

Ian Carruthers, Chair  
International Public Sector Accounting Standards Board

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Dear Ian

**Auckland Council submission to the IPSASB Exposure Draft 64: Accounting for Leases**

Thank you for the opportunity to comment on the consultation document of the International Public Sector Accounting Standards Board (IPSASB) Exposure Draft 64, *Leases*.

Auckland Council is Australasia's largest local government entity and is made up of the Council and six substantive council controlled organisations. We invest heavily in infrastructure and many of our decisions will have a fiscal impact on Auckland's future generations.

We have given our responses to the specific matters for comment for the respondents as an attachment to this letter.

Once again, thank you for the opportunity to comment.

Yours sincerely



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## Exposure Draft 64 – Accounting for Leases

### Attachment – Auckland Council’s Responses to Specific Matters for Comment

#### 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 your reasons. If you do agree, please provide any additional reasons not already discussed in the basis for conclusions.

#### Auckland Council Response:

We agree with IPSASB’s proposal to adopt IFRS 16 right-of-use model for lessees. For Auckland Council Group that is a mixed group (being a group that includes both public benefit entities and for-profit entities), better convergence of public benefit entity (PBE) Standards with IFRS means fewer differences or adjustments during consolidation and reporting.

Auckland Council is also a bond issuer in the New Zealand Stock Exchange (NZX), Swiss and Singapore Stock Exchanges. Part of the Group’s requirements of the international stock exchanges is to identify differences between the PBE standards adopted by Auckland Council Group and IFRS. Thus, it is helpful for Auckland Council’s bondholders that there are only minor differences between PBE standards and IFRS in our financial statements.

We understand that the rating agencies such as Standard & Poor’s and Moody’s have different views on operating leases. These rating agencies make an adjustment to bring operating leases onto the balance sheet based on the net present value. The net present value is calculated at high level based on the current lease standards’ required disclosures on operating lease commitments. We believe that with the right-of-use model, we can account for a more precise net present value of operating lease liability since the calculation is based on more granular data.

#### 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.

#### 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?

#### Auckland Council Response

We do not agree with IPSASB’s decision to depart from IFRS 16 risks and rewards model for lessor accounting and the proposal to use a single right-of-use for lessor and lessee accounting.

We believe that the rationale provided under the basis of conclusion does not strongly support the decision to depart from IFRS 16. We also do not believe that the three key practical issues summarised (consolidation and asymmetrical information) under BC10 are more prevalent in the public sector. The consolidation issues being prevalent in the public sector are not thoroughly discussed and supported by the IPSASB in the basis of conclusion. We believe that there is also a significant number of consolidated groups in the for-profit entities with an entity within the group undertaking property management as this is one of the ways to centralise and be cost effective within a group structure.



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### Qualitative characteristics

Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of financial reporting (Chapter 3.6 of IPSASB's Conceptual Framework). We believe that the recognition of "right-of-use" asset and the corresponding lease liability by the lessee in its financial statements is relevant information. There has been a long history discussing the relevance of this information in the lessee's financial statements. As noted in our response to specific matter for comment 1 above, the rating agencies adjust the financial information in the financial statements by adding a right-of-use asset and a corresponding lease liability to reasonably account for all the obligations of the entity.

Whilst recognising a lease receivable by the lessor as proposed under ED 64 seems reasonable at first reading, we believe that recognising this asset does not provide relevant information to the users of the financial statements. As it is currently proposed, this requirement allows the entity to report overstated total assets in its financial statements. The carrying value of the underlying assets represent their future benefit potential. Adding a lease receivable asset overstates the total assets as it inflates the future benefit potential beyond what we expect to receive through use or ultimate sale.

There are notable differences between public sector and for-profit entities especially on revenue generating activities, however, public sector issuer entities such Auckland Council aim to prepare financial information for its users with minor differences between the two sets of accounting standards. One of the important users of Auckland Council's financial statements are the investors who also invest in listed for-profit entities. We believe that the difference in lessor accounting as presented in the financial statements of public sector and for-profit entities will deter comparability.

### Constraints on Information

Adopting new accounting standards always entails costs to ensure adherence to the new requirements, that information is properly gathered, and controls and processes are effectively in place.

Auckland Council Group is a lessor in some of our lease contracts and the proposed requirements of ED 64 will impact us. However, as noted above, we don't believe that changing the current requirements for lessors and departing from IFRS 16 gives the council group any benefits in preparing our financial reports. In this instance, we firmly believe that the cost of adopting ED 64's proposed lessor accounting requirements outweighs the benefits since we must ensure that 1) we've properly accounted for "the lease receivable" asset in our financial statements to meet the requirements of ED 64 and 2) we've identified this as a major adjustment to our financial statements for the investors to understand the difference between IPSAS and IFRS. Professional fees such as valuation fees and audit fees are expected to increase due to additional audit considerations.

### Double counting

We firmly believe that there is double counting on the recognition of the underlying asset and lease receivable on the balance sheet for lessors. An underlying asset is recognised in the financial statements of the entity since it is "*probable that the future economic benefits that are associated with the underlying asset will flow to entity and cost is measured reliably*". The basis of economic benefits for the underlying assets is the lease contracts for which it is now proposed to be recognised as a separate asset on the balance sheet under ED 64.

We believe that the IPSASB has not thoroughly addressed the double counting in the basis of conclusion. We note that this was one of the overwhelming areas of feedback from practitioners when IFRS 16 was being finalised. The current IPSASB literature mentioned under the basis of conclusion, to avoid double counting is applicable to current requirement in the accounting standards which do not recognise another type of asset based on the "right-of-use" model for lessors. The double counting is



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not also explicit in IPSAS 17, *Property, Plant and Equipment*, in consideration of fixed assets at revalued amount. Auckland Council Group, for example, has asset classes such as operational land and buildings which are both subject to lease contracts and for Group's use. Auckland Council Group's operational land and buildings is a significant asset class which is carried at revalued amount.

### Transfer of risks and rewards

Classifying a lease as operating or finance for a lessor is sometimes an onerous exercise as it involves significant judgement based on the terms of the lease agreement, however, this practice has been working well for all entities, whether for-profit, public sector or not-for-profit. The current lease accounting standard and IFRS 16 have provided examples of situations/indicators that individually or in combination would suggest a lease be classified as finance lease. These indicators and examples which serve as guidance for classification, are no longer available in ED 64 since the classification requirement is removed. However, if these situations occur, a higher level of judgement is now involved for management to assess if the underlying asset should be derecognised because control over the underlying asset might be lost. We know that lawyers and project managers are often thinking of these kinds of characteristics such as lease term being for the major part of the economic life of the underlying asset, in negotiating and finalising contracts.

We note that under the basis of conclusion on lessor accounting (BC9 c.ii), transactions that transfer control of the assets are considered sales or purchases within the scope of the current standards such as IPSAS 9 and IPSAS 17, which requires derecognition of underlying asset. However, the current guidance of IPSAS 9 and IPSAS 17 for sale of assets does not include lease terms that may suggest loss or transfer of control. We believe that ED 64 does not provide enough guidance if there is indeed loss or transfer of control of the underlying asset when those indicators are individually or collectively evident in the lease contracts.

### Service concession arrangement principle

We note that the IPSASB has considered the principle behind the "grant of a right to the operator model" in IPSAS 32 *Service Concession Arrangements – Grantor* under ED 64 Basis of Conclusion BC40. However, it is difficult to understand that the principle of service concession's "grant of a right to the operator" model is consistent or applicable to the right-of-use model for lessor accounting.

Under the service concession arrangement, if the criteria are met under paragraph 9, the grantor will recognise a service concession asset since the economic substance of the transaction suggests that the grantor is able to control the service and the significant remaining useful life of the asset. Recognition of the service concession asset and unearned income will still result in an increase in the net assets of the grantor. This is due to the service concession asset being depreciated over the useful life of the asset while the unearned income is amortised over the term of the agreement, which is essentially shorter due to the criterion that the grantor gets significant remaining useful life.

Unlike in lease arrangements, the grantor in a service concession arrangement does not normally receive a cash consideration from the use of the asset. The grantor receives the asset or an upgrade to the asset, thus, an accumulated unearned income is recognised at initial recognition. For simplicity, we recognise unearned income as a liability because we receive an asset that is not yet recognised in the balance sheet. Under ED 64 lessor accounting, we would recognise a "lease receivable" asset that is based on a legal contract which has already been considered an economic benefit of an underlying asset recognised on the balance sheet.

Also, under the proposed lessor accounting, the recognition of both lease receivable and the unearned income do not essentially result in an increase in net assets, as these are collected and amortised over the same period of time.



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### Recommendation

We propose that the IPSASB retains the operating and finance lease classification for lessor accounting consistent with IFRS 16. While we understand the theoretical arguments for the single right-of-use model for both lessee and lessor, we believe that there are fundamental flaws to the right-of-use model proposed in ED 64. We encourage a collaboration between the standard setting bodies such as the IPSASB and the IASB in addressing issues around the accounting standards which are not specific to public sector to avoid significant differences.

### Specific Matter for Comment 4

For lessors, the IPSASB proposes to measure concessionary leases at fair value and recognise 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). For lessees, the IPSASB proposes to measure concessionary leases at fair value and recognise 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?

### Auckland Council Response:

Although reasonable, we propose that concessionary leases should not be recognised at fair value. This view is largely based on consideration of the cost versus benefit for both preparers and users of the financial statements. The basis of conclusion discussed the importance of accountability to provide useful information in reporting of concessionary leases at fair value, as it shows the cost of the decision to grant the concession. We challenge this view of the IPSASB as we have observed that the decision makers within the council group do not require this information. Their focus is on providing facilities to deliver community services.

For Auckland Council Group, we are accountable to provide value for money to the ratepayers for every dollar of rates and user fees we collect. We believe that spending money to obtain a formal valuation for the thousands of concessionary leases of Auckland Council Group to comply with the proposed accounting standards is not a prudent use of ratepayers' funds and does not represent value for money. In addition, the elected members and the members of the committees are more interested in operating results, net of non-cash transactions, in order for them to make decisions over the prudent use of ratepayers' money.

### Concessionary lease – lessor

We do not agree with the proposed lessor accounting in relation to concessionary leases.

Within the council group, we believe that the ratepayers of Auckland do not want their money to be spent in completing fair value estimates of the concessionary leases to account for non-cash elements of services. As part of the initial evaluation exercise we have done, we've identified in excess one thousand three hundred concessionary leases entered into by Auckland Council and not-for profit entities, to operate from Auckland Council owned properties to provide community services such as pools, leisure, sporting events, etc.

### Concessionary lease – lessee

While we acknowledge the reasonableness of recognising the right-of-use asset at its fair value, we question the significant cost versus benefit particularly for smaller charitable entities. Obtaining the fair value of these concessionary leases that result in grossing up "non-cash" revenue and expenses does not represent value for money use of their sponsors or donors' funds. For those charitable entities supported by Auckland Council Group, we expect they will ask us to do the fair value assessment on their behalf or provide additional funding to them for this exercise. Either way, we will be spending additional ratepayers' money to comply with the required reporting with no improved service delivery benefit.



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### Standards that are included in IPSASB’s work plan

We also noted issues in the proposed requirement for concessionary leases that are related to the standards that are currently in the IPSASB’s work plan:

- 1) Fair value – the biggest issue for the concessionary leases is how to determine the fair value specific in the public sector. Unlike for-profit-entities who already have IFRS 13 *Fair value measurement*, entities in the public sector and not-for-profit currently do not have specific guidance on fair value. Determining fair value in the public sector remains a significant judgement. Specific to Auckland Council, we have an asset class of restricted land and buildings which by virtue of legislation, we are not allowed to sell or dispose. We have a number of concessionary leases in relation to these restricted assets and since these assets are restricted and are to be used to provide public service, the lease payments are always expected to be below market rates.

There are also significant number of lease arrangements between public sector entities at “peppercorn” consideration (nil or a dollar). We may conclude that the fair value of the lease arrangement is indeed a dollar or nil in the absence of specific guidance covering this kind of consideration.

- 2) Non-exchange revenue – during the last quarter of 2017, the IPSASB completed its consultation on Accounting for Revenue and Non-exchange Expenses. The current IPSASB literature does not include guidance on concessionary leases and yet ED64 has included a reference to IPSAS 23 for the accounting of the non-exchange component of concessionary leases. With this proposed requirement, management has to apply significant judgement in applying IPSAS 23, while noting that the standard is likely to change as a result of the consultation recently completed by the IPSASB. We suggest that the IPSASB consider including specific guidance on concessionary leases in the upcoming revenue standard.
- 3) Non-exchange expenses – as noted in above non-exchange revenue, we also note that the proposed requirements of ED64 refers to non-exchange component of expenses in a concessionary lease for lessors. We understand that the IPSASB has been working on accounting for non-exchange expenses for quite some time, thus, we recommend that the accounting for non-exchange expenses be finalised first ahead of guidance on concessionary leases.

### Recommendation

We agree that it is necessary for the IPSASB to issue a new lease standard based on IFRS 16. We believe that it is relevant in New Zealand to use public benefit entity (PBE) standards with minimal differences when compared to IFRS, especially for mixed groups. Auckland Council Group is a mixed group and has the same responsibilities as listed for-profit entities to provide financial information to New Zealand and international stock exchanges.

We recommend completion of guidance on non-exchange expenses ahead of finalising a guidance on concessionary leases.

We also encourage the IPSASB to cover the specific issues on concessionary leases especially in relation to determining fair value relevant to public sector entities, when finalising the standards on public sector measurement and the accounting for revenue and non-exchange expenses.

Specific to concessionary leases, we believe that to inform the users of the financial statements, it is reasonable to provide appropriate note disclosure of the entity’s concessionary leases, including “peppercorn” and nil value leases.