The Chartered Institute of Public Finance & Accountancy

Local Authority Leases Briefing 1

Briefing from CIPFA Policy and Technical

June 2018

Introduction

This CIPFA briefing on the adoption of IFRS 16 *Leases* in the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code) is the first in a series which will:

- update stakeholders on the development of the approach to the adoption of the standard in the Code by the CIPFA/LASAAC Local Authority Accounting Code Board (CIPFA/LASAAC)
- assist with the implementation of the standard from both technical and practical perspectives.

Each briefing will focus on particular aspects of the standard while also updating stakeholders on latest developments.

This briefing focuses on recognition and measurement and the adaptations to the Code for the adoption of IFRS 16.

Need for Consultation

IFRS 16 replaces IAS 17 *Leases* and its related interpretations. It will apply to the 2019/20 financial statements subject to the consultation process and CIPFA/LASAAC's decisions for adoption in the 2019/20 Code.

The changes introduced by the standard will have substantial practical implications for local authorities that currently have material operating leases, and are also likely to have an effect on the capital financing arrangements of the authority.

CIPFA/LASAAC has already consulted on the principles of adoption of IFRS 16 alongside the consultation on the 2018/19 Code; see Appendix C to the ITC – IFRS 16 Leases. Responses to the early consultation have fed into the overall development on the proposed approach. Respondents also focused on the practical issues for adoption. As a result, CIPFA/LASAAC will develop the revised Code having obtained information on practical issues which local authority preparers will face in implementing the new requirements.

On 22 May 2018, CIPFA/LASAAC issued its single issue consultation on the adoption of IFRS 16 – see CIPFA/LASAAC Consultation on IFRS 16 Leases.

CIPFA/LASAAC included a readiness assessment questionnaire in the consultation documents which will help local authorities consider their own preparations. CIPFA/LASAAC is also requesting that this questionnaire is returned to the CIPFA/LASAAC secretary in order to assess overall preparedness for adoption of the standard.

CIPFA is also undertaking an impact assessment exercise to assess matters arising from the adoption of the standard by local authorities.

IFRS 16 leaves arrangements largely unchanged for lessors, with two exceptions: the classification of sub-leases and sale and leaseback accounting. These will be covered in later briefings.

Recognition and Measurement – Lessees

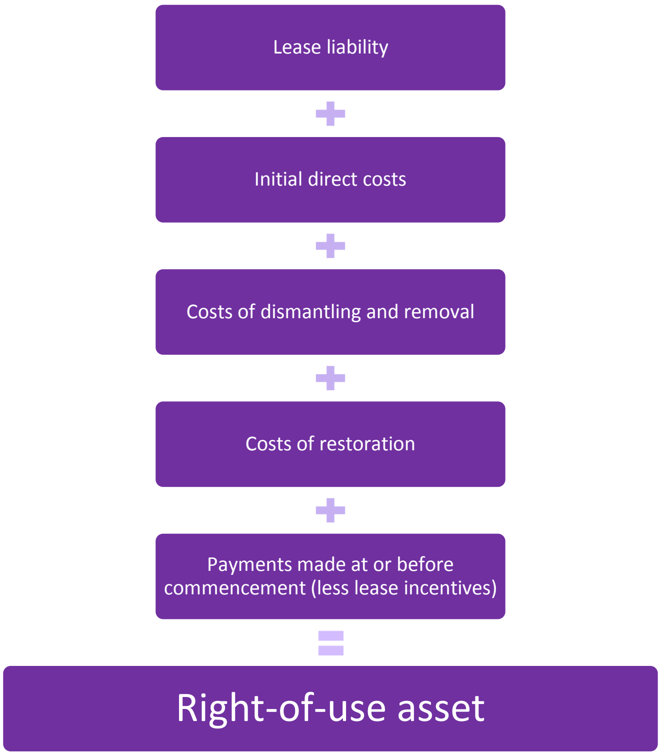
The new leasing standard will lead to a substantial change in accounting practice for lessees for whom the current distinction between operating and finance leases will be removed. Instead it requires that a lessee recognises assets and liabilities for all leases with a term of more than 12 months unless the underlying asset is of low value. A lessee will recognise a right-of-use asset representing its right to use the underlying leased property, and a lease liability representing the lessee’s obligation to make lease payments for the asset.

At the commencement date of the lease, a lessee is required to recognise a right-of-use asset and a lease liability.

Initial recognition and measurement of the right-of-use asset

At initial recognition the right-of–use asset is measured at cost (if the lease is made on commercial terms). The measurement of the right-of-use asset is initially directly related to the initial measurement of the lease liability with a number of potential adjustments. This is demonstrated in the diagram below.

Diagram 1: Initial measurement of the right-of-use asset

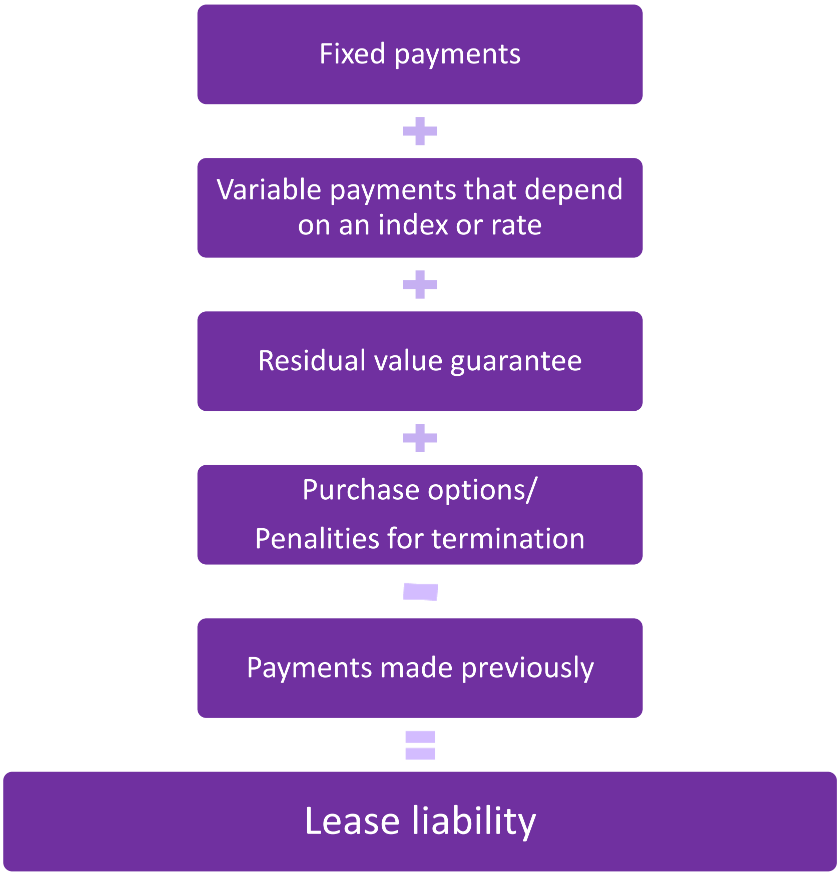


The initial measurement of the right-of-use asset is similar to the requirements for initial measurement of assets under IFRS, and so should not raise substantial issues for local authorities. This is with the exception of the requirement to restore the asset to the condition required by the terms and conditions of the lease.

Initial recognition and measurement of the lease liability

At the commencement date 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 its incremental borrowing rate. The components of the lease liability are summarised in the following diagram.

Diagram 2: Initial measurement of the lease liability



Subsequent measurement of the right-of-use asset

Where an entity uses the revaluation model under IAS 16 *Property, Plant and Equipment*, IFRS 16 permits a choice in measurement approach for items of property, plant and equipment. The right-of-use asset can be measured under the cost model or the revaluation model under IAS 16. The Code's current approach for finance leases and the principle generally held in the Code is that subsequent measurement of assets for local authorities should be at current value, subject to cost/benefit considerations. The Exposure Draft includes the proposal to adapt the provisions of IFRS 16 and requires that the subsequent measurement of the right-of-use asset for property, plant and equipment follows the measurement requirements in Section 4.1 of the Code.

CIPFA/LASAAC is seeking interested parties' views on this proposed adaptation, particularly in relation to cost/benefit considerations. It is also proposing to limit the valuations that may be required by including either a materiality based approach to current value measurement (and is requesting information from local authorities on lease terms to facilitate this) or an approach based on information which is available without undue cost or effort.

HM Treasury's consultation IFRS 16 Leases: Exposure Draft is also considering adapting the approach to measurement of the right-of-use asset and is focusing on similar issues to the proposed approach by CIPFA/LASAAC. The Exposure Draft recognises the difficulties inherent in the revaluation of the right-of-use asset and that the cost model in IFRS 16 is more progressive than the depreciated historical cost measurement under IAS 16. It proposes that as a practical expedient the cost model is used as a proxy for all items of property, plant and equipment. The Exposure Draft also recognises that some discussions have highlighted concerns over the consistency of applying such a proxy, especially where assets may be held for their entire lease term and is seeking views on the approach to subsequent measurement.

CIPFA/LASAAC is also seeking views from interested parties on which of the two options below best is the best fit for local government circumstances and provides an appropriate cost/benefit balance for the users of local authority financial statements:

- **Option 1** – Subsequent measurement at current value with practical expedients applying to lower value property, plant and equipment which allow the IFRS 16 cost model to be used as a proxy for current value for those lower value items (including an option related to undue cost or effort).

- **Option 2** – The approach proposed by HM Treasury ie that as a practical expedient the cost model is used as a proxy for all leased items of property, plant and equipment.

The consultation is seeking interested parties' views on the technical and practical merits of each option.

Subsequent measurement of the lease liability

After the commencement date, 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

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

Ongoing Adaptations

The ITC and Exposure Draft include proposals for three adaptations on an ongoing basis on adoption of IFRS 16. They are as follows:

1. **Short-term leases exemptions on recognition** – these are leases with a lease term of 12 months or less. IFRS 16 includes an accounting policy choice for entities not to apply the recognition, measurement and presentation requirements of the standard for leases which have a short term. CIPFA/LASAAC proposes mandating the exemption – it considers that most local authorities would choose this option.

2. **Subsequent measurement of the right-of-use asset** – IFRS 16 permits entities to measure the right-of-use asset (where the underlying asset is an item of property, plant and equipment) using either the cost model in IFRS 16 or the revaluation model (in IAS 16). To be consistent with the Code's principles for the measurement of property, plant and equipment, CIPFA/LASAAC proposes adapting the standard to only allow measurement at current value, but is consulting on options for relevant practical expedients – see above for a more detailed description of the proposed adaptation.

3. **Concessionary leases (lessees)** – CIPFA/LASAAC has decided to propose the same treatment for concessionary leases as that in the IPSASB consultation paper Exposure Draft 64, Leases. It therefore proposes that the right-of-use asset for concessionary leases should be measured at fair value by discounting the market based lease payments using the market rates. It also proposes recognising a subsidy in accordance with IPSAS 23 *Revenue from Non-exchange Transactions (Taxes and Transfers)* as income on the initial entry into

the transaction. As an authority satisfies the present obligation, the liability is reduced and an equal amount of revenue is recognised. CIPFA/LASAAC has proposed this treatment because the same principles are already adopted by the Code in relation to soft loans and non-exchange transactions.

Impact Assessment

CIPFA/LASAAC has considered the impact of the changes to standards on local authorities in some detail by means of its extensive consultation processes. However, CIPFA has decided that to assist CIPFA/LASAAC it will initiate a formal impact assessment process to evaluate the costs and the benefits of the adoption of IFRS 16 *Leases* and to consider particular aspects of adoption of the standard.

CIPFA will be liaising directly with a number of authorities across the UK to consider in detail the impacts that the adoption of the standard will have on local authority financial statements, the information requirements and the processes and systems used by local authorities. If you are interested in taking part in this impact assessment please contact CIPFA at E: financial.reporting@cipfa.org by 22 June 2018.

Other Useful Sources of Information

Information on implementation of the standard will be available by means of the CIPFA/LASAAC pages of the CIPFA website.

The IASB also includes substantial educational information on the implementation of the standard on its website.

Further Briefings and Other Support

Future briefings to support the implementation of the new standard will complement other forms of communication, such as CIPFA bulletins and Technical Enquiry Service FAQs. These are likely to cover the following topics: identifying the lease, recognition exemptions, issues for lessor accounting, transitional reporting arrangements, concessionary leases etc, more on the practical issues relating to adoption, and any other areas where we feel a briefing would be beneficial. If you have any suggestions for future topics, please contact CIPFA Policy and Technical at E: financial.reporting@cipfa.org.

The next issue will cover identifying the lease, recognition exemptions and transitional reporting requirements.

Briefings will be published on the CIPFA/LASAAC pages of the website. Alerts to new briefings will be sent out through social media and the usual communication channels, such as the CIPFA networks and via Treasurers' Societies.