Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

Proposed new lease accounting standard

Tier 1 & 2 Public Benefit Entities

PBE IPSAS 43 *Leases*

Consultation document

August 2022

Comment period closes 25 November 2022

Contents

PART ONE:
Introduction

1. What is this consultation about?

Many public benefit entities (PBEs) in both the public and the not-for-profit sector enter into different forms of leasing arrangements.

This consultation proposes to introduce a new lease accounting standard based on the recently-issued IPSASB standard IPSAS 43 *Leases*. The accompanying Exposure Draft (ED) proposes to require lessees to recognise almost all leases on the statement of financial position, and removes the distinction between operating leases and finance leases. For lessors, the accounting requirements remain largely unchanged.

The proposals are aligned with international accounting standards issued by the IPSASB and IASB – allowing New Zealand PBEs to benefit from the latest international thinking on leases. The proposals would also enhance transparency around PBEs' leases, and increase comparability between the financial statements of PBEs that lease assets and those that purchase assets. As the proposals are aligned with the lease accounting requirements for for-profit entities, the proposals will make it easier for 'mixed groups' that contain both PBEs and for-profit entities to prepare group financial statements.

Background

In January 2022, the IPSASB issued IPSAS 43 *Leases*, which is aligned with NZ IFRS 16 *Leases*.

IPSAS 43 superseded the IPSASB's old leasing standard, IPSAS 13 *Leases*. Under IPSAS 13, lessees classified leases as 'operating leases' or 'finance leases' – finance leases were recognised as assets and liabilities on the statement of financial position, whereas 'operating leases' were not. Instead, operating lease payments were treated as expenses in surplus/deficit over the lease term. In New Zealand, PBEs currently apply PBE IPSAS 13 *Leases*, which is based on the requirements of IPSAS 13.

When proposing to issue a new PBE Standard based on an IPSAS, we consider and seek feedback on the need for New Zealand-specific amendments and/or guidance.

The accompanying Exposure Draft (ED) PBE IPSAS 43 *Leases* is a draft of the proposed New Zealand accounting standard, which would be applicable to Tier 1 and Tier 2 PBEs.

Note on concessionary leases

Our proposals, consistent with IPSAS 43, do not include specific requirements for the accounting for the 'concessionary portion' of concessionary leases and similar arrangements.

The IPSASB has a separate ongoing project on the accounting for concessionary leases (i.e. leases with below-market terms) and other lease-like arrangements, such as arrangements where an entity has a right to use an asset over a specified period of time for *no* consideration. The IPSASB expects to issue an ED on *Other Lease-type Arrangements* in December 2022.

The proposals in ED PBE IPSAS 43 clarify that while concessionary leases that involve the lessee paying consideration are within the scope of the standard (as they meet the definition of a lease), such leases are accounted for by taking into account the agreed lease payments as per the lease agreement – rather than what the lease payments would have been had the lease been on market terms.

We have previously consulted in New Zealand on the IPSASB's exposure drafts (EDs) on leases, which contained the proposals that are now finalised in IPSAS 43. The feedback we received indicated **broad support** for the proposals to align lease accounting with IFRS 16, except for concerns with respect to accounting for concessionary leases.

We note that the proposed PBE IPSAS 43 does not require PBEs to account for the concessionary portion of a concessionary lease at fair value.

Benefits of the proposals

The proposed PBE IPSAS 43 is expected to result in the following benefits, which are consistent with those that led to the introduction of NZ IFRS 16 *Leases* in the for-profit sector.

Increased transparency: The proposals require lessees to recognise a 'right of use' asset and a lease liability with respect to all leases, with limited exemptions. Recognition of these assets and liabilities on the statement of financial position would increase transparency in relation to the resources available to the public benefit entity as a result of lease agreements, and the public benefit entity's obligations to make lease payments. This also means that for users of financial statements, the statement of financial position will provide a 'fuller picture' of the resources that a public benefit entity uses in its operations – and which generate service potential and/or economic benefit for the public benefit entity – and the public benefit entity's obligations for future payments.

Reduced information asymmetry: Under the current requirements, if a user of financial statements wants to know how the public benefit entity's financial position is impacted by its operating lease obligations, the user would need to make adjustments to the amounts shown in the statement of financial position, based on the lease commitments disclosures in the notes. However, different users would use different techniques to make such adjustments, and the level of detail provided in lease commitments disclosure notes may vary. The recognition of (almost all) leases on the statement of financial position would mean that users no longer need to make such adjustments using different techniques. Therefore, from a user perspective, there would be less 'information asymmetry' under the proposals.

Increased comparability: By requiring lessees to recognise a right-of-use asset and a lease liability for (almost all) leases, the proposals would increase comparability between the financial statements of public benefit entities that lease assets and those that purchase assets. At the same time, the proposals still reflect the economic differences between the two types of transactions (for example, the lessee recognises the right to use the leased asset, rather than the underlying asset itself).

International alignment: The proposals are based on the IPSASB's latest standard on leases, IPSAS 43 – which is in turn substantially aligned with the IASB's IFRS 16 *Leases*.

Easier reporting for 'mixed groups': The proposed PBE IPSAS 43 is substantially aligned with NZ IFRS 16 *Leases.* For public benefit entities with for-profit subsidiaries – sometimes called 'mixed groups' – this means that fewer accounting adjustments are needed when preparing the consolidated group financial statements.

Purpose of this Consultation Document

The purpose of this Consultation Document is to seek comments on the proposals set out in the ED.

Timeline and next steps

Submissions on the ED are due by 25 November 2022. Information on how to make submissions is provided on page 6 of this Consultation Document.

After the consultation period ends, we will consider the submissions received, and subject to the comments in those submissions, we expect to finalise and issue the Standard.

2. How to provide feedback

Responding to consultation questions

We are seeking comments on the questions raised in this Consultation Document. We will consider all comments received before finalising the proposals for PBE IPSAS 43 *Leases*.

Please feel free to comment on any or all of the questions or any part of the proposed Standard.

We appreciate both formal and informal comments, whether supportive or critical, as both supportive and critical comments are essential for us to reach a balanced view.

Making a submission

You can provide feedback to us via:

- the consultation page on our website (where you can upload your comments); or
- emailing your formal or informal comments to accounting@xrb.govt.nz

Please include PBE IPSAS 43 *Leases* in the subject line and indicate whether the comments are made on your own behalf, or on behalf of a group of people, or an entity.

The closing date for submissions is 25 November 2022.

Projected Timeline

August 2022

ED PBE IPSAS 43 *Leases* issued for public consultation

25 November 2022

Submissions due to the NZASB

April 2023

PBE IPSAS 43 *Leases* issued as final standard

1 January 2027

PBE IPSAS 43 *Leases* effective (mandatory) for periods beginning on or after this date

Publication of submissions, the Official Information Act and the Privacy Act

We intend on publishing all submissions on the XRB website (xrb.govt.nz), unless the submission may be defamatory. If you have any objection to publication of your submission, we will not publish it on the XRB website. However, it will remain subject to the Official Information Act 1982 and, therefore, it may be released in part or in full. The Privacy Act 1993 also applies.

If you have an objection to the release of any information contained in your submission, we would appreciate you identifying the parts of your submission to be withheld, and the grounds under the Official Information Act 1982 for doing so (e.g. that it would be likely to unfairly prejudice the commercial position of the person providing the information).

PART TWO: Questions for Respondents

3. Questions for respondents

The questions for respondents focus on the proposed New Zealand specific amendments to IPSAS 43, as discussed in Section 4 of this Consultation Document.

Clarification of the scope of PBE IPSAS 43 with respect to concessionary leases (Section 4.4)

1. Do you agree with the proposed scope clarification with respect to concessionary leases? That is, do you agree with the clarification that:

   - Concessionary leases that meet the definition of a lease are in the scope of the proposed PBE IPSAS 43;
   - Arrangements that convey the right to use an asset for a specified period of time for no consideration do not meet the definition of a lease in the proposed PBE IPSAS 43; and
   - In applying the measurement requirements in PBE IPSAS 43, an entity takes into account the lease payments as per the lease agreement, and not the lease payments that would have been charged had the lease been on market terms?*

   * Except when PBE IPSAS 43 or another Standard requires or permits a different accounting treatment (for example, if right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in PBE IPSAS 17, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment).

Leases of low-value assets (Section 4.5)

2. Do you agree that the assessment of whether a leased asset is of 'low value' should be performed on an absolute value basis for each individual leased asset, as proposed in the ED? If not, on what basis should this assessment be performed?

RDR concessions (Section 4.6)

3. Do you agree with the proposed RDR concessions for Tier 2 PBEs?

Effective date and other comments (Section 4.7)

4. Do you agree with the proposed effective date of 1 January 2027?
5. Do you have any other comments on the ED?

PART THREE: Overview of Proposals

4. Overview of proposals

4.1 Summary

In this section, we highlight the key aspects of the proposals and those areas where we are particularly interested in your feedback. This section is organised as follows.

4.2 Approach to developing PBE IPSAS 43

4.3 Main changes from existing lease accounting requirements;

4.4 Scope clarification for concessionary leases;

4.5 Low-value leases: whether we should modify the requirements in IPSAS 43;

4.6 RDR concessions; and

4.7 Effective date and other comments.

4.2 Approach to developing PBE IPSAS 43

The proposed PBE IPSAS 43 is closely based on IPSAS 43 which, in turn, is closely based on IFRS 16. In accordance with its usual approach to developing a PBE Standard based on an IPSAS the NZASB has:

- aligned terminology with that used in PBE Standards (for example, PBE Standards include the concept of other comprehensive revenue and expense);
- ensured coherence within PBE Standards by considering the existence of New Zealand-specific standards or requirements;
- considered the need for any enhancements to make the standard more appropriate for public benefit entities in New Zealand, such as scope clarifications; and
- identified reduced disclosure requirements (RDR) for Tier 2 public benefit entities, with respect to disclosure requirements (aligned with the RDR concessions in NZ IFRS 16 *Leases*).

4.3 Main changes from existing lease accounting requirements

Current requirements

PBE IPSAS 13 *Leases* currently requires **lessees** to distinguish between the following two types of leases, based on what is described as the 'risks and rewards' model:

(a) Finance leases: A lease that is economically similar to purchasing the leased asset; it is recognised on the lessee's statement of financial position as a liability and an asset; and

(b) Operating leases: All other leases not classified as finance leases; not recognised on the statement of financial position. They are recognised as an annual operating expense through surplus or deficit over the lease term – with the total amount of future lease payments disclosed in the notes only. For this reason, operating leases are sometimes referred to as 'off-balance sheet' leases.

Proposals

The proposed PBE IPSAS 43 introduces the 'right of use' model for lessees. Under these proposals, lessees are required to recognise almost all leases on the statement of financial position. This means that lessees would need to bring on to their statement of financial position nearly all of those leases that are currently classified as 'operating' leases.

4.3 Main changes from existing lease accounting requirements (continued)

PBE IPSAS 43: proposed lessee accounting requirements for (almost) all leases[1]	Impact on financial statements of lessees with 'operating' leases
Initial recognition of lease on the statement of financial position: • a lease liability, for the obligation to make future lease payments as per the lease agreement, discounted to present value; and • a right-of-use (ROU) asset, for the right to use the underlying asset over the lease term, in exchange for the lease payments. **Accounting after initial recognition:** • The lease liability decreases as the lessee makes payments. • Interest (unwinding of lease liability discount) is recognised as an expense, and is included in finance costs. • Generally, the ROU asset is depreciated with an expense recognised, usually on a straight-line basis.	**Statement of financial position** Liabilities ↑ Assets ↑ **Statement of comprehensive revenue and expense** Operating expenses (excluding depreciation and amortisation) ↓ Depreciation and amortisation ↑ Finance costs ↑ Plus: Change in the pattern of expense recognition: The ROU asset is usually depreciated on a straight-line basis. For the lease liability, the interest expense is higher at the start of the lease term and lower at the end of it, because the 'principal' of the lease liability decreases as the lessee makes payments (similar to a table mortgage). In contrast, under the current requirements the operating lease expense is generally recognised evenly throughout the lease term. Discount rates: The lease liability and right-of-use asset amounts are calculated based on the agreed future lease payments, *discounted* to present value. The proposed PBE IPSAS 43 contains requirements for determining the discount rate. We expect that under the proposed PBE IPSAS 43, in most cases a PBE lessee would determine the discount rate under PBE IPSAS 43 as the lessee's incremental borrowing rate[2] – i.e. "the interest rate that the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment".

[1] **Exemptions from the right-of-use model under proposed PBE IPSAS 43**

- Short-term leases (where the lease term is shorter than 12 months); and
- Leases of low-value assets (where the underlying leased asset is of low value).

A lessee may choose to account for these leases by recognising the associated payments as an expense over the lease term.

[2] The IPSASB's Basis for Conclusions for IPSAS 43 notes that the incremental borrowing rate can be determined by:

(a) Taking into account the leases' terms and conditions;

(b) Referring to a rate that is readily observable as a starting point (for example, the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases); and

(c) Adjusting such observable rates as needed to determine the lessee's incremental borrowing rate as defined in IPSAS 43.

4.3 Main changes from existing lease accounting requirements (continued)

What changes for lessors?

Under the proposed PBE IPSAS 43, the requirements for lessors are generally similar to the current requirements under PBE IPSAS 13. That is, lessors would still apply the ‘risks and rewards’ model, meaning that they would still distinguish between operating leases and finance leases.

However, the proposed PBE IPSAS 43 includes the following specific changes for lessors:

- Lease modifications: The proposals require modification to a finance lease to be treated as a separate lease if certain conditions are met, and modifications to an operating lease to be treated as a new lease from the effective date of the modifications. PBE IPSAS 13 does not contain specific requirements relating to lease modifications.
- Sub-leases: The proposals require an intermediate lessor to classify subleases by reference to the right-of-use asset (i.e. the head lease) – rather than by reference to the underlying asset, as per the current requirements in PBE IPSAS 13.
- Disclosures: The proposals include enhanced disclosure for lessors about the timing and uncertainty of cash flows relating to leases.

The ED proposes that when a contract contains more than one lease component, or a lease component and a non-lease component, a lessor applies the requirements in the for-profit standard NZ IFRS 15 *Revenue from Contracts with Customers* to allocate the consideration in the contract to the lease and/or non-lease components. The IPSASB has taken the same approach in IPSAS 43. The reference to NZ IFRS 15 is a temporary measure. We plan to update these references when the IPSASB finalises and issues its new standard on Revenue – which we expect to happen before PBE IPSAS 43 becomes effective.

Other ED proposals to note

- Requirements for identifying a lease
- Requirements on combining contracts
- Requirements for lessees on how to treat variable lease payments when determining the lease liability
- Transitional provisions for moving from PBE IPSAS 13 to PBE IPSAS 43

Sale and leaseback transactions

Under the current requirements of PBE IPSAS 13, an entity is able to report fewer assets and less debt by selling an asset and leasing it back through an ‘operating lease’. However, in substance, the entity continues to have a right to use the sold asset.

The proposed PBE IPSAS 43 requires a seller-lessee to assess whether the transfer of an asset is accounted for as a sale of that asset, which then impacts the accounting for the transaction. If the transfer of the asset is determined to be a sale, then PBE IPSAS 43 requires a seller-lessee to recognise the right to use the sold asset (and the related lease liability), and restricts the amount of gain that can be recognised in a sale and leaseback transaction. If the transfer of the asset is not a sale, then PBE IPSAS 43 requires a seller-lessee to continue to recognise the transferred asset and to recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying PBE IPSAS 41.

The ED proposes that when a seller-lessee transfers an asset to a buyer-lessor, both entities determine whether the transfer is accounted for as a sale by applying the requirements in the for-profit standard NZ IFRS 15 for determining when a performance obligation is satisfied. The IPSASB has taken the same approach in IPSAS 43. The reference to NZ IFRS 15 is a temporary measure. We plan to update these references when the IPSASB finalises and issues its new standard on Revenue – which we expect to happen before PBE IPSAS 43 becomes effective.

4.4 Scope clarification for concessionary leases

Concessionary leases are leases with below-market terms. For the purpose of this section (4.4), when we refer to concessionary leases we are also referring to 'leases' for nil consideration, unless otherwise stated. In issuing IPSAS 43, the IPSASB did not explicitly provide a scope exclusion from the standard with respect to concessionary leases. We understand that concessionary leases in which the lessee pays consideration meet the definition of a lease, and are in the scope of IPSAS 43.

The IPSASB has a separate project on developing accounting requirements for concessionary leases. It is not yet clear whether the IPSASB will require fair value measurement for the 'concessionary component' of concessionary leases.

The proposed PBE IPSAS 43 does not include any requirements on the accounting for the 'concessionary component' of concessionary leases. We understand that some New Zealand constituents have concerns about the possibility of having to measure concessionary leases at fair value. We have therefore included in the ED paragraphs 4.1 – 4.2, which clarify the following:

- Concessionary leases <u>where the lessee pays consideration</u> meet the definition of a lease and are within the scope of the proposed standard; but
- PBEs are <u>*not*</u> required to measure the 'concessionary portion' of their concessionary leases at fair value. That is, when accounting for leases under the proposed standard, a PBE is required to take into account the amounts of lease payments as per the lease agreement, and not what the payments would have been had the lease been on market terms.

Staff note:

In the ED, a **lease** is defined as: "a contract, or part of a contract, that conveys the **right to use an asset** (the underlying asset) for a **period of time** in exchange for **consideration**".

Therefore, an arrangement that conveys a right to use an asset for a period of time for *no consideration* does *not* meet the definition of a lease, and is outside the scope of the proposed PBE IPSAS 43.

The term 'consideration' in the definition of a lease includes *consideration at below-market terms* (even if it is *nominal*).

These scope clarifications will be reconsidered after the IPSASB finalises its project on concessionary leases, which we expect to happen before PBE IPSAS 43 becomes effective.

We have considered whether PBEs that adopt PBE IPSAS 43 should be *permitted* to recognise and measure at fair value the 'concessionary portion' of their concessionary leases (e.g. by applying PBE IPSAS 23). We have decided *not to permit* such fair value measurement at this stage, for the following reasons.

- There is currently no guidance in PBE Standards on how to measure concessionary leases at fair value. We do not intend to consider developing such guidance until the IPSASB's position on this topic becomes clear as part of their separate ongoing project.
- We propose that PBE IPSAS 43 have a mandatory effective date beginning on or after 1 January 2027. PBEs will not be required to adopt PBE IPSAS 43 before this effective date. Therefore, if some PBEs are currently accounting for their concessionary leases at fair value, or at any value that does not reflect the actual lease payments per the lease agreement, such PBEs will be able to continue with this practice until 1 January 2027 (unless they choose to early adopt PBE IPSAS 43). By the time PBE IPSAS 43 becomes effective, we expect to have developed accounting requirements for concessionary leases and to have these requirements available for early adoption.

4.4 Scope clarification for concessionary leases

Questions

1. Do you agree with the proposed scope clarification with respect to concessionary leases? That is, do you agree with the clarification that:

- Concessionary leases that meet the definition of a lease are in the scope of the proposed PBE IPSAS 43;
- Arrangements that convey the right to use an asset for a specified period of time for no consideration do not meet the definition of a lease in the proposed PBE IPSAS 43; and
- In applying the measurement requirements in PBE IPSAS 43, an entity takes into account the lease payments as per the lease agreement, and not the lease payments that would have been charged had the lease been on market terms?*

* Except when PBE IPSAS 43 or another PBE Standard requires or permits a different accounting treatment (for example, if right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in PBE IPSAS 17, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment).

4.5 Leases of low-value assets

We did not modify the requirements of IPSAS 43 for leases of low value assets.

The following requirements from IPSAS 43 have been replicated in the proposed PBE IPSAS 43.

- A recognition exemption is provided for 'leases for which the underlying asset is of low value'. An entity need not recognise a ROU asset and a lease liability for leases of low-value assets. Instead, the lease payments relating to such leases may be accounted for as expenses over the lease term.
- IPSAS 43 requires entities to determine whether a leased asset is of 'low value' on an *absolute basis* – and *not based on whether the asset is material* to the entity. The determination of whether a leased asset is of 'low value' is unaffected by the size, nature or circumstances of the lessee. Therefore, *different lessees are expected to arrive at a similar conclusion as to whether a leased asset is of 'low value'*.
- Examples of 'low value' underlying assets can include tablets and personal computers, small items of office furniture and telephones (but not cars).
- The assessment of whether a leased asset is of low value is performed on an individual asset basis.

The proposals for 'leases of low value assets' are illustrated in the following example:

If a PBE leases 100 laptops for the use of its employees, the PBE considers whether each individual laptop is considered to be an asset of low value, when applying paragraph AG4–AG9 in the proposed PBE IPSAS 43.

In performing this assessment, the PBE need not determine whether the 100 laptops taken together are considered to be of low value. The PBE also need not determine whether each laptop, or the 100 laptops taken together, are material to the PBE. If the PBE determines that each individual laptop is an asset of low value, then the PBE may choose not to recognise a ROU asset and a lease liability with respect to the lease of the laptops, but instead to recognise the lease payments as an expense over the lease term.

The exemption for low value assets is consistent with the IASB's requirements in IFRS 16 *Leases*. However, unlike the IASB, the IPSASB did not provide an indicative figure that would constitute a 'low value' leased asset. The Basis for Conclusion of IFRS 16 states that when developing the recognition exemption for leases of low-value assets, the IASB had in mind leases of assets whose value (when new) is "in the order of magnitude of US $5,000 or less". In the Basis for Conclusions of IPSAS 43, the IPSASB explains that it decided not to refer to a specific monetary threshold for 'low value' leased assets, noting that the application guidance in AG4–AG9 provides sufficient guidance on how to determine 'low value'.

Question

2. Do you think that the assessment of whether a leased asset is of 'low value' should be performed on an absolute value basis for each individual leased asset, as proposed in the ED?

If not, on what basis should this assessment be performed?

4.6 RDR concessions

The ED includes proposed disclosure concessions for PBEs in Tier 2. These disclosure concessions are aligned with those provided to Tier 2 for-profit entities under NZ IFRS 16 *Leases*. The proposed Tier 2 disclosure concessions are summarised below:

(a) Tier 2 PBEs will not be required to provide certain disclosures in tabular format [see paragraphs 57, RDR 57.1 and 90];

(b) Lessees in Tier 2 will not be required to disclose a maturity analysis for lease liabilities [see paragraph 61];

(c) Lessors in Tier 2 will not be required to disclose operating lease revenue relating to variable lease payments that do not depend on an index or a rate separately from other operating lease revenue [see paragraph 89(b) and RDR 89.1];

(d) Tier 2 PBEs will not be required to provide certain disclosures relating to lease term extension options, lease termination options, residual value guarantees and sale and leaseback transactions [see paragraphs AG51–AG53].

Question

3. Do you agree with the proposed RDR concessions?

4.7 Effective date and other comments

The ED proposes that PBE IPSAS 43 *Leases* be effective for annual financial statements covering periods beginning on or after 1 January 2027, with early adoption permitted.

We believe that an effective date of 1 January 2027 would allow PBEs sufficient time to prepare for the application of the Standard. Furthermore, we proposed this effective date with a view to ensuring that the requirements of PBE IPSAS 43 do not become mandatory in New Zealand before the requirements for concessionary leases (to be developed after the IPSASB finalises its project on the topic) become available.

With early application permitted, those PBEs who wish to adopt PBE IPSAS 43 early will be able to do so.

Questions

4. Do you agree with the proposed effective date of 1 January 2027, with early adoption permitted?

5. Do you have any other comments on the ED?

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