ACAG Australasian Council of Auditors-General

2 July 2018

Ian Carruthers
Chair
International Public Sector Accounting Standards Board
277 Wellington Street West
Toronto, ON M5V 3H2

Dear Mr. Carruthers

Exposure Draft ED 64 *Leases*

The Australasian Council of Auditors-General (ACAG) welcomes the opportunity to comment on the IPSASB Exposure Draft ED64 *Leases*.

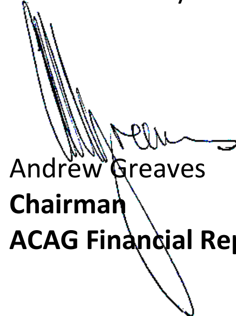
The views expressed in this submission represent those of all Australian members of ACAG.

ACAG agrees with the decision to adopt IFRS 16 *Leases* accounting for lessees. However, ACAG disagrees with the current proposals for lessor accounting and supports the use of IFRS 16 accounting for lessors, based on the finance and operating lease classification.

We have also raised concerns regarding the accounting for concessionary leases for both lessees and lessors. The attachment to this letter addresses the specific matters for comment outlined in the Exposure Draft.

ACAG appreciates the opportunity to comment and trust that you will find the attached comments useful.

Yours sincerely



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ATTACHMENT

IPSASB Exposure Draft ED 64 *Leases*

Specific Matter for Comment 1
The IPSASB decided to adopt the IFRS 16 right-of-use model for lessee accounting (see paragraphs BC6–BC8 for IPSASB's reasons). Do you agree with the IPSASB's decision? If not, please explain the reasons. If you do agree, please provide any additional reasons not already discussed in the basis for conclusions

ACAG agrees with the decision to adopt IFRS 16 accounting for lessees.

Specific Matter for Comment 2
The IPSASB decided to depart from the IFRS 16 risks and rewards model for lessor accounting in this Exposure Draft (see paragraphs BC9–BC13 for IPSASB's reasons). Do you agree with the IPSASB's decision? If not, please explain the reasons. If you do agree, please provide any additional reasons not already discussed in the basis for conclusions.

ACAG disagrees with the decision. ACAG supports the use of IFRS 16 accounting for lessors, based on the finance and operating lease classification. Our reasons are similar to IASB's reasons for rejecting similar proposals to those contained in ED 64 (refer IASB Exposure Draft ED/2010/9) including:

- the lack of support for derecognising components of non-monetary assets based on rights
- existing lessor accounting requirements work well in practice.

ACAG disagrees that keeping the current finance and operating lease distinctions for lessors would involve more issues on consolidation (refer paragraphs BC10 and BC11). ACAG expects that most intra-government accounting will be operating leases. ACAG believes that the ED 64 proposals would require greater consolidation processes.

Specific Matter for Comment 3
The IPSASB decided to propose a single right-of-use model for lessor accounting consistent with lessee accounting (see paragraphs BC34–BC40 for IPSASB's reasons). Do you agree with the requirements for lessor accounting proposed in this Exposure Draft? If not, what changes would you make to those requirements?

ACAG disagrees with the proposed lessor accounting for numerous reasons, including:

Assets effectively sold remaining on balance sheet

In Australia, there have been numerous government entity privatisations that have involved "selling" infrastructure assets on 99-year leases. Under these leases, the government lessor has transferred to the operator substantially all the risks and rewards of the underlying assets, with the infrastructure required to be returned in a suitable condition at the end of the lease. Infrastructure assets privatised have included airports, electricity distribution and transmission assets, and ports. Also, in some instances, Crown land has been leased out on 99-year terms.

Under the ED 64 proposals, recognition of the underlying asset would be subject to IPSASB 9 *Revenue from Exchange Transactions*, which is currently based on a risk and return assessment. It is unclear whether assets that are effectively sold (per the current definition of a finance lease) would be required to remain on balance sheet under the ED 64 proposals as the assets would be subject to a lease.

The lease receivable is not a financial asset
The proposals state that the lease receivable meets the definition of a financial asset (refer for example BC9, BC41, and BC58). However, ACAG believes that the lease receivable is not a financial asset, as the lessor does not have the unconditional right to receive cash. Leases are often subject to termination clauses because of the failure of the lessee or lessor to meet their contracted responsibilities.

ACAG agrees that a lease receivable has the characteristics of a financial asset, and that some financial instrument accounting (such as impairment and de-recognition) is applicable. However, given that the definition of a financial asset is not met, ACAG questions whether the IPSASB's reasoning for recognition of lease receivable as a financial asset is appropriate.

Double counting of certain types of assets
ACAG believes that some assets may be double counted under these proposals. For example, an investment property will often be valued by reference to future cash flows. However, under the proposals, the future cash flows represented by existing leases of these properties will require the recognition of an additional asset. Therefore, the same cash flows will be recognised in two assets.

This would also be the case where an asset is subleased. The right-of-use leased asset (lessee accounting) will represent future use of cash flows from the asset. Under the ED 64 proposals, the lessee will not use the asset for any of that time, and instead receive future cash flows from the sublease. Yet, the ED 64 proposals suggest the lessee will recognise a right-of-use asset, as well as a future rentals receivable asset.

Financing effect on results of lessors
ACAG disagrees with lessors' results being impacted by the financing effect of imputed interest on the lease receivable and straight-line revenue recognition for the amortisation of the credit.

Fair value of underlying asset
It is not clear how the revaluation of public sector property, plant and equipment will operate under the ED 64 proposals. Fair valuing such assets (particularly land, buildings, and infrastructure) is common in Australia. Under the ED 64 proposals, would the underlying asset (e.g. PPE) be revalued in full, but the portion "monetised" as a lease receivable and remain at historical value?

The proposed unearned revenue is not a liability
ACAG disagrees that the proposed unearned revenue is a liability, as there is no expected outflow of resources to another entity.

Recognising the credit against the asset would result in confusing valuation of public sector assets
When considering the ED 64 proposals, ACAG considered the consequences of having to recognise the credit for the lease receivable against the underlying asset i.e. derecognising the underlying asset into the lease receivable and residual components (where residual is the asset to be returned at the end of the lease). A concern was in relation to fair valuing the residual of the underlying asset. ACAG is unclear from the proposals how revaluing that portion of the underlying asset would be performed and whether it would provide useful information to users.

Specific Matter for Comment 4(a) (Lessors)
For lessors, the IPSASB proposes to measure concessionary leases at fair value and recognize the subsidy granted to lessees as a day-one expense and revenue over the lease term consistent with concessionary loans (see paragraphs BC77–BC96 for IPSASB's reasons. Do you agree with the requirements to account for concessionary leases for lessors and lessees proposed in this Exposure Draft? If not, what changes would you make to those requirements?

ACAG disagrees with requiring an upfront recognition of a grant expense (representing the discounted amount "lost" for future lease payments) and the recognition as revenue of this discounted amount on a straight-line basis over the lease term.

ACAG believes that if IFRS 16 accounting is followed, there should be no upfront grant expense, or impairment of the underlying asset, as the underlying asset is being used for its intended purpose.

Our main reasons for disagreeing are:

- The requirement to recognising an upfront opportunity cost and recognising the benefit over time
- the proposed accounting (of an upfront expense) is counter intuitive for a public sector entity providing public services
- the total revenues recognised do not equate to the undiscounted imputed market rentals.

As noted above, the total revenues recognised under the ED 64 proposals do not equate to the undiscounted imputed market rentals. Below is a calculation of the revenue and expenses based on ED 64 illustrative example 23:

Interest revenue	$2,493,471
Revenue (unearned over time)	$23,000,000
Total	$25,493,471

This amount differs to the total "market rent" of 5 x $5,312,420 = $26,562,100. The difference appears to relate to interest not being imputed on the upfront subsidy.

Specific Matter for Comment 4(b) (Lessees)
For lessees, the IPSASB proposes to measure concessionary leases at fair value and recognize revenue in accordance with IPSAS 23 (see paragraphs BC112–BC114 for IPSASB's reasons). Do you agree with the requirements to account for concessionary leases for lessors and lessees proposed in this Exposure Draft? If not, what changes would you make to those requirements?

ACAG agrees with the proposals to recognise upfront grant revenue for a concessionary lease, and a corresponding right-of-use asset (and subsequent depreciation). However, ACAG is unsure of the proposals to distinguish concessionary leases between those with zero or nominal consideration and the remainder. ACAG believes that different outcomes may arise as different standards are applied.

ED 64 proposes that concessional leases (for lessees) should be accounted for under IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers).* We don't consider it is clear that all concessional leases would be recognised under IPSAS 23. In relation to lessors, ACAG requests clarification on which accounting standard(s) the IPSASB is referring to, given the absence of an IPSAS standard for expenses. Further, ACAG believes that all concessionary leases should be accounted for within one standard.

ACAG also have identified the following issues relating to concessionary leases by lessees:

Excessive compliance cost on lessees
ACAG believes that the proposals are likely to cause excessive costs for lessees. ED 64 defines a concessionary lease as a lease at below market terms. This would require all leases to be checked for whether any rentals are, or are not, at market rates – potentially a significant cost burden for lessees.

In Australia, concessionary leases accounting is dealt with an Australian specific accounting standard, AASB 1058 *Income for Not-for-Profit Entities*. This standard's concessionary lease provisions only apply to those leases that have *"significantly below-market terms and conditions principally to enable the entity to further its objectives"*. This ensures there is a threshold where lessees will not be unnecessarily burdened by having to search for situations to determine if the lease terms and conditions are at any amount below market rates.

ACAG believes that without such a suitable threshold in ED 64 that entities will have to incur significant costs on transition in identifying concessionary leases.

Accounting effects on lessees
ACAG notes that many public sector lessees disagree with the proposed accounting and the effect on their results (i.e. large upfront revenue recognition and increased subsequent depreciation expense) arguing that it is not representative of their underlying activities. They suggest either not recognising the subsidy at all, or recognising the subsidy over time (and matching the depreciation of the right-of-use asset).

While the proposed illustrative example to be included in amendments to IPSAS 23 (paragraph IG55) refers to upfront and deferral, ACAG considers that depending on conditions, this would likely change to only upfront if the IPSASB adopts the performance obligation approach for revenue recognition.

Valuation issues
While the equivalent requirements are not yet operational in Australia, ACAG have encountered a number of issues in the valuation of concessionary leases. These include:

Market Participant

1. What / who is the market participant for a concessionary lease to a not-for-profit entity?
2. Should valuations be based on commercial market rates that would be paid by a for-profit entity, even though the arrangements would not actually be made available to a for-profit entity?
   Should valuations be based on the rent that a not-for-profit entity could afford to pay? How would this be determined?
3. Should a deprival value notion be considered, i.e. that if a not-for-profit had to pay commercial lease rates, would it continue to operate?

Fair Value

4. How should any legal restrictions and conditions on concessionary leases of a specialised nature be accounted for?

5. What is the fair value of a right-to-use asset under a 99 year lease when the lessor has the right to terminate the lease with no penalty on shorter notice (for example two years)? A market participant (i.e., not a related party) would ordinarily not contain a 99 year lease term. They would only value the right as being for two years use, or potentially some risk adjusted premium on the understanding that the lessor would not terminate the lease early.

Contingent Rent option

6. What is the fair value of a concessionary lease with contingent rent? If the fair value is based on fixed rent, and then the lease liability for the minimum payments (possibly nil) are deducted, large upfront revenue for a 'notional' subsidy would be recognised. Such accounting would not reflect substance of the actual lease agreement (i.e., arbitrary), as the subsidy would have to be measured against a comparable (contingent) rent for an applicable market participant.

Other Matters

ACAG provides the following specific paragraph comments for consideration:

Paragraph 27—While ACAG notes the paragraph 27 requirement for the lessee in a sublease to use the head lease discount rate, ACAG believes that in some situations there may be differences in the head lease rate and what would otherwise be used. For example, the lessor has a lease for a considerably different term than that leased to the lessee, or where the sublessee is not a controlled entity. ACAG notes that paragraph 29 (concessionary leases) overrides the requirement for subleases, requiring a market interest rate to be used.

Paragraph 58—ED 64 proposes a maturing analysis disclosures for each of next 5 years, and then for the remaining years of the lease. ACAG suggests that disclosure requirements be consistent with lessees and IFRS 7 *Financial Instruments: Disclosures* and equivalent IPSAS 30.

Paragraph 73—ACAG questions if paragraphs 69(c) (initial direct costs) and paragraph 69(d) (dismantling and rehabilitation costs) are included within the fair value, or added to the fair value?

Paragraph 74—ACAG suggests that the paragraph be re-drafted to clarify that such that cost should be fair value (possibly with items in paragraphs 69(c) and 69(d) added), rather than that fair value is equal to cost.

Paragraph 128—ACAG seeks clarification on what is the residual value in relation to the transition provisions for leases previously classified as finance leases.

Paragraph 129—ACAG questions, in relation to the simplified transition method, should a similar choice (as for lessees) be given to recalculate unearned revenue from the start of the lease?

Paragraph AG37—ACAG questions why this differs to IFRS 16 (refer paragraph BC127) in relation to the assessment of lease term?

Paragraph AG41—(underlying asset with a low value) ACAG considers this guidance appears too generous as it ensures any lease would be low-valued if assessed within confines of how material it is the lessee's financial statements.