph 20 of the Statutory Guidance would retain the status quo if it were amended simply to delete the reference to “finance” and therefore extend its scope to all leases that involve recognition of a lease liability. The guidance in the latter part of the paragraph relating to the transition from UK GAAP to IAS 17 could apply equally to the implementation of IFRS 16.

Lessor Accounting – Extract from ED 64 (As considered by IPSASB – September 2017)

IFRS 16 Risks and Rewards Incidental to Ownership Model

BC31. The IPSASB noted that IFRS 16 retained the risks and rewards incidental to ownership dual model that previously existed in IAS 17. The IPSASB also noted that with the introduction of the single right-of-use model in lessee accounting and the retention of the dual model in lessor accounting, there is a lack of symmetry in analyzing the economics of a lease from a conceptual point of view. This lack of symmetry in lease accounting leads to the following accounting situations:

(a) If the lessor classifies the lease as a finance lease, the underlying asset is not recognized by the lessee nor by the lessor; and

(b) If the lessor classifies the lease as operating lease, the lease receivable is not recognized by the lessor, while the lessee always recognizes the lease liability.

BC32. The IPSASB concluded that the situations identified in BC31(a) and BC31(b) would lead to assets not being recognized in the public sector when both lessee and lessor are public sector entities in the same lease contract.

BC33. The IPSASB is of the view that a lease conveys the right to use an underlying asset for a period of time and does not transfer control of the underlying asset to an entity—such transactions are sales or purchases within the scope of other Standards (for example, IPSAS 9, Revenue from Exchange Transactions or IPSAS 17, Property, Plant, and Equipment).

BC34. Therefore, the IPSASB concluded that the retention of the IFRS 16 lessor accounting model is not appropriate for public sector financial reporting for the following reasons:

(a) It is inconsistent with The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the Conceptual Framework) because:

(i) The Conceptual Framework follows a control-based approach to recognizing and derecognizing assets; and

(ii) The underlying asset and the lease receivable meet the definition of an asset;

(b) It impairs the public sector financial reporting objectives of accountability and decision-making because by not recognizing in the statement of financial position the underlying asset that it controls

(i) The public sector entity does not provide "information about the entity's management of the resources entrusted to it for the delivery of services to constituents and others, and its compliance with legislation, regulation, or other authority that governs its service delivery and other operations;"2 and

(ii) Users of the statement of financial position do not have information about the economic benefits embedded in the underlying asset from the cost, sale, re-lease or use of the underlying asset at the end of the lease term that would enable them to "make decisions about whether to provide resources to support the current and future activities of the government or other public sector entity;"3

(c) It is inconsistent with IPSAS 32, Service Concession Arrangements: Grantor because:

(i) IFRS 16 is not a symmetrical Standard like IPSAS 32 is with IFRIC 12, Service Concession Arrangements;

(ii) IFRS 16 applies a risks and rewards model to one party (lessor), while IPSAS 32 and IFRIC 12 apply a control model to both parties; and

(iii) IFRS 16 does not apply the same recognition criterion for the underlying asset and lease receivable, while in IPSAS 32 the grantor never derecognizes the underlying asset in the grant of a right to the operator model.

(d) It is inconsistent with IPSAS 29, Financial Instruments: Recognition and Measurement because:

(i) Leases are in, substance, financing transactions; and

(ii) The lease receivable meets the definition of a financial asset; and

[2] Paragraph 2.8 of the *Conceptual Framework*
[3] Paragraph 2.9 of the *Conceptual Framework*

(e) It is inconsistent with the right-of-use model for lessee accounting as explained in BC31.

BC35. As a consequence, the IPSASB decided to develop a single right-of-use model for lessor accounting specifically designed for public sector financial reporting