Accounting Treatment

Public Private Partnership Guidance Note 14

14 April 2000

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I. Introduction

Purpose and Scope of Guidance Note

1.1 This Guidance Note provides guidance for Central and Contracting Authorities on the accounting implications of Public Private Partnership projects. The purpose of the Guidance Note is:

- to describe the key issues that are likely to arise in relation to accounting for Public Private Partnership transactions;
- to provide a brief description of the accounting systems that are currently employed within the public sector for the reporting of capital expenditure;
- to provide guidance as to how Public Private Partnership projects should be reported in accordance with the current public sector accounting systems;
- to describe a number of new developments in both Irish and international accounting methods that will impact on the reporting of such transactions; and
- to provide guidance on how Public Private Partnership transactions should be reported within the context of these new accounting developments.

1.2 This Guidance Note is one of a series of Guidance Notes which provide contextual information on Public Private Partnerships and procedural guidance for Central and Contracting Authorities covering each stage in the development and implementation of infrastructure projects using the Public Private Partnership approach. The titles of all of the other Guidance Notes are set out in Appendix A to this Guidance Note.

1.3 The Guidance Notes are designed to be informative rather than prescriptive and the aim is to reflect good practice. They are generic in that they provide guidance on the use of Public Private Partnerships across a range of projects in the roads, water and waste sectors. However, different projects will give rise to different issues and the guidance provided will have to be reviewed in the context of each individual project. For this reason it is important that Central and Contracting Authorities obtain expert advice in order to help them to make best use of the Guidance Notes and to complete a successful Public Private Partnership procurement.

Structure of Guidance Note

1.4 The key accounting matters addressed in this Guidance Note are as follows:

- ***Section Two*** - distinguishes between the accounting systems that are in use in various parts of the public sector, and describes the key issues that are likely to arise in relation to accounting for Public Private Partnership projects;
- ***Section Three*** - describes the accounting systems that are currently employed within the public sector for the reporting of capital expenditure;

- ***Section Four*** - provides guidance on how Public Private Partnership projects should be reported in accordance with current public sector accounting rules;

- ***Section Five*** - sets out a number of new developments in accounting methods that will impact on the reporting of Public Private Partnership projects; and

- ***Section Six*** - provides guidance on how to report Public Private Partnership transactions within the context of these new accounting developments.

1.5 The final Section provides a summary of the main conclusions and recommendations that are identified and discussed within this Guidance Note.

Public Private Partnership Route Map

1.6 The process of project development and implementation changes significantly when a project is taken forward as a Public Private Partnership. For this reason a Public Private Partnership Route Map has been developed.

1.7 The Public Private Partnership Route Map sets out the main stages in the development and implementation of a Public Private Partnership project that must be undertaken by the Central Authority or the Contracting Authority. The Route Map is presented in the diagram shown overleaf.

1.8 The Public Private Partnership Route Map shows how the traditional processes of project development, procurement and implementation change for a Public Private Partnership project. A more detailed description of the Public Private Partnership Route Map is provided in the separate Guidance Note entitled *Introduction to Public Private Partnerships*.

1.9 The accounting implications of a Public Private Partnership transaction should be considered at two stages in the procurement lifecycle, namely:

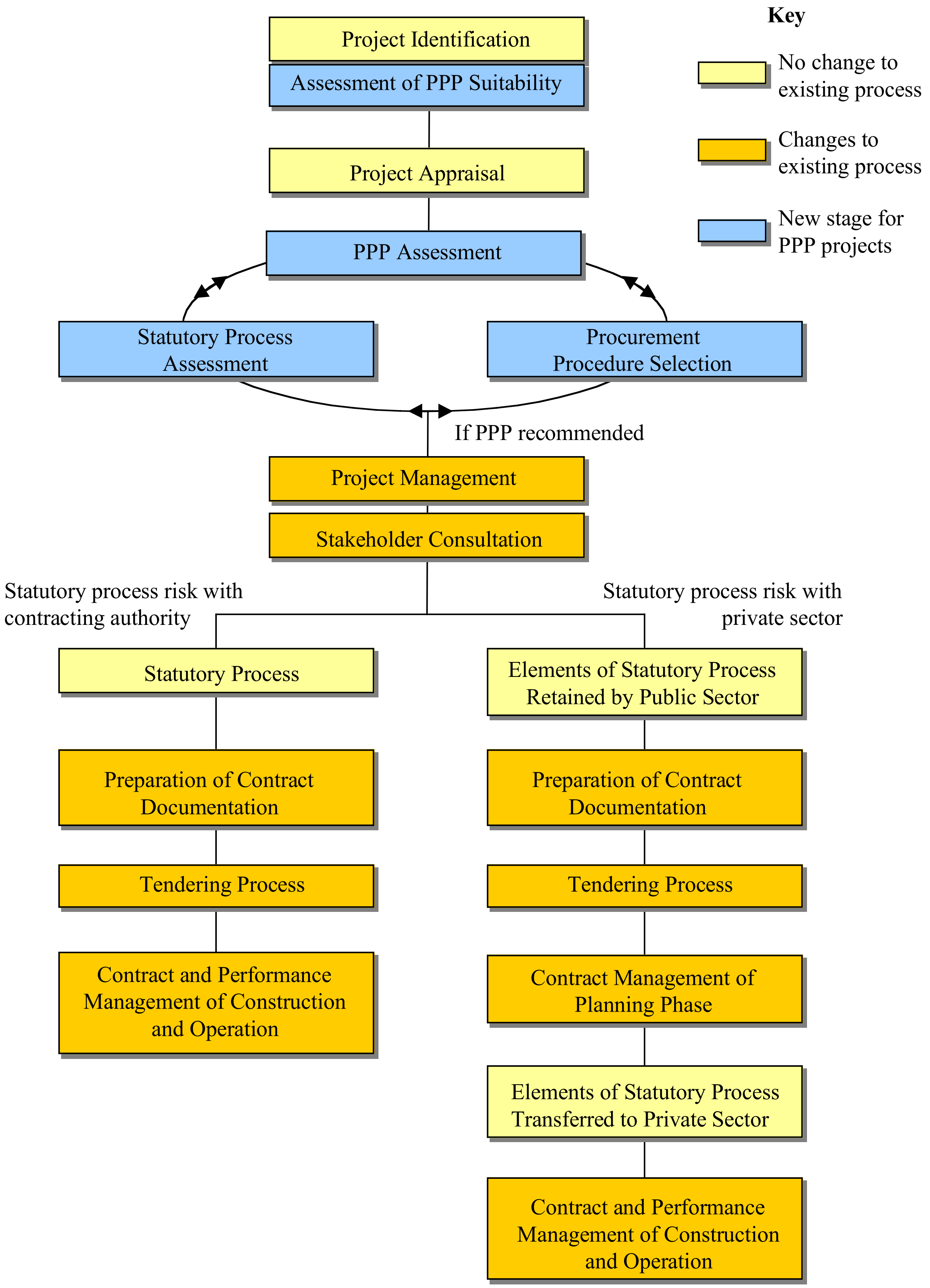
- ***Contract documentation*** - prior to issuing the Invitation to Tender or the Invitation to Negotiate, the Central and Contracting Authorities should obtain an initial view of the likely accounting treatment for the transaction; and

- ***Tendering process*** - prior to award of contract, the Central and Contracting Authorities should confirm the actual accounting treatment based upon the risk allocation set out in the Project Agreement and the Financial Model.

Specific Guidance

1.10 This Guidance Note does not attempt to provide specific guidance on the accounting treatment of individual transactions. The evolving approach to accounting within the public sector and differences in individual contract terms will affect the accounting treatment in individual cases. It is recommended that the terms of each Public Private Partnership transaction be separately examined and that specific advice be obtained in relation to the appropriate accounting treatment for an individual transaction. This advice should be sought from the financial advisers appointed to each project.

Figure 1: Public Private Partnership Route Map



II. Background and Key Issues

Accounting Systems

2.1 Accounting for Public Private Partnership transactions must take account of the fact that accounting information is prepared for multiple purposes and the definitions set out in the paragraphs below will help to frame this discussion.

National Accounts

2.2 The National Accounts are published by the Central Statistics Office in the annual *National Income and Expenditure* publications. Since 1999, these accounts have been compiled on an accruals basis in accordance with the European System of National and Regional Accounts. The government element of these accounts is compiled on a General Government basis, which defines the government sector more broadly than the system of Government Accounting. The annual measure of the performance of the public finances derived under the National Accounts is the General Government Balance. The bi-annual reports submitted to the European Commission in accordance with the Excessive Deficit Procedure are compiled on a National Accounts basis.

Government Accounts

2.3 The system of Government Accounting is set out in the *Public Financial Procedures Book* and is generally based on cash receipts into and payments out of the Exchequer Account (or Central Fund). This is the legal basis for the Government to account to the Oireachtas for its receipts and payments. The annual measure of the performance of the public finances under this accounting system is the Exchequer Balance. In addition, a limited form of accruals accounting has been recently introduced and will be further developed purely as a management tool. In the context of road expenditure, there is a similar treatment for any grants channelled through the National Roads Authority as for other capital and current expenditure under Government Accounting rules.

Local Authority Accounts

2.4 Local authority expenditure is currently accounted for on a cash basis, but will move to accruals based accounting in line with the *Statement of Recommended Practice on Local Authority Accounting*, which was issued by the Department of the Environment and Local Government in November 1998. The target date for implementation of this new accounting code is 2002.

Accounting Developments

2.5 Accounting for Public Private Partnership transactions must also take account of the fact that the accounting environment itself is in the process of evolving. The table shown overleaf summarises the current accounting systems being used, together with the accounting systems that will be used in the future.

Accounting System	Pre 1999	Pre 2002	Post 2002
National Accounts	Cash/Accruals	Accruals	Accruals
Government Accounts	Cash	Cash	Cash
Local Authority Accounts	Cash	Cash/Accruals	Accruals

2.6 The impact of this evolving accounting environment at the level of the Contracting Authority is that Public Private Partnership transactions will have to be reported under both cash and accrual accounting systems for the foreseeable future.

2.7 Until 2002, transactions will be recorded on a cash basis in Local Authority Accounts, while additional reporting on an accruals basis will be required for National Accounts purposes. From 2002, transactions will be recorded on an accruals basis in Local Authority Accounts, while additional reporting on a cash basis will be required for the purposes of Government Accounts.

Balance Sheet Reporting

2.8 The bulk of capital funding for infrastructure projects in the roads, water and waste sectors ultimately comes from Exchequer funds, with the result that the funding of these projects generally has an impact on the National Accounts.

2.9 The question of the balance sheet treatment of Public Private Partnership transactions has been the subject of much debate in the United Kingdom in relation to the Private Finance Initiative. Balance sheet treatment was a major issue largely because access to private finance and the need to reduce the recorded level of public sector debt was seen as a key driver underlying the development of the Private Finance Initiative.

2.10 The situation in Ireland is markedly different at present and decisions to proceed with individual Public Private Partnership projects will be predicated on an assessment of economic benefit and value for money, rather than on the balance sheet treatment of a transaction. In addition, the transition to resource or accruals accounting in parts of the public sector is much less advanced in Ireland than in the United Kingdom, so that many of the principles that are now axiomatic in the United Kingdom are not yet applicable to public sector accounting in Ireland.

2.11 Nevertheless, it will be important for Central Authorities and Contracting Authorities to understand whether a Public Private Partnership transaction gives rise to an asset and (more importantly) a liability in the Government and National Accounts. Public Private Partnership contracts can create long-term liabilities that comprise part of the General Government Debt and this represents a significant change as heretofore, the issuance of debt was managed exclusively by the National Treasury Management Agency.

Funding Treatment

2.12 The accounting treatment adopted for a Public Private Partnership transaction can also affect the measurement of the performance of Central and Contracting Authorities against budgetary targets.

2.13 Expenditure on projects and programmes at Central and Contracting Authority level is recorded against capital and current expenditure budgets. Anomalies will arise where the accounting treatment adopted for a payment or series of payments differs from the expenditure budget that has funded the payment. In theory, all capital expenditure should be on-balance sheet, while all current expenditure should be off-balance sheet, but this will not always hold true for every Public Private Partnership transaction.

2.14 Accordingly, any payments made under a Public Private Partnership transaction must be considered within the context of existing funding arrangements as well as within the context of current (cash) and future (accruals) accounting systems.

Transfer of Assets

2.15 Under most Public Private Partnerships, the private sector contractor will undertake to provide and operate an asset or facility over the term of the Project Agreement. As a result, Central and Contracting Authorities will need to address the accounting issues (including valuation) associated with the hand back of the asset at the expiry of the Project Agreement.

2.16 In addition, Central and Contracting Authorities will need to develop an appropriate policy to address the accounting treatment of any public sector assets contributed to the private sector as part of a Public Private Partnership project.

Contingent Liability

2.17 Contracting Authorities will frequently bear a statutory obligation for the delivery of the service that is contracted for under a Pubic Private Partnership contract. Where the contracted service is not being delivered, the Contracting Authority will need to consider whether or not this gives rise to a contingent liability and how such a liability should be recorded.

2.18 The Contracting Authority will also need to consider the accounting implications of any other obligations or contingent liabilities arising from a Pubic Private Partnership.

III. Current Accounting Treatment

Background

3.1 The current accounting records maintained within the public sector are divided into the following three main areas:

- National Accounts;
- Government Accounts; and
- Local Authority (Contracting Authority) Accounts.

National Accounts

3.2 National Accounts are prepared using the European System of National and Regional Accounts ("ESA95") that came into effect in 1999. This accounting system generally operates on an accruals basis and is designed to ensure that the performance of each member state is measured on a comparable and reliable basis. Its aim is to gradually replace all other accounting systems as a reference framework of common standards, definitions, classifications and accounting rules. The bi-annual reports submitted to the European Commission in accordance with the Excessive Deficit Procedure are compiled on a National Accounts basis.

3.3 ESA95 provides for the use of the double entry accounting system and records transactions on an accruals basis. The accruals basis applies to all flows, monetary and non-monetary, intra-unit as well as between units. The only exception to this rule is in relation to certain taxation transactions.

3.4 The framework provided by ESA95 consists of the following two main sets of tables:

- ***Sector accounts*** - which provide a description of the different stages of the economic process including production, generation of income, distribution of income, redistribution of income, use of income, financial accumulation and non-financial accumulation. The sector accounts also include balance sheets to describe the stocks of assets, liabilities and net worth at the beginning and end of the accounting period.

- ***Input output framework*** - which together with the *Accounts By Industry* describe in detail the production process (cost structure, income generated and employment) and the flows of goods and services (output, imports, exports, final consumption, intermediate consumption and capital formation by product group).

3.5 ESA95 applies to National Accounts submitted to all international organisations, but strict adherence to this system in national publications is not obligatory.

Government Accounts

3.6 The Government Accounts are prepared under the cash receipts and payments basis and report the overall surplus or deficit generated during the year. The Government Accounts also report the movement in the National Debt for the year.

3.7 Overall finances and capital expenditure are managed through the annual *Book of Estimates*, which are provided for by the Oireachtas by way of separate votes. The annual planned capital expenditure of each government department is set out in the Public Capital Programme and included in the *Book of Estimates*. The money granted for each project is known as a Supply Grant.

3.8 The accounts of both the Department of the Environment and Local Government (the "Department") and the National Roads Authority are prepared on a cash receipts and payments basis. The accounting systems record amounts actually paid and received during the period. However, government departments in general are encouraged to adopt accruals accounting in their internal financial management systems and details in relation to financial commitments entered into are now required within the main appropriation account. Also, as a general principle, Government Accounting is on a gross basis and receipts are not netted off against payments.

3.9 The Department does not prepare a balance sheet and so does not record the capital value of infrastructure assets procured by local authorities. The statement of assets and liabilities prepared as part of the appropriation account mainly relates to the assets of the Department itself, which comprise mainly computer equipment and fixtures and fittings. As such, the accounts of the Department only reflect the amount of money granted to local authorities for the construction of capital assets against the amount of voted expenditure for those projects.

3.10 The National Roads Authority also prepares annual financial statements under the historic cost convention and in a form approved by the Minister for the Environment and Local Government with the consent of the Minister for Finance in accordance with Paragraph 5(2) of the Third Schedule of the Roads Act, 1993.

Local Authority Accounts

3.11 With regard to Local Authority Accounts, the cash receipts basis is generally used to account for all transactions, including capital expenditure. However, at the end of the financial year, any unpaid bills outstanding are included and added to the total of the payments for the year. Accordingly, the traditional accounting principles and forms prescribed by Irish Generally Accepted Accounting Principles do not currently apply to local government accounting.

3.12 Capital expenditure is incurred by local authorities and is subsequently reimbursed by the Department. In limited circumstances the Department makes payments to local authorities in anticipation of expenditure. This procedure is required in order to:

- ensure that all matured liabilities incurred by local authorities are paid up to the end of the financial year;

- limit the circumstances in which local authorities would be in deficit on the capital account at the end of the financial year; and

- ensure that local authorities do not have to use expensive overdraft facilities to fund contractual obligations.

3.13 Local authorities do not currently employ the accruals system of accounting and therefore no estimates of amounts outstanding at the end of each financial year are prepared.

3.14 Local authorities do not prepare a balance sheet and therefore assets and liabilities are not recorded separately. Instead only actual capital expenditure during the accounting period is recorded in the accounts of local authorities. Consequently, no estimates of depreciation are made and no depreciation charge is incurred. Under the current local authority accounting system the capital value of assets procured for specific contracts is recorded as capital expenditure during the period and does not appear as an asset or corresponding liability in the accounts of the local authority.

IV. Cash Accounting for Public Private Partnerships

Introduction

4.1 In advance of the adoption of accruals accounting, this Section of the Guidance Note describes how certain aspects of Public Private Partnership transactions should be accounted for within the current cash accounting environment.

Implications for the Department

4.2 Under traditional procurement methods, infrastructure and some other assets procured by local authorities have largely been funded through the capital expenditure budget of the Department. The Department does not make any direct contribution to the costs incurred in operating the asset and instead these costs are funded from the local government grant allocated to each local authority and from other resources.

4.3 The implications of Public Private Partnership transactions for the Department under the cash accounting system are summarised below:

- in the case of a Design and Build, or a Design, Build and Operate contract, there should be no change to the current accounting arrangements; and
- in the case of a Design, Build, Operate and Finance contract or a Concession contract where there is some public subvention, the terms generally result in a change in the timing of capital spending from an up-front series of payments to annual payments over the term of the contract. As a result:
  - payments made by local authorities under Public Private Partnership contracts should be split between current and capital elements, and the Department should, where appropriate, continue to fund the capital element of the expenditure, and record this against its capital budget;
  - the capital element of the payments made by the Department under such an arrangement should not be considered when calculating the annual increase in net current expenditure; and
  - the capital element of the payment should be determined by reference to the fair value of the asset (fair value is the price at which the asset could be exchanged in an arm's length transaction), regardless of whether the asset is on or off balance sheet.

4.4 The appropriation account maintained by the Department in respect of each supply grant shows details of actual cash receipts and payments, against the initial voted estimate provision. Public Private Partnership transactions should not cause a major change to this approach, except that the initial voted estimate provision will be affected by the change in the timing of capital spending inherent in Design, Build, Operate and Finance contracts and Concession contracts.

4.5 Under the cash accounting system, the Department does not record the capital value of infrastructure assets that have been procured by local authorities. The Department does not currently take direct ownership of these assets, so there will be no change resulting from the adoption of the Public Private Partnership approach.

4.6 The Department does not currently note or record any contingent liabilities arising as a result of statutory obligations, so again there should be no change arising from the adoption of the Public Private Partnership approach.

Implications for Local Authorities

4.7 Under traditional procurement methods, capital assets procured by local authorities have been funded largely through the capital expenditure budget of the Department. Local authorities then meet the operating costs of these assets using their allocation from the local government fund and other resources.

4.8 The implications of Public Private Partnership transactions for local authorities under cash accounting are summarised below:

- in the case of a Design and Build or a Design, Build and Operate contract, there should be no change to the current accounting arrangements; and
- in the case of a Design, Build, Operate and Finance contract or a Concession contract where there is some public subvention, the terms generally result in a change in the timing of capital spending from an up-front series of payments to annual payments over the term of the contract. As a result:
  - payments made by local authorities under Public Private Partnership contracts should be split between current and capital elements and, where appropriate, funding may be sought from the Department for the capital element of the expenditure; and
  - the capital element of the payment should be determined by reference to the fair value of the asset, regardless of whether the asset is on or off balance sheet.

4.9 Local authorities do not currently prepare balance sheets and so infrastructure assets are not recorded separately. Under Design, Build, Operate and Finance contracts and Concession contracts, local authorities may be entering into long term commitments to make payments to the private sector.

4.10 As a result, prior to contract award, the local authority must assist the Department in preparing a briefing paper for the Department of Finance which includes a discussion of the proposed accounting treatment of the contract and the impact that it will have on the level of General Government Balance and Debt (see the separate Guidance Note entitled *Financial Context*). This discussion should recommend whether the commitments being entered into have any implications for the General Government Accounts.

4.11 Given the wide variety of Public Private Partnership forms, and the complexities of recording some borderline cases in the National Accounts, local authorities should provide an inventory description of each major Public Private Partnership project until there is certainty that transactions are being recorded and reported consistently in the National Accounts in accordance with the principles set down by Eurostat in Annex II of ESA95, and in Part IV of the Draft Manual on Government Debt.

4.12 Information should be collected quarterly, because there is a demand from Eurostat for full quarterly sector accounts for General Government, and this demand is likely to become a legal requirement in the near future. Therefore, at the end of each quarterly accounting period, a local authority should report the amount of imputed loans outstanding, and an estimate of the depreciation costs of the assets in the quarter (see the discussion of accruals accounting presented in Section Six of this Guidance Note).

4.13 Local authorities do not currently record the capital value of the infrastructure assets that they procure. Nevertheless, local authorities presently own all of these assets, and this situation is unlikely to change under a Design and Build contract or a Design, Build and Operate contract.

4.14 However, in Public Private Partnership transactions involving private sector finance, the following specific situations may arise:

- an existing asset or facility may be transferred to a Contractor as part of a Public Private Partnership transaction. Unless a cash payment is made by the Contractor for the asset, this transaction will have no accounting effect; and

- an existing or new asset may be handed back to a local authority at the end of a Public Private Partnership and in these circumstances the local authority should record the amount (if any) paid to the Contractor for the asset.

4.15 Local authorities do not currently note or record any contingent liabilities arising as a result of their statutory obligations. Local authorities will need to consider whether such a note is required, and if so, make an estimate of the quantum of the potential liability or loss, in light of the provisions of a Public Private Partnership contract.

4.16 In conclusion, it should be noted that local authorities are moving towards an accruals based accounting system and accordingly the guidance set out in Section Six of this Guidance Note will be of greater relevance in future.

V. Accruals Accounting Framework

Introduction

5.1 The guidance that is likely to determine the accounting treatment of Public Private Partnership transactions on an accruals accounting basis comprises:

- Statement of Recommended Practice on Local Authority Accounting;
- Statement of Standard Accounting Practice 21 ("SSAP21");
- Financial Reporting Standard 5 ("FRS 5"); and
- Application Note F to Financial Reporting Standard 5 ("Application Note F").

5.2 This body of guidance establishes the core accounting principle that all transactions should be accounted for in accordance with their economic substance rather than their strict legal form.

Statement of Recommend Practice

5.3 A *Statement of Recommended Practice on Local Authority Accounting* was issued by the Department in November 1998 and the target date for the implementation of this new accounting code is 2002. The code derives its principles from the universally recognised and adopted accounting concepts of going concern, matching, consistency, and prudence.

Accounting Standards

5.4 Accounting Standards are applicable to the financial statements of a reporting entity that are intended to give a true and fair view of its state of affairs at the balance sheet date and of its income and expenditure for the financial period ending on that date. Accounting Standards need not be applied to immaterial items.

5.5 Under current accounting principles, the issues of asset and liability recognition and on or off balance sheet accounting treatment are determined largely by Statement of Standard Accounting Practice 21 (*Accounting for leases and hire purchase contracts*) and Financial Reporting Standard 5 (*Reporting the Substance of Transactions*). The more recent Application Note F to Financial Reporting Standard 5 (*Private Finance Initiative and Similar Contracts*) will also be of particular relevance to Public Private Partnership transactions.

5.6 The decision as to which accounting standard to apply to a particular Public Private Partnership transaction is complex and will be determined by reference to whether or not the elements of the payments made to the Contractor under the Project Agreement operate independently of each other and can be separately identified. This will in turn be evaluated through a detailed examination of the contractual terms and the payment mechanism.

5.7 Application Note F contains a flow chart which shows how to determine whether a transaction should be accounted for in accordance with SSAP 21 or FRS 5 and a copy of the flow chart is set out in Appendix B to this Guidance Note. It also identifies the circumstances in which a transaction may be separable and these are set out below:

- the contract identifies a discrete element of the payment stream which varies according to the usage or performance of certain elements;
- different parts of the contract run for different periods or can be terminated separately; or
- different parts of the contract can be renegotiated separately.

5.8 Once any separable elements have been excluded, Application Note F suggests that all Public Private Partnership transactions will fall into one of two categories:

- ***Leasing contracts*** - where the only remaining elements are payments for the asset or the facility and the transaction should be accounted for in accordance with the requirements of SSAP 21; and
- ***Other contracts*** - where the remaining elements of the transaction include the provision of some services and the transaction should be accounted for in accordance with the requirements of FRS 5.

Statement of Standard Accounting Practice 21

5.9 SSAP 21 was introduced in 1984 and is concerned with accounting for leases. The standard distinguishes between finance leases and operating leases, a key distinction that determines whether an asset and related liability is included on the balance sheet of the lessee or the balance sheet of the lessor. The standard defines a finance lease as a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It then states that such a transfer exists if, at the inception of the lease, the present value of the minimum lease payments amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset.

5.10 A finance lease should be recognised in the balance sheet of the lessee as an asset, while an obligation to pay future rentals should be recognised as a liability. In addition, at the start of the lease the asset and liability should be recorded at the fair value of the asset. Annual rentals are apportioned between the finance charge and the reduction of the liability to produce a consistent periodic rate of the finance charge on the remaining balance of the liability. An asset leased under a finance lease should be depreciated over the shorter of the lease term and its useful economic life.

5.11 All other forms of lease are defined as operating leases and there are no balance sheet implications for the lessee beyond the accrual of rentals payable. Revised guidance on accounting for operating leases is set out in International Accounting Standard 17. This standard extends the disclosure requirements in relation to operating leases but does not recommend that assets leased under such an arrangement be included in the balance sheet.

5.12 The classification of leases between finance and operating is critical in determining whether the financial obligations associated with the use of an asset should currently be recognised as a liability or an operating cost.

5.13 In this context, it should be noted that the accounting profession is developing new proposals in relation to accounting for lease interests. A discussion paper is currently being considered that contains a proposal to abolish the present distinction between finance leases and operating leases and replace it with a single approach that would be applied to all leases. Such a development may have some implications for accounting for Public Private Partnership transactions

Financial Reporting Standard 5

5.14 Financial Reporting Standard 5 was published in 1994 and subsequently amended. It requires the financial statements of an entity to report the substance of the transactions it enters into. It sets out guidance on how to determine the substance of a transaction, including how to identify its effects on the assets and liabilities of an entity.

5.15 In assessing the effect of a transaction on the assets and liabilities of an entity, it is necessary to have a uniform definition of assets and liabilities. FRS 5 defines *assets* as defined rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. Control in the context of assets is the ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits. Evidence of whether an entity has access to such benefits is determined by whether it bears the risk inherent in those benefits.

5.16 FRS 5 defines *liabilities* as obligations to transfer economic benefits as a result of past transactions or events. Evidence that a liability exists is provided if there are some circumstances in which the entity is unable to avoid an outflow of benefits.

5.17 In determining the substance of a transaction, all its aspects and implications should be identified and greater weight attributed to those aspects that are more likely to have a commercial effect in practice. The overall accounting principle established by FRS 5 is that all transactions should be accounted for in accordance with their economic substance rather than their strict legal form and this has important implications for the way in which Public Private Partnership transactions are reported.

Application Note F

5.18 Under the general principles established by FRS 5, a party will have an asset of a property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits.

5.19 Application Note F suggests that the question of whether a party has an asset of the property created by a Public Private Partnership transaction should be determined by looking at the extent to which each party will be exposed to any variations arising in property profits or losses. Application Note F then sets out three important principles that must be considered when undertaking any analysis of the variations in property profits or losses that may arise under a Public Private Partnership transaction.

5.20 The three important principles may be summarised as follows:

- the analysis should be based on a consideration of the overall effect of the range of factors which determine the extent to which each party is exposed to variations in property profits or losses;

- the analysis should exclude any variations in profits or losses that relate purely to a service; and

- the analysis should attribute greater weight to those factors that are more likely to have commercial effect in practice.

5.21 In applying Application Note F to a Public Private Partnership project, the key test is to establish which party will bear any variations in the profits or losses arising from the property and the most important factors that will influence this test are presented below:

- ***Demand risk*** - to what extent can demand be greater or less than anticipated and which party bears the effects of reasonably likely variations in demand;

- ***Third party revenues*** - to what extent is the project reliant upon third party revenues to cover its property related costs and which party bears the effects of variations in third party usage;

- ***Nature of the property*** - which party determines the key features of how the property is to be built and how the property is to be operated, and which party bears the cost implications of changes in the method of building or operation;

- ***Penalties for underperformance*** - the likelihood of such penalties occurring and the significance of any penalties on the property profits or losses;

- ***Potential changes in relevant costs*** - the extent to which changes in relevant costs can vary and the extent to which changes are shared between the parties;

- ***Obsolescence*** - which party bears the future costs and gains the future benefits associated with obsolescence or changes in technology; and

- ***Residual value risk*** - the risk that the actual value of the property at the end of the contract will differ from that expected, and which party bears this risk.

Treasury Taskforce Technical Note

5.22 The Treasury Taskforce in the United Kingdom has issued a *Technical Note* covering the practical implementation of Application Note F. This document suggests that the factors set out above should be evaluated using quantitative risk analysis in order to identify the party (the Contracting Authority or the Contractor) that is most exposed to variations in property profits or losses. A comparison of potential variations in property profits or losses will provide a quantitative indicator of which party has an asset of the property, and a corresponding liability for the funding of the asset.

5.23 The Treasury Taskforce recommend that this quantitative analysis is carried out in conjunction with a qualitative review that looks at the following indicators:

Feature	**Indication that the property is an asset of the Contracting Authority**	**Indication that the property is an asset of the Contractor**
Termination for Contractor Default	If the contract is terminated early, the bank financing will be fully paid out by the Contracting Authority in all circumstances, including operator default.	There is no guarantee that the bank financing will be fully paid out by the Contracting Authority.
Nature of the Contractor's financing	Very high levels of gearing are an indicator that insufficient risk has been transferred and that the property is an asset of the Contracting Authority.	The level of equity funding should not be used as an indicator that the property is an asset of the Contractor, because the Contractor may require that level of equity to match the service risk it has accepted under the contract.
Who determines the nature of the Property.	If the Contracting Authority determines the key features of the property and how it is to be operated, bearing the cost implications of any changes to the method of operation.	If the Contractor is free to redesign the property extensively during the term of the contract (perhaps even to scrap the original property and build a replacement), in the hope of reducing its costs.

5.24 If, as a result of this assessment the risks and rewards associated with an asset are deemed to rest largely with the public sector procuring entity, then the fair value of the asset should be capitalised as an asset of that entity, and an equivalent liability recognised for all future payments.

VI. Accruals Accounting for Public Private Partnerships

Introduction

6.1 The introduction of accruals accounting will have a significant impact on accounting within the public sector. This Section of the Guidance Note, however, only deals with those aspects of accruals accounting relevant to Public Private Partnerships.

Implications for the Department

6.2 While there are plans to introduce elements of accruals accounting as a management tool for Department reporting, the legal basis of Department accounting will continue to be cash for the foreseeable future. Nevertheless, in light of the current reporting requirements for National Accounts and the introduction of accruals accounting at local authority level, the Department and the National Roads Authority should have a thorough understanding of the implications of accruals accounting for the reporting of Public Private Partnership transactions.

Implications for Local Authorities

6.3 Under the accruals accounting system, expenditure should be recognised and recorded as it is incurred and not as money is paid. In this respect, expenditure made under a Public Private Partnership contract will be no different than other expenditure of a local authority.

Balance Sheet Treatment

6.4 Under the accruals accounting system, local authorities will prepare balance sheets and separately record the capital value of the infrastructure assets that they control. In the case of a Design and Build contract or a Design, Build and Operate contract a local authority will capitalise the value of any investment made in new infrastructure and depreciate this value over the estimated useful economic life of the asset.

6.5 In the case of a Public Private Partnership transaction involving private sector finance, the identification of the correct balance sheet treatment under the accruals accounting system will be more complex and involve an analysis predicated on the key principles set out in Section 5 of this Guidance Note. The balance sheet treatment adopted will determine whether a Public Private Partnership transaction results in the recognition of an asset and a liability in the balance sheet of the local authority, in which case the treatment will be akin to a finance lease. Alternatively, the Public Private Partnership transaction may be treated as off balance sheet in which case the treatment will be akin to an operating lease.

6.6 If a local authority is considered to be more exposed to variations in property profits or losses than a Contractor, the assets provided as part of a Public Private Partnership project will be deemed to be on the balance sheet of the local authority. As a result:

- a finance lease should be recorded in the balance sheet of the local authority as an asset and an obligation to pay future rentals. At the start of the lease, the asset and the liability should be recorded at the fair value of the asset;

- the asset should be depreciated over the shorter of the lease term and its useful economic life;

- payments made under the Public Private Partnership contract should be analysed between the amounts associated with the purchase of the asset and the amounts associated with the provision of a service;

- the amounts associated with the purchase of the asset should be apportioned between the finance charge and the reduction in the liability, in order to produce a consistent periodic charge on the balance of the liability; and

- the amounts associated with the provision of a service should be included in net current expenditure.

6.7 If a Contractor is considered to be more exposed to variations in property profits or losses than a local authority, the assets provided as part of a Public Private Partnership project will be deemed to be off the balance sheet of the local authority. As a result:

- the contract should be treated in a manner akin to an operating lease;

- rentals should be charged on a straight-line basis over the lease term;

- rentals should be included in net current expenditure; and

- there will be no balance sheet impact other than the accrual of rentals payable.

Asset Contributions

6.8 In a number of Public Private Partnership transactions an existing asset or facility may be transferred to the Contractor as part of the contract and the appropriate accounting treatment for this transaction will depend on whether the asset contributed gives rise to future economic benefits for the local authority.

6.9 Where the contribution is by way of assets that can be exploited by the Contractor and this results in lower charges or payments under the contract then:

- if the overall Public Private Partnership transaction is considered to be on the balance sheet of the local authority, no specific accounting is required for the contribution; and

- if the overall Public Private Partnership transaction is considered to be off the balance sheet of the local authority, the net book value of the property should be reclassified as a prepayment (current asset), and subsequently charged as an operating cost over the period of the reduced payments.

- The difference between the sales value (market value) and the net book value of the asset should be recognised in the income and expenditure account of the local authority. The difference between the total reduction in payments and the sales value of the asset represents interest receivable by the local authority on the outstanding balance of the prepayment, and should be apportioned over the period of the payment reductions.

Example from Treasury Taskforce Technical Note

An asset owned by a Contracting Authority with a carrying value of £100 is sold to a Contractor for £150 as part of a Public Private Partnership transaction. The consideration is satisfied by a reduction in the unitary charge of £18 per annum for 10 years. For the purpose of this example it is assumed that the finance charge is allocated on a straight-line basis.

The accounting required under the Technical Note is as follows:

- Record a profit of £50 being the sales value of £150 less the carrying value of £100;
- Set up a debtor (prepayment) for £150; and
- Reduce the unitary charge by the repayment element of £15 per annum and the finance charge (interest receivable) of £3 per annum.

6.10 Where the contribution is by way of assets that can be exploited by the Contractor and this results in an up-front payment by the Contractor then:

- if the overall Public Private Partnership transaction is considered to be on the balance sheet of the local authority, the up front payment should be accounted for as a reduction in the lease obligations under the contract; and

- if the overall Public Private Partnership transaction is considered to be off the balance sheet of the local authority, the transaction should be treated as a disposal, and the difference between the sales value (market value) and the net book value of the property recognised in the income and expenditure account of the local authority.

6.11 Where the contribution does not give rise to any future economic benefits for the local authority and no value is assigned to the asset contributed under the contract then:

- if the overall Public Private Partnership transaction is considered to be on the balance sheet of the local authority, no specific accounting is required for the contribution; and

- if the overall Public Private Partnership transaction is considered to be off the balance sheet of the local authority, it should be charged as an expense when the contribution is made.

Asset Handback

6.12 Where assets are handed back to a local authority at the end of the contract term:

- if the overall Public Private Partnership transaction is considered to be on the balance sheet of the local authority, then no specific accounting implications arise at the end of the contract term;

- if the contract has been treated as off-balance sheet for the local authority, and the local authority acquires the asset at market value at the end of the contract term, then no accounting arises at the outset of the Public Private Partnership contract, as this represents future capital expenditure for the local authority; and

- if the contract is to be treated as off-balance sheet for the local authority, and the local authority acquires the asset at a predetermined price at the end of the contract term, then any difference between the predetermined price and the expected fair value of the asset at the end of the contract should be accrued for over the term of the contract.

Example from Application Note F

The expected residual value of an asset at the expiry of a 30 year Public Private Partnership contract is £20 million, but the Project Agreement specifies that £30 million should be paid by the Contracting Authority for the asset at that date.

A credit balance of £10 million should be accrued over the life of the contract, with the corresponding charge each year being included in the service expense.

The payment of £30 million at the end of the contract will extinguish the balance of £10 million and establish an asset of £20 million, representing the residual value of the asset itself.

Contingent Liabilities

6.13 Local authorities do not currently note or record any contingent liabilities arising as a result of statutory obligations. Local authorities will need to consider whether such a note is required and if so make an estimate of the quantum of the potential liability or loss in light of the provisions of each Public Private Partnership contract.

6.14 In addition, local authorities should also consider whether any other obligations or contingent liabilities arise under Financial Reporting Standard 12, *Provisions, Contingent Liabilities and Contingent Assets*.

Conclusions

6.15 Under Design, Build, Operate and Finance contracts and Concession contracts, local authorities may be entering into long term commitments to make payments to the private sector. As a result, prior to contract award, the local authority must assist the Department in preparing a briefing paper for the Department of Finance which includes a discussion of the proposed accounting treatment of the contract and the impact that it will have on the level of General Government Balance and Debt. This discussion should recommend whether the commitments being entered into have any implications for the General Government Accounts. The discussion should deal with the matters set out in Section Six of this Guidance Note, and the local authority should obtain specific accounting advice in arriving at its conclusions.

6.16 As the Public Private Partnership programme develops in Ireland, it is anticipated that relatively standard contract forms will be developed in each of the roads, water and waste sectors. Accordingly, it may be possible to obtain provisional opinions as to the proposed accounting treatment of Public Private Partnership transactions based on the standard contract forms. Nevertheless, it is recommended that any such opinions be subject to review prior to contract award, based upon the actual contract terms agreed and the quantitative risk analysis undertaken.

VII. Conclusions and Recommendations

Accrual or Cash Accounting

7.1 The evolving accounting environment means that at Contracting Authority level Public Private Partnership transactions will have to be reported on under both cash and accrual accounting systems for the foreseeable future.

- until 2002, transactions will be recorded on a cash basis in the accounts of the Contracting Authority, while additional reporting on an accruals basis will be required for National Accounts purposes; and

- from 2002, transactions will be recorded on an accruals basis in the accounts of the Contracting Authority, while additional reporting on a cash basis will be required for the purposes of Government Accounts.

Balance Sheet Reporting

7.2 The Contracting Authority should not allow the accounting treatment of a Public Private Partnership transaction to determine the terms of the contract. The contractual terms should be dictated by value for money considerations and the optimal allocation of risk between the Contracting Authority and the Contractor. The optimal allocation of risk may often result in contracts being treated as off balance sheet for accounting purposes.

7.3 Where the risks and rewards of ownership are deemed to reside with the Contracting Authority, the related liability should be recognised in the calculation of the General Government Debt. This is irrespective of whether or not the Contracting Authority maintains a balance sheet in its own right.

Funding Treatment

7.4 It will be important to ensure that value for money decisions are not compromised by accounting, reporting and funding systems. It is recommended that the Department should consult with the Department of Finance in developing an approach whereby the classification of any public expenditure in relation to Public Private Partnership transactions is not driven by the accounting treatment adopted for the contract.

7.5 Under the cash accounting system, payments made by a Contracting Authority to a Contractor under a Design, Build, Operate and Finance contract or a Concession contract should be analysed as between capital and current components. The Central Authority should exclude the capital element of payments arising directly under these contracts in calculating the annual increase in net current expenditure where the Central Authority is funding the capital element of the payments.

Asset Transfers

7.6 Under most Public Private Partnerships, the private sector contractor will undertake to provide and operate an asset or facility over the term of the Project Agreement. As a result, Central and Contracting Authorities will need to address the accounting issues (including valuation) associated with the hand back of the asset at the expiry of the Project Agreement.

7.7 In addition, Central and Contracting Authorities will need to develop an appropriate policy to address the accounting treatment of any public sector assets contributed to the private sector as part of a Public Private Partnership project.

7.8 The accounting for assets that are contributed to the private sector as part of a Public Private Partnership project should be done in the context of the on or off balance sheet analysis and should be undertaken in accordance with Application Note F.

Contingent Liability

7.9 Contracting Authorities will frequently bear a statutory obligation for the delivery of the service that is contracted for under a Pubic Private Partnership contract. Where the contracted service is not being delivered, the Contracting Authority will need to consider whether or not this gives rise to a contingent liability and how such a liability should be recorded. In addition, Contracting Authorities should consider whether any other contingent liabilities arise under Financial Reporting Standard 12*, Provisions, Contingent Liabilities and Contingent Assets*.

Specific Guidance

7.10 This Guidance Note does not attempt to provide specific guidance on the accounting treatment of individual transactions. The evolving approach to accounting within the public sector and differences in individual contract terms will affect the accounting treatment in individual cases. It is recommended that the terms of each Public Private Partnership transaction be separately examined and that specific advice be obtained in relation to the appropriate accounting treatment for an individual transaction. This advice should be sought from the financial advisers appointed to each project.

7.11 As the Public Private Partnership programme develops in Ireland, it is anticipated that relatively standard contract forms will be developed in each of the roads, water and waste sectors. Accordingly, it may be possible to obtain provisional opinions as to the proposed accounting treatment of Public Private Partnership transactions based on the standard contract forms. Nevertheless, it is recommended that any such opinions be subject to review prior to contract award, based upon the actual contract terms agreed and the quantitative risk analysis undertaken.

Appendices

A. Public Private Partnership Guidance Notes

Public Private Partnership Guidance Notes

The Public Private Partnerships Policy Framework comprises a series of fifteen individual Guidance Notes, the titles of which are as follows:

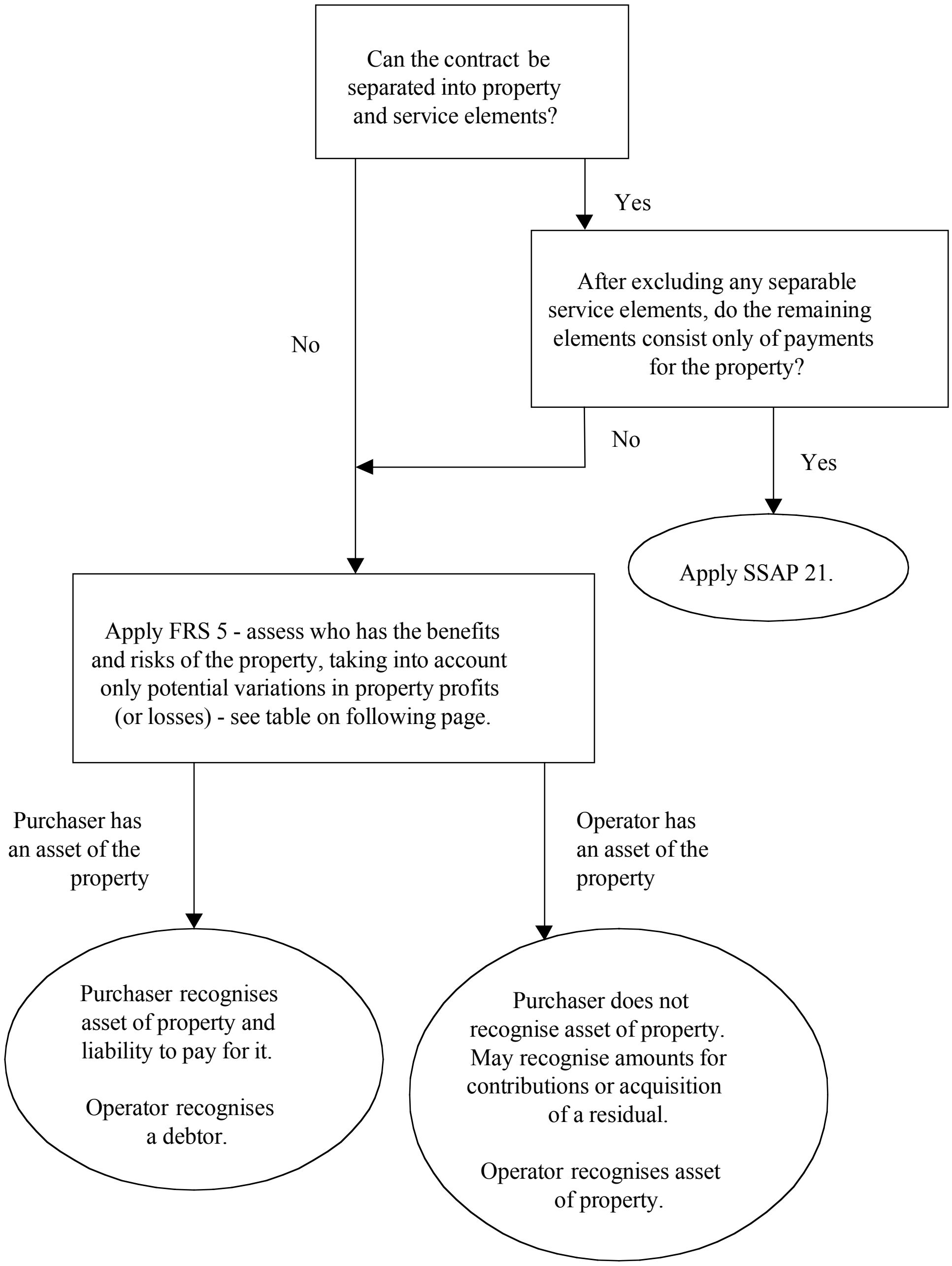
- *Introduction to Public Private Partnerships*
- *Financial Context*
- *Legal Context*
- *Public Private Partnership Assessment*
- *Statutory Process Assessment*
- *Procurement Procedure Selection*
- *Project Management*
- *Stakeholder Consultation*
- *Procurement Management*
- *Output Specifications*
- *Risk Assessment*
- *Payment Mechanisms*
- *Key Contractual Issues*
- *Accounting Treatment*
- *Contract and Performance Management*

Appendices

B. Extracts from FRS 5 Application Note F

Extracts from FRS 5 Application Note F

This flow chart summarises the decision route set out in the Application Note



Summary of main provisions and indicators included within Application Note F:

Variations in profits/losses for the property, in transactions falling directly within the FRS rather than SSAP 21.

Three principles govern the assessment of the indications set out below:

1. Only variations in property profits/losses are relevant.
2. The overall effect of all of the factors taken together must be considered.
3. Greater weight should be given to those factors that are more likely to have a commercial effect in practice.

Indications that property is an asset of the purchaser	Indications that property is an asset of the operator
Demand risk is significant and borne by the purchaser, e.g. (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 (b) The purchaser gains where future demand is greater than expected.	Demand risk is significant and borne by the operator, e.g. (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 (b) The operator gains where future demand is greater than expected.
There is genuine scope for significant third-party use of the property but the purchaser significantly restricts such use.	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. The purchaser does not guarantee the operator's property income.
The purchaser determines the key features of the property and how it will be operated	The operator has significant ongoing discretion over what property is to be built and how it will be replaced.
Potential penalties for underperformance or non-availability of the property are either not significant or are unlikely to occur.	Potential penalties for underperformance or non-availability of the property are significant and have a reasonable possibility of occurring.
Relevant costs are both significant and highly uncertain, and all potential material cost variations will be passed on to the purchaser.	Relevant costs are both significant and highly uncertain, and all potential material cost variations will be borne by the operator.
Obsolescence or changes in technology are significant and the purchaser will bear the costs and any associated benefits.	Obsolescence or changes in technology are significant, and the operator will bear the costs and any associated benefits.
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.	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.
The position of the parties to the transaction is consistent with the property being an asset of the purchaser, e.g. (a) the operator's debt funding is such that it implies the contract is in effect a financing arrangement (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.	The position of the parties to the transaction is consistent with the property being an asset of the operator, e.g. (a) the operator's funding includes a significant amount of equity (b) The bank financing would be fully paid out by the purchaser only in the event of purchaser default or limited force majeure circumstances.