

Meeting: IPSASB Consultative Advisory Group

Meeting Location: Stellenbosch, South Africa

Meeting Date: December 5, 2016

From: João Fonseca

Agenda Item 7

For:

☐ Approval

☒ Discussion

☒ Information

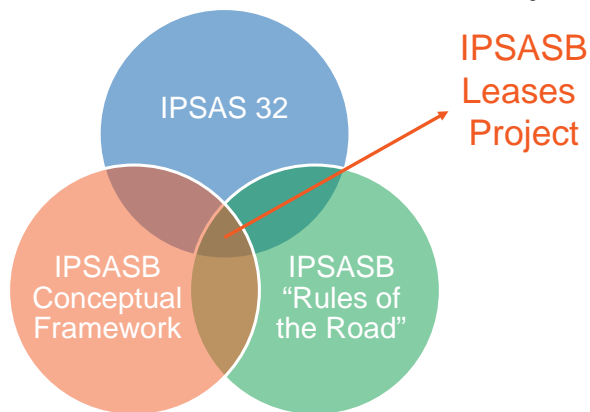
LEASES

Project summary	Develop revised requirements for lease accounting covering both lessees and lessors in order to maintain convergence with IFRS 16, <i>Leases</i> , to the extent appropriate. The project will result in a new IPSAS that will replace IPSAS 13, <i>Leases</i> .	
Meeting objectives	Topic	Agenda Item
Discussion Items	Lack of symmetry between lessee and lessor accounting in IFRS 16 and the users' needs of public sector financial reports	7.1
	The subsidized component of a concessionary lease and the users' needs of public sector financial reports	7.2
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Other supporting items	Summary of IPSASB Project on Leases	7.4

Lack of symmetry between lessee and lessor accounting in IFRS 16 and the users' needs of public sector financial reports

- Figure 1 below shows that the IPSASB Leases project is constrained by IPSAS 32, Service Concession Arrangements: Grantor, The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the *Conceptual Framework*), and the IPSASB's Policy Paper, Process for Reviewing and Modifying IASB Documents (also known as "Rules of the Road").

Figure 1 – Boundaries of IPSASB Leases Project



- IPSAS 32 has the following characteristics:
 - Grants rights to use the underlying asset (right to access/operate);
 - Follows a control based approach to identify the underlying asset; and
 - Mirrors IFRIC 12, *Service Concession Arrangements*.
- The Conceptual Framework follows a control based approach for assets where derecognition of assets occur in the context of transfer of control, measurement uncertainty, and inexistence of economic benefits.
- The Rules of the Road requires that, when public sector issues warrant a departure from an IASB document, all IPSASB's decisions will be made in the context of considering consistency with the Conceptual Framework and internal consistency with existing IPSASs.
- As indicated above, the IPSASB has formed a view that the recognition requirements of lessee accounting in IFRS 16 are appropriate for public sector financial reporting. However, the IPSASB considered that the risks and rewards model for lessor accounting in IFRS 16 is not appropriate for public sector financial reporting.

6. IFRS 16 introduces a single lessee accounting model—the right-of-use model— where the lessee recognizes a right-of-use asset¹ and a lease liability² (except for short-term leases³ and leases for which the underlying asset⁴ is of low value) in the statement of financial position. However, the lessor continues to apply the risks and rewards incidental to ownership approach where leases are classified as finance leases and operating leases.
7. In a finance lease, the lessor derecognizes the underlying asset and recognizes a lease receivable as the net investment in the lease⁵. In an operating lease, the lessor continues to recognize the underlying asset, but does not recognize a lease receivable. Instead, the lessor recognizes lease payments as revenue on either a straight-line basis or another systematic basis.
8. When both lessee and lessor are public sector entities, this lack of consistency of approaches leads to the following situations:
 - (a) If the lessor classifies the lease as a finance lease, the underlying asset is neither recognized by the lessee nor by the lessor; and
 - (b) If the lessor classifies the lease as an operating lease, the lessor does not recognize a lease receivable.
9. These accounting treatments are not consistent with *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the *Conceptual Framework*) because both the underlying asset, and the lease receivable meet the definition of an asset.
10. In this context, it can be argued that, when items that meet the definition of an asset are not recognized in the financial statements, it can impair the objectives of public sector financial reporting of accountability and decision-making, and, as a consequence, such a treatment would not be in the public interest.
11. The **CAG's views are sought** on whether the non-recognition of the underlying asset by either the lessee or by the lessor, and the non-recognition of the lease receivable by the lessor meet the users' needs of public sector financial reporting.

¹ An asset that represents a lessee's right to use an underlying asset for the lease term.

² Corresponding to the present value of the lease payments that are not paid at the commencement date.

³ A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

⁴ An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

⁵ The gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is the sum of:

(a) The lease payments receivable by a lessor under a finance lease; and

(b) Any unguaranteed residual value accruing to the lessor.

The subsidized component of a concessionary lease and the users' needs of public sector financial reports

1. Quite often public sector entities and international organizations enter into a “peppercorn lease”⁶ or concessionary lease for the whole period of use of the underlying asset. This type of leases usually occur between public sector entities and between international organizations.
2. IFRS 16 requires initial recognition at cost. This means that when leases are granted at below market value, the historical cost in IFRS 16 does not capture the subsidized component in the lease.
3. Concessionary leases share one common feature with concessionary loans: both are non-exchange transactions. The IPSASB’s literature already provides guidance on how to account for concessionary loans.
4. Guidance on accounting for the subsidized component of concessionary loans for recipients is in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*, and guidance for transferors is in IPSAS 29, *Financial Instruments: Recognition and Measurement*.
5. According to IPSAS 23⁷, the recipient recognizes as revenue the difference between the transaction price (loan proceeds) and the fair value of the loan (the subsidized component) on initial recognition, except if a present obligation exists⁸. Where a present obligation exists, it is recognized as a liability. As the recipient satisfies the present obligation, the liability is reduced and an equal amount of revenue is recognized.
6. According to IPSAS 29, in the transferor’s accounts the subsidized component “is treated as an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners. Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference may represent a capital contribution, i.e., an investment in an entity, rather than an expense.”⁹
7. Staff considers it in the public interest that transactions with the same economics are accounted in the same way.
8. At the December 2016 meeting, the IPSASB will discuss applying the same accounting treatment on the subsidized component of concessionary loans to concessionary leases.
9. The **CAG’s views are sought** on whether applying the accounting treatment on the subsidized component of concessionary loans to concessionary leases meet the user’s needs of public sector financial reporting.

⁶ “Peppercorn leases” are leases that are not exchange transactions as defined in *The Glossary of Defined Terms for IPSASs*. “Peppercorn leases” can also be called concessionary leases or subsidized leases.

⁷ See IPSASB 23.105B

⁸ For example, where specific conditions imposed on the transferred assets by the recipient result in a present obligation.

⁹ IPSAS 29.AG89

Agenda Item 7.3

Outreach events to communicate the IPSASB's consultation documents on Leases

1. As stated above in Agenda Item 7.1, the IPSASB decided not to apply the IFRS 16 requirements for lessor accounting. This decision may raise questions from the IPSASB's constituents, many of whom are also IASB's constituents.
2. During the development of a Standard, the IPSASB publishes consultation papers and exposure drafts to receive feedback from its constituents.
3. More recently, the IPSASB has been producing webinars to present proposals. The IPSASB staff is also thinking participating in or organizing some outreach events (roundtables, conferences, and meetings with regional bodies that have a public sector accounting capacity).
4. The **CAG's views are sought** on what other types of activities the IPSASB could initiate to best reach out to its constituents.

Summary of IPSASB Project on Leases

Background

1. IPSAS 13, *Leases*, was issued in December 2001. It is a converged standard based on International Accounting Standard (IAS) 17, *Leases*.
2. In January 2016, the IASB issued International Financial Reporting Standard (IFRS) 16, *Leases*, which supersedes IAS 17. It also supersedes three interpretations: IFRIC 4, *Determining whether an Arrangement contains a Lease*, SIC-15, *Operating Leases-Incentives* and SIC-27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.
3. IFRS 16 introduces "a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value"¹⁰. The lessor accounting in IFRS 16 remains substantially the same as in IAS 17. IFRS 16 retains the dual lessor accounting model in IAS 17, in which leases are categorized as operating leases and finance leases.
4. IFRS 16 is effective for annual periods beginning on or after 1 January 2019 with earlier application permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, at or before the date of initial application of IFRS 16.
5. Many public sector entities use leasing arrangements for gaining access to assets, which they use in service delivery. Leasing is a means of obtaining finance, and of reducing an entity's exposure to the risks of asset ownership. The prevalence of leasing means that it is important that users have a complete and understandable picture of an entity's leasing activities.
6. Like IAS 17, lease classification using IPSAS 13 has focused on the extent to which the risks and rewards incidental to ownership of a lease lie with the lessor or the lessee. IPSAS 13 classifies leases as either finance leases or operating leases. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership. For finance leases, the lessee recognizes assets and liabilities in the statement of financial position. For operating leases, the lessee accounts for lease payments as an expense on a straight-line basis over the lease term.
7. This model has been criticized for failing to meet the needs of users because:
 - (a) The resulting financial statements do not always provide a faithful representation of leasing transactions, because they omit resources and obligations that, conceptually, meet the definitions of an asset and a liability, particularly for operating leases; and
 - (b) The significant difference in recognition requirements for finance and operating leases has created incentives to structure transactions as operating leases to achieve off-balance sheet accounting.

¹⁰ Paragraph IN10 of IFRS 16

8. The IASB noted that, as a result, many users adjust the amounts reported in a lessee's financial statements to reflect the assets and liabilities arising from off-balance sheet leases, and make other consequential adjustments. Because of the limited information provided by the financial statements, such estimates may be inaccurate. In contrast, other users do not make adjustments. This creates asymmetry and leads to unreliable information in the market.
9. The objective of the IPSASB's Leases project is to develop revised requirements for lease accounting covering both lessees and lessors in order to maintain alignment with the underlying IFRS, while taking account of relevant public sector circumstances. The project will result in a new IPSAS that will replace IPSAS 13. The intermediate objective is to publish an Exposure Draft on Leases.

History of the project

10. In June 2016, the IPSASB approved the [Project Brief, Leases](#). The Project Brief identified seven key issues.
11. At the same meeting, the [IPSASB](#)¹¹:
 - (a) Formed a view that the recognition requirements of lessee accounting in IFRS 16 are appropriate for public sector financial reporting;
 - (b) Decided to adopt the IFRS 16 recognition exemptions in the new IPSAS on Leases because a public sector reason to warrant different recognition exemptions was not identified;
 - (c) Decided that the recognition exemptions mirroring those in IFRS 16 should be an option, rather than a requirement, in the new IPSAS on Leases;
 - (d) Considered that the appropriateness of the risks and rewards model for lessor accounting in IFRS 16 for public sector financial reporting is a key issue.
 - (e) Acknowledged that the IASB faced several difficulties with lessor accounting during the development of IFRS 16; and
 - (f) Concluded that it was necessary to know in more detail what were the difficulties that the IASB faced with lessor accounting and whether those difficulties are also applicable to public sector financial reporting.
12. At the September 2016 meeting¹², the IPSASB took the view that a symmetrical approach to lease accounting is more appropriate for public sector financial reporting because often public sector entities are lessee and lessor in the same contract. For example, quite often there are public sector entities working as centralized lessors, whose sole function is to lease out assets to other public sector entities.
13. The retention of IFRS 16 requirements in lessor accounting creates a conflict with the IPSASB's Conceptual Framework and the IPSAS 32, *Service Concession Arrangements: Grantor*. Therefore, the IPSASB decided not to adopt the lessor accounting requirements in IFRS 16, *Leases*.
14. The IPSASB also made a tentative decision not to include explicit guidance in an exposure draft on the assessment of a sale within the context of a sale and leaseback transaction based on a

¹¹ Please find [here](#) the Agenda Item 7, Leases.

¹² Please find [here](#) the Agenda Item 8, Leases.

performance obligation approach, prior to any decision on, and development of, an IPSAS drawn from IFRS 15, *Revenue from Contracts with Customers*.

Current stage of the project

15. At the December 2016 meeting, the IPSASB will consider:
- (a) Two approaches of the right-of-use model to lessor accounting;
 - (b) Measurement of leases; and
 - (c) Sale and leaseback transactions.

Further information

16. [Agenda Item 8.3.2](#) of the IPSASB September 2016 meeting includes a brief history of the IASB's project on Leases, and [Agenda Item 7.5](#) of the IPSASB June 2016 meeting provides the reasons why the IASB decided to retain the risks and rewards model in IFRS 16.