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# Draft guidance on applying the requirements of IFRS 16 *Leases* to service concession arrangements (PFI PPP contracts)

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# Introduction

## The purpose of this guidance

The purpose of this guidance is to set out the aspects of service concession arrangement accounting which are different when IFRS 16 is adopted by a local authority with such schemes, and which may result in a different treatment.

Section 4.3 of the Code of Practice on Local Authority Accounting in the United Kingdom (the Code) sets out requirements for accounting for service concession arrangements, ie private finance initiatives (PFIs), public-private partnerships (PPP) and similar schemes.

The Code requires that these arrangements are accounted for in a manner that is consistent with an adaptation of IFRIC 12 *Service Concession Arrangements.* In addition, the Code's requirements are augmented by provisions from IPSAS 32 *Service Concession Arrangements: Grantor*. A key element of the adaptation is that the treatment of the service concession liability is analogous to lease accounting. At present lease accounting in the Code is based on IAS 17 *Lease*s, and service concession liabilities follow the treatment for finance lease liabilities. As the Code adopts the newer standard IFRS 16 *Leases*, this adaptation will be reframed in terms of that standard.

## Background: application of IFRS 16 to finance leases under indexation

The most significant difference between IFRS 16 and IAS 17 is in relation to the accounting treatment for lessees. Under IAS 17 leases may be operating leases and accounted for off-balance sheet, or finance leases which are accounted for on-balance sheet. Under IFRS 16 a uniform model is applied; right-of-use assets are recognised for all leases and the financing obligation is recognised as a lease liability. The accounting for IFRS 16 lease liabilities is very similar to that for finance leases under IAS 17. For leases previously classified as operating leases, the change in accounting approach is a very significant change. For leases previously classified as finance leases the change is much less significant, but there is one difference in the measurement requirements which will apply to some leases.

Under IAS 17, finance lease liabilities are not remeasured when the value of payments changes in a way which is not predetermined in the lease contract; for example where payments are increased in line with an inflation index such as RPI or CPI. The increase in payments arising from indexation is treated in the same way as finance costs and simply expensed in the period to which the payment relates. This additional payment is known as 'contingent rent'. (NB in theory there could be a reduction in payments.)

Under IFRS 16 a different treatment is applied: where indexation or changes in a rate affect future payments, the lease liability is remeasured. Instead of expensing the additional (or reduced) payment, the net present value of future payments that comprise the liability is recalculated based on the revised level of payments. Increases (or reductions) in expenditure are realised as increases (or reductions) in the amortisation charge taken against the remeasured liability. It should be noted that the remeasurement reflects only indexation or rate changes which have already occurred and result in a change to the payment amount. It does not encompass anticipated movements in the index/rate which have not happened yet, or other undetermined changes in future years.

## When will the new treatment be applied in local authority financial statements?

The Code has not yet adopted IFRS 16 *Leases* on a mandatory basis and local authorities may continue to apply the requirements of IAS 17 in their 2022/23 and 2023/24 financial statements.

However, local authorities are permitted to choose to implement IFRS 16 on a voluntary basis before it becomes mandatory in 2024/25. Where local authorities exercise this option, they must apply requirements set out in Appendix F of the Code.

When Appendix F was drafted, it was anticipated that local authorities that implemented IFRS 16 *Leases* would apply the standard to leases and to service concession arrangements at the same time. However, to maximise alignment with financial reporting in other parts of the UK public sector, local authorities that wish to implement IFRS 16 *Leases* in their 2022/23 financial statements will be able to opt out of applying the standard to PFI PPP arrangements for that accounting period, applying the standard only to arrangements containing a lease. They will however be required to apply IFRS 16 to both leases and PFI PPP arrangements in 2023/24.

Local authorities implementing IFRS 16 for the first time in 2023/24 (voluntarily) or in 2024/25 (when IFRS 16 is mandatory) will need to implement for both leases and PFI PPP arrangements from the outset.

## Guidance provided in this document

Most PFI PPP accounting will be unchanged, and guidance on this is provided in previous editions of the Code Guidance Notes, including the Guidance Notes for 2022/23.

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This document provides guidance on the narrow aspects of PFI PPP accounting which are different as a result of the change from IAS 17 to IFRS 16, where they have chosen to apply IFRS 16 to the service concession arrangement liability.

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# Year on year remeasurement of the lease liability

Illustrative examples are provided of three relatively straightforward PFI PPP arrangements. Each has similar fact patterns, but with key differences.

Illustration 1 sets out the treatment of a simple arrangement where the payments before indexation are constant.

Illustration 2 sets out the treatment where there are minimum annual increases, and these affect all payments in future years.

Illustration 3 sets out the treatment where there are increased minimum payments in each year, but an increase in one year may not affect future payment levels.

The examples are based upon convenient assumptions on the timing of payments and the alignment of contract years with financial reporting years. Where contract years do not align with financial reporting years, calculating the treatment for the contract year and apportioning this to the relevant portion of the financial year should give a materially correct estimate of the charge attributable to the year and the closing balances.

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## Illustration 1: equal amounts over the contract term, with indexation

Pellingforth City Council enters into a 20-year PFI scheme with Darlosga Industrial plc for new waste disposal facilities with the following features (all figures before adjustments for inflation):

- At the start of Year 1, the first and only tranche of facilities become available for use, with a fair value of £18m.
- In Year 1 a unitary payment of £3m becomes due. The fair value of services received is assessed as £1.7m. The unitary payment is due in arrears at 31 March each year.
- In Years 2 to 20 the unitary charge is uprated by the movement in CPI. The uprating is based on the movement in the CPI between 1 April in the previous year and 1 April in the year of charge.
- At the end of Year 20 the contract is terminated and there is no residual interest.
- The CPI movement applicable to the Year 2 unitary charge is 1.5%.
- The CPI movement applicable to the Year 3 unitary charge is 1%.
- The CPI movement applicable to the Year 4 unitary charge is 2%.
- The PFI contract is not separable, so the default assumption is that percentage increases apply equally to payments for services and payments for the asset.

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**Illustration 1 (continued)**

The council calculates the lease rentals payable under the scheme using the following process:

- Schedule out the unitary charge payments to be made to the operator each year (column A).
- Deduct the fair value of services to be received (column B) from the unitary payment to arrive at the amount for lease rentals (column C).
- Recognise the fair value of the asset in at the start of the contract (column D).
- The resulting annual amounts (column E) are the basis for the internal rate of return (IRR) calculation of the implicit interest rate.

In this example, the IRR derived from the data in column E is 3.79% – the discount rate that reduces the sum of the net present values of the column to zero.

**Table 1A**

| Contract year | (A) Unitary charge | (B) Service element | (C) Lease rental | (D) Fair value of asset | (E) DCF/IRR analysis |
|---|---|---|---|---|---|
| 0 | | | | 18,000,000 | 18,000,000 |
| 1 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 2 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 3 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 4 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 5 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 6 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 7 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 8 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 9 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 10 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 11 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 12 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 13 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 14 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 15 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 16 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 17 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 18 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 19 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 20 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| | 60,000,000 | 34,000,000 | 26,000,000 | | 3.79% |

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**Illustration 1 (continued)**

The council then applies the implicit interest rate to the schedule of lease rentals to split them into principal and interest, producing the schedule for writing down the lease liability each year:

- The fair value of the £18m of assets is balanced by the opening balance of the lease liability and is posted in column F.
- Finance costs for Year 1 are calculated in column G by multiplying the opening liability balance by the 3.79% discount rate derived in the preceding table.
- The finance costs are then deducted from the lease rental (column H) to give the amount applied to redeem the lease liability (column I).
- The balance on the liability carried forward to the following year (column J) is calculated by deducting the figure in column I from the opening liability at the start of the year (column F). The figure in column J becomes the opening balance (column F) in the next year of the contract.
- This process is repeated for each year of the scheme. This serves to reduce the liability to zero at the end of the contract.

**Table 1B**

| Contract year | (F) Opening liability | (G) Finance cost | (H) Rental | (I) Redemption of principal | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 682,262 | 1,300,000 | 617,738 | 17,382,262 |
| 2 | 17,382,262 | 658,848 | 1,300,000 | 641,152 | 16,741,110 |
| 3 | 16,741,110 | 634,546 | 1,300,000 | 665,454 | 16,075,656 |
| 4 | 16,075,656 | 609,323 | 1,300,000 | 690,677 | 15,384,979 |
| 5 | 15,384,979 | 583,144 | 1,300,000 | 716,856 | 14,668,122 |
| 6 | 14,668,122 | 555,972 | 1,300,000 | 744,028 | 13,924,095 |
| 7 | 13,924,095 | 527,771 | 1,300,000 | 772,229 | 13,151,866 |
| 8 | 13,151,866 | 498,501 | 1,300,000 | 801,499 | 12,350,367 |
| 9 | 12,350,367 | 468,122 | 1,300,000 | 831,878 | 11,518,489 |
| 10 | 11,518,489 | 436,590 | 1,300,000 | 863,410 | 10,655,079 |
| 11 | 10,655,079 | 403,864 | 1,300,000 | 896,136 | 9,758,943 |
| 12 | 9,758,943 | 369,898 | 1,300,000 | 930,102 | 8,828,841 |
| 13 | 8,828,841 | 334,644 | 1,300,000 | 965,356 | 7,863,485 |
| 14 | 7,863,485 | 298,053 | 1,300,000 | 1,001,947 | 6,861,538 |
| 15 | 6,861,538 | 260,076 | 1,300,000 | 1,039,924 | 5,821,614 |
| 16 | 5,821,614 | 220,659 | 1,300,000 | 1,079,341 | 4,742,273 |
| 17 | 4,742,273 | 179,749 | 1,300,000 | 1,120,251 | 3,622,022 |
| 18 | 3,622,022 | 137,287 | 1,300,000 | 1,162,713 | 2,459,309 |
| 19 | 2,459,309 | 93,216 | 1,300,000 | 1,206,784 | 1,252,525 |
| 20 | 1,252,525 | 47,475 | 1,300,000 | 1,252,525 | 0 |
| | | | 26,000,000 | 26,000,000.00 | |

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### Illustration 1 (continued)

As described in the initial explanation:

- In Years 2 to 20 the unitary charge is uprated by the movement in CPI.
- The CPI movement applicable to the Year 2 unitary charge is 1.5%.
- The CPI movement applicable to the Year 3 unitary charge is 1%.
- The CPI movement applicable to the Year 4 unitary charge is 2%.

Under IAS 17 this would have resulted in the following charges being made to the financial statements:

**Table 1C**

| Contract year | Unitary charge | Service element | Finance cost | Redemption of principal | Contingent rent |
|---|---|---|---|---|---|
| 1 | 3,000,000 | 1,700,000 | 682,262 | 617,738 | |
| 2 | 3,045,000 | 1,725,500 | 658,848 | 641,152 | 19,500 |
| 3 | 3,075,450 | 1,742,755 | 634,546 | 665,454 | 32,695 |
| 4 | 3,136,959 | 1,777,610 | 609,323 | 690,677 | 59,349 |

In the above table, the unitary charge has increased, and so has the charge for services. However, the finance cost and redemption of principal are unchanged. The balance sheet accounting is also unchanged and continues to follow the pattern set out in Table 1B. The movement in the lease rental has not impacted on the balance sheet but has instead been classified as 'contingent rent'. It is expensed in the same way as service costs and finance costs.

*This is not the approach taken under IFRS 16, as shown in the following pages.*

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### Illustration 1 (continued)

When rental payments change as a result in a change in an index or a rate, under IFRS 16 the assumption is made that future payments will also reflect that index or rate. The liability is recalculated in the same way as it was before, using the new minimum payment levels, but without amending the rate of return.

So in Year 2, when the unitary charge is increased by 1.5%, the revised table looks like this:

**Table 1D**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 682,262 | 1,300,000 | 617,738 | 17,382,262 |
| Remeasure in Year 2 | 17,382,262 | | | | 17,642,996 |
| 2 | 17,642,996 | 668,730 | 1,319,500 | 650,770 | 16,992,227 |
| 3 | 16,992,227 | 644,064 | 1,319,500 | 675,436 | 16,316,791 |
| 4 | 16,316,791 | 618,463 | 1,319,500 | 701,037 | 15,615,753 |
| 5 | 15,615,753 | 591,891 | 1,319,500 | 727,609 | 14,888,144 |
| 6 | 14,888,144 | 564,312 | 1,319,500 | 755,188 | 14,132,956 |
| 7 | 14,132,956 | 535,688 | 1,319,500 | 783,812 | 13,349,144 |
| 8 | 13,349,144 | 505,979 | 1,319,500 | 813,521 | 12,535,623 |
| 9 | 12,535,623 | 475,143 | 1,319,500 | 844,357 | 11,691,266 |
| 10 | 11,691,266 | 443,139 | 1,319,500 | 876,361 | 10,814,905 |
| 11 | 10,814,905 | 409,922 | 1,319,500 | 909,578 | 9,905,328 |
| 12 | 9,905,328 | 375,446 | 1,319,500 | 944,054 | 8,961,274 |
| 13 | 8,961,274 | 339,663 | 1,319,500 | 979,837 | 7,981,437 |
| 14 | 7,981,437 | 302,524 | 1,319,500 | 1,016,976 | 6,964,461 |
| 15 | 6,964,461 | 263,977 | 1,319,500 | 1,055,523 | 5,908,938 |
| 16 | 5,908,938 | 223,969 | 1,319,500 | 1,095,531 | 4,813,407 |
| 17 | 4,813,407 | 182,445 | 1,319,500 | 1,137,055 | 3,676,352 |
| 18 | 3,676,352 | 139,346 | 1,319,500 | 1,180,154 | 2,496,198 |
| 19 | 2,496,198 | 94,615 | 1,319,500 | 1,224,885 | 1,271,313 |
| 20 | 1,271,313 | 48,187 | 1,319,500 | 1,271,313 | 0 |

The opening liability for Year 2 (highlighted in blue) equates to the net present value of the increased rental payments for Years 2 to 20 (highlighted in grey) based on the CPI for Year 2. All of the other calculations are the same.

- Finance costs are calculated in column G by multiplying the opening liability balance by the 3.79% discount rate derived in the preceding table.
- The finance costs are then deducted from the lease rental (column H) to give the amount applied to redeem the lease liability (column I).
- The balance on the liability carried forward to the following year (column J) is calculated by deducting the figure in column I from the opening liability at the start of the year (column F). The figure in column J becomes the opening balance (column F) in the next year of the contract.
- This process is repeated for each year of the scheme, and serves to reduce the liability to zero at the end of the contract

In this particular case, each of the rental payments has been uprated by 1.5%. The net present value is a series where each value has been increased by 1.5%, and it follows that the remeasured liability could have been calculated by uprating the closing liability in Year 1 by 1.5%:

$$17,382,262 \times 1.015 = 17,642,996$$

This relationship can't be guaranteed as it depends on the pattern of minimum payments, which in turn depend on the contract conditions, but it can happen under many circumstances.

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**Illustration 1 (continued)**

Similarly in Year 3, when the unitary charge is increased by 1.0%, the revised table looks like this:

**Table 1E**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 682,262 | 1,300,000 | 617,738 | 17,382,262 |
| 2 | 17,642,996 | 668,730 | 1,319,500 | 650,770 | 16,992,227 |
| Remeasure in Year 3 | 16,992,227 | | | | 17,162,149 |
| 3 | 17,162,149 | 650,505 | 1,332,695 | 682,190 | 16,479,958 |
| 4 | 16,479,958 | 624,647 | 1,332,695 | 708,048 | 15,771,911 |
| 5 | 15,771,911 | 597,810 | 1,332,695 | 734,885 | 15,037,026 |
| 6 | 15,037,026 | 569,955 | 1,332,695 | 762,740 | 14,274,286 |
| 7 | 14,274,286 | 541,045 | 1,332,695 | 791,650 | 13,482,635 |
| 8 | 13,482,635 | 511,038 | 1,332,695 | 821,657 | 12,660,979 |
| 9 | 12,660,979 | 479,895 | 1,332,695 | 852,800 | 11,808,179 |
| 10 | 11,808,179 | 447,571 | 1,332,695 | 885,124 | 10,923,054 |
| 11 | 10,923,054 | 414,021 | 1,332,695 | 918,674 | 10,004,381 |
| 12 | 10,004,381 | 379,201 | 1,332,695 | 953,494 | 9,050,886 |
| 13 | 9,050,886 | 343,060 | 1,332,695 | 989,635 | 8,061,251 |
| 14 | 8,061,251 | 305,549 | 1,332,695 | 1,027,146 | 7,034,106 |
| 15 | 7,034,106 | 266,617 | 1,332,695 | 1,066,078 | 5,968,027 |
| 16 | 5,968,027 | 226,209 | 1,332,695 | 1,106,486 | 4,861,541 |
| 17 | 4,861,541 | 184,269 | 1,332,695 | 1,148,426 | 3,713,115 |
| 18 | 3,713,115 | 140,740 | 1,332,695 | 1,191,955 | 2,521,160 |
| 19 | 2,521,160 | 95,561 | 1,332,695 | 1,237,134 | 1,284,026 |
| 20 | 1,284,026 | 48,669 | 1,332,695 | 1,284,026 | 0 |

Again the remeasured liability highlighted in blue equates to the net present value of the increased rental payments for the remaining years of the contract highlighted in grey based on the most recent assessment of CPI. It also corresponds to a 1% uprating of the closing liability for Year 2.

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**Illustration 1 (continued)**

Finally in Year 4, when the unitary charge is increased by 2.0%, the revised table looks like this:

**Table 1F**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 682,262 | 1,300,000 | 617,738 | 17,382,262 |
| 2 | 17,642,996 | 668,730 | 1,319,500 | 650,770 | 16,992,227 |
| 3 | 17,162,149 | 650,505 | 1,332,695 | 682,190 | 16,479,958 |
| 4 | 16,809,558 | 637,140 | 1,359,349 | 722,209 | 16,087,349 |
| 5 | 16,087,349 | 609,766 | 1,359,349 | 749,583 | 15,337,766 |
| 6 | 15,337,766 | 581,354 | 1,359,349 | 777,995 | 14,559,771 |
| 7 | 14,559,771 | 551,866 | 1,359,349 | 807,483 | 13,752,288 |
| 8 | 13,752,288 | 521,259 | 1,359,349 | 838,090 | 12,914,198 |
| 9 | 12,914,198 | 489,493 | 1,359,349 | 869,856 | 12,044,342 |
| 10 | 12,044,342 | 456,522 | 1,359,349 | 902,827 | 11,141,515 |
| 11 | 11,141,515 | 422,302 | 1,359,349 | 937,047 | 10,204,468 |
| 12 | 10,204,468 | 386,785 | 1,359,349 | 972,564 | 9,231,904 |
| 13 | 9,231,904 | 349,921 | 1,359,349 | 1,009,428 | 8,222,476 |
| 14 | 8,222,476 | 311,660 | 1,359,349 | 1,047,689 | 7,174,788 |
| 15 | 7,174,788 | 271,949 | 1,359,349 | 1,087,400 | 6,087,388 |
| 16 | 6,087,388 | 230,733 | 1,359,349 | 1,128,616 | 4,958,772 |
| 17 | 4,958,772 | 187,955 | 1,359,349 | 1,171,394 | 3,787,378 |
| 18 | 3,787,378 | 143,555 | 1,359,349 | 1,215,794 | 2,571,584 |
| 19 | 2,571,584 | 97,472 | 1,359,349 | 1,261,877 | 1,309,707 |
| 20 | 1,309,707 | 49,642 | 1,359,349 | 1,309,707 | 0 |

Again the remeasured liability highlighted in blue equates to the net present value of the increased rental payments for the remaining years of the contract highlighted in grey based on the most recent assessment of CPI. It also corresponds to a 2% uprating of the closing liability for Year 3.

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### Illustration 1 (continued)

The overall effect of this results in a different profile of charges.

Under IAS 17, charges in Year 1 to Year 4 would be as below in Table 1C.

**Table 1C**

| Contract year | Unitary charge | Service element | Finance cost | Redemption of principal | Contingent rent |
|---|---|---|---|---|---|
| 1 | 3,000,000 | 1,700,000 | 682,262 | 617,738 | |
| 2 | 3,045,000 | 1,725,500 | 658,848 | 641,152 | 19,500 |
| 3 | 3,075,450 | 1,742,755 | 634,546 | 665,454 | 32,695 |
| 4 | 3,136,959 | 1,777,610 | 609,323 | 690,677 | 59,349 |

This shows unchanged finance costs and redemptions from the initial model.

In contrast the profile of charges under IFRS 16 would be per Table 1G below.

**Table 1G**

| Contract year | Unitary charge | Service element | Finance cost | Redemption of principal |
|---|---|---|---|---|
| 1 | 3,000,000 | 1,700,000 | 682,262 | 617,738 |
| 2 | 3,045,000 | 1,725,500 | 668,730 | 650,770 |
| 3 | 3,075,450 | 1,742,755 | 650,505 | 682,190 |
| 4 | 3,136,959 | 1,777,610 | 637,140 | 722,209 |

Because the liabilities have been remeasured to reflect the increased unitary charge attributable to the asset, both finance costs and the redemption amounts have also increased.

This comparison is not shown for Illustration 2 or Illustration 3, but there will be similar increases in the profile of charges.

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## Illustration 2: minimum increases over the contract term (per year)

Ambleport Borough Council enters into a 20-year PFI scheme with Damp and Wet plc for flood defence barriers with the following features (all figures before adjustments for inflation):

- At the start of Year 1, the first and only tranche of facilities become available for use, with a fair value of £18m.
- In Year 1 a unitary payment of £3m becomes due. The fair value of services received is assessed as £1.7m. The unitary payment is due in arrears at 31 March each year.
- In Years 2 to 20 the unitary charge is uprated by the movement in CPI or 0.5%, whichever is the greater. The uprating is based on the movement in the CPI between 1 April in the previous year and 1 April in the year of charge.
- At the end of Year 20 the contract is terminated and there is no residual interest.
- The CPI movement applicable to the Year 2 unitary charge is 1.5%.
- The CPI movement applicable to the Year 3 unitary charge is 1%.
- The CPI movement applicable to the Year 4 unitary charge is 2%.
- The PFI contract is not separable, so the default assumption is that percentage increases apply equally to payments for services and payments for the asset.

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**Illustration 2 (continued)**

The council calculates the lease rentals payable under the scheme using the following process:

- Schedule out the unitary charge payments to be made to the operator each year (column A). Note that these increase by 0.5% each year.
- Deduct the fair value of services to be received (column B) from the unitary payment to arrive at the amount for lease rentals (column C). Note that this increases by 0.5% each year.
- Recognise the fair value of the asset in at the start of the Contract (D).
- The resulting annual amounts (column E) are the basis for the internal rate of return (IRR) calculation of the implicit interest rate.

In this example, the IRR derived from the data in column E is 4.25% – the discount rate that reduces the sum of the net present values of the column to zero.

**Table 2A**

| Contract year | (A) Unitary charge | (B) Service element | (C) Lease rental | (D) Fair value of asset | (E) DCF/IRR analysis |
|---|---|---|---|---|---|
| 0 | | | | 18,000,000 | -18,000,000 |
| 1 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 2 | 3,015,000 | 1,708,500 | 1,306,500 | | 1,306,500 |
| 3 | 3,030,075 | 1,717,043 | 1,313,033 | | 1,313,033 |
| 4 | 3,045,225 | 1,725,628 | 1,319,598 | | 1,319,598 |
| 5 | 3,060,452 | 1,734,256 | 1,326,196 | | 1,326,196 |
| 6 | 3,075,754 | 1,742,927 | 1,332,827 | | 1,332,827 |
| 7 | 3,091,133 | 1,751,642 | 1,339,491 | | 1,339,491 |
| 8 | 3,106,588 | 1,760,400 | 1,346,188 | | 1,346,188 |
| 9 | 3,122,121 | 1,769,202 | 1,352,919 | | 1,352,919 |
| 10 | 3,137,732 | 1,778,048 | 1,359,684 | | 1,359,684 |
| 11 | 3,153,420 | 1,786,938 | 1,366,482 | | 1,366,482 |
| 12 | 3,169,187 | 1,795,873 | 1,373,315 | | 1,373,315 |
| 13 | 3,185,033 | 1,804,852 | 1,380,181 | | 1,380,181 |
| 14 | 3,200,959 | 1,813,877 | 1,387,082 | | 1,387,082 |
| 15 | 3,216,963 | 1,822,946 | 1,394,017 | | 1,394,017 |
| 16 | 3,233,048 | 1,832,061 | 1,400,988 | | 1,400,988 |
| 17 | 3,249,213 | 1,841,221 | 1,407,992 | | 1,407,992 |
| 18 | 3,265,460 | 1,850,427 | 1,415,032 | | 1,415,032 |
| 19 | 3,281,787 | 1,859,679 | 1,422,108 | | 1,422,108 |
| 20 | 3,298,196 | 1,868,978 | 1,429,218 | | 1,429,218 |
| | 62,937,346 | 35,664,496 | 27,272,850 | | 4.25% |

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**Illustration 2 (continued)**

The council then applies the discount rate to the schedule of lease rentals to split them into principal and interest, producing the schedule for writing down the lease liability each year:

- The fair value of the £18m of assets is balanced by the opening balance of the lease liability and is posted in column F.
- Finance costs for Year 1 are calculated in column G by multiplying the opening liability balance by the 4.25% implicit interest rate derived in the preceding table.
- The finance costs are then deducted from the lease rental (column H) to give the amount applied to redeem the lease liability (column I).
- The balance on the liability carried forward to the following year (column J) is calculated by deducting the figure in column I from the opening liability at the start of the year (column F). The figure in column J becomes the opening balance (column F) in the next year of the contract.
- This process is repeated for each year of the scheme. This serves to reduce the liability to zero at the end of the contract.

**Table 2B**

| Contract year | (F) Opening liability | (G) Finance cost | (H) Rental | (I) Redemption of principal | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| 2 | 17,465,588 | 742,858 | 1,306,500 | 563,642 | 16,901,947 |
| 3 | 16,901,947 | 718,885 | 1,313,033 | 594,147 | 16,307,800 |
| 4 | 16,307,800 | 693,615 | 1,319,598 | 625,983 | 15,681,816 |
| 5 | 15,681,816 | 666,990 | 1,326,196 | 659,206 | 15,022,611 |
| 6 | 15,022,611 | 638,952 | 1,332,827 | 693,875 | 14,328,736 |
| 7 | 14,328,736 | 609,440 | 1,339,491 | 730,051 | 13,598,685 |
| 8 | 13,598,685 | 578,389 | 1,346,188 | 767,800 | 12,830,885 |
| 9 | 12,830,885 | 545,732 | 1,352,919 | 807,187 | 12,023,698 |
| 10 | 12,023,698 | 511,400 | 1,359,684 | 848,284 | 11,175,415 |
| 11 | 11,175,415 | 475,320 | 1,366,482 | 891,162 | 10,284,253 |
| 12 | 10,284,253 | 437,417 | 1,373,315 | 935,898 | 9,348,355 |
| 13 | 9,348,355 | 397,611 | 1,380,181 | 982,570 | 8,365,785 |
| 14 | 8,365,785 | 355,819 | 1,387,082 | 1,031,263 | 7,334,522 |
| 15 | 7,334,522 | 311,957 | 1,394,017 | 1,082,061 | 6,252,462 |
| 16 | 6,252,462 | 265,934 | 1,400,988 | 1,135,054 | 5,117,408 |
| 17 | 5,117,408 | 217,657 | 1,407,992 | 1,190,335 | 3,927,073 |
| 18 | 3,927,073 | 167,029 | 1,415,032 | 1,248,003 | 2,679,069 |
| 19 | 2,679,069 | 113,948 | 1,422,108 | 1,308,160 | 1,370,910 |
| 20 | 1,370,910 | 58,308 | 1,429,218 | 1,370,910 | 0 |
| | | | 27,272,850 | 27,272,850 | |

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### Illustration 2 (continued)

When rental payments change as a result in a change in an index or a rate, the assumption is made that future payments will also reflect that index or rate. The liability is recalculated in the same way as it was before, but using the new payment levels, but without amending the rate of return.

So in Year 2, when the unitary charge is increased by 1.5%, the revised table looks like this:

**Table 2C**

| | (F) | (G) | (H) | (I) | (J) |
|---|---|---|---|---|---|
| **Contract year** | **Opening or remeasured liability** | **Finance cost** | **Rental** | **Redemption** | **Closing liability** |
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| Remeasure in Year 2 | 17,465,588 | | | | 17,639,375 |
| 2 | 17,639,375 | 750,250 | 1,319,500 | 569,250 | 17,070,125 |
| 3 | 17,070,125 | 726,038 | 1,326,098 | 600,059 | 16,470,066 |
| 4 | 16,470,066 | 700,516 | 1,332,728 | 632,212 | 15,837,854 |
| 5 | 15,837,854 | 673,627 | 1,339,392 | 665,765 | 15,172,089 |
| 6 | 15,172,089 | 645,310 | 1,346,089 | 700,779 | 14,471,311 |
| 7 | 14,471,311 | 615,504 | 1,352,819 | 737,315 | 13,733,995 |
| 8 | 13,733,995 | 584,144 | 1,359,583 | 775,439 | 12,958,556 |
| 9 | 12,958,556 | 551,162 | 1,366,381 | 815,219 | 12,143,337 |
| 10 | 12,143,337 | 516,489 | 1,373,213 | 856,724 | 11,286,613 |
| 11 | 11,286,613 | 480,050 | 1,380,079 | 900,029 | 10,386,584 |
| 12 | 10,386,584 | 441,769 | 1,386,979 | 945,210 | 9,441,374 |
| 13 | 9,441,374 | 401,567 | 1,393,914 | 992,347 | 8,449,027 |
| 14 | 8,449,027 | 359,360 | 1,400,884 | 1,041,524 | 7,407,503 |
| 15 | 7,407,503 | 315,061 | 1,407,888 | 1,092,827 | 6,314,675 |
| 16 | 6,314,675 | 268,580 | 1,414,928 | 1,146,348 | 5,168,328 |
| 17 | 5,168,328 | 219,823 | 1,422,002 | 1,202,180 | 3,966,148 |
| 18 | 3,966,148 | 168,691 | 1,429,112 | 1,260,421 | 2,705,727 |
| 19 | 2,705,727 | 115,082 | 1,436,258 | 1,321,176 | 1,384,551 |
| 20 | 1,384,551 | 58,889 | 1,443,439 | 1,384,551 | 0 |

The opening liability for Year 2 (highlighted in blue) equates to the net present value of the increased rental payments for Years 2 to 20 (highlighted in grey) based on the most recent assessment of CPI. All of the other calculations are the same.

- Finance costs are calculated in column G by multiplying the opening liability balance by the 4.25% discount rate derived in the preceding table.
- The finance costs are then deducted from the lease rental (column H) to give the amount applied to redeem the lease liability (column I).
- The balance on the liability carried forward to the following year (column J) is calculated by deducting the figure in column I from the opening liability at the start of the year (column F). The figure in column J becomes the opening balance (column F) in the next year of the contract.
- This process is repeated for each year of the scheme, and serves to reduce the liability to zero at the end of the contract

It's important to note that each of the rental payments has been uprated by the same proportion, but it is 0.995% rather than 1.5%.
That is because the model already includes a 0.5% rise, and 1.005 x 1.00995 = 1.0015.

The net present value is a series where each value has been uprated by 0.995%, and it follows that the remeasured liability could have been calculated by uprating the closing liability in Year 1 by 0.995%.

17,465,588 x 1.00995 = 17,639,375

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## Illustration 2 (continued)

Similarly in Year 3, when the unitary charge is increased by 1.0%, the revised table looks like this:

**Table 2D**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| 2 | 17,639,375 | 750,250 | 1,319,500 | 569,250 | 17,070,125 |
| | 17,070,125 | | | | 17,155,051 |
| 3 | 17,155,051 | 729,650 | 1,332,695 | 603,045 | 16,552,007 |
| 4 | 16,552,007 | 704,001 | 1,339,358 | 635,357 | 15,916,650 |
| 5 | 15,916,650 | 676,978 | 1,346,055 | 669,077 | 15,247,572 |
| 6 | 15,247,572 | 648,520 | 1,352,786 | 704,265 | 14,543,307 |
| 7 | 14,543,307 | 618,566 | 1,359,549 | 740,984 | 13,802,324 |
| 8 | 13,802,324 | 587,050 | 1,366,347 | 779,297 | 13,023,026 |
| 9 | 13,023,026 | 553,904 | 1,373,179 | 819,275 | 12,203,752 |
| 10 | 12,203,752 | 519,058 | 1,380,045 | 860,986 | 11,342,765 |
| 11 | 11,342,765 | 482,438 | 1,386,945 | 904,507 | 10,438,258 |
| 12 | 10,438,258 | 443,967 | 1,393,880 | 949,913 | 9,488,346 |
| 13 | 9,488,346 | 403,565 | 1,400,849 | 997,284 | 8,491,062 |
| 14 | 8,491,062 | 361,148 | 1,407,853 | 1,046,706 | 7,444,356 |
| 15 | 7,444,356 | 316,628 | 1,414,893 | 1,098,264 | 6,346,092 |
| 16 | 6,346,092 | 269,916 | 1,421,967 | 1,152,051 | 5,194,041 |
| 17 | 5,194,041 | 220,917 | 1,429,077 | 1,208,160 | 3,985,880 |
| 18 | 3,985,880 | 169,530 | 1,436,222 | 1,266,692 | 2,719,188 |
| 19 | 2,719,188 | 115,654 | 1,443,404 | 1,327,749 | 1,391,439 |
| 20 | 1,391,439 | 59,182 | 1,450,621 | 1,391,439 | 0 |

Again, the remeasured liability highlighted in blue equates to the net present value of the increased rental payments for the remaining years of the contract highlighted in grey based on the most recent assessment of CPI. It also corresponds to a 0.4975% uprating of the closing liability for Year 2. That is because the model already includes a 0.5% rise, and 1.005 x 1.004975 = 1.001.

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## Illustration 3: minimum increases staged over the contract term

Merrydown Borough Council enters into a 20-year PFI scheme with Wise Owls plc for secondary school provision with the following features (all figures before adjustments for inflation):

- At the start of Year 1, the first and only tranche of facilities become available for use, with a fair value of £18m.
- In Year 1 a unitary payment of £3m becomes due. The fair value of services received is assessed as £1.7m. The unitary payment is due in arrears at 31 March each year.
- In Years 2 to 20 the unitary charge is increased to reflect the movement in CPI since Year 1, or 0.5% compounded annually since Year 1, whichever is the greater. The uprating is based on the movement in the CPI between 1 April in the previous year and 1 April in the year of charge.
- At the end of Year 20 the contract is terminated and there is no residual interest.
- The CPI movement applicable to the Year 2 unitary charge is 1.5%.
- The CPI movement applicable to the Year 3 unitary charge is 1%.
- The CPI movement applicable to the Year 4 unitary charge is 2%.
- The PFI contract is not separable, so the default assumption is that percentage increases apply equally to payments for services and payments for the asset.

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The council calculates the lease rentals payable under the scheme using the following process:

- Schedule out the unitary charge payments to be made to the operator each year (column A). Note that these increase by 0.5% each year.
- Deduct the fair value of services to be received (column B) from the unitary payment to arrive at the amount for lease rentals (column C). Note that this increases by 0.5% each year.
- Recognise the fair value of the asset in at the start of the contract (column D).
- The resulting annual amounts (column E) are the basis for the internal rate of return (IRR) calculation of the implicit interest rate.

In this example, the IRR derived from the data in column E is 4.25% – the discount rate that reduces the sum of the net present values of the column to zero.

**Table 3A**

| Contract year | (A) Unitary charge | (B) Service element | (C) Lease rental | (D) Fair value of asset | (E) DCF/IRR analysis |
|---|---|---|---|---|---|
| 0 | | | | 18,000,000 | -18,000,000 |
| 1 | 3,000,000 | 1,700,000 | 1,300,000 | | 1,300,000 |
| 2 | 3,015,000 | 1,708,500 | 1,306,500 | | 1,306,500 |
| 3 | 3,030,075 | 1,717,043 | 1,313,033 | | 1,313,033 |
| 4 | 3,045,225 | 1,725,628 | 1,319,598 | | 1,319,598 |
| 5 | 3,060,452 | 1,734,256 | 1,326,196 | | 1,326,196 |
| 6 | 3,075,754 | 1,742,927 | 1,332,827 | | 1,332,827 |
| 7 | 3,091,133 | 1,751,642 | 1,339,491 | | 1,339,491 |
| 8 | 3,106,588 | 1,760,400 | 1,346,188 | | 1,346,188 |
| 9 | 3,122,121 | 1,769,202 | 1,352,919 | | 1,352,919 |
| 10 | 3,137,732 | 1,778,048 | 1,359,684 | | 1,359,684 |
| 11 | 3,153,420 | 1,786,938 | 1,366,482 | | 1,366,482 |
| 12 | 3,169,187 | 1,795,873 | 1,373,315 | | 1,373,315 |
| 13 | 3,185,033 | 1,804,852 | 1,380,181 | | 1,380,181 |
| 14 | 3,200,959 | 1,813,877 | 1,387,082 | | 1,387,082 |
| 15 | 3,216,963 | 1,822,946 | 1,394,017 | | 1,394,017 |
| 16 | 3,233,048 | 1,832,061 | 1,400,988 | | 1,400,988 |
| 17 | 3,249,213 | 1,841,221 | 1,407,992 | | 1,407,992 |
| 18 | 3,265,460 | 1,850,427 | 1,415,032 | | 1,415,032 |
| 19 | 3,281,787 | 1,859,679 | 1,422,108 | | 1,422,108 |
| 20 | 3,298,196 | 1,868,978 | 1,429,218 | | 1,429,218 |
| | 62,937,346 | 35,664,496 | 27,272,850 | | 4.25% |

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**Illustration 3 (continued)**

The council then applies the implicit interest rate to the schedule of lease rentals to split them into principal and interest, producing the schedule for writing down the lease liability each year:

- The fair value of the £18m of assets is balanced by the opening balance of the lease liability and is posted in column F.
- Finance costs for Year 1 are calculated in column G by multiplying the opening liability balance by the 4.25% implicit interest rate derived in the preceding table.
- The finance costs are then deducted from the lease rental (column H) to give the amount applied to redeem the lease liability (column I).
- The balance on the liability carried forward to the following year (column J) is calculated by deducting the figure in column I from the opening liability at the start of the year (column F). The figure in column J becomes the opening balance (column F) in the next year of the contract.
- This process is repeated for each year of the scheme. This serves to reduce the liability to zero at the end of the contract.

**Table 3B**

| Contract year | (F) Opening liability | (G) Finance cost | (H) Rental | (I) Redemption of principal | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| 2 | 17,465,588 | 742,858 | 1,306,500 | 563,642 | 16,901,947 |
| 3 | 16,901,947 | 718,885 | 1,313,033 | 594,147 | 16,307,800 |
| 4 | 16,307,800 | 693,615 | 1,319,598 | 625,983 | 15,681,816 |
| 5 | 15,681,816 | 666,990 | 1,326,196 | 659,206 | 15,022,611 |
| 6 | 15,022,611 | 638,952 | 1,332,827 | 693,875 | 14,328,736 |
| 7 | 14,328,736 | 609,440 | 1,339,491 | 730,051 | 13,598,685 |
| 8 | 13,598,685 | 578,389 | 1,346,188 | 767,800 | 12,830,885 |
| 9 | 12,830,885 | 545,732 | 1,352,919 | 807,187 | 12,023,698 |
| 10 | 12,023,698 | 511,400 | 1,359,684 | 848,284 | 11,175,415 |
| 11 | 11,175,415 | 475,320 | 1,366,482 | 891,162 | 10,284,253 |
| 12 | 10,284,253 | 437,417 | 1,373,315 | 935,898 | 9,348,355 |
| 13 | 9,348,355 | 397,611 | 1,380,181 | 982,570 | 8,365,785 |
| 14 | 8,365,785 | 355,819 | 1,387,082 | 1,031,263 | 7,334,522 |
| 15 | 7,334,522 | 311,957 | 1,394,017 | 1,082,061 | 6,252,462 |
| 16 | 6,252,462 | 265,934 | 1,400,988 | 1,135,054 | 5,117,408 |
| 17 | 5,117,408 | 217,657 | 1,407,992 | 1,190,335 | 3,927,073 |
| 18 | 3,927,073 | 167,029 | 1,415,032 | 1,248,003 | 2,679,069 |
| 19 | 2,679,069 | 113,948 | 1,422,108 | 1,308,160 | 1,370,910 |
| 20 | 1,370,910 | 58,308 | 1,429,218 | 1,370,910 | 0 |
| | | | 27,272,850 | 27,272,850 | |

Note that tables 3A and 3B are exactly the same as Tables 2A and 2B in Illustration 2 – the minimum payments under both contracts are the same. However, there are differences in the way the liability is remeasured in subsequent years, and these will be immediately apparent.

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## Illustration 3 (continued)

When rental payments change as a result in a change in an index or a rate, the assumption is made that future payments will also reflect that index or rate. The liability is recalculated in the same way as it was before, using the new payment levels, but without amending the rate of return.

So in Year 2, when the unitary charge is increased by 1.5%, the revised table looks like this:

**Table 3C**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| Remeasure in Year 2 | 17,465,588 | | | | 17,484,009 |
| 2 | 17,484,009 | 743,642 | 1,319,500 | 575,858 | 16,908,150 |
| 3 | 16,908,150 | 719,149 | 1,319,500 | 600,351 | 16,307,800 |
| 4 | 16,307,800 | 693,615 | 1,319,598 | 625,983 | 15,681,816 |
| 5 | 15,681,816 | 666,990 | 1,326,196 | 659,206 | 15,022,611 |
| 6 | 15,022,611 | 638,952 | 1,332,827 | 693,875 | 14,328,736 |
| 7 | 14,328,736 | 609,440 | 1,339,491 | 730,051 | 13,598,685 |
| 8 | 13,598,685 | 578,389 | 1,346,188 | 767,800 | 12,830,885 |
| 9 | 12,830,885 | 545,732 | 1,352,919 | 807,187 | 12,023,698 |
| 10 | 12,023,698 | 511,400 | 1,359,684 | 848,284 | 11,175,415 |
| 11 | 11,175,415 | 475,320 | 1,366,482 | 891,162 | 10,284,253 |
| 12 | 10,284,253 | 437,417 | 1,373,315 | 935,898 | 9,348,355 |
| 13 | 9,348,355 | 397,611 | 1,380,181 | 982,570 | 8,365,785 |
| 14 | 8,365,785 | 355,819 | 1,387,082 | 1,031,263 | 7,334,522 |
| 15 | 7,334,522 | 311,957 | 1,394,017 | 1,082,061 | 6,252,462 |
| 16 | 6,252,462 | 265,934 | 1,400,988 | 1,135,054 | 5,117,408 |
| 17 | 5,117,408 | 217,657 | 1,407,992 | 1,190,335 | 3,927,073 |
| 18 | 3,927,073 | 167,029 | 1,415,032 | 1,248,003 | 2,679,069 |
| 19 | 2,679,069 | 113,948 | 1,422,108 | 1,308,160 | 1,370,910 |
| 20 | 1,370,910 | 58,308 | 1,429,218 | 1,370,910 | 0 |

The opening liability for Year 2 (highlighted in blue) equates to the net present value of the increased rental payments for Years 2 to 20 (highlighted in grey) based on the most recent assessment of CPI. All of the other calculations are the same.

However, the pattern of lease rental payments is very different because of the different contract terms. In the second contract, the indexation in Year 2 affects the minimum payments in all future years. In this contract, the increase in Year 2 affects only the payments in Year 2 and Year 3 (lighter grey shading).

For this reason, it is not possible to calculate the NPV as a simple multiple of the liability before remeasurement. The NPV needs to be calculated explicitly.

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### Illustration 3 (continued)

Similarly in Year 3, when the unitary charge is increased by 1.0%, the revised table looks like this:

**Table 3D**

| Contract year | (F) Opening or remeasured liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 1 | 18,000,000 | 765,588 | 1,300,000 | 534,412 | 17,465,588 |
| 2 | 17,484,009 | 743,642 | 1,319,500 | 575,858 | 16,908,150 |
| Remeasure in Year 3 | 16,908,150 | | | | 16,938,594 |
| 3 | 16,938,594 | 720,444 | 1,332,695 | 612,251 | 16,326,342 |
| 4 | 16,326,342 | 694,403 | 1,332,695 | 638,292 | 15,688,051 |
| 5 | 15,688,051 | 667,255 | 1,332,695 | 665,440 | 15,022,611 |
| 6 | 15,022,611 | 638,952 | 1,332,827 | 693,875 | 14,328,736 |
| 7 | 14,328,736 | 609,440 | 1,339,491 | 730,051 | 13,598,685 |
| 8 | 13,598,685 | 578,389 | 1,346,188 | 767,800 | 12,830,885 |
| 9 | 12,830,885 | 545,732 | 1,352,919 | 807,187 | 12,023,698 |
| 10 | 12,023,698 | 511,400 | 1,359,684 | 848,284 | 11,175,415 |
| 11 | 11,175,415 | 475,320 | 1,366,482 | 891,162 | 10,284,253 |
| 12 | 10,284,253 | 437,417 | 1,373,315 | 935,898 | 9,348,355 |
| 13 | 9,348,355 | 397,611 | 1,380,181 | 982,570 | 8,365,785 |
| 14 | 8,365,785 | 355,819 | 1,387,082 | 1,031,263 | 7,334,522 |
| 15 | 7,334,522 | 311,957 | 1,394,017 | 1,082,061 | 6,252,462 |
| 16 | 6,252,462 | 265,934 | 1,400,988 | 1,135,054 | 5,117,408 |
| 17 | 5,117,408 | 217,657 | 1,407,992 | 1,190,335 | 3,927,073 |
| 18 | 3,927,073 | 167,029 | 1,415,032 | 1,248,003 | 2,679,069 |
| 19 | 2,679,069 | 113,948 | 1,422,108 | 1,308,160 | 1,370,910 |
| 20 | 1,370,910 | 58,308 | 1,429,218 | 1,370,910 | 0 |

Again the remeasured liability highlighted in blue equates to the net present value of the increased rental payments for the remaining years of the contract based on the most recent assessment of CPI (highlighted in grey).

However, the pattern of lease rental payments continues to be very different because of the different contract terms. In the second contract, the indexation in Year 2 affects the minimum payments in all future years. In this contract, the increase in Year 3 affects only the payments in Year 3, Year 4 and Year 5 (lighter grey shading).

Again, for this reason it is not possible to calculate the NPV as a simple multiple of the liability before remeasurement. The NPV needs to be calculated explicitly.

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# Accounting entries for year on year remeasurement of the lease liability

The accounting entries for a year on year remeasurement can be exemplified using the figures for Year 2 of Illustration 1:

| | | £ |
|---|---|---|
| | Remeasuring the lease liability: | |
| Dr | Property, plant and equipment | 260,734 |
| Cr | Current creditors | 9,618 |
| Cr | Long-term creditors | 251,116 |
| | To increase the lease liability from £17,382,262 to £17,642,996. The element identified as a current creditor is the increase in the redemption amount for Year 2 from £641,152 to £650,770. | |
| | The addition to the property, plant and equipment balance is an increase in the historical cost of the asset. Where the increase in the carrying amount means there is a risk of material misstatement of the current value of the asset, a new valuation of the asset may be required. See Illustration 4 for the accounting entries if this is the case. | |
| | | |
| | Accounting for the in-year transactions: | |
| Dr | Comprehensive Income and Expenditure Statement – Financing and investment income and expenditure | 668,730 |
| Dr | Current creditors | 650,770 |
| Cr | Cash | 1,319,500 |
| | To split the increased unitary charge for Year 2 into the elements needed to meet the finance cost and to write down the liability. | |

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# Transition from IAS 17 to IFRS 16 – the first remeasurement of the lease liability

IFRS 16 *Leases* includes a number of practical expedients which aim to help preparers transition from IAS 17. One of these is the 'modified retrospective' approach. The proposed Code mandates the 'modified retrospective' approach.

Instead of restating balances in previous years, for leases accounted for as finance leases the opening balance of the lease liability on transition is simply read across from the closing balance in the previous financial statements. Remeasurement of the lease liability is thereafter applied prospectively, when a requirement to reassess the liability is triggered by a change in future payments.

Applying the 'modified retrospective' approach means that preparers do not need to recalculate the opening balance of the lease liability, and they can defer subsequent remeasurement until a change in future payments is triggered. So for example, where rental uplifts are on a five-yearly schedule, remeasurement may not be required for some time. However, where changes are made on an annual basis through annual indexation, remeasurement will need to be carried out in the first year of reporting under IFRS 16.

In most PFI PPP arrangements that CIPFA is aware of, where there is any use of indexation, it is on an annual basis, so remeasurement of the liability will be required in the year of transition.

The example on the following page incorporates an assumption that payment increases are triggered on the first day of the reporting year.

In cases where the trigger for changes to payment amounts is part way through the reporting year, it will be expedient to remeasure the liability on 1 April based on the indexation or rate changes which have taken effect since the arrangement commenced. By remeasuring in this way, the finance charge and repayment of principal will reflect the IFRS 16 based liability and will be the same as if an IFRS 16 approach had always been in place. Contingent rent must not be recognised. This treatment is mandatory for central government and health bodies, and following it will eliminate the need for consolidation adjustments in WGA returns.

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# Illustration 4: transition where payments are for equal amounts over the contract term, with indexation

This example uses the contract terms for Illustration 1, and also specifies that:

- transition to IFRS 16 is being undertaken in Year 16 of the contract
- indexation applied to the unitary charge in Year 16 amounts to 50% uplift.

The below excerpt is taken from Table 1B in Illustration 1.

**Table 4A**

| Contract year | (F) Opening liability | (G) Finance cost | (H) Rental | (I) Redemption of principal | (J) Closing liability |
|---|---|---|---|---|---|
| 15 | 6,861,538 | 260,076 | 1,300,000 | 1,039,924 | 5,821,614 |
| 16 | 5,821,614 | 220,659 | 1,300,000 | 1,079,341 | 4,742,273 |
| 17 | 4,742,273 | 179,749 | 1,300,000 | 1,120,251 | 3,622,022 |
| 18 | 3,622,022 | 137,287 | 1,300,000 | 1,162,713 | 2,459,309 |
| 19 | 2,459,309 | 93,216 | 1,300,000 | 1,206,784 | 1,252,525 |
| 20 | 1,252,525 | 47,475 | 1,300,000 | 1,252,525 | 0 |

On transition, the opening balance of the lease liability is carried forward from the closing balance in the previous year.

Thereafter, remeasurement is carried out in the first period when the payment is increased as a result of indexation, which is Year 16.

The rental payment stream is increased by 50% as set out below. The remeasured service concession arrangement liability (highlighted in blue) is the NPV of the future payments at the interest rate of 3.79%, per the table below.

**Table 4B**

| Contract year | (F) Opening or remeasured Liability | (G) Finance cost | (H) Rental | (I) Redemption | (J) Closing liability |
|---|---|---|---|---|---|
| 15 | 6,861,538 | 260,076 | 1,300,000 | 1,039,924 | 5,821,614 |
| Remeasurement in Year 16 | 5,821,614 | | | | 8,732,421 |
| 16 | 8,732,421 | 330,989 | 1,950,000 | 1,619,011 | 7,113,410 |
| 17 | 7,113,410 | 269,623 | 1,950,000 | 1,680,377 | 5,433,032 |
| 18 | 5,433,032 | 205,931 | 1,950,000 | 1,744,069 | 3,688,963 |
| 19 | 3,688,963 | 139,824 | 1,950,000 | 1,810,176 | 1,878,787 |
| 20 | 1,878,787 | 71,213 | 1,950,000 | 1,878,787 | 0 |

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# Implications for the measurement of the lease asset

## How remeasurement of the lease liability affects the lease asset

Paragraph 4.2.2.59 of Appendix F of the Code sets out the accounting treatment following a reassessment of lease liabilities under IFRS 16 *Leases*:

- the lease liability is adjusted to the re-measured amount
- the balancing entry is an adjustment to the right-of-use asset (treated as an adjustment to its historical cost).

This approach is primarily designed for leases where a right-of-use asset is valued using historical cost information.

This doesn't always happen for leases, and for service concession (PFI PPP) arrangements the assets will generally be treated as a conventional PPE asset on a current value basis and subject to regular valuation. The balancing adjustment may therefore result in a value for the asset which exceeds the valuation. Subject to review of the valuation, it will therefore generally be necessary to write the asset back down to its confirmed valuation amount by making a revaluation adjustment. The adjustment will be matched by a reduction in the revaluation gains previously accumulated in the revaluation reserve for the asset, but where there are no accumulated gains or they are insufficient to cover the full amount of the adjustment, a charge will be made to the relevant service line(s) in the Comprehensive Income and Expenditure Statement. However, any debit made to the CIES will be reversible out of the General Fund balance to the capital adjustment account, in order to prevent a capital-related loss impacting on revenue.

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## Accounting entries for transition

The accounting entries for transition can be exemplified using the figures for Year 16 of Illustration 4:

| | | £ |
|---|---|---|
| | Remeasuring the lease liability: | |
| Dr | Property, plant and equipment | 2,910,807 |
| Cr | Current creditors | 539,670 |
| Cr | Long-term creditors | 2,371,137 |
| | To increase the lease liability from £5,821,614 to £8,732,421. The element identified as a current creditor is the increase in the redemption amount for Year 16 from £1,079,341 to £1,619,011. | |
| | The addition to the property, plant and equipment balance is an increase in the historical cost of the asset. Where the increase in the carrying amount means there is a risk of material misstatement of the current value of the asset, a new valuation of the asset may be required. | |
| | | |
| | Accounting for revaluation of the property, plant and equipment asset, assuming the asset had a carrying amount of £12m at the end of Year 15 and is revalued to £12.5m at the start of Year 16: | |
| Dr | Revaluation reserve and/or CIES – relevant service line | 2,410,807 |
| Cr | Property, plant and equipment | 2,410,807 |
| | To process the revaluation. The Year 15 carrying amount of £12m has been increased to £14,910,807 by the addition to the historical cost of the asset to match the increase in the lease liability. The revaluation therefore results in a loss of £2,410,807, reducing the carrying amount to the new current value of £12.5m.<br><br>The appropriate account for the debit will depend on the amount of revaluation gains held in the revaluation reserve for the asset. The revaluation loss will be charged to the reserve until any balance of previous gains might have been reduced to zero, after which the remainder will be debited to the CIES. If there are no accumulated revaluation gains, the loss will be posted in its entirety to the CIES. | |
| Dr | Capital adjustment account | 2,410,807 |
| Cr | General Fund balance | 2,410,807 |
| | If the debit was made to the CIES, as a write down in the value of the item of property, plant and equipment, the impact of the debit on the General Fund balance will need to be neutralised by a transfer to the capital adjustment account. | |
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