The Chartered Institute of Public Finance & Accountancy

Local Authority Leases Briefing 2

Briefing from CIPFA Policy and Technical

August 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 second 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 identifying the lease, recognition exemptions, portfolio application and transitional reporting requirements under IFRS 16. It also provides an update on the impact assessment process thus far.

Code Consultation on IFRS 16 Leases

The Code consultation on IFRS 16 is available on the CIPFA website. Please note that the consultation period ends on **7 September 2018**. It is vitally important that CIPFA/LASAAC understands both the financial reporting and practical impact of the consultation proposals on local authorities; please send the responses to E: code.responses@cipfa.org.

Identifying the Lease

IFRS 16 defines a lease as **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**. This definition is similar to that in IAS 17 *Leases* and appears relatively straightforward. However, it may require judgement to determine whether the contract conveys the right to use an asset or is a service contract. For this reason, IFRS 16 provides substantial application guidance.

At the inception of the contract IFRS 16, as adopted by the Code, will require a local authority to assess whether a contract is or contains a lease. A contract is or contains a lease if it conveys the right to use an identified asset in exchange for consideration. Local authority accounts preparers will need to consider a number of factors set out in the table below.

Table: Factors to consider in the identification of a lease for local authorities (and whether a contract contains a lease)

Issue	Discussion	Local authority considerations/ examples
Whether an identified asset is explicitly or implicitly specified in the contract	An **identified asset** may be specified *explicitly* (eg by means of a serial number or other form of marking or identification), or *implicitly*. In this case the asset is not included in the contract but it may be the case that only one asset can deliver the contract specifications. If an asset is neither explicitly nor implicitly specified in a contract, then the contract does not contain a lease.	Local authorities may need to review their outsourcing contracts and consider whether the contracts identify assets either explicitly or implicitly. Typical contracts which may need to be considered are in areas such as finance, IT, the use of data centres, waste management, property and grounds maintenance, fleet and highways vehicles.
If an asset is specified in a contract, a local authority needs to determine whether the supplier has a substantive right to substitute that asset	A customer (a local authority) **does not have the right to use an identified asset** if the supplier has the **substantive right to substitute** the asset throughout the period of use. Substitution rights are substantive if both the following conditions are met: ▪ the supplier has the practical ability to substitute the asset (for example, if alternative assets are readily available and the customer cannot prevent the substitution), and ▪ the supplier would benefit economically from the substitution (ie the economic benefits of the substitution exceed the costs). If a customer cannot readily determine if the supplier has a substantive right to substitute, it must presume that any such right is not substantive. If the supplier has the **substantive right to substitute** the asset throughout the period of use, then the customer does not have the right to use an identified asset and the contract does not contain a lease.	Issues relating to suppliers' ability to substitute may arise where local authorities lease fleet items. An example of a supplier benefitting economically would be when it can substitute a refuse truck at little or no cost and can lease the replaced assets to another customer for an economic consideration.
Whether the asset specified in a contract is physically distinct	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 a portion of an asset that is **not distinct** is not an identified asset (for example, a capacity portion of a	Local authority examples of contracts where the issue of capacity portion may need to be considered include the use of buildings, or parts of buildings and use of fibre optic cables.

<table>
<tr><th>Issue</th><th>Discussion</th><th>Local authority considerations/ examples</th></tr>
<tr><td></td><td>fibre optic cable) unless it represents substantially all of the capacity of the asset.

If a capacity portion of an asset is distinct, a contract will include an identified asset and may contain a lease, subject to the other criteria in this table.</td><td></td></tr>
<tr><td>Whether the customer (a local authority) has the right to obtain substantially all of the economic benefits and service potential from use of the asset throughout the period of use</td><td>A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

To control the use of an identified asset, a customer must have the right to obtain substantially all the economic benefits and/or service potential from the use of the asset throughout the period of use.

Where the customer has the right to control the use of the asset, the contract may include a lease subject to whether it has a right to direct the use of the asset (see the next row of this table).</td><td>Note that the Code includes reference to controlling service potential as well as economic benefits to reflect the different economic substance of resource utilisation on the use of assets by local authorities. Therefore local authorities use assets in this case as lessees primarily (though not exclusively) for the provision of services rather than income generation.</td></tr>
<tr><td>Whether the customer (a local authority) has the right to direct the use of the asset throughout the period of use.</td><td>A customer has the right to direct the use of an identified asset throughout the period of use if:

▪ the customer has the right to direct how and for what purpose the asset is used throughout the period of use, or

▪ the relevant decisions about how and for what purpose the asset is used are predetermined, and

– the customer has the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions, or

– the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.</td><td>Rights to control the identified asset for local authorities will be the most relevant decision-making rights, for example, whether the authority can specify how, when and where to change the outputs of a contract.

If an authority has a contract for the use of refuse trucks, relevant factors will include whether the authority decides when the trucks are used, the frequency of collection, what items are collected by each type of vehicle etc.</td></tr>
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Recognition Exemptions

IFRS 16 provides two major recognition and measurement exemptions as practical expedients and to reduce the reporting burden on entities. Under IFRS 16 both exemptions are optional. If these exemptions are applied the accounting treatment is similar to the current treatment for operating leases, ie lease payments are charged on a straight line basis unless another systematic basis is more representative of the economic effect of the lease benefit. There are two forms of exemption: **short-term leases** and **low value leases**.

Short-term leases

Short-term leases are defined as leases that, at the commencement date, have a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease. The lease term also includes periods covered by an option to extend or an option to terminate if the lessee is reasonably certain to exercise the extension option or not exercise the termination option. CIPFA/LASAAC proposes to mandate this option as it considers that local authorities will normally make this accounting policy choice, and therefore is of the view that this will reduce the reporting burden on local authorities. This is also the approach taken by HM Treasury in the consultation on the approach to the adoption of IFRS 16 in the Government's Financial Reporting Manual (FReM).

Low value leases

IFRS 16 includes an exemption for leases where the underlying asset is of low value. IFRS 16 does not provide a definition or a threshold for low value leases. It confirms that the assessment of the value of the asset is based on the asset when it is new and on an absolute basis, ie this is regardless of the volume of transactions of a particular asset. The Basis of Conclusions for the standard, paragraph BC100, sets out that the IASB "had in mind leases of underlying assets with a value, when new, in the order of magnitude of US $5,000 or less". Importantly the IASB included this commentary as a part of the Basis of Conclusions which is not a part of the standard.

The application guidance in IFRS 16 provides examples of what might typically be low value assets including laptops, tablet computers and small items such as office furniture and telephones. It also comments that leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

IFRS 16 also sets out that leases of low value apply regardless of whether the leases are material to the lessee. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis.

A number of respondents to the early consultation on the Code's adoption of IFRS 16 raised the issue of materiality and use of the de minimis. IFRS 16 is clear that the assessment of which assets qualify is to be made regardless of whether the lease is material to the particular lessee. The CIPFA/LASAAC sub-group that produced the early drafts of the consultation papers considered this in some detail. It is the view of CIPFA/LASAAC that it would subsequently be a decision for the authority on how it applied materiality and any de minimis to right-of-use asset recognition. This decision should be no different from other de minimis decisions made by local authorities.

Portfolio Application

The requirements for IFRS 16 are applied to individual leases. However, the application guidance includes a practical expedient to allow the standard to be applied to a portfolio of leases with similar characteristics for both lessees and lessors. This is provided that it is reasonably expected that effects on the financial statements of using the practical expedient will not differ materially from applying IFRS 16 to individual leases in that portfolio.

Transitional Reporting Requirements

IFRS 16 as adopted by the Code will have an effective date of 1 April 2019. This will therefore be the date of initial application. The following paragraphs describe the main issues relating to transition, but the full transitional requirements including disclosures will need to be considered carefully by those preparing local authority accounts.

Definition of a lease on transition

IFRS 16 includes a practical expedient on transition. Under this practical expedient an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted (in an approach often described as 'grandfathering'):

- to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 and IFRIC 4 *Determining Whether an Arrangement Contains a Lease*
- not to apply IFRS 16 to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

If an entity applies the practical expedient it is required to apply it to all of its contracts and is also required to disclose that fact.

CIPFA/LASAAC proposes mandating the use of this practical expedient to reduce the reporting burden on local authorities (although it is considered that this is the approach that local authorities would normally adopt). This approach is also consistent with the proposed approach in the FReM consultation. This practical expedient very substantially reduces the resource burden on implementation, for example, it would mean that there is no requirement to review the authority's decisions using the table above on transition. However, CIPFA would recommend that as a part of their preparations for the adoption of the standard, local authorities carry out some review of their decisions under both IAS 17 and importantly IFRIC 4 to ensure that they are content with them as of 1 April 2019.

Retrospective application

IFRS 16 offers two approaches on transition to adopt the standard:

1. retrospectively with full retrospective restatement
2. retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application (for local authorities this is 1 April 2019) as an adjustment to reserves – preceding year information is not restated.

The cumulative catch-up approach provided by the second option is also accompanied by a number of practical expedients on transition discussed below. The approach chosen by an entity has to be applied to the entire lease portfolio. CIPFA/LASAAC, following its approach to previous standards and mindful of the reporting burden, proposes mandating the cumulative catch-up approach for local authorities.

Practical expedients under the cumulative catch-up approach

Measurement of the right-of-use asset on transition

A lessee is permitted to choose on a lease-by-lease basis to measure the right-of-use asset that was previously held under an operating lease in one of two ways, ie measured at:

1. its carrying amount, as if the IFRS 16 had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application (for local authorities this is 1 April 2019), or

2. 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 proposes mandating the second option as it is easier on a cost/benefit basis to estimate this measurement and is likely to be more transparent. This approach is also consistent with the proposed approach in the FReM.

Other practical expedients under the cumulative catch-up approach

There are also a number of practical expedients under the cumulative catch-up retrospective approach to transition. A lessee:

- **is not required to make any adjustments on transition for leases for which the underlying asset is of low value**
- may apply a single discount rate to a portfolio of leases with reasonably similar characteristics
- may use hindsight, such as in determining the lease term – this practical expedient removes the need to reconstruct an authority's initial assessment of the lease term including how lease options might be exercised
- may rely on the authority's 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 – this practical expedient will allow the right-of-use asset to be adjusted by any amount assessed as an onerous provision before 1 April 2019
- **may account for leases for which the lease term ends within 12 months of the date of initial application as short-term leases**
- may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

CIPFA/LASAAC proposes mandating the two practical expedients in bold in the list above as it is of the view that this will reduce the reporting burden and is consistent with its other proposals for short-term leases. This is consistent with the HM Treasury proposals in the FReM. However, unlike the FReM, CIPFA/LASAAC has not mandated the use of hindsight as it is of the view that local authorities are best placed to take that decision. CIPFA/LASAAC would welcome feedback on this issue.

Impact Assessment

CIPFA is undertaking an impact assessment to support CIPFA/LASAAC in its deliberations on the adoption of IFRS 16 and evaluate the impact on local authorities. A substantial part of the impact assessment is to seek information from volunteer local authorities and other bodies that adopt the Code. The objective is to gather evidence on the anticipated financial reporting issues, including transition and the practical and financial management issues which will arise. The impact assessment work is being undertaken alongside, and in addition to, the formal CIPFA/LASAAC consultation.

To ensure that the full range of circumstances and situations is considered, CIPFA is currently liaising with, and supporting, one organisation of each of the following types:

- English county councils
- English district councils

- English fire and rescue services
- English police forces
- English metropolitan borough councils
- London borough councils
- Northern Ireland councils
- Scottish councils
- Welsh councils.

CIPFA greatly appreciates the participation of the volunteer organisations and the staff involved. Each organisation is being requested to provide evidence relating to the implementation of the proposals, particularly in the following areas:

- baseline information – leases and service concessions arrangements at 31 March 2018
- identification of leases under IFRS 16, including the recognition exemptions
- initial recognition and measurement
- subsequent measurement
- the application of the practical expedients in the standard
- group accounts reporting
- the disclosure framework under the standard
- the measurement of the service concession arrangement liability
- the practical application issues including both the costs and benefits of adopting IFRS 16
- the capital financing implications.

In addition, the impact assessment will include insight from other external stakeholders including the audit community.

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 is available on the CIPFA website. The briefings are likely to cover the following topics: issues for lessor accounting, discount rates, concessionary leases, the disclosure framework, measurement of the service concession arrangement liability, more on the practical issues relating to adoption, updates on the impact assessment, 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 issues for lessor accounting, reporting on concessionary leases and discount rates.

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.