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10 June 2008

RABIG (2008) 05

*Dear colleague*

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

**Attached to this letter is the final iFReM text on the accounting treatment of PPP arrangements, including PFI, under IFRS.**

2. Thank you for responses to my letter of 11 March 2008, in which I sought comments on the draft text for the IFRS-based FReM (iFReM) and asked a series of questions about the need for additional guidance in some areas. The Treasury discussed the responses, and a slightly revised text, with the Financial Reporting Advisory Board (the Board) at its meeting on 5 June. As a result of those discussions, the iFReM text has been finalised and has been incorporated into chapter 6 of the iFReM. I thought it would be helpful if, in addition, I circulated the text under cover of this letter and explained what was discussed at the Board meeting.

### **Accounting standard for PPP arrangements, including PFI, under IFRS**

3. The Board reaffirmed its agreement that an approach based on IFRIC 12 is appropriate. The attached guidance has been inserted into chapter 6 of the iFReM; it applies for 2009-10 and subsequent years, and Treasury Technical Note No. 1 *How to account for PFI transactions* is withdrawn at the same time. The guidance should also be applied to the 2008-09 shadow IFRS-based accounts.

### *Scope and definition*

4. Some respondents raised the question of the definition of an infrastructure asset and therefore the scope of the accounting standard for PPP arrangements, including PFI. International Public Sector Accounting Standard 17 *Property, Plant and Equipment* notes that there is no universally accepted accounting definition of infrastructure assets, although they usually display one or more of the following characteristics:

- they are part of a system or network;
- they are specialised in nature and do not have alternative uses;
- they are immovable; and
- they may be subject to constraints on disposal.

5. The Board agreed that there should be no attempt to define infrastructure assets in the iFReM, restricting the text to include only examples. The list of examples has been expanded to include “permanent installations for military etc. operations”.

6. The text circulated under cover of my 11 March letter added to the list of examples taken from IFRIC 12 “buildings used for administrative purposes in delivering services to the public”. The Board discussed the question of whether assets covered by the accounting standard for PPP arrangements, including PFI, should be restricted to infrastructure used by the operator in delivering public services under a concession arrangement. The likely practical effect of this would be that the buildings used for administrative contracts would fall to be accounted for under IFRIC 4 and IAS 17 – with, probably, the same accounting answer of balance sheet recognition. Such an approach, however, carries the risk of ‘creep’: if it were decided to try and contain the scope within a ‘direct to the public’ as against ‘indirectly to the public’, then that in itself gives rise to questions. For example, does the Ministry of Defence deliver services direct to the public, or do prisons (one of the examples in IFRIC 12) represent a direct delivery?

7. On balance, the Board agreed with the Treasury recommendation that including “non-current assets used for administrative purposes in delivering services to the public” provides clear guidance on what assets should be included within the scope of this standard. The Board also agreed with the Treasury view that not all PPP arrangements or PFI contracts will involve infrastructure assets and that, in those cases, IFRIC 4 and IAS 17 will apply.

#### *Decision tree/flowchart*

8. The flowchart is based on IFRIC 12, but is written from the public sector grantor’s viewpoint. The Treasury raised with the Board the question of whether or not the final decision boxes in IFRIC 12 (the operator’s right to receive cash or other financial asset from the grantor or to charge the public) should be interpreted in the flowchart. The Board took the view that it is unnecessary and adds further complication to the flowchart. Other helpful comments have resulted in a flowchart that is easier to follow.

#### *Interest rate*

9. In estimating the interest charge and service charge elements in an inseparable contract, the original draft text required the use of the interest rate inherent in the lease. The IPSASB Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements* suggests using the operator’s cost of capital. Some commentators felt that the Treasury’s text should use a single rate, but that it should be the grantor’s rate, and the text considered by the Board referred to using the interest rate set out in the Treasury’s Green Book.

10. The Board disagreed with using the operator's cost of capital, since the accounts should reflect the cost to the grantor. However, the Board did not agree with the fixed rate set out in the Green Book, preferring to see a rate that was more aligned with the date of the contract – and this would be the rate inherent in the contract. The Board recognised, however, that this would need to be interpreted – it needs to be an appropriate market risk-free, real (i.e., excluding inflation) rate. The Treasury has expanded the text in the iFReM: the interest rate that preparers should use is the UK long-term real interest rate. A schedule of monthly rates for January 1996 to April 2008 has been placed on the FReM website, based on the information in HM Treasury's Pocket Data Bank. From May 2008 onwards, the rate should be calculated by adjusting the UK's long-term nominal interest rate (found in table 26 of HM Treasury's Pocket Data Bank) by the UK inflation rate (table 16 of HM Treasury's Pocket Data Bank). There is a link to the Data Bank on the FReM website, and there will also be an example of how to calculate a real rate using the nominal rate and the inflation rate.

11. The Board also agreed that the FReM website should also contain an example of how to use the estimation techniques set out in principle in the accounting standard to unbundle a contract in order to account correctly for the capital, interest and service elements.

#### *Specific guidance*

12. Half of the respondents said that they need additional guidance in the areas set out in my letter of 11 March. The other half said that either IFRIC 12 or other IFRS provided sufficient guidance. Given the dangers associated with providing additional guidance – it turns into a rule book, and there is a danger that a "Technical Note 2" is introduced by the back door – the Treasury recommended that no additional guidance or accounting examples should be produced. The Board agreed.

13. The Treasury will ensure that the existing worked example on the FReM website (a barter deal) is reviewed to ensure that it is IFRS-compliant. It appears, however, that the concern lies more with the budgeting treatment rather than the accounting treatment. Given that the existing example is of an on-balance sheet contract, the budgeting treatment will not change.

#### *Disclosures*

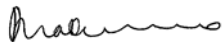
14. A short paragraph has been added to the section to refer to disclosure requirements being set out in chapter 5 of the iFReM. The requirements are no different from the current requirements, and all but a new paragraph (5.4.59 on *Commitments under PFI contracts*) were in the iFReM text circulated on 29 June 2007. I have not included that text here; it is already available in chapter 5 of the iFReM on the website.

#### **Budgeting**

15. My letter to Finance Directors (MS FD (08) 12) of 28 April 2008 set out the Trigger Points and key dates and activities associated with the move to IFRS. You need to determine the accounting treatment of your PPP arrangements/PFI contracts in order to prepare shadow resource accounts for 2008-09. However,

there is no intention of preparing shadow budgets or shadow Estimates for 2008-09. You are required to provide to spending teams by 13 March 2009 the indicative impact of IFRS on your budgets. The Consolidated Budgeting Guidance will then be updated and budgets and control totals will be on the new basis from 2009 winter Supplementary Estimates. Kirstin Baker's and Gordon McKechnie's letter to Finance Directors (MS FD (07) 31), indicated the Treasury's commitment to the levels of PFI that have been agreed in spending reviews, irrespective of balance sheet treatment. The letter stated that projects in procurement will continue to be supported and the Treasury expects departments to allocate PFI credits and take forward PFI programmes agreed in the CSR alongside their conventional capital programmes. Budgets will be adjusted as necessary to enable this to be achieved.

Yours sincerely



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**Financial Reporting Policy Team**