HM Treasury

FRAB 142 (13)

19th November 2020

Financial Reporting Advisory Board Paper

IFRS 16 *Leases*—Interaction with treatment of index linked payments for on balance sheet PPP arrangements

Issue:	This paper discusses the interaction between IFRS 16 and PPPs, with regards to the treatment of index linked payments and therefore 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 future years WGA.
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	HM Treasury recommends Approach 3: Apply IFRS 16 requirements from 2022-23, with 'IAS 17 type' treatment permitted to persist for 2021-22
Timing:	We ask the Board to make a decision at this meeting to ensure that there is clarity for 2021-22 reporting.

Introduction

1. This issue was previously brought before FRAB for discussion in June 2020. FRAB agreed to HM Treasury's recommendation that existing accounting for on balance sheet PPPs is maintained in the short term, with a longer-term project to explore changes to PPP accounting.

2. HM Treasury have since had the opportunity to consult stakeholders more widely and therefore have brought this issue back before the Board to seek direction on longer term changes to PPP accounting in this area.

Background

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. This was because the FReM did not directly reference IAS 17 or leases when discussing the measurement of 'on balance sheet' PPP liabilities. Preparers were to be referred to IFRS 16 guidance only for the initial measurement of assets in 'on balance sheet' PPP arrangements. The Board 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.

Subsequent issue identified

4. Following this meeting, a Board member identified an issue that had not previously been considered. The issue arises for on-balance sheet PFI/PPP contracts which contain future payments linked to a price index.

5. When measuring the liability in theste contracts, the requirements of IAS 17 were applied directly or by analogy. IAS 17.25 required that 'contingent rents shall be charged as expenses in the period in which they are incurred', with contingent rents being the portion of lease payments which varies based on factors other than time, including movement in indices. Therefore, amounts relating to changes in RPI/CPI have been expensed by entities in the periods to which these additional payments relate.

6. Conversely, IFRS 16 requires that when lease payments change to reflect movement in an index or rate, the lease liability is recalculated. As a result, if the future liability were recorded in accordance with IFRS 16, it would include the increases which have taken place to date. This results in an increased liability compared to an IAS 17 approach.

7. 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 (following the requirements of IAS 8). The application of IFRS 9 would require the financial liability to be measured at amortised cost and thus include estimated future contingent rentals in the cash flows used to derive the carrying amount of the financial liability. This would result in a larger upfront lease liability than either IAS 17 or IFRS 16 measurement bases.

8. Currently, there is no public sector adaptation to exclude IFRS 16 or IFRS 9 requirements and allow for an IAS 17 type treatment to be retained.

Discussion at the June 2020 FRAB meeting

9. It was discussed and agreed at the June FRAB meeting that HM Treasury would maintain existing accounting in the short term, and take some time to explore longer term changes to PPP accounting. This was to enable wider consultation with stakeholders.

Stakeholder consultation

10. Since the June 2020 FRAB meeting, HM Treasury has consolidated existing feedback and consulted further with central government stakeholders via the IFRS 16 technical working group. HM Treasury also held individual sessions with departments who may be more impacted, to explore the advantages and disadvantages in more detail. There was further discussion with the Relevant Authorities Working Group.

11. CIPFA LASAAC has consulted with local government stakeholders on this issue on three occasions. The most recent consultation, part of the invitation to comment on the CIPFA LASAAC Code 2021/22, closed on 23 October 2020.

Conceptual themes

12. The departments who fed into the Technical Working Group discussion agreed that the conceptual arguments were in favour of alignment with IFRS 16 on this issue. [1]

13. Points raised included the lack of coherence of the FReM referring to IAS 17 within the PPP guidance post IFRS 16 implementation, that alignment with IFRS 16 would be more consistent, and that it would provide a true and fair view of the liabilities in PPP arrangements. A further comment was that PPPs are lease style relationships and have similar risk levels. Contributors discussed the conceptual differences between PPPs and leases.[2]

14. As noted, CIPFA LASAAC have separately consulted local government stakeholders on this issue on three occasions. On the second occasion, 29/36 (81%) of respondents were supportive of alignment with IFRS16 on this issue. On the third, most recent occasion,

[1] HM Treasury also asked stakeholders for their views on other areas of the PPP guidance which may need to be amended for consistency with IFRS 16. There were no specific areas raised to us as needing further investigation.

[2] Discussion include that PPPs are more likely to involve government specific assets, and there is certainty over controlling the residual interest and greater power to obtain implicit rates. It was noted that IFRS 16 is liability led, but this is less obviously applicable where the department will use/consume the asset over its entire useful life.

12/24 (50%) of respondents were in favour, with 29% preferring the status quo and 21% providing no comment.[3]

Specific conceptual and application issues

15. **Asset or service component** - An issue which was not highlighted by central government, but was raised in the CIPFA LASAAC consultation of local government entities, is whether indexation increases relate to the asset or service component of the PPPs. CIPFA LASAAC agreed at their recent Board meeting to set up a working group to consider this issue.

16. **Estimated future indexation increases already included in contracts** – It may be useful context for FRAB to note that some indexation increases in PPPs may have a 'floor': therefore, a portion of the indexation related amount should have already been included as fixed payments in an IAS 17 measurement. This means that there may be a less dramatic difference between IAS 17 and IFRS 16 measurements than initially anticipated. Further detail is included in Annex 1.

Practical themes

17. Departments had previously raised concerns about the cost-benefit rationale of changing the liability measurement methodology. Further consultation has developed our understanding of these practical concerns, which fall into the following categories:

- Cash costs & resourcing
- Balance sheet impacts
- Timescales

18. CIPFA LASAAC have separately consulted local government stakeholders on this issue on three occasions, where concerns over costs of implementation were also raised.

Cash costs & resourcing

19. There were three broad areas of concern over costs & resourcing requirements. Comments are summarised below, with more detail provided in Annex 1.

20. Initial Implementation: some departments felt it would be difficult for their finance teams to revise the models, due to lack of familiarity or knowledge of the models, lack of time or lack of specialised technical skill. Therefore, they may need to engage external consultants which could be expensive.

[3] Favourable comments were that IAS 17 was not extant, and that the symmetry of alignment with IFRS 16 meant it was easy to implement. A comment opposed to changing the accounting noted that for PPPs, the organisation is not measuring a lease liability but a deferred asset purchase.

21. <u>Ongoing work:</u> under the proposed changes, liabilities would need to be uplifted annually in response to movements on underlying indices, and there were some concerns raised about the level of work this would drive on an annual basis.

22. <u>Further Revision of PPP models:</u> there were some concerns raised that making this change could open the door to increased investigation of these models by audit teams, driving additional work.

Balance sheet impact

23. Changing the accounting in this area would increase the size of departments balance sheet liabilities. This could be significant or material for the most impacted departments.

24. Some departments noted that they would need to consider and plan for the potential budgetary impacts of changing the accounting in this area. Budgetary impact would be limited due to the existing misalignment between accounting and budgeting for PPPs[4], but we would want to ensure enough time is allowed to work through any budgeting consequences.

Timescales

25. Departments agreed it was important that sufficient time be granted to prepare for this change, both for technical consideration and for the practical work of implementation.

26. It was observed that implementing such a change without sufficient time to prepare could prove a distraction from the other work that is needed to implement IFRS 16.

27. As we discuss separately in our paper on the impact of Covid-19, 2020 has been a difficult period for finance teams who are facing a number of competing pressures.

28. There was widespread agreement from the departments consulted that 2022/23 would be the earliest period they would consider feasible to implement a change in this area.

Potential approaches

29. Following the June 2020 FRAB meeting, HM Treasury agreed to explore longer term changes to PPP accounting. After consideration and consultation, we put forward three main approaches which could be followed in resolving the issue.

Approach 1: Create a public sector adaptation to diverge from alignment with IFRS 16 or IFRS 9, outlining specific 'IAS 17 like' treatment to be followed for PPPs long term

[4] Budgetary impact would be more limited because the misalignment means that PPPs on balance sheet for accounting may be off balance sheet from a budgetary perspective

30. This approach would be preferable from a practical standpoint, eliminating the issues discussed in the 'practical themes' section.

31. An adaptation specifying the treatment of this issue and divergence from alignment with IFRS 16 or IFRS 9 would remove some of the inconsistencies of overtly referring to the superseded standard IAS 17.

32. However, HM Treasury have concluded that ultimately the conceptual incoherence of continuing to apply (whether it is explicitly stated or not) elements of a standard which is no longer in force, mean that this approach should not be adopted. There is no strong public sector specific conceptual reason that has been identified for choosing this approach.

Approach 2: Apply IFRS 16 requirements from 2021-22

33. The benefit of this approach would be that it would align with the implementation of IFRS16 across central government (for those who are not early adopters). Conceptually, this would be the ideal approach.

34. The disadvantage would be the significant pressure this approach would place on departments. Consultation with departments showed that they would find it difficult to implement this change in 2021-22. A 2021-22 timeframe may result in sub-optimal application or failure to be able to apply these changes.

35. A 2021-22 timeframe is not felt to offer sufficient time to departments for full technical consideration or practical application.

36. Therefore, HM Treasury would not recommend this approach is adopted.

Approach 3: Apply IFRS 16 requirements from 2022-23, with 'IAS 17 type' treatment permitted to persist for 2021-22

37. The disadvantage of a 2022-23 timeframe is that as IFRS16 is due to be implemented across central government for 2021-22, it would result in a year where the requirements of a superseded standard (IAS 17) were de facto applied to this area of accounting. This is not ideal from a conceptual viewpoint.

38. The advantage would be that it would allow government departments, especially those with high volumes of PPP arrangements, sufficient time for implementation.

39. Our consultation with departments has confirmed our initial thoughts that this requirement has the potential to be resource intensive to implement and it is important to allow enough time for this. There may be further technical and application issues which emerge during this process, which will require time to work through.

40. HM Treasury's view is that the practical aspects of implementation would support a delay in applying this change until 2022-23.

Recommendation

41. HM Treasury therefore recommends Approach 3: *Retain the current accounting treatment for 2021-22 and apply IFRS 16 requirements from 2022-23*

42. HM Treasury believe this provides the best balance between the conceptual viewpoint which would favour a 2021-22 alignment with IFRS 16, and the practical viewpoints which would favour either delay, or an adaptation excluding alignment with IFRS 16.

43. Accounting would not change for 2021-22, however HM Treasury would plan to add a brief update to the 2021-22 FReM PPP guidance section to explain previous treatment and confirm that previous treatment in this area should continue for 2021-22. The change would then be implemented in 2022-23 and the 2022-23 FReM updated accordingly.

44. We would expect the transition provisions in IFRS16 to be followed for this change, even if the change is implemented one year after IFRS 16. This would mean a cumulative catch up approach rather than retrospective application.

Question for the Board: Does the Board agree with HM Treasury's recommendation of Approach 3? Is the Board content with an IFRS 16 transition approach to the adjustment?

Annex 1

Detail of stakeholder consultation

Conceptual and application issues

Estimated future indexation increases already included in contracts – additional detail

45. Some PPP contracts have a fixed annual uplift based on an estimated or assumed change in the rate of indexation, with an annual adjustment for the difference between this assumption and reality. Several departments have mentioned this as something which may or does exist in some of their PPP contracts.

46. This would mean that a certain element of the indexation increase is effectively fixed, and therefore would have already been included in the liability measurement per IAS 17. Only the contingent element of the indexation increase would be expensed under IAS 17, with IAS 17 defining contingent rents being the portion of lease payments which varies based on factors other than time.

47. The extent to which department's PPP contracts have an 'indexation floor' built in to their annual uplifts and how this 'indexation floor' has been treated in assessing PPP liabilities to date, will affect the size of the impact that alignment to IFRS16 in this area may have.

Practical issues

Cash costs & resourcing issues – additional detail

48. Initial Implementation: a number of departments noted the difficulties in finance team staff being able to review and revise their PPP models to prepare for such a change. In some cases, the models originated outside of finance teams, being produced by external consultants or built by the PPP provider as part of the original negotiations. There is also the issue of a lack of institutional knowledge, as staff members involved at the time the PPP arrangements came into being may have since moved on. It was noted that the work to review the models would be highly specialised, and even where the skills for this specialised work were available 'in house', staff may not have the time to complete this work given competing pressures. There was uncertainty as to how much assistance might be needed or obtainable from the PPP provider. Where there are closer working relationships with PPP providers, such help may be easier to obtain, but the strength of working relationships is likely to vary.

49. As such, many entities may need to engage external consultants to complete or assist with this work, which could be expensive. However, it is not clear how much work to revise models would cost in comparison to costs to originally develop models. Where PPP arrangements commenced a number of years ago, issues of unfamiliarity with the original

models may be exacerbated and this may drive increased work being needed to review the models (which would add to the cost). Departments would need to ensure Arm's Length Bodies comply with the change, which would require staff resource in central finance teams.

50. Where external consultants are recruited to assist this would lessen the demands on finance teams, however there could be difficulties in recruiting enough external resource if a large number of entities needed this work performed within a short window of time.

51. Ongoing work: under the proposed changes, liabilities would need to be uplifted annually in response to movements on underlying indices. It may be worth noting that the calculation of the contingent rent element is something which would already take place in order to be able to expense this amount, per IAS 17. However, the difference would be that the uplift would now need to be added to the liability instead. There were some concerns raised about the level of work this would drive on an annual basis, and how far models would need to be revised annually to accommodate this.

52. Further Revision of PPP models: there were some concerns raised that making this change could open the door to increased investigation of these models by audit teams, driving additional work. This would especially be the case where there would be a material balance sheet impact caused by the change. Any wider remodelling triggered by this change would increase the cost and resourcing issues previously discussed.