IFRS 16 *Leases*

Introduction

C.1 IFRS 16 *Leases* introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

C.2 The IASB focus on the leasing project was to respond to concerns about the lack of transparency of information. The central feature of the current standard for leases (IAS 17 *Leases*) is that classification as a finance lease is determined by whether a lease is economically similar to purchasing the asset being leased. If so an asset and related liability are recognised on an entity's balance sheet. All other leases are classified as operating leases and no assets or liabilities are recognised. The existence of two different accounting models for leases means that transactions that are economically similar could be accounted for very differently. This meant that investors had to make adjustments to financial statements to compare economically similar entities.

C.3 This Appendix provides a list of investigatory questions which will provide useful feedback for the CIPFA/LASAAC sub group to develop the Exposure Draft and consultation papers for the December consultation on IFRS 16. CIPFA/LASAAC would welcome any comments on any of these areas, but also welcomes comments on individual questions which might be of specific interest to an interested party or more general comments on the approach to adoption in the Code.

Initial Recognition

Identifying a Lease

C.4 Under IFRS 16 a lease is a contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration (whether or not it has the legal status of a lease). A contract is or contains a lease on the basis of whether the customer has the right to control the use of an identified asset for a period of time. A contract conveys the control of the right to use of an identified asset if throughout the contract period the customer has the right:

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

C.5 An asset is often identified by being explicitly specified in a contract but an asset can also be identified by being implicitly specified at the time it is made available for use by the customer.

C.6 Where a supplier has a substantive right of substitution throughout the period of use, IFRS 16 specifies that a customer does not have a right to use the identified asset. A supplier's right of substitution is only considered substantive if the supplier has both the practical ability to substitute and it would economically benefit from the substitution.

C.7 A capacity portion of an asset is an identified asset if it is physically distinct (for example a floor of a building). A capacity or other portion of an asset that is not physically distinct is not an identified asset, unless the capacity represents substantially all of the economic benefits of using the asset.

Recognition Exemptions

C.8 Short-term (less than 12 months) and low value leases for items such as office furniture, laptops and tablet computers are exempt from the recognition requirements (the basis of conclusions for IFRS 16 includes an indication of the low value ie a monetary value of $5,000 for the underlying asset). However, this means that material leased cars, fleet items, plant and machinery and property items currently held under operating leases will need to be recognised on local authority balance sheets as right-of-use assets.

C.9 The volume of transactions to be considered is likely to be an important consideration for local authorities preparing to adopt the Standard. Therefore, CIPFA/LASAAC wishes to seek the views of interested parties whether the Code should include more explicit guidance on the application on the low value exemption for local authority circumstances.

C.10 CIPFA/LASAAC is also giving early consideration to whether the short-term exemption should be mandated by means of an adaptation in the Code. This has the advantage of providing consistency in application for local authorities and will also reduce the reporting burden for local authorities.

Issues Arising from Initial Recognition

C.11 The definition of a lease is similar to that contained in IAS 17 and IFRIC 4 *Determining Whether an Arrangement Contains a Lease*. CIPFA/LASAAC does not have details of how many contracts held by local authorities contain leases which were identified under IFRIC 4 and would be interested in feedback from interested parties on this issue.

C.12 IFRS 16 includes detailed guidance to help entities assess whether a contract contains a lease or a service, or both. The definition of a lease is met where the customer has the right to control the use of an identifiable asset for a period of time in exchange for consideration. Judgement will be required to make this decision. Areas of difficulty might be service contracts for IT, for example, network equipment and the use of data and storage facilities, as well as shared use of fibre optic cables but could also apply to property leases.

C.13 CIPFA/LASAAC would note that the definition of a lease is the area of the Standard where the most application guidance has been produced. The distinction between leases and services is now more important because accounting for operating leases used to be akin to accounting for services so potentially the identification of operating leases previously was not a priority. However, it is likely that for the vast majority of contracts the identification of leases will be straightforward but on the margins there will be areas which will require judgement. Local authorities will need to ensure that they have the relevant information to make these judgements.

Initial Measurement

Lease Liability

C.14 The lease liability is initially measured at the present value of the lease payments payable over the lease term. This is discounted at the rate implicit in the lease. If the rate implicit in the lease cannot be readily determined, the lessee is required to use their incremental borrowing rate.

C.15 The components of the lease liability include:

- fixed payments (including in substance fixed payments) less any lease incentives receivable
- variable lease payments that depend on an index or a rate
- amounts payable under residual value guarantees
- the exercise of a purchase option if the lessee is reasonably certain to exercise the option, and
- payments of penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.

The measurement of the lease liability excludes payments made before the commencement date.

C.16 The lease term determines which lease payments are included in the measurement of the lease liability therefore determining the lease term will be an important task under the Standard.

C.17 An IASB article[1] identified that it is likely that in many cases lessees will not currently have sufficient information about how the lessor priced the contract to determine the rate implicit in the lease. If this is the case for local authorities then they will need to use their incremental borrowing rate. In theory this is not a new issue as this is the same as the accounting requirements for finance leases in IAS 17. However, a relevant incremental borrowing rate will be based on a rate that would have to be to be paid in borrowing funds over a similar term and with a similar security to acquire an asset of a similar value in a comparable economic environment. This will therefore vary across the different types of assets that local authorities hold under operating leases. CIPFA/LASAAC is interested in any comments that interested parties may have on whether local authorities will need to use the option in the Standard in relation to the use of the incremental borrowing rate and the practicalities of identifying this rate across an authority's portfolios of leased assets.

Right-of use Asset

C.18 The right-of-use asset is initially measured at cost. The cost of the right-of-use asset comprises: the initial measurement of the lease liability, lease payments made at or before lease commencement less any lease incentives received, the lessee's initial direct costs and an estimate of restoration, removal and dismantling costs taking into account the lease term as determined under the IFRS 16.

Initial Recognition and Measurement	
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.

1 *Leases one year on—putting IFRS 16 into practice*, IASB January 2017

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.
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?
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.

Subsequent Measurement

Lease Liability

C.19 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.

C.20 Under IFRS 16 an entity recognises the effects of these remeasurements as an adjustment to the carrying value of the lease liability and right-of-use asset as at the time of remeasurement; prior period figures are not adjusted. If the carrying value of the right-of-use asset is less than the amount of an adjustment, the carrying value is reduced to zero with any further reductions being recognised in profit or loss.

C.21 The Standard also specifies when to remeasure by discounting the revised leased payments under the following circumstances and approach to discount rates ie:

- Changes in original assessment of lease term or purchase/termination options (the Standard requires use a revised discount rate)
- Changes in estimate of residual guarantee (this does not require a change in discount rate)
- Changes in index or rate affecting payments (this does not require a change in discount rate).

Right-of-Use Asset

C.22 For subsequent measurement of leased assets, a lessee is required to measure the right-of-use asset using the cost model, unless:

- the right-of-use asset is an investment property and the lessee applies the fair value model to its investment property under IAS 40 *Investment Property*, or
- the right-of-use asset relates to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment*; in such circumstances a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

C.23 CIPFA/LASAAC's preliminary view is that subsequent measurement of the right-of-use asset (property, plant and equipment) should be at current value and it anticipates that it will adapt the Standard for this. Such an approach is consistent with its approach to current value for (the majority of) property, plant and equipment assets and to the measurement of finance lease assets. It also follows the principle adopted in the Code that current value represents the best measurement of an asset (this is subject to a cost benefit analysis on obtaining that measurement).

C.24 This will mean more assets being recognised on the local authority balance sheets, many of which may be of a lower value than those assets than were typically recognised as finance leases. CIPFA/LASAAC considers that the best way to approach this measurement is to allow materiality to determine whether current values are actually applied in particular instances (as it currently does in the Code by allowing a proxy to be used for short-life/low value assets).

C.25 It will also mean that subject to any statutory requirements being maintained or extended there will be an impact on the General Fund as under IFRS 16 current value depreciation on the right-of-use asset will be charged to the Surplus or Deficit on the Provision of Services.

Subsequent Measurement	
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?

Impact on the Financial Statements Including Statutory Reporting Requirements

Balance Sheet

C.26 The most significant effect of the new requirements in IFRS 16 will be an increase in lease assets and lease liabilities. For lessees all leases (with the exception of those short or low value leases discussed above) will be accounted for in a similar way to the current IAS 17 treatment for finance leases ie the recognition of a right-of-use asset and a liability for the obligation to make lease payments.

C.27 Local authorities that currently have operating leases will appear to be more asset rich but this will be accompanied by a commensurate increase in indebtedness.

Impact on the Surplus or Deficit on the Provision of Services

C.28 IFRS 16 changes the nature of expenses for those local authorities with substantial operating leases. Under IAS 17 expenditure was normally incurred as a straight line expense for operating leases and for finance leases a charge was made for depreciation for finance lease assets and an interest expense in financing and investment income and expenditure. Under IFRS 16 operating lease charges are replaced with a depreciation charge for lease assets and an interest expense on lease liabilities. Importantly, this, dependent on CIPFA/LASAAC's final decisions for implementation, is likely to be current value depreciation which would differ from most private sector practice.

C.29 For local authorities currently the Minimum Revenue Provision (MRP) guidance for England and Wales and loans fund for Scotland stipulates the statutory charge for finance leases should be the lease payment. This will need to be considered by the relevant administrations because there will no longer be a distinction between finance and operating leases for lessees in local authority financial statements. Administrations in these jurisdictions will have to decide whether these provisions will be extended to all leases with a right-of-use asset.

C.30 Considerations for government bodies might be consistency with the previous statutory guidance and the impact of CIPFA/LASAAC decisions on subsequent measurement ie whether depreciation for subsequent measurement of the right-of-use asset is current value depreciation or historical cost depreciation.

Impact on the Cash Flow Statement

C.31 The introduction of IFRS 16 will not impact on the total cash flows in the cash flow statement. The accounting requirements will not change the payments made to lessors. It will have an impact on the presentation of the cash flows in the statement. On application of the new requirements principal repayments on all lease liabilities will be included within financing activities. Interest payments may also be included within financing activities applying IFRS 16. In comparison with the amounts reported under IAS 17 this is likely to mean operating cash flows will decrease with a corresponding increase in financing cash flows.

Impact on the Financial Statements and the General Fund	
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.

Disclosure Requirements

C.32 Overall the disclosure requirements have increased under IFRS 16. The Standard has also introduced a disclosure objective which gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee and lessor. This includes additional disclosures for the right-of-use asset, depreciation charges and interest expense on the lease liabilities and disclosures on the exemptions for recognition (ie low value and short-term leases).

Lessor Accounting

C.33 The lessor accounting model is essentially the same as is in IAS 17 ie leases are accounted for as finance or operating leases. There are two areas where there are changes from the approach under IAS 17:

- The structure of a sub-lease - under IAS 17 a sub-lease was classified with reference to the underlying asset. However, IFRS 16 requires the lessor to assess the sub-lease with reference to the right-of-use asset.

- Sale and leaseback accounting – IAS 17 accounting requirements depended on whether the leaseback was an operating lease. For IFRS 16 the determining issue is whether the transfer of the asset qualifies as a sale in accordance with the requirements of IFRS 15 *Revenue from Contracts with Customers*.

C.34 IFRS 16 also requires a lessor to provide some additional disclosures to enable users of financial statements to better evaluate the uncertainty of cash flows associated with the lessor's leasing activities.

C.35 CIPFA/LASAAC's early view at this juncture is that there are no local government circumstances requiring adaptations or interpretations of the lessor's requirements under IFRS 16. It would seek interested parties' views on this issue including whether the use of sub-leases or sale and leaseback transactions are substantial transactions for local authorities.

Lessor Accounting	
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.

Transition

Identification of a Lease on Transition

C.36 As a practical expedient an entity is not required to reassess whether a contract is or contains a lease at the date of initial application. Instead an entity is permitted:

- to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 and IFRIC 4

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

CIPFA/LASAAC considers that there are advantages of adopting this practical expedient on transition as this should ease the reporting burden for accounts preparers.

Transition Approach

C.37 IFRS 16 provides two approaches to transition:

- a full retrospective restatement, or

- a cumulative catch-up retrospective approach.

The approach chosen by an entity has to be applied to the entire lease portfolio. Under the cumulative catch-up retrospective approach, a lessee is not required to restate preceding year information.

C.38 Under the cumulative catch-up retrospective approach, at the date of initial application of IFRS 16 lessees are required to recognise the cumulative effect of initial application as an adjustment to the opening balance of equity (reserves). In line with CIPFA/LASAAC's previously held view on the approaches to the adoption of IFRSs 9 and 15 CIPFA/LASAAC's early view is that it would wish to adopt the cumulative catch-up retrospective approach to transition and it would seek interested parties' views on this issue.

C.39 Under the cumulative catch-up retrospective approach for leases that were previously operating leases at the date of initial application an entity is able to choose on a lease by lease basis to measure the right-of-use asset at either:

- 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, or
- 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.

CIPFA/LASAAC's early view is that the second option is preferred on a cost benefit basis and an understandability basis. However, CIPFA/LASAAC is keen to seek interested parties' views on this option as there are arguments that the first option might be considered to be more transparent in terms of ascertaining the best measurement of the right-of-use asset.

Other transitional provisions

C.40 Assets which were previously recognised as finance leases lessees are permitted to measure the right-of-use asset and the lease liability as the previous carrying amount.

C.41 There are also a number of practical expedients for measurement. Under the cumulative catch-up retrospective approach to transition a lessee may:

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

Transition	
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?
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?
I11	Do interested parties agree with CIPFA/LASAAC's early view for the approach on transition for measurement of the right-of-use asset for leases originally classified as operating leases? If not, why not? What alternatives do you suggest?

Approach to Preparing the Provisions for the 2018/19 Code on IFRS 16 *Leases*

C.42 CIPFA/LASAAC's sub group has had its initial meeting on the adoption of the Standard. It has identified the following issues for consideration by that group.

- The issues for contracts containing a lease and the decisions required - an example referred to was outsourcing contracts such as refuse services.
- Outsourcing contracts and the boundary between the leasing standard and contracts within the provisions of Section 4.3 of the Code (Service Concession Arrangements: Local Authority as Grantor).
- The move from 'risk and rewards' to 'control' when recognising assets in contracts that contains leases.
- Making the judgement on whether the customer has the right to obtain 'substantially all' of the economic benefits from the use of the asset throughout the period of use.
- The impact of the standard on the Group Accounts.
- The practical and resource issues required to meet the requirements of the standard.

Approach to Preparing the Provisions for the 2018/19 Code on IFRS 16 Leases	
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.