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PBE News
Knowledge, Experience, Insight

At a glance

Three years after its initial attempt at lease accounting reform in the PBE sector, on 16 January 2021, the IPSASB has issued Exposure Draft 75 Leases (ED 75) to replace IPSAS 13 Leases. The exposure draft proposes to align PBE lease accounting with the for-profit sector requirements prescribed in IFRS 16 Leases. If the exposure draft is issued in its current form and adopted by the NZ Accounting Standards Board it will bring about a significant change in lessee accounting for the PBE sector in New Zealand.

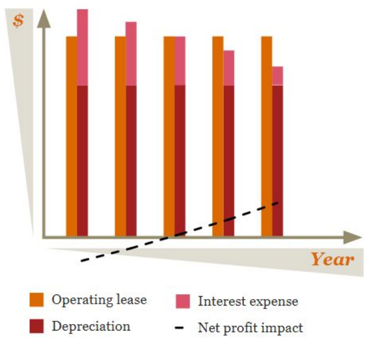
IPSASB publishes ED 75 Leases

Three years after its issue of ED 64 on lease accounting (which received very mixed feedback) the IPSASB, has had another attempt to reform accounting in this area with the issue of a new exposure draft, ED 75 Leases. If issued and adopted in New Zealand as proposed, the new requirements will have substantial impact on both the statement of financial position and statement of financial performance of public benefit entities that are lessees. The ED has been issued to deal with lease accounting model(s) for both lessees and lessors based on IFRS 16. A separate exposure draft will be issued to deal with public sector specific issues, such as concessionary leases.

Lessee accounting

For lessees, the distinction between operating and finance leases will no longer be relevant in determining the appropriate accounting treatment. Instead, a single right-of-use model will be applied to almost all leases, resulting in the recognition of a right-of-use asset and lease liability, based on the present value of future lease payments.The only exemptions are for certain short-term leases and leases of low-value assets.

Under the proposed model, assets and liabilities in the statement of financial position will increase and virtually all financial ratios and performance metrics such as gearing will be affected. These changes could also result in organisations reassessing certain ‘lease versus buy’ decisions. There will also be a change to both the expense classification (lease expense replaced with depreciation and interest expense) and recognition pattern (acceleration of interest expense relative to recognition pattern of operating leases currently).



PwC Insight

Currently under the Public Finance Amendment Act 2004, public entities have been dissuaded from entering into finance leases. This is because entering into finance leases constitutes borrowing on behalf of the Crown, which departments and other public entities subject to the Public Finance Amendment Act cannot lawfully do without permission from the Minister of Finance. Under the proposed amendments, all leases including those previously classified as operating leases, will be included in the statement of financial position as a financial liability and right of use asset.
If the NZASB chooses to adopt a standard similar to ED 75, further consideration will need to be given to how its adoption will impact public entities’ obligations under the Public Finance Amendment Act 2004.

Lessor accounting

Lessor accounting will remain substantially the same under ED 75, which continues to require a lessor to classify a lease as a finance lease or an operating lease in the same manner as currently required in IPSAS 13. However, lessors should be aware of the new guidance on the definition of a lease, lease term, accounting for subleases and sale and leaseback transactions. The changes in lessee accounting might also have an impact on lessors when negotiating with their tenants whose needs and behaviours may change as a result of the new accounting rules.

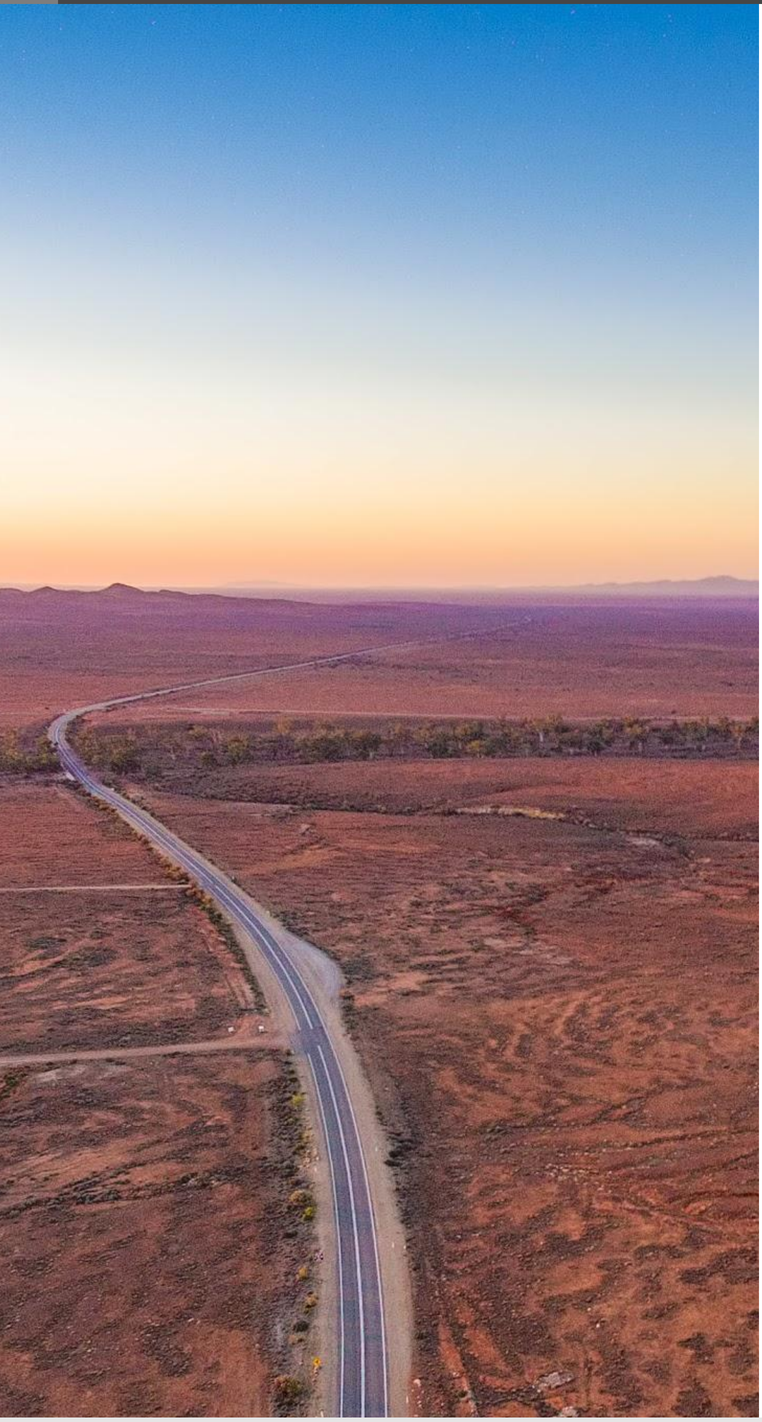
Comparison to IFRS 16

The proposed standard is substantially the same as IFRS 16 with the exception of provisions related to “manufacturer and dealer lessors” which are not included. The IPSASB decided to refer to both “economic benefits” and “service potential” when identifying a lease to ensure consistency with *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. Early application will be permitted for entities that apply the new financial instruments and revenue standards, IPSAS 41 *Financial Instruments*, ED 70 *Revenue with Performance Obligations* as well as ED 79 *Non-current Assets Held for Sale and Discontinued Operations*.

PwC Insight - Top Issues faced by corporates in adopting NZ IFRS 16

NZ IFRS 16 became mandatory for for-profits for periods beginning on or after 1 January 2019. Below are some examples of common issues faced by corporates in adopting NZ IFRS 16, which are likely to be relevant to PBEs if the new standard is issued as proposed:

- *Completeness and accuracy of underlying data* - the transition has been particularly complex for corporates who have a large number of operating leases. Lease information is often not maintained in one central location causing problems with completeness of data and choice of transition method adopted. PBEs should start collecting and evaluating their lease data as soon as possible.
- *Difficulties in determination of the interest rate implicit in a lease and incremental borrowing rate* - At commencement, a lease liability is calculated as the present value of the lease payments required to be paid by the lessee. For lessees, the discount rate should be the interest rate implicit in the lease if readily determinable. In practice, the interest rate implicit in the lease is unlikely to be stipulated within the agreement. Where this cannot be readily determined the lessee’s incremental borrowing rate (IBR) can be used to discount payments. However its determination is also not a simple exercise. The IBR cannot simply be the rate from a recent borrowing. Information that the lessee may need to gather in its determination includes:
    - The lease term
    - The type of asset being leased
    - An approximation of the value of the right of use asset at the commencement
    - The lessee’s credit rating
- *Determining the lease term will require judgement* - All lease liabilities are to be measured with reference to the lease term which includes optional lease periods when an entity is reasonably certain to exercise the option to extend (or not terminate) a lease. Entities will need to consider all relevant facts and circumstances that create economic incentive for the lessee to exercise the option including the importance of the leased assets to the entity's operations and the availability of suitable alternatives.



Leases at below market terms

Public sector entities often enter into leases at below market terms (where the consideration stipulated per the lease agreement is lower than market rental). The IPSASB is planning on releasing an additional ED, focused on concessionary leases and other public sector specific issues. With ED 75, the IPSASB has issued a Request for Information (RFI), seeking information on how concessionary leases and other arrangements are being accounted for currently.

Constituents have been asked to provide information on the following seven areas:

(a) Concessionary leases/arrangements;

(b) Leases for zero or nominal consideration;

(c) Access rights (or right of access to property and/or land);

(d) Arrangements allowing Right-of-Use;

(e) Social housing rental arrangements;

(f) Shared properties with or without lease arrangements in place; and

(g) Other arrangements similar to leases.

Comment Period

Comments are due to the IPSASB by 17 May 2021.

More information

For further details please refer to the IPSASB's website here.

Need more information?

If you wish to discuss this or any other financial reporting related matter, please contact your usual PwC contact or one of the following financial reporting specialists:

Stephen Hogg
Partner, Auckland
stephen.c.hogg@pwc.com

Lesley Mackle
Executive Director, Wellington
lesley.j.mackle@pwc.com

Robert Harris
Partner, Christchurch
harris.r@pwc.com

Tiniya du Plessis
Partner, Auckland
tiniya.b.du.plessis@pwc.com

Mariann Trieber
Director, Auckland
mariann.m.trieber@pwc.com

Clive Brodie
Director, Wellington
clive.r.brodie@pwc.com