



Local Authority Accounting Panel Bulletin 45

PFI Transactions

SUMMARY

On 10 September 1998 the Accounting Standards Board published an amendment to FRS5 'Reporting the Substance of Transactions' by way of a new Application Note F – 'Private Finance Initiative and similar contracts'. The Application Note provided guidance on the accounting transactions required in relation to a PFI contract and also provided guidance on the question of which contract partner should recognise the asset and liability associated with the contract in their balance sheet.

For local authorities the Code of Practice on Local Authority Accounting (the SORP) defines 'proper practice' as regards producing an authority's statement of accounts and already adopts FRS 5 and the concept of substance over form.

SUBSTANCE OVER FORM

2.8 The accounting statements should be prepared so as to reflect the reality or substance of the transactions and activities underlying them, rather than only their formal legal character. In determining the substance of a transaction, it is necessary to identify all of the transaction's aspects and implications. A group or series of transactions that achieves or is designed to achieve an overall economic effect should be viewed as a whole.

1999 AND 2000 SORP

The 1999 and 2000 SORP incorporate the principles and disclosure requirements of Application Note F. The principles are discussed specifically in Appendix E to the SORP (this is attached). Application note F requirements are therefore applicable to the local authority Statement of Accounts. As well as the requirements regarding the recognition or not of an asset within the local authority accounts certain disclosures are required. They are as follows:

Consolidated Revenue Account

(f) The amounts of any outstanding undischarged obligations arising from long term contracts such as PFI transactions

Balance Sheet

(f) The gross amounts of assets that are recognised under a PFI arrangement together with the related accumulated depreciation, for each category of asset.

2000 SORP

The Accounting Standards Board requested an amendment to Appendix E of the 2000 SORP during its annual review. The amendment is in regard to development costs. A footnote has been appended to the paragraph on development costs which has the effect that any development costs that are reimbursed by the operator (usually private sector body) that are, in substance, repaid back to the operator through higher annual payments must be recognised in the year that they occur and a liability established covering the loan. Such costs cannot be carried forward as a prepayment. The reimbursement is classed as a loan from the operator and must be reflected as a liability in the authority's accounts. This loan is reduced each year as the loan is paid off through the increased annual payments charged by the operator. The exact wording of the footnote is :

“ This does not cover reimbursement where the substance is that it is merely a deferment of cost through an increased annual payment”

It is recommended that this treatment of development costs be adopted for the 1999/2000 financial year where possible.

RECOGNITION OF AN ASSET

APPLICATION NOTE F

The application note clarifies how the principles and requirements of FRS5 should apply to transactions conducted under the UK Government's Private Finance Initiative (PFI).

The application note and this bulletin uses the following terminology:

(a) the entity or local authority that acquires services under the Private Finance Initiative (PFI) contract is referred to as the 'purchaser'.

(b) the entity (usually a private sector body) that provides services under the PFI contract in return for payments from the purchaser is referred to as the 'operator'.

(c) the road, school or other object that is the subject of the PFI contract is referred to as the 'property'. The word 'asset' is reserved for items that are recognised in the balance sheet.

The application note concerns itself with the analysis required to determine:

(a) whether the purchaser in a PFI contract has an asset of the property used to provide the contracted services together with a corresponding liability to pay the operator for it or, alternatively, has a contract only for services; and

(b) whether the operator has an asset of the property used to provide the contracted services or, alternatively, a financial asset being a debt due from the purchaser.

The overall guidance is that a party will have an asset of the property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits. The legal ownership is overridden by the 'substance over form' principle. The difficulty is in establishing these benefits and risks and identifying which party bears the significant proportion.

The application note also introduces the concept of separability whereby elements of a PFI contract may operate independently of each other and hence can be separately identified. Where such elements relate only to services, rather than to the property and service element together, the service element should be ignored when determining which party has an asset of the property.

If, following the separation of the elements of the contract, it is established that the only remaining elements are payments for the property then those payments are akin to a lease and SSAP 21 applies.

Where it is identified that the contract is required to be analysed under FRS5, the contract must be analysed to establish which party bears the risk i.e. variations in profits/losses of the property and hence which party has an asset.

SEPARABILITY OF A CONTRACT

A PFI contract may be separated into service and property elements depending upon whether they operate independently of each other ie the elements behave differently. This is dependent upon how the contract is designed and how the payment streams are linked to the services provided.

A PFI contract often has an income stream in the form of a unitary payment linked to factors such as availability, performance and levels of usage i.e. level of service required. It may still be possible to identify different aspects within that unitary payment particularly where the different elements are dependent upon specific performance criteria being achieved.

The areas likely to be separable are ancillary services such as cleaning, catering or day to day maintenance as they are likely to have their own performance targets and be measured individually. The payment will often be dependent upon the performance levels.

Application note F states that a contract may be separable in a variety of circumstances, including but not limited to the following:

- a) 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.

b) 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.

c) 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.

A PFI transaction is designed such that individual elements of a payment do not relate to the delivery of specific inputs nor do they contain a fixed element designed to cover the operator's debt service obligation. PFI transactions must be related to performance.

TECHNICAL NOTE NUMBER 1 (REVISED)

In July 1999, the Treasury taskforce issued PFI Technical Note number 1 (revised) 'How to account for PFI transactions' which provides practical guidance for certain public sector bodies on the adoption of the principles of application note F. The Technical Note is mandatory for all bodies preparing their financial statements in accordance with the Resource Accounting Manual and for NDPB's, Trading Funds, NHS Trusts and Public Corporations that prepare their financial statements in accordance with an Accounts Direction issued with the approval or consent of the Treasury. The status of the guidance for Local Authorities is influential but not mandatory.

FRS 5 v SSAP 21

If the authority is satisfied that the contract cannot be separated, the next stage is to apply FRS5 and to identify the risks associated with the property. The analysis of that risk then takes place in order to identify which party has the asset.

Both the Application Note and the Treasury taskforce revised technical note provide further guidance and suggests methodologies in relation to the separation of a contract and the subsequent quantitative risk analysis.

If the contract is separable, the next stage is to identify, after stripping out the separable elements, whether the remaining elements are purely payments for the property. If they are then this will be akin to a lease and SSAP 21 'Accounting for leases and hire purchase contracts' (interpreted in the light of the FRS) should be applied. If elements of service provision remain after separation of the contract has been undertaken then the requirements of FRS 5 must be applied.

The detailed accounting requirements for PFI transactions have been developed and are available as part of the regular annual update to the Guidance Notes.

CAPITAL FINANCING IMPLICATIONS - ENGLAND

The Department of Environment and Transport and the Regions (DETR) issued 'The Local Authorities (Capital Finance)(Amendment)(England) Regulations 1999' in December 1999 – SI 1999/3423. They come into force on 1 April 2000. The regulations amend the PFI risk transfer test previously identified in regulation 40 (the contract structure test) and bring the test in line with the accounting requirements of Application Note f.

The overall effect of the new regulation is that no credit cover is required where there is no increase in any amounts on the authority's balance sheet in respect of the assets provided, constructed or improved under the contract. It is up to each authority to determine the balance sheet treatment in accordance with Application Note f. The credit arrangement will have a nil initial cost if the asset remains off balance sheet.

If the authority has an asset from a PFI contract that remains off its balance sheet (in accordance with Application Note f requirements) the scheme will only need to be submitted to a government department if the authority wishes to apply for a notional credit approval which confers additional revenue support for PFI projects endorsed by the Project Review Group (PRG).

Where a scheme results in the asset being recognised in a local authority's balance sheet the authority is required to provide the full amount of credit cover calculated in the normal way – the NPV of all payments due under the contract throughout its life.

The DETR recognise that a PFI contract may result in assets being recognised by the local authority and it states that departments will be prepared to consider an application for a supplementary credit approval equal to the credit cover required for that contract. This will also entitle the authority to receive revenue support. A number of criteria have been established which must be followed prior to an authority applying for a supplementary credit approval.

Further details of these criteria and further guidance regarding the new capital financing regulations can be found on the DETR website.

Transitional arrangements

Projects endorsed by the Project Review Group prior to December 1998 will not be affected by the amended regulations. If the scheme reaches contract signature on or after 1 April 2000 and passes the Application Note f requirements no action will be needed. Where such a contract does not meet the Application Note f requirements, but would have passed the contract structure test, a supplementary credit approval will be issued equal to the credit cover required.

CAPITAL FINANCING IMPLICATIONS — SCOTLAND

In Scotland the section 94 rules apply to capital finance transactions. These do not contain the equivalent of the contract structure test. The accounting rules determined by the Treasury need to be satisfied before a private finance transaction can receive the go ahead from the Scottish Office. The accounting arrangements set by the Code need to be followed.

CAPITAL FINANCING IMPLICATIONS — WALES

The National Assembly for Wales issued The Local Authorities (Capital Finance) (Amendment) (Wales) Regulations 2000 in March 2000. They come into force on 1 April 2000 and repeal the contract structure test in regulation 40. The effect is that the balance sheet treatment of a PFI deal does not affect whether it is a private finance transaction for the purpose of the regulation: funding will be from revenue.

A credit arrangement which is a private finance transaction is therefore excluded from section 49(2), and the initial cost and cost at any time of the arrangement will be nil. The definition of private finance transactions contained in regulation 16 still applies. Regulations 41 and 42 have also been repealed.

REVENUE FUNDING

Where local authorities in England receive revenue funding for PFI schemes and their related transactions it should be recognised in the consolidated revenue account as a government grant not attributable to specific services. If the grant is classed as a specific grant then the income should be recognised within the relevant service revenue account.

The revenue funding should not be matched to expenditure as, if allocated through the SSA calculation, the amounts for each individual year are unlikely to be equal. This follows the existing principle as regards the remainder of the RSG funding.

In Wales, if the National Assembly provides support for Local Authority PFI schemes, that support is currently provided in the form of an adjustment to the authority's SSA.

DETAILED TRANSACTION REQUIREMENTS

Further detail regarding the PFI transactions accounting entries can be found in chapter 8 of the Code of Practice on Local Authority Accounting in Great Britain – guidance notes for practitioners. Authorities that have recently purchased the update pack will receive a copy as soon as it is printed. The guidance notes can be purchased from CIPFA publications and via the CIPFA website.

ACCOUNTING FOR PFI TRANSACTIONS AND SIMILAR CONTRACTS

The purpose of this appendix is to set out a summary of the implications of the issues raised by Application Note F “ Private Finance Initiative and similar contracts as an amendment to FRS5” as regards Local Authority Accounting

The SORP embodies the concept of substance over form in paragraph 2.8.

Overview of basic principles :

Present practice is not to capitalise contracts for services. However, where a property is needed to fulfil a contract for services, present practice may require the property to be recognised as the local authority's asset. (For example, this is the case for some

take-or-pay contracts where the operator builds a specialist property with little alternative use.) The purpose of the analysis below is to determine:

(a) whether the local authority has an asset of the property used to provide the contracted services together with a corresponding liability to pay the operator for it or, alternatively, has a contract only for services; and

(b) whether the operator has an asset of the property used to provide the contracted services or, alternatively, a financial asset being a debt due from the local authority.

Under the general principles of FRS 5, a party will have an asset of the property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits. If that party is the local authority, it will have a corresponding liability to pay the operator for the property where the commercial effect of the PFI contract is to require the local authority to pay amounts to the operator that cover the cost of the property.

In some cases the contract may be separable, ie the commercial effect will be that elements of the PFI payments operate independently of each other. 'Operate independently' means that the elements behave differently and can therefore be separately identified. Where this is the case, and where some elements relate only to services (such as cleaning, laundry, catering etc) rather than to the property, any such service elements are not relevant to determining whether each party has an asset of the property and should be ignored.

Once any separable service elements have been excluded, PFI contracts can be classed into:

(a) those where the only remaining elements are payments for the property. These will be akin to a lease and SSAP 21 'Accounting for leases and hire purchase contracts' (interpreted in the light of the FRS) should be applied.

(b) other contracts ie where the remaining elements include some services. These contracts will fall directly within the FRS rather than SSAP 21.

For those contracts that fall directly within FRS 5, the question of whether a party has an asset of the property should be determined by looking at the extent to which each party would bear any variations in property profits (or losses). There are three important principles to be considered when undertaking such an analysis:

(a) A range of factors will be relevant in determining the extent to which each party would bear any variations in property profits (or losses) and it will be necessary to look at the overall effect of these factors when taken together.

(b) However, any potential variations in profits (or losses) that relate purely to a service should be excluded since it is only the property that may be included on the balance sheet of one of the parties, not the capitalised value of the whole service contract. Consequently, potential variations relating to the

provision of services are not relevant to determining whether each party has an asset of the property.

(c) in determining the appropriate accounting treatment, greater weight should be given to those features that are more likely to have a commercial effect in practice. Where there is no genuine commercial possibility of a particular scenario or cash flow occurring, this scenario/cash flow should be ignored.

Any private finance transaction entered into prior to the date of the application note should be accounted for in accordance with the requirements of the application note.

Specific Issues :

(i) Development costs

Development costs associated with a private finance initiative transaction should be written off as incurred. Development costs may be carried forward, as a prepayment where the cost is to be reimbursed and there is certainty that reimbursement will occur. Costs, which are not written off but are carried forward, should be disclosed as a note to the Consolidated Revenue Account or Housing Revenue Account

(ii) Donated assets

Where assets are “donated” into a private finance transaction this will represent a disposal of an asset. The economic benefit derived from donation will need to be recognised in the accounts and written off over the period in which the benefit is received. This is normally over the length of the contract.

(iii) Capital Finance Regulations

In England and Wales the capital finance regulations establish a contract structure test. These tests have no direct significance to the determination of proper accounting. There should be no presumption that if the contract structure test is satisfied that the transaction will be accounted for off balance sheet.

In Scotland the section 94 rules apply to capital finance transactions. These do not contain the equivalent of the contract structure test. The accounting rules determined by the Treasury need to be satisfied before a private finance transaction can receive the go ahead from the Scottish Office. The accounting arrangements set by the Code need to be followed.

(iv) Residual value

Whilst in many private finance initiative transactions any asset used in service delivery will not automatically transfer to the local authority at the end of its term, it does sometimes occur. Where automatic transfer does occur either for nothing or for a set sum practitioners should consider paragraphs F55 – F57 of the application note to determine if the accounts need to recognise the difference between the specified amount and the fair value of the residual estimated at the start of the contract.

(v) Disclosure requirements

Any long term revenue contract, such as that likely to exist in a private finance transaction, will need to be disclosed in the notes to the Consolidated Revenue Account (4.21 f).

Practitioners who need to determine how to account for a private finance transaction should read the text of the application note. Attached is the flow chart and table, reproduced courtesy of the ASB, which summarises the decision route set out in the application note and provides indications regarding where the asset should be recorded.

TABLE

<p>Variations in profits/losses for the property, in transactions falling directly within the FRS rather than SSAP 21</p> <p>Three principles govern the assessment of the indications set out below:</p> <ul style="list-style-type: none"> • only variations in property profits/losses are relevant. • the overall effect of all of the factors taken together must be considered. • greater weight should be given to those factors that are more likely to have a commercial effect in practice. 	
<p>Indications that the property is an asset of the purchaser</p>	<p>Indications that the property is an asset of the operator</p>
<p>Demand risk is significant and borne by the purchaser, eg</p> <p>(a) the payments between the operator and the purchaser will not reflect usage of the property so that the purchaser will have to pay the operator for the property whether or not it is used</p> <p>(b) the purchaser gains where future demand is greater than expected.</p>	<p>Demand risk is significant and borne by the operator, eg</p> <p>(a) the payments between the operator and the purchaser will vary proportionately to reflect usage of the property over all reasonably likely levels of demand so that the purchaser will not have to pay the operator for the property to the extent it is not used</p> <p>(b) the operator gains where future demand is greater than expected.</p>
<p>There is genuine scope for significant third-party use of the property but the purchaser significantly restricts such use.</p> <p>The purchaser in some way guarantees the operator's property income.</p>	<p>The property can be used, and paid for, to a significant extent by third-parties and such revenues are necessary for the operator to cover its costs.</p> <p>The purchaser does not guarantee the operator's property income.</p>
<p>The purchaser determines the key features of the property and how it will be operated.</p>	<p>The operator has significant ongoing discretion over what property is to be built and how it will be operated.</p>
<p>Indications that the property is an asset of the purchaser</p>	<p>Indications that the property is an asset of the operator</p>
<p>Potential penalties for underperformance or non-availability of the property are either not significant or are unlikely to occur.</p>	<p>Potential penalties for underperformance or non-availability of the property are significant and have a reasonable possibility of occurring.</p>

<p>Relevant costs are both significant and highly uncertain, and all potential material cost variations will be passed on to the purchaser.</p>	<p>Relevant costs are both significant and highly uncertain, and all potential material cost variations will be borne by the operator.</p>
<p>Obsolescence or changes in technology are significant, and the purchaser will bear the costs and any associated benefits.</p>	<p>Obsolescence or changes in technology are significant, and the operator will bear the costs and any associated benefits.</p>
<p>Residual value risk is significant (the term of the PFI contract is materially less than the useful economic life of the property) and borne by the purchaser.</p>	<p>Residual value risk is significant (the term of the PFI contract is materially less than the useful economic life of the property) and borne by the operator.</p>
<p>The position of the parties to the transaction is consistent with the property being an asset of the purchaser, eg</p> <p>(a) the operator's debt funding is such that it implies the contract is in effect a financing arrangement</p> <p>(b) the bank financing would be fully paid out by the purchaser if the contract is terminated under all events of default including operator default.</p>	<p>The position of the parties to the transaction is consistent with the property being an asset of the operator, eg</p> <p>(a) the operator's funding includes a significant amount of equity</p> <p>(b) the bank financing would be fully paid out by the purchaser only in the event of purchaser default or limited force majeure circumstances.</p>