

Meeting: IPSASB Consultative Advisory Group

Meeting Location: Kuala Lumpur, Malaysia

Meeting Date: December 3, 2018

Agenda Item 5

Leases

Project summary	Develop revised requirements for lease accounting covering both lessors and lessees in order to maintain convergence with IFRS 16, <i>Leases</i> , to the extent appropriate. The project will result in a new IPSAS that will replace IPSAS 13, <i>Leases</i> .	
Meeting objectives	Topic	Agenda Item
Discussion Items	Responses to IPSASB's Exposure Draft 64, <i>Leases—New Strategy to Move the Leases Project Forward and Main Issues on Lease Accounting</i>	5.1
Other supporting items	Appendix A: Comparison between Concessionary Loan and Concessionary Lease on the Accounting of the Subsidy	5.2
	Appendix B: IPSASB Due Process Checklist	5.3
	Appendix C: Links to Other Documents	5.4

Agenda Item 5.1

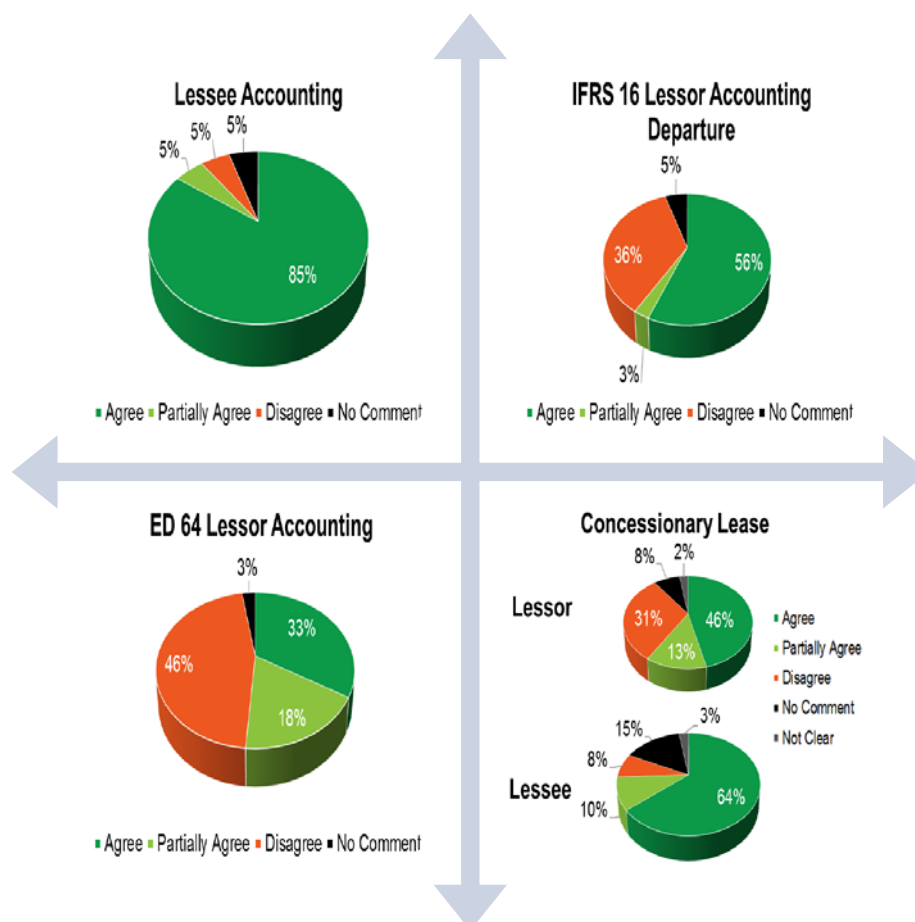
Background

- The IPSASB published Exposure Draft (ED) 64, *Leases* in January 2018. The main ED 64 proposals were:
 - Single right-of-use model for lease accounting; and
 - Public sector specific guidance on concessionary leases¹.
- The single right-of-use model for lessees is drawn from IFRS 16, *Leases*, and for lessors is specifically designed for public sector financial reporting.

Responses Received and Main Issues on Lease Accounting

New Strategy to Move the Leases Project Forward

- Overall, 39 responses were received to the ED, which is similar to other recent IPSASB consultations.
- The graphs below provide a high-level overview of the responses to ED 64².



¹ A concessionary lease is a lease at below market terms.

² Agree means that respondents agree with the proposals in ED 64. Partially agree means that respondents, while agreeing with the principles in ED 64, provided several suggestions to improve ED 64 proposals. Disagree means that respondents disagree with the proposals in ED 64.

5. The vast majority of respondents agree with the ED 64 right-of-use model for lessee accounting. However, regarding lessor accounting and concessionary leases overall respondents:
 - (a) **Do not have unified views**—respondents have different views on the economics of lease accounting;
 - (b) **Have opposing views on the same issues**—for example, some respondents agree with recognizing the subsidy in a concessionary lease, and others do not agree with recognizing the subsidy in a concessionary lease;
 - (c) **Advocate for different approaches**—for example, respondents that disagreed with ED 64 proposals on lessor accounting have proposed seven types of lessor accounting; and
 - (d) **Have inconsistent views**—for example, four respondents do not agree with the proposals in ED 64 for concessionary leases for lessors because they do not agree with the proposals in ED 64 for lessor accounting. However, other six respondents although disagreeing with proposals in ED 64 for lessor accounting, agree with the proposals in ED 64 for concessionary leases for lessors.
6. As a consequence, at the September 2018 meeting the IPSASB:
 - (a) Tentatively decided to proceed with the proposed lessee accounting requirements, subject to a more detailed review of responses at the December 2018 meeting; and
 - (b) Decided to adopt a new project timetable and approach, where the IPSASB will review all key decisions in ED 64 in light of respondents' views.
 - (c) Decided to get CAG's views on the Leases project at the December 2018 meeting.
7. This means that the timeline for completion of a new IPSAS on Leases is delayed until the step identified in paragraph 6(b) is complete.
8. The IPSASB has adopted this approach as a result of the feedback and views received in response letters, which highlight the complexity of the issues related to lease accounting in the public sector. The IPSASB deems it in the public interest to extend the project timeline to ensure that all views receive due consideration so that the IPSASB can agree the way forward.

Questions to the CAG:

- *From a project management perspective, is there any other action in developing the Leases project the IPSASB should consider in the public interest?*

Main issues on lessor accounting and concessionary leases³

9. Although the responses still need to be further analyzed by staff and the IPSASB, it is clear that there are opposing views on:
 - (a) Whether there is double-counting by on one side continuing to recognize the underlying asset, measuring it in accordance with the applicable IPSAS, and on the other side recognizing a

³ In this section, the IPSASB' views are to be considered at the time of approval of ED 64.

debit entry for the lease receivable⁴ and a credit entry for the liability (unearned revenue) in lessor's statement of financial position; and

- (b) Whether the subsidy in a concessionary lease should be recognized in the lessors' and lessees' financial statements.

Whether there is double-counting in lessor accounting

- 10. Consistent with IPSASB's Conceptual Framework and IPSAS⁵, ED 64 proposes to continue to recognize the underlying asset, measuring it in accordance with the applicable IPSAS, and recognize a lease receivable and a liability (unearned revenue) in lessor's statement of financial position.
- 11. While some respondents agreed with ED 64 proposals for lessor accounting, other respondents believe there is double-counting if the lessor continues to recognize the underlying asset and recognizes a debit entry for the lease receivable and a credit entry for the liability (unearned revenue). Therefore, these respondents claim that double-counting inappropriately grosses up or inflates the lessor's statement of financial position. Some of these respondents, also advocated that:
 - (a) The credit entry for the liability (unearned revenue) should offset the underlying asset; or
 - (b) The underlying asset should be impaired at the commencement date of a lease irrespective of its terms and conditions.

Meaning of "Double-Counting", "Gross" and "Offset"/"Net"

- 12. Double-counting is where a single transaction (economic phenomenon) is recognized or counted more than once. Double-counting is an accounting error because it leads to a misrepresentation of financial performance and financial position.
- 13. Double-counting is addressed in several IPSAS⁶ as follows: assets and liabilities recognized in the financial statements should not be repeated or used for recognition and measurement of other assets⁷.
- 14. Unlike double-counting, "gross" and "offset"/"net" is related to presentation of elements in the financial statements, and do not give rise to accounting errors.
- 15. Because of the different meaning of "double-counting" and "gross" in IPSAS, the IPSASB is of the view that they should not be used interchangeably.

Is there double-counting in ED 64 proposals for lessor accounting, as some respondents suggest?

- 16. The IPSASB considered this in the development of ED 64 and was of the view⁸ that there is no double-counting for the following reasons:

⁴ The lease receivable is measured at the present value of the lease payments that are not received at the commencement date of a lease.

⁵ Namely with the Grant of a Right to the Operator Model with existing assets in IPSAS 32, *Service Concession Arrangements: Grantor*.

⁶ For example, paragraph 59 of IPSAS 16, *Investment Property* and paragraph 56 of IPSAS 26, *Impairment of Cash-Generating Assets*.

⁷ This statement is based on paragraphs IPSAS 16.59 and IPSAS 26.56

⁸ IPSASB's views expressed in this document as at the moment of approval of ED 64.

- (a) **The underlying asset and the lease receivable are different economic phenomena.** The underlying asset and the lease receivable are a result of different transactions. The underlying asset is controlled by the lessor as a result of a purchase to a third party. In a lease, the lessor transfers the right to use an underlying asset for a period of time to the lessee, but does not transfer control of the underlying asset.
- (b) **The cost to purchase the underlying asset is economically different from the right to receive lease payments in a lease.** Historical cost is not a cash-flow-based measure because it results from a contractual price from the purchase. A prospective purchaser is likely to assess future cash flows in determining whether to purchase an asset with the intention to lease it, but this does not make cost a cash-flow-based measure.

Should the credit entry for the liability (unearned revenue) offset the underlying asset, as some respondents suggest?

17. The IPSASB is of the view that there should not be any offsetting for the following reasons:

- (a) The cost of the underlying asset is the amount that the purchaser (prospective lessor) spent to purchase the underlying asset, and the credit entry is the amount of revenue from the sale of an unrecognized right-of-use asset⁹.
- (b) The underlying asset and the lease are negotiated separately, with the counterparty to the purchase of the underlying asset being a different entity from the counterparty to the lease. Accordingly, for a lessor, the rights and obligations from controlling an underlying asset are not permanently extinguished by the terms and conditions of the lease.
- (c) The exposures arising from owning assets are different from the exposures arising from a lease transaction. Therefore, presenting these on a net basis could provide misleading information about a lessor's financial position because it would obscure the existence of some transactions, assets and liabilities¹⁰. Presenting these two economic transactions net, is also against the IPSASB's current guidance for financial instruments on when offsetting is permitted, which requires a legally enforceable right to set off the recognized amounts and the entity intends to settle on a net basis, or to realize the asset and settle the liability simultaneously¹¹.

Should the underlying asset be impaired at the commencement date of a lease irrespective of its terms and conditions, as some respondents suggest?

18. The IPSASB is of the view that the underlying asset should not be impaired at the commencement date of a lease. The view is that the existence of a lease by itself does not indicate that the underlying asset:
- (a) **Is obsolete or physically damaged**—the lessee is using the underlying asset in its operations;

⁹ Under the right-of-use model, when a lease contract is signed there is a simultaneous creation and sale of the right-of-use asset to the lessee.

¹⁰ Staff notes that both ED 64 and IFRS 16, *Leases* do not permit offsetting assets and liabilities arising from a head lease and a sublease for the same reasons. In other words, an intermediate lessor should not offset assets and liabilities arising from a head lease and a sublease of the same the right-of-use asset, unless the financial instruments requirements for offsetting are met.

¹¹ See paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*.

- (b) **Will become idle or will be discontinued**—the lessor will continue to receive economic benefits from leasing out the underlying asset in the form of lease payments from the lessee; and
- (c) **Economic performance is, or will be, worse than expected**—the terms and conditions of the lease might even lead to an economic performance of the underlying asset higher than expected.

19. In conclusion, the IPSASB is of the view that:

- (a) The terms “double-counting” and “grossing up” should not be used interchangeably;
- (b) There is no double-counting in ED 64 proposals for lessor accounting;
- (c) The credit entry in lessor accounting should not offset the underlying asset; and
- (d) The underlying asset should not be impaired at the commencement date of a lease irrespective of its terms and conditions.

Questions to the CAG:

- *Does the CAG agree with the IPSASB that there is no double-counting in continuing to recognize both the underlying asset and to recognize a debit entry for the lease receivable on one side and a credit entry for the liability (unearned revenue) on the other side?*

Whether the subsidy in a concessionary lease should be recognized in the lessors' and lessees' financial statements.

- 20. Consistent with IPSASB's Conceptual Framework and IPSAS¹², ED 64 proposes to recognize the subsidy in a concessionary lease for both lessors and lessees.
- 21. While some respondents agree with ED 64 proposals for concessionary leases, other respondents disagree with recognizing the subsidy for the following main reasons:
 - (a) **For cost-benefit reasons.** In the public sector it is very difficult to determine the fair value of specialized assets (for example, a school) or with restricted use (for example, an entity is permitted to undertake only certain activities from the leased property), and the valuation costs would be better utilized by the lessee¹³.
 - (b) **Recognizing revenue above cash being received by the lessor is not conceptually sound and is inconsistent with existing revenue principles.** The lessor has not earned the revenue related to the concession, and therefore it should not be recognized in the financial statements. Additionally, the unearned revenue is based on the benefits the entity has given away in the lease rather than the benefits it expects to receive, which is inconsistent with the principles in the revenue standards which indicate revenue is measured based on the value of the consideration received or to be received.
 - (c) **A concessionary lease is not comparable to a concessionary loan.** The great majority of concessionary leases in the public sector are leases for zero consideration, which do not have

¹² Namely, IPSAS 16, *Investment Property*, IPSAS 17, *Property, Plant, and Equipment*, IPSAS 31, *Intangible Assets*, IPSAS 23, *Revenue from Non-exchange Transactions (Taxes and Transfers)*, and IPSAS 41, *Financial Instruments*.

¹³ After all, a concessionary lease is to financially support the lessee.

a financing element. Therefore, concessionary leases are not comparable to concessionary loans, but comparable to grants.

Conc. (a): Does the cost of recognizing the subsidy in a concessionary lease exceeds its benefits, as some respondents suggest?

22. The IPSASB is of the view that the cost of recognizing the subsidy in a concessionary lease does not exceed its benefits for the following two reasons:

- (a) **Volume and financial significance of non-exchange transactions in the public sector**—the non-recognition of the subsidy in a concessionary lease fails to acknowledge one of the main characteristics of the public sector, according to the Preface to the Conceptual Framework.
- (b) **Accountability and decision-making**—the recognition of the subsidy in a concessionary lease enhances accountability to citizens and decision-making on the management of public sector resources.

Conc. (b): Is it conceptually unsound to recognize revenue above cash received in a concessionary lease, as some respondents suggest?

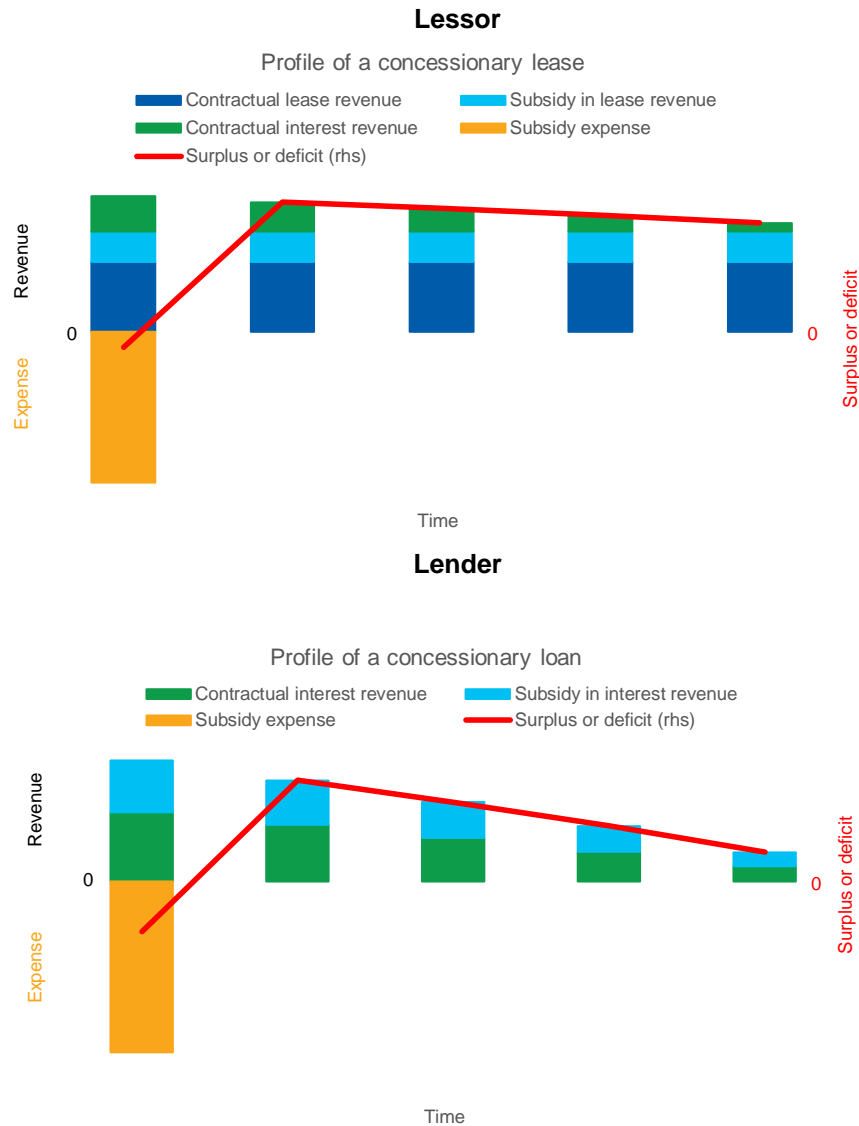
23. The IPSASB is of the view that it is conceptually sound to recognize revenue above cash received for the following two reasons:

- (a) **Consistency with the accrual basis of accounting**—accrual accounting requires revenue to be recognized when there is an inflow of resources, irrespective of whether there is cash being transferred. Under the right-of-use model, the resource is the right-of-use asset that is simultaneously created and transferred to the lessee when a lease contract is signed.
- (b) **Accounts for the full economic value of the lease**—the sum of the cash and the subsidy represent the full economic value of the resource created (the right-of-use asset) and transferred to the lessee, which is higher than the cash inflows (contractual lease receipts) of the lessor. In other words, the credit entry for the liability (unearned revenue) reflects the lessor's performance obligation to leave the asset for use to the lessee – which is related to the service potential embodied in the leased asset – and does not relate to the payments made by the lessee. In a similar way, the lessee is also recognizing the subsidy as revenue above the future cash outflows (contractual lease payments) in a concessionary lease because it is related to the service potential embodied in the leased asset.

Conc (c): Is a concessionary lease not comparable to a concessionary loan, as some respondents suggest?

24. The IPSASB is of the view that a concessionary lease is comparable to a concessionary loan because a subsidy to the price of the right-of-use asset is economically equivalent to a subsidy to the price of money (interest rate), including leases for zero or nominal consideration and loans for zero or nominal interest rate. In other words, the nature of the resource transferred (right-of-use asset or cash) does not affect the economic substance of a subsidy.

25. The following two graphs show that the accounting of a subsidy in a concessionary lease as proposed in ED 64 is similar to a concessionary loan according to IPSAS 41, *Financial Instruments* (see [Appendix A](#) for an illustrative example).



26. In conclusion, the IPSASB is of the view that:

- (a) The cost of recognizing the subsidy outweigh its benefits;
- (b) It is conceptually sound to recognize revenue above cash being transferred; and
- (c) A concessionary lease is comparable to a concessionary loan.

Questions to the CAG:

- Does the CAG agree with the IPSASB that the subsidy in a concessionary lease should be recognized in lessors' and lessees' financial statements?

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Appendix A: Comparison between Concessionary Loan and Concessionary Lease on the Accounting of the Subsidy

Concessionary Loan

Loan: CU5,000

Contractual Interest Rate: 5%

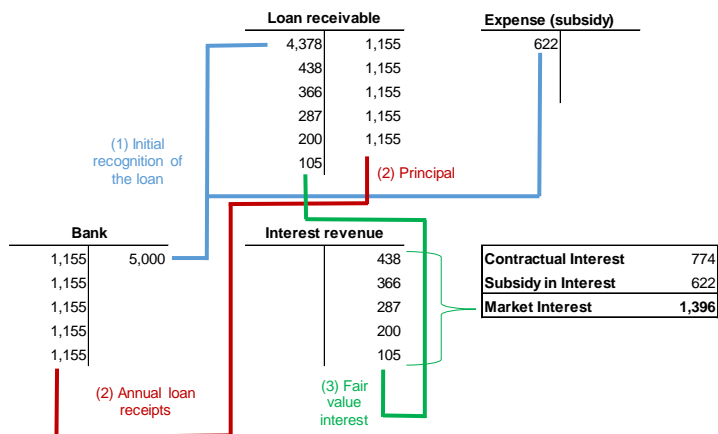
Market Interest Rate: 10%

Loan Term: 5 years

Loan Plan						Cash Flow	Present Value	Dif.	Coef. 10%
Year	Op Bal	Int (5%)	Princ	Cash Flow	Cl Bal				
1	5,000	250	905	1,155	4,095	1,155	1,050	105	0.909
2	4,095	205	950	1,155	3,145	1,155	954	200	0.826
3	3,145	157	998	1,155	2,147	1,155	868	287	0.751
4	2,147	107	1,048	1,155	1,100	1,155	789	366	0.683
5	1,100	55	1,100	1,155	0	1,155	717	438	0.621
Total		774	5,000	5,774		5,774	4,378	1,396	

Fair Value of Loan Plan			
Year	Op Bal	Int (10%)	Cash Flow
1	4,378	438	1,155
2	3,661	366	1,155
3	2,872	287	1,155
4	2,004	200	1,155
5	1,050	105	1,155
Total		1,396	5,774

Loan	5,000
FV Loan	4,378
Subsidy	622



Conclusion:

In a concessionary loan, the subsidy is recognized:

- (a) As expense at initial recognition; and
- (b) As interest revenue over the loan term.

Concessionary Lease

Annual Market Lease Payments: CU1,500

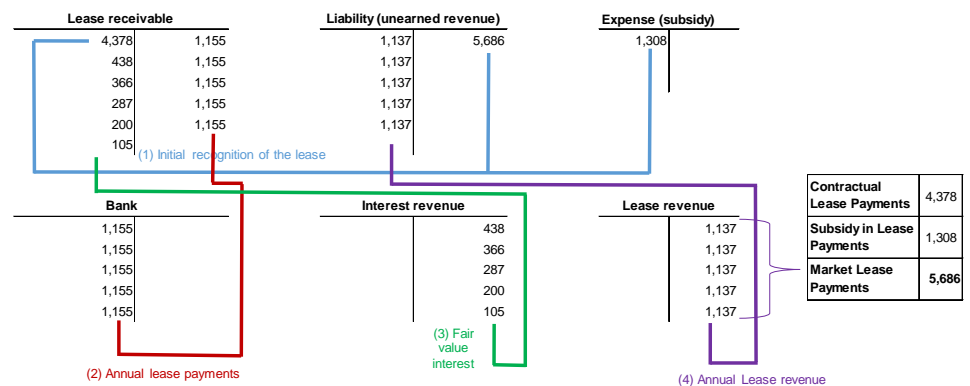
Annual Contractual Lease Payments: CU1,155

Market Interest Rate: 10%

Lease Term:

	70% of:				
	Undiscounted Annual Market Lease Payments	Present Value of Annual Market Lease Payments	Undiscounted Annual Contractual Lease Payments	Present Value of Annual Contractual Lease Payments	Off-market portion of the lease
	1	2	3	4	5=2-4
Year 1	1,500	1,364	1,155	1,050	314
Year 2	1,500	1,240	1,155	955	285
Year 3	1,500	1,127	1,155	868	259
Year 4	1,500	1,025	1,155	789	236
Year 5	1,500	931	1,155	717	214
Total	7,500	5,686	5,775	4,378	1,308

	Year 1	Year 2	Year 3	Year 4	Year 5
Capital balance	4,378	3,661	2,872	2,005	1,050
Interest payable	438	366	287	200	105
Principal	717	789	868	955	1,050
Contractual Lease payments	1,155	1,155	1,155	1,155	1,155
Capital balance	3,661	2,872	2,005	1,050	0



Conclusion:

In a concessionary lease, the subsidy is recognized:

- (a) As expense at initial recognition; and
- (b) As lease revenue over the lease term.

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Appendix A: Comparison between Concessionary Loan and Concessionary Lease on the Accounting of the Subsidy (cont.)

	Concessionary Loan (Lender)		Concessionary Lease (Lessor)
	1,396 Market interest revenue		5,686 Market lease revenue
	-622 Subsidy		-1,308 Subsidy
Net impact on surplus or deficit	774 Contractual interest payments	Net impact on surplus or deficit	4,378 Contractual lease payments

Overall conclusion: The net impact on surplus or deficit of concessionary loans and concessionary leases is the contractual interest/lease payments, respectively.

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Appendix B: IPSASB Due Process Checklist (condensed to included portions relevant to the CAG)

Project: Leases

#	Due Process Requirement	Yes/No	Comments
A. Project Brief			
A1.	A proposal for the project (project brief) has been prepared, that highlights key issues the project seeks to address.	Yes	The IPSASB considered the project brief at its March 2016 meeting (see Agenda Item 6).
A2.	The IPSASB has approved the project in a public meeting.	Yes	See the approved Project Brief, Leases See the minutes of the June 2016 IPSASB meeting (section 7) .
A3.	The IPSASB CAG has been consulted on the project brief.	N/A	<ul style="list-style-type: none"> This step is not in effect for this project.
B. Development of Proposed International Standard			
B1.	The IPSASB has considered whether to issue a consultation paper, or undertake other outreach activities to solicit views on matters under consideration from constituents.	No	As stated in the Project Brief, the IPSASB concluded this project will have an exposure draft. Exposure Draft 64, <i>Leases</i> was issued in January 2018: http://www.ifac.org/publications-resources/exposure-draft-64-leases
B2.	If comments have been received through a consultation paper or other public forum, they have been considered in the same manner as comments received on an exposure draft.	N/A	
B3.	The IPSASB CAG has been consulted on significant issues during the development of the exposure draft.	Yes	In December 2016 the CAG was on the lack of symmetry between lessee and lessor accounting in IFRS 16, the subsidized component of a concessionary lease and the outreach events to communicate the IPSASB's consultation documents on Leases.

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#	Due Process Requirement	Yes/No	Comments
<i>D. Consideration of Respondents' Comments on an Exposure Draft</i>			
D4.	The IPSASB CAG has been consulted on significant issues raised by respondents to the exposure draft and the IPSASB's related responses.	Yes	The IPSASB received 39 comments to the Exposure Draft. The IPSASB considered an initial review of responses at the September 2018 meeting.
D5.	Significant comments received through consultation with the IPSASB CAG are brought to the IPSASB's attention. Staff have reported back to the IPSASB CAG the results of the IPSASB's deliberations on those comments received from the CAG.	Yes	The IPSASB CAG Chair communicated to the IPSASB the results of the December 2016 IPSASB CAG session on Leases at the June 2017 IPSASB meeting.

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Appendix C: Links to Other Documents

1. This appendix provides links to document which may be useful to CAG members in providing a background related to the project.
 - (a) IPSASB Leases [project page](#)
 - (b) IPSASB Leases agenda items links:
 - (i) [September 2018](#)
 - (c) IPSASB Leases agenda presentations links:
 - (i) [September 2018](#)