International Public Sector Accounting Standards Board
Mr Ian Carruthers, IPSASB Chair
and Mr John Stanford, IPSASB Deputy Director
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Dear Mr Carruthers, dear Mr Stanford,

Exposure Draft on Leases

We are pleased to respond to the invitation from the International Public Sector Accounting Standards Board (IPSASB) to comment on Exposure Draft 64 Leases on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of those firms that commented on the Exposure Draft. "PricewaterhouseCoopers" or 'PwC' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We support the work the IPSASB undertakes to develop high-quality accounting standards for use by governments and other public sector entities around the world with the aim of enhancing the quality, consistency and transparency of public sector financial reporting worldwide.

- We agree with the conclusion to adopt the IFRS 16 right-of-use model for lessee accounting.

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- We also agree with the proposed model to depart from the IFRS 16 risks and rewards model for lessor accounting and to apply a "symmetrical approach" to lessee accounting with some caveats and proposed amendments.
- With respect to lessor accounting we prefer approach 2 (as per ED 64.BC35) for conceptual reasons, but could concur with approach 1 for practical reasons. If the IPSASB would follow approach 1 we believe some refinement or clarification to the ED 64 version is necessary.
- We agree with the proposal for concessionary lease and also have some suggestions for changes or clarification.
- Furthermore we give feedback on some aspects that have not been identified as "specific matter for comment" by the IPSASB.

Our detailed responses are in the Appendix to this letter.

If you would like to discuss any of these points in more detail, please contact Henry Daubeney ((+44) 20 7804 2160), Patrice Schumesch ((+32) 2 710 40 28) or Sebastian Heintges ((+49) 69 9585 3220).

Yours sincerely,

PricewaterhouseCoopers

PricewaterhouseCoopers

Appendix: Responses to the questions in IPSASB's Exposure Draft on Leases

1. 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.

We agree with the conclusion to adopt the IFRS 16 right-of-use model for lessee accounting.

As an additional reason, we would like to point out that the IFRS 16 right-of-use model also recognizes a lease liability related to future lease payments that meet the definition of a financial liability for all leases as compared to the risk-and-reward based model where the liability for operating leases is off-balance sheet. We note that financial analysts tend to adjust financial statements for this off-balance sheet liability.

2. 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.

We agree with the proposed model to depart from the IFRS 16 risks and rewards model for lessor accounting and to apply a "symmetrical approach" to lessee accounting with some caveats and proposed amendments.

We note that the conceptual framework establishes the concepts that are to be applied in developing IPSAS (CF para 1). In the proposed strategy and work plan 2019-2023 the IPSASB also confirmed its objective "to continue to work to maintain convergence with IFRS". We concur with the IPSASB that a "symmetrical approach" is more in accordance with the conceptual framework, whereas the "risk-and-reward" model is not. Therefore, we appreciate that the IPSASB is in a dilemma as to which objective it should follow.

We note that the IASB decided to keep the lessor accounting model as in IAS 17 for cost-benefit reasons and because of established past practice in the private sector. So, any reason to keep the IPSAS lessor model would not primarily be based on sound conceptual reasons, but rather on the desire to keep alignment with IFRS (which, in itself has merits). The IPSASB, however, believes that different cost-benefit considerations apply in the public sector and wants to align lessor accounting for the receivable with lessee accounting for the payable (see ED 64.BC11). We also note that the past practice of using IPSAS 13 is much less than was the case with IAS 17 in the private sector (many public sector entities still need to make the move to IPSAS). Along with the assumption that consolidation issues for leases are more prevalent in the public sector as compared to the private sector and that it is important to develop a consistent set of financial reporting standards, we understand that the IPSASB has not followed IFRS 16 for lessor accounting and instead, introduced the "symmetrical approach". It might also be beneficial that for the IPSASB to evaluate whether the cost of making a one-time change from current lessor accounting for those already applying IPSAS to the "symmetrical approach" is outweighed by cost-savings in following the "symmetrical approach" going forward, which might be easier to apply than following the operate/finance lease model and in accounting for intra-group leases. We invite the IPSASB to double-check that the cost-benefit justification is robust enough to justify this accounting treatment, thus respecting the IPSASB due process for departing from IFRS .

3. 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?

We agree that a lease is the sale of an unrecognized "right-of-use asset" and agree that the lessor shall recognize the lease receivable as an asset, which, as a separate economic phenomenon, is distinct from the underlying asset.

Preference for approach 2 for conceptual reasons

We generally concur with the analysis of approaches 1 and 2 (ED 64.BC 35). We note that the IASB also discussed a "gross" and a "net" approach in discussing lease accounting before it reverted to the "risk-and-reward model". We also note that the disadvantage of approach 1 is that it is difficult to substantiate the credit entry (lease liability), respectively unearned revenue. We note that the IPSASB itself had difficulties in justifying that aspect of approach 1 (ED 64.BC 53) and that this difficulty does not arise in relation to approach 2.

We agree that the lease receivable in the lessor's books should mirror the lease payable in the lessee's books. However, we do not agree with having the full asset recognised in the balance sheet, as it would imply double counting of the economic benefits that can be derived from that asset (so in this sense would not meet the definition of an asset). We believe it is wrong to compare this with a concession asset under IPSAS 32, as a grantor has control of a concession asset (including the way it should be used), whereas a lessor relinquishes control of the use of the asset for the duration of the lease term. The measurement of the underlying asset should therefore be reduced proportionately for the portion corresponding to the right-of-use granted. A receivable should be recognised (counterpart to the lessee's liability) and possibly a gain or loss is recorded in the lessor's books as the difference between the reduction in the carrying amount of the underlying asset and the lease receivable. Applying this treatment, no payable would be recognised in the lessor's books; which would also best reflect economic reality and reconcile with the definition of a liability in the framework. In fact, there is no liability: The credit entry does not represent a performance obligation of the lessor (to make the leased asset available) over the term of the lease, as the right of use asset has been delivered to the lessee at the commencement of the lease.

Proposed approach 1 is also inconsistent with the control concept. The lessor has transferred the right to use the underlying asset to the lessee for the term of the lease, and so it is unclear how the lessor retains control of the underlying leased asset during the term of the lease. We think that the rights of the lessor under a lease agreement consist of (i) the lease receivable, and (ii) the rights retained (residual rights) in the underlying leased asset, rather than the underlying asset itself. We agree that the right-of-use asset and the underlying leased asset are different economic phenomena. However, it does not follow that the economic benefits/service potential embodied in the right-of-use asset are additional to the economic benefits/service potential embodied in the underlying leased asset.

Could concur with approach 1 for practical reasons

We note that approach 2 is more difficult to apply in practise. The question arises what portion of the underlying assets should be derecognized at inception of the lease, is it a proportion in relation of the lease term in comparison of the useful life of the asset, is it based on a present value calculation or is it simply the same amount as the lease receivable. For this detriment we can also concur with approach 1 as proposed in ED 64.

The current IPSAS guidance on offsetting can also be a reason why this would be appropriate. IPSAS 1.48 points out that assets and liabilities shall not be offset unless required or permitted by any IPSAS. Offsetting should only be allowed if that reflects the economic substance of the transaction. We concur with the IPSASB that there are three different economic phenomenon being

- underlying asset
- lease receivable, and
- unearned lease revenue

and that based on their substance the liability should not be offset with any of the two assets:

- Though the entity might be restricted in the use of the underlying asset through the lease contract it is free to sell that asset to a third party as it has not sold but leased the asset. Therefore, it controls the underlying asset.
- The entity is entitled to the lease receivable as stipulated in the lease contract.
- The entity has to provide access to the leased asset during the lease term.

If approach 1 would be followed, further refinement necessary

We would like to point out the following:

- As pointed out in ED 64.BC 40 "a lease under the right-of-use model is in substance a sale of an unrecognized right-of-use asset." The lessor has transferred this right-of-use asset and therefore recognizes a lease receivable as financial asset. As we believe the nature of the credit entry can only be the lessor´s obligation to continually allow the lessee full access to the underlying asset, the liability is a **counterbalance to the underlying asset** and not to the lease receivable, as the lessor is restricted in using the leased asset. The lease receivable is initially measured based on the payment terms of the lease contract and subsequently reduced using the effective interest method depending on when contractual lease payments are made, whereas, in contrast, the access to the asset is granted on a continual basis. Therefore, we do not agree with the provision in ED 64.44 of subsequent measurement of the liability: "A lessor shall adjust the liability (unearned revenue) by the same amount as the change resulting from the remeasurement of the lease receivable." Payment terms of leases (e.g. up-front payments, key-money or lease free periods) may be, and often are, unrelated to access granted on a continual basis.
- For the same reason we propose consequential amendments to IPSAS 26 – Impairment of cash-generating assets to avoid double counting. The lease receivable is subsequently measured according to IPSAS 29. The underlying asset is subsequently tested for impairment according to IPSAS 26. As the cash flows during the lease period are reflected in the lease receivable (IPSAS 29), in order to avoid double-counting they may not be considered in the cash flows in determining the fair value less cost to sell (if a discounted cash flow model is used) or the value in use.. The IPSASB should explore whether it is more appropriate to

- either require an impairment test for the cash-generating-potential of the underlying asset and lease receivable together and consider the cash flows from the lease contract in the estimate of future cash flows or
- require an impairment test for the underlying asset excluding the cash flows from the lease contract, but deducting the unearned lease revenue as a liability based on IPSAS 26.87 (b).

4. Specific Matter for Comment 4

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). 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?

We agree that a lease contract at below-market terms includes a non-exchange component (concessionary lease) and will generally not constitute a lease agreed at a "bargain price" for the lessee. The non-exchange portion of the lease represents a grant or subsidy from a lessor to a lessee and a phenomenon that is specific to the public sector. It should be accounted for in accordance with similar phenomena already dealt with in IPSASB's literature.

We agree that the below-market component should be treated as a subsidy. This is consistent with other IPSAS requirements dealt with in other standards or projects. Specifically, we refer to the CP and upcoming ED on Revenue and Non-Exchange Expenses, which deal with donations, goods in kind and services in kind. These kinds of transactions are frequent in the public sector and should be made transparent in the financial statements. For example, some public sector entities sometimes receive large real estate properties at below-market conditions (even for free) for use throughout long periods; not recognising anything in the balance sheet would make financial statements less transparent and would not meet the accountability objective of financial statements. Public sector entities should show the resources entrusted to them. A simple disclosure would, in our view, not be enough.

We note that the following changes or considerations should be made with respect to concessionary leases:

- According to ED 64.AG61 (b) the lessor considers whether the concessionary component is a transaction with owners, in their capacity as owners (e.g. representing a capital contribution). We do not understand why accounting requirements for the lessee – receiving the capital contribution - are not consistent with lessor accounting (refer to ED 64.61 (a)). We would expect that the concessionary component, representing a capital contribution, is treated as such by the lessor and by the lessee.
- If a concessionary component is not a transaction with owners, it is treated as an expense at initial recognition by the lessor (ED 64.AG61 (b)). The entity receiving the concessionary lease recognizes revenue at initial recognition, except if a present obligation exists, in which case, it recognizes a liability (IPSAS 23.105C-105D). From a consistency perspective, we question why the lessor would not also consider whether to recognize an asset if the lessee recognizes a liability.
  We would like to draw the IPASB's attention to its current Revenue and Non-Exchange Expenses project. In example 10 (June 2018 Paper 9.2.3, Appendix A) a Central Government provides funds to a University for the construction of teaching space. The University is required to provide teaching for 30 years. In this example the non-exchange component (forgiveness of the loan) is recognized as an asset at initial recognition and expensed over time by the Central Government. We would expect that, had the Central Government not provided funds, but a concessionary lease, the concessionary component would equally not be recognized as an expense immediately, but deferred and recognized as expense over time.

  In our opinion, outcome of the Revenue and Non-Exchange Expenses Project for the non-exchange component and accounting for a concessionary lease component by the lessor as well as by the lessee should be consistent. This should be considered when finalizing the Leasing standard and the Revenue and Non-Exchange Project.

- We would assume that a concessionary lease might create some incentive at least for the lessee to continue the lease. We note that ED 64.16-19 and ED 64.AG29-37 on lease term have not been changed as compared to IFRS 16. We think the IPSASB should explore what effect a concessionary lease has on the lease term and include appropriate guidance.

5. Additional comments

In addition to our comments to the SMC above we would like to point out the following:

- ED 64.28: This is the definition of lease payments included in the ***lessor's*** lease receivable. ED 64.28(a) should state "...less any lease incentives ***payable***", instead of "...***receivable***".
- ED 64.41: This paragraph addresses the remeasurement of the lease receivables of the lessor. 41(a) does not fit the definition of lease payments in ED 64.28. "...amounts expected to be payable under a residual value guarantee" in refering to the definition of lease payments for the lessee (see ED 64.76). Residual value guarantees are included in the lessor's lease receivable as "any residual value guarantees", not "amounts expected to be payable". Also, as it is from the lessor's view, it should state "receivable", instead of "payable".
- What is the difference between ED 64.54(a) and (c)? "Variable lease payments that do not depend on an index or a rate", as stated in .54(a), are "variable lease payments not included in the measurement of the lease receivable", as stated in .54(c). Thus, both (a) and (c) refer to the same type of variable lease payments.
- ED 64.78: Why is the fair value of the lease liability calculated using the lessee's incremental borrowing rate? Shouldn't, in any case, a market interest rate be used to determine a fair value?
- ED.AG60 states: “An entity firstly assesses whether the substance of the concessionary lease is in fact a financing transaction, a grant or a combination thereof.” We note a contradiction in this sentence. We understand that leasing is a kind of financing. ED 64.15 states a concessionary lease is at below market terms. Therefore, in our understanding a concessionary lease can only be a grant or a combination of a financing and a grant. If it were a financing transaction without a grant, it would not be concessionary.
- In the public sector, the form of the arrangements in respect of concessionary leases may vary a lot, ranging from clear contractual arrangements to public promises or declarations of intent. Examples include buildings put freely or at below-market conditions by governments at the disposal of international organisations or other public sector organisations to attract them in their country or region. What constitutes an **enforceable right** and **determination of the lease term** in such circumstances might be judgmental and have a big impact on the amounts to be recognised in the balance sheet. Reflecting the impact of these arrangements in the balance sheet would meet the accountability objectives of financial statements and make the resources that are entrusted to the public sector entity transparent. We would welcome the IPSASB to provide more guidance on this matter to ensure consistency in the accounting of such arrangements.