The Chartered Institute of Public Finance & Accountancy

Local Authority Leases Briefing 3

Briefing from CIPFA Policy and Technical

October 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 third 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.

The Briefing will provide an update on the impact assessment. It also looks at:

- discount rates
- lessor accounting
- disclosure requirements
- concessionary leases – lessees
- measurement of the service concession arrangement (PFI/PPP) liability.

Code Consultation on IFRS 16 Leases

The Code consultation on IFRS 16 closed on 7 September 2018. CIPFA/LASAAC received 80 responses to the consultation and would like to take this opportunity to thank all those respondents that provided responses. It is now considering those responses in detail and will finalise its decisions on the approach to adoption of IFRS 16 in the Code at its November 2018 meeting.

The consultation papers also included a readiness assessment questionnaire which has been completed by respondents to the consultation. These provide very useful information which will support the work of CIPFA/LASAAC and CIPFA on IFRS 16.

Impact Assessment

The impact assessment has been completed by those bodies outlined in Local Authority Leases Briefing 2. CIPFA is now analysing the information completed and has a wealth of information which will also be useful to both CIPFA/LASAAC and CIPFA to support local authorities in their implementation of the standard through the Code and by means of application and practical guidance. CIPFA wishes to thank those participants in the impact assessment for their time and contributions to this key project.

Discount Rates

[Local Authority Leases Briefing 1](#) explained that 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.

Information from the private sector indicates that for many entities it will be difficult to identify the interest rate implicit in the lease and therefore a company's incremental borrowing rate will need to be used. Similar issues may arise for local authorities.

In theory this is not a new issue as the definition of the incremental borrowing rate is the same as the accounting requirements for finance leases under IAS 17 *Leases*. A relevant incremental borrowing rate in accordance with IFRS 16 will therefore be based on a rate that would have to be to be paid in borrowing funds over a similar term and with a similar security to acquire an asset of a similar value in a comparable economic environment. This should vary across what is anticipated to be a wider range of different types of assets that local authorities hold under leases currently held as operating leases.

The International Accounting Standards Board (IASB) decided to define the lessee's incremental borrowing rate to take into account the terms and conditions of the lease.

The IASB provided relevant examples of the rate in its basis of conclusions ie a rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases. The IASB noted that the lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16 (see Basis of Conclusions, IFRS 16, paragraph BC162).

Lessor Accounting

The classification tests for the lessor accounting model remain substantially unchanged from those in IAS 17. Lessors are still required to split leases between finance and operating leases. Leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases. All other leases are operating leases.

There are two areas where there are changes from the approach under IAS 17:

- the structure of a sublease
- sale and leaseback accounting.

Structure of a sublease

A lessee may become an intermediate lessor if it sublets an asset it in turn leases from another lessor (the head lessor). Previously under IAS 17, a sublease was classified with reference to the underlying asset. IFRS 16 (paragraph B58) requires that an intermediate lessor classifies the sublease as a finance lease or an operating lease as follows:

- if the head lease is a short-term lease (ie a lease that at the commencement date has a lease term of 12 months or less), the sublease is classified as an operating lease
- otherwise, the sublease is required to be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant and equipment that is subject of the lease).

Sale and leaseback transactions

In a sale and leaseback transaction, a lessee (seller-lessee) sells an asset to a lessor (the buyer-lessor) who then leases it back to the lessee. To determine how to account for a sale and leaseback transaction, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of IFRS 15 *Revenue from Contracts with Customers* (as adopted by the Code). The following table summarises the accounting treatment following that determination.

Transfer to buyer-lessor qualifies as a sale	Transfer to buyer-lessor does not qualify as a sale
• Lessee (seller): – derecognises the asset and applies lessee accounting model to leaseback – measures right-of-use asset as proportion of the carrying value – recognises a gain or loss on the rights transferred to the lessor.	• Lessee (seller): – continues to recognise the asset – amounts recognised as a financial liability under the Code's adoption of IFRS 9 Financial Instruments.
• Lessor (buyer): – applies lessor accounting requirements to the purchased asset.	• Lessor (buyer): – purchased asset is not recognised – amounts recognised as a financial asset under the Code's adoption of IFRS 9.

Disclosure Requirements for IFRS 16

IFRS 16 has increased the disclosure requirements for leases. It has introduced a disclosure objective for both lessees and lessors, ie to disclose information in the notes that, together with the information provided in the Balance Sheet, Comprehensive Income and Expenditure Statement and Cash Flow Statement, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee and lessor as relevant. The standard has introduced both quantitative and qualitative disclosures to meet this objective.

Disclosures for Lessees

The following diagram presents an overview of the quantitative disclosures for lessees:

BALANCE SHEET	COMPREHENSIVE INCOME AND EXPENDITURE STATEMENT	CASH FLOW STATEMENT
• Additions to right-of-use assets • The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset • Lease liabilities • Maturity analysis for lease liabilities	• Depreciation charge for the right-of-asset by class of underlying asset • Interest expense on lease liabilities • Expense relating to short-term leases for which the recognition exemption is applied • Expense relating to low value leases for which the recognition exemption is applied • Expense relating to variable lease payments not included in the measurement of lease liabilities • Income from subletting right-of-use assets • Gains or losses arising from sale and leaseback transactions	• Total cash outflow for leases

The Standard also sets out that the lessee is required to disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective outlined above and sets out that this may include:

- the nature of the authority’s leasing activities
- future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities including:
  - variable lease payments
  - extension options and termination options
  - residual value guarantees
  - leases not yet commenced to which the lessee is committed
- restrictions or covenants imposed by leases
- sale and leaseback transactions.

For Disclosures for lessors

The following diagram presents an overview of the quantitative disclosures for lessors:

Finance Leases

- selling profit or loss
- finance income on the net investment in the lease
- income relating to variable lease payments not included in the measurement of the net investment in the lease
- significant changes in the carrying amount of the lease
- maturity analysis of the lease payments receivable.

Operating Leases

- lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate
- maturity analysis of lease payments receivable
- disclosure requirements from IAS 16, IAS 36 and 38 as adopted by the Code separately for leased assets.

IFRS 16 sets out that a lessor is required to disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective outlined above the additional information includes but is not limited to:

- the nature of the lessor's leasing activities
- how the lessor manages the risk associated with any rights it retains in underlying assets.

The disclosure requirements emanate from a disclosure objective outlined above. Local authorities should ensure that their disclosures meet that objective to the extent necessary for material transactions and balances.

Concessionary Leases – Lessees

A number of the consultation responses raised practical issues in relation to the use of the market rate for the estimation of fair value. CIPFA/LASAAC and its subgroup are therefore considering the approach to this issue in some detail and will provide an update in Local Authority Leases Briefing 4.

Measurement of the Service Concession Arrangement Liability

The Code requires the measurement of a service concession arrangement (PFI/PPP arrangement) liability to follow those provisions in the Code and IAS 17 for a finance lease. As IAS 17 will no longer be an extant IFRS, the proposals in the consultation papers were to change 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, 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 lessee is required to remeasure the lease liability to reflect those revised lease payments when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). This would mean where PFI contract payments are increased, for example, by RPI that the liability would need to be remeasured.

The consultation papers offered a possible alternative to this approach, ie to retain the current IAS 17 provisions in the Code for service concession arrangements. This would retain the economic effect of the current measurement provisions for service concession arrangements (PFI/PPP).

These proposals were subject to substantial debate amongst consultation respondents and Local Authority Leases Briefing 4 will include an update on CIPFA/LASAAC's considerations.

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. Local Authority Leases Briefing 1 which covers recognition and measurement and proposed adaptations and Local Authority Leases Briefing 2 which covers identifying the lease, recognition exemptions, portfolio application and transitional reporting requirements are both available on the CIPFA website.

The next issue will cover more feedback from the consultation exercise and impact assessment, concessionary leases – lessees, service concession arrangements and audit issues relating to the adoption of IFRS 16. If you have any suggestions for future topics, please contact CIPFA Policy and Technical at E: financial.reporting@cipfa.org.

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 Treasurers' Societies.