Appendix 4 to Agenda Item B2

Background

IFRS 16 is a financial reporting standard issued by the International Accounting Standards Board (IASB) that primarily deals with lease accounting. The standard is not specifically tailored for the public sector; it applies to both public and private sector entities. The standard replaces IAS 17 Leases.

IFRS 16 introduces a significant change in how leases are accounted for by lessees (defined as the entities that obtain the right to use an asset for a specific period in exchange for lease payments).

Under the previous standard (IAS 17), lessees classified leases as either operating leases or finance leases, with only finance leases being recognised on the Balance Sheet. Under the new standard (IFRS 16), most leases are now recognised on the Balance Sheet, as the distinction between operating and finance leases is removed. This means lessees are required to recognise a lease liability representing their obligation to make lease payments and a corresponding 'right-of-use' asset, reflecting their right to use the leased asset.

The introduction of IFRS 16 aims to enhance transparency and comparability in financial reporting by bringing leases onto the Balance Sheet.

The standard was issued in January 2016 and was originally planned to be adopted by local authorities in 2020-21 but was initially deferred to 2021-22. Due to the pressures on finance teams during and after Covid-19, the adoption has been deferred further to 2024-25.

The CIPFA Code of Practice contains specific guidance for local authorities which KCC Finance have considered and incorporated into their draft Accounting Policy. In reviewing the leases held by KEIFCA, the same policy and guidelines are used.

Identifying Relevant leases

The types of assets within scope of IFRS 16 include property lease agreements, residential tenancies, vehicles, and large contracts are assessed as leases for the purposes of IFRS 16.

Easements, licences, licences to carry out works, agreements for a lease and office equipment (unless the individual asset value exceeds £10,000) are excluded.

All leases held by KEIFCA have been reviewed against the exemptions (see below). Most of the leases (mainly office equipment and defibrillators) are exempt. The new standard does however apply to the building leases - The Sail Loft, Brightlingsea and Paragon House, Ramsgate.

Exemptions

The standard excludes leases which are considered 'short term'. Short term leases are defined as leases that have a lease term of 12 months or less at the commencement date of 1 April 2024. Therefore, leases which have a lease end date of 31 March 2025 or earlier are excluded. The only exception to this is for holding over leases (see below).

The standard allows authorities to elect not to apply IFRS 16 lease accounting to leases where the underlying asset is of low value. The low value exemption applies to the asset value when it is new, irrespective of its age. The assessment is made on a lease-by-lease basis, and the assessment is on an absolute basis (therefore it applies to individual assets).

To ensure consistency between capital expenditure accounting for Property, Plant & Equipment, a low value exemption limit of £10,000 has been implemented. This ensures that the treatment of both owned and leased assets is presented in the same manner on the Balance Sheet.

Holding Over Leases

While this does not apply at this time, should the property leases expire without renewal but with continued agreed occupation, this section may then be relevant.

A remaining lease term is required to calculate the lease liability under IFRS 16. For leases which are still within their lease term, the original lease dates as per the agreement can be used to determine the lease end of the lease period, subject to any additional clauses which are expected to be taken, such as an extension or break clause.

In the case of expired leases where there is a 'holding over' position usually amounting to a [legally defined] 'periodic tenancy', the remaining lease term is commonly accepted to be a rolling period equivalent to the rent payment dates (e.g. monthly, quarterly etc.) along with a statutory notice period (3 months for the tenant, minimum 6 months for the landlord). This is automatically the position with a lease that has not been contracted out of the Landlord and Tenant Act 1954 but will also be the case where a tenant has remained in occupation and continued to pay rent even if the original lease was contracted out.

For the context of IFRS 16, holding over leases occur when a tenant stays, with consent from the landlord, in occupation of a lease beyond its expiry date, without renewing or entering a new agreement. Using the notice period for these leases (which is usually around three months) would mean these leases are treated as short term. However, as these agreements generally hold over for a longer period, it is more appropriate to recognise an asset and liability on the Balance Sheet.

In the absence of a lease end date, these leases will be treated as having a three-year lease term, KCC Finance and Infrastructure colleagues considered the three years as an appropriate management planning timeframe after which it cannot be reasonably certain of business decisions in relation to these leases.

It is important to recognise that the assumed lease end date is used solely for the purposes of accounting for IFRS 16 and does not reflect either KCC's or KEIFCA's commercial position nor does it represent the commercial reality of any agreement with a third party.

Assessing the lease term

It is a requirement of IFRS 16 to assess the lease term where there are options to terminate or extend. Lease options will be reviewed annually.

Valuations

Both leased buildings are charged at market value rent. The Sail Loft, Brightlingsea has 3 yearly rent reviews over a 10 year lease. Paragon House, Ramsgate is a 5 year lease. Both of these are of a short enough duration that rents reflect current market values, so additional valuations are not required.

Changes to the accounts as a result of implementation of IFRS16

Assets :

New Fixed Asset set up for Right of Use Assets this includes Paragon House, Ramsgate and The Sail Loft, Brightlingsea. The asset value is the expected cost of the remaining full term rental from 01/04/24	169,015.50
Right of Use Asset depreciation and Interest Charge. The depreciation is calculated annually and is based on the lease term. There is also an interest charge which is based on daily Bank of England interest rates	(27,038.79)

Liabilities:

Right of Use Assets Long term liability -to offset the asset on the balance sheet, the liability for the lease is also recorded. The long term liability is for the rental liability for the term of the lease, but reduced each year by the annual lease charge value which is held in the short term liability code	(117,056.31)
Right of Use Assets Short term liability – this is for the liability within the current year	(26,562.26)
Surplus credit in the balance sheet which is the difference between the cost of the right of use asset and the depreciation / interest charges. This is recorded as a balancing figure	(1,641.86)

Change to Revenue budget:

Credit of the rental costs for Paragon House and the Sail Loft to revenue budget subjectives	(32,878.00)
Depreciation - charged to the revenue budgets	27,038.79
Interest - charged to the revenue budgets	7,481.07
Surplus charged to the Revenue budgets – this nets off to the balance figure	1,641.86