



HM TREASURY

Financial Reporting Advisory Board

Accounting for PPP arrangements including PFI contracts

Issue:	A discussion paper on accounting for PPP arrangements including PFI contracts
Impact on guidance:	To inform the development of new guidance on accounting for PPP under IFRS
IAS/IFRS adaptation?	No.
IPSAS compliant?	IPSASB is considering a draft consultation paper, which has yet to be approved.
Interpretation for the public sector context?	Yes
Impact on budgetary regime?	There will be no change to the budgetary regime itself. HMT will discuss the impact on individual budgets separately with departments.
Alignment with National Accounts	Still to be determined.
Impact on Estimates?	No, other than as related to the impact on budgets.
Conclusion in this paper:	That PPP arrangements, including PFI contracts, that fall within the scope of IFRIC 12 be recognised on the public sector grantor's balance sheet. Normally, this would mean that the operator would not recognise the infrastructure asset because the two conditions of paragraph 5 of IFRIC 12 are met from its viewpoint.
Timing:	2008-09

DETAIL

Introduction

1. The recent announcement (Budget 2007) that Government will prepare its accounts using International Financial Reporting Standards (IFRS) from 2008-09 onwards means that the Government Financial Reporting Manual (FRoM) – issued jointly by the Treasury and the devolved administrations – needs to contain guidance on how to account for Public-Private

Partnership (PPP) arrangements under IFRS, since there is no specific PPP IFRS that is directly applicable to the public sector.

2. This paper discusses how service concession arrangements, including PFI contracts, should be accounted for under IFRS.

PPP contracts and service concession arrangements

3. This section of the paper introduces the types of PPP contracts into which government enters and considers how they compare with the type of service concession arrangements covered by the scope of IFRIC 12. A brief overview of the requirements of IFRIC 12 is included at Annex A.

Types of PPP

4. PPP is used in the UK as a broad term that covers a number of different partnering arrangements between the public and private sectors. The most common of these arrangements are PFI contracts, which often involve the design, build, finance and operation (DBFO) of a particular asset – hospitals, prisons, schools, roads and bridges all fall into this category. Other PPP schemes (which might include headquarters buildings and, in the past, IT networks) might involve the grantor passing an existing asset to an operator, with the operator financing the refurbishment or other enhancement of the asset and then operating it – an example is the London Underground PPP.
5. Other types of PPP projects include:
 - Joint Ventures – these are arrangements where the risks and rewards of a discreet project are shared between two parties, usually through a sharing of the economic ownership of a new body. Joint Ventures are rare within central government departments, but are more common in the health and education sectors, examples being the local improvement finance trust and local education partnerships; and
 - financially free-standing projects (i.e., concessions), where the private sector undertakes the project on the basis that its investment will be recovered entirely through charges for the service(s) provided to the final user. This type of arrangement is relatively rare.
6. Typically, PFI contracts are let for periods less than the life of the asset, with the asset reverting, fully operational, to the grantor at little or no cost at the end of the contract.

How do PPP contracts compare with service concession arrangements covered by the scope of IFRIC 12?

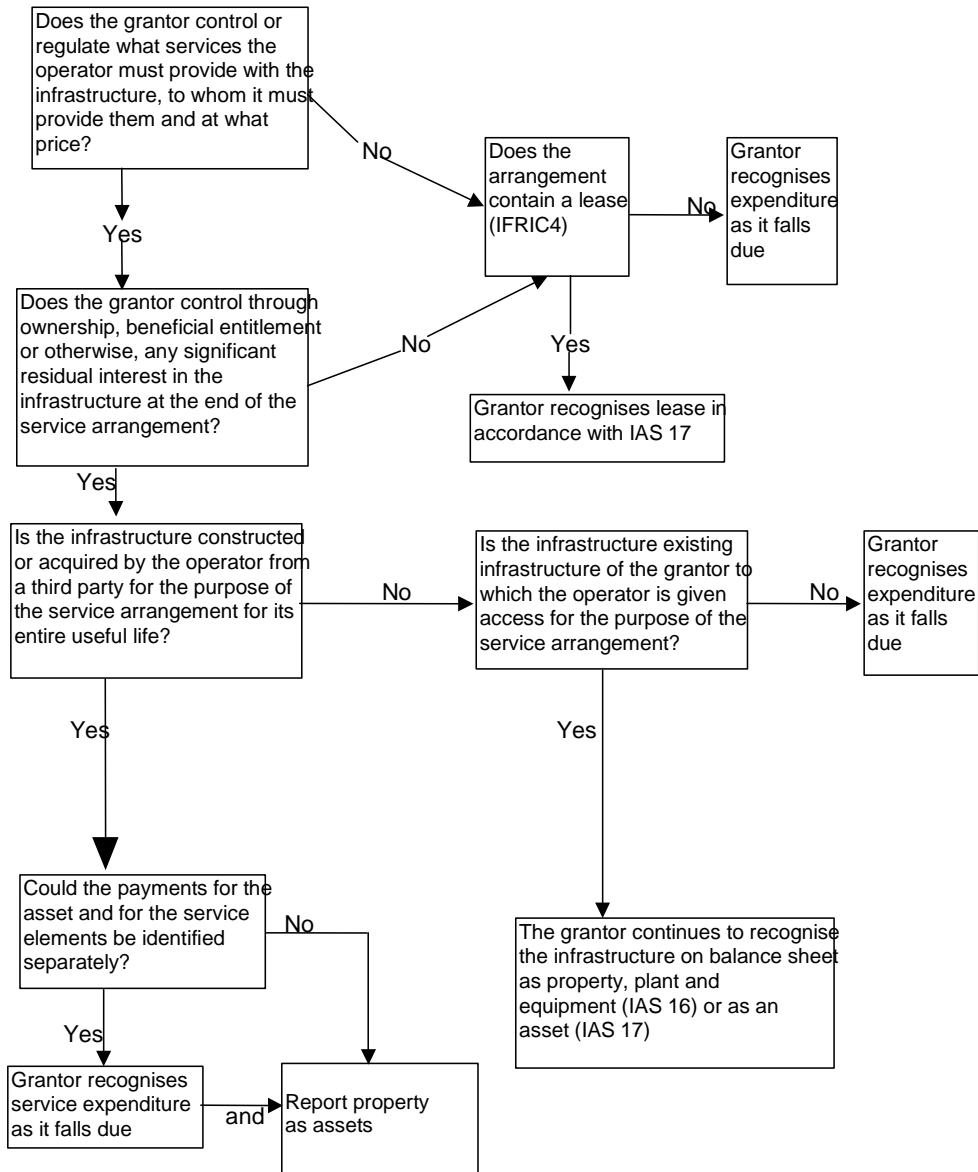
7. IFRIC 12 provides guidance to the private sector operator on the recognition and measurement of revenues receivable under service concession arrangements, once it has been demonstrated that the arrangement is within the scope of IFRIC 12. To be within the scope, the arrangement contractually obliges the operator to provide the services related to the infrastructure to the public on behalf of the grantor (the public sector) (IFRIC 12.3). The private sector operator will apply IFRIC 12 to those arrangements where:

- 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
 - the grantor controls – through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.
8. 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.
 9. 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 7 above.
 10. DBFO-type PPP contracts appear to exhibit the characteristics of service concession arrangements covered by IFRIC 12. The infrastructure assets created under such schemes are used to provide a public service – health care, custodial care, education, etc., although normally these services are provided free at the point of use (or any revenues generated are owned by the public sector). Instead of setting the price that the operator can charge, in these cases the government contracts to pay a unitary charge in return for the operator making the infrastructure available for use. Other schemes where the grantor has provided an existing asset to the operator for the purpose of providing a public service also appear to fall within the scope of IFRIC 12 as far as the operator is concerned. One would therefore expect the private sector operator of such PPP contracts accounting under IFRS to apply IFRIC 12.
 11. It might be argued that it is less clear that an operator uses infrastructure assets to provide a public service in the case of, for example, the management of headquarters buildings, which one might characterise as being analogous to serviced offices. However, IAS 16 *Property, Plant and Equipment* includes assets held for administrative purposes in its definition of property, plant and equipment and, therefore, by applying that definition more widely, accommodation contracts of this type fall within the scope of IFRIC 12 (provided they meet the criteria set out in paragraph 7 above), given that the public sector uses these assets as inputs into the production of public services.
 12. An initial analysis would also suggest that some PPP contracts are not service concession arrangements as defined in IFRS because the type of contract does not meet the definitions in IFRIC 12. 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.
 13. Other PPP arrangements might not be service concession arrangements within the meaning of IFRIC 12. For example, where the private sector operator uses or constructs his own infrastructure to fulfil the concession and retains ownership of the infrastructure at the end of the contract, that arrangement will be outside the scope of IFRIC 12. In such a case, the public sector grantor will need to consider how to account for the arrangement under IFRS –

which will include consideration of whether or not the arrangement contains a lease in line with IFRIC 4. If there is an implicit lease, then the grantor will use the guidance in IAS 17 to determine whether it is a finance lease or an operating lease. If the arrangement does not contain a lease, then the grantor will recognise expenditure as it falls due under the arrangement.

Grantor accounting for service concession arrangements under IFRS – proposed approach under IFRIC 12

14. Once it has been determined that the PPP arrangement is a service concession within the meaning of IFRIC 12 the grantor should record the infrastructure as an asset. Normally, this would mean that the operator would not recognise any infrastructure asset because, from its viewpoint, the two conditions in paragraph 7 above (paragraph 5 of IFRIC 12) are met.
15. The flowchart overleaf provides a decision tree that helps the grantor to decide how to account for service concession arrangements under this approach.
16. In determining how to account for a PPP arrangement under IFRS, the grantor has first to determine whether it falls within the meaning of a service concession arrangement as set out in IFRIC 12. Once that decision has been taken, our preliminary view is that the next stage of the accounting analysis is to determine if the contract is separable between the service element and the infrastructure asset (see paragraphs 18 and 19). The grantor will also need to identify separately the interest charge included within the unitary payment.
17. Where an infrastructure asset is to be recognised by the grantor as a result of applying IFRIC 12, that asset should be valued in the same way as other assets of that generic type. The part of the contract relating to the services should be expensed because the service component of the transaction is not an asset; rather, it represents a recurrent obligation, which should be recognised as incurred over the term of the concession arrangement.



Separability

- 18 It is not considered appropriate to include all elements of the service concession arrangement in the measurement of the value of that asset. The grantor therefore should separate out the service and property elements. 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 lease liability payable. The total unitary payment is then divided into repayment of the lease obligation, interest expense on the lease obligation (using the interest rate implicit

in the lease), with the remainder deemed to relate to the service charge and expensed annually to the Operating Cost Statement.

19. A contract may be separable in a variety of circumstances, including but not limited to the following.
- 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.
 - 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.
 - 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 purchaser in such a way that the part of the payment by the purchaser that relates specifically to that service can be identified.

Links with the National Accounts

- 20 In preparing the National Accounts' balance sheet, the Office for National Statistics (ONS) currently uses the accountants' assessment of the resource accounting treatment of PFI contracts. These assessments are based on a risks and rewards approach. If the proposals in the above paragraphs are adopted for resource accounts, it is probable that the ONS will then also require information on the existing basis (i.e. the risks and rewards approach) for current and new PFI contracts.
- 21 Our preliminary view is that accounting information on a risks and rewards approach could be supplied using IAS 17, with the lessee in a service concession arrangement being taken to be the public sector grantor. IAS 17 sets out the criteria for recognising an asset on the lessee's balance sheet, based around risks and rewards – if a lease transfers substantially all the risks and rewards of ownership, then the leased item is to be recognised as an asset of the lessee (a finance lease). A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use the asset for a period of time. A brief overview of the factors that, individually or collectively, result in a lease being treated as a finance lease are given in Annex B.
- 22 **Would an assessment of the accounting treatment of your PFI contracts that meet the definition of a service concession arrangement differ under IAS 17 from the approach proposed in paragraph 14? Please give examples of key projects where the treatment would differ, together with the reasons why. Would an approach that required you to assess projects under both IFRIC 12 and IAS 17 impose significant additional burdens?**

Other Guidance

23. Separate draft interpretations of IFRS in the following areas relevant to accounting for PFI will be issued for consultation using the usual due process arrangements before Christmas 2007:
- timing of recognition of the assets (particularly assets under construction);

- accounting for revenue earned by the grantor from the service concession arrangement;
- accounting for guarantees made by the grantor as part of the arrangement; and
- the accounting treatment where the grantor provides land and existing assets to the operator.

24. **If there are other areas where you believe guidance should be provided, please say what those are as are and why you believe it is needed.**

Summary

25. This paper sets out our conclusions on how to account for PPP arrangements, including PFI contracts. Where a PPP arrangement meets the definition of a service concession arrangement within the meaning of IFRIC 12, the public sector grantor should report that infrastructure asset on its balance sheet, separating out the interest and service charge elements of the contractual payments where this is possible. Normally, this would mean that the operator would not recognise the infrastructure asset because, from its viewpoint, the two conditions in paragraph 7 above (paragraph 5 of IFRIC 12) are met
26. A separate accounting assessment of the contract might be needed for National Accounts purposes under the risks and rewards approach in IAS 17. Reporting entities are requested to consider whether this assessment would differ from that under the proposed approach and whether this would impose significant additional burdens. Examples of key projects where the treatment would be different should be provided.

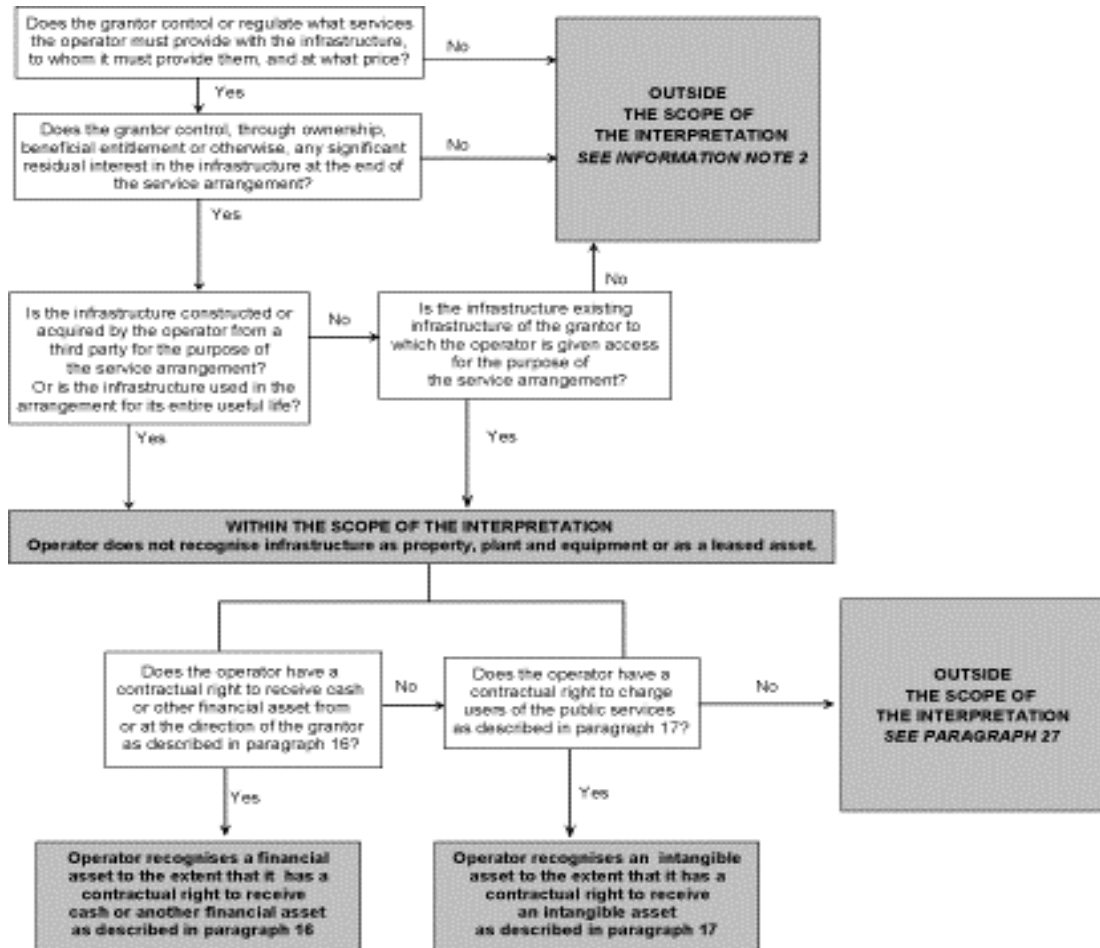
**HM Treasury
December 2007**

ANNEX A

IFRIC 12 – a brief overview

This annex provides a brief overview of Interpretation 12 Service Concession Arrangements (IFRIC 12), which was issued by the International Financial Reporting Interpretations Committee in November 2006. It gives guidance on the accounting by operators (the private sector) for public-to-private service concession arrangements. IFRIC 12 does not cover accounting by the grantor (the public sector).

IFRIC 12 states that it is control that determines the accounting treatment by the operator. If the grantor retains control, then the infrastructure asset is not an asset of the operator. This suggests that the infrastructure asset becomes or remains (depending on how the infrastructure asset is provided) an asset of the grantor. The flowchart below, taken from IFRIC 12 (paragraph references in the table are to paragraphs in IFRIC 12), shows how the operator can determine whether or not the concession arrangement is within the scope of IFRIC 12.



IFRIC 12 applies to service concession arrangements if (paragraph 5 of IFRIC 12):

- (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 ownership, beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.

Paragraph 6 of IFRIC 12 notes that infrastructure used in a public-to-private service concession arrangement for its entire useful life is within the scope of IFRIC 12 where the condition in IFRIC 12.5(a) is met. That is, even if the grantor does not have any significant residual interest in the infrastructure at the end of the arrangement, but controls the services, to whom they are supplied and the price during the arrangement, then the infrastructure does not belong to the operator. The inference is that it will belong to, and be accounted for, by the grantor.

The Application Guidance to IFRIC 12 provides further guidance on what type of arrangement might fall into the scope of IFRIC 12.

ANNEX B

IAS 17 – Brief overview of the factors to consider in assessing whether a lease is a finance lease

To qualify as a finance lease, the lessee needs to consider the substance of the transaction rather than the legal form of the contract. Examples of situations that individually or in combination would result in the lease being treated as a finance lease are:

- ownership is transferred to the lessee at the end of lease term;
- there is a 'bargain purchase option';
- the lease term is for the majority of the leased asset's economic life;
- the present value of minimum lease payments equals substantially all the fair value of the leased asset; and
- the leased asset is of a specialised nature such that only the lessee could use it without major modifications.

Examples of situations that individually or in combination could result in the lease being treated as a finance lease are:

- if the lease is cancelled, the lessor's losses are borne by the lessee;
- gains and losses from the fluctuation in the fair value of the residual are borne by the lessee; and
- the lessee has the ability to continue the lease for a secondary period at below market rental.

IAS 17 uses the concept of risks and rewards associated with ownership. In many PFI contracts, the infrastructure is either constructed by (or for) the operator or passed to the operator by the grantor. Ownership of the property might therefore be considered to vest with the operator. However, in practice:

- ownership of the infrastructure asset might revert free of charge to the grantor at the end of the concession arrangement – usually the case with transport, prisons, hospitals, schools and head office accommodation;
- if ownership of the infrastructure asset does not revert to the grantor for nil consideration, reversion might be achieved at a 'bargain' price;
- the present value of the service payments is likely to equal substantially all the fair value of the asset, since the payments are set to recover not only the cost of the infrastructure but also a profit margin (although the effect of the service element would need to be considered);

- it is likely that the asset is of a specialised nature such that only the grantor could use it without modifications – that is, use it in its existing use. This is not necessarily true for all types of PFI contract, particularly where there are emerging markets in relation to hospitals, for example; and
- there may be some PFI contracts where the indicative factors of the grantor bearing the operator's losses on cancellation, bearing any fluctuations in fair value, and the ability to continue the arrangement at a below market price also exist.