Proposed International Public Sector Accounting Standard

“Leases”

REQUEST FOR COMMENTS

Task force IRSPM A&A SIG, CIGAR Network, EGPA PSG XII

June 22, 2018

The objective of the Exposure Draft is to develop a proposal for lease accounting, including both lessees and lessors, with the aim to provide relevant information in a manner that faithfully represents leasing transactions. The information included in the financial statements should be useful for users to assess the effect that leases have on the financial position, financial performance and cash flows of an entity for accountability and decision-making purposes

The Exposure Draft contains some questions in its REQUEST FOR COMMENTS. The responses prepared by the Task Force IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are presented hereafter.

The IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are three research networks that focus on Public Sector Accounting. The Task Force is made up of 16 researchers from these networks. The responses being presented are based on an analysis of the Consultation Paper, the IPSASB Conceptual Framework, relevant IPSAS, and various published research papers on the subject. Following various meetings and discussions, the members of the Task Force have reached the following common conclusions and suggestions.

The views expressed in this document represent those of the members of the Task Force and not those of the whole research community represented by the networks, nor the Institutions/Universities with which they are affiliated.

Core assumptions

We are of the opinion that, in general, public sector entities require public sector specific principles and standards that properly accommodate public sector specificities. As such, when public sector transactions resemble those taking place in the private sector, then principles and standards may be kept as aligned as possible. However, for public-sector-specific transactions, we are in favour of standards that are not confined to those of the private sector, and we think there is a need to seek options that best fit the public sector. This core thesis underpins our proposals and recommendations herein.

In our view, when the public sector deals with leasing contracts with an economic objective the proposed IPSAS is generally acceptable. In those cases where public sector characteristics play a role, such as when lease payments are explicitly very low in comparison to the economic value of the right-of-use, then the proposed IPSAS disregards the public interest, social and cultural goals, and related governmental initiatives. We believe that the financial effects of such social objectives should be reported clearly and should be made transparent to the *stakeholders off-balance sheet.*

<u>Specific Matter for Comment 1:</u>

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.

Comment

We agree that the right-of-use asset satisfies the definition of, and recognition criteria for, an asset in the IPSASB's Conceptual Framework.

The consideration of all leases as finance leases would result in the balance sheets of public administrations showing increased assets and liabilities. In the public sector, the control of debt and other liabilities are important issues. In this respect, the change to the proposed treatment will have an important effect. Nevertheless, it must be taken into account that public administrations often have many leases, and the application of the new requirements could sometimes prove difficult due to the lack of information on individual lease-type arrangements.[1] We would also highlight that the European System of Accounts 2010 (ESA10) retains the distinction between finance and operating leases, so that a difference between national accounting and financial reporting in the treatment of leasing transactions will be created. It would be useful to disclose the nature and extent of these differences in notes to the financial statements.

<u>Specific Matter for Comment 2:</u>

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.

Comment:

We agree

The risks and rewards model in IFRS 16 is an indirect approach to determine who controls the asset. According to the IPSASB conceptual framework, control of the asset should determine its recognition by the lessor, as well as by the lessee. In public administrations, it is very rare for the lessor to lose control of the underlying assets, so we consider the proposed treatment adequate.

[1] This was evidenced, for example, in the paper from the UK Treasury to the Financial Reporting Advisory Board (2017), entitled "IFRS 16 Leases-Progress update and feedback from the initial impact assessment".

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?

Comment:

We agree. We stated earlier, it is unusual for public administrations to lose control of the assets and therefore, the lessor should maintain the asset on its balance sheet. Furthermore, this model presents a coherent treatment for both lessee and lessor accounting.

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?

Comment:

We do not agree.

According to the IPSASB, a concessionary lease is an example of a financial arrangement, and should be recorded and reported as such by both the lessee and the lessor. In the concessionary situation, the contracted value of the right-of-use does not fit the market terms (often the payments are much lower than the market terms), so that the IPSASB proposed standard requires the recognition of non-earned amounts.

We believe that, in the public sector, the economic criteria and the fair value are not necessarily the main factors to determine about the recognition of transactions. A leasing contract with concessionary characteristics cannot be considered a pure financial arrangement because the reconstitution of all the amounts paid does not fit to the economic values of the rights-of-use. In profit-oriented enterprises, such a concessionary situation (perhaps between related parties) would indeed imply the expression of unearned amounts because enterprises think economically/financially; but in governments there are many other reasons why lease-type arrangements might not be based upon market values. For example, governments might enter a lease contract on concessionary terms to support common social or cultural goals of governmental organisations. In our view, concessionary leasing under these characteristics should not have balance sheet consequences, but only impact the statement of financial performance with additional disclosures describing the details of the concession in the notes to the financial statements.

A lease for zero or nominal consideration is a non-exchange transaction that could be considered as services in-kind. The services in-kind themselves are free and should not be accounted for in the general ledger. We believe that the quantification of the market value of the right-of-use asset would add much subjectivity to the balance sheet. Services in-kind should still be reported: they can have important consequences and should be documented, explained and disclosed off-balance sheet.

The treatment of concessionary leases in the proposed IPSAS might, nevertheless, be maintained where the lease has initially been contracted using economic reasoning but then the conditions change and the lease is adjusted to concessionary terms. For example, the terms of a “normal” leasing contract that has been made with a value corresponding to market prices between a central government (lessor) and a local government (lessee) might be adjusted if the local government undergoes serious financial difficulties so that the central government agrees to a partial remission of the debt by adapting the original contract. In this case, the concessionary lease includes a non-exchange transaction that could be considered as a capital grant received or transferred, which leads to the following reasoning:

(i) With respect to the lessor, we agree with the recognition of the subsidy granted to the lessee as an immediate expense, assuming that there are no further obligating events, and that there is a market value for the lease that can be identified so that the value of the concession can be measured reliably.

(ii) With respect to the lessee, the recognition and measurement of a concessionary lease should consider the non-exchange revenue as a capital grant at the initial point of recognition (corresponding to the day-one expense of the lessor). The remaining liability should be measured at the present value of the future lease payments, discounted using the interest rate implicit in the lease, if that rate can be readily determined.

OTHER COMENTS

Scope

Paragraph 3 and 4

The proposed standard is not applicable to rights held by a lessee under licensing agreements within the scope of *IPSAS 31, Intangible Assets,* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

A lessee may, but is not required to, apply this [draft] Standard to leases of intangible assets other than those described in paragraph 3

Comment:

The elimination of just some examples introduces uncertainty about the applicability of the standard. Due to the special characteristics of intangible assets, a specific section of the standard should deal with the leasing of intangibles.

Date: 22 June 2018 **Signed:**

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