HM Treasury

Financial Reporting Advisory Board Paper

IFRS 16 *Leases*—Interaction with PPP requirements

Issue:	This paper discusses the interaction between IFRS 16 and PPPs, particularly with regard to the measurement of liabilities in PPPs.
Impact on guidance:	Yes, if approved by the FRAB.
IAS/IFRS adaptation or interpretation?	Possibly, pending the FRAB's decision in this area.
Impact on WGA?	Yes, FRAB's decision may have an impact on the 2021-22 WGA (as the first year of full public sector adoption).
IPSAS compliant?	Prior to IFRS 16, IPSAS and IFRS were broadly consistent for lease accounting. IPSASB are developing a new IPSAS on lease accounting.
Impact on budgetary regime?	No, the budgetary treatment of PPPs is aligned to ESA10
Alignment with National Accounts (ESA10)?	No, neither lease accounting or PPP accounting is fully aligned between IFRS or national accounts.
Impact on Estimates?	No, the treatment of PPPs in Estimates is aligned to ESA10
Recommendation	For the Board to agree to maintain existing accounting for on-balance sheet PPP liabilities in the short term, with a longer-term project to explore changes in this area.
Timing:	We ask the Board to make a decision at this meeting to ensure that there is clarity in the short term for 2019/20 and 2020/21 financial reporting

Background

1. At the November 2019 meeting, the Board discussed a number of issues related to finalising the IFRS 16 guidance in the 2019/20 and 2020/21 FReMs, including the interaction between IFRS 16 and PPP guidance. Subsequent to this meeting, during the process of finalising the 2020/21 GAM and CIPFA Code, a Board member identified an issue which arises from the requirements of those manuals (and the FReM) for PPP arrangements, including PFI contracts. We would like to bring this issue to the Board for further consideration.

2. This paper is very similar to the paper presented at the March 2020 FRAB meeting. There was not time at that meeting for this paper to be discussed, so it is being brought back to the Board with some amendments. These include an extra section added following limited HM Treasury consultation around this issue; additional alternatives for the Board to consider; and a recommendation to the Board.

3. At the November 2019 meeting, HM Treasury proposed bringing forward guidance for PPP arrangements, including PFI contracts, essentially unchanged after the implementation of IFRS 16. FRAB 138(06) contained the following rationale:

> 'We are aware that other relevant authorities are considering whether to provide additional guidance for the measurement of the liability in an 'on balance sheet' service concession arrangement in their respective manuals following the obsolescence of IAS 17.
>
> No changes are proposed in this respect in the FReM given it does not currently directly reference IAS 17 or leases when discussing the measurement of 'on balance sheet' service concession liabilities. Adding new guidance in this area would constitute a substantive change outside the scope of IFRS 16 implementation.
>
> Additionally, IFRS 16 contains a scope exclusion for IFRIC 12, but we are introducing a reference in the FReM for the initial measurement of 'on balance sheet' service concession arrangement assets (to replace the existing reference to IAS 17). We do not consider this to override the scope exclusion in IFRS 16; instead preparers are referred to IFRS 16 guidance *only* for the initial measurement of assets in 'on balance sheet' service concession arrangements. Preparers should use the guidance in the FReM in every other aspect of accounting for these arrangements.
>
> In summary, no further changes to the FReM regarding the interaction between IFRIC 12, FReM PPP guidance and IFRS 16 are proposed apart from the ones summarised in the rows above. The existing guidance should be sufficient and should not introduce substantive changes to the accounting for PPPs.'

4. The principle applied was that, if there is a PPP that previously met the definition of a lease or contained a lease under IAS 17 requirements, those leases are subject to the requirements of IFRS 16. However, if a PPP was not previously accounted for as giving rise to a lease under IAS 17, then it would be outside the scope of IFRS 16 and therefore IFRS 16 should not introduce any change in how those arrangements should be measured.

5. At the November meeting, the Board discussed drafting clarifications in respect of the interaction between PPP guidance in the FReM and IFRS16 and also agreed an overall aim that IFRS16 should not introduce changes for accounting for PPP arrangements which had not previously met the definition of a lease.

6. However, since the meeting a FRAB member has raised concerns regarding the accounting for PPP arrangements and the interaction with IFRS 16. The concern relates to the risk that in some instances, the previous and now withdrawn IAS 17 accounting principles of not applying indexation to these contracts will be employed in practice. Where arrangements do not fall within scope of IFRS16, IFRS9 would apply. Consequently, the issue has been brought back to the Board for further consideration. The main observations and concerns of that FRAB member are summarised below.

FRAB member observations and concerns

7. The issue arises for on-balance sheet PFI/PPP contracts which contain future payments linked to a price index (whether RPI or CPI). There are a number of these contracts in the public sector, including local authorities and some central government departments.

8. In respect of this type of contract, consideration is given to how they have been accounted for prior to the adoption of IFRS 16. In summary, for the purposes of measuring the liability, either the requirements of IAS 17 were applied directly, or by analogy. The following paragraphs summarise the accounting approach that was followed in previous years.

9. IAS 17 defined 'contingent rent' as being:

   '…that portion of lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).'
   IAS 17.25 then required, for a lessee when accounting for a finance lease, that:
   '…Contingent rents shall be charged as expenses in the period in which they are incurred.'

10. Consequently, by applying the requirements of IAS 17 to their on-balance sheet PPPs, entities have recorded a lease (or unspecified type of) liability, based on the initial payment amounts, and have expensed any amounts relating to future changes in RPI/CPI in the

periods to which those additional payments relate. That is, the liability has not been increased to take account of increases in RPI/CPI.

11. If the liabilities had not been accounted for in accordance with the requirements of IAS 17 and had not been considered to fall within the scope of that standard, then they could have fallen within scope of IFRS 9 *Financial Instruments* (which replaced IAS 39 *Financial Instruments: Recognition and Measurement*). In which case, if IFRS 9 or IAS 39 had been applied, the financial liability would have been measured at amortised cost and would have incorporated the future RPI/CPI increases. That is, all estimated contingent rentals would have been included in the cash flows used to derive the (much larger in comparison to the lease liability) carrying amount of the financial liability. This was acknowledged in a publication dated October 2009 in which accounting for the liabilities in accordance with IAS 17 was mandated, with the Department of Health and Social Care noting that:

    'In developing this guidance, the Department has consulted with HM Treasury (HMT) on the possibility of measuring the liability under IAS 39 instead of IAS 17. However, HMT are clear that the liability should be measured under IAS 17 and this is reflected in the wording in the FReM.'

12. In contrast to IAS 17, IFRS 16 contains specific requirements for future lease payments that are linked to an index or rate. These requirements are that, when lease payments change to reflect movement in an index or rate used to calculate the amount of those lease payments, the lease liability is recalculated on the basis of the revised lease payments. Consequently, although future estimated changes in lease payments are not included in the lease liability, the lease liability recorded in accordance with IFRS 16 includes the increases which have already taken place. Therefore, the lease liability recorded in accordance with IFRS 16 will be substantially higher than the lease liability recorded in accordance with IAS 17.

13. The approach taken by some departments for those leases, following the adoption of IFRS 16, is to propose continuing with the previous IAS 17 accounting approach. However, that approach is technically feasible. If the liabilities are to be accounted for in accordance with IFRS 16, then all the requirements (subject to public sector adaptations) apply, including the requirement to remeasure liabilities relating to lease payments linked to an index or rate. Currently, there is no public sector adaptation to exclude this requirement.

14. Alternatively, if it is asserted that the liabilities do not fall within the scope of IFRS 16, then they fall within the scope of IFRS 9 with the accounting consequences noted above. This is because, if a transaction or event is within the scope of a specific IFRS standard (in this case, IFRS 9), then IAS 8 requires that standard to be applied and prohibits the application of the requirements of another standard by analogy.

Additional context

15. HM Treasury would like to provide the Board with additional information on financial reporting requirements in this area, for context:
    a. The FReM currently provides guidance on how to account for on-balance sheet PPPs, including some guidance on the liabilities arising in those arrangements (that is separate to IFRS 9 or IAS 17 guidance on liability accounting). It states that the liability should be recognised for the capital value of the contract and should not include service or interest elements, with guidance on separating these elements. It is silent on the issue of index-based payment remeasurement.
    b. The FReM also contains specific disclosure requirements for PPPs, including a requirement to disclose future commitments for on-balance sheet PPPs. This includes future indexation commitments (so although these commitments are not currently included in the measurement of PPP liabilities, they are disclosed).
    c. In developing the guidance on PPPs in November 2008, the FRAB previously made a decision not to link IAS 17 and PPP accounting, and instead develop bespoke PPP guidance. Minutes of the relevant meeting show that FRAB members considered there to be substantive differences between leases and on-balance sheet PPP arrangements.
    d. IFRS 16 contains a scope exclusion for service concession arrangements in the scope of IFRIC 12.

16. HM Treasury would also like to note that, while it has not been possible to perform wide central government consultation on this issue, we have spoken to a few departments that have on-balance sheet PPPs who currently do not include index-based payment uplifts in the liability measurement. These departments are concerned about the cost-benefit rationale of changing the liability measurement methodology. They note that:
    a. This change may lead to auditors requiring preparers to review all existing on-balance sheet PPP arrangements and revise those models, which given the volume of on-balance sheet PFI arrangements would be extremely resource-intensive and very costly;
    b. This change would make financial statements more volatile and complex; and
    c. As explained above, future indexation commitments for these arrangements are already disclosed in the notes to the financial statements.

Potential approaches

17. There are four main approaches which could be followed in resolving the issue. It has been assumed that departments would not wish to take an approach under which PPP/PFI contract liabilities are scoped out of IFRS 16 and therefore into IFRS 9. Consequently, potential ways forward include:

Approach 1: Apply IFRS 16 requirements to on-balance sheet PPP liabilities

18. Departments could be required to apply the requirements of IFRS 16 to on-balance sheet PPP liabilities, including to remeasure index linked lease liabilities.

19. This would have the main advantages of consistency between lease and PPP liability accounting, and increased transparency around future index-based commitments (by including them in the measurement of the liability). However, this approach would involve significant cost and resource for departments, and it is not clear that the benefits would outweigh the costs.

20. Given the IFRIC 12 scope exclusion in IFRS 16, if the Board decided to follow this Approach, guidance would need to be added to the FReM to clarify that IFRS 16 should apply to liabilities in on-balance sheet service concession arrangements.

Approach 2: Maintain existing accounting for on-balance sheet PPPs

21. Departments could maintain their existing accounting for on-balance sheet PPPs. Language could be added to the FReM to clarify that the previous IAS 17-like treatment should be used to account for liabilities in on-balance sheet PPPs, and that future uplifts in index-based payments should not be included in the measurement of those liabilities.

22. The primary advantage of this approach is that it maintains consistency with the way that PPPs are currently accounted for, and therefore minimises cost for departments.

23. It can also be seen as consistent with the FReM providing stand-alone guidance for PPP accounting, separate from leases or financial instruments guidance. This reflects that PPP accounting from the grantor's perspective is a public-sector specific issue.

24. However, under this approach the liability in an on-balance sheet will be accounted for significantly differently from other, similar liabilities under IFRS requirements (when PPP liabilities are arguably very similar to lease liabilities or other financial liabilities).

Approach 3: Only require IFRS 16 treatment for new PPPs entered into after implementation

25. Departments could maintain their existing accounting for existing on-balance sheet PPPs, but use IFRS 16 for any new on-balance sheet PPPs entered into after IFRS 16 implementation. This approach would combine some of the advantages of Approaches 1 and 2 (minimising costs for departments by allowing them to maintain consistent accounting treatment for existing on-balance sheet PPPs while at the same time maintaining consistency between lease and PPP accounting for any new on-balance sheet PPPs).

26. However, this approach would introduce inconsistency in accounting for on-balance sheet PPPs depending on the date in which they were entered into. Moreover, it is questionable how different this would actually be in practice compared to Approach 2 as the government publicly committed in the 2018 Budget to abolish the use of PFI arrangements for future projects[1].

Approach 4: Maintain existing accounting for on-balance sheet PPPs in the short term, with a longer-term project to explore changes to PPP accounting

27. Departments could maintain their existing accounting for on-balance sheet PPPs in the short term (ie for financial years 2019/20 and 2020/21 for the existing early adopters, and potentially for 2021/22 to ease the burdens on preparers transitioning to IFRS 16 in that year). In the meantime, HM Treasury could explore whether this change should be made to PPP liability measurement, along with any other related changes to PPP accounting.

28. This would provide departments with certainty in the short-term, while giving more time to explore a significant change to PPP accounting. Again, the proposed change in liability measurement would be resource-intensive to implement, would be likely to need external modelling skills, and departments would ideally have a significant amount of lead time to prepare. Moreover, HM Treasury has not had the opportunity to perform extensive outreach on this issue. This would give us more time to perform that outreach.

Recommendation

29. HM Treasury recommends Approach 4. A change to align PPP liability accounting with IFRS 16 has the potential to be very resource-intensive for departments and should not be done without giving departments proper time to prepare.

30. Additionally, HM Treasury has not had the opportunity to perform a wide consultation on this issue. It would be ideal to broadly consult stakeholders to make sure we have the most complete understanding of the advantages and disadvantages of aligning IFRS 16 and PPP liability accounting.

31. This could be operationalised by including wording in the FReM similar to Approach 2 for the short term. Alternatively, the FReM could be amended as follows:

    a) Require liabilities arising from PPP/PFI contracts that give rise to assets to be accounted for as lease liabilities within the scope of IFRS 16.

    b) Permit (but not require) increases in lease payments arising from PPP/PFI contracts due to linkage to a price index to be accounted for as if they are variable lease payments, and

[1] https://www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech

not variable lease payments dependent on an index or rate. The effect of this approach would be to continue with the previous IAS 17 accounting. Although many (if not most) departmental entities might wish to follow this approach, there are corporate entities within groups required to report in accordance with IFRS, and those entities would have to follow the IFRS 16 requirements for index linked lease payments in their statutory financial statements.

32. HM Treasury would recommend that the Approach 2 wording be included, rather than a direct reference to IFRS 16. This is because departments have expressed concern that requiring PPP liabilities to follow IFRS 16 accounting requirements in this way could still involve a significant amount of resource in terms of reassessing PPP models to ensure they were following the IFRS 16 guidance apart from the index-based payment issue, even if there was relatively little (or no) accounting change.

Question for the Board: Does the Board agree with HM Treasury's recommendation of Approach 4?