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## **EPSAS Working Group meeting**

To be held in Luxembourg by videoconference  
on 09-10 November 2020, starting at 10:00

### **Item 4 of the Agenda**

## **Draft EPSAS Screening Report IPSAS 13: IFRS 16 – Leases**

*Paper by PwC in cooperation with Eurostat  
- for discussion -*

*This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.*

# EPSAS screening report

New proposed leases accounting  
model for the public sector

October 2020



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# Background

## Objectives

Reference should be made to the general introduction to the EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

## General introduction to the new proposed leases accounting model for the public sector

In March 2020, as part of Phase 1 of its Leases project, the IPSASB decided that ED 64 (modifying IPSAS 13 'Leases') will be replaced to be fully aligned with IFRS 16 (the new IFRS standard for leases), which implies the application of the right-of-use model for lessees only. International Financial Reporting Standard (IFRS) 16 'Leases' was issued by the International Accounting Standards Board (IASB) in January 2016.

In developing the new leases accounting model for the public sector, the IPSASB applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The envisaged new leases accounting model for the public sectors sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the entity.

In alignment with IFRS 16 'Leases', it introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases, with the exception of short-term leases (those with a term of 12 months or less) and leases where the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments over the lease term.

A lessor continues to classify its leases as operating leases or finance leases, based on a risks and rewards approach, and to account for those two types of leases differently.

Under IFRS 16, a lessee has to choose either the full retrospective approach or the modified retrospective approach to transition to this IFRS standard. This choice only applies if governments used IPSAS before.

### **Scope of the report**

The present screening report analyses the recognition, measurement, presentation and disclosure requirements applicable to the leases in the scope of the envisaged new leases accounting model for the public sector.

The report analyses the requirements of the new IFRS 16 standard instead of those of the current IPSAS 13 standard. The IPSASB decided to fully align with IFRS 16 as constituents and the CAG (Consultative Advisory Group) confirmed that they saw no strong case for a divergence from IFRS for public sector specific reasons. References to the EFRAG publications on IFRS 16 are also applicable and used in this paper.

### **Reference to EFRAG assessment**

EFRAG published its final comment letter to IFRS 16 on 14 October 2013 and its endorsement advice on 27 March 2017.

Based on the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG provided an opinion on IFRS 16 'Leases'. EFRAG summarised its conclusions and its endorsement advice to the European Commission as follows:

*'EFRAG has concluded that IFRS 16 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and raises no issues regarding prudent accounting. EFRAG has identified some limitations with regard to relevance, reliability and comparability but has assessed that they constitute an acceptable trade-off between the objective of achieving a complete and faithful representation of information on the one hand and reducing complexity of applying IFRS 16 on the other hand. These limitations would not prevent IFRS 16 from meeting the said qualitative characteristics.*

*EFRAG has also assessed that IFRS 16 does not create any distortion in its interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that IFRS 16 is not contrary to the true and fair view principle.*

*EFRAG has assessed that IFRS 16 would improve financial reporting and would reach a cost-benefit trade-off that is acceptable. EFRAG has not identified that IFRS*

*16 would have major deleterious effects on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing IFRS 16 is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.*

(...) *Therefore, we recommend IFRS 16 for endorsement.* EFRAG identified areas in which limitations exist to relevance, reliability and comparability (mainly in relation to the practical expedients allowed by the standard, that is the optional recognition exemption for short-term leases and leases of low-value assets, and the practical expedient to not separate non-lease components from lease components). However, it was assessed that none of the limitations identified impedes IFRS 16 from meeting each of the criteria and from delivering prudent accounting.

Further, certain specific matters that were included in the request for endorsement advice have been analysed. These matters are the following:

- General: definition of a lease and identification of contracts that convey control of the right of use an asset for a period of time.
- Improvement to financial reporting: contribution of IFRS 16 in the improvement of financial reporting.
- Potential effects on stakeholders' behaviour (including lessees, users of financial statements, lessors and other lenders).
- Potential impact on the leasing industry.
- Potential effects on competitiveness (including SMEs): how IFRS 16 could affect small and medium-sized entities (SMEs).
- Potential effects and risks on financial stability.
- Cost-benefit analysis: one-off and ongoing costs of implementing IFRS 16.

The endorsement advice on IFRS 16 Leases covered these specific matters, with no significant objections. EFRAG has therefore recommended IFRS 16 for endorsement.

### **Reference to EPSAS issue paper**

An EPSAS issue paper was prepared on the topic of 'the notion of control'. The paper was issued in September 2018.

The aim of this issue paper is to analyse the function/purpose of the notions of control used in IPSAS; compare them with the notions of control or their equivalents in ESA 2010 and, where relevant and applicable, also MGDD (reference to IFRS is added if it is deemed relevant to the analysis). The paper also analyses and explains why particular notions of control are used under IPSAS and, as a result, develops an approach for organising the future discussion on the notion of control with EPSAS stakeholders.

The notion of control is one of the fundamental aspects of accounting and financial reporting. Under international financial reporting frameworks such as IPSAS, this

notion is key in the definition of an asset and in the recognition criteria for various forms of assets in the balance sheet of the reporting entity. The period over which control is exercised may also influence the measurement of the assets controlled, as it provides an indication of the period over which service potential or economic benefits may be obtained.

With regards to lease contracts, to assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity should assess whether, throughout the period of use, the customer has both of the following:

- (a) The right to obtain substantially all of the economic benefits from use of the identified asset; and
- (b) The right to direct the use of the identified asset (ED 64 AG4).

The new proposed approach to lease accounting by lessees implies having control over the resource during the lease term, moving away from the previous approach under IPSAS 13 'Leases'. IPSAS 13 required recognition of a leased asset and a lease liability by the lessee based on a risks and rewards approach, i.e. a lease was recognised in the balance sheet of the lessee if substantially all risks and rewards incidental to ownership of the leased asset are transferred from the lessor to the lessee.

Based on the analysis of the pros and cons of both a control-based approach to asset recognition and an approach based on risks and rewards, the conclusion of the issue paper states that there are both conceptual merits (e.g. consistency in the approach) and more compelling reasons with regards to the users' needs and accountability and decision-making objectives of financial statements (neutrality, transparency) to recommend the use of an approach built on control, as required in international accounting standards such as IPSAS and IFRS.

No other EPSAS issue paper was prepared dealing with the topic of leases.

# Screening of IFRS 16 against criteria set in the draft EPSAS framework

## Introduction

IPSAS 13 'Leases' was issued in December 2001. In December 2006 the IPSASB issued a revised IPSAS 13. In January 2018, the IPSASB issued ED 64 'Leases'.

The Exposure Draft proposed a single right-of-use model for lease accounting that would replace the risks and rewards incidental to ownership model in IPSAS 13 'Leases'.

For lessees, ED 64 proposed accounting requirements that are converged with IFRS 16 'Leases' issued by the IASB. For lessors, ED 64 proposed a right-of-use model specifically designed for public sector financial reporting.

ED 64 also proposed new public sector specific accounting requirements for leases at below market terms (also known as "concessionary leases") for both lessors and lessees.

Subsequent to the publication of ED 64, the IPSASB decided that it would reconsider the concessionary leases in Phase 2 of the Leases Project.

In March 2020, as part of Phase 1 of the project, the IPSASB also decided that ED 64 would be replaced by a standard that will be fully aligned with IFRS 16, which implies the application of the right-of-use model for lessees only.

Consequently, the EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IFRS 16 for both lessees and lessors.

First, the paper addresses whether IFRS 16 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

Further, this paper includes a high-level comparison between the requirements of IFRS 16 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as ESA 2010 and EU Accounting Rules (AR), bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

The findings are presented below and the conclusions are included in the next section of this report.

# Conformity with Qualitative Characteristics

## Relevance

Prior to the issuance of IFRS 16, leases were classified as either finance leases (substantially all the risks and rewards incidental to ownership of an asset are transferred from the lessor to the lessee) or operating leases (all leases other than finance leases). Lessees were required to recognise assets and liabilities arising under finance leases and not to recognise assets and liabilities arising under operating leases.

The IPSASB initiated a project to improve the financial reporting of leasing activities to respond to criticisms from users of financial statements that the accounting model for leases failed to meet their needs. The criticisms included the fact that information reported by lessees about operating leases lacked transparency by failing to recognise that these transactions give rise to assets and liabilities. As a result, many users adjusted a lessee's financial statements by estimating how operating leases should be capitalised in order to reflect the financing and assets provided by leases.

In order to address the above criticisms, the IPSASB leases project (aligned to IFRS 16) is aiming at ensuring that lessees and lessors provide comparable and relevant information in a manner that faithfully represents lease transactions.

## Definition and identification of a lease

During the development of IFRS 16, concerns were raised that the definition of a lease might incorrectly scope services into the definition of a lease or exclude contracts that are leases from the scope of the standard.

The requirements in IFRS 16, for a lessee to recognise assets and liabilities for most leases on the balance sheet places significant emphasis on the definition of a lease and supporting guidance. For this reason, it is important to have a definition that draws the appropriate distinction between leases and service agreements and that is sufficiently understandable to be applied in a consistent manner.

IFRS 16 states that a contract is, or contains, a lease when all of the following three conditions are met:

- (a) there is an identified asset;
- (b) the customer has the right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use; and
- (c) the customer has the right to direct the use of the identified asset throughout the period of use.

These conditions are similar to the definition of a lease in ED 64. However, the new envisaged lease accounting model for the public sector introduces various modifications and clarifications. For example, it includes additional guidance and examples on assessing whether a contract conveys the right to control an underlying asset.

Each of the IFRS 16 conditions highlighted above are necessary, but not sufficient in isolation, to identify whether a contract conveys the right to control the use of an asset for a period of time. Some of the characteristics of these conditions are as follows:

- IFRS 16 requires the existence of an identified asset. One of the implications of this is that the supplier does not have the unilateral right and ability to replace the asset. The reasoning is that the customer cannot be considered to control an asset if the supplier is able to substitute the asset throughout the lease term. A second implication is that a portion of capacity that is not physically distinct cannot be an identified asset unless it represents substantially all of the capacity of the underlying asset. The control over a portion of an asset depends on the ability to physically segregate that portion - for instance, a lessee of a portion that cannot be segregated would be unable to unilaterally decide when its portion of capacity is used or where its portion of output is produced.
- The entitlement to the economic benefits arising from the use differentiates between a lessee that has control over an underlying asset and an agent that acts on behalf of others.
- The right to direct the use of the identified asset occurs when control has passed from the supplier to the customer. That is, this criterion excludes contracts from the scope of the standard where the customer has only a right to future performance, but not a current ability to control a resource. This right to direct the use does not need to be absolute: a lessee can still have the right to direct the use even though the agreement includes limitations on the use of the identified asset such as protective rights. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

The correct identification of contracts that are, or that contain, a lease is particularly important for lessees because it triggers the recognition of assets and liabilities. Clear guidance on the identification of a lease contributes to the relevance of information because it excludes from recognition those contracts that do not give control of an asset to a customer.

In addition, despite the fact that judgement is required to assess if the customer has obtained control over an identified asset, such judgements are not dissimilar nor more complex than those required in other IPSAS standards. In addition, guidance is provided in the Application Guidance to assist preparers in the exercise of judgement.

The right-of-use asset is recognised when the lessee controls the asset, which is consistent with the IPSAS Conceptual framework. The IPSASB noted that the ‘risks and rewards incidental to ownership’ model is not based on control and is therefore not consistent with the Conceptual framework.

### Lessee accounting

#### *Recognition of a right-of-use asset and a lease liability*

The requirement for a lessee to recognise a right-of-use asset and a lease liability provides relevant information because information about the nature and amounts of the different economic resources available to the lessee and claims against those resources can help users to identify an entity’s financial strengths and weaknesses.

That is, recognition of an asset over which the entity has obtained control has predictive value in that it assists users to assess the entity’s ability to generate future cash inflows or access service potential through the use of the underlying assets and enhances transparency about the capital employed. Recognition of a lease liability provides information about obligations to make future cash outflows and, hence, enhances transparency about an entity’s financial leverage.

The IPSASB acknowledged that there would be costs associated with adopting the right-of-use model in the public sector. However, the IPSASB did not consider that these would outweigh the benefits of so doing, particularly if the IPSASB also adopted the exemptions in IFRS 16 (for short-term leases and low-value assets).

#### *Separating components of a contract*

Separating lease and non-lease components in a contract provides relevant information to users because leases create assets and liabilities for a lessee (by virtue of the lessor’s performance at lease commencement) while service components that require continued performance by the lessor throughout the lease term do not. Consequently, requiring lessees to capitalise service components would result in lessees overstating right-of-use assets and lease liabilities.

#### *Exemptions and practical expedients on recognition*

IFRS 16 allows for optional recognition exemptions for short-term leases and leases for which the underlying asset is of low value (low-value assets) and introduces the practical expedient to not separate non-lease components from lease components would result in the omission of relevant information.

Fieldwork conducted by the IASB during the preparation of IFRS 16 has suggested that, in most cases, assets and liabilities arising from leases within the scope of the low-value assets exemption would not be material, even in aggregate. In such cases, the effects of the exemption would not be different from applying the concept of materiality in the Conceptual framework.

In addition, when a lessee uses the exemptions for short-term leases and leases of low-value assets, specific disclosures are required and in particular:

- (a) the lease expenses for short-term leases and leases of low-value assets are disclosed separately; and
- (b) the future lease commitments for short-term leases are disclosed if the portfolio of short-term leases at the end of the reporting period is dissimilar to the portfolio over the reporting period.

The above disclosures will enable users to understand some of the effects of use of the exemptions for short-term leases and leases of low-value assets.

The above disclosures will generally provide users with sufficient information to understand how the recognition exemptions and practical expedients affect a lessee's financial statements.

#### *Initial measurement of the right-of-use assets and the lease liability*

The lease liability is measured as the present value of the future lease payments for the right to use the underlying asset during the lease term. The lease term encompasses:

- (a) periods covered by options to extend the lease if the lessee is reasonably certain to exercise the option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise the option.

These requirements provide relevant information to users in relation to the period over which the lease will affect the lessee's cash flows. Based on evidence received on Exposure Draft ED/2013/6 Leases (the 2013 ED) (in relation with IFRS 16), EFRAG understood that the current practice of accounting for lease options that are 'reasonably certain' to be exercised works well in practice for both preparers and users.

IFRS 16 requires a lessee to consider all relevant facts and circumstances that create an economic incentive to exercise, or not to exercise, an option. It also includes extended illustrative guidance on the types of factors that should be considered in making the assessment.

Not recognising options that are reasonably certain to be exercised could distort the depiction of the financial position and performance of the entity. For example, when the terms are advantageous to the lessee, the value of the option is likely to have been incorporated in the payments for the initial term, which will then be higher relative to the payments for the optional periods. Excluding the payments for the optional periods would result in recognising a higher cost of the lease in the first non-cancellable period which would not result in relevant information.

Variable lease payments relate to:

- (a) payments based on an index or rate - these should be included in the measurement of the lease liability; and
- (b) payments linked to future performance - these should not be included in the measurement of the lease liability.

Including variable lease payments that are based on an index or rate using the index or rate at the commencement date (i.e. excluding estimates of the effects of future changes in indexes or rates) in the measurement of lease liabilities provides relevant information. These payments represent the lessee's unavoidable obligation based on conditions at the applicable date.

Additional disclosures are required for payments that are not included in the measurement of the lease liability, in particular:

- (a) the expense for the period relating to variable lease payments not included in the measurement of lease liabilities; and
- (b) the future cash outflows to which the lessee is potentially exposed that have not been reflected in the measurement of lease liabilities (when required to meet the disclosure objective).

These disclosures will provide useful information to users about the effect of variable lease payments.

#### *Subsequent measurement of the right-of-use assets and the lease liability*

The subsequent measurement of the right-of-use asset is at cost less accumulated depreciation and accumulated impairment losses, adjusted for remeasurements of the lease liability. This reflects the consumption of the economic benefits in the right-of-use asset and is similar to the subsequent measurement of assets of a similar underlying nature such as property, plant and equipment. This provides relevant information which has confirmatory value as it provides information about the economic resources available to generate future cash inflows or access service potential.

Subsequent measurement of the lease liability is on an amortised cost basis, subject to the requirements on lease modifications. This provides information which is useful for predicting future cash outflows as it reflects the lessee's obligation to pay the amounts specified in the contract.

In principle, users of financial statements receive more relevant information if lessees reassess whether the exercise of extension, termination and purchase options is reasonably certain on a regular basis. This is because the reassessment would reflect current economic conditions. However, requiring reassessment at each reporting date would be costly for an entity with many leases that include options.

An appropriate balance has been achieved between relevance and cost and complexity by requiring reassessment only upon the occurrence of a significant event or change in circumstances that is within the control of the lessee and that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option.

### *Presentation*

IFRS 16 requires lessees to present right-of-use assets separately from other assets, and lease liabilities separately from other liabilities. The separate presentation of right-of-use assets and lease liabilities results in the provision of relevant information because it enables users of the financial statements to better evaluate the respective risks associated with owned and leased assets and provides useful insights into the economic characteristics of the lease liability which may include specific features such as options and variable lease payments.

IFRS 16 also requires a lessee to present separately:

- (a) in profit or loss, the interest expense relating to the lease liability and the depreciation expense for the right-of-use asset; and
- (b) in the statement of cash flows, the principal portion of cash repayments of the lease liability as financing activities and cash payments relating to interest consistently with other interest payments (as either operating or financing activities).

Separating interest and depreciation provides cohesion between the lessee's statement of financial position, the statement of financial performance and the statement of cash flows. The recognition of an interest expense relating to the lease liability is consistent with the financing nature of that liability. The classification of the cash outflows is similarly consistent with nature of the liability. Likewise, the recognition of a depreciation expense is consistent with the non-financial nature of the right-of-use asset. Cohesion between the primary financial statements enhances the quality of information including its use in calculating of key metrics such as return on capital employed and leverage ratios.

### *Disclosures*

IFRS 16 sets out an overall disclosure objective that requires lessees to disclose information that gives users a basis to assess the effect that leases have on the entity. It identifies two-tiers of disclosures:

- (a) specific quantitative requirements that will arise with all leases; and
- (b) additional entity-specific quantitative and qualitative information when necessary to meet the disclosure objective.

Including objective-based disclosure requirements and requiring lessees to exercise judgement on how to meet these objectives, is more likely to lead to the provision of relevant information. Given that leases may include complex or unique terms and conditions, the most useful information can be different for different lease portfolios. Fully prescriptive disclosure requirements may be less effective in meeting the information needs of users.

### Lessor accounting

#### *Asymmetry between lessee and lessor accounting*

By retaining lease accounting of IFRS 16 for lessors based on the existing requirements, IFRS 16 does not provide symmetry between the lessee and lessor accounting models. A controls-based approach is adopted for lessees, while a risks and rewards approach is retained for lessors, which triggers some conceptual issues.

However, several points should be noted:

- (a) users indicated that they did not currently adjust lessors' financial statements for the effects of leases, indicating that the existing lessor accounting model provides users with the information that they need;
- (b) lessor accounting resulting from the requirements in IFRS 16 is well understood and, unlike lessee accounting, is not deemed to be fundamentally flawed; and
- (c) a symmetrical approach to lessor accounting would involve the partial derecognition of assets owned by lessors, compensated by the recognition of a right-of-use asset, which would be complex and costly to apply.

For these reasons, a risks and rewards model is kept for lessors. The relevance of the IFRS 16 model for lessees is justified by the following factors:

- it aligns to the control-based recognition principles used for other assets, bringing more consistency;
- it is less judgmental compared to the risk and rewards approach and reduces accounting structuring opportunities;
- it brings more assets (and liabilities) on the balance sheet therefore better meeting the accountability objectives of financial statements (entities will be more accountable for the assets they have under control).

### **Faithful representation / Reliability**

The IPSASB initiated a project to improve the financial reporting of leasing activities to respond to criticisms from users of financial statements. Criticisms also included inadequate information for users about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the

underlying asset), particularly for leases of equipment and vehicles that were classified as operating leases.

For lessors, the IPSASB concluded that existing lessor accounting was well understood. As a result, it was decided in March 2020 that the new lease accounting model for the public sector will carry forward substantially all of the existing lessor accounting requirements. However, to address the criticism that lessors did not provide adequate information about their exposure to certain risks, it will require enhanced disclosures of information about a lessor's leasing activities.

### Lessee accounting

#### *Separating components of a contract*

Separating the lease components of a contract provides reliable information about the amounts of a lessee's right-of-use assets and lease liabilities because the amounts recognised reflect how a right-of-use asset could have been priced had it been in a separate contract.

Excluding the non-lease components of a contract from recognition in the statement of financial position and statement of financial performance faithfully represents the distinction between lease and non-lease assets, liabilities, income and expenses. This separation enables the faithful representation of the different economics underlying lease contracts and other contracts.

#### *Disclosures*

The specific disclosures required by IFRS 16 provide information that is useful for understanding the nature of a lessee's leasing activities and associated cash flows. For example, IFRS 16 requires a maturity analysis of lease liabilities where lessees are required to exercise judgement to determine the appropriate time bands. Having a prescriptive approach when identifying the appropriate time bands might not necessarily result in providing the most useful disclosures to users of financial statements. These disclosure requirements can enhance the predictive value of the financial information, especially when assessing the flexibility, restrictions and risks imposed by leases and evaluating any deviations from industry practice.

### Lessor accounting

#### *Disclosures*

The disclosure requirements in IFRS 16 provide relevant information to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities. IFRS 16 requires a lessor to disclose:

- (a) information about the different components of lease income recognised during the reporting period: This disaggregation of lease income (for instance separately disclosing income relating to variable lease payments that do not

depend on an index or a rate) enhances the usefulness and predictive value of information;

(b) information about how the entity manages its risk associated with any rights it retains in the underlying asset: The risks associated with the residual value of leased assets are often a lessor's primary risks. These risks can affect the profitability of the leases. The disclosure will therefore provide useful information about lessor's risk exposures and will enable users to evaluate the risks associated with residual interests and differentiate those risks from credit risk;

(c) a disaggregation of each class of property, plant and equipment into assets that are subject to operating leases and assets that are not subject to operating leases: thus allowing users to obtain information about leased assets that generate lease income separately from owned assets held and used by the lessor; and

(d) for finance leases, a maturity analysis of the lease payments receivable, for a minimum of each of the first five years and a total of the amounts for the remaining years: this will provide useful information about the timing of the cash flows and the lessor's liquidity risk.

The disclosure requirements contribute to the completeness of information about the effect that leases have on the financial position, financial performance and cash flows of the lessor.

## **Completeness**

### Lease modifications

Unlike the current IPSAS 13, the proposed leases accounting model contains guidance for both lessees and lessors on modifications to leases. For lessees, and lessors of finance leases, a lease modification is now accounted for as a separate lease if the modification increases the scope of the lease by adding the right to use one or more underlying assets and the consideration is commensurate with the stand-alone price for the increase in scope.

For lease modifications that are not accounted for as a separate lease, a lessee accounts for the modification by remeasuring the lease liability. The lessee adjusts the carrying amount of the right-of-use asset and, for a decrease in the scope of a lease, recognises any gain or loss in profit or loss.

For lessors with operating leases, a modification is recognised as a new lease.

Through adding guidance on the topic of lease modifications, the new version of the standard brings more completeness and consistency.



## Lessee accounting

Similar to current finance lease accounting, IFRS 16 requires the lease liability to be measured initially on the basis of the present value of future lease payments. However, it provides more detailed guidance. The lease payments included in the measurement comprise:

- (a) fixed lease payments (including in-substance fixed payments) less any lease incentives receivable;
- (b) variable lease payments that are based on an index or a rate, using the index or rate as at the commencement date;
- (c) amounts expected to be payable under residual value guarantees; and
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option and payments of penalties to terminate the lease if the lease term reflects early termination.

Through adding guidance on the topic of lease payments to be included in the measurement of the lease liability, the new version of the standard brings more completeness.

## Lessor accounting

The new accounting model carries forward lessor accounting substantially unchanged. However, it requires additional information about a lessor's leasing activities and, in particular, the exposure to certain risks, which makes the disclosed information related to lessors more complete.

## Presentation and disclosure

IFRS 16 provides an overall disclosure objective which applies to both lessees and lessors. It requires an entity to '*disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows*'.

For lessees, unlike IPSAS 13, IFRS 16 contains detailed presentation and disclosure requirements, including requiring information about leases to be provided in a single note or a separate section in the financial statements. In particular:

- (a) Separate presentation of the right-of-use asset and lease liabilities either in the statement of financial position or in the notes.
- (b) Information relating to revenues and expenses including depreciation and impairment of right-of-use assets by class of underlying asset, interest expense on lease liabilities, expenses relating to short-term leases and leases

of low-value assets, expenses for variable lease payments not included in lease liabilities and income from sub-leasing right-of-use assets.

(c) Information relating to the statement of cash flows including the total cash outflow for leases, cash payments for the principal portion of the lease liability and cash payments for the interest portion of the lease liability.

(d) Any additional entity-specific information that is relevant to satisfying the disclosure objective.

With regard to the latter point, lessees are required to apply judgement to determine which additional disclosures are necessary to meet the overall disclosure objective and IFRS 16 provides examples of such additional disclosures. This objective-based approach ensures that entity-specific information is provided about features of leasing activities that can be particularly complex or contract-specific and contributes to the completeness of the information about a lessee's leasing activities. For example, IFRS 16 requires a lessee to disclose information about short-term leases and leases of low-value assets whenever a lessee has elected to apply the recognition exemptions. In such cases, a lessee needs to assess whether additional disclosures are required, such as the remaining lease term of leases of low-value assets, for the information to be complete.

New disclosure requirements for lessors include information about leasing activities including how the lessor manages the risks associated with the rights that it retains in underlying assets.

Thanks to the more detailed presentation and disclosure requirements introduced in IFRS 16, information provided to the users of the financial statements will be more complete.

### Concessionary leases

Concessionary leases are leases granted at below-market conditions and are common in the public sector. The topic is however not addressed in IFRS 16.

Respondents to ED 64 did not have a unified or consistent view on the appropriate accounting for concessionary leases (for either lessors or lessees). Progress on concessionary leases will be dependent on the IPSASB first agreeing on an approach to lessor accounting. It was therefore decided to defer the work on concessionary leases from the current phase of the Leases project.

### **Prudence**

#### *Recognition of liabilities arising from lease contracts*

By requiring the recognition of liabilities arising from all lease contracts (with limited exemptions) corresponding to the unavoidable payments to be made under the lease, IFRS 16 is consistent with the concept of prudence.

### *Initial measurement of right-of-use assets and lease liabilities by lessees*

The initial measurement of the lease liability only includes fixed payments (including in-substance fixed payments) and those variable lease payments that depend on an index or a rate. The lessee has no ability to avoid variable payments that depend on an index or a rate under the terms of the lease and therefore these are appropriately included in the initial measurement of the lease liability.

IFRS 16 requires the variable payment clauses to be analysed to determine whether or not they are in-substance fixed payments. This limits the risk of understatement of the lease liabilities by ensuring that payments that contain, in form, variability but which are, in substance, fixed are included in the initial measurement of the lease liability and right-of-use asset. Including in-substance fixed payments in the lease liability leads to prudent accounting.

The requirements for the lessee, when initially determining the lease term, to consider whether it is reasonably certain to exercise extension and termination options by looking at all relevant facts and circumstances that create an economic incentive to exercise, or not to exercise, the option leads to prudent accounting and reduces the risk that non-substantive clauses are taken into account to increase or reduce the lease term beyond what is economically reasonable for the lessee.

The reassessment as to whether a lessee is reasonably certain to exercise, or not to exercise, an option only occurs in the case of an event (or a change in facts or circumstances) that is within the control of the lessee. Limiting the reassessment requirements in this way is prudent because only events and factors that the lessee has control over are considered as opposed to reassessing options in response to external events.

Overall, the initial measurement of lease liability ensures that the unavoidable payments arising from the lease contract are not understated. The initial measurement of the lease liability has a direct effect on the initial measurement of the right-of-use asset as the lease liability is the main component in that measurement. All of the above assessments on the impact of the initial measurement of the lease liability are therefore also applicable to the right-of-use asset and ensures that the asset is not overstated. As a result, the initial measurement by lessees of right-of-use assets and lease liabilities leads to prudent accounting in that the liability does not understate the required payments and the asset is subject to an impairment test to ensure that it is not overstated.

### *Subsequent measurement of right-of-use assets by lessees*

After the commencement date, the right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment losses, adjusted only for remeasurements due to lease modifications. Overall, the requirements are aligned with those applicable to owned property, plant and equipment, including the

impairment requirements the right-of-use asset. These requirements are assessed to lead to prudent accounting.

For lease modifications that increase the consideration paid for a lease, the change to the lease liability is accounted for as an increase in the carrying amount of the right-of-use asset even if the scope or the term of the lease has not changed. Some might consider that this requirement results in the overstatement of the right-of-use asset as the 'value' of the right-of-use asset has not changed and therefore the increase in lease cost should be expensed. However, such a lease modification represents a change in the cost of the right-of-use asset as a result of the modification. Given that lease assets are subject to an impairment test, it is not imprudent to increase the carrying amount of the right-of-use asset for a modification.

## **Neutrality**

### *Control-based approach*

The application of the control-based approach for asset recognition is more neutral and freer from bias as its application tends to require less judgment than an approach based on risks and rewards.

Application of a control-based approach will make it more difficult to structure certain transactions in a way that allows assets used by the entity (and the related liabilities) to be presented off balance sheet.

In addition, this approach is more transparent as it tends to bring more assets in the balance sheet than an approach based on economic ownership (i.e. based on risks and rewards).

Bringing assets on the balance sheet following application of a control-based approach seems to better serve the accountability and decision-making objectives of financial statements. It would provide a more comprehensive picture of the assets under the control of the government entity and therefore of the resources entrusted to that government entity, which is key information for a public sector entity. Recognition of assets on the balance sheet makes them apparent to the public and should force governments to make conscious decisions on how best to manage these assets.

## **Verifiability**

Application of IFRS 16 requires the exercise of judgment in certain areas (refer to the comments under the QC 'Understandability'). However, the use of judgment is inherent in the preparation of financial statements and is needed to best reflect the substance of the various lease transactions.

Furthermore, IFRS 16 includes detailed guidance on how to apply the principles, making application of the new proposed rules more verifiable.

These aspects were assessed by EFRAG before it endorsed IFRS 16 and EFRAG concluded that IFRS 16 rules constitute an acceptable trade-off between the objective of achieving a complete and faithful representation of information on the one hand and reducing complexity of applying IFRS 16 on the other hand.

### **Substance over form**

Lease contracts create assets and liabilities that should be recognised by lessees. Information on the face of the financial statements is more relevant than disclosures in the notes. It follows that the requirement for a lessee to recognise right-of-use assets and lease liabilities arising under leases is critical to the provision of relevant information.

IFRS 16 defines a lease based on criteria that identify only those situations in which a lessee has obtained control over a resource.

The substance of a lease is that the lessee acquires the economic benefits or service potential of the use of the underlying asset in return for assuming an obligation to pay for that right. This is because, once the asset is made available for use by the lessee, the lessor is unable to retrieve or otherwise use the underlying asset for its own purposes despite being its legal owner. The lessee can determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use. The 'substance over form' principle implies that transactions and other events that are accounted for and presented in accordance with their substance and not merely with their legal form provide more relevant information to users.

### **Understandability**

Lease transactions can sometimes be complex, and the accounting rules laid down in IFRS 16 are designed to address this complexity, be it in respect of the identification of transactions that constitute a lease or of the accounting treatment of such transactions. This might in certain cases somewhat impair understandability.

#### *Identification of a lease*

The definitions of a lease in IPSAS 13 and IFRS 16 are similar. However, IFRS 16 introduces new and more detailed guidance on identifying a lease. Indeed, the new requirements state that a contract is (or contains) a lease only when all of the following three conditions are met:

- (a) There is an identified asset. An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer. Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset throughout the period of use. A substantive substitution right exists if the supplier has the practical ability to substitute the asset and

would benefit economically from exercising its substitution right. A legal right to substitute is not, in itself, conclusive. If the customer is unable to reach a conclusion on whether a substitution right is substantive, there is a presumption that any substitution right is not substantive.

(b) In order to control the use of the identified asset, the customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.

(c) The customer has the right to direct the use of the identified asset throughout the period of use. This requires assessing which party has the right to direct how and for what purpose the asset is used. If those decisions are predetermined, the customer assesses whether it has the right to operate (or direct others to operate) the asset, or whether it has designed the asset in a way that predetermines how and for what purpose it is used. A supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of the asset.

#### *Single accounting model for lessees*

The selection of a single or dual measurement model for lessees was the subject of substantial debate. A single measurement model is less complex to apply and easier to understand, as it removes the need to apply judgement in order to classify leases.

Although IFRS 16 introduces some new concepts (such as right-of-use assets or in-substance fixed payments) it principally extends the well-understood accounting treatment currently applicable to finance leases to all leases. In addition, the subsequent measurement requirements are similar to those for other non-financial assets and financial liabilities. For example, right-of-use assets are depreciated in a similar way to depreciation of other non-financial assets, such as property, plant and equipment, and interest is recognised on lease liabilities in a similar way to interest on other financial liabilities.

#### *Presentation and disclosure for lessees*

The presentation requirements in IFRS 16 reflect the cohesion of the recognition requirements for lease activities between the statement of financial position, statement of profit or loss and the statement of cash flows. Consequently, this cohesiveness results in improved understandability of the reported financial information.

The separate presentation of:

(a) right-of-use assets from other assets enhances the understandability of an entity's choice between the use of leased and owned assets to derive economic benefits;

- (b) lease liabilities from other liabilities provides information that is useful in understanding a lessee's obligations from lease arrangements and highlights the contractual link to a corresponding asset;
- (c) interest expense from depreciation expense; and
- (d) cash payments for the principal portion of the lease liability from cash payments for the interest portion of the lease liability provides cohesion between the lessee's statement of financial position, the statement of profit or loss and the statement of cash flows.

IFRS 16 requires a lessee to disclose information about its leases in a single note or separate section in its financial statements. Requiring all disclosures about a lessee's leasing activities in one place makes it easier for users to assess the effect of these activities on the financial statements.

The principle-based overall disclosure objective enables lessees to determine the most appropriate way to disclose information with complex terms and conditions whereas fully prescriptive disclosure requirements may be less effective in enabling users to understand a lessee's leasing activities. The decision to include a disclosure objective instead of requiring disclosure of specific information about complex leases was to address concerns raised by some constituents that it would be difficult to provide meaningful information when an entity has a large volume of complex leases.

The presentation and disclosure of information relating to a lessee's leasing activities will generally improve users' understanding of the effect of these activities on the financial statements.

#### *Presentation and disclosure for lessors*

IFRS 16 provides enhanced disclosures beyond those previously required. The enhanced disclosure requirements for lessors relating to a lessor's exposure to residual asset risk and credit risk enable users of financial statements to understand how a lessor manages its risk exposures and result in improved understandability about a lessor's leasing activities.

### **Comparability**

#### *Single accounting model for lessees*

The key reason for issuing IFRS 16 is that users have indicated that the assets and liabilities created by lease contracts should be recognised by lessees. This results in enhanced comparability for assets and liabilities within and between reporting entities. Many users indicated that they currently make adjustments to entities' reported liabilities to reflect lease obligations and some users indicated that they also make adjustments to entities' reported assets in order to enhance comparability between entities.

In addition, criticisms from users of the financial statements relates to the existence of two different lessee accounting models (finance leases and operating leases) meant that transactions that were economically similar could be accounted for very differently, thus reducing comparability for users of the financial statements.

To answer this issue, the IPSASB decided in March 2020 that the new leases accounting model for the public sector will introduce a single lessee accounting model, thereby eliminating the classification of leases as either finance or operating and requiring lessees to recognise assets and liabilities for the rights and obligations created by leases.

### *Exercise of judgment*

Application of the new model should be simple in many cases and should not reduce comparability. However, it could be argued that the judgements required in some areas could limit comparability. This could arise when IFRS 16 requires various factors to be considered and those factors contain an unusual degree of uncertainty or where the information is extremely difficult to obtain. The main areas where judgement is required by IFRS 16 are:

- (a) determining whether a contract contains a lease;
- (b) determining the lease term (i.e. whether lease extension and termination options are 'reasonably certain' to be exercised by the lessee);
- (c) determining whether payments are variable or in-substance fixed;
- (d) determining whether a sale has occurred in a sale and leaseback transaction (for seller-lessees);
- (e) for lessees, determining the discount rate; and
- (f) for lessors, determining whether a contract is an operating or a finance lease.

Making judgements is inherent in principles-based standards and may be necessary to best reflect the substance of a transaction or event. Furthermore, the level of judgement required by IFRS 16 is not so exceptional that it would be impracticable to apply the requirements. The extensive application guidance included in IFRS 16 provides the relevant framework for the exercise of judgement, and illustrates the principles included in the standard.

In addition, IFRS 16 has removed the need for lessees to assess whether a lease is an operating lease or a finance lease, thereby removing a major area where judgement was required.

IFRS 16 provides guidance on the most important issues, including providing additional guidance on areas where the previous guidance was considered to be insufficient, therefore providing the foundation for greater comparability.

#### *Measurement of the right-of-use asset and the lease liability*

The basis for the initial measurement of the right-of-use asset and lease liability is cost, based on the present value of the lease payments due over the lease term; therefore an entity with a lease for a shorter period of time will recognise a lower lease liability and right-of-use asset than an entity with a lease for a longer period. This allows users to appropriately compare the financial position between entities that lease for different periods, and between entities that lease and entities that purchase. An entity that leases an asset for a shorter period of time retains more flexibility than an entity that leases the same asset for its full economic life or purchases it, because the entity that leases an asset for a shorter period of time is not obligated beyond the lease term. However, this entity is exposed to the risk that the asset, or a similar one, will not be available at the end of the lease, so it is appropriate that the measurement of its right-of-use asset reflects the terms and conditions of the contract.

#### *Presentation*

The separate disclosure of right-of-use assets from other assets and lease liabilities from other liabilities enhances the comparability of the financial statements and as such allows:

- (a) comparison across entities in the way they derive and finance economic benefits or service potential from their owned and leased assets; and
- (b) comparison within the same entity by allowing a comparison between the return on investment on owned and leased assets.

In addition, separating interest and depreciation in the lessee's statement of profit or loss improves cohesion between the financial statements by presenting separately the interest expense arising from the lease liability and the depreciation expense related to the right-of-use asset. This will also enhance comparability between entities that borrow to buy assets and those that lease similar assets.

#### *Use of exemptions and practical expedients*

For comparability purposes, the use of exemptions and practical expedients (the optional recognition exemption for short-term leases and leases of low-value assets, and the practical expedient to not separate non-lease components from lease components) results in like items being accounted for differently. However, participants in EFRAG's 2014 limited survey on simplifications to the lessee

accounting model identified that exemptions and practical expedients were necessary to reduce complexity and implementation costs.

EFRAG also observed that the IASB has conducted fieldwork to assess the effect that low-value asset leases would have if the right-of-use assets and lease liabilities were recognised in the financial statements of lessees and concluded that, in most cases, assets and liabilities arising from leases within the scope of the exemption would not be material, even in aggregate.

Finally, the required disclosures when these exemptions and practical expedients are used may mitigate, in part, the loss of comparability.

## Alignment with other frameworks

### ESA 2010

IPSAS adopts a control-based approach to asset recognition and both recent IPSAS and IFRS developments tend to align the rules in that domain. Under ESA 2010 rules, assets are recorded by the economic owner leading in certain cases (e.g. when accounting for leases) to a risks and rewards approach to asset recognition, thus creating a difference with the approach based on control prescribed by international accounting standards.

The IPSASB indeed concluded that control is an essential characteristic of an asset because the presence of control facilitates the association of an asset with a specific entity (Conceptual framework BC 5.9). The IPSASB concluded that the economic ownership approach is subjective and difficult to operate, and therefore rejected this approach (Conceptual framework BC 5.13).

### IFRS<sup>1</sup>

IFRS 16 is used as a basis to develop the new leases accounting model. The new IPSAS standard on leases will therefore be aligned with IFRS 16. Some differences will probably remain, such as:

- the new proposed model under IPSAS will use different terminology;
- the new proposed model under IPSAS will contain additional requirements related to concessionary loans.

The above guidance is helpful in achieving the objective of comparability between public sector entities without creating unnecessary differences between IFRS and IPSAS.

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<sup>1</sup> Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on [https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard\\_June%202019.pdf](https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf)

## EU accounting rules

The objective of this EU accounting rule is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

EU Accounting Rule (AR) 8 prescribes the accounting treatment of leases for lessees and lessors and applies to the appropriate accounting policies and disclosures to apply in relation to finance and operating leases. EU AR 8 is derived from IPSAS 13 'Leases'. It has not been updated for upcoming changes to the standard.

## European Public Good

### **Assessing whether the new leases accounting model for the public sector is conducive to the European public good**

The assessment of whether the new leases accounting model for the public sector would be conducive to the European public good addresses the following items:

- a) Whether the standard will improve financial reporting;
- b) The costs and benefits associated with the standard; and
- c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why the new model would not be conducive to the European public good:

- The new model will contribute to improving financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. It will bring a distinct improvement in enabling users to evaluate the significance of lease transactions for the entity's financial position and performance. It will bring greater consistency and transparency by bringing all lease transactions (with some exemptions) in the balance sheet of lessees.
- The information needed for the application of the new proposed model can be available in a timely manner only if the necessary systems and procedures are in place. Implementation of the requirements would involve one-off costs and more moderate costs thereafter on preparers. The benefits derived from the improvements should however outweigh the costs. A proportionate pragmatic approach to implementation contributes to this objective.

# Conclusion

## **Assessing IFRS 16, and thereby the new proposed lease accounting model for the public sector, against the criteria formulated in the draft EPSAS framework**

The analysis has not revealed major conceptual issues with IFRS 16 and has not identified any inconsistency between IFRS 16 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider the following conclusions. The information resulting from the application of IFRS 16:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

## **Alignment of lease accounting models for lessees and lessors with IFRS 16**

The IPSASB decided to replace IPSAS 13 'Leases' proceeding with the right-of-use model for lessees and keeping the risks and rewards model for lessors. This decision is:

- less costly/challenging to implement;
- aligned with the IPSASB's strategy & work plan to maintaining IFRS alignment where no public sector specificity warrants a different treatment; and
- the most feasible option as it allows greater certainty on the timeline and outcome for a new IPSAS on leases.

However, in order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, additional guidance and improvements in certain areas might be desirable.

- *Concessionary leases.* IFRS 16, which has been screened for the purpose of informing the future EPSAS standard setting, does not address the accounting of leases at below-market conditions (the so-called 'concessionary leases'). Concessionary leases are however frequent in the public sector. Developments at the level of the IPSASB leases project should be followed up and analysed to determine whether the rules that will be proposed for concessionary lease are suitable for use by EU governments.

- *Judgment and comparability.* The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of the upcoming IPSAS standard on leases, based on IFRS 16, and thereby the new leases accounting model for the public sector as a starting point in implementing the equivalent EPSAS, considering the need for additional guidance in certain areas and resolution of the matters identified in the present EPSAS screening report.