In previous IFRS briefings, we noted that final guidance from the Department of Health on the accounting treatment for Private Finance Initiative (PFI) and Local Investment Finance Trust (LIFT) schemes was outstanding. We said that we would issue another briefing once there was further clarity on accounting.

PFI and LIFT schemes are conceptually complex arrangements. While schemes are often covered by standard, national contract terms, specific local requirements and agreements can create practical difficulties in interpreting accounting treatment. Consequently, all PFI and LIFT schemes must be considered on their own merits when deciding on the appropriate accounting treatment.
PFI

IFRIC 12: Service Concession Arrangements provides an interpretation on accounting for service concession arrangements from the perspective of the private sector operator. There is no equivalent interpretation for the public sector. Consequently, HM Treasury has adopted an accounting treatment that is a mirror image of IFRIC 12. Following that, there is now agreement across the public sector that assets related to most PFI schemes will come on to the public sector balance sheet under IFRS. In response, on 3 April 2009 the Department of Health published guidance on accounting for PFI and a related universal model spreadsheet. These address many of the more complex accounting issues that bodies with PFI schemes face when bringing the assets on balance sheet, such as accounting for lifecycle costs and calculating the interest rate implicit in the arrangement.

The guidance and spreadsheet will enable NHS bodies to review their PFI schemes and calculate the entries that they need to make in their IFRS based accounts. It is important that bodies undertake that work as soon as possible if they are to achieve the deadline for the restatement of the 2008/09 accounts later this year. Bodies may already have reviewed their PFI schemes. If so, we would encourage them to read the Department of Health’s guidance and consider whether the approach they have adopted is consistent with it.

LIFT

There has been less agreement over the proper accounting treatment for LIFT schemes. Following discussions with the Department of Health, the Audit Commission issued guidance to its auditors on 13 March 2009, clarifying our view that most LIFT schemes fall within the scope of IFRIC 12. That guidance is also available on our web site and the Department of Health has provided a link to it from its Finance Manual website. It is also attached as an appendix to this briefing. In the Commission’s view, the outcome of LIFT schemes falling within the scope of IFRIC 12 is that the related assets and liabilities will come on to primary care trusts’ (PCTs’) balance sheets under IFRS. However, as discussed earlier, each scheme will need to be considered on its merits when deciding on the most appropriate accounting treatment.

The Department of Health is now preparing more detailed guidance on accounting for LIFT schemes. This will be in a form consistent with the PFI guidance discussed above. Once available, PCTs will need to review their schemes in accordance with the guidance to achieve the restatement of their 2008/09 accounts by the Department of Health’s deadlines.
Appendix – Audit Commission guidance to its auditors

Accounting for LIFT schemes under IFRS

Background

The implementation of IFRS for the preparation of NHS statements of accounts from 2009/10 has generated debate over the accounting treatment of PFI and LIFT schemes. Following adoption by HM Treasury of an accounting treatment that is a mirror image of IFRIC 12: Service Concession Arrangements, there is now agreement across the public sector that assets related to the majority of PFI schemes will come on to the public sector balance sheet under IFRS. However, a debate has been ongoing regarding the appropriate accounting treatment for LIFT schemes. This debate has arisen because of differing interpretations of the terms and conditions of the standard Leaseplus LIFT contract.

What’s the issue?

This is a contentious issue. The assets relating to LIFT schemes will, in most circumstances, be material to the accounts of the PCT. Consequently, a change in accounting treatment will have a significant impact on the PCT’s reported financial position.

There are no explicit provisions on the subject in the Manual for Accounts. Furthermore, the Department of Health has not issued supplementary guidance on LIFT accounting to date. Consequently, there is uncertainty among PCTs as to the appropriate accounting treatment for LIFT schemes, with financial advisors offering views based on different interpretations of the accounting framework. Consequently, auditors will be faced with different accounting proposals.

Two forms of LIFT scheme exist within the NHS:

- Land retained agreements (LRAs) – these are used for larger, more complex schemes and the Department of Health has acknowledged that these mimic PFI. The accounting treatment will therefore follow that for PFI schemes, with assets being recognised on the PCT balance sheet. Therefore, as there is consensus in this area, LRA schemes are not considered further in this guidance.
- Leaseplus agreements (LPA) – these are the more common form of LIFT schemes.

The remainder of this paper considers accounting for LPA arrangements (LPA LIFT). Although the majority of LPA LIFT schemes use a standard form of agreement specified by the Department of Health, the nature of individual schemes may vary considerably. Each scheme will, therefore, need to be assessed on a case by case basis. The remainder of this section considers the steps that need to be considered when assessing the accounting treatment:

- Are LPA LIFT schemes service concessions?
- Does the PCT control the services to be provided?
- Does the PCT control any significant residual interest in the infrastructure at the end of the contract?
- If IFRIC 12 does not apply, what is the accounting treatment under IAS 17: Leases?

Are LPA LIFT schemes service concessions?

In considering the appropriate accounting treatment for LPA LIFT schemes, it is first necessary to consider whether they are service concessions in accordance with the Treasury interpretation of IFRIC 12. To do this, it is necessary to consider whether the scheme satisfies a series of criteria. Paragraph 6.2.34 of the Treasury IFRS based Financial Reporting Manual (iFREM) states that a service concession arrangement must contractually oblige the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor. For a sample of LPA LIFT
schemes reviewed by the firms on behalf of the Department of Health, such a contractual obligation existed in all cases.

The same paragraph also considers what constitutes infrastructure assets for public services. This provides a wide scope, including non-current assets used for administrative purposes in delivering services to the public. Again, there was agreement across the firms’ analyses that infrastructure assets exist within all the schemes seen.

The iFREM then considers who controls the assets related to the LPA LIFT scheme. Unlike, IAS 17: Leases, where consideration of finance leases is based on the transfer of risks and rewards, IFRIC 12 considers where control of those assets lies. Paragraph 6.2.35 of the iFREM states that the private sector operator will apply IFRIC 12 to those arrangements where:

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

**Does the PCT control the services to be provided?**

The standard LPA LIFT contract sets out what services the private sector partner (the Liftco) must provide with the assets, to whom it must provide them and the price for the services. It is sufficient for the price to be regulated by the PCT, contract or regulator, for example by a capping mechanism. Only substantive features should be considered. From that analysis, we conclude that the PCT does control the services to be provided, to whom they must be provided and at what price.

**Does the PCT control any significant residual interest in the infrastructure at the end of the contract?**

Schedule 14a of the standard LPA LIFT agreement specifies that the PCT has the option to purchase the asset at the end of the agreement at an adjusted market price, which recognises the difference between the actual open market value at the end of the contract and the residual value of the asset. The schedule also specifies that the PCT is only required to confirm whether it wishes to take its purchase option in an option period that commences 12 months before the end of the contract and expires six months before the end of the contract.

Paragraph 6.2.35 of the iFREM states that the private sector operator will apply IFRIC 12 to those arrangements where the grantor controls, through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement.

Paragraph AG 4 of the application guidance to IFRIC 12, states:

‘The grantor’s control over any significant residual interest should both restrict the operator’s practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement. The residual interest in the infrastructure is the estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement.’

The existence of the option to purchase will restrict the operator’s ability to sell or pledge the asset. Consequently, the PCT has control over the residual interest in the asset.
Conclusion

Taking the above considerations into account, in the Commission’s view, the majority of LPA LIFT schemes meet the recognition criteria and control criteria set out in the iFREM and should, therefore, be accounted for as service concessions. This will require the assets and related liabilities to be brought on to the PCT’s balance sheet.

However, the Department of Health asserts that a number of LPA LIFT schemes exist that do not have a significant level of related services and do not, therefore, meet the criteria for a service concession. To date, the Commission has not been presented with contract details that support such a scheme. If such a scheme were to be identified, then it would need to be considered within the scope of IAS 17: Leases.

Accounting under IAS 17: Leases

The initial consideration under IAS 17 is whether land and buildings can be separately identified and accounted for. Paragraph 15 of IAS 17 states that the land and buildings elements of a lease are considered separately for the purposes of lease classification. In most cases, the land element will be classified as an operating lease, unless title to the land is expected to transfer to the lessee by the end of the lease period. The building element would then be considered separately and classified appropriately.

Paragraph 16 of IAS 17 then states that if the lease payments cannot be allocated reliably between land and buildings, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases. It is then necessary to consider whether the lease (or the building element of the lease if land and buildings have been separated) is an operating or finance lease. Paragraph 10 of IAS 17 identifies examples of situations that, individually or in combination, would normally lead to a lease being classified as a finance lease. The Commission’s interpretation of this is that, if any one of those criteria clearly indicates a transfer of risk, then the lease is a finance lease. If there were no one criteria that clearly indicated a transfer of risk, then the balance of risk transfer by looking at the criteria in aggregate should be considered.

The net present value (NPV) of lease payments as a percentage of the fair value of the asset criterion is potentially the most significant of those set out in IAS 17. The 90 per cent test in the UK SSAP 21 was often considered the key test when considering the classification of leases. Equally, under IAS 17, this test, while there is no quantitative comparator in the standard, can be conclusive evidence of a finance lease on its own, as are any of the items listed in Paragraph 10 of the standard. However, it must be stressed that this is not a 90 per cent test as under SSAP 21 and some advisors have applied a lower threshold. From the schemes the Commission has seen, results of the NPV test in excess of 100 per cent are not uncommon.

It is not possible to provide definitive guidance on the proportion of NPV that would indicate a finance lease, as there is no quantitative measure in the standard. It will, therefore, be necessary to consider each scheme on its merits.

Why is it important?

The correct accounting treatment for LPA LIFT schemes may have a material impact on the accounts of PCTs. Bringing the assets and related liabilities on to the balance sheet will have potentially significant implications for the financial performance of PCTs. To date, the Department of Health has not issued detailed guidance on accounting for PCTs. For budgetary and planning purposes, PCTs have been encouraged to take a worst-case view and assume that LPA LIFT assets will come on to the PCT balance sheet.
In the absence of earlier authoritative guidance on LPA LIFT accounting, there has been a disparity of treatment by PCTs. At recent IFRS events run by strategic health authorities, some PCTs have been advised that LPA LIFT is off of the balance sheet, while others have been told these schemes are on. Auditors may well, therefore, be presented with different accounting treatments for similar schemes in different parts of the country.

What should I do about it?

As you continue your discussions with PCTs regarding the restatement of their accounts under IFRS, you will need to consider their proposals for accounting for LPA LIFT and what analyses of arrangements they have undertaken in making that proposal. Individual PCTs will need to review their LIFT schemes and assess whether schemes should be accounted for as a service concession under the Treasury interpretation of IFRIC 12 in the iFREM, or as leases in accordance with IAS 17.

LPA LIFT should be accounted for as a service concession and brought on to the PCT balance sheet where all of the following are met:

- there is a contractual obligation on the private sector operator to provide the services related to the infrastructure to the public on behalf of the PCT;
- the PCT controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and
- the PCT’s option to purchase at the end of the contract terms mean that it controls any significant residual interest in the infrastructure.

In the Commission’s view, a large majority of LPA LIFT schemes will be caught by these criteria and will, therefore, come on to the PCT balance sheet.

If the PCT can reasonably demonstrate that its LPA LIFT scheme is not a service concession because there is no significant service element, you will need to consider how the PCT has assessed the scheme in accordance with IAS 17, taking account of the following factors:

- Can the land and buildings elements of the lease be separately identified? If so, the land element can be treated as an operating lease, unless the land reverts to the PCT at the end of the contract.
- Do any of the criteria in Paragraph 10 of IAS 17 indicate, either individually or in combination, that the lease is a finance lease? Where the NPV of the minimum lease payments represents substantially all of the fair value of the asset, then this may be enough on its own to demonstrate that the lease is a finance lease.

In undertaking their work, auditors should refer to:

- the PCT Manual for Accounts for 2009/10;
- the Treasury iFREM;
- IFRIC 12: Service Concessions; and
- IAS 17: Leases.