Proposed International Public Sector Accounting Standard

"Leases"

REQUEST FOR COMMENTS

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

May 14, 2021

The IPSASB has requested comments and answers to specific questions regarding ED 75. The objective 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 comments and responses prepared by the Task Force IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are presented below. 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 18 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks, and neither of 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 favor of standards that are not adapted artificially from private sector accounting 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.

Lease arrangements are an implicit and material way to borrow, avoiding control and possibly rules in relation to borrowings. Also, sale-and-lease-back agreements may allow cash availability for current spending although they increase future payments for lease services. These are illustrative examples of issues on accounting for leases which were not properly addressed by the IFRS 16, as explained in the literature[1].

It should be noted that we have already participated in the consultation on ED 64[2], where we strongly supported the right-of-use asset approach as a single model for lessee and lessor accounting. We welcome the opportunity to comment on ED 75, however, we do not unreservedly welcome the IPSASB's decision to follow the two models approach in IFRS 16 for lessee and lessor accounting. We incorporate challenging specificities of the public sector in our response.

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[1] Biondi, Y. et al.: A perspective on the Joint IASB/FASB Exposure Draft on Accounting for Leases, Accounting Horizons, Vol. 25, No.4, 2011 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1768083

[2] https://www.ifac.org/sites/default/files/publications/exposure-drafts/comments/TASKFORCEComments_on_Proposed_IPSAS_Leases.pdf

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

> The IPSASB decided to propose an IFRS 16-aligned Standard in ED 75 (see paragraphs BC21–BC36). Do you agree with how the IPSASB has modified IFRS 16 for the public sector (see paragraphs BC37–BC60)? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

Comment

> The IPSASB decided to propose an IFRS 16-aligned Standard in ED 75 (see paragraphs **BC21–BC36**). …

In general, we are neither in favour of IPSAS merely aligned with IFRS 16 nor with the distinction of two phases. There are reasons not to follow the two models approach and particularities that justify a departure from IFRS 16 (mentioned as core assumptions above). Instead of the two models approach, we have pointed out in our comment to ED 64, that we prefer to have a single model to be applied for lessee and lessor accounting. We supported the right-of-use asset approach for lessee and lessor accounting. Therefore, reverting to the greatest possible alignment with IFRS 16 is a second best solution in our view. It leads to inconsistencies between lessee and lessor accounting and risks developing a standard for business-like leases rather than a specific one for the public sector. The risks and rewards model in IFRS 16 seeks to determine who controls the asset, and according to the conceptual framework, this should determine the criteria for the recognition of the lessor, as well as for the lessee. Nevertheless, it is very rare for public administration entities as the lessor to lose control of the underlying assets.

Furthermore, the two phase approach can lead to inconsistencies between the general business-like and the public sector specific accounting requirements for leases. In an exaggerated way, the distinction of two phases could be seen as an indication, that the IPSAS are treated as a subordinated set of standards driven by the IFRS only – in this case IFRS 16. Pushing governmental accounting through this "pipeline" is causing many difficulties and obstacles. Therefore, we are concerned about the fact that the accounting for specific transactions for public entities will only be added to the leasing standard retrospectively through the further phase, which aims to specifically address distinctive issues of public sector entities. Instead of starting from the context and examples of leasing coming from enterprises (IFRS 16), the IPSASB should first empirically look at the real governmental world and its many specific kinds of contracts, regulations and influences by governmental procurement and typical legal regulations. Based on these real world examples, the IPSASB should then think about the related accounting consequences, and then, finally, IFRS might be a reference, not the other way around.

Moreover, the current ED 75 does not seem to consider the many and very important and creative "arrangements" in governments, for e.g. military constructions, tunnels, roads, bridges, works of art, libraries, social housing, school buildings, etc. These arrangements do not aim at economic profits as in enterprises, but are public interest driven and, for financial reasons, they are very often implemented as Public Private Partnerships (PPP's, e.g. DBFM). This ED 75 Leases does not seem to consider any PPP arrangements.

… Do you agree with how the IPSASB has modified IFRS 16 for the public sector (see paragraphs **BC37–BC60**)? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

We do not agree with the decision not to provide additional guidance for determining the incremental borrowing rate (BC54 ff.). On the one hand, the lessor does not need the incremental borrowing rate. The lessor should always be able to determine the implicit rate of the lease, as the crucial information on the acquisition cost and the residual value of the lease asset after the lease term should be available to the lessor. Lacking this information, on the other hand, the lessee needs the incremental borrowing rate in order to measure the lease liability by the present value of future lease payments (ED 75.27). This interest rate is needed for initial and subsequent measurement. The judgements necessary to determine the incremental borrowing rate and its effects on debts and interest expenses do not ascertain comparability with respect to the lessee's lease accounting. As comparability has higher weight in public sector accounting than in the private sector, the argument that IFRS 16 adopters have similar difficulties is not convincing (BC55). On the contrary, the hint, that observable rates should be anyhow adjusted, provokes material divergence in practice between public sector entities which is in conflict of the need for comparability and the paramount objective of accountability.

Public sector entities have some particularities in the use of financial resources, debt and also in the interest rate that they can obtain. This requires providing some guidance about the definition of the incremental borrowing rate, considering the difficulties that its definition can have in the public sector in particular.

Specific Matter for Comment 2:

The IPSASB decided to propose the retention of the fair value definition from IFRS 16 and IPSAS 13, Leases, which differs from the definition proposed in ED 77, Measurement (see paragraphs **BC43–BC45**). Do you agree with the IPSASB's decision? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

We do not agree, as this introduces a foreseeable inconsistency in the IPSAS accounting regime between a "fair value, for the purpose of applying lessor accounting requirements" and the general fair value definition. The respective definitions are as follows:

	ED 75 / IPSAS 13	Measurement ED 77
IPSAS	Fair value, for the purpose of applying the lessor accounting requirements in this [draft] Standard, is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
IFRS	idem	idem

Comparing the definitions, the argument, that the proposed procedure in ED 75 is in line with the IASB's decision, "as the previous lessor accounting model in IAS 17 was not fundamentally flawed and should not be changed" (BC45b) is not convincing. On the contrary, we consider that the general definition provided by the Measurement ED 77 could be used, accompanied by guidance for identifying the fair value from a lessor perspective.

Specific Matter for Comment 3:

The IPSASB decided to propose to refer to both "economic benefits" and "service potential", where appropriate, in the application guidance section of ED 75 on identifying a lease (see paragraphs **BC46–BC48**). Do you agree with the IPSASB's decision? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

Yes, it is consistent with the definition of assets contained in *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, which defines assets considering both economic benefits and service potential.

In particular, we consider that in assessing whether a contract conveys the right to control the use of an identified asset over a period of time, it is important to assess whether the customer (that is, the lessee) has both the right to obtain substantially all of the economic benefits or *service potential* from use of the identified asset; and the right to direct the use of the identified asset.

Further comments

The IPSASB has requested comments and answers to specific questions regarding the paragraphs BC37–BC60 of ED 75. In the following, we would like to comment on further aspects as on the option for intangibles, the definition of low value assets and the illustrative examples section of ED 75.

On the option for intangible assets:

ED 75 contains an option for leased intangible assets. They may be accounted for as leases, but this is not required. In any case, due to the special characteristics of intangible assets, the application of the lease accounting provisions should be explicitly explained, at least in the future lease standard.

The definition of low value assets:

ED 75 states a Recognition Exemption for Leases for which the underlying asset is of low value.

In this sense, AG5 states "The assessment of whether an underlying asset is of **low value is performed on an absolute basis**. Leases of low-value assets qualify for the accounting treatment in paragraph 7 regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value". In accordance with it, the materiality principle would not be applicable.

However, the argument in the BC53 states: "The IPSASB acknowledged that, for many public sector entities that are services-based, a figure of US$5,000 might represent the value of most of their individual assets. The IPSASB concluded that public sector entities, if they decide to apply the exemption, should use a threshold for determining leases of low-value assets, **considering the materiality of leasing transactions in relation to their financial statements**. The IPSASB concluded that it would not provide guidance on a specific monetary amount. In assessing materiality, preparers consider whether the omission of information could influence financial statement users' assessments of accountability or their decision-making."

Summarizing, it seems that there is an inconsistency between the arguments in the BC and the AG.

On the illustrative examples section of ED 75:

It is questionable whether each illustrative example is dedicated to public sector specific cases, such as the fibre optic cable, the truck and shirts examples.

Most of the examples provided are straightforward. But sometimes open questions remain.

- The office unit **example 4** explains that the supplier has the right to relocate the supplier's office unit at his discretion. It should be explained, whether this clause is irrelevant for the classification of a lease because it is not likely that the relocation conditions will be triggered, making the relocation event unlikely.
- The truck **example 5** describes limiting conditions of the use (timeframe, cargo, starting and end section, maximum distance). It is not completely clear how those limits are weighted against the right to operate the truck at the customer's discretion (speed, route, rest stops etc.).
- While discussing the shirt **example 8**, a whole factory is qualified as an identified asset, although it appears to be rather a cash-generating unit than a single asset. The same is true for other examples, as the solar farm and the power plant in **example 9**. Therefore, it would be interesting to illustrate, for instance, which plant-related assets are included in the lease (and accounted accordingly) and which are not (maybe assets such as vehicle and truck fleet, or reserve machines may be excluded). On this matter, a reference to the distinction between lease and non-lease assets as explained in **example 12** would not be sufficient.
- The leases of low-value assets example (p. 111) raises the question whether those low-value modules of a server really represent assets rather than components or parts of that server as an asset.
- The allocating consideration to components of a contract in **example 12** concludes that the fixed consideration is allocated between the lease assets and the non-lease maintenance services according to the individual observable stand-alone prices of the lease assets (CU170,000+CU102,000+CU224,000) and on the individual observable stand-alone prices of the non-lease services (CU32,000+CU16,000+CU56,000). The sum of both allocating components is CU600,000, which is equal to the fixed consideration. It would be of interest to clarify how the allocation will change, if the sum of those individual observable stand-alone prices differs from the fixed consideration.
- Variable payment in **example 22**: "Refer to the management commentary for tourism outlet information presented on a like-for-like basis and to Note X for segmental information applying IPSAS 18, Segment Reporting relating to Tourism Outlets A–D" (p. 123). We do not see clearly the references to (which?) management commentary and to (which?) segment reporting.

Date: 14th May, 2021 Signed on behalf of those persons listed below

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