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Chief Executives of trading funds  
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RABIG (2008) 03

*Dear colleague*

## **Accounting for PPP arrangements, including PFI, under IFRS: text for the IFRS-based Financial Reporting Manual (iFReM)**

**This letter introduces, and seeks your comments on, the iFReM text on the accounting treatment of PPP arrangements, including PFI, under IFRS. The text was considered by the Financial Reporting Advisory Board at its meeting on 28 February 2008, when the Board agreed that the accounting approach for these arrangements should be based on IFRIC 12.**

My letter of 12 December 2007 (RABIG (2007) 23) introduced a paper setting out, in principle, how PPP arrangements, including PFI contracts, should be accounted for under IFRS. The paper concluded that, where such arrangements fall within the scope of IFRIC 12 (and some arrangements will not), the public sector grantor should recognise the infrastructure asset on its balance sheet. RABIG (2007) 24 discussed auxiliary accounting and financial reporting Issues relating to PPP arrangements.

2.The Financial Reporting Advisory Board (the Board) discussed a further paper at its meeting on 28 February that analysed the responses to those RABIG letters and also set out a first draft of the detailed text of the accounting guidance for the iFReM. The text is set out in the attached annex.

3.The text takes account of many of the comments raised in response to the earlier RABIG letters. There are some, however, that have not been addressed in the text. Some matters appear not to fall within the scope of this section of the iFReM – i.e., they do not appear to relate to arrangements that meet the definition of a service concession arrangement. But that does not mean that additional guidance is not needed somewhere else. I should be grateful for your views on whether additional guidance is required and, if it is, whether it should be incorporated into the text or dealt with in stand-alone guidance. The matters are:



- how to depreciate individual assets whose lives are significantly less than the life of the PFI contract and replaced during the life of the contract (IT systems are given as an example);
- how to account for enhancements to the value of assets provided under a contract, where new assets are added or existing assets are enhanced;
- how to calculate and/or estimate the asset-related and service charge and interest elements of any unitary payment stream;
- how to account for other types of partnership arrangements (that is, those that fall outside the scope of this text);
- how to account for a situation where the grantor has a contractual requirement to purchase an on-balance sheet asset at the end of the contract;
- how to determine the point at which the public sector does not have control of the asset; and
- guidance on residual interest where assets are leased from third parties where the department can request an extension of the lease or has an option to purchase the assets at fair value.

4.I should be grateful if you would let me have your comments by 12 May 2008. The final version of the text will be discussed by the Board at its meeting on 5 June.

Yours sincerely



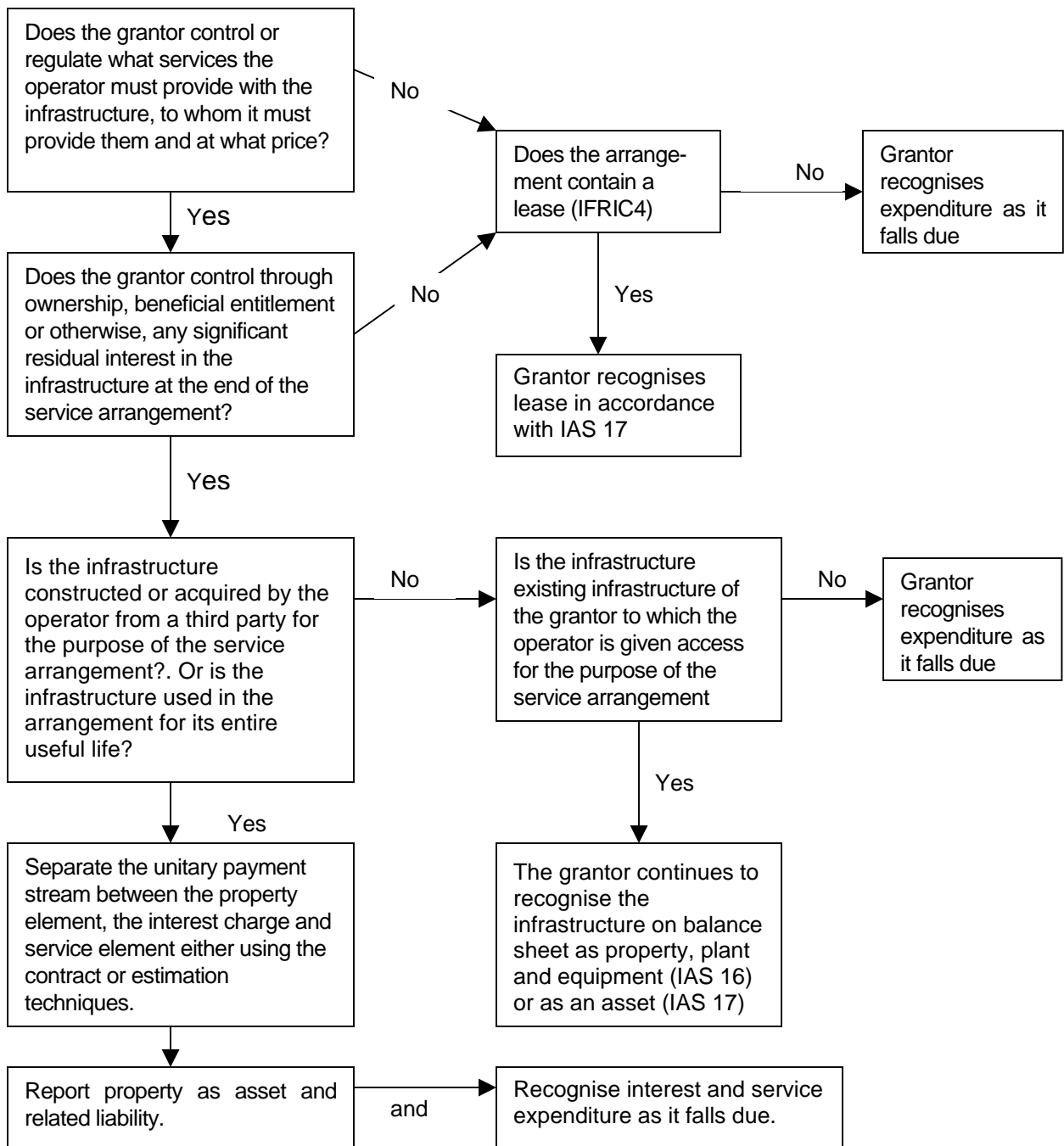
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PROPOSED DRAFT TEXT FOR THE IFRS BASED GOVERNMENT FINANCIAL REPORTING MANUAL

Accounting for PPP arrangements, including PFI contracts, under IFRS

*Scope*

- 6.2.28 This section of the Manual deals with the accounting treatment of PPP arrangements, including PFI contracts, that meet the definition of service concession arrangements IFRIC 12 *Service Concession Arrangements*. To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor (the public sector) (IFRIC 12.3). Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public. Examples of infrastructure for public services given in IFRIC 12 and which will apply to reporting entities covered by the requirements of this Manual are: roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, and telecommunication networks. To this list, reporting entities should add buildings used for administrative purposes in delivering services to the public.
- 6.2.29 The private sector operator will apply IFRIC 12 to those arrangements where:
- a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and
  - b) the grantor controls – through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.
- 6.2.30 IFRIC 12 (Application Guidance paragraph 3) notes that, in determining the applicability of the first condition, non-substantive features (such as price capping that would apply only in remote circumstances) should be ignored and the substance of the arrangement considered.
- 6.2.31 IFRIC 12 applies to arrangements where the infrastructure is used for its entire useful life, to infrastructure that the operator constructs or acquires from a third party and to infrastructure that the grantor provides to the operator for the purpose of the concession. It does not specify the accounting for infrastructure that was held and recognised as an asset by the operator prior to entering the arrangement (IFRIC 12.6-8). Where the infrastructure asset is used for its entire useful life, and there is little or no residual interest, the arrangement would fall within the scope of IFRIC 12 where the grantor controls or regulates the services as described in the first condition in paragraph 6.2.29 above. The flowchart overleaf will assist in determining the appropriate accounting treatment.



*Initial recognition and measurement of assets and liabilities in new arrangements and contracts*

6.2.32 Where the grantor controls:

- a) or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price;
- b) through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement; and

the infrastructure:

- c) has been constructed or acquired by the operator from a third party for the purpose of the service arrangement; or
- d) will be used in the arrangement for its entire useful life; or
- e) is existing infrastructure of the grantor to which the operator is given access for the purpose of the service arrangement

then the PPP arrangement or PFI contract is a service concession within the meaning of IFRIC 12.

6.2.33 The grantor should recognise the infrastructure as a non-current asset and value it in the same way as other non-current assets of that generic type. The asset will be recognised when:

- a) it is probable that future economic benefits associated with the asset will flow to the organisation; and
- b) the cost of the asset can be measured reliably.

In practice, this is likely to mean that the grantor will only recognise the asset when the asset comes into use. Where the grantor makes contributions to the operator in advance of the asset coming into use, the grantor should account for those payments as prepayments.

6.2.34 The asset will be measured in one of two ways:

- a) where the contract is separable between the service element, the interest charge and the infrastructure asset (see also paragraph 6.2.35), the asset will be measured under IAS 17, with the service element and the interest charge recognised as incurred over the term of the concession arrangement; or
- b) where there is a unitary payment stream that includes asset related and service elements that cannot be separated, the various elements will be separated using estimation techniques as set out in paragraph 6.2.36.

6.2.35 The grantor should separate out the service, interest and property elements. A contract may be separable in a variety of circumstances, including but not limited to the following.

- a) the contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services;
- b) different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract; or
- c) different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.

6.2.36 In situations where it is not possible to separate the contract due to commercial reality, then the service element of the payment must be estimated, which could be achieved by obtaining information from the operator or using the fair value approach. The fair value of the asset determines the amount to be recorded as an asset with an offsetting contract liability payable. The total unitary payment is then divided into three: repayment of the capital element of the contract obligation and the interest expense on it (using the interest rate implicit in the lease), with the remainder deemed to relate to the service charge.

6.2.37 Under either approach, the grantor will recognise a liability for the capital value of the contract. That liability does not include the interest charge and service elements, which are expensed annually to the Operating Cost Statement.

#### *Initial recognition of existing arrangements which were off-balance sheet under UK GAAP*

6.2.38 On initial recognition of existing PPP arrangements or PFI contracts under this approach (that is, those arrangements or contracts that had previously been off-balance sheet), reporting entities should measure the non-current asset at the opening balance sheet date in the same way as other non-current assets of that generic type. The liability should be measured at its fair value at the balance sheet date, which will normally be the outstanding liability in respect of the property (that is, excluding the interest and service elements), discounted by the interest rate implicit in the contract.

#### *Subsequent measurement*

6.2.39 Reporting entities should adopt an appropriate asset revaluation approach as set out earlier in this chapter. Liabilities will be measured using the appropriate discount rate, taking account of the reduction arising from the capital payments included in the unitary payment stream.

#### *Income generated by the grantor from the service concession arrangements*

6.2.40 Revenue received under any revenue sharing provision in the service concession arrangement should be recognised when all the conditions as laid down in IAS 18 have been satisfied.

*Consideration given by the grantor to the operator (guarantees made by the grantor as part of the arrangement)*

- 6.2.41 The grantor should recognise any guarantees to the operator that it will meet any shortfalls in revenue or repay the debt if the operator defaults in line with the requirements of IAS 32 and IAS 39. Additional guidance on accounting for financial instruments is available on the Manual's dedicated website.

*Items provided to the operator by the grantor*

- 6.2.42 The grantor should derecognise a non-current asset provided to the operator (and not used in the arrangement) and recognise any consideration received at fair value. If the consideration received is in the form of a reduction in future payments, this should be recognised as an asset representing a reduction in the future liability (normally as a prepayment).