HM Treasury

FRAB 141 (04)

18th June 2020

Financial Reporting Advisory Board Paper

IFRS 16 *Leases*: Treatment of Irrecoverable VAT Payments

Issue:	Whether there should be a FReM adaptation for IFRS 16 to include irrecoverable VAT in lease payments within the scope of IFRS 16 - *Leasing*.
Impact on guidance:	Yes, if approved by the FRAB.
IAS/IFRS adaptation or interpretations?	Yes, if approved by the FRAB.
Impact on WGA?	Yes, the 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 and Estimates?	Yes, the adaptation (if approved) will have the impact of increasing Capital and Ringfenced Resource expenditure whilst reducing non-ringfenced RDEL expenditure.
Alignment with National Accounts (ESA10)?	ESA10 specifies that the purchase price of a product should include taxes but exclude deductible VAT. Broadly, national accounts and IFRS 16 are not fully aligned in the measurement of lease assets and liabilities.
Impact on Estimates?	Yes, the adaptation (if approved) will have the impact of increasing Capital and Ringfenced Resource expenditure whilst reducing non-ringfenced RDEL expenditure.
Recommendation:	The FRAB is invited to agree amendments to the FReM to take account of the public sector implications.
Timing:	Any changes approved will be for inclusion in the 2020-21 FReM.

HM Treasury

DETAIL

Background

1. This paper has been brought to FRAB on behalf of a member of the Board who would like to raise the issue of irrecoverable VAT on lease payments within the public sector. The paper is written to represent this Board member's view. The HM Treasury view on this issue is included in Annex A.

2. There is an emerging issue with the treatment of VAT on lease payments within the scope of IFRS 16. The issue is whether irrecoverable VAT should be included in the lease payments and hence the cost of the ROU asset under IFRS 16. A number of government bodies have been in contact on the issue, including with the FRAB member and Technical Accounting Centre of Excellence (TA CoE) on whether irrecoverable VAT should be included in lease payments.

3. IFRS 16 does not specifically refer to VAT payments in the measurement of the lease liability - i.e. it does not state whether irrecoverable VAT should be included in, or excluded from, the lease payments. This is in contrast to IAS 16 - *Property, Plant and Equipment* which explicitly states that non-refundable purchase taxes should be included in the cost of owned assets.

4. The view expressed from the large accountancy firms, either through their technical accounting manuals or information on their websites, is generally supportive of the approach that irrecoverable VAT should be excluded from the lease payments (and the associated ROU asset).

5. The VAT is deemed to be the lessor collecting a levy on behalf of the government and so should be accounted for under IFRIC 21 - *Levies*. Furthermore the VAT liability should only be recognised when the obligating event (usually invoicing) takes place and not at the commencement of a lease.

HM Treasury consideration

6. When this issue was raised, the Technical Accounting Centre of Excellence approached HM Treasury for a view, given the impacts that the issue will have on government departments.

7. The Treasury provided advice that it is most appropriate for individual departments to agree the relevant financial reporting treatment with their auditors. To date, the Treasury has not considered there to be a public sector-specific reason to provide an interpretation or adaptation to the standard in ths area. HM Treasury's views on this issue are expressed in more detail in Annex A.

Current Position

8. From the Accounting Period 9 audits of certain departments, the view from audit teams is that the VAT does not constitute part of the lease payments under IFRS 16 and is the lessor collecting a levy on behalf of the government so should be accounted under IFRIC21 Levies – and recognised only upon the obligating event. Due to the delay in implementation not all bodies have had this conversation with their auditors.

9. The arguments can be broadly set out as: *'The irrecoverable VAT is not part of the lease liability and should not be capitalised as part of the right-of-use asset. Instead it should be treated in line with IFRIC 21 and expensed at the tax point. The reason for this is that the payment of VAT is not included in the definition of a lease payment in IFRS 16. Instead, any VAT elements are levies imposed by the government that the lessor collects as agent for the government. Therefore IFRIC 21 applies.*

10. *VAT liabilities are within the scope of IFRIC 21 as it is "an outflow of economic resources embodying economic benefits that is imposed by governments on entities in accordance with legislation" that does not meet either exemption. As this is a standard or interpretation that "specifically applies" to VAT, it applies before IFRS 16 under IAS 8.7. IFRS 16 does not specifically address the issue of VAT treatment.*

11. *The recognition point for VAT liabilities under IFRIC 21 is the tax point, which is usually the invoice date, as this is the "obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy". This means that liabilities for irrecoverable VAT on leases should be recognised at the point the invoice is received and not at the start of the lease. Under accruals accounting, the VAT expenses should hit expenditure at the same point the VAT liability is recognised.'*

12. The Department for Transport, and the Department for Culture, Media, and Sport, as IFRS 16 early adopters, have not included irrecoverable VAT in their measurement of lease payments for their FY19/20 accounts, as agreed with the NAO.

FReM Adaptation to IFRS 16

13. This paper does not seek to challenge the views of HM Treasury and the NAO on how VAT on lease payments should be accounted for. These views, and the supporting arguments, are understood and respected. However, it is considered appropriate for FRAB to consider this matter given the important issues that arise from a decision to exclude VAT from IFRS16 leased asset and liability valuations. This paper to the FRAB therefore seeks to inform a discussion on whether, on balance, there should be a public sector adaptation on this matter.

14. The FReM states that it follows GAAP to the extent that it is meaningful and appropriate in the public sector context. The impact of the treatment of excluding irrecoverable VAT from lease payments and ROU assets is expected to be largely a public sector issue as, in most circumstances, it would be expected that the private sector would be able to recover its VAT.

15. As this is largely a public sector issue, it would appear appropriate to consider whether a specific public sector treatment is needed to consider whether the accounting outcome is meaningful and appropriate in the public sector context.

Arguments in Favour of Excluding Irrecoverable VAT from Lease Payments and the Associated Asset (No FReM Adaptation)

16. These arguments are captured above.

Arguments in Favour of Including Irrecoverable VAT from Lease Payments and the Associated Asset (FReM Adaptation Required)

17. The arguments in favour of including Irrecoverable VAT in lease payments and the associated asset are set out below.

Comparability to Owned Assets

18. The measurement basis of owned assets and leased assets will be less comparable. This is because the cost (and subsequent valuation) of owned assets accounted for under IAS 16 will include irrecoverable VAT while the same asset, if leased, will exclude irrecoverable VAT from its cost.

19. The Conceptual Framework (paragraph 2.24) states that information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. It is viewed that meaningful comparability is significantly weakened by potentially having an 'identical' in substance asset at different cost/values through it being purchased or leased.

20. It is appreciated that the IFRS 16 Basis of Conclusions (BC) accompany, but do not form part of, IFRS 16. However, it is helpful to consider the IFRS 16 BC. In the section on discussion the need to provide requirements in IFRS 16 to distinguish a lease from a sale or purchase of an asset, the IASB stated that there was little support and it observed that (in paragraph BC139):

a. the accounting for the leases that are similar to the sale or purchase of the underlying asset would be similar to that for sales and purchases applying the respective requirements of IFRS 15 and IAS 16; and

b. accounting for a transaction depends on the substance of a transaction and not its legal form.

21. In the public sector, if irrecoverable VAT is excluded from the ROU asset valuation, then assets which are purchased or leased will not be as comparable, particularly in light of the examples above.

22. If the treatment stands it appears two identical assets, one purchased and one leased for the full economic value, at the same time could be on the same SOFP at different values. This seems contradictory if assets held at fair value.

Transparency - Off the Statement of the Financial Position Financing ('Off Balance Sheet Financing')

23. One of the concerns for users of financial statements, as stated in IFRS 16 BC 42, was the extent of off balance sheet financing provided through operating leases. Due to the expected greater level of irrecoverable VAT for public sector leases, this will represent a significant element of off balance sheet financing in the public sector. While it is appreciated that there is no obligating event for the VAT until the tax point, a FReM adaptation to bring the future irrecoverable VAT payments onto the public sector statement of financial position would increase transparency as it would be reasonable to assume that leases would be held for their lease term.

Peppercorn Leases Treatment

24. There is a precedent for updating the FReM to adapt IFRS 16 for a specific public sector issue. This is the treatment of peppercorn leases. Zero or nominal lease payment leases are expected to exist in the public sector but not to such an extent in the private sector. An IFRS 16 adaptation is made to reflect appropriate public sector treatment to treat peppercorn leases on a consistent basis to donated owned assets. A similar situation arises for this irrecoverable VAT issue where it is expected to be predominantly a public sector issue and it is appropriate to consider whether leased assets should be treated on a consistent basis with owned assets.

Other Considerations

25. The FReM states that in selecting relevant accounting policies, entities should have regard to budgetary and control requirements, but should give paramount importance to the need for financial statements to give a true and fair view. By excluding irrecoverable VAT from lease payments and the ROU asset, capital "cost" would be deferred, and liabilities unrecognised making leasing an apparently cheaper option for departments working with tight budgets. It is probable that this accounting treatment would drive decision making.

26. While the financial accounting in the public sector context is of higher importance in the determination of whether an adaptation is appropriate, the capital and resource classification impacts are potentially significant (i.e. 20% switch from the former to the latter where VAT is irrecoverable).

27. This also raises other ancillary questions if irrecoverable VAT should be excluded from provisions and uninvoiced accruals. Current disclosures on operating lease and other financial commitments are also likely to reflect the economic outflow including VAT. Regardless further guidance on these issues would be welcome and give clarity.

28. It should be considered whether the accounting outcome of excluding irrecoverable VAT from lease payments and the associated ROU assets is appropriate and meaningful in the Public Sector. In particular, the judged greater comparability and judged greater transparency seem to provide sufficient justification for an adaptation to be made of IFRS 16.

Recommendation

29. The FRAB is invited to:

a. Consider whether the accounting outcome of excluding irrecoverable VAT from lease payments and the associated Right-Of-Use asset is meaningful and appropriate in the Public Sector context;
b. Approve an adaptation in the FReM to IFRS 16 to state that irrecoverable VAT should be included in the anticipated lease payments and correspondingly included in the associated Right-Of-Use (ROU) asset; and
c. Irrespective of a. and b., the application guidance for IFRS 16 should be amended to clearly show the treatment of irrecoverable VAT on recognition and subsequent payments.

Q. Does the Board agree this is an issue for the public sector and agree with some or all of the recommendations above?

Annex A: HM Treasury View

A1. As described earlier in this paper, when initially approached about this issue, HM Treasury provided advice that it is most appropriate for departments to agree the relevant financial reporting treatment with their auditors.

A2. HM Treasury continues to hold the view that it is not necessary to provide an adaptation or interpretation to IFRS 16 in this area. This is consistent with the general approach in the FReM on VAT-related issues, where the expectation is that departments will apply the principles in IFRS to VAT where relevant. The appropriate treatment may be dependent on individual contracts and the VAT rules applicable during the reporting period, which may be subject to change.

A3. HM Treasury, moreover, is not convinced that there is a public-sector-specific reason to provide an adaptation or interpretation to IFRS 16 in this area. HM Treasury agrees that irrecoverable VAT would likely be more prevalent in central government. However, private sector accountancy firms have provided guidance in this area, which indicates that this issue also exists in the private sector.

A4. HM Treasury has examined the guidance produced by accountancy firms and discussed this issue with the NAO. HM Treasury cannot identify anything in the firm guidance or the NAO view that would be inappropriate in the central government context.

A5. Given the challenge that has been presented in this paper, HM Treasury recognise that there may be merit in providing additional application guidance in this area. This would also promote consistency in application for the purposes of Whole of Government Accounts.