



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.
Alignment with National Accounts	Still to be determined.
Impact on Estimates?	No.
Recommendation:	The Board is asked to comment on the preliminary views set out in this paper.
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 (FReM) – 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 puts forward proposals for discussion on 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.

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. The other types of PPP projects include:
 - Joint Ventures – these are arrangements where the risks and rewards of a discrete 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.
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, it is assumed for the purposes of this paper that some accommodation contracts of this type could fall within the scope of IFRIC 12 given that the public sector uses these assets as inputs into the production of public services. **Do Board members agree with this assumption?**
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. Such contracts, which generally involve the provision of services (such as training) but not the transfer or creation of an infrastructure asset for the purpose of the contract, therefore fall outside the scope of IFRIC 12. **Do Board members have any views?**

Grantor accounting for PPP arrangements, including PFI, under IFRS

13. The first important step is to determine whether the PPP arrangement under consideration is a service concession arrangement 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.

14. If the PPP arrangement is a service concession within the meaning of IFRIC 12 and the operator would not recognise any infrastructure asset because the two conditions in paragraph 7 are met, then this appears to resemble a lease (finance). Our preliminary view is that the grantor's accounting treatment should be based on IAS 17. If the PPP arrangement is not a service concession within the meaning of IFRIC 12, and the operator does recognise an asset, then the grantor needs to consider whether the agreement contains a lease (IFRIC 4) – if there is an implicit lease, the grantor will account under IAS 17 and, if not, will recognise expenditure as it falls due. **Do Board members agree?**

IAS 17

15. 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. (Given our preliminary view in paragraph 14, the lessee in a PPP arrangement is taken to be the grantor.)
16. 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.
17. 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.

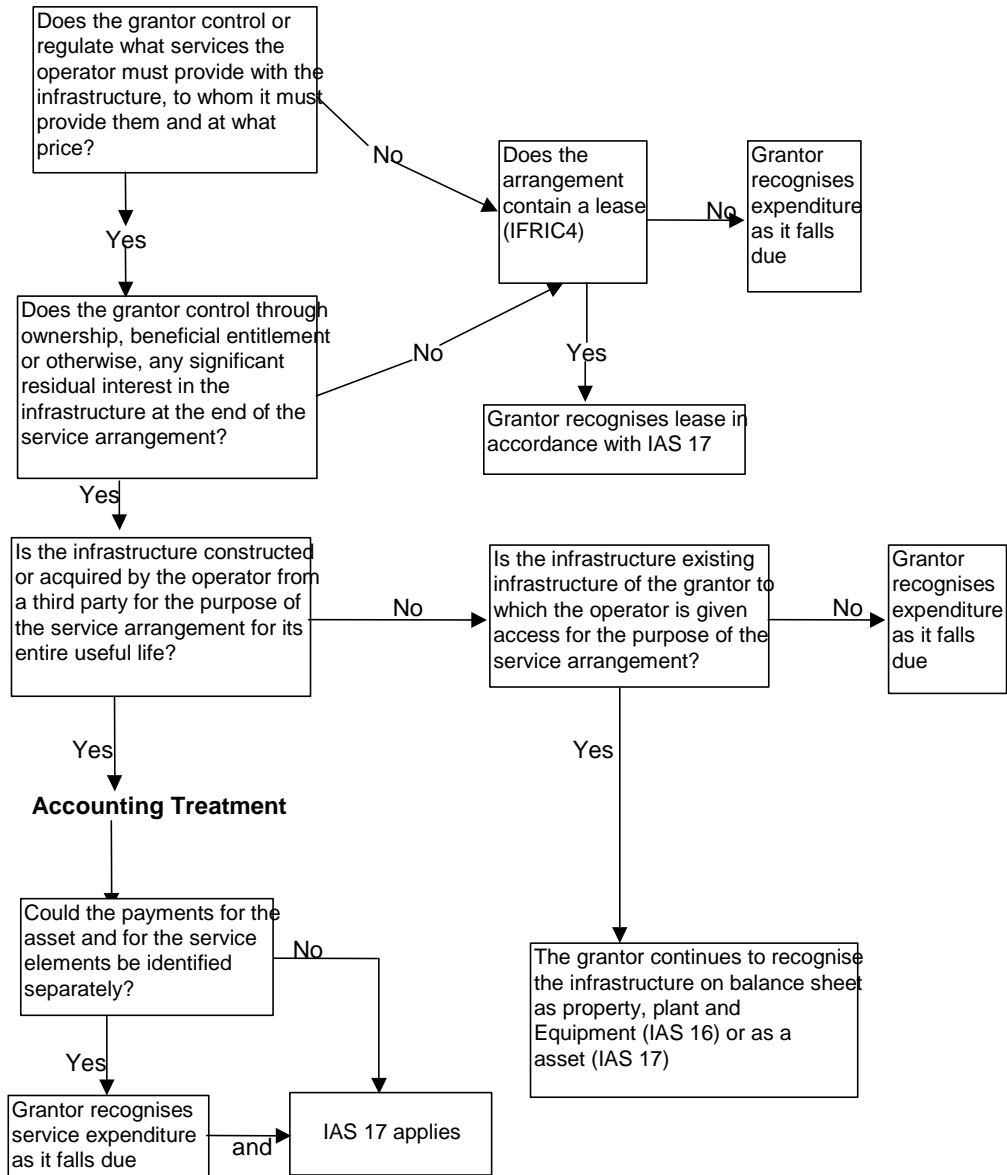
18. IAS 17 uses the concept of risks and rewards associated with ownership. In many PFI contracts, the infrastructure is either constructed by (or for) the operator or passed to the operator by the grantor. Ownership of the property might therefore be considered to vest with the operator. However, in 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.
19. Thus, using the tests in IAS 17, it appears that, in many cases, the grantor should recognise the infrastructure asset as a finance lease.

Proposed Approach

20. The flowchart overleaf provides a decision tree that helps the grantor to decide what IFRS should be applied to PPP arrangements.
21. 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 it has been determined that the arrangement is a service concession, then the grantor will use IAS 17 to determine the accounting treatment – i.e., is it a finance lease (the asset is on the grantor's balance sheet) or is it an operating lease (the asset is not on the grantor's balance sheet). 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 24 and 25). The grantor will also need to identify separately the interest charge included within the unitary payment. **Do Board members agree with this approach?**
22. The infrastructure asset should be valued in accordance with the requirements of IAS 17. 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. **Do Board members agree?**

23. If it is not a service concession within the meaning of IFRIC 12, then the grantor will determine whether or not the arrangement contains an implicit lease in line with IFRIC 4 (when IAS 17 will apply) or not (when expenditure will be recognised as it falls due). **Do Board members agree?**

Determining economic



Separability

24. Currently, where a contract is not deemed to be commercially separable, then FRS 5 (Application Note F) allows the deal in its entirety to be assessed using the risks and rewards approach. In using IAS 17, however, it does not appear appropriate to include all elements of

the service concession arrangement in the measurement of the value of the lease. It will be necessary, therefore, to 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 approach is consistent with IAS 17. The difference between the fair value of the property and the total unitary payments will comprise the interest payment and the service charge and will be expensed annually to the Operating Cost Statement.

25. 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.

Other Guidance

26. Once the principles set out in this paper for determining the economic ownership and the accounting treatments are agreed, there are a number of other accounting and financial reporting issues to be addressed, which will require some guidance. Subject to acceptance of the preliminary views set out in this paper, draft guidance on the following areas will be issued for consultation using the usual due process arrangements before Christmas 2007:
- timing of recognition of the assets;
 - the amount at which the asset should be recognised;
 - revenue generated by the grantor from the service concession arrangement;
 - guarantees made by the grantor as part of the arrangement;
 - arrangements where the grantor does not recognise the property as an asset; and
 - arrangements where the grantor provides land and existing assets to the operator.

Preliminary views

27. The preliminary views reached in this paper, on which we seek the Board's views, are:
- contracts that include the management of headquarters buildings might be service concession arrangements within the meaning of IFRIC 12 (paragraph 11);

- some PPP contracts will not be service concessions within the meaning of IFRIC 12 – probably the contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract (paragraph 12);
- those PPP contracts that have the characteristics of service concession arrangements should be recognised under IAS 17 (paragraphs 14 and 21);
- those PPP contracts that do not have the characteristics of service concession arrangements should be accounted for under IAS 17 where there is an implicit lease in line with IFRIC 4 or, where there is no implicit lease, expenditure should be recognised as it falls due (paragraphs 22 and 23); and
- once the grantor has determined that the arrangement falls to be accounted for as a service concession arrangement, the grantor should assess the contract's separability (paragraph 21).

Next steps

28. Subject to any comments the Board might have on these preliminary views, the intention is to issue this paper to departments on 11th December using the usual due process arrangements, followed by the more detailed guidance referred to in paragraph 26 in week commencing 17th December. Further papers will be brought to the Board at its meeting in February 2008.

HM Treasury
10 December 2007