

report

Paper CL 06 03 19

Board	CIPFA/LASAAC
Venue	CIPFA, 160 Dundee Street, Edinburgh EH11 1DQ
Date	5 March 2019
Author	CIPFA Technical Managers as Secretariat
Subject	IFRS 16 Leases

Purpose

To seek CIPFA/LASAAC direction on IFRS 16 Leases implementation plans for the 20/21 Code

Background and Areas for Review

- 1.1 As CIPFA/LASAAC will be aware proposed Code provisions for IFRS 16 Leases were consulted on, with a specific Invitation To Comment, during 2018. The responses were considered in November 2018 and the Board indicated its development decisions.
- 1.2 In December 2018 the Board issued a [statement deferring implementation of IFRS 16](#) to 1 April 2020 (the 20/21 Code). This was in conjunction and alignment with a FRAB determination to defer implementation in central government.
- 1.3 Subsequently to this HM Treasury and stakeholders have undertaken further work on the FReM IFRS 16 Leases proposals. A FRAB out of meeting paper has been circulated to inform FRAB members of the current position. FRAB member initial feedback has been requested and the FReM proposals may therefore be subject to amendment.
- 1.4 FRAB will not be requested to provide specific approval for the FReM proposals until 4 April. A clear decision at that point is however required since the FReM anticipates allowing two departments to apply the requirements for 2019/20 (i.e. early adoption is permitted).
- 1.5 This will influence CIPFA/LASAAC in giving due consideration to the desire and intention to maintain alignment with central government requirements.
- 1.6 In order to avoid subsequent alignment issues, and support mutual communications with HM Treasury and FRAB, the Board is requested to provide direction on:
 - a. Subsequent measurement of right of use assets
 - b. Comparison to FReM proposals
 - c. Service Concession Arrangements / PFI – Liability Measurement
 - d. Potential early adoption by bodies in 2019/20

A. Subsequent Measurement of Right of Use Assets

- 1.7 CIPFA/LASAAC is aware that FRAB noted concern at the difference in proposals between the FReM and the Code for subsequent measurement of right of assets (RoU assets).
- 1.8 Consequently HM Treasury and CIPFA/LASAAC secretariat have co-operated in seeking to identify proposals which will support alignment in this. HM Treasury have co-ordinated with a stakeholder working group to inform the proposals.

Cost and Benefits

- 1.9 Following the views expressed by both CIPFA/LASAAC and FRAB the proposals seek to balance the potential costs and benefits of implementing valuation based measurement for RoU assets. To assist the Board's scrutiny of the proposals key aspects of consideration are briefly noted below.

Potential Cost Considerations

- a. The cost of an individual valuation for a (or each) RoU asset. This will clearly vary for each RoU asset but a valuation methodology that requires more valuer time will normally increase costs.
- b. The volume of RoU assets that may be required to be specifically valued
- c. A requirement for unnecessary judgements to justify, and evidence, the approach taken for each RoU asset (or group of RoU assets).
- d. Software capacity to cater for significant volumes of RoU asset valuation measurements have been noted as a concern, specifically a need to adapt private sector 'cost based' systems. This applies to ongoing annual or recurring costs as well as initial investment.
- e. The expectation that in most cases the current value of an RoU asset would not be significantly different from the cost model carrying value. This view was supported by valuation professionals.

Potential Benefit Considerations

- a. The principle of current value, and particularly Existing Use Value, is central for public sector financial reporting. Representing the cost of replacing service potential can inform assessment of the risk arising from loss of an asset. 'Current value' based depreciation charges can indicate the current cost of service provision resulting from the consumption of an asset. This information may, for some organisations, be relevant for asset management planning, such as investment and maintenance decisions.
- b. The treatment of assets leased in on finance leases is considered to be generally equivalent to that of owned assets. This provides comparable information regarding significant assets used for service delivery. Moving to a cost model for all RoU assets would remove this information from financial reports.

Potential Benefit Considerations

- c. The use of cost as a proxy is already allowed in some instances in both the Code and the FReM, and thus allowing similar appropriate flexibility for specified RoU assets is possible.

Overview of the Proposal

- 1.10 The proposal seeks to ensure that valuation is only undertaken, and only considered necessary, for those right of use assets where a significant difference between current value (Existing Use Value or Fair Value dependent on RoU asset type) and the IFRS 16 cost model is expected to be significant.
- 1.11 In general terms the proposal specifies that:
 - a. The default is to use the IFRS 16 cost model as a proxy for current value for RoU assets unless this is considered inappropriate. This is applied on an asset by asset basis.
 - b. Use of the IFRS 16 cost model is expected to be inappropriate where *both* of the following conditions are met:
 - i. A longer-term lease has no provisions to update lease payments for market conditions (eg rent reviews, relevant indexation) or there is a significant period of time between those updates
And
 - ii. There is a significant risk that the fair value or existing use value will fluctuate due to changes in market prices. The draft notes that this may particularly apply to property assets. This is intended to prevent revaluation of a significant volume of non-property assets.
 - c. The application of the criteria however may be rebutted, for example where there is evidence that despite both criteria being met the IFRS 16 cost model is not significantly different from the existing use value
- 1.12 Appendix A provides a detailed comparison of the previous Code draft and the new proposals. To assist scrutiny and transparency the end column indicates specific aspects for CIPFA/LASAAC attention and discussion. Clearly this is not intended to preclude other implications or issues from discussion.

- 1.13 Appendix B provides an extract of the key text as proposed for the Code draft.

Valuation Considerations

- 1.14 Valuation professional input, from both central government and local government sectors, was influential and extremely appreciated during the development of the proposals.
- 1.15 The Code normally focuses on the measurement basis to be applied to assets (eg existing use value, fair value etc) rather than provide specification as to the measurement methodology.
- 1.16 The FReM includes more specific coverage of valuer responsibilities. For example [the FReM 18/19 para 7.1.3](#) specifies that the valuer determines the appropriate measurement methodology for property, plant and equipment.

- 1.17 The Code draft has not been amended to reflect anticipated valuation practices or guidance however CIPFA/LASAAC will wish to be aware of some aspects as they will affect IFRS 16 practical implementation. These are briefly noted below as a basis for further discussion.

Valuation Considerations

- a. Valuer professionals noted that a number of approaches may be taken to the valuation of property RoU assets. In particular two key methods noted were:
 - i. 'Tenant calculation' approach – this would indicate the additional cost that would be incurred, up until the next rent review or indexation point, that an incoming (replacement) tenant for the asset would be expected to pay. Consequently the difference between the cost model and the valuation would not normally be significant.
 - ii. 'Landlord calculation' approach – this would seek to identify the cost to the landlord of replacing the remaining service potential of the asset for the rest of the lease term. Consequently the difference between the cost model and the valuation may normally be more significant.
- b. Following discussions it is considered that ii is a more appropriate methodology for determining existing use value for property RoU assets. The proposed FReM specifically indicates this.
- c. It has been indicated that guidance for valuers would be required to support understanding and consistent application of the landlord calculation method, since it departs from normally applied practices for the private sector.
- d. Valuation colleagues have indicated that the unit cost ('per calculation') would not differ significantly between the two options (i and ii).
- e. Discussion also noted that a market based valuation should always provide a reasonable proxy for fair value. In some rare instances it may not provide a satisfactory proxy for EUV. This may arise due to changes in service delivery arrangements (eg a smaller replacement property asset might be required) or legislative changes.
- f. Neither the FReM nor the Code proposals provide specification on this matter. It is anticipated that professional valuer practices and/or guidance can address the matter.
- g. In addition the risk of overstatement of an EUV may be regarded as being addressed through the application of RoU asset impairment review requirements.

- 1.18 CIPFA/LASAAC may wish to note that the FReM proposals, which are subject to potential amendment, include the following text:

"a valuer should calculate the full replacement cost of the right-of-use asset by identifying the current market rental value (or rent that could be achieved for existing use) of the right-of-use asset and capitalise it for the full remaining lease term from the valuation date. The Royal Institution of Chartered Surveyors (RICS) will publish guidance for valuers consistent with the above."

Risk Considerations

- 1.19 In scrutinising these Code proposals for measurement of RoU assets CIPFA/LASAAC will wish to consider key risks and whether the proposals, or other arrangements, effectively manage these risks. The following are suggested as example areas for consideration:

Risk Consideration	Possible Risk Management
a. Code proposals do not support CIPFA/LASAAC vision statement	Amendment to the proposed Code requirements and consideration of FReM implications.
b. Alignment with the FReM	Will require continuing co-operation and mutual (informal) agreement before the first body finalises a position.
c. Cost / benefit balance is not optimal eg a high number of (normally property) RoU assets will require to be valued	Amendment to the proposed Code requirements and consideration of FReM implications. And/or Some reliance may also be placed on non-Code / third party guidance
d. Ambiguity or lack of clarity for practitioners and auditors regarding evidence requirements to support RoU asset measurement.	Amendment to the proposed Code requirements and consideration of FReM implications. And/or Some reliance may also be placed on non-Code / third party guidance
e. Ambiguity, or lack of clarity, for valuers regarding implementation and compliance practices.	Reliance on valuation professional practices and/or guidance And /or Amendment of the Code proposals to specify valuation expectations

Risk Consideration	Possible Risk Management
f. Ambiguity, or lack of clarity, regarding transition requirements for RoU assets carried at current value	Amendment to the proposed Code requirements and consideration of FReM implications. And/or Some reliance may also be placed on non-Code / third party guidance

Recommendation and Requested CIPFA/LASAAC Action

1.20 The secretariat recommends that the Code proposals in appendices A and B for the subsequent measurement of right of use assets are approved.

1.21 CIPFA/LASAAC is requested to:

A. Scrutinise the Code proposals in appendices A and B

B Approve or amend the Code proposals

B.Comparison to FReM Proposals

1.22 [CIPFA/LASAAC's Terms of Reference](#) require the board to inform FRAB of departures from accounting standards and differences from the FReM.

1.23 In doing so CIPFA/LASAAC will consider the requirements of local government stakeholders.

1.24 The table in Appendix C provides a brief comparison of the current Code and FReM approaches to IFRS 16 implementation. The current status of each difference is noted below:

Difference (FReM Implementation Plans not included in the Code)	Status
a. Permits restricted early adoption in 2018/19	Discussed later in report
b. Includes intra UK Government non-legally binding arrangements	Previously accepted
c. Extends definition of a lease to include 'nil consideration' arrangements	Not previously determined
d. Peppercorn leases: <ul style="list-style-type: none"> • RoU assets may be recognised at EUV instead of Fair Value • Specifies treatment for heritage assets 	Previously accepted

**Difference
(FReM Implementation Plans not
included in the Code)**

Status

- | | | |
|----|--|--|
| e. | Interest rate specified by government where own incremental rate or implicit rate unavailable. | Previously accepted |
| f. | Right of Use Asset subsequent measurement | Alignment sought (see earlier) |
| g. | Transition: use of hindsight, for instance in determining the lease term, is mandatory | FRAB has queried the difference |

1.25 Regarding the use of hindsight on transition CIPFA/LASAAC had requested some further information regarding the potential impact of mandating this. Discussions with local government practitioners included:

- a. The situation may arise where an initial lease had previously expired but had been subsequently rolled forward on an annual basis. In this instance, unless it was clearly indicated that the lease would be rolled forward for more than one year (eg it was part of asset management planning that the property would remain in service for the next three years), the lease would be treated as a short term-lease. In this scenario it is not clear that mandating hindsight would affect the decision to treat as a short-term lease.
- b. Potential concern was noted concerning the workload requirements that may apply if each individual lease is examined. Practitioner concern was expressed that this may arise under mandating (ie additional work to prove or establish the actual history of the lease).
- c. It was noted that retention of the option as allowed by IFRS 16, would enable each local authority to make its own cost-benefit decision regarding hindsight application. This would avoid the risk that a mandatory requirement might, in some circumstances, result in an undesirable cost-benefit balance.

1.26 CIPFA/LASAAC may wish to consider amending the transition requirements to apply an interpretation that the use of 'hindsight' is mandatory subject to cost-benefit consideration. It is considered that this would narrow the difference with the FReM, provide a clearer indication of expectations but still maintain scope for local determination to avoid increased costs.

1.27 Precedence for cost-benefit consideration exists in the Code in respect of Heritage Asset valuation (Code 4.10.2.6). The amendment could be implemented as indicated:

Existing 4.2.2.93 d) .“a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.”

Alternative 4.2.2.93 d): “a lessee will use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease, but only where the cost of using hindsight is commensurate with the benefits to users of the financial statements”

- 1.28 It is considered that this would narrow the difference with the FReM, provide a clearer indication of expectations and maintain scope for local determination to avoid increased costs.

Recommendation and Requested CIPFA/LASAAC Action

- 1.29 The secretariat recommends that CIPFA/LASAAC considers making the use of 'hindsight' mandatory subject to cost-benefit consideration**

- 1.30 CIPFA/LASAAC is requested to:**

- A. Scrutinise and challenge the basis for differences between the Code and the FReM proposals identified in Appendix C.**
- B. Confirm to FRAB that it regards the differences between the Code and FReM proposals as appropriate for local government, or amend the Code proposals**

C. Service Concession Arrangements (PFI/PPP)

- 1.31 CIPFA/LASAAC will be aware that responses to the IFRS post-implementation review process in 2018 included a request for more specification regarding Service Concession Arrangements (SCA).
- 1.32 The matter was consequently included in the 19/20 Code ITC.
- 1.33 CIPFA/LASAAC will also be aware that the responses to the 19/20 ITC on the use of IFRS 16 to measure SCA liabilities indicated that:
- 38 per cent (30 respondents) supported the proposal to measure the service concession arrangement (PFI/PPP Schemes) liability as a lease liability (using IFRS 16 which would require recalculation of the liability on indexation application)
 - 35 percent (28 respondents) disagreed with the approach, and largely advocated the alternative of retaining the current measurement provisions based on IAS 17
- 1.34 The report on the ITC responses noted
- The Secretariat would recommend that the accounting requirements for service concession arrangements as a whole be reviewed with a focus on the measurement of the service concession arrangement liability and the recognition of income for third party payments.
 - The Secretariat would recommend that a group be established with local authorities that have service concession arrangements and experts in the field. The sub group should also consider the approach taken by UK GAAP on the recognition of third party payments.
- 1.35 CIPFA/LASAAC agreed the proposed actions.
- 1.36 The current Code proposals related to IFRS 16 implementation include the measurement of SCA liabilities using IFRS 16 lease liability measurement.

1.37 Significant proposals which depart from IFRS or differ from the FReM are required to be notified to FRAB for consideration.

Recommendation and Requested CIPFA/LASAAC Action

1.38 The secretariat recommends that CIPFA/LASAAC:

- a. Identifies members to participate in the working group**
- b. Develops proposals for inclusion in the 20/21 ITC**
- c. Plans for early review of Code ITC responses regarding liability measurement**
- d. Plan for early approval of the Code 20/21 requirements regarding IFRS 16 Leases, separately from the main 20/21 Code.**

1.39 CIPFA/LASAAC is requested to:

- A. Approve or amend the recommendation regarding the measurement of SCA liabilities**

D.Potential Early Adoption By Bodies in 2019/20

1.40 The FReM proposes allowing bodies which meet the following criteria to adopt the FReM IFRS 16 implementation requirements early i.e. effective from 1 April 2019 (19/20 year).

1.41 The criteria to do so, which all have to be met, are expected to be:

- a. The entity has a subsidiary/ subsidiaries which applies EU adopted IFRS; and
- b. The total assets of the subsidiary/ subsidiaries comprise 10% or more of total group assets; and
- c. The subsidiary/ subsidiaries have operating lease commitments that comprise 10% or more of group operating lease commitments; and
- d. HM Treasury provides approval to early adopt

1.42 The criteria are anticipated to apply to two entities.

1.43 Specific adjusting information is anticipated to be required from early adopters for the Whole of Government Accounts consolidation exercise.

1.44 The Code proposals do not currently allow for early adoption.

1.45 One local government entity (Transport for London) has indicated that it would wish to early adopt IFRS 16 for the 2019/20 financial year, for similar reasons to those applying in central government.

1.46 The entity concerned reports that:

- a. It has a significant number of entities (30) within the group structure, with the majority (24) preparing accounts under EU adopted IFRS.
- b. The 24 entities hold all the group's material leases.

- c. Significant dual reporting and adjustments will arise if consolidated at the local government level is required without early adoption of IFRS 16.
- d. Users of its accounts would benefit from a comprehensive and consistent view, between the different individual reporting entities (eg [Transport for London Code based accounts](#) and [London Underground Limited](#) EU IFRS accounts), of lease liabilities and assets.
- e. It has already undertaken significant work on IFRS 16 implementation and anticipates being able to comply with IFRS 16 requirements
- f. WGA adjustments would be anticipated to be required in the event of early adoption. The entity considers that it will be able to provide relevant adjustment data, both for new leases in 19/20 and for leases commencing before 1 April 2019.
- g. While notification of permission to early adopt would be appreciated as soon as possible, it is understood that this may be provided during 2019/20. A CIPFA/LASAAC decision by 1 April 2019 is not essential.

1.47 Further considerations for CIPFA/LASAAC will include:

- a. The Code provisions for IFRS 16 would presumably require to be finalised, with no expectation of later amendment, before permitting early adoption.
- b. In the event of amendment to the code provisions the entity would face a risk of requiring to restate its 2019/20 figures in the 20/21 accounts.
- c. Central government and private sector initial implementation of IFRS 16 during 2019/20 may provide early feedback of implementation challenges, either technical or logistical.
- d. The entity may not be the sole body which would wish to early adopt.
- e. It is however not clear that there will be a significant number of entities which would
 - o Include subsidiaries reporting under EU adopted IFRS, and which also meet similar criteria to those for central government
 - o Wish to early adopt even where the criteria are met
- f. Alignment with the FReM may be considered desirable
- g. Liaison with central government on the WGA requirements would be appropriate
- h. The implications for the National Accounts will also need to be assessed via liaison with HM Treasury / ONS.

Recommendation and Requested CIPFA/LASAAC Action

1.48 The secretariat recommends that CIPFA/LASAAC agrees to discuss the implications of early adoption with the entity, the WGA team and HM Treasury / ONS.

1.49 CIPFA/LASAAC is requested to:

- A. Approve or amend the recommended action regarding the request for early adoption of IFRS 16 in 19/20**