



Exposure Draft 64 - Leases

Comments of Ichabod's Industries on the Consultation Paper

Ichabod's Industries is an accountancy consulting firm that provides technical accounting support to a number of local government bodies in the United Kingdom. We have also been commissioned on a regular basis to draft guidance for the Chartered Institute of Public Finance and Accountancy, most recently on the application of IFRS 9 *Financial Instruments* and the Group Accounts standards by UK local authorities.

UK local authorities have not generally applied IPSASs, but a consultation on lease accounting has been opened by the relevant standard setter (the CIPFA/LASAAC Local Authority Accounting Code Board) which informs consultees about the IPSASB proposals for the lessor accounting model and asks for views.

We wish to contribute particularly to discussion on **Specific Matter for Comment 3**.

We are not convinced that the proposed right-of-use model is consistent with the IPSASB Conceptual Framework and properly reflects the substance of a lease transaction.

This arises fundamentally from our disagreement with the assertions in paragraph BC35 that the right-of-use asset is either a separate economic phenomena from the underlying asset or that it is a component of the underlying asset. In our view, the underlying asset is not intended by IFRS 16 to be an accounting concept but a descriptor of the physical item(s) that are the subject of the lease.

In this sense, the underlying asset is not something per se to be accounted for but a focus for the assessment of the resource represented by the leased property and how control is exercised over that property.

Applying the criteria for control in paragraph 5.12 of the Conceptual Framework, our view is that:

- the lessor retains legal ownership of the underlying asset
- the lessee acquires access to the resource represented by the underlying asset (or the ability to deny or restrict access to the resource) in its entirety on entry into the lease
- the lessee acquires the means to ensure that the resource is used to achieve its objectives
- the lessee has an enforceable right to service potential or the ability to generate economic benefits arising from the resource.

On the basis of past events, the lessor effectively transfers control of the entirety of the resource to the lessee, certainly in terms of the underlying asset. The lessee then determines through its use or misuse of the property whether it will be returned to the lessor in the expected state at the end of the lease. It is only the future event of the successful completion of the lease term that will actually return the underlying asset to the control of the lessor.

This can be seen with the example of a vehicle lease:

- at the commencement of the lease, the lessor hands over the keys and loses access to the vehicle
- the lessee then has access to the vehicle, the usage of which could lead to it being unable to deliver the identified vehicle back to the lessor at the end of the lease term – for example, it could be stolen or damaged beyond repair
- in these circumstances, it would be inappropriate for the lessor to account for the underlying vehicle asset as its Property, Plant and Equipment until control of the identified vehicle is returned to it at the end of the lease term and a past event then confirms the lessor's access

The appropriate model would then follow the existing lessor principles for finance leases in IFRS 16:

- on entry into the lease, the lessor derecognises the Property, Plant and Equipment asset in its entirety
- in its place, the lessor recognises its investment in the lease as an asset – the payments that the lessee will make for the right to use the vehicle, plus the value the lessee will return to the lessor at the end of the lease term (in the form of either the identified vehicle, a replacement vehicle and/or some other form of consideration to cover the lessee's inability to return the identified vehicle in the contracted state)
- the lessor recognises no liability, as it has satisfied its obligation to transfer the right-of-use asset when it put the vehicle into the physical care of the lessee
- at the end of the lease term, the lessor's investment is settled by the re-acquisition of a newly recognised Property, Plant and Equipment asset (or compensatory income)

This approach would more fairly represent the substance of the leasing transaction because:

- It does not require the lessor to assert during the lease term that it has a Property, Plant and Equipment asset that is available for use in the provision of goods and services at the end of each reporting period – its control over a PP+E asset will only be confirmed by the future event of the successful conclusion of the lease term.

The difficulties of continuing to carry a PP+E asset will be shown if the entity applies a revaluation model to its PP+E balances (as entities in the UK are required to do). To be consistent with the treatment in Approach 1, the valuation would presumably be based on the underlying asset in its entirety, ie, ignoring the fact that the property has been leased out on terms which might not currently reflect the fair value. To do otherwise would be to acknowledge that the underlying asset and the right-of-use asset are not separate economic phenomena.

- The lessor will not be accounting for a liability for an obligation that it is asserting it has yet to meet. It is difficult to see how the logic for setting up a lease receivable and recognition of a liability for unearned income would particularly for a contract for the supply of goods or services in return for specified periodic payments. The entity would have committed to transfer economic benefits to the receiver over the life of the contract in return for payment. Consistency with Approach 1 would require an asset and a liability to be recognised on entry into the contract, rather than as performance obligations arise and are met.

In summary, we consider that the role of the underlying asset is overplayed in the Exposure Draft and that a more appropriate lessor model would reflect that a lease passes control of the underlying property item to the lessee until such time as the future event of the termination of the lease confirms (or otherwise) the reacquisition of control over the identified underlying property.

A viable lessor model consistent with the Conceptual Framework would therefore be possible by extending the finance lease lessor model in IFRS 16 to operating leases.

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