Proposed International Public Sector Accounting Standard

"Concessionary Leases and Right-of-Use Assets In-kind (Amendments to IPSAS 43 and IPSAS 23)"

REQUEST FOR COMMENTS

Task force IRSPM PSAAG, CIGAR Network, EGPA PSG XII

Draft May 9, 2023

The IPSASB has requested comments and answers to specific questions regarding its ED 84 *Concessionary Leases and Right-of-Use Assets In-kind (Amendments to IPSAS 43 and IPSAS 23)*. Its objective is to develop a proposal to amend IPSAS 43, on how to identify and account for concessionary leases for both lessees and lessors, with the aim to provide relevant information in a manner that faithfully represents concessionary leases transactions. Furthermore, the ED proposes additional guidance to identify and measure a right-of-use asset in-kind.

The aim is that the information included in the financial statements is useful for users to assess the effect that concessionary leases and right-of-use assets in-kind have on the financial position, financial performance and cash flows of an entity for accountability and decision-making purposes.

The comments and responses prepared by the Task Force IRSPM PSAAG, CIGAR Network and EGPA PSG XII are presented below.

The IRSPM PSAAG, CIGAR Network and EGPA PSG XII are three research networks that focus on public sector accounting. The Task Force is made up of 16 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks, and neither of the institutions/universities with which they are affiliated.

Core assumptions

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

Concessionary leases are very common in the public sector, where public entities have right-of-use arrangements with specific considerations and agreed terms which are not referenced to a market. This means that the contracted value of the right-of-use does not fit market terms and often the payments are much lower than the market price.

Similarly, right-of-use assets in-kind are also very specific for the public sector. Because of this, specific treatment is required for these transactions, and we welcome the opportunity to comment on the proposals of ED 84.

Specific Matter for Comment 1:

The IPSASB decided to propose new accounting guidance for concessionary leases for lessees (see paragraphs IPSAS 43 BC124-BC137) and right-of-use assets in-kind (see paragraphs IPSAS 23 BC28-BC30). Do you agree with the proposed amendments to IPSAS 43 and IPSAS 23? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

We take note of the proposed necessary amendments in order to clarify accounting of these types of transactions. We appreciate very much the proposal of ED 84 in order to simplify accounting for concessionary leases and right-of-use assets in-kind, considering that these arrangements are very often used in the public sector and nearly never in the private sector. However, we have some concerns about how the ED proposes to modify these criteria and from our perspective, these types of contracts cannot be analysed by just applying economic rationalities because they are not arranged with economic aims.

According to ED 84, a concessionary lease is an example of a financial arrangement and should be recorded and reported as such by the lessee. In the concessionary situation, the contracted value of the right-of-use does not fit the market terms (often, the payments are much lower than the market terms). Therefore, the IPSASB's proposed standard requires the recognition of non-exchange revenues.

From our point of view, the theoretical lens applied in business accounting cannot be directly applied in this case for public sector entities as these are transactions with specific characteristics for public sector entities. In fact, one issue that must be considered to avoid the application of economic criteria in this type of leases is that, in most of the cases, the assets have no economic benefits for the lessee but only service potential.

We believe that, in the public sector, the economic criteria and the fair value are not necessarily the main factors to determine the recognition of transactions. A leasing contract with concessionary characteristics cannot be considered a purely financial arrangement because the reconstitution of all the amounts paid does not fit to the economic values of the right-of-use. In profit-oriented enterprises, such a concessionary situation would indeed imply the expression of unearned amounts because enterprises think economically/financially; but in the public sector setting there are many other reasons why lease-type arrangements might not be based upon market values. For example, governments might enter a lease contract on concessionary terms to support common social or cultural goals of governmental organisations. Such goals cannot be financialised.

To sum up, public sector capital goods obtained below market terms are not meant to yield economic benefits, but for providing social services and that is why they are obtained in a concessionary way: they cannot be recorded as if they were providing economic benefits, therefore, they should be recorded based on the contractual terms both parties agreed on.

For right-of-use assets in-kind, the ED proposes to apply the principles in IPSAS 43 to identify them, and recognize them in accordance with IPSAS 23. In this respect, the main issue is to what extent are these assets included in the concept of a lease? Many agreements of right-of-use assets in-kind cannot be characterized as financing transactions.

Furthermore, it can be even difficult to define what a right-of-use asset in-kind is in a precise way. For example, governments can, in different circumstances, use facilities such as roads, areas, buildings, IT software, etc., of other governments without strict agreements: how will it be possible to define such a right-of-use asset in-kind?

We agree with the necessary amendment to IPSAS 23 in order to consider non-exchange revenues due to the right-of-use asset in-kind when the asset generates economic benefits. In this case, probably it would be better to define this type of arrangement directly in IPSAS 23 as it constitutes a type of non-exchange revenue. Therefore, we ask whether it is necessary to define this type of asset in IPSAS 43. Can it be defined directly in IPSAS 23?

In our opinion, there are particularities that justify a departure from IPSAS 43 for this type of agreement.

If a right-of-use asset in-kind can be objectively defined, and provided that it generates economic benefits, only then can it be registered as an asset – and just to the extent that it will generate economic benefits. Only in that case, one can consider the present value of the expected future cash-flows. As such, this would not be a fictitious journal entry, and it represents a real situation.

Specific Matter for Comment 2:

For lessors, the IPSASB decided to propose accounting for leases at below-market terms in the same way as for leases at market terms (see paragraphs IPSAS 43 BC138-BC149). Do you agree with the proposed amendments to IPSAS 43? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

We do not agree. Firstly, it must be considered that the differentiation between operating and finance lease is complex under a concessionary lease and, in most cases, these agreements cannot be considered as a finance lease.

In accordance with the ED, the lessor must identify if the lease is a finance lease or an operating lease, and consequently account for the agreement following IPSAS 43. Since in many cases it is difficult to consider these arrangements as a finance lease, then the lessor should account it as an operating lease.

Furthermore, when the agreement is classified as a finance lease, the unearned finance revenue is recognized totally at the initial recognition of the agreement. In this respect, the diagram of page 13 clarifies how to value the receivable at the inception of the lease and the unearned finance revenue. Following the arguments that we are maintaining in our comment letter, we do not consider that economic rationality can be applied in these types of contracts, irrespective of whether the public sector entity is a lessee or lessor. Because of this, from our perspective, the lessor should record the transaction following the lease agreement and the amounts within, without expressing subjective and fabricated values. This information could be explained in the notes to the financial statements, where the lessor could record the non-exchange services, the reasons, and financial impact that these can have.

In this respect, it can be useful that the implementation guidance provides other practical examples of the concessionary lease classified as a finance lease.

Specific Matter for Comment 3:

> The IPSASB decided to propose initially measuring right-of-use assets in concessionary leases (see paragraphs IPSAS 43 BC124-BC131) and right-of-use assets in-kind (see paragraphs IPSAS 23 BC28-BC30) at the present value of payments for the lease at market rates based on the current use of the underlying asset as at the commencement date of the lease. Do you agree with IPSASB's decision? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the basis for conclusions.

We do not agree. As we explain below, the treatment is complex and difficult to apply, and can introduce some subjectivity in accounting data that does not reflect a fair view of the financial situation. Because of this, we consider that the contracts should be recognised in accordance with the terms agreed and the values in the contract, to avoid the recognition of non-exchange revenues that can be subjective and fictitious. When the non-exchange revenue needs to be considered due to economic reasons, the matching principle should be considered, and this implies that the revenue cannot be considered only in the year of the contract.

For concessionary leases, the proposed amendments include to recognize a right-of-use asset measured at the present value of payments for the lease at market rates based on the current use of the underlying asset and, at the same time: a) recognize a lease liability measured at the present value of the contractual payments for the lease; and b) recognize non-exchange revenue for the concession component as the difference between the right-of-use asset and the liability, except when a present obligation exists.

This means that, even if it is not necessary to measure the right in the asset at the highest and best use implicit in the fair value definition, criteria based on the market rates are still maintained.

In this sense, it is necessary to consider that this type of arrangement is usually used for very specific assets, for which market value, even when based on the current use of the underlying asset, can be very difficult to obtain. Furthermore, usually there are some restrictions regarding the purpose of the assets for very specific activities, which can limit the identification of the right to direct the use, although these are considered in the definition of the lease.

The assets acquired in the concessionary lease usually have service potential for the future but not economic benefits. This makes it very difficult to value the lease at market rates based on the current use of the underlying asset, which, at the same time, could justify a different criterion to value them.

From our point of view, market value cannot be applied because it does not reflect the actual reality of the transaction that financial accounting aims to represent, but it is more of a hypothetical assumption:

1) public sector capital goods obtained below market terms are not meant to yield economic benefits, but for providing social services, and that is why they are obtained in a concessionary way. Therefore, they cannot be recorded as if they were providing economic benefits;

2) recording the difference between the agreed value and the value in market terms as revenues is incorrect since these revenues are fictitious and are not realized in the accounting period. It may inflate the financial performance of entities without the existence of substance in revenue recognition. It could also motivate opportunistic actions of public sector entities when in distress;

3) when recognizing a right-of-use asset measured at the present value of payments for the lease at market rates, an additional fictitious depreciation each year will occur. If one considers its effects in cost accounting, these would imply that an extra cost would be assigned to the services. Financial accounting and management accounting can have different criteria when justified; but in this case, there is no justification;

4) recording the difference as a revenue in the current accounting period in respect of the recurring depreciation as charges in the coming years creates an improper matching problem.

Consequently, we consider that this criterion can be maintained only for assets with economic benefits. In these cases, the matching concept should be applied for the difference between cost and the present value of payments for the lease at market rates, so that the non-exchange revenues are recognized in the financial performance statements over all the period of the contract, in accordance with the use of the asset.

This criterion could also be applied in those cases where the contract includes a real non-exchange revenue, for example, in contracts with interest-free leases or interest (intentionally) set below the market rate. In this situation, the agreement should be treated in the same way as an interest-free loan, and then the revenue could be accounted for as the financial expenses are accrued.

In other cases, public sector entities should register the lease at cost – where cost is the present value of the payments for the lease at the commencement date. In this respect, we should be aware also of the difficulties for identifying the interest rate implicit in the lease, due to the characteristics of the contract, that will lead, in most of the cases, to use the lessee´s incremental borrowing rate.

The lessee should disclose concessionary leases in the notes to the financial statements, where the reasons of the contract under market prices and the potential financial impact that this can have, should be explained.

For right-of-use assets in-kind, as we explained before, we have some concerns about whether these agreements can be considered as pure financial agreements.

The recognition of such assets is proposed to be based on the existence (or not) of conditions:

a) If the assets in-kind are received without conditions attached, the revenue is recognized directly.
b) When conditions are attached, a liability is recognized, which is reduced, and revenue is recognized as the conditions are satisfied.

Here again, we have to consider that the obligations are usually linked to the purpose the right-of-use assets are used for, which can be pre-determined, as is normal for very specific activities and assets. Due to difficulties to value the asset and the liability, it can be more realistic to only require disclosure of the information in the notes to the financial statements.

The ED proposes that right-of-use assets in-kind are measured at market prices in accordance with IPSAS 43. We have already commented on the (un)suitability of this approach as general criterium. This approach can only be maintained for assets that can provide economic benefits. These assets could be measured at the present value of expected future cash flows, which would be reflecting the real situation. It is important to underline that, as these assets in-kind will be shown in the balance sheet, it would be more adequate that the non-exchange revenue would be recognised as revenue in the performance statement in accordance with the use of the right-of-use assets, instead of in the year in which is received. This allows for the balancing of the non-exchange revenue with the expense in the financial performance statement.

Furthermore, we consider that some agreements do not need to be accounted for in the balance sheet. When the characteristics of the agreement and the underlying asset can introduce subjectivity and an unfair view of the financial situation, it would be convenient to account for just an annual non-exchange revenue in the performance statement and disclose all the information of the contract in the notes to the financial statements.

To sum up, we believe that the quantification of the present value of payments for the lease at market rates based on the current use of the underlying asset would add subjectivity to the values in the balance sheet and would not represent the real rationality of the transaction. Assets in-kind should, of course, be reported, because they can have important consequences, and should be documented, explained and disclosed in the notes to the financial statements.

Specific Matter for Comment 4:

When the payments for the lease at market rates based on the current use of the underlying asset are not really available, the IPSASB decided to propose initially measuring right-of-use assets in concessionary leases (see paragraphs IPSAS 43 BC 132-BC133), at the present value of contractual payments for the lease. Do you agree with IPSASB's decision? If not, please explain your reasons. If you agree, please provide any additional reasons not already discussed in the Basis for Conclusions.

Yes, we agree. As we stated before, we consider that this should be an allowed treatment in general because, in most of the cases, it can be difficult or even impossible to know the payments at market rates.

Accordingly, we appreciate that at least this option be stated in the IPSAS 43 for those contracts where the payments for the lease at market rates based on the current use of the underlying asset are not readily available. In fact, there are already some examples of standards for non-profit organizations, including public sector entities, that, although initially proposed to recognize concessionary leases at fair value, difficulties led to the use of the cost as an alternative option. This is the case, for example, in Australia, where the Australian Accounting Standard Board (AASB) issued the AASB 2018-8 Amendments to Australian Accounting Standards-Right of use Assets of Not-for-Profit Entities, that allows lessees to decide between the cost and fair value for the initial recognition of right-of-use assets in concessionary leases. This solution was intended to be temporary, while the AASB analyzed the situation; but it was eventually incorporated in the AASB 16 for private not-for-profit organizations as a permanent option. For the public sector, there is no final decision yet.

Further comments

Initial Measurement of the Right-of-use Asset

Paragraph 26A defines how the lessee recognizes the concessionary lease, and considering that the general reference is the cost, it is stated that "**the cost** shall be measured at the present value of the payments for the lease at market rates based on the current use of the underlying asset at the commencement date".

In order to avoid confusion with the definition of cost used in paragraph 25 for the right-of-use asset in general, it could be just added as an exception to the general criterion, clarifying how to measure the right-of-use asset in concessionary leases but avoiding the reference to cost, as it is difficult to see the concept of cost there.

Disclosure of Concessionary Leases for Lessees

Paragraph 64A requires disclosing the amount of the contractual payments for the lease when the payments for the lease at market rates based on the current use of the underlying asset are not readily available. Due to the difficulties and subjectivity that the quantification of the latter may have, we consider that it is important that contractual payments be disclosed in any case. Similarly, for each concessionary lease that has been recognized during the period, the lessee should disclose the exchange component and the non-exchange component.

Furthermore, since these right-of-use assets usually have some restrictions about their use, which are predetermined, these restrictions should also be disclosed in the notes to the financial statements.

Additional and Implementation guidance

In order to clarify the proposal for right-of-use assets in-kind, it could be convenient that an implementation guidance for this type of assets provides examples about recognition and measurement of right-of-use assets in-kind.

Furthermore, from our point of view, if the IPSASB maintains the proposed criterion, many practical examples will be needed in order to guide users on its implementation. The existing examples are simplified and theoretical and do not capture the real difficulties in practice.

In example 13B-Concessionary Leases (Lessee) – Concession results from 30% lower contractual payments than payments from the leases in the Market Rates. It is mentioned that "An entity would consider whether the substance of the CU6,900,000 is a contribution from owners or revenue", but there is no reference to the conditions should be considered.

Moreover, the example states that "the non-exchange component of CU 6,900,000 is accounted in accordance with IPSAS 23", and later in Table 2 that "the non-exchange component for the lease to be recognized as non-exchange revenue over the five years". In the sample example in IPSAS 23 (IG60) it is mentioned that, if the concessionary lease were granted with no obligations, the entity would recognize the non-exchange revenue on initial recognition.

Date: May 9, 2023 Signed on behalf of the persons listed below:

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