Audit Committee

29 September 2023

Implementation of Accounting Standard IFRS 16 Leases

Paul Darby, Corporate Director of Resources

Electoral division(s) affected:

None

Purpose of the Report

1 This report provides the Audit Committee with a summary of the key changes and implications of implementing accounting standard IFRS16 Leases. A glossary of terms is included at Appendix 2.

Executive Summary

2 Accounting standard IFRS16 Leases, was issued by the International Accounting Standards Board in 2016 and was initially due to be implemented in April 2022 but due to issues in local audit, the CIPFA LASAAC Local Authority Accounting Code Board decided to defer mandatory implementation until 1 April 2024. This new standard supersedes the existing accounting standards for leases, IAS 17.

3 The main impact of IFRS16 is to remove (for lessees) the traditional distinction between finance leases and operating leases. Finance leases have historically been accounted for as acquisitions (with the asset on the balance sheet, together with a liability to pay for the asset acquired shown in long term liabilities). In contrast, operating leases have been treated as 'pay as you go' arrangements similar to renting an item, with rentals charged to revenue in the year they are paid and no requirement to reflect this in the balance sheet. IFRS16 requires all substantial leases to be accounted for using the acquisition approach, recognising the rights acquired to use an asset.

4 The council currently accounts for finance leases and vehicle leases (although currently operating leases) on its balance sheet, recognising a 'right of use' asset and the associated liability payable for its use. On transition to IFRS16, any existing and new operating leases (including property rentals) that meet the Code of Practice on Local Authority

Accounting (the Code) definition of a lease may need to be accounted for on the same basis, which is not currently the case.

5 There are two exemptions from applying the new accounting requirements in terms of lease transactions:

(a) Short-term leases.

(b) Leases where the underlying asset is of low value.

6 The changes mean that the initial value of any 'right of use' asset carried on the balance sheet will be determined using the 'cost model' and after initial recognition will then need to be revalued and accounted for in accordance with the council's current valuation policies.

7 Lease liabilities will be recognised from the commencement date of the lease and expressed as the present value of any lease payments not paid to date. These payments are to be discounted using the interest rate implicit in the lease or the council's incremental borrowing rate.

8 The application of IFRS16 will impact on statutory reporting requirements and lead to an increase in liabilities (debt) on the council's balance sheet. This increase in liabilities will be treated as capital expenditure, which will in turn increase the council's capital financing requirement (CFR).

9 The council's current depreciation policy will subsequently apply to new 'right of use' assets brought onto the balance sheet.

10 As the council is already making lease payments for these 'right of use' assets, budget adjustments will be made to avoid funds being set aside twice. The adjustments will be equal to the principal element of the existing lease repayments (which will be included in the annual minimum revenue provision (MRP) charge), and therefore there will be a net nil effect on the council's revenue budget.

11 In consultation with the council's leasing and IFRS16 consultants, a detailed action plan has been developed. Work is progressing well against this plan and the council is on track to be compliant with the standard by the effective date. In order to ensure compliance by the effective date of 1 April 2024 the following transition tasks are now underway:

(a) Determine policy requirements and document key considerations and the basis for policy decisions;

(b) Identify all current arrangments covered by the Code definition of a lease;

(c) Identify low value and short term arrangements;

(d) Identify and procure a suitable lease management and accounting tool;

(e) Determine the financial implications on the council’s CFR, MRP and revenue budgets, and balance sheet; and

(f) Determine and implement change requirements to systems and processes.

Recommendation

12 Audit Committee is asked to note the contents of the report and associated accounting implications.

Background

13 In addition to purchasing assets outright, the council can obtain finance to acquire assets for service delivery through lease arrangements. There are two types of lease arrangement, a finance lease or an operating lease, and the accounting treatment for each is currently different.

14 Finance leases are effectively accounted for as acquisitions (with the asset on the balance sheet, together with a liability to pay for the asset acquired). In contrast, operating leases are treated as ‘pay as you go’ arrangements, with rental payments charged to the revenue account over the term of the lease and no asset reflected in the councils balance sheet.

15 Accounting standard IFRS16 (Leases) was issued in January 2016 by the International Accounting Standards Board following concerns raised by users of financial statements that where leases were classified as operating leases, they were not reflected on an entities balance sheet. It was felt there was a perceived lack of transparency about the assets being used under leases classified as operating leases and the exposure to risk from the future liabilities payable under these operating lease arrangements were not being shown.

16 The new IFRS16 standard was developed to enhance transparency in relation to leased assets and related liabilities in the balance sheet. It was accepted that the lessor accounting model worked without fundamental flaws, therefore accounting requirements for lessors are not significantly changed. The focus of IFRS16 is mainly on lessee accounting, especially for leases currently not reflected in the balance sheet.

17 The standard was originally scheduled to be implemented by local authorities in April 2022, but due to issues in local audit, the CIPFA LASAAC Local Authority Accounting Code Board decided to defer mandatory implementation until 1 April 2024.

Lease Recognition

18 The council currently accounts for finance leases and vehicle leases through its balance sheet, recognising a ‘right of use’ asset and the corresponding liability payable for its use. On transition to IFRS16, new and existing operating leases (including property rentals) may need to be accounted for on the same basis. This means that operating lease

arrangements will reflect the operating lease value as new debt in the council's balance sheet over the term of the lease.

19 Lease accounting is not limited to arrangements that have the legal form of a lease. They apply to any arrangement that meets the the Code's definition of a lease as a contract (or part of a contract) that conveys the 'right to use' an asset for a period of time.

20 There are two specific exemptions for lessees from applying the detailed accounting requirements to transactions that would meet the definition of a lease. On the advice of the council's leasing and IFRS16 consultants these two exemptions will be used:

(a) Short-term leases - a lease that has a term of 12 months or less at the commencement date.

(b) Leases where the underlying asset is of low value, even if the impact of doing so would be material. This exemption is unusual under IFRS in that it allows the council to avoid accounting treatment wholly on the basis of avoiding the cost of work that would otherwise be necessary. Examples of low-value assets include: photocopiers, laptops, mobile phones, hand driers and water coolers. The standard specifies that vehicles would not be treated as low value.

21 The Code and IFRS16 allows for individual entities to determine a monetary amount that will constitute low value. The proposal is that the council will apply a threshold of £10,000. This is reflective of typical low value thresholds being used within the sector and it is determined that the council's balance sheet would not be materially misstated if 'right of use' assets up to this value were not recognised.

22 Under IFRS16, the council will account for exempt leases (because they are short-term or involve low value items) as follows:

(a) Lease payments will be recognised as a revenue expense on a straight line basis over the lease term. Another systematic basis may be used if it would better represent the pattern of the economic benefit to the council.

(b) Additional disclosures within the council's financial statements will be required, detailing the expenses incurred each year on such leases.

23 Under IFRS16, the council will account for leases that are not exempt as follows:

(a) A ‘right of use’ asset representing the economic benefit and service potential over which it has obtained control for the lease term will be carried in the balance sheet.

(b) A liability for the payments the council will make for the acquisition of the ‘right to use’ asset will be carried in the balance sheet.

(c) Lease payments will be split between an amount to pay off the lease liability (a principal repayment to reduce the outstanding debt on the council’s balance sheet) and finance charges (interest on the lease liability charged as a revenue expense).

24 The approach to determining the initial value of the asset to be carried on the balance sheet will be to use the ‘cost model’, which equates the value of the leased asset as the sum of the principal repayments within the lease contract. This approach will apply to all assets except where the assets are leased for a concessionary or nil consideration. Where leases are provided at a concessionary rate (e.g peppercorn) or nil consideration this approach would result in an understatement of the value of the asset. Consequently, assets from such arrangments will need to be recognised at fair value. The gain on entry to the balance sheet is neutralised by a statutory reversal so there is no net balance sheet impact. These valuations will be undertaken as part of the council’s annual asset valuation work going forward.

25 After initial recognition of leased assets in the balance sheet the assets will be revalued and accounted for in accordance with the council’s current valuation policies.

26 The Code requires that the lease liability is recognised at the commencement date of the arrangement, measured at the present value of the lease payments that are not paid at that date. The payments are discounted using:

(a) The interest rate implicit in the lease, or

(b) The council’s incremental borrowing rate (but only if the implicit rate cannot be readily determined). CIPFA have mandated that this will be the Public Works Loan Board (PWLB) annuity certainty rate on the date of commencement.

Capital Financing Implications

27 The application of IFRS16 will impact on statutory reporting and capital finance requirements for leased assets which refer to finance leases. The recognition of ‘right of use’ assets brings leases into the scope of the Prudential Code.

28 The cost of the 'right of use' asset serves a dual role. As well as providing the basis for the balance sheet entries it also constitutes capital expenditure, resulting in an increase to the council's CFR.

29 An annual charge is posted to revenue for the use of assets through the council's depreciation policy. This policy will also apply to new 'right of use' assets brought into the balance sheet. IFRS16 requires these assets to be depreciated on a straight line basis over the lower of the remaining useful life of the asset or the remaining years on the associated liability.

30 In line with statutory accounting requirements, depreciation is not a recognised charge to revenue and is reversed out of the general fund balance in the movement in reserves statement (MiRS). It is replaced by a charge to the general fund balance for MRP.

31 The CFR is reduced each year as resources are set aside to finance the capital expenditure either from capital receipts, grants and contributions or by annual charges of MRP. Whilst the Code does not stipulate what the associated MRP charge should be for 'right of use' type arrangements, common treatment (as promoted by statutory guidance in England and Wales) is to set aside an amount by which the lease liability has been written down by payments in the year. The overall effect will be, that in aggregate, the general fund balance is debited with the annual lease payment (MRP and finance lease interest).

32 As the council is already making lease payments for these 'right of use' assets, budget adjustments will be required to avoid funds being set aside twice. The adjustments will be equal to the principal element of the lease repayments leading to a nil effect on the revenue budget.

Transition arrangements

33 The Code requires that the council applies accounting standard IFRS16 Leases from 1 April 2024. Work has begun on the following tasks to ensure compliance from the effective date:

(a) Determination of policy requirements and documentation of key considerations and the basis for policy decisions. This will help shape the overall approach to implementing the standard and ensure the processes and systems developed and adopted are efficient from the outset.

(b) Identification of all current arrangements covered by the Code definition of a lease. This will allow analysis of all arrangements to determine existing operating leases including leases where there is nil/minimal consideration (peppercorn).

(c) Identification of low value and short term lease arrangements. This will reduce the level of work involved in data collation.

(d) Identification and procurement of a suitable lease management and accounting tool. This software will aid effective portfolio management, accounting compliance and provide reporting solutions to fully address transition requirements and ongoing reporting.

(e) Determination of the financial implications on the council's CFR, MRP and revenue budgets, and balance sheet. This will include: confirming revenue budget requirements for exempt leases that will continue to be charged to revenue; calculating MRP and interest budgets to include the impact of newly recognised 'right of use' assets; factoring 'right of use' assets and lease liabilities into the capital strategy and prudential indicators, including the affordable borrowing limits; and including lease acquisitions in capital budgets and the CFR.

(f) Determination and implementation of change requirements in systems and processes, to ensure the right data is collected to aid completion of notes and disclosures within the council's financial statements. This work will involve a number of departments including Procurement, Corporate Property and Land and Finance working collaboratively to ensure procedures are fully documented and shared throughout the organisation.

Conclusion

33 There is a mandatory requirement for the council to implement accounting standard IFRS16 Leases on 1 April 2024. The new standard provides a comprehensive model for the identification of lease arrangements and their treatment in the council's financial statements.

34 Significant changes to lessee accounting will be introduced with the distinction between operating and finance leases removed and assets and liabilities recognised in respect of all leases (subject to exceptions for short term leases and leases of low value assets).

35 In consultation with the council's leasing and IFRS16 consultants, a detailed action plan has been developed. Work is progressing well against this plan and the council is on track to be compliant with the standard by the effective date.

Other Useful Documents

- The CIPFA Code of Practice for Local Authority Accounting in the UK 2022/23.

- CIPFA IFRS16 Leases – An early guide for local authority practitioners.

Contact:	**Jeff Garfoot**	**Tel:**	**03000 261946**
	Andrew Baldwin	**Tel:**	**03000 263490**

Appendix 1: Implications

Legal Implications

It is a requirement of the Local Government Act 2003 and the Accounts and Audit (England) Regulations 2015 that the council's Statement of Accounts is produced in accordance with proper accounting practices.

Accounting standard IFRS16 Leases, was issued by the International Accounting Standards Board in 2016 and was initially due to be implemented in April 2022 but due to issues in local audit, the CIPFA LASAAC Local Authority Accounting Code Board decided to defer mandatory implementation until 1 April 2024. This new standard supersedes the existing accounting standards for leases, IAS 17

Finance

There will be no direct financial impact for the council as a result of the implementation of the new accounting standard IFRS16 Leases.

As the council is already making lease payments for these 'right of use' assets, budget adjustments will be made to avoid funds being set aside twice. The adjustments will be equal to the principal element of the existing lease repayments (which will be included in the annual minimum revenue provision (MRP) charge), and therefore there will be a net nil effect on the council's revenue budget.

The number of assets on the council's balance sheet required to be valued at fair value on an annual basis in future years will increase. This may have an impact on costs associated with the independent valuations of the council's assets. It is not possible to assess the scale of this cost at this stage.

The cost associated with acquiring these 'right of use' assets will qualify as capital expenditure and in turn will increase the councils CFR and impact on a number of Prudential Indicators.

Consultation

None

Equality and Diversity / Public Sector Equality Duty

None

Climate Change

None

Human Rights

None

Crime and Disorder

None

Staffing

To ensure the council has in place appropriate systems and processes, ensure the right data is collected to aid completion of the required notes and disclosures within the council's financial statements a number of departments, including Procurement, Corporate Property and Land and Finance are working collaboratively to ensure procedures are fully documented and shared throughout the organisation and that the council fully complies with IFRS16 requirements by 1 April 2024.

Accommodation

None

Risk

None compliance with the requirements of the Code and the accounting standard could have negative implications on the outcome of the council's annual external audit opinion.

Procurement

None

Appendix 2: Glossary of Terms

Capital Financing Requirement (CFR)	This sum represents the council's underlying need to borrow for capital purposes. It is calculated by summing all items on the Balance Sheet that relate to capital expenditure, e.g. non-current assets, financing leases, government grants deferred etc. The CFR will be different to the actual borrowing of the council. This figure is then used in the calculation of the council's minimum revenue provision.
Code of Practice on Local Authority Accounting (the Code)	A publication produced by CIPFA constituting proper accounting practice for Local Authorities.
Cost Model	A valuation method used to determine the value of an asset. It equates the value of a 'right of use' asset as the sum of the principal repayments within a lease contract.
Depreciation	The fall in the value of an asset, as recorded in the financial records, due to wear and tear, age, and obsolescence.
Finance Lease	A finance lease transfers substantially all of the risks and rewards of ownership of a non-current asset to the lessee and falls within the capital system.
General Fund	This is the main revenue fund of the council and includes the net cost of all services financed by local taxpayers and Government grants.
IFRS	International Financial Reporting Standards – issued and set by the International Accounting Standards Board (IASB). These are standards that companies and organisations follow when compiling their financial statements. They have been adapted to apply to local authorities and are consolidated in the Code of Practice on Local Authority Accounting (the Code).
Incremental Borrowing Rate	The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar

	value to the right-of-use asset in a similar economic environment.
Leases	Leases are a contract, or part of a contract, that conveys a right to use an asset for a period of time. The right to use the asset and the associated liability are recognised in the balance sheet and accounted for as finance leases.
Lessee	A person or organisation that makes regular payments in order to use an asset that another person or organisation owns.
Lessor	A person or organisation that allows another person or organisation to use something they own in return for regular payments.
Minimum Revenue Provision (MRP)	The minimum amount that the council must charge to the income and expenditure account to provide for the repayment of debt.
Movement in Reserves Statement (MiRS)	This statement is a summary of the changes that have taken place in the bottom half of the Balance Sheet over the financial year. It shows the movement in reserves held by the council analysed into 'usable' reserves and 'unusable' reserves.
Operating Lease	An operating lease is similar to renting; the ownership of the asset remains with the lessor and the transaction does not fall within the capital system.
Prudential Code	The Government removed capital controls on borrowing and credit arrangements with effect from 1st April 2004 and replaced them with a Prudential Code under which each local authority determines its own affordable level of borrowing. The Prudential Code requires authorities to set specific prudential indicators on an annual basis.
'Right of Use' Asset	An underlying asset for which the lessee has a right to use during the term of a lease arrangement.