Agenda Item 7: Leases

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Manager, Standards Development and Technical Projects

IPSASB Meeting
June 21-24, 2016
Toronto, Canada
Objective of Session & Material Presented

• Agenda Item 7.1—Project Brief, *Leases*

• Agenda Item 7.2—Lessee—Applicability of IFRS 16 recognition and measurement requirements to public sector financial reporting

• Agenda Item 7.3—Lessee—“Peppercorn” leases

• Agenda Item 7.4—Lessor—Applicability of IFRS 16 recognition requirements to public sector financial reporting

• Agenda Item 7.5—Project Brief, *Leases* (marked-up version from March 2016 meeting)
Leases

Project Brief, *Leases* (Agenda Item 7.1)

- **Main amendments from March 2016 meeting**
  - Objective of the Leases project: issuance of a new IPSAS
  - Introduction of options in *Key Issue #4*—Sale and leaseback transactions
  - Introduction of *Key Issue #6*—Lack of symmetry in lease accounting
  - Introduction of *Key Issue #7*—“Peppercorn” leases
  - Government Finance Statistics update on leases
  - Project timetable
Leases

Project Brief, *Leases* (Agenda Item 7.1)

• **Sale and leaseback transactions** (*Key Issue #4*)
  - IFRS 16
    - Sale?
      - *Yes*, if it satisfies the performance obligation in IFRS 15
      - *No*, if it does not satisfy the performance obligation in IFRS 15
    - IASB’s view:
      - This requirement “will be beneficial for both preparers and users of financial statements because it will increase comparability between sales entered into as part of a sale and leaseback transactions and all other sales.”
  - IPSAS 9  →  *Risks and rewards of ownership* approach
  - IPSAS 23  →  *Present obligation* approach
Leases

Project Brief, *Leases* (Agenda Item 7.1)

- **Sale and leaseback transactions (Key Issue #4)**

**Step 1**

**Option 1**
Do not include any requirement now (current situation in IPSAS 13)

**Option 2**
Include requirements based on current IPSASs (IPSAS 9 and 23)

**Step 2**

Include the performance obligation approach later (consequential amendment of the new IPSAS on Revenue)
• Lack of symmetry in lease accounting (Key Issue #6) Compatibility (?) between two models for the same transaction in public sector financial reporting

<table>
<thead>
<tr>
<th></th>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting Model</td>
<td>Right-of-use model</td>
<td>Risks and rewards incidental to ownership</td>
</tr>
<tr>
<td>Identification and</td>
<td>1. Identification</td>
<td>1. Identification</td>
</tr>
<tr>
<td>Classification</td>
<td>• Service versus Lease</td>
<td>• Service versus Lease</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Classification</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Finance lease versus Operating lease</td>
</tr>
</tbody>
</table>
**Leases**

**Project Brief, Leases (Agenda Item 7.1)**

- Lack of symmetry in lease accounting *(Key Issue #6)*

<table>
<thead>
<tr>
<th>Financial Position</th>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
</table>
| **Right-of-use asset** for all leases over 12 months unless the underlying asset is of low value | Finance lease:  
- Net investment in the lease recognized  
- Underlying asset derecognized  
**Operating lease:**  
- Lease receivable is not recognized  
- Underlying asset recognized |

<table>
<thead>
<tr>
<th>Financial Performance</th>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
</table>
| **Expense:**  
- Depreciation, impairment  
- Constant periodic rate of interest | Revenue:  
**Finance lease:**  
- Constant periodic rate of return  
**Operating lease:**  
- Straight-line basis |
• “Peppercorn” leases *(Key Issue #7)*
  
  - Reduced, nominal, or rent-free leases for the whole period of use of the underlying asset that does not involve a sale and leaseback transaction
  
  - IFRS 16 – Lease asset is initially measured at cost
  
  - Understatement of the lease asset
  
  - Failure to recognize the subsidy from the lessor to the lessee in the financial statements of the lessee and of the lessor
Project Brief, Leases (Agenda Item 7.1)

• “Peppercorn” leases (Key Issue #7)
  • Two mutually exclusive options:

<table>
<thead>
<tr>
<th>Option 1</th>
<th>Option 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within the scope of the new IPSAS on Leases</td>
<td>Within the scope of IPSAS 23 or in IPSASB’s current projects on non-exchange expenses and revenue</td>
</tr>
</tbody>
</table>
• Indicative Project Timetable—Summary

<table>
<thead>
<tr>
<th>Meeting</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016 June</td>
<td>Approval of Project Brief</td>
</tr>
<tr>
<td>2017 March</td>
<td>Approval of Exposure Draft</td>
</tr>
<tr>
<td>2018 June</td>
<td>Approval of new IPSAS</td>
</tr>
</tbody>
</table>
Leases

Lessee (Agenda Item 7.2)

• Rules of the Road

IAS 17
• Risks and rewards model

IPSAS 13
• Risks and rewards model

IFRS 16
• Right-of-use model

Public sector financial reporting issues:
• That have not been comprehensively or appropriately dealt with in IFRS 16; or
• By adapting IFRS 16 to the public sector context

Accounting
• Recognition
• Measurement

New IPSAS
• Recognition
• Measurement
**Rules of the Road — Step 1: Are there public sector issues that warrant departure?**

<table>
<thead>
<tr>
<th>Element</th>
<th>Recognition</th>
<th>Measurement basis (initial measurement)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>Right-of-use asset</td>
<td>Cost</td>
</tr>
<tr>
<td>Liability</td>
<td>Lease liability</td>
<td>Cost (reference to present value of the lease payments that are not paid at the commencement date)</td>
</tr>
</tbody>
</table>
• **Criteria to assess IFRS 16 requirements**
  1) Objectives of public sector financial reporting
  2) Qualitative characteristics (QCs) of public sector financial reporting
  3) Undue cost or effort
  4) Consistency with other aspects of the *Conceptual Framework*
  5) Internal consistency with existing IPSASs
  6) Consistency with Government Finance Statistics (GFS)
## Lessee (Agenda Item 7.2)

<table>
<thead>
<tr>
<th></th>
<th>Recognition</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Right-of-use Asset</strong></td>
<td>Reinforces</td>
<td>Impairs, unless fair value is used for “peppercorn” leases</td>
</tr>
<tr>
<td><strong>Lease liability</strong></td>
<td>Reinforces</td>
<td>Meets</td>
</tr>
<tr>
<td><strong>Objectives</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>QCs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Undue effort or cost</strong></td>
<td>No foreseen undue cost or effort.</td>
<td></td>
</tr>
<tr>
<td><strong>Conceptual Framework</strong></td>
<td>Consistent</td>
<td>Consistent, but not appropriate</td>
</tr>
<tr>
<td><strong>IPSASs</strong></td>
<td></td>
<td>Consistent</td>
</tr>
<tr>
<td><strong>GFS</strong></td>
<td></td>
<td>N/A</td>
</tr>
</tbody>
</table>
Lessee (Agenda Item 7.2)

• Staff’s conclusions
  – Staff did not identify any public sector financial reporting reason that warrants departure from IFRS 16’s recognition requirements on the applicability of the right-of-use model in lessee accounting
  – The lessee accounting recognition requirements of the right-of-use model better reflects the economics of a lease than the previous model of risks and rewards incidental to ownership
Lessee (Agenda Item 7.2)

- **Staff’s conclusions**
  - The lessee **no longer** recognizes an underlying asset that it does not control, as in requirements in IPSAS 13 for finance leases;
  - The lessee **always** recognizes an asset (the right-of-use asset), unlike in IPSAS 13 for operating leases;
  - The lessee **always** recognizes the obligations resulting from the lease contract as liabilities, unlike in IPSAS 13 for operating leases;
• Staff’s conclusions
  – The right-of-use model **prevents** arbitrage, gaming and information asymmetry, and improves comparability between public sector entities that lease assets and public sector entities that purchase assets.
Lessee (Agenda Item 7.2)

- **Optional Recognition Exemptions in IFRS 16**
  - Short-term leases (lease term of 12 months or less)
  - Leases for which the underlying asset is of low value (absolute basis)

- **Staff’s conclusion**
  - Staff did not identify a public sector financial reporting reason that would warrant different recognition exemptions from IFRS 16.
Leases

Lessee (Agenda Item 7.2)

• Require *versus* Permit recognition exemptions

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Increased comparability between public sector entities</td>
<td>• Divergence with IFRS 16</td>
</tr>
<tr>
<td>• Increased cost relief in the application of the new IPSAS on Leases</td>
<td>• In low value leases that last a number of years may impact negatively reliability and accuracy of financial statements</td>
</tr>
<tr>
<td>• It is still within the <em>Rules of the Road</em></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**
1. Does not impair comparability with private sector entities
2. Entities with a "mixed group" can adopt same accounting policy regarding recognition exemptions
Leases

Lessee (Agenda Item 7.2)

• Rules of the Road
  – Step 2: Should a separate public sector project be initiated?
    • Staff did not identify a persuasive case for initiating a public sector specific project on recognition exemptions and measurement of leases.
  – Step 3: Modify IASB documents
    • Elimination of the option on recognition exemptions is covered by paragraph iii) of Step 3
Leases

Lessee (Agenda Item 7.2)

• Does the IPSASB agree with staff’s recommendation to:
  – **Adopt** the recognition requirements of the IFRS 16’s right-of-use model in lessee accounting in the new IPSAS on Leases
  – **Consider** whether recognition exemptions should be a requirement or an option in the new IPSAS on Leases
Lessee—“Peppercorn” leases (Agenda Item 7.3)

- Two options:

<table>
<thead>
<tr>
<th>Option 1</th>
<th>Option 2</th>
</tr>
</thead>
</table>
| Within the scope of the new IPSAS on Leases   | Within the scope of IPSAS 23 or in IPSASB’s current projects on non-
                                                                 | exchange expenses and revenue                                             |
## Lessee—“Peppercorn” leases (Agenda Item 7.3)

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Option 1</th>
<th>Option 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange transaction vs Non-exchange transaction</td>
<td>A “peppercorn” lease is still a lease</td>
<td>A “peppercorn” lease is in substance a grant or donation</td>
</tr>
<tr>
<td>Sector neutral vs sector specific approach to the definition of a lease</td>
<td>The definition of a lease should reflect a more neutral approach to lease accounting in the public sector</td>
<td>The new IPSAS on Leases should only address leases that are exchange transactions</td>
</tr>
<tr>
<td>Explicit requirements vs professional judgement</td>
<td>IPSASs should explicitly address transactions that are typical in the public sector and in international organizations</td>
<td>Use the principles in IPSAS 23 for professional judgement</td>
</tr>
<tr>
<td>Concentration vs dispersion of subject in IPSASs</td>
<td>Include all leases in the new IPSAS on Leases and the subsidized component in IPSAS 23</td>
<td>IPSAS 23 guidance can be applicable to “peppercorn” leases</td>
</tr>
</tbody>
</table>
Lessee—“Peppercorn” leases (Agenda Item 7.3)

**Staff’s view:**
- The arguments in Option 1 outweigh those in Option 2 and recommends that the IPSASB proceeds with Option 1

**Does the IPSASB agree with staff’s recommendation to:**
- Address “peppercorn” leases in this project (Option 1); and
- Include specific requirements in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* to address the non-exchange component of the lease (similar to concessionary loans)?
• Rules of the Road
  – IFRS 16, *Leases* retains the risks and rewards model of IAS 17;

  - Lack of symmetry
    - Conceptual
      • Two models for the same transaction
    - Accounting
      • Different recognition requirements

  - Appropriate for public sector financial reporting?
**Lessor (Agenda Item 7.4)**

- **Rules of the Road**
  - IFRS 16’s lessor accounting **should be assessed** on whether it is **still applicable** to public sector financial reporting and **compatible** with the right-of-use model in lessee accounting;
  
  - **Positive answer**, then **no adaption** to public sector context is required;
  
  - **Negative answer**, then IFRS 16 **needs to be adapted** to the public sector context;
Lessor (Agenda Item 7.4)

• Two-step approach
  (a) Identify the requirements in IFRS 16 for lessor accounting that are not based on the right-of-use model;
  (b) Apply the Rules of the Road to the accounting requirements identified in (a)
Leases

Lessor (Agenda Item 7.4)

- Rules of the Road—Step 1: Are there public sector issues that warrant departure?

<table>
<thead>
<tr>
<th>Element</th>
<th>Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Finance Lease</strong></td>
</tr>
<tr>
<td><strong>Asset</strong></td>
<td>Derecognition of the underlying asset</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Non-recognition of the unearned revenue (liability)</td>
</tr>
</tbody>
</table>
Lessor (Agenda Item 7.4)

- **Rules of the Road—Criteria to assess IFRS 16 requirements**
  1. Objectives of public sector financial reporting
  2. QC's of public sector financial reporting
  3. Undue cost or effort
  4. Consistency with other aspects of the *Conceptual Framework*
  5. Internal consistency with existing IPSASs
  6. Consistency with Government Finance Statistics (GFS)
### Lessor (Agenda Item 7.4)

<table>
<thead>
<tr>
<th></th>
<th>Finance Lease</th>
<th>Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Derecognition of the underlying asset</td>
<td>Non-recognition of the unearned</td>
</tr>
<tr>
<td></td>
<td></td>
<td>revenue (liability)</td>
</tr>
<tr>
<td>Objectives</td>
<td>Impairs</td>
<td></td>
</tr>
<tr>
<td>QCs</td>
<td>Impairs</td>
<td></td>
</tr>
<tr>
<td>Undue effort or cost</td>
<td>On-going consolidation issues with public</td>
<td></td>
</tr>
<tr>
<td></td>
<td>sector entities depending on whether they</td>
<td></td>
</tr>
<tr>
<td></td>
<td>are lessee or lessor</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Need to interpret two different models for</td>
<td></td>
</tr>
<tr>
<td></td>
<td>the same transaction</td>
<td></td>
</tr>
<tr>
<td><strong>Conceptual Framework</strong></td>
<td>Inconsistent</td>
<td>Decided at standards level</td>
</tr>
<tr>
<td><strong>IPSASs</strong></td>
<td>Inconsistent with IPSAS 32 (symmetry with</td>
<td>Inconsistent with IPSAS 29 (leases</td>
</tr>
<tr>
<td></td>
<td>IFRIC 12)</td>
<td>are in substance financing transactions)</td>
</tr>
<tr>
<td><strong>GFS</strong></td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>
Risks and rewards model

Lack of symmetry

Conceptual
- Two models for the same transaction

Appropriate for public sector financial reporting?

Do not meet the objectives and QCs of public sector financial reporting

Is inconsistent with other aspects of the Conceptual Framework

Is inconsistent with IPSAS 29 and 32

Accounting
- Different recognition requirements

Leases

Lessor (Agenda Item 7.4)
Staff’s conclusion

Proprietary and Copyrighted Information
Leases

Lessor (Agenda Item 7.4)

• IASB’s rationale for retaining the dual model in lessor accounting
  – “The lessor accounting model in IAS 17 is well understood”;
  – “Most users of financial statements do not currently adjust lessors’ financial statements for the effects of leases”;
  – “Investors generally analyse the financial statements of individual entities (and not a lessee and lessor of the same underlying asset)”
  – “In contrast to lessee accounting, lessor accounting in IAS 17 is not fundamentally flawed and should not be changed solely because lessee accounting is changing”.
Lessor (Agenda Item 7.4)

• IASB’s rationale for retaining the dual model in lessor accounting
  – IASB’s stakeholders changed their views on lessor accounting
    • Initially they supported changes to lessor accounting;
    • In the 2013 ED, they suggested that no changes should be made to lessor accounting for cost-benefit reasons.
  – “In the light of this feedback, the IASB concluded that requiring a lessor to recognise a lease receivable for all leases would not improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with that change.”
Leases

Lessor (Agenda Item 7.4)

• Staff’s comments on IFRS 16 lessor accounting (lack of symmetry)
  – The reasons provided by the IASB’s stakeholders:
    • Are not related to the economics of a lease nor to any identified fundamental or conceptual flaw in the application of recognition requirements of the right-of-use model to the lessor; and
    • Are specific to the business environment in which they operate and specific to users’ needs in the for-profit sector.
  – The economic environment and users’ needs in the for-profit sector may be different from the public sector. For example, it might be difficult for public sector stakeholders to understand different accounting principles for the same transaction.
Leases

Lessor (Agenda Item 7.4)

- Staff’s comments on IFRS 16 lessor accounting (lack of symmetry)

<table>
<thead>
<tr>
<th>Public Sector Issue</th>
<th>Description</th>
</tr>
</thead>
</table>
| Accountability           | The public sector entity **does not provide** “information about the entity’s management of the resources entrusted to it for the delivery of services”.
|                           | ![Image](#)                                                                                                                                 |
| Decision-making          | • Users of the statement of financial position **do not have information** about the economic benefits embedded in the underlying asset from the cost, sale, re-lease or use of the underlying asset in finance leases.  
  • Often **public sector users do** analyse the financial statements of lessee and lessor of the same underlying asset.                  |
| Lack of symmetry         | **Creates asymmetrical information** in public sector financial reporting when governments do not publish consolidated financial statements. |
## Lessor (Agenda Item 7.4)

- **Staff’s comments on IFRS 16 lessor accounting (lack of symmetry)**

<table>
<thead>
<tr>
<th>Public Sector Issue</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understandability</td>
<td><strong>Increasing difficulty</strong> for public sector stakeholders to understand leasing arrangements with different accounting models for the same transaction.</td>
</tr>
<tr>
<td>Centralized lessors</td>
<td><strong>Existence of centralized lessors</strong> in the public sector that manage assets of other public sector entities (under common control or not)</td>
</tr>
</tbody>
</table>
| Frequency of lessees and lessors at the same time | **Very often** public sector entities:  
  - Lease in and lease out the **same underlying asset**;  
  - Are lessor and lessee in **different lease contracts**;                                                                                      |
Leases

Lessor (Agenda Item 7.4)

- Staff’s comments on IFRS 16 lessor accounting (lack of symmetry)
  - Example: National public sector accounting standard setter
    - Governmental Accounting Standards Board (GASB) published an Exposure Draft proposing the right-of-use model to be applicable to lessee and lessor (symmetry in lease accounting)
    - Reasons:
      - “governmental lessees and lessors should account for the same transaction in a way that mirrors how the other party accounts for it”;
      - “when the lessor and lessee are both part of the same reporting entity, symmetry in accounting prevents distortion of the total government’s financial position”.
Leases

Lessor (Agenda Item 7.4)

• Costs and benefits of applying symmetry to lessor accounting

<table>
<thead>
<tr>
<th>Costs</th>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off implementation costs for lessors</td>
<td>Represents faithfully the economics of a lease</td>
</tr>
<tr>
<td>On-going consolidation issues with commercial public sector entities that apply IFRS</td>
<td>Achieves the objectives of public sector financial reporting</td>
</tr>
<tr>
<td>On-going costs of monitoring all leases in the balance-sheet</td>
<td>Improves on-going consolidation of public sector entities that apply IPSASs</td>
</tr>
<tr>
<td></td>
<td>Better understanding of financing activities within the public sector and between the public sector and the private sector</td>
</tr>
<tr>
<td></td>
<td>Improves comparability between public sector entities</td>
</tr>
<tr>
<td></td>
<td>Increases simplicity and understandability of lease accounting</td>
</tr>
<tr>
<td></td>
<td>Provides more transparent, relevant and verifiable information</td>
</tr>
</tbody>
</table>
Leases

Lessor (Agenda Item 7.4)

• Does the IPSASB agree to adopt:
  • The right-of-use model for lessor accounting, as the mirror accounting of IFRS 16 lessee’s right-of-use model; or,
  • IFRS 16’s lessor accounting model?
### Service versus Lease versus Service Concessions

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Service</th>
<th>Lease</th>
<th>Service Concessions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control of an asset</td>
<td>Supplier: Yes, Customer: No</td>
<td>Lessor: Yes, Lessee: No</td>
<td>Grantor: Yes, Operator: No</td>
</tr>
<tr>
<td>Control the use of an asset</td>
<td>Supplier: Yes, Customer: No</td>
<td>Lessor: No, Lessee: Yes</td>
<td>Grantor: Yes, Operator: No</td>
</tr>
<tr>
<td>Access to operate an asset</td>
<td>Supplier: Yes, Customer: No</td>
<td>Lessor: No, Lessee: Yes</td>
<td>Grantor: No, Operator: Yes</td>
</tr>
</tbody>
</table>
# Leases

**IFRS 16, IPSAS 32 and IFRIC 12**

- **Service versus Lease versus Service Concessions**

<table>
<thead>
<tr>
<th>Item of statement of financial position</th>
<th>Service</th>
<th>Lease</th>
<th>Service Concessions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying asset</td>
<td>Supplier: Yes</td>
<td>Lessor: Yes (op. lease)</td>
<td>Grantor: Yes</td>
</tr>
<tr>
<td>Receivable (net investment in the lease)</td>
<td>Customer: No</td>
<td>Lessor: No</td>
<td>Operator: No</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>Lessor: Yes (finance lease)</td>
<td></td>
</tr>
<tr>
<td>Financial asset/liability</td>
<td></td>
<td>Lessor: No</td>
<td></td>
</tr>
<tr>
<td>(unconditional right to receive/pay cash)</td>
<td>Lessee: Yes</td>
<td>Lessee: Yes</td>
<td>Grantor: Yes (L-FI)</td>
</tr>
<tr>
<td>Intangible asset (right to charge users)</td>
<td></td>
<td>Grantor: Unearned revenue</td>
<td>Operator: Yes</td>
</tr>
</tbody>
</table>

**Notes:**
- **Supplier:** Yes if a service provider.
- **Customer:** No if a service provider.
- **Grantor:** Yes if the entity grants an asset to another party.
- **Operator:** Yes if the entity operates an asset for another party.
- **Lessor:** Yes if the entity has a legal right to receive payments from the lessee.
- **Lessee:** Yes if the entity has a legal right to use the asset.