



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 options and issues identified and discussed by the PFI working group, and to seek the views of the Board.
Timing:	N/A

DETAIL

Background

1. At the FRAB meeting on the 8 May, HM Treasury provided the Board with an oral update on initial progress made by the PFI working group during its first meeting, held on the 24 April. The Board were also advised that, following a planned second meeting of the PFI working group, which took place on the 17 May, HM Treasury would report further progress to the Board in writing. This paper provides the Board with an update on progress made.

2. Discussion within the working group identified some very real practical issues, in that despite their best efforts, the major firms (Deloitte and PwC) have been unable to agree whether the conclusions drawn under the Treasury Technical Note (TN) will always be the same as those drawn under Application Note F to FRS 5 (AN). As a result the firms are encountering scenarios in which no party

claims ownership of the asset for accounting purposes, seen by many as an indicator of an underlying problem.

Conclusions from the initial meeting of the PFI working group – 24 April

3. From its initial deliberations on the 24 April, the working group concluded that there were four possible options that needed further consideration. These were:

- Option 1 - Withdraw the TN completely;
- Option 2 - Withdraw the TN, but retaining some content, to be placed elsewhere;
- Option 3 - Withdraw the TN, but retaining some content, to be placed elsewhere, plus possibly adding some additional material;
- Option 4 - Major re-write of the TN.

Issues arising from discussion within the working group on the 17 May

4. The meeting between working group members on the 17 May began with discussion of some key issues relating to:

- a. Interpretation of the AN by auditors in relation to its application to the public and private sectors. Discussion within the group revealed that whilst the major firms had no differences in applying the AN to the private sector, this was not the case in applying the AN to the public sector;
- b. The possibility of seeking a pronouncement from the UITF. The working group discussed the possible role of the UITF in providing a pronouncement in relation to areas of the AN, which may give rise to differing interpretation in practice. The group also discussed the likely timing of this, with views ranging from significantly into 2007, or perhaps earlier;
- c. The potential impact and timing of international guidance. The group also discussed the potential impact of international guidance, in relation to the IFRIC Interpretation on Service Concessions, and the related paper expected from the IPSASB by summer 2007.

5. Discussion then centred on what could be done to improve consistency in accounting for PFI in the context of existing UK guidance. Discussion of the above options brought out issues where different views were expressed within the working group. These issues concerned differences in accounting judgement arrived at between using the TN and the AN, and differences in interpretation of some of the content of the AN. The issues are aired below.

Differences in accounting judgement arrived at between using the TN and the AN

6. Within the working group the NAO and Deloitte highlighted material differences between assessing the accounting treatment of a PFI transaction under the TN and the AN. This issue relates to auditors and advisers using the TN to justify different accounting judgements to those that may have resulted by following the principles of the AN.

7. From the NAO perspective, whilst there is not any issue that a quantitative analysis under the TN should give a different result from a qualitative analysis under the AN, there is an issue that the quantitative techniques have not been correctly applied, or have been over selective, or used untested or unvalidated data. Consequently, results have then been relied upon without wider consideration of all the relevant factors. In practice, the NAO also do not see any need to use the 'Monte Carlo' type analyses with their attendant difficulties of logic and data, when invariably, a qualitative analysis provides clearer evidence of where the asset should be accounted for.

8. There was also support for the view that under F29 of the AN (which is not regarded as sufficiently reflected in the TN) demand risk is 'significant' where there is a commitment to pay, whether or not the capacity is needed, and the minimum payments more than cover the cost of the property, then this is a clear indicator that the property should be on the balance sheet.

9. Deloitte see the key difference between the differing views of firms as being the inputs to the quantitative analysis, and particularly how demand risk and residual value risk are modelled. The view is held that whilst both Deloitte and PwC could use quantitative analysis, both firms would consider demand risk in doing so, and in many situations each firm would draw a different conclusion about the proportion of demand risk that should be considered significant for modelling purpose

10. Within the working group, PwC consider that there is not a material difference between the AN and the TN, and expressed views based on their interpretation of the AN which contradict what they understand to be those expressed by the NAO and Deloitte. This represents a very real area of disagreement where contradictory views exist regarding the interaction of the TN and the AN, and which are detailed below.

Areas of ambiguity and different interpretation of the AN

11. In working group discussions PwC consider that the NAO, and Deloitte in particular, highlighted themes which they consider reflect a difference between assessing the accounting treatment of a PFI transaction under the AN and the Technical Note, as follows:

- a. Firstly, that the AN does not encourage use of modelling to value and compare risks, but rather encourages a more qualitative approach focusing on a potentially wider range of factors than the TN. [PwC in interpreting paras F21 and F49 of the AN consider that it is incorrect to argue that the AN does not encourage use of quantitative analysis];
- b. Secondly, that the reference in para F29 of the AN to the issue of a 'commitment to pay' makes demand risk significant, which in almost all cases will mean an on balance sheet conclusion where demand risk is retained. [PwC in interpreting paras F21 and F49 of the AN consider that it is incorrect to argue that one factor, i.e. commitment to pay, taken in isolation should always make a difference to the conclusion on balance sheet treatment];
- c. Lastly, that schemes with only property related services provided by the operator would generally be seen as more likely to be on the public sector balance sheet compared to those schemes with significant non-property services which would be more likely to be off balance sheet, since the asset is less significant in relation to the size of the element in the latter. [PwC in interpreting para F20 of the AN consider that it is incorrect to argue that the level of non-property related services should have a major influence on whether a project is on or off balance sheet].

12. The full text of the relevant paragraphs of the AN which give rise to ambiguity or different interpretation, and for completeness other relevant paragraphs, are at Annex A.

Conclusions from the second meeting of the PFI working group – 17 May

13. In addition to identifying the above issues, from its further deliberations of the original options, the working group concluded that it could narrow the possible options down to three, as follows:

- Option 1 - Withdraw the TN completely;
- Option 2 - Withdraw the TN, but retaining some content, to be placed elsewhere;
- Option 3 - Major re-write of the TN.

Options – advantages and disadvantages

14. The working group will need to meet again to further discuss the options and in due course make recommendations to the Board. The group's initial view is that the advantages and disadvantages of each option (summarised in Annex B) are finely balanced. However, the group believes that it cannot sensibly make substantive progress until the areas of ambiguity and differing interpretation are resolved.

Summary for information

15. The working group has identified areas of the AN to which different interpretations are being applied by auditors in relation to its application to the public sector. This is not an issue when interpreting the AN in its application to the private sector.

16. Three options have been identified by the working group as possible ways of achieving greater consistency in the accounting for PFI. The relative advantages and disadvantages of each option have been identified.

17. Discussion in the working group has raised the fundamental issue of needing to resolve areas of ambiguity and achieve a mutual and consistent understanding of the interpretation of the AN in practice as applied to the public sector, and before considering further any options.

18. The working group discussed the possible role of the UITF in providing a pronouncement in relation to areas of the AN which may give rise to differing interpretation in practice.

19. The potential impact and timing of international guidance was discussed in relation to the IFRIC Interpretation on Service Concessions, and the related paper expected from the IPSASB.

20. The Board is invited to offer its views on the issues and differing interpretations outlined in this paper, and on how resolution might be achieved.

HM Treasury

29 June 2006

**APPLICATION NOTE F TO FRS 5 – AREAS OF AMBIGUITY/DIFFERENT
 INTERPRETATION**

AN REFERENCE	TEXT	POSSIBLE INTERPRETATION
Para F20	<p>There may be features that could lead directly to profit variations for reasons that relate purely to a service. Such variations may take the form of potential penalties for underperformance, or potential variations in revenues or in operating costs. These should be ignored when assessing who has an asset of the property, irrespective of their size. For example, a penalty may arise in a PFI contract for a prison because the security staff have not been trained satisfactorily, or in a PFI contract involving a catering facility because the food purchased is not up to standard. Similarly, potential variations in operating costs may relate purely to a service, for example the cost of raw materials and consumables in a catering facility. Such potential variations are irrelevant to determining which party has an asset of the property.</p>	<p>It can be interpreted that it is incorrect to argue that the level of non-property related services should have a major influence on whether a project is on or off balance sheet.</p>
Para F21	<p>There may be a significant number of property factors (for example, those listed in paragraph F22). It will be important to assess the effect 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. It will not be appropriate to focus on one feature in isolation. It will be necessary to consider both the probability of any future profit variation arising from a property factor and its likely financial effect. Additional costs may be incurred to correct a problem rather than risking the imposition of a much greater penalty, in which case the relevant variation to consider is the likely increase in costs rather than the possible penalty. Similarly, a possible increase in future costs may be avoided by altering some feature of the property at a lower net cost, in which case the variation to consider is the cost of altering the property.</p>	<p>It can be interpreted that it is incorrect to argue that the AN does not encourage use of quantitative analysis.</p>
Para F24	<p>Demand risk is the risk that demand for the property will be greater or less than predicted or expected. Where demand risk is significant, it will normally give the clearest evidence of who should record an asset of the property. Demand risk is imposed by the economic conditions of the market in which the PFI contract is written. Its existence and significance cannot be altered by the terms of the contract; the contract can only allocate demand risk between the parties to the contract, for example by allowing renegotiation of the contract at certain demand</p>	

	levels.	
Para F25	The first step is to identify whether demand risk is a significant risk. There may be instances where there is little genuine uncertainty about the level of future demand for the services provided by the property. For example, in a short-term IT contract there may be very little likelihood of demand varying greatly from the levels predicted under the contract. In such a case, demand risk is not significant and little weight should be given to this test. In other cases there may be much genuine uncertainty over the extent to which a property will be used – for example, a new road to be built in a newly developed area. In these cases demand risk will be significant and who bears it will be highly relevant to determining the appropriate accounting treatment.	
Para F26	The length of the contract may influence the significance of demand risk. In general, demand risk will be greater the longer the term of the contract, since it is usually more difficult to forecast for later periods.	
Para F27	It is also important to distinguish where demand risk is insignificant from where the terms of the contract are such that it is passed to one or other party. For example, there may be much uncertainty over the demand for a certain type of property in the long term. However, the terms of a long-term PFI contract for such a property may be such that the purchaser would fill the PFI property in preference to properties not subject to PFI, with the effect that it is very unlikely that the PFI property will not be full. In such a case, the purchaser has retained demand risk.	
Para F29	Where the PFI payments do not vary substantially with demand or usage of the property (although they may vary with other factors), the purchaser will be obliged to pay for the output or capacity of the property (eg prison places, hospital beds) whether or not it is needed (ie whether or not there are sufficient prisoners or patients). This is evidence that the property is the purchaser's asset and the purchaser has a liability to pay for it. In particular, if the purchaser, in substance, is obliged to pay a minimum amount (ie there is no genuine commercial possibility of non-payment) whether or not it will need the property, and the minimum amount more than covers the cost of the property, this is evidence that the property is an asset of the purchaser. In making this assessment of demand risk, any penalties or reductions in payments for non-availability of the property should be ignored: these relate to whether the property is in a state fit for use and do not affect the incidence of demand risk.	<p>This reference to the issue of 'commitment to pay' can be interpreted as making demand risk 'significant', which in almost all cases will result in an on balance sheet conclusion where demand risk is retained in the public sector.</p> <p>Schemes with only property related services provided by the operator would generally be viewed as more likely to be on the public sector balance sheet compared to those schemes with significant non property related services, which would be more likely to be off the public sector balance sheet since the asset is</p>

		less significant in relation to the size of the service element in the latter.
Para F49	In determining whether each party has an asset of the property, it will not be appropriate to focus on one feature in isolation. Rather, the combined effect of all relevant factors should be considered for a range of reasonably possible scenarios, with greater weight being given to those outcomes that are more likely to occur in practice.	It can also be interpreted that it is incorrect to argue that one factor (commitment to pay) taken in isolation should always make a material difference to the conclusion on balance sheet treatment of PFI deals.

ANNEX B

COMPARISON OF POSSIBLE OPTIONS

OPTION	DESCRIPTION	ADVANTAGES	DISADVANTAGES
1	Withdraw the Technical Note completely.	<p>Would remove different interpretations on demand risk in TN – possibly bringing level playing field across public sector.</p> <p>In principle, should result in the consistent application of AN F by all public sectors.</p>	<p>In practice, different interpretations of the AN exist in relation to its application to the public sector.</p> <p>Risks associated with difficulty in achieving consistency in accounting (e.g. potential litigation risks related to changed opinions?)</p> <p>Potential to increase inconsistency through embedded use of the TN?</p> <p>Loss of some useful guidance from the TN.</p>
2	Withdraw the Technical Note, retain a minimum level of content elsewhere.	<p>Would remove different interpretations on demand risk in TN – possibly bring level playing field across public sector.</p> <p>In theory, should result in the consistent application of AN F by all public sectors.</p> <p>Would retain some guidance that is helpful, i.e. payment mechanism guidance – Chapter 3 of TN.</p>	<p>In practice, different interpretations of the AN exist in relation to its application to the public sector.</p> <p>Risks associated with difficulty in achieving consistency in accounting (e.g. potential litigation risks related to changed opinions?)</p> <p>Potential to increase inconsistency through embedded use of the TN?</p> <p>Establishing the ‘status’ of retained guidance placed elsewhere.</p> <p>Retained guidance effectively duplicating what is in AN?</p>
3	Major re-write of the Technical Note.	<p>Could produce universally agreed guidance for public sector use, in principle, bringing greater consistency of accounting.</p>	<p>Need to have a mutual and consistent understanding of the interpretation of AN F to FRS 5 in practice, as applied to the public sector, before proceeding.</p>

			<p>Need to define 'significant', at least by sectors within the public sector?</p> <p>The TN is not mandatory for all the public sector – unless this were to be reviewed, e.g. local government.</p> <p>In practice, may be difficult to achieve total consistency across sectors.</p>
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