



HM TREASURY

Financial Reporting Advisory Board Paper

PFI UPDATE

Issue:	To provide the Board with an update on progress on PFI.
Impact on guidance:	No
UK GAAP adaptation?	N/A
IAS/IFRS compliant?	N/A
IPSAS compliant?	N/A
Impact on budgetary regime?	No
Recommendation:	For information. To update the Board on the further progress of the PFI working group.
Timing:	N/A

DETAIL

Background

This Paper is in two parts. Part A provides a written update on the work of the PFI Working Group, and suggests that the FReM might be amended to reflect that Application Note F to FRS 5: *Reporting the Substance of Transactions : Private Finance Initiative and Similar Contracts* (AN) would solely apply in the event of the removal of the Treasury Technical Note No 1 (Revised) *How to account for PFI transactions* (TN), were this to happen. Part B provides an update of Treasury actions since the Board's meeting on 31 October.

Part A

1. At the FRAB meeting on the 21 September, the Treasury provided an update on the progress made by the PFI working group. It was reported that the working group had identified areas of the

AN that were being interpreted differently by the big four firms in relation to its application to the public sector. No such differences were identified by the firms in applying the AN to the private sector.

2. To test whether all four firms would arrive at the same accounting opinions when solely applying the AN to representative PFI projects, three case studies (comprising a prison, school and hospital project) were prepared and distributed to the four firms, in order that they could provide an accounting 'opinion' to the Working Group.

3. This exercise permitted the firms to 'flush out' their initial differences, confirming that some of these were within the scope of reasonable professional judgement. The outcome of this work revealed that all four firms reached a similar conclusion on the prison and school projects, in that both projects were considered by all firms to be on the public sector balance sheet. Although there was a difference in opinion between the firms on the remaining hospital project, with some firms noting that they would need more information in order to be able to conclude, it was recognised by all firms that their views were finely balanced, and within the scope of reasonable professional judgement.

4. The good progress made by the working group has helped reduce, if not entirely eliminate, the scope for differing interpretations between the firms in applying the AN to the public sector.

5. The working group has already confirmed that, in accordance with its Terms of Reference, that its final report will be submitted to the FRAB in February 2007. This paper provides a further progress update to the Board, in advance of the working group's final report.

Principled positions of the firms

Primacy of demand risk and residual value risk

6. In analysing property related risks, two of the firms (Deloitte and Ernst & Young) view demand and residual value risk as the principal factors in deciding on whose balance sheet the PFI asset should appear, i.e. whether demand and residual value risk are significant. This is based particularly on the extensive guidance on demand risk that is incorporated in the AN in paragraphs F24-F31, with a particular emphasis on paragraphs F25-F29.

7. In particular, the above firms conclude that the AN gives primacy to demand risk, and notwithstanding that the AN requires that all relevant factors should be considered rather than focusing on one factor in isolation, nevertheless concur with the AN (F24) that where demand risk is significant, it will give the clearest evidence of who should account for the PFI asset on its balance sheet. In addition, the two firms strongly support the guidance in the AN (F29) that a 'commitment to pay' by the purchaser for output or capacity, whether or not it is needed, is evidence that the property is the purchaser's asset.

8. In respect of residual value risk, the firms' view is that where the asset life is longer than the contract period and, at the end of the contract period, the asset reverts to the purchaser for little or no consideration, then this provides evidence that the asset is that of the purchaser.

Assessment of all relevant factors v demand risk

9. The remaining two firms (KPMG and PwC) strongly support the guidance in the AN (F21 and F49) that it is important to assess the effects of all relevant factors and the interaction between them,

giving greater weight to those that are more likely to have a commercial effect in practice. The two firms support the AN view that it is not appropriate to focus on one factor in isolation.

10. The two firms consider that whilst the allocation of demand risk will often give the clearest evidence as to accounting treatment, it should not be assumed to be the single determinant in all cases. Rather all relevant factors should be considered in reaching an accounting determination. In some situations, when there is little genuine uncertainty about the levels of demand for the property, a party may bear some or all of the demand risk during the contract term without necessarily being required to record the property on its balance sheet (see e.g. the example in the AN paragraph F25).

11. Similarly, the two firms consider that the allocation of residual value risk will often give clear evidence as to accounting treatment, but should not be considered in isolation.

IFRIC Interpretation: Service Concession Arrangements

12. The IFRIC Interpretation on Service Concession Arrangements has been approved by the IASB and is likely to be issued in 2006. It will provide guidance on the accounting by operators for public to private service concession arrangements if:

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

13. The Interpretation will not provide accounting guidance for grantors, however IPSASB is planning to issue a Standard in 2008, which will consider the accounting treatment for public sector grantors.

14. Significantly, the effect of the Interpretation would be a move away from the risk/reward basis (as with the AN) to an approach based on control. Therefore, when the grantor regulates what services are provided, to whom they are provided and at what price, and the grantor controls any significant residual interest, then the asset would not be a tangible asset of the operator. In this event it may be inferred that it would be an asset of the grantor.

15. The effective application date of the IFRIC Interpretation, as agreed by the IASB, is for accounting periods beginning on or after 1 January 2008, although the IFRIC now has to be adopted by the EU (a process that takes a minimum of ten months) before becoming part of "EU-IFRS". In the interim, it is desirable to reduce further any remaining differences between the four firms in their interpretation of the AN in its application to the public sector, to bring about more consistent accounting for PFI.

Interpreting the AN in relation to the public sector

16. In the event of the TN being withdrawn, then all entities covered by the FReM will solely apply the AN from the relevant date in accounting for PFI transactions. It is being considered by the working group that the FReM be amended to include a reference that the AN solely applies, however, there are divergent views on the need to include any interpretation into the FReM, and this needs to be explored in more depth by the working group. Given that the case studies considered by the working group showed that the firms are not that far apart on their views in relation to the public sector deals,

and that they are as one on private sector deals, then the working group needs to explore this issue further.

Part B

Treasury actions – implications of withdrawing the TN

17. The various Treasury teams have held a series of internal meetings to discuss issues arising from the potential withdrawal of the TN. These are ongoing, but interim conclusions we have reached are:

- Retrospection. From a Treasury position if the TN were to be withdrawn then retrospection would be a given. This is based on:
 - information received that certain auditors are likely to conduct retrospection work for existing PFI projects in the event of FRAB recommending the withdrawal of the TN; and;
 - the requirement for retrospection work in relation to the fiscal rules and National Accounts.
- Policy context of off balance sheet PFI schemes (e.g., funding). This issue is for the Treasury and should not be a direct concern of the working group or the Board.
- PFI VFM assessment guidance. The view that the superseded or new Treasury VFM assessment guidance linked or no longer directly links affordability with balance sheet treatment is misplaced. The VFM guidance does not deal with accounting, but is directly concerned with affordability and budgeting.

PFI working group – further work agenda

18. The PFI working group at its next meeting (to be arranged) will need to:

- Conclude on whether the AN needs to be interpreted for the public sector context in the FReM; and
- The format of its final report and likely recommendations to the FRAB.

Summary

19. It has been established that there are differing interpretations of the AN by the firms in relation to its application to the public sector, apparently caused by the TN, although there is much less diversity in its application to the private sector. The work currently being conducted within the working group aims to narrow significantly any differences in interpretation of the AN, if not entirely eliminating them.

20. The IFRIC Interpretation on Service Concessions will relate to the accounting for operators. The issue of the Interpretation is imminent but endorsement may take some time and additional work will be required to establish guidance on accounting by grantors under the IFRIC model.

21. The working group is considering proposing that the TN be withdrawn and that the FReM be amended to reflect that the AN should solely apply, subject to further deliberations by the working group.

22. The PFI working group will make its final report and submit its recommendations to the Board in February 2007.

HM Treasury

1 December 2006