XRB
EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho
NZ ACCOUNTING STANDARDS BOARD

30 June 2018

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Submitted to: www.ifac.org

Dear John

ED 64 *Leases*

Thank you for the opportunity to comment on ED 64 *Leases* (ED 64). The ED has been exposed in New Zealand and some New Zealand constituents may comment directly to you.

We are pleased that the IPSASB has undertaken this project to update the accounting for leases in IPSAS. This is a significant project which is also impacted by other ongoing IPSASB projects (for example, revenue and non-exchange transactions, and public sector measurement). In addition to commenting on the proposals in ED 64 we have highlighted areas where we consider that further work on those other projects may be required before aspects of this project can be progressed (in particular, concessionary leases).

While we agree with the accounting model proposed for lessees in ED 64, we disagree with the accounting model proposed for lessors and with the proposed accounting for concessionary leases by both the lessee and the lessor.

In our view, the IPSASB should:

(a) proceed with the proposals in ED 64 for lessee accounting, except for concessionary leases;

(b) not proceed with the proposals in ED 64 for lessor accounting and instead develop proposals based on IFRS 16 *Leases* (which would need to be exposed for comment); and

(c) not proceed at present with the proposals in ED 64 for concessionary leases. This topic should be reconsidered at a later date after the IPSASB has made further progress on related on-

going projects (such as the IPSASB's projects on Revenue, Non-Exchange Expenses and Measurement).

The IPSASB initiated this project following the completion of IFRS 16 *Leases* by the International Accounting Standards Board (IASB). We support this strategy as it puts the IPSASB in a position to benefit from the detailed analysis and lengthy debates that occurred during the development of IFRS 16. The IASB's project considered a number of approaches for both lessors and lessees and involved a number of exposure drafts. The final requirements in IFRS 16 were determined after due consideration of both the conceptual and practical arguments identified by the IASB's constituents.

We acknowledge that public sector specific circumstances may lead the IPSASB to form different views about the merits of various lessor accounting approaches in contrast to the IASB. However, we do not think that the arguments for and against various lessor accounting approaches have been sufficiently explored in the Basis for Conclusions on ED 64 (BC). Where the IPSASB has departed from IFRS 16 the public sector specific reasons for doing so should be clearly articulated, including the conceptual, practical and user information considerations.

We consider that the BC is incomplete and, as a result, does not provide adequate information for constituents to make an informed decision regarding the lessor accounting proposals, particularly for those constituents that are not fully familiar with the IASB's deliberations during its project to develop IFRS 16. The BC does not include the counter-arguments against Approach 1 (right-of-use model proposed in ED 64) nor the counter-arguments in favour of Approach 2 (derecognition approach). In developing IFRS 16 the IASB proposed approaches which are similar to Approach 1 and Approach 2 considered by the IPSASB. Inclusion in the BC of the IASB's reasons for rejecting both of these approaches and instead choosing the lessor accounting approach in IFRS 16 would have provided a more balanced view of the advantages and disadvantages of both approaches.

In our view the omission of these counter-arguments from the BC may be interpreted as giving a biased view of the conceptual arguments for and against each approach, and means that constituents have not been provided with some key information that is necessary to make an informed evaluation of the lessor accounting proposals in ED 64. This could result in constituents supporting the proposals in ED 64 based on incomplete information, and the IPSASB then making inappropriate decisions based on the feedback received from constituents who were not fully informed about the arguments for and against each approach. In our opinion, the BC is an important document for explaining the IPSASB's deliberations and should, therefore, include a comprehensive and balanced view of the proposals in ED 64.

In view of these omissions from the BC and the potential consequences, we believe that the IPSASB should consider whether the content of ED 64 relating to lessor accounting was sufficient from a due process perspective. However, this point depends on whether or not the IPSASB decides to proceed with the proposals in ED 64 on lessor accounting – as explained earlier, we believe that it should not do so, and should instead develop an ED based on IFRS 16.

Our recommendations and responses to the Specific Matters for Comment are set out in the Appendix to this letter. If you have any queries or require clarification of any matters in this letter, please contact Vanessa Sealy-Fisher (Vanessa.Sealy-Fisher@xrb.govt.nz) or me.

Yours sincerely

Kimberley Crook
Chair – New Zealand Accounting Standards Board

APPENDIX

Response 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 the reasons. If you do agree, please provide any additional reasons not already discussed in the basis for conclusion.

The NZASB agrees with the IPSASB's decision to adopt the IFRS 16 right-of-use model for lessee accounting. We agree that the right-of-use asset and the lease liability meet the definition of, and the recognition criteria for, an asset and a liability respectively in the IPSASB's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the Conceptual Framework).

We agree that for lease accounting it is important that IPSAS be updated to reflect the latest thinking of the IASB in IFRS 16. Where transactions are the same for the public and private sector it is important that convergence with IFRS® Standards is maintained. This process ultimately contributes to the IPSASB developing high-quality IPSAS.

From outreach activities conducted in New Zealand, we did not identify any public sector specific reasons to depart from the IFRS 16 right-of-use model for lessee accounting.

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 conclusion.

The NZASB does not agree with the IPSASB's decision to depart from the model for lessor accounting in IFRS 16. See also our response to SMC 3 below for further comments.

We acknowledge that the lessor accounting in IFRS 16 (based on risks and rewards incidental to ownership) is not consistent with the lessee accounting (based on control), and that a control-based approach would be more consistent with the Conceptual Framework. However, after having debated the options considered over the course of IFRS 16's development and the matters that led the IASB to largely retain its previous lessor accounting requirements, we do not believe that the case put forward by the IPSASB for departing from IFRS 16 is strong enough. Our reasons for this are as follows.

(a) In our view the IPSASB appears to have ignored some factors, such as user information needs, that would support the retention of the IFRS 16 approach.

(b) The IPSASB has argued that the approach proposed in ED 64 is consistent with its Conceptual Framework and is an improvement on the IFRS 16 approach. We think that both arguments are debatable.

In preparing our response to this SMC we have carefully considered the IPSASB's reasons for departing from IFRS 16. The IPSASB's key reasons for departing from IFRS 16 appear to be those outlined in paragraph BC10. We are not convinced that the arguments in paragraph BC10(a) surrounding consolidation are sufficiently different in the public sector to warrant a departure from IFRS 16. There will always be adjustments needed for consolidation purposes, for example, to eliminate inter-entity transactions and align accounting policies.

We have some specific comments on paragraph BC10 as follows.

(a) Paragraph BC10(a) states that if the lessor classifies the lease as a finance lease the underlying asset would not be recognised by either the lessee or the lessor, and that separate records would need to be maintained for consolidation purposes. We doubt that this situation would arise often in practice for the following reasons.

  (i) The types of leasing arrangements discussed in paragraph BC11 (where a centralised entity undertakes the property management for a government) are unlikely to involve finance leases. Feedback from New Zealand constituents indicated that these types of leases are classified as operating leases, in which case the underlying asset remains on the lessor's statement of financial position.

  (ii) The types of finance lease arrangements commonly seen in the corporate sector (such as manufacturers or dealers providing finance to customers, or banks providing financing to companies) are unlikely to occur between public sector entities.

(b) Paragraph BC10(a) also states that additional records would be needed if the lessor classifies the lease as an operating lease (because the lessor will not recognise a lease receivable but the lessee will recognise a lease liability). We question this statement on the following grounds.

  (i) From the perspective of the consolidated reporting entity there would be no lease, and therefore no lease receivable. The lease accounting would need to be eliminated, and the underlying leased asset would be accounted for in accordance with the relevant standard. The creation of a lease receivable is not necessary to report assets in the consolidated financial statements.

  (ii) Paragraph BC10 seems to assume that the non-recognition of a lease receivable by the lessor would make it more difficult to eliminate the lease liability of the lessee during the consolidation process. However, even if the lessor recognised a lease receivable, the lease receivable and the lease liability would not necessarily be the same amount (for example, because of different discount rates). Also, for consolidation purposes, there are other ways of eliminating lease accounting by the lessee and lessor that might be more efficient, irrespective of how the lessor accounts for the lease.

(c) According to paragraph BC10(b), using different accounting models in the financial statements of the lessee and the lessor might make leasing transactions less understandable to some

users. However, there are some counter-arguments that have not been explored in the Basis for Conclusions.

(i) There appears to be no discussion of whether applying a different lessor accounting model in the public sector to the lessor accounting model in the private sector would make the financial statements of public sector entities less understandable to users.

(ii) One of the key reasons for the IASB retaining the existing lessor accounting model was that users of the financial statements preferred the existing approach to other approaches considered by the IASB. Other approaches considered by the IASB included an approach similar to the lessor model proposed in ED 64. This suggests that users of the financial statements would be better served by maintaining the current approach to lessor accounting. As explained in our response to SMC 3, there are valid reasons why the IASB retained the requirement for a lessor to classify a lease as either an operating lease or a finance lease.

In addition to the concerns we have raised about the arguments in paragraph BC10, we are concerned about the impact of different accounting requirements for lessors where a public sector controlling entity prepares consolidated financial statements that include for-profit controlled entities. A significant amount of work will be required on consolidation where the controlled for-profit entity is a lessor that applies IFRS 16 and the public sector controlling entity applies the model proposed in ED 64. We are aware that New Zealand is not the only country that would be impacted by having a different accounting model under IPSAS to the lessor model under IFRS 16.

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?

The NZASB does not agree with the lessor accounting model proposed in ED 64 and is of the view that the IPSASB should develop proposals for lessor accounting based on IFRS 16 rather than proceed with the proposals in ED 64.

During the development of IFRS 16 the IASB proposed a similar lessor model, the performance obligation approach, set out in IASB ED/2010/9 *Leases*. Many of the IASB's respondents were of the view that the performance obligation approach would result in an entity double counting its assets in the statement of financial position, and questioned how one set of cash flows (those received from the lessee) could relate to both the lease receivable and the underlying asset. Many also questioned how the obligation to permit the lessee to use the asset would meet the definition of a liability. We agree with these views and consider the reasons for not supporting the performance obligation approach for lessor accounting in the private sector are also applicable to the public sector.

Our views on the two approaches discussed in the Basis for Conclusions in ED 64 are explained below.

Concerns with Approach 1 and the IPSASB's reasons given for supporting Approach 1

Paragraph BC36 sets out the IPSASB's conclusions for proposing the lessor accounting model in ED 64 (Approach 1). Under Approach 1 the right-of-use asset is considered to be a separate economic phenomenon to the underlying asset. Under this approach the lessor recognises both the underlying asset (in its entirety) and a lease receivable. We have the following concerns with the conclusions reached in relation to Approach 1.

(a) The IPSASB has concluded that the lessor has retained control of the entire underlying asset, but the Basis for Conclusions does not provide any explanation of how the IPSASB reached that conclusion. In considering whether the lessor has control of the asset, we raise the following matters.

    (i) Paragraph 5.11 of the Conceptual Framework states that "…control of the resource entails the ability of the entity to use the resource (or direct other parties on its use)…". However, as the lessor has transferred the right to use the underlying asset to the lessee for the term of the lease, it is unclear to us how the lessor can have the ability to use the underlying asset or direct other parties on its use during the term of the lease. The lessor may still have some residual rights to the asset but, in our view, these rights are not equivalent to the lessor having control over the originally recognised resource.

    (ii) Paragraph BC36(d) draws parallels between the thinking underlying IPSAS 32 *Service Concession Arrangements: Grantor* and the proposed lease accounting in ED 64. In our view, a comparison of the requirements in IPSAS 32 with the proposed lessor accounting is not appropriate because the control that the grantor has over the service concession asset is not the same as the control that the lessor has over the underlying asset in a lease. A grantor controls or regulates the services that the operator must provide, to whom the operator must provide them and at what price (IPSAS 32, paragraph 9(a)). A lessor grants the lessee a right to use the lease asset but has no say in how the lessee operates the asset, what services are provided and what price the lessee charges for those services. Because of the significant differences in the rights of the grantor versus the rights of the lessor relating to the use of the asset during the terms of the arrangement, it is not valid to use the conclusion in IPSAS 32 (that the grantor has control over the service concession asset in a service concession arrangement) as the basis for concluding that the lessor has control over the entire leased asset in a lease arrangement. In addition, this is an example of where the proposals in ED 64 are being based on standards-level requirements that have not yet been assessed for consistency with the Conceptual Framework.

    (iii) The definition of an asset in the IASB's *Conceptual Framework for Financial Reporting* is similar to the definition of an asset in the IPSASB's Conceptual Framework. However, the IASB has concluded that the rights of the lessor under a lease agreement consist of two sets of rights, being (i) the lease receivable, and (ii) the rights retained in the underlying leased asset (see paragraphs BC35–BC40 of IFRS 16), rather than the underlying asset itself. Furthermore, in March 2018 the IASB published a revised *Conceptual Framework for Financial Reporting* which has a revised asset definition and more discussion of the unit of account and derecognition than the 2010 version. This

revised pronouncement sets out the IASB's view that (i) an asset comprises several rights which are often treated as a single unit of account, and (ii) that derecognition is the removal of all or part of a recognised asset. We think that these ideas could be particularly useful when thinking about accounting for leases and encourage the IPSASB to consider these ideas when the IPSASB undertakes the limited review of its Conceptual Framework.[1]

(b) We also have the following concerns with the proposals in ED 64 for the recognition of a liability (unearned revenue) by the lessor.

(i) Paragraph BC53 acknowledges that (i) recognising the credit entry as a liability until the revenue recognition criteria are met may not be consistent with the Conceptual Framework, and (ii) recognising revenue directly in the statement of financial position would not be consistent with existing IPSAS. We are of the view that the credit entry does not meet the definition of a liability because there is no outflow of resources by the lessor.

(ii) One of the IPSASB's reasons for not adopting the IFRS 16 lessor model is that the "risks and rewards incidental to ownership" model in IFRS 16 is not consistent with the lessee accounting control-based model. However, ED 64 includes several references to IPSAS 9 *Revenue from Exchange Transactions* which is also based on risks and rewards. We think it is inconsistent to argue against a risks and rewards approach and then refer a lessor to a standard that is based on that approach. We acknowledge that the IPSASB is working on proposals to update its revenue standards, but this could be one example of where another project needs to be further advanced before significant changes to lessor accounting can be fully considered.

(iii) We question how a lessor can continue to have a performance obligation (to make the underlying asset available) over the term of the lease when the lessee accounting model is based on the premise that the right to use the asset has been delivered to the lessee at the commencement of the lease.

(c) We agree with the conclusion in paragraph BC9(b) that the right-of-use asset and the underlying leased asset are <u>different</u> economic phenomena. However, it does not follow that the economic benefits/service potential embodied in the right-of-use asset are <u>additional</u> to the economic benefits/service potential embodied in the underlying leased asset.

Rejection of Approach 2 by the IPSASB

The IPSASB considered and rejected Approach 2. Under Approach 2 the-right-of use asset is considered to be a component of the underlying asset. The lessor would derecognise the component of the underlying asset that is transferred to the lessee and would recognise a residual asset (as well as a lease receivable). Paragraph BC38 states that Approach 2 is not consistent with IPSASB literature and provides reasons to support this statement. We disagree with those reasons as follows.

[1] This project is identified as a priority project for 2019–2023 in the IPSASB's Proposed Strategy and Work Plan 2019–2023.

Paragraph BC38(a) states that Approach 2 is not consistent with the principles in other IPSAS because it requires the derecognition of a portion of the underlying asset. As explained below, we do not think that derecognition of a portion of an asset is inconsistent with the Conceptual Framework and note that partial derecognition is already required by some standards.

(a) Paragraph 6.10 of the Conceptual Framework refers to the derecognition of an element, which in this case is an asset. An asset is defined in paragraph 5.6 of the Conceptual Framework as "A resource…". Paragraph 5.7 of the Conceptual Framework explains that "A resource is an item with service potential or the ability to generate economic benefits. Physical form is not a necessary condition of a resource. …". Nowhere in the discussion of assets does it suggest that resources, once recognised as an asset, are not divisible. Simple examples such as cash and inventory are clearly divisible, and portions of the carrying amount of certain assets are derecognised when assets are consumed or sold.

(b) A number of existing IPSAS require the derecognition of portions of recognised assets. Some examples follow.

- IPSAS 29 *Financial Instruments: Recognition and Measurement* requires the derecognition of a portion of a financial asset when it is transferred to another party (and certain criteria are met).

- IPSAS 17 *Property, Plant and Equipment* requires the derecognition of parts of the property, plant and equipment (PP&E), for example, when replacing parts of the PP&E item or if part of a building is demolished. Although the division of the asset, and the derecognition of those parts of the asset that have been disposed of, is based on physical components, the basic point is that parts of the asset are derecognised.

- IPSAS 37 *Joint Arrangements* requires a party to a joint operation to recognise and derecognise parts of PP&E. For example, if a party to a joint operation transfers an item of PP&E into the joint operation, it must derecognise the share of the PP&E item now held by other parties to the joint operation while continuing to recognise the retained portion (its share of the asset now held jointly).

(c) A similar outcome to Approach 2 could be achieved using a full derecognition approach. The execution of the lease could be regarded as resulting in the entity derecognising the underlying leased asset in its entirety and recognising two new assets – the lease receivable and the residual ownership interest in the PP&E. So, in the same way that the right-of-use asset under a lease is a different economic phenomenon to the underlying asset (the PP&E), the residual ownership interest of the lessor in the underlying asset can be viewed as a different economic phenomenon from the underlying leased asset.

We also disagree with the other reasons in paragraph BC38.

(a) Paragraph BC38(b) states that Approach 2 is not consistent with the IPSASB literature because it is more complex and costly than Approach 1. Both Approach 1 and Approach 2 are more complex and costly than the existing lessor accounting – so complexity and cost would be an argument for retaining the existing lessor accounting, rather than for preferring one new approach over another new approach.

(b) Paragraph BC38(c) appears to be included in error, as it is discussing the 'risks and rewards' lessor accounting model in which leases are classified as operating or finance leases, not Approach 2 (which is a derecognition approach).

(c) Paragraph BC38(d) states that Approach 2 is not consistent with IPSAS 32's requirements. We have outlined our concerns with basing lessor accounting on the grantor accounting requirements in IPSAS 32 earlier in this letter. We are also of the view that at some point the requirements in IPSAS 32 should be assessed against the Conceptual Framework for consistency, and this could result in changes to the requirements in IPSAS 32 and different conclusions than those reached when IPSAS 32 was first developed.

Next steps for lessor accounting

In our opinion, the IPSASB should not pursue the performance obligation approach (Approach 1) for lessor accounting. In our view, it is conceptually flawed and, in particular, it results in the overstatement of the lessor's total assets, which is misleading.

Although we support the conceptual reasoning underlying the derecognition approach (Approach 2), we consider that there are strong practical reasons to support the IFRS 16 lessor accounting model.

- The IFRS 16 model avoids introducing *unnecessary* differences between IFRS and IPSAS requirements by having a consistent approach to lessor accounting across the public sector and the corporate sector. This is beneficial for groups which comprise both public sector and for-profit entities and is less confusing for users of the financial statements.
- The derecognition approach is complex to apply in practice, as evidenced by responses to the IASB's exposure draft in which this approach was proposed.

Therefore, the IPSASB should not proceed with the proposals in ED 64 for lessor accounting and should instead develop proposals based on IFRS 16 (which would need to be exposed for comment).

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?

The NZASB agrees conceptually with the proposals for lessee accounting for concessionary leases. However, we do not support the recognition of the concession at this time, for the reasons outlined below.

The NZASB disagrees with the proposals for lessor accounting for concessionary leases, in particular, the recognition of the credit entry for the concession as unearned revenue. We are also of the view that the IPSASB should progress its project on non-exchange expenses before considering the lessor

accounting for concessionary leases rather than referring lessors to the relevant international or national standard.

We are aware that, over the years, entities applying IPSAS have requested the IPSASB to develop requirements for the accounting for concessionary leases, for example, international agencies that are provided with office space in cities around the world. The proposals in ED 64 for lessees would likely be appropriate in such circumstances because the fair value of the lease can be determined and, therefore, the assets and liabilities can be reliably measured.

However, we are of the view that there are many circumstances where the proposals in ED 64 for concessionary leases may not be appropriate for both lessees and lessors because of the challenges with measuring the fair value of the lease and other reasons, as discussed further below.

Accounting for concessionary leases by lessees

Conceptually we agree with the proposals for the recognition of the concession by the lessee, but we do have some concerns regarding the proposals.

Some of the IPSASB's decisions regarding the proposals in ED 64 are linked to other active IPSASB projects, for example, the *revenue and non-exchange expenses* project and the *public sector measurement* project. We are of the view that the IPSASB should first make progress on these projects, in particular, amendments to IPSAS 23 and developing guidance on what is meant by fair value in the public sector (especially for assets with restricted use), before progressing the proposals in ED 64. This would avoid unnecessary changes in the short to medium-term to the accounting for the concessionary portion of the lease. Although some New Zealand constituents supported the IPSASB's proposals for the recognition of the concession by the lessee, they raised questions about how to measure fair value (as discussed further below) and raised similar issues about when revenue should be recognised (e.g. on commencement of the lease or over the lease term) as have been raised in the revenue and non-exchange expenses project.

We also have concerns about whether the benefits of recognising and reporting the concession would exceed the costs of determining the fair value of the lease. For example, where the leased asset is of a specialised nature (for example, a school) or there are restrictions in the lease agreement (for example, an entity is permitted to undertake only certain activities from the leased property), the market value of the lease may be difficult to determine because of a lack of information about such leases. In some cases, the contractual lease payments could represent the fair value of the lease because of the specialised nature of the asset or the restrictions in the lease. ED 64 does not appear to cater for these types of circumstances. A further concern is that the valuation costs that lessees would incur in applying the proposals in ED 64 could be better utilised by the lessee (bearing in mind that concessionary leases are generally intended to support entities with complementary objectives to the lessor).

Next steps on accounting for concessionary leases by lessees

Although we agree conceptually with the proposals for lessees, at present we do not agree that lessees should be required to recognise the subsidy component of a concessionary lease for cost-benefit reasons (as explained above). We think that disclosure about the existence of the lease, the fact that it is on concessionary terms and any key conditions of the lease would provide useful

information for users. Disclosure would also provide flexibility for a lessee to provide more contextual information about its concessionary leases, for example, where specialised activities are undertaken from prime properties, or the lessee undertakes activities that complement the objectives of the grantor.

We are also of the view that the IPSASB should further progress both its revenue project and its public sector measurement project and then reconsider the accounting for concessionary leases by lessees. This would avoid unnecessary changes to accounting requirements that depend on decisions made by the IPSASB during the development of other projects that have an impact on the proposals in ED 64. In undertaking this further work, we recommend that the IPSASB also considers the guidance developed by the Australian Accounting Standards Board on accounting for concessionary leases by the lessee.

Accounting for concessionary leases by lessors

We do not agree with the proposals for accounting for concessionary leases by lessors. In particular, we do not agree that the proposed accounting by the lessor for a concessionary lease is similar to the existing accounting treatment by the grantor for a concessionary loan. In other words, although the IPSASB has justified its proposals on the grounds of consistency with the accounting treatment of concessionary loans, we consider that the proposed lessor accounting for a concessionary lease is *not* consistent with the accounting treatment of concessionary loans. As explained below:

- The proposals in ED 64 would result in the grossing up of lease revenue, whereas there is no grossing up of interest revenue when accounting for a concessionary loan.
- The proposals in ED 64 do not adjust the carrying amount of the asset to reflect the concession granted, whereas the accounting for a concessionary loan requires the loan balance to be reduced to reflect the concession granted.

More generally, we do not agree with the proposed accounting for the concessionary portion by lessors.

In our view, the IPSASB has mischaracterised the current accounting treatment by the grantor for a concessionary loan. Our understanding of the accounting treatment by the grantor of a concessionary loan is illustrated by means of an example.

Example

A loan of $100 (principal) with zero interest is granted (the transaction is not a transaction with owners). Market interest rates are 10% and the net present value of the future cash inflows (calculated at market rates) is $80.

As per paragraphs AG88 and AG89 of IPSAS 29, the $100 paid to the borrower is divided into two components.

New loan granted

Dr Loan	80	
Dr Grant expense	20	
Cr Bank		100

(Payment of the loan)

The future cash flows to be received over the term of the loan ($100 principal and zero interest per the loan documentation) are equivalent to a loan of $80 at normal market rates.

Although the loan is documented as $100 at zero interest, in economic terms, it is the same as a loan of $80 at 10% interest. The accounting reflects the economics, not the legal form (loan documentation) of the transaction.

Example

A loan of $100 (principal) with zero interest is granted (the transaction is not a transaction with owners). Market interest rates are 10% and the net present value of the future cash inflows (calculated at market rates) is $80.

As per paragraphs AG88 and AG89 of IPSAS 29, the $100 paid to the borrower is divided into two components.

Over the term of the loan the $100 cash inflows are treated as representing repayment of $80 principal and payment of $20 interest (under the effective interest rate method of measuring financial assets at amortised cost).

Some people refer to the interest recognised under the effective interest rate method as “reversing” the original $20 expense, but this is not reflective of the economics that the accounting is intended to show. The $20 is the interest revenue received on the $80 loan, and this is reflective of the actual cash flows received.

The mechanics of the effective interest rate method result in the expense and the interest revenue being the same amount (that is, $20), which is likely causing some confusion.

Existing loan and then concession granted

	Dr	Cr
Dr Loan	100	
Cr Bank		100
(Loan at normal market rates)		
Dr Expense	20	
Cr Loan		20
(Concession granted – no interest to be paid)		

In this case, the loan is granted at $100 at normal market rates. The existing loan is subsequently written down to reflect the concession granted, that is, the loan is now interest free. The balance on the loan now represents principal of $80 with interest at normal market rates of $20, which is reflective of the actual cash flow subsequently received.

Accounting for concessionary loans does not result in the grossing up of the interest revenue, as the interest revenue recognised for a concessionary loan is supported by cash inflows (as illustrated in our example). In contrast, the proposals in ED 64 result in the grossing up and reporting of revenue that is not supported by cash inflows.

In addition, the balance sheet amounts under the proposals in ED 64 are not consistent with the accounting for concessionary loans. When accounting for a concessionary loan, the loan is reported at a reduced amount (being $80 in our example), not the nominal amount of the loan (being $100 in our example). This reduced amount reflects the fact that the concession reduces the future economic benefits (present value of the future cash inflows) to be derived from the loan below the nominal amount of the loan. In contrast, the proposals in ED 64 do not reduce the carrying amount of the leased asset to reflect the reduction in economic benefits/service potential to be derived from the leased asset as a consequence of transferring economic benefits/service potential to the lessee without equivalent consideration in return.

Therefore, we do not agree with either (i) the IPSASB’s characterisation of the accounting treatment of concessionary loans or (ii) the accounting treatment for concessionary leases that involves the grossing up of lease revenue, resulting in the reporting of lease revenue that is not supported by cash inflows. Instead, if the concession is recognised, we consider it should result in the reduction of the carrying amount of the leased asset to reflect the concession granted.

We also have some concerns regarding the costs of the proposals where a lessor grants hundreds of concessionary leases and leases for zero or nominal consideration. For example, local governments in New Zealand grant many concessionary leases to public sector and not-for-profit entities. The concessions are a way of providing support to such entities and acknowledging the complementary nature of their objectives and the goods and services they deliver. If those entities did not provide those goods and services, local governments would have to undertake some of those activities

themselves. In some circumstances the value of the concessions granted may be immaterial to the lessor, but the lessor would still incur costs in determining the value of those concessions and forming a judgement on the materiality of the concessions.

Next steps on accounting for concessionary leases by lessors

As explained in SMC 3, we disagree with the lessor accounting proposed in ED 64. This means that we also disagree with the proposed accounting for concessionary leases by lessors and, in particular, recognition of the credit entry for the concession as revenue. And even under the lessor accounting model proposed in ED 64, we are of the view that the credit entry for the concession should be against the leased asset if the lessor is to recognise the concession as an expense, as explained above. Hence, irrespective of whether the IPSASB proceeds with its proposed lessor accounting model or reverts to the IFRS 16 lessor accounting model (discussed below), in our view the IPSASB should not proceed with an approach that results in the grossing up of lease revenue when accounting for a concessionary lease.

Under the IFRS 16 lessor accounting model, if a lessor classifies a lease as a finance lease, the concession would be recognised as part of the 'sale' of the asset. This could also be further explained in the notes to the financial statements. If a lessor classifies a lease as an operating lease, the credit entry would be against the leased asset.

We also believe that further consideration should be given to the measurement of the concession granted in situations in which the leased asset is measured using the cost model under IPSAS 17 *Property, Plant and Equipment*, as it is likely to be more appropriate to measure the concession as an allocation of the carrying amount of the leased asset rather than at fair value.

In addition, we also think the IPSASB should progress its non-exchange expenses project before considering the lessor accounting for concessionary leases rather than referring the lessor to the relevant international or national standard.

Leases for zero or nominal consideration

Leases for zero or nominal consideration are effectively scoped out of ED 64 per the diagrams following paragraphs 22 and 62, and paragraph AG60 of ED 64. However, proposed new paragraph 43A of IPSAS 23 requires the lessee to measure the right-of-use asset held by a lessee in accordance with ED 64. We question the reason for this scope exclusion if the fair value of a right-of-use asset acquired under a lease for zero or nominal consideration is measured in exactly the same way as a right-of-use asset acquired under a concessionary lease. Drawing an artificial boundary between concessionary leases and leases for zero or nominal consideration creates challenges for preparers of financial statements.

We would prefer that ED 64 apply to all leases. We acknowledge that the definition of a lease under both IFRS 16 and ED 64 requires "exchange for consideration" and that the IPSASB has wanted to keep this definition. We also note that paragraphs BC112 and proposed new paragraph 123A of IPSAS 23 refer to "concessionary leases for zero or nominal consideration", and proposed new paragraph 105C of IPSAS 23 refers to "at below market terms, including leases for zero or nominal consideration.". We recommend that the Scope section of ED 64 be amended to specifically include leases for zero or nominal consideration. This can be achieved by adding guidance to explain that if a

transaction meets the definition of a lease other than “exchange for consideration”, then the transaction is within the scope of ED 64. It could be argued that leases for *nominal consideration* are within scope of ED 64 because there is some consideration paid.

If the IPSASB decides to continue with ED 64 and effectively exclude leases for zero or nominal consideration, it is not helpful to refer lessors to the “relevant international or national standard” to account for the concessionary portion of the lease (see diagram following paragraph 22, and paragraph AG06(b)). It is not clear which standard the IPSASB would expect lessors to refer to. As noted earlier, we are of the view that the non-exchange expenses project should be progressed further if the IPSASB continues with the proposals for concessionary leases in ED 64.

Other matters

We have received feedback that it is unclear whether the scope of ED 64 includes leases with perpetual rights of renewal (for example, leases of land that provide the lessee with a perpetual right of renewal, subject to rent reviews undertaken on a regular basis (such as every 27 years)) and leases with long terms (which could effectively be a sale rather than a lease). The forthcoming IPSAS dealing with lease accounting should include guidance that clarifies its scope.