Agenda Item No. 7

South Ayrshire Council

Report by Chief Financial Officer to Audit and Governance Panel of 26 February 2025

Subject: International Financial Reporting Standard 16 – Update to Accounting for Lease Contracts

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1. Purpose

1.1 The purpose of this report is to inform Members of the upcoming changes to the reporting of leases due to the mandatory implementation of International Financial Reporting Standard (IFRS) 16 and to seek approval to add a new accounting policy in advance of the 2024/25 financial year end

2. Recommendation

2.1 It is recommended that the Panel:

2.1.1 notes the mandatory implementation of IFRS16 for 2024/25; and

2.1.2 approves the introduction of a new draft IFRS16 Accounting Policies shown in 4.3.

3. Background

3.1 From 1 April 2024, a new International Financial Reporting Standard, IFRS 16, is coming into effect for Local Authorities. IFRS 16 introduces a new 'Right of Use' asset class to the balance sheet and recognises a corresponding lease liability. This is a mandatory requirement and applies to all leases - property, land, vehicles, plant, and equipment.

3.2 IFRS 16 is primarily intended to bring more transparency to leases in companies' financial statements. By reducing the number of leases that are off balance sheet and allowing users of financial statements to make more informed comparisons between companies in particular sectors, the result is greater transparency.

3.3 Despite not having the same comparative and investment requirements as the private sector, IFRS 16 also applies to the public sector. So, whilst finance leases are already accounted for as an asset and corresponding lease liability on the Council Balance sheet, from 1 April 2024 any operating leasing commitments must also be accounted for on the balance sheet (aside from some exemptions).

3.4 An operating Lease permits the use of an asset without transferring the ownership rights of said asset whereas a Finance Lease. The majority of existing operating leases held by the Council will come on to the balance sheet in 2024/25.

3.5 Any operating lease agreements (new and existing) now create a new debt in the Council’s accounts, over the life of the lease. This has financial implications for the Council’s Treasury Management Strategy, its Capital Programme, and its Financial Statements. Under IFRS 16, all leases are now classified as capital expenditure and must be included in the Capital Programme.

3.6 The standard also considers 'Embedded Leases' which exist if there is an explicit or implicit identified asset in the contract and the customer controls the use of the asset, in order to continue the service. Work needs to be undertaken to identify these leases.

3.7 Previous Operating and Finance Lease arrangements where the Council is the lessee will now be accounted for under the new standard. There is no change where the Council act as a lessor.

4. Proposals

4.1 ***Key matters for consideration***

4.1.1 When a lease contract is signed, this commits the Council to a debt liability in exchange for the control of an asset for a fixed period of time. It is, therefore, important that the correct ‘value for money’ procedures are undertaken, and the correct approvals are in place for the value of the lease agreement. This is managed through the Councils Scheme of Delegation.

4.1.2 Under the new standard a lease will require to be included in the Capital Programme for the total value of the leased asset and, therefore, contracts previously paid through revenue will now need to be included in the Capital Programme at their total cost over the life of the scheme and funded through the creation of a debt, which is equivalent to the total lease liability. The debt will be financed through the annual lease payment to the supplier through Capital Financing from Current Revenue (CFCR) payments shown in revenue.

4.1.3 The Council will require to amend the prudential indicators reported in the Treasury management strategy and will be reported in the Treasury Management and Investment Strategy 2025-26:

4.1.4 Under the standard, the Council is able to set a de-minimis policy to exclude smaller office furniture type leases from the technical accounting requirements. The Council’s current de-minimis level is £5,999. In line with procurement procedures i.e. approval over £10,000 is the minimum requirement, it is intended to now increase the de-minimis level to £10,000. This will then allow all new contracts to be captured.

4.1.5 A disclosure of the value of leases falling under this policy will be required within the Council's Statement of Accounts. At the time or writing report the value of the lease liability is estimated to be £1.812m. The data will continue to be collated with a final figure reported in Annual Accounts for 2024-25.

4.1.6 The standard also makes provision to exclude any leases than run for less than 12 months or that have less than 12 months remaining on 1 April 2024. The Council will also be required to disclose the value and number of leases that fall into this category as part of the Statement of Accounts. As part of considering whether lease arrangements should be included in the exemption, the Council needs to consider what the intention is rather than just the legal form of the lease arrangement. If the lease arrangement has previously been allowed to run on and/or there is no alternative provision for this asset or service, then the lease should be accounted for on this basis. This poses some difficulties when calculating and accounting for lease arrangements but does more accurately reflect the Council's exposure to debt and asset base.

4.2 ***PPP arrangements***

4.2.1 The new standard also impacts the accounting for Service Concession Arrangements (SCA's). Under the previous accounting standard, International Accounting Standard (IAS) 17, when the value of payments change in a way which is not predetermined in the lease contract (for example where payments are increased in line with an inflation index such as RPI or CPI) the increase in payments arising from indexation is treated in the same way as finance costs and expensed in the period to which the payment relates. This additional payment is known as contingent rent.

4.2.2 Under IFRS 16 a different treatment is applied: where indexation or changes in a rate affect future payments, the lease liability is remeasured. The net present value of future payments that comprise the liability is recalculated based on the revised level of payments. Increases (or reductions) in expenditure are realised as increases (or reductions) in the amortisation charge taken against the remeasured liability.

4.2.3 The Treasury Team, alongside the Councils Treasury Management consultants, have determined a revenue benefit in the short to medium term linked to the councils three PPP arrangements. Appendix 1 shows the combined repayment comparisons between IAS17 and the new IFRS16 requirements.

4.2.4 For 2024/25 this benefit is estimated to be a reduced revenue cost of £1.788m, and whilst this figure will be finalised at the year end, it is considered prudent to include the impact of this change on the overall financial status of the council for 2024/25. This has been factored into recent Budget Management Reports to Cabinet.

4.3 ***New Accounting Policy***

4.3.1 It is proposed that the following draft wording be added to the Council's Accounting Policies for the financial year 2024/25 thereby ensuring compliance with the Cipfa Code of Practice requirements. A final version of the policy will be included in the draft Annual Accounts for 2024/25 presented to the Audit and Governance Panel in June 2024.

PPP (to be added to current accounting policy)

Under IFRS16, where indexation (or other changes in a rate) affects future service concession payments, the lease liability requires to be remeasured. Instead of *expensing the increased payment, the net present value of future payments that comprise the liability is recalculated based on the revised level of payments.*

Right of Use assets

The Council adopted IFRS 16 (Leases) with effect from 1 April 2024. The main impact of the requirements of IFRS 16 is that, for arrangements previously accounted for as operating leases (i.e. without recognising the leased vehicles, plant, equipment, property and land as an asset, and future rents as a liability), a right-of-use asset and a lease liability are now included on the balance sheet from 1 April 2024. The Council has elected to apply recognition exemptions to low value assets (below £10,000 when new) and to short term leases i.e. existing leases that expire on or before 31 March 2025, and new leases with a duration of less than 12 months. 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.

As noted under the PPP policy above, with effect from 1 April 2024 IFRS16 also applies to Service Concession Agreements and recognition of the resultant remeasurement of the lease liability.

4.4 Members are asked to note the mandatory implementation of IFRS16 for 2024/25 and agree the introduction of the new draft IFRS16 Accounting Policies as outlined in 4.3 above.

5. Legal and Procurement Implications

5.1 There are no legal implications arising from this report.

5.2 There are no procurement implications arising from this report.

6. Financial Implications

6.1 As outlined in above.

7. Human Resources Implications

7.1 Not applicable.

8. Risk

8.1 ***Risk Implications of Adopting the Recommendations***

8.1.1 There are no risks associated with adopting the recommendations.

8.2 ***Risk Implications of Rejecting the Recommendations***

8.2.1 Should the recommendations be rejected, then the Council will not be in compliance with the CIPFA Code of Practice on Treasury Management.

9. Equalities

9.1 The proposals in this report do not require to be assessed through an Integrated Impact Assessment.

10. Sustainable Development Implications

10.1 ***Considering Strategic Environmental Assessment (SEA)*** - This report does not propose or seek approval for a plan, policy, programme, strategy, or document otherwise described which could be considered to constitute a plan, programme, policy, or strategy.

11. Options Appraisal

11.1 An options appraisal has not been carried out in relation to the subject matter of this report.

12. Link to Council Plan

12.1 The matters referred to in this report contribute to Commitment 1 of the Council Plan: Fair and Effective Leadership/ Leadership that promotes fairness.

13. Results of Consultation

13.1 There has been no public consultation on the contents of this report.

13.2 Consultation has taken place with Councillor Ian Davis, Portfolio Holder for Finance, Human Resources and ICT, and the contents of this report reflect any feedback provided.

Background Papers	**CIPFA IFRS 16**
Person to Contact	**Tim Baulk, Chief Financial Officer** **County Buildings, Wellington Square, Ayr, KA7 1DR** **Phone 01292 612620** **E-mail tim.baulk@south-ayrshire.gov.uk**

Date: 17 February 2025

Revised PPP schedule of payments

Year ending	Period no.	Total previous charges	New LFR schedule	Variance
		IAS 17	IFRS 16	
		£'000	£'000	£'000
31/03/2025	1	4,448	2,660	(1,788)
31/03/2026	2	4,675	2,810	(1,865)
31/03/2027	3	4,907	2,968	(1,939)
31/03/2028	4	5,143	3,135	(2,009)
31/03/2029	5	4,991	3,311	(1,680)
31/03/2030	6	5,217	3,498	(1,719)
31/03/2031	7	5,448	3,694	(1,754)
31/03/2032	8	5,684	3,902	(1,782)
31/03/2033	9	5,926	4,122	(1,804)
31/03/2034	10	6,721	4,354	(2,367)
31/03/2035	11	7,001	4,599	(2,402)
31/03/2036	12	7,288	4,858	(2,431)
31/03/2037	13	7,583	5,131	(2,453)
31/03/2038	14	7,886	5,420	(2,467)
31/03/2039	15	9,417	5,725	(3,693)
31/03/2040	16	5,805	6,047	242
31/03/2041	17	3,119	6,387	3,268
31/03/2042	18	3,295	6,746	3,451
31/03/2043	19	3,480	7,126	3,646
31/03/2044	20	3,676	7,527	3,851
31/03/2045	21	3,883	7,950	4,067
31/03/2046	22	4,101	8,398	4,296
31/03/2047	23	4,332	8,870	4,538
31/03/2048	24	4,576	9,369	4,793
		128,605	**128,605**	**0**