HM Treasury

PPP arrangements:

Guidance on accounting for indexation linked payments

August 2023

Background

1. HM Treasury did not originally propose any changes to the guidance for PPP arrangements, including PFI contracts, as a result of the implementation of IFRS 16[1]. This was because the FReM does not directly reference IAS 17 or leases when discussing on-balance sheet PPP arrangements.
2. Subsequently, we identified an issue which did require new guidance. This is for on-balance sheet PPP contracts containing capital payments linked to a price index. New guidance is required because the principles of IAS 17 were commonly being applied to these contracts. This paper only refers to this specific issue, and entities should check their PPP agreements to consider if it applies.
3. When measuring the liability in these contracts, central government entities most commonly used the requirement in IAS 17.25, which stated that 'contingent rents shall be charged as expenses in the period in which they are incurred'. IAS 17 defined contingent rents as the portion of lease payments which varies based on factors other than time, including movement in indices. Therefore, where entities applied IAS 17 requirements to these contracts, amounts relating to changes in price indices were expensed in the periods to which these additional payments related.
4. Conversely, IFRS 16[2] requires that 'a lessee shall remeasure the lease liability...if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments. This results in an increased liability compared to an IAS 17 approach.
5. The Financial Reporting Advisory Board has agreed with HM Treasury that the treatment of indexation linked payments in on-balance sheet PPP arrangements should be based on IFRS 16 accounting principles from 2023/24.
6. Guidance on the accounting treatment will be brought forward in the in-year update to the 2023/24 FReM. The guidance below confirms this treatment and provides additional detail and illustration, including by way of a worked example[3].

Accounting treatment of payments linked to a price index for on-balance sheet PPP contracts from 2023/24

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[1] As 'PPP arrangements' as a term is inclusive of PFI contracts, please take all subsequent references to PPP arrangements/contracts as inclusive of PFIs.

[2] IFRS 16, paragraph 42-43

[3] Further background information is available in [FRAB paper 142 (13)]

7. Entities should record index linked payments in PPP liabilities in accordance with IFRS 16 from 2023/24[4]. The liability is remeasured to include the indexation linked increases which have impacted lease payments to date. There are two elements required to implement this change:

<u>Initial remeasurement</u>

7.1 The future PPP liability will need to be remeasured at 1 April 2023 to include the actual indexation-linked changes to payments for the capital/infrastructure element which have taken effect in the cash flows since the PPP agreement commenced. This should use a cumulative catch-up approach, where the cumulative effect is recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate). In line with FReM's IFRS 16 interpretation, upon transition, entities shall recognise the cumulative effects of initially applying IFRS 16 pirinciples recognised at the date of initial application as an adjustment to the opening balances of tax payers' equity (or other component of equity, as appropriate) per IFRS 16(C5(b)).

Liabilities should be discounted using an appropriate rate, consistent with the rate determined at the inception of the arrangement. However, if a nominal rate was used per FReM requirements[5] when accounting for PPP under IAS 17 principles, then a real rate should now be used to match the real cash flows included in the liability under IFRS 16 principles.

<u>Subsequent measurement</u>

The PPP liability will continue to require remeasurements whenever cash payments change in response to indexation movements as set out in the individual PPP contract. The double entry for the subsequent liability remeasurement should be Debit Finance Cost, Credit PPP liability. This is mandatory in order to provide consistency across central government.

8. The liability does not include estimated future indexation linked increases.
9. A worked example is set out in Annex A.
10. The service element continues to be expensed as incurred over the lifetime of the PPP arrangement. Any indexation linked increases specifically tied to this element (specified in the PPP agreement rather than assumed) would therefore continue to be expensed.
11. <u>PPP contracts with indexation floors:</u> 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. This would mean that a certain element of the indexation increase is

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[4] Specific guidance in IFRS 16 can be found in paragraphs 27 (b), 28, 42 & 43 of the Standard.

[5] 22-23 FReM, 10.1.61 'Entities covered by the requirements of this manual should use the Treasury discount rate for investment appraisal purposes as their cost of capital rate. This rate is stated in real terms and must be adjusted for the inflation rate to arrive at the nominal rate. The nominal rate can be calculated using inflation rates provided by the Office for National Statistics: https://www.gov.uk/government/statistics/weekly-economic-indicators'

effectively fixed, and therefore should have already been included in the liability measurement per IAS 17.

12. The extent to which PPP contracts have an ‘indexation floor’ built into 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 the change discussed above will have.

Budgeting treatment

13. Budgeting continues to follow the approach laid out in Chapter 13 of the CBG, noting that the budgetary treatment for PPPs follows the national accounts on/off balance sheet distinction rather than IFRS requirements.

Annex A

Relevant information for worked example

PPP term	10 years or 120 months
PPP commencement date	1 April 2020
Service element: expensed to SOCNE as incurred	£500 p.a.
PPP liability equivalent to the capital/infrastructure element	£120,000 (120 monthly payments of £1000, paid on the 1st of the month)
Interest rate on capital/infrastructure element	3.50% p.a.
Terms of indexation linked payment increase	Monthly capital repayments of £1000 increase annually on 1 October by ‘Example Index Rate’ from year 2 onwards

	FY		Date	IAS 17 approach					
				Accounting					
				P&L		BS			
	FY		Date	Income	Expense	Assets	Cash	Liab	Equity
PPP commences @ 1 April 2020		PPP liability recognition	01/04/2020		85,070			-85,070	
	20/21	Interest expense	31/03/2021		2,977			-2,977	
		Cash payment	31/03/2021				-12,000	12,000	
		Opening balance	01/04/2021		88,048		-12,000	-76,048	
		Interest expense	30/09/2021		1,331			-1,331	
2% increase @ 1 October 2021		Cash payment	30/09/2021				-6,000	6,000	
	21/22	Contingent rent	31/03/2022		120			-120	
		Interest expense	31/03/2022		1,249			-1,249	
		Cash payment	31/03/2022				-6,120	6,120	
		Opening balance	01/04/2022		90,748		-24,120	-66,628	
		Interest expense	30/09/2022		1,166			-1,166	
3% increase @ 1 October 2022		Cash payment	30/09/2022				-6,120	6,120	
	22/23	Contingent rent	31/03/2023		424			-424	
		Interest expense	31/03/2023		1,079			-1,079	
		Cash payment	31/03/2023				-6,304	6,304	
	23/24	Opening balance	01/04/2023		93,417		-36,544	-56,873	
		Adjustment from IAS 17 to IFRS 16	01/04/2023				0	-2847	2847

FY		Date	IFRS 16 approach from inception for comparator					
			Accounting					
			P&L		BS			
FY		Date	Income	Expense	Assets	Cash	Liab	Equity
	PPP liability recognition	01/04/2020		85,070			-85,070	
20/21	Interest expense	31/03/2021		2,977			-2,977	
	Cash payment	31/03/2021				-12,000	12,000	
	Opening balance	01/04/2021		88,048		-12,000	-76,048	
	Interest expense	30/09/2022		1,331			-1,331	
	Cash payment	30/09/2022				-6,000	6,000	
21/22	PPP liability remeasurement	01/10/2022		1,428			-1,428	
	Interest expense	31/03/2022		1,274			-1,274	
	Cash payment	31/03/2022				-6,120	6,120	
	Opening balance	01/04/2022		92,080		-24,120	-67,960	
	Interest expense	30/09/2023		1,189			-1,189	
	Cash payment	30/09/2023				-6,120	6,120	
22/23	PPP liability remeasurement	01/10/2023		1,891			-1,891	
	Interest expense	31/03/2023		1,103			-1,103	
	Cash payment	31/03/2023				-6,304	6,304	
23/24	Opening balance	01/04/2023		96,263		-36,544	-59,720	

	FY		Date	IFRS 16 post-implementation					
				Accounting					
				P&L		BS			
	FY		Date	Income	Expense	Assets	Cash	Liab	Equity
		IFRS 16 opening balance	01/04/2023		93,417		-36,544	-59,720	2,847
		Interest expense	30/09/2023		1,045			-1,045	
4% increase at 1 October 2023		Cash payment	30/09/2023				-6,304	6,304	
	23/24	PPP liability remeasurement	01/10/2024		2,178			-2,178	
		Interest expense	31/03/2024		991			-991	
		Cash payment	31/03/2024				-6,556	6,556	
		Opening balance	01/04/2024		97,631		-49,403	-51,075	2,847
		Interest expense	30/09/2024		894			-894	
5% increase @ 1 October 2024		Cash payment	30/09/2024				-6,556	6,556	
	24/25	PPP liability remeasurement	01/10/2025		2,271			-2,271	
		Interest expense	31/03/2025		834			-834	
		Cash payment	31/03/2025				-6,884	6,884	
	25/26	Opening balance	01/04/2025		101,630		-62,842	-41,635	2,847