

# Financial Reporting Advisory Board Paper

## PRIVATE FINANCE INITIATIVE (PFI): CONSISTENCY OF ACCOUNTING TREATMENT ADOPTED BY THE PUBLIC AND PRIVATE SECTORS – PROGRESS REPORT

<b>Issue:</b>	Progress update on HM Treasury actions.
<b>Impact on guidance:</b>	N/A
<b>UK GAAP adaptation?</b>	N/A
<b>IAS/IFRS compliant?</b>	N/A
<b>IPSAS compliant?</b>	N/A
<b>Impact on budgetary regime?</b>	N/A
<b>Recommendation:</b>	For information, and discussion by the FRAB.
<b>Timing:</b>	N/A

### DETAIL

#### Background

1. The Treasury's paper of 5 December 2003 (FRAB (65)3) provided the Board with the background and detail of the consultation work carried out by HM Treasury with the National Audit Agencies on the consistency of accounting treatment adopted by the public and private sectors in PFI transactions. The paper also outlined a number of suggested actions, including some which fell to HM Treasury (detailed below).
2. Further short oral updates on PFI were provided to the Board under 'matters arising' at the FRAB meetings of 8 March 2004 and 24 May 2004, on progress made with, or intended actions by, HM Treasury.
3. This paper aims to provide the FRAB with a current summary of the progress made.

#### Actions

4. In summary HM Treasury proposed to take the following actions:

- Discuss with the Treasury's Private Finance Unit how the message might be reinforced that the key determinant of PFI is Value for Money (VFM), not the accounting treatment, including reminding all bodies that the "Method Statement" was not formally issued and should not be applied in PFI assessments;
- Discuss the issue of sectoral PFI guidance with the relevant Government departments, in particular to reaffirm the value for money message and the primacy of the existing accounting guidance;
- Consider suggested amendments to Treasury Taskforce Technical Note No 1, (Revised) *How to Account for PFI Transactions* (TN1) from the National Audit agencies, consulting as appropriate, in order that TN1 might be expanded to provide greater emphasis and guidance for those areas that may be subject to different interpretations in practice; bearing in mind the backdrop of wider developments in accounting for PFI and similar transactions, and mindful of the dangers that making changes to TN1 that could turn it into a detailed 'rule book';
- Continue to monitor the work being undertaken internationally on accounting for service concession arrangements and to input to that work – both through the ASB and directly, as appropriate.

5. To address the FRAB's concerns with accounting for PFI, as expressed in the FRAB Report for 2003-04, HM Treasury has continued to work towards these actions to help remove inconsistencies in the accounting for PFI.

#### Value for Money

6. The action to reinforce the VFM message has been fully completed.

7. HM Treasury seeks to ensure that investment uses the most appropriate procurement option, offering the best VFM, and that there is no inherent bias between procurement options. PFI should be used where it offers VFM, and where it can meet our requirements of equity, efficiency and accountability. The balance sheet treatment of projects is immaterial to this decision.

8. HM Treasury has reiterated this position in our *Value for Money Guidance*<sup>1</sup> published in August 2004 which outlined:

- That VFM assessments should take place at the earliest practical stage of any decision making process;
- That departments ensure there is the flexibility to pursue alternative procurement routes if PFI does not offer the best VFM;
- The criteria which should be examined at every stage to ensure VFM;
- That projects should not be chosen to ensure a particular balance sheet treatment.

---

<sup>1</sup> Found on HM Treasury website at <http://www.hm-treasury.gov.uk/media/95C/76/95C76F05-BCDC-D4B3-15DFDC2502B56ADC.pdf>

9. The HMT VFM guidance was published with the primary intention of ensuring that VFM was the sole determinant of the decision to use PFI in procurement. This is stated in the third paragraph:

“ PFI should only be pursued where it delivers value for money (VfM), where VfM is the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user’s requirement, and does not always mean choosing the lowest cost bid. It should not be chosen to secure a particular balance sheet treatment.”

10. To ensure a concentration on VFM throughout the procurement process, the Value for Money Guidance implemented a three-stage procedure:

- A new assessment of the potential VFM of procurement options when overall investment decisions are being made in the context of the Spending Review, to ensure PFI is only used when it is the best option and has a good prospect of offering VFM (Stage 1);
- Reforming the Public Sector Comparator into an early, rigorous economic appraisal of an individual project at the outline business case stage prior to involving the private sector, to allow projects to proceed down alternative procurement routes where they offer VFM (Stage 2); and
- Setting up a final assessment of competitive interest in a project, and the market’s capacity to deliver, at the procurement stage (Stage 3).

11. Extensive public and private consultation during the development of the guidance was a useful tool for communicating the message that VFM, not accounting treatment, should drive the decision to undertake PFI projects. During the consultation period, public and private sector bodies had significant opportunities to understand HM Treasury’s emphasis on VFM.

12. It should be noted that at the programme level assessment stage 1, departments must decide:

- Allocations between capital and revenue budgets;
- The volume and scale of work programmes to be supported, given the amount of capital and revenue funding available; and
- The combination of procurement routes that are likely to deliver VFM programmes.

13. The guidance is being enforced by HM Treasury Corporate and Private Finance team. Stage 1 was compulsory from January 2004. The detailed guidance on Stages 2 and 3, published August 2004, became compulsory from January 2005. HM Treasury is in discussion with departmental Private Finance Units to ensure that stage 2 assessments are being undertaken robustly.

#### Method Statement for implementing Technical Note 1 (Method Statement)

14. The action to communicate to departments that the ‘Method Statement’ should not be applied to PFI assessments has been successfully completed.

15. The draft Method Statement was never officially issued, and HM Treasury has made it clear to departmental Private Finance Units that, in the interest of accurate and consistent accounting treatment, procuring authorities should be aware that the draft note Method Statement for Implementing Technical Note 1 is not accepted guidance and should not be used for accounting

judgements. Departments should ensure that PFI procuring authorities for projects they support do not employ argumentation based on the Method Statement.

### Sectoral PFI guidance

17. The issue of sectoral guidance has been robustly discussed with the relevant departments, particularly in relation to HM Treasury reaffirming the VFM message, and in the context of the primacy of the existing central PFI accounting guidance, i.e. Treasury Taskforce Technical Note No 1 (Revised)/Application Note F to FRS 5.

18. As a result of this the sectoral PFI guidance to procuring authorities published by the Department for Education and Skills and the Department of Health, has been removed from the relevant departmental websites. Both departments, at HM Treasury's request, are additionally reviewing their sectoral guidance to ensure it is compliant with HM Treasury's *Value for Money Guidance*, which emphasises that PFI should be used where it offers VFM, and that the balance sheet treatment of projects is immaterial to this decision. As with all PFI issues, we expect the relevant audit agencies, including NAO, to be consulted on the content of proposed redrafts.

19. It is confirmed that the guidance will be revised in the next few months, and this will be eventually republished on the relevant websites. Furthermore, the Department of Health has revised the Final Business Case (FBC) approval guidance for Strategic Health Authorities, responsible for approving the FBCs, to emphasise the primacy of value for money in the approval decision. Both departments will reiterate to procuring authorities the importance of value for money. HM Treasury continues to closely monitor departments' progress.

### Treasury Taskforce Technical Note No 1 (Revised) (TN1)

20. There has been a mixed response from the National Audit agencies on the issue of offering suggestions on how TN1 might be amended. Audit Scotland and the Northern Ireland Audit Office have not found it necessary to provide suggestions for amending TN1. The National Audit Office and the Audit Commission have helpfully provided suggestions for amending TN1, which if progressed will require extensive consultation with all the National Audit agencies on points of detail, and to ensure consensus on what sections of TN1 could be amended and how, before consulting more widely on any proposal to amend TN1.

21. There are several potentially significant obstacles that must be overcome to successfully amend TN1:

- The potential difficulty from a drafting perspective in understanding how the effects of proposed amendments to TN1 may actually manifest themselves in practice on future auditing determinations conducted by the National Audit agencies, and the need for consensus on the practical interpretation of any amendments;
- What could be a lengthy process in gaining ASB agreement to proposed changes post consultation, should the FRAB agree proposed changes;
- We are conscious of the burdens that would be imposed on bodies having to revisit the accounting treatments of schemes in the light of any changes to TN1 (as happened in the 'retrospection' exercise when Application Note F to FRS 5 and TN1 became applicable);

- Whether we wish to unilaterally amend our existing guidance on PFI, but rather take account of any international developments, as adopted by the ASB into UK GAAP, e.g. the work being undertaken internationally on service concession arrangements which has recently progressed.

22. As the process of amending TN1 does present significant, although not insurmountable obstacles, and given the impending international developments, it is HM Treasury's current view that the pragmatic approach would be to take into account the latter before committing to amending TN1. In that way if we were to amend TN1 this would represent a one-off process, precluding the requirement to unnecessarily revisit the Technical Note soon after issuing a revised version.

### International developments

23. The absence of an international equivalent to FRS 5 is well known. Meanwhile the International Financial Reporting Interpretations Committee (IFRIC) has been progressing proposals for three draft Interpretations on Service Concession Arrangements. These arrangements would encompass PFI, albeit the guidance will strictly apply to private sector operators. Nevertheless, this is likely to provide a strong indication of the possible future accounting treatment impact on the public sector if the Service Concession arrangements were to be adopted by the ASB into UK GAAP.

24. It is anticipated that an Invitation to Comment (ITC) on the IFRIC draft interpretations will be issued on the 1 March 2005, and that the ASB will consider these papers at its meeting on the 3 March 2005. It is hoped that the initial view of the ASB will be known by the time of the FRAB meeting on the 7 March.

25. In brief summary, the primary purpose of the interpretations is to provide guidance on the accounting by operators for public to private infrastructure service concessions, but will also apply to other arrangements that meet the following primary conditions:

- The grantor (public sector entity that grants the concession) 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 interest or otherwise – the residual interest in the infrastructure at the end of the concession, and the residual interest is significant.

26. In practical terms the IFRIC are proposing that whether an operator will recognise PFI assets will depend on whether the grantor in the service concession contract controls the use of the infrastructure, and if so, providing other conditions are met, the operator will not recognise the infrastructure as an asset on its balance sheet. This infers that in such circumstances the asset would appear on the grantor's balance sheet, although this is not considered in the IFRIC interpretations. The proposals put forward by the IFRIC represent a different concept of one of control, as opposed to the 'risks and rewards' based approach adopted under current UK GAAP.

27. In advance of the FRAB having the opportunity to study the ITC on the IFRIC draft interpretations, and in its role as an advisory body to HM Treasury, the FRAB's very early initial view would be welcomed on the IFRIC's proposals for introducing its alternative concept for accounting for PFI, and the potential implications for the future accounting of PFI in the public sector.

HM Treasury