National Audit Office

PFI in Housing

A paper prepared by Deloitte LLP for the National Audit Office

Accounting treatment of PFI housing projects

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Introduction by the National Audit Office

In October 2009 the National Audit Office published a paper, Private Finance Projects,[1] to support the Lords Economic Affairs Committee with their inquiry on Private Finance. This paper, reflecting on over 12 years of National Audit Office work on the use of private finance in public sector delivery, noted that the issue of accounting treatment for private finance projects had distracted attention away from value for money. Historically, by number, most private finance projects have been off balance sheet and not included in Government statistics of Public Sector Net Debt. The introduction of International Financial Reporting Standards and, from April 2009, changes to the rules used to determine how Private Finance is included in the financial statements of Government bodies presented the opportunity for a more consistent approach to the balance sheet treatment of Private Finance Projects across the public sector. In this context, in July 2009 the National Audit Office commissioned a short paper from Deloitte LLP setting out the application and particular issues around balance sheet treatment for Private Finance projects in the housing sector.

The treatment and rules discussed in this paper are those that applied during the previous administration as at July 2009 when the work was commissioned. It is not yet clear what changes the current administration may implement.

1 Private Finance Projects: *A paper for the Lords Economic Affairs Committee*, National Audit Office, October 2009.

Paper prepared by Deloitte LLP

Introduction

1 Given that the aim of a well constructed PFI transaction is to identify, price and allocate risk in the most efficient manner, each individual transaction will have features that are unique. Accordingly, reaching a determination on the balance sheet treatment of assets that underlie a PFI transaction is complex and no *"one size fits all"* accounting judgement can be applied to a model PFI transaction. This means that for accounting purposes each transaction must be assessed according to its own characteristics. The accounting determination is significant on the grounds that whether a transaction is judged as being "on" or "off" the public sector balance sheet determines how affordable a project is deemed to be within fixed expenditure and borrowing limits. These factors combine to make accounting for PFI a difficult and often contentious area.

2 This paper sets out the background to accounting for PFI transactions across central and local government and the way PFI is budgeted for within those sectors as at July 2009. It also discusses the accounting implications of PFI and how this impacts on the National Accounts (and so the Government's fiscal rules), how the balance sheet determination is made and the often contentious nature of these determinations. It also highlights that many PFI housing projects are more complex than PFI in other sectors.

3 Overlaid on this inherently complex area, there are the different accounting frameworks used by different parts of the public sector to consider (**Box 1**). Further, the budgetary and approvals frameworks, used respectively to allocate and control public expenditure and ensure that transactions demonstrate appropriate value for money, can make one accounting determination seem more attractive than another, such that accounting considerations may influence the method by which procurement of assets and services is structured. **Box 2** on page 4 explains fiscal policy as it has operated during most of the time the PFI housing programme has been in operation.

Box 1
Accounting frameworks used by government

National Accounts. The National Accounts are the set of integrated economic statistics that cover the whole economy. Several key economic indicators are derived from these statistics, including Gross Domestic Product and Gross National Income. The sub-set of the National Accounts that deal with the public sector is termed the Public Sector Finance statistics. It is these numbers that Government bases fiscal policy decisions on; that is the levels of taxation, public expenditure, borrowing and debt targeted through the Government's Temporary Operating Rule.[1]

The National Accounts, and the Public Sector Finance statistics, are prepared by the independent Office for National Statistics under the standards set out in the European System of Accounts 1995[2], and supporting guidance, which are issued by the European statistical agency, Eurostat. All European Union Member States are required to make returns to the European Commission under these rules and to maintain their deficit and debt below agreed levels relative to their Gross Domestic Product.

Financial statements. All public sector entities prepare financial statements in a format similar to those prepared by private sector companies.

Prior to 1 April 2009, these statements were produced based on an application of Generally Accepted Accounting Principles as applied in the UK:

- Central government departments and health sector bodies followed the Financial Reporting Manual, which is the accounting guidance prepared by HM Treasury on the basis of commercial accounting standards having taken advice from the independent Financial Reporting Advisory Board;
- Non-Departmental Public Bodies, which are not part of their parent departments, were required to prepare accounts under Generally Accepted Accounting Principles as applied in the UK, but with consideration given to the accounting policies and disclosure requirements set out in the Financial Reporting Manual; and
- Local authorities followed a **Statement Of Recognised Practice** issued by the Chartered Institute of Public Finance and Accountancy, which was also based on Generally Accepted Accounting Principles as applied in the UK.

Post 1 April 2009, central government and health sector bodies have moved to an application of International Financial Reporting Standards, following a new Financial Reporting Manual based on International Financial Reporting Standards.[3] Non-Departmental Public Bodies will follow International Financial Reporting Standards but with consideration given to the accounting policy and disclosure requirements of the new Financial Reporting Manual.

Local authorities will prepare accounts for 2009-10 on the basis of the 2009-10 Statement Of Recognised Practice, which is based on Generally Accepted Accounting Principles as applied in the UK except for PFI transactions, where the balance sheet determination is made on the same International Financial Reporting Standards based rules that are to be applied in central government from 1 April 2009. An International Financial Reporting Standards based "Code of Practice" is being developed to replace the Statement Of Recognised Practice, for implementation in 2010-11.

NOTE

1 Prior to the introduction of the Temporary Operating Rule at Pre-Budget Report 2008, the Government's two fiscal rules, the Golden Rule and the Sustainable Investment Rule (currently suspended), were also based on aggregates derived from the National Accounts (see Box 2 for an explanation of these rules and their relationship with the Temporary Operating Rule).

2 http://circa.europa.eu/irc/dsis/n faccount/info/data/esa95/en/titelen.htm

3 http://www.hm-treasury.gov.uk/frem_index.htm

Source: Deloitte LLP

Box 2
Fiscal policy

The previous administration first set out its two fiscal rules in the **Code for Fiscal Stability** in 1998.[1] The fiscal rules are defined and measured with reference to aggregates and balances derived from the National Accounts.

The **Golden Rule** states that, over the economic cycle, the government will only borrow to invest. That means that all current costs, including depreciation, should be met by current income. Performance against the Golden Rule is measured with reference to an aggregate named the **current balance** which is presented as part of the Public Sector Finance statistics. The current balance is calculated as total current receipts minus total current expenditure minus depreciation (measured in current prices).

The second fiscal rule is the **Sustainable Investment Rule**. The Sustainable Investment Rule stated that public debt, as a proportion of national income, will be held at a stable and prudent level. This has been clarified in subsequent Budget and Pre-Budget Reports as meaning that debt should be held below 40 per cent of Gross Domestic Product in each year of the current economic cycle. The Sustainable Investment Rule is measured with reference to an aggregate called Public Sector Net Debt. Public Sector Net Debt is calculated as total liabilities from borrowings net of liquid assets. In practice we understand it to be the sum of borrowings in the form of financial liabilities, including finance leases, net of cash deposits and foreign exchange reserves.[2]

In the Pre-Budget report 2008 the Chancellor announced that the fiscal rules were being suspended and in their place a **Temporary Operating Rule** was being put in place. The Temporary Operating Rule aims to:

> "… improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn so it reaches balance and debt is falling as a proportion of Gross Domestic Product once the global shocks have worked their way through the economy in full".

As such, the Temporary Operating Rule continues to focus on the same balances and aggregates as the Golden Rule and the Sustainable Investment Rule, but has the effect of suspending the limits until such time in the future yet to be determined.

NOTES

1 http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm

2 For more information on Public Sector Net Debt and the effect of finance leases see http://www.statistics.gov.uk/cci/article.asp?id=1638

Source: Deloitte

4 Crucially, an on balance sheet deal requires the public sector capital expenditure implied by the transaction, and the associated increase in liabilities, to be managed within fixed capital spending allocations and borrowing limits, such that the project must be assessed against the requirement for other capital assets. Deals that are judged as being off balance sheet do not imply public sector capital expenditure, borrowing and debt, and as such do not require up front capital budget cover. As well as the initial capital requirements, there are further differences on an ongoing basis, which affect the revenue position of procuring authorities, and so ultimately local and national tax requirements.

5 Given these issues, there is a risk that the accounting and budgetary impact could provide an incentive for procuring authorities to structure deals other than to achieve optimum risk transfer, with the aim of achieving an off balance sheet treatment. This may result in deals that do not provide optimum value for money should the private sector be allocated risks that they are not well placed to manage but for which a premium is priced into the transaction.

6 In the Housing sector, PFI is further complicated by the nature of the assets, with significant residual values and alternative uses to consider. Further, there are a range of models and agencies used for the delivery of social housing that have different impacts on an authority's reported financial position.

Key differences between on and off balance sheet transactions

7 There are significant differences in the accounting impact of PFI deals that are assessed as being on balance sheet compared to those assessed as being off balance sheet. It is these differences that have the potential to make a transaction more or less affordable within budgetary totals. **Figure 1** contains worked examples showing both on and off balance sheet presentations.

Accounting for an on balance sheet transaction

8 Where a deal is assessed as being on balance sheet, the procuring authority is viewed as having purchased the newly-created assets in the project. In the accounts, this purchase is financed by the acquisition of a liability to pay over the life of the project. Effectively, the public sector is viewed as having borrowed from the private sector to finance the acquisition of the asset.

Figure 1
Worked examples

This sets out the cash flows for an example transaction, and the accounting entries required under both an on and off balance sheet scenario.

Cash outflows

	Years										
	0	1	2	3	4	5	6	7	8	9	10
Fair value of asset (£m)	565										
Annual cash outflow from public sector (£m)		100	103	105	108	110	113	116	119	122	125
of which											
attributable to services (£m)		20	21	21	22	22	23	23	24	24	25
asset only cashflows (£m)		80	82	84	86	88	91	93	95	97	100
Interest rate implied in deal (%)	9										

Figure 1
Worked examples continued

On balance sheet illustrative example

	Years										
	0	1	2	3	4	5	6	7	8	9	10
Asset brought forward (£m)		565	509	452	396	339	283	226	170	113	57
Depreciation (£m)		57	57	57	57	57	57	57	57	57	57
Asset carried forward (£m)		509	452	396	339	283	226	170	113	57	0
Liability brought forward (£m)		565	536	502	464	419	369	311	246	174	92
Interest expense (£m)		51	48	45	42	38	33	28	22	16	8
Unitary charge payment related to asset (£m)		-80	-82	-84	-86	-88	-91	-93	-95	-97	-100
Liability carried forward (£m)		536	502	464	419	369	311	246	174	92	0
Operating statement											
Interest expense (£m)		51	48	45	42	38	33	28	22	16	8
Depreciation (£m)		57	57	57	57	57	57	57	57	57	57
Services (£m)		20	21	21	22	22	23	23	24	24	25
Total operating expense cost (£m)		**127**	**125**	**123**	**120**	**116**	**112**	**108**	**102**	**97**	**90**

Off balance sheet accounting illustrative example

	Years										
	0	1	2	3	4	5	6	7	8	9	10
Annual cash outflow from public sector (payment for services)[2] (£m)		100	103	105	108	110	113	116	119	122	125

NOTES

1 Calculating the interest rate inherent in the transaction. The total interest charge payable across the lease term is calculated as the difference between the fair value of the asset and the sum of the future asset related cashflows. This charge should be allocated to accounting periods over the term of the lease so as to produce a constant rate of interest (or a reasonable approximation to it) on the remaining balance of the liability. The interest rate implied in the transaction is therefore the rate that discounts the future nominal asset related cashflows back to the fair value of the asset at the outset of the transaction.

2 In practice, where assets with a significant residual value transfer to the public sector at the end of the contract, a portion of the unitary payment may be added to the balance sheet, rather than being expensed. This *residual interest* asset increases over time therefore and is used to notionally finance the acquisition of the property asset at the end of the contract.

Source: Deloitte LLP

9 Having recognised the asset and liability on balance sheet, the annual unitary payment from government is disaggregated into its constituent parts for the purposes of the accounts, as follows:

- an element that relates to services that are delivered auxiliary to the asset; and
- an element that relates only to the financing of the underlying asset.

10 The services element of the unitary payment is expensed as those services are delivered.

11 The asset-only element of the unitary payment is further split between an amount to cover the interest accruing on the liability and an amount that reduces the principal amount outstanding. As cash is paid by the public sector, the finance charge is met and the principal amount outstanding is reduced, in the same way as payments under a repayment mortgage. By the end of the transaction, the liability has been reduced to zero, and the public sector has no obligation outstanding. Commonly, ownership of the asset will transfer to the public sector procuring authority at that point for no additional consideration.

12 Under an on balance sheet model, the accounts recognise the depreciation on the asset as the public sector consumes the asset, taking into account any residual value.

Accounting for an off balance sheet transaction

13 In an off balance sheet transaction, the public sector is deemed not to have acquired the assets that underlie the transaction and as such no long-term liability is recognised to pay for those assets. Rather, the view is that the private sector provides services in the form of access to the asset. In the accounts of the procuring authority the whole unitary payment is expensed to reflect the view that services are being provided to the public sector.

Impact of PFI on the Government's key fiscal indicators

14 For those transactions considered to be on the public sector balance sheet for the purposes of national accounts, Public Sector Net Investment increases at the point the asset is recognised, matched by an increase in Public Sector Net Borrowing, the measure of the public sector deficit. Since 20 September 2006, when estimates of the impact were first produced by the Office for National Statistics, Public Sector Net Debt includes the value of outstanding liabilities acquired under on balance sheet PFI deals and excludes the assets.

15 This means that on balance sheet transactions are recognised as capital spending and borrowing upfront in government expenditure statistics, matched by an increase in public sector debt.

16 Any service payments, interest costs and depreciation on the newly acquired public sector asset forms part of the calculation of Public Sector Current Expenditure, which impacts on the Public Sector Current Budget.

17 In an off balance sheet deal, the payment for services associated with the asset form part of Public Sector Current Expenditure and impact on the Public Sector Current Budget, but no public sector capital expenditure, borrowing or debt is recognised.

Budgeting for PFI

18 The aim of the public expenditure budgeting system is to protect the fiscal position as measured with reference to the National Accounts. Accordingly, when a central government body enters into a PFI transaction that is on balance sheet for the purposes of national accounts, that department requires capital budget cover for the upfront cost of the asset. This capital expenditure needs to be balanced against other capital spending requirements in recognition of the Public Sector Net Investment, Public Sector Net Borrowing and Public Sector Net Debt implications of the transaction.

19 Subsequently, the department requires resource budget cover for any services associated with the project, interest costs and depreciation of the asset. The amortisation of the liability does not represent an ongoing cost to the department's budget, on the grounds that the acquisition of the asset has previously been managed within the capital budget, i.e. at the point the asset was initially recognised.

20 In the local government context budgeting for PFI is complex. Whilst some local authority PFI, or similar, deals do go ahead without support from central government (on the grounds that local authorities are free to borrow, prudentially and within a national affordability limit), the majority of local authority projects are supported by an allocation of so called PFI credits, provided by sponsoring central government departments.

PFI credits

21 A total quantum of PFI credits is announced as part of the Spending Review Process alongside the announcement of departmental budgets, but do not themselves form part of the budgets allocated to departments. Local authorities bid for PFI credits from sponsor departments in bidding rounds, with successful projects given awards of PFI credits.

22 The effect of an allocation of PFI credits is that, as part of the Local Government Finance Settlement, an amount of Revenue Support Grant (that is the large block grant from central government to local authorities) is top-sliced and allocated to the holders of the credits in order to finance the unitary payment due to the PFI contractor. Consequently, the effect of PFI credits for local authority is that PFI deals which would not otherwise be affordable can proceed.

23 Qualifying criteria for a local authority to gain credit approvals include:[2]

- the transaction must be structured following standardised guidance;
- it must have sufficient service elements to be accounted for as a contract for services rather than a lease only arrangement;
- it must have appropriate risk transfer to the private sector; and
- it must be demonstrated to be value for money.

24 The appropriate risk transfer criterion is seen as being synonymous with a requirement to demonstrate an off balance sheet treatment. Whilst PFI credits may be allocated to deals that are on balance sheet, in such cases the sponsor department is required to allocate capital budget to cover the impact of the project on the fiscal position.

Making a balance sheet determination

25 The way PFI transactions are accounted for has changed over time. This section sets out a brief history and approach to accounting for PFI in financial statements and the National Accounts.

Prior to 1 April 2009 – approach based on Generally Accepted Accounting Principles as applied in the UK

26 Since 1998, the key standard for assessing PFI and similar transactions under Generally Accepted Accounting Principles as applied in the UK is **Application Note F: Accounting for PFI and similar transactions, to Financial Reporting Standard 5: Reporting the substance of transactions.**[3]

27 Application Note F takes a "risks and rewards" based approach to determining whether a reporting entity should show the newly created assets on its balance sheet and formed the basis of the accounting in the public sector prior to 1 April 2009. In order to make the balance sheet determination, Application Note F seeks to identify which party is subject to the majority of the potential variations in property related profits or losses. Under the standard, the party that has access to the majority of the risks and rewards should report the asset on its balance sheet.

2 Guidance from Department for Communities and Local Government can be found here http://www.local.communities.gov.uk/pfi/sg0809.pdf.
3 http://www.frc.org.uk/asb/technical/standards/pub0100.html

28 The key indicators of risk and reward are identified in the standard, and can be allocated to the parties to the transaction based on the specific characteristics of the project to provide an indication of which party should report the asset on its balance sheet. The standard is clear that the determination should be based on the specific characteristics of the transactions and that those risks likely as having the biggest impact on the distribution of potential risks and rewards should be given greatest weighting in reaching a conclusion and requires that the financing arrangements be examined to see whether they are aligned to the analysis of the risk and reward. The key risk factors under Application Note F are generally seen to be demand and residual value risk.

29 In June 1999, HM Treasury PFI Taskforce issued revised guidance on accounting for PFI by public sector entities in PFI **Technical Note 1: How to Account for PFI Transactions (revised).**[4] Commonly, this guidance is termed the Treasury Taskforce Technical Note 1, and was issued with the aim of providing additional guidance on the application of Application Note F by the public sector to improve consistency of reporting across the public sector.

30 The objective of Technical Note 1 is stated as being:

> "… to provide additional practical guidance for certain public sector bodies (see paragraph 1.7) on the following areas of the Application Note to ensure the over-arching principles of the Application Note are consistently applied"

31 Technical Note 1 was mandatory for those entities that prepared their accounts under the Financial Reporting Manual, Non-departmental Public Bodies, Trading Funds, NHS Trusts, and those Public Corporations that prepared their accounts under a direction issued by their sponsor entity. Although not mandatory in local government, the Statement Of Recognised Practice required local authorities to consider the provisions of Technical Note 1 as a guide to applying the principles that underpin the Statement Of Recognised Practice.

32 There are essentially three key sets of guidance contained within Technical Note 1.

- Firstly, Technical Note 1 provides specific guidance on determining whether a transaction should be within the scope of the guidance or not; that is whether the contract should be assessed as a contract for (asset rich) services in line with Application Note F, or whether the transaction should be viewed as a, more simple, lease transaction (in which case Generally Accepted Accounting Principles as applied in the UK lease accounting standards should be applied).

- Secondly, Technical Note 1 requires that the procuring authority consider the nature and quantum of finance provided by the private sector that is actually at risk to the performance of the project. Should it be the case that there is insufficient finance at risk to the performance of the project, or the public sector provides guarantees that senior debt will be repaid in all scenarios, Technical Note 1 states that this would be seen as an indicator of the assets underlying the project as being on the public sector balance sheet.

4 http://www.hm-treasury.gov.uk/d/PPP_TTF_Technote 1.pdf

- Thirdly, Technical Note 1 provides additional guidance, where a narrative assessment of the risks does not provide a clear indication of which party holds the majority of the potential property related risks and rewards, on the statistical quantification of the distribution of potential risks and rewards in the project.

33 It is this quantification of risks that proved the most contentious aspect of Technical Note 1. Commonly, Monte Carlo, or other statistical analysis was used under Technical Note 1 to determine the distribution of potential variations in property related cash-flows. These statistical analyses were based on management's assessment of the likely potential variations in the project cash-flows. In effect, this allows the significance to the analysis of certain risks, including demand and residual value to be reduced on the grounds that the potential variations in profits or losses associated with these risks would be expected to be small.

34 **Figure 2** sets out the risks listed in Technical Note 1 and provides an indication of the typical risk allocation for a generic accommodation PFI transaction.

Figure 2
Typical risk allocation for a generic accommodation PFI transaction

Risk	Council	Operator
Availability and performance risk		●
Inflation risk		●
Design risk		
Failure against initial requirements		●
Change in law	●	●
Latent defects		●
Variation in maintenance and works costs		●
Obsolescence and technology risk	De minimis	De minimis
Third party revenue		●
Demand risk	●	
Residual value risk	●	

NOTE
1 Whilst the table identifies that for a typical PFI transaction the risks of demand and residual value rest with the public sector, this does not necessarily preclude an off balance sheet determination, as the quantification of these risks may lead to the reduction in their significance on the grounds that the potential variations in profits or losses associated with these risks would be expected to be small.

Source: Deloitte LLP

Prior to 1 April 2009 – approach in the National Accounts

35 When considering the impact on the National Accounts, it should be noted that the standards that underpin the National Accounts, the European System of Accounts 1995, are distinct from those that underpin the production of public sector financial statements. However, the application of Generally Accepted Accounting Principles as applied in the UK in the public sector was previously seen to align with the general approach set out in the European System of Accounts 1995, including the specific Eurostat guidance for PFI issued in the Manual on Government Deficit and Debt. As a result, the Office for National Statistics have historically, prior to 1 April 2009, used the accounting determination based on Generally Accepted Accounting Principles as applied in the UK reached under Financial Reporting Standard 5 and Technical Note 1 in assessing whether the assets that underlie a PFI deal should be reported with the Public Sector Finance statistics.

Post 1 April 2009 – approach based on International Financial Reporting Standards

36 As set out in Box 1, the public sector is in the process of transitioning to International Financial Reporting Standards. The International Financial Reporting Interpretations Committee issued their **Interpretation 12: Service Concession Arrangements**[5], to provide guidance to the private sector partner, termed the operator, of service concessions. Interpretation 12 explicitly states that is applicable only to the Operator and provides advice on certain aspects of the recognition and timing of transactions and assets, mainly with reference to other accounting standards.

37 Interpretation 12 does not take a risks and rewards based approach. Rather, the key issues are deciding whether the transaction meets the definition of a service concession and whether the public sector procuring authority (termed the grantor) controls the asset within the meaning of the interpretation. Where these criteria are met then the private sector does not recognise the tangible fixed asset on its balance sheet as property, plant and equipment.

38 Under Interpretation 12, the grantor is deemed to control the asset where both the following criteria are satisfied:

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

Note that, where point (a) is satisfied, infrastructure that is used in a service concession for its entire useful life is within the scope of the guidance, that is criteria (b) is deemed to be met where the asset is exhausted over the life of the service concession.

5 *International Financing Reporting Standards*, International Accounting Standards Board.

39 Interpretation 12 is clear that it does not directly apply to the public sector. Accordingly, HM Treasury issued guidance for central government and health sector procuring authorities in the 2009-10 Financial Reporting Manual that mirrors the application of Interpretation 12 in the private sector, that is it states that where the transaction falls within the scope of Interpretation 12, that is the public sector is viewed as controlling the assets such that the Operator should not recognise an asset of the property, then the public sector should account for the underlying tangible fixed asset on its balance sheet in its financial statements.

40 Should a transaction fall outside the scope of Interpretation 12, due to one or both of the control criteria not being met, then Interpretation 12 requires that the transaction be assessed to see whether it contains a lease or not under the provisions of **Interpretation 4: Determining whether an arrangement contains a lease**[6]**.** Interpretation 4 states that where access is granted to a specified asset in return for a stream of payments then the transaction contains a lease. Where an arrangement contains a lease then it is necessary to assess that lease arrangement under the provisions of **International Accounting Standard 17: Leases**[7], in order to determine whether the lease is classified as an operating lease or a finance lease. **Figure 3** shows a flowchart extracted from the Financial Reporting Manual. When considering International Accounting Standard 17, it is noted that it takes a risks and rewards based approach to determining whether a lease is an operating or finance lease focusing on the asset only aspect of the transaction, that is any services are separated from the transaction and an assessment is made as to which party to the transaction is exposed to the majority of the risks and rewards associated with the underlying asset.

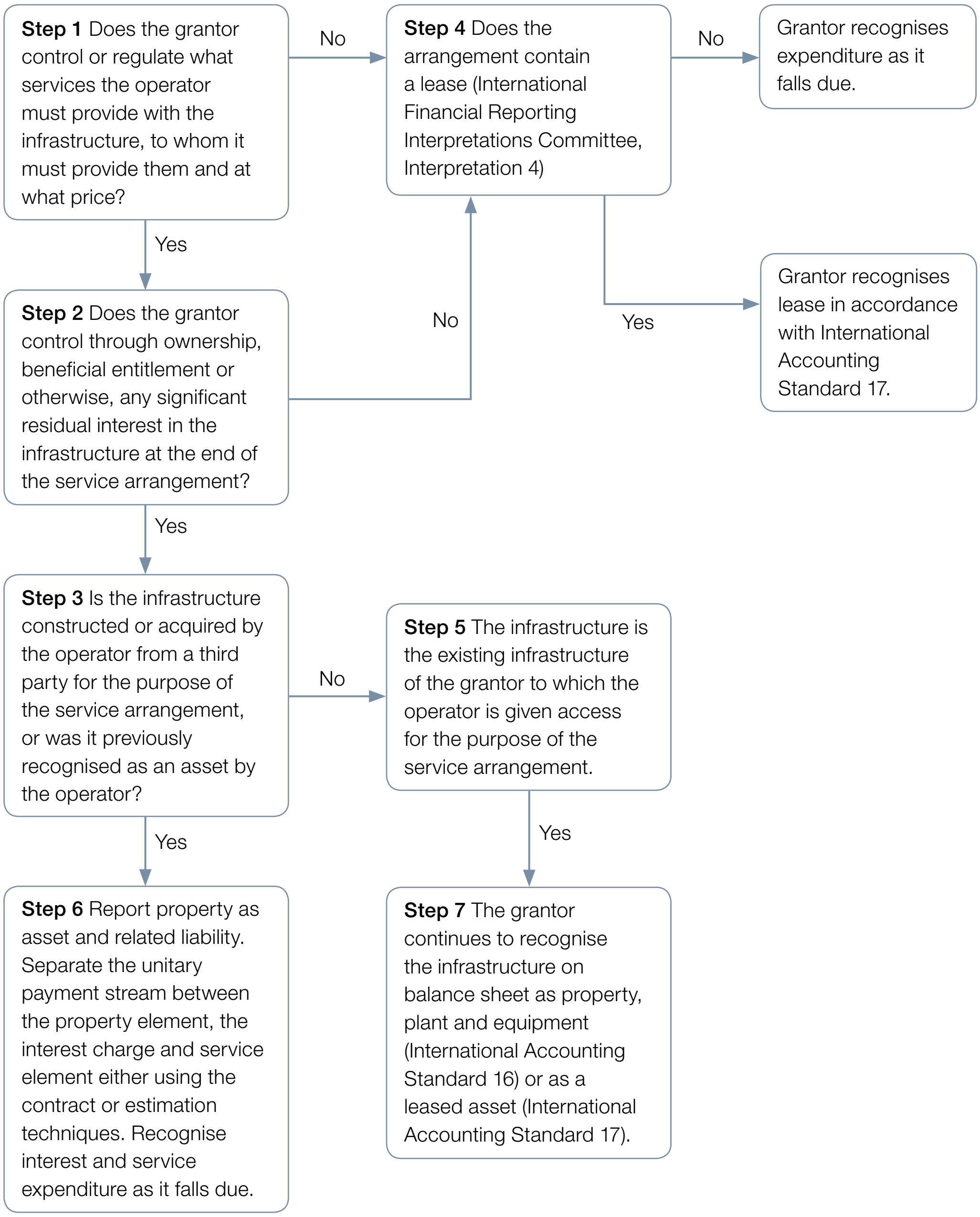
Post 1 April 2009 – approach in the National Accounts

41 Post the introduction of International Financial Reporting Standards the Office for National Statistics has stated that they can no longer use the accounting determination reached for the purposes of the production of individual public sector financial statements to assess the treatment in the National Accounts. This is on the basis that, in contrast to the approach based on Generally Accepted Accounting Principles as applied in the UK, the control based approach required under International Financial Reporting Standards is not deemed by the Office for National Statistics to be consistent with the principles that underpin the production of the National Accounts or the specific Eurostat guidance on PFI transactions contained in the Manual on Government Deficit and Debt.

42 When considering the Manual on Government Deficit and Debt approach, it is noted that the manual's guidance provides some simplified tests that aim to understand the allocation of the risks and rewards in the project with reference to three primary indicators. Where the private sector carries construction and one of either demand or availability risk then, in the absence of any complicating factors, the public sector should not account for the assets on its balance sheet for the purposes of national accounts.

6 *International Financial Reporting Standards.*
7 *International Financial Reporting Standards.*

Figure 3
HM Treasury Guidance Decision Tree



Source: Treasury Financial Reporting Manual

43 In a letter to HM Treasury dated 5 October 2007, the Office for National Statistics confirmed that the control based approach required under Interpretation 12 is not consistent with the risk and reward based approach required under the standards set out in the European System of Accounts 1995 and other guidance. The effect of this is that the Office for National Statistics is no longer able to rely on the determination in the financial statements when compiling the National Accounts and dual reporting will be required where the results of an analysis under Interpretation 12 are different to the results under an analysis performed for the purposes of national accounts.

44 HM Treasury has confirmed that the budgeting treatment will now follow the treatment in the National Accounts, i.e. the impact on the departmental resource and capital budget will not be based on the Interpretation 12 determination but rather based on an application of the Manual on Government Deficit and Debt balance sheet tests.

45 When considering those tests that have historically been applied (i.e. Technical Note 1 and Application Note F), and those which continue to be applied post 1 April 2009 (i.e. Manual on Government Deficit and Debt and Interpretation 12), it is possible to identify differing 'hurdles' to achieving an off balance sheet determination. **Figure 4** summarises the key tests and demonstrates the increasing hurdles to achieving an off balance sheet determination implied by the tests.

Figure 4
Hurdles to achieving off balance sheet (i.e. revenue not capital budget)

Eurostat – European System of Accounts 1995

Risk

Under the European System of Accounts 1995, underlying assets and liabilities do add to Public Sector Net Investment, Public Sector Net Borrowing or Public Sector Net Debt where the private sector bears construction risk plus one of either availability risk or demand risk.

Treasury Task Force Technical Note 1

Risk

Detailed description of risks and defined approach to performing the analysis.

Quantitative analysis used to consider the distribution of potential variations in property related cash-flows, which can lead to minimisation of demand and residual value risk.

Potentially, different conclusion to Application Note F.

Financial Reporting Standard 5 Application Note F

Risk

Substance-based approach.

No requirement for quantitative modelling.

Considers total quantum of demand and residual value risk.

Financial Reporting Manual based on International Standards – Interpretation 12

Control

Assets and liabilities recognised on the public sector balance sheet where public sector is judged to:

- Control how the asset is used and the residual interest, where this is significant; or
- Control how the asset is used and the residual interest is not deemed significant.

Potential to provide a different answer to Application Note F.

Source: Deloitte

Application of PFI in the housing sector

46 In the housing sector, PFI offers an alternative to conventional procurement, stock transfer or social housing grant, for the provision or investment in social housing. Projects best suited to the PFI method of procurement are those with a capital-intensive element and a service provision element, both of which will be paid for by local authorities under a long-term contract (typically 25-30 years). PFI housing projects have the potential to, in theory, differ from those in other sectors, as there is generally a significant residual value that the private sector could be encouraged to hold, so passing more risks associated with the project, both during and at the end of the contract, to the private sector.

47 When considering how to account for housing schemes, it is the substance of the transaction or delivery model that needs to be considered. Generally, housing PFI schemes fall into one of two categories:

- Council housing projects, also known as Housing Revenue Account projects (see **Box 3** overleaf for an explanation of the Housing Revenue Account): these are commonly the provision or refurbishment of (and/or the demolition and re-provision of) local authority owned general housing stock.
- The provision of new build or newly converted stock for non-council social housing, often together with the provision of social care services to different tenant groups, for example those requiring residential care, and typically delivered by the private sector.

48 For council housing PFI schemes, in practice there has been a limited transfer of demand risk and residual value risk to the private sector. Generally, the properties remain in the ownership of the local authority both during and after the contract, and the tenants remain tenants of the authority, who sets and retains the rents. The private sector will be responsible for capital works and on-going maintenance. Unitary payments made by authorities to operators will cover all refurbishment, construction, financing, operating costs and an appropriate return.

49 Under a Technical Note 1 analysis based on Generally Accepted Accounting Principles as applied in the UK, many council housing PFI deals are accounted for as being off the authority’s balance sheet, notwithstanding the limited appetite of authorities to transfer demand and/or residual value risk.

Box 3
Overview of the Housing Revenue Account ("HRA")

All local housing authorities are required to keep a Housing Revenue Account as a record of expenditure and income relating to their own housing stock. Items that may be credited or debited to the Housing Revenue Account are prescribed by statute. It is not a separate account but a ring-fenced account of certain defined transactions, relating to local authority housing, within the authority's General Fund. This ring-fencing serves to ensure that rents paid by the local authority appropriately reflect the actual cost of providing the housing service, thus rent levels can not be subsidised by increases in council tax.

Main items of expenditure included in the account are loan finance charges, depreciation, and management and maintenance costs. The primary items of income are rents from tenants and the Housing Revenue Account subsidy from central government. The Housing Revenue Account subsidy is calculated with reference to a notional Housing Revenue Account, i.e. a model of each authority's Housing Revenue Account, and subsidy is payable to meet the difference between income and expenditure on the notional Housing Revenue Account amounts.

Included within the subsidy paid is the Major Repairs Allowance, which provides authorities with resources necessary to maintain the service capability of their housing stock. Authorities are required to transfer a sum equal to the Major Repairs Allowance into a Major Repairs Reserve, which ensures funds are available to authorities to finance capital expenditure on Housing Revenue Account assets and repay borrowings and certain liabilities incurred under credit arrangements. Any unspent Major Repairs Allowance funds can be carried over from one year to the next, and the Housing Revenue Account may also benefit from any short-term investment of unspent funds.

Authorities in overall negative subsidy entitlement, i.e. where the Housing Revenue Account is in surplus, are required to transfer the negative subsidy to the Secretary of State, where it will be used as part of the subsidy pool. This pooling of Housing Revenue Account surpluses is therefore a mechanism to ensure that authorities that are able to generate surplus rental income contribute towards meeting the costs of authorities unable to generate sufficient income to cover costs.

Source: Deloitte LLP

50 Non-council social housing differs. Generally the operator, a registered provider (usually a housing association) who is outside the public sector, owns the properties during and after the contract, and will set, collect and retain the rents, and thereby be exposed to demand risk and residual value risk. Again, under a Technical Note 1 analysis based on Generally Accepted Accounting Principles as applied in the UK, the majority of non-council social housing PFI deals are accounted for as being off the authority's balance sheet on the grounds that the majority of the risks and rewards are judged to lie with the private sector. Indeed, compared to council housing transactions more risk sits with the private sector.

51 The typical allocation of risks for both types of deal are illustrated in **Figure 5**.

52 Note that for council housing the key risks of demand and residual value rest with the public sector. However, under the Technical Note 1 guidance these deals were assessed as being off balance sheet following an analysis of the distribution of potential variations in property related profits or losses between the public and private sectors.

53 With the adoption of International Accounting Standards, the consideration of a PFI housing project's risk profile will no longer be considered for the purposes of local government accounting. Determination of the accounting treatment will focus on the control based tests for the purposes of an authority's financial statements, which will provide a higher hurdle to off balance sheet treatment given that many deals are structured to allow, for example, the authority the right to nominate tenants and control the residual interest in the properties. This makes it very difficult to achieve an off balance sheet assessment for council housing post the introduction of International Financial Reporting Standards.

54 For non-council social housing it is likely that the residual interest can be proven to lie with the private sector partner, such that an assessment of the risks shared between the parties need to be considered.

Figure 5
Typical allocation of risks in PFI housing deals

Risk	PFI council housing		PFI non-council social housing	
	Public Sector	Operator	Public Sector	Operator
Demand risk	●			●
Third-party revenue	●			●
Who determines the nature of the property (design risk)	●		●	
Availability and performance risk		●		●
Potential changes in relevant costs (inflation costs)		●		●
Obsolescence and technology risk	●		●	
Residual value risk	●			●

Source: Deloitte LLP

Other housing models

Arms Length Management Organisation

55 The establishment of an Arms Length Management Organisation as a separate legal entity to deliver the investment in social housing in order to meet the Decent Homes Standard is an extension to the Housing Revenue Account model described in Box 3.

56 Key features of an Arms Length Management Organisation are:

a ownership of the housing stock remains with the local authority;

b the local authority remains the legal landlord;

c tenants remain tenants of the local authority and there is no change in their rights, for example the right to buy; and

d an arms length body may manage all or part of a local authority's housing stock.

57 The key point to note with an Arms Length Management Organisation is that that stock remains in legal ownership of the local authority, and so on the public sector balance sheet. This means that any improvements to the stock need to be assessed to see whether they should be accounted for as improvements to the authority's assets.

Large Scale Voluntary Transfer

58 Large Scale Voluntary Transfers provide an alternative to PFI or other refurbishment projects for local authorities. As housing associations are classified as the private sector they are able to borrow without the constraints imposed on local authorities. This means that the housing association can raise finance to quickly improve standards by enabling a programme of catch-up repairs and improved ongoing maintenance.

59 Typically, only Housing Revenue Account assets are transferred to the housing association, with any debt associated with those assets retained by the local authority. This overhanging debt is then paid for by the Department for Communities and Local Government post transfer through an on-going grant stream. Receipts, if any, from the transfer may be used by the local authority for capital purposes or set aside voluntarily, as additional provision for credit liabilities.

Other support to housing associations

60 Local authorities may support housing associations financially through the provision of grant finance, termed social housing grant. Social housing grant is generally available for capital projects such as new build or refurbishment. Typically, this enables the housing associations to borrow less than the cost of the capital works, which in turn enables the housing association to offer lower rents as a function of needing to support lower borrowings than would otherwise be the case. Social housing grant for capital purposes will count against a local authority's capital budget.

Joint Venture Models

61 Public private partnerships that involve the creation of a jointly controlled entity represent an alternative to the fully public sector Housing Revenue Account model and the private sector model discussed above. The level of control that the local authority has over an entity will determine how this relationship is accounted for under International Financial Reporting Standards. **International Accounting Standard 31: Joint venture arrangements**[8], defines joint control as being a contractually agreed sharing of control, which only exists where the strategic financial and operating decisions require the unanimous consent of the parties.

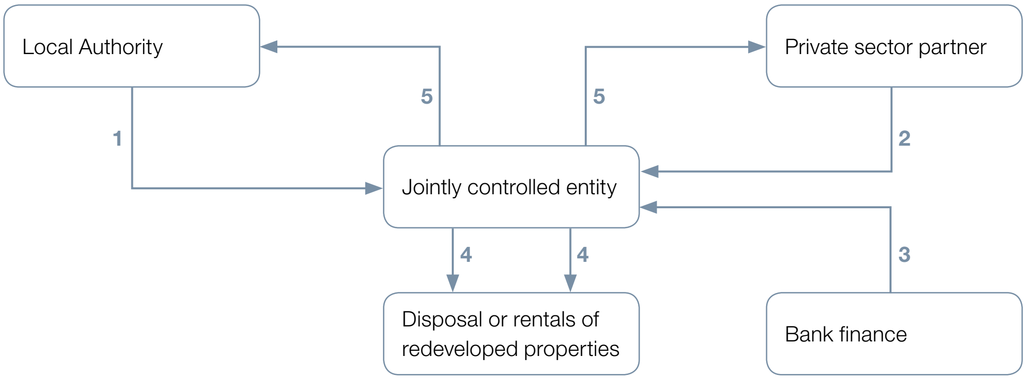
62 Typically, a local authority joint venture project would involve the local authority making available land and the private sector partner providing an equivalent amount of cash (**Figure 6** overleaf). In return both parties receive an interest in the new entity. The entity may then borrow from the private sector and use the cash proceeds to develop the land, potentially into social housing. Any profits generated by the jointly controlled entity are then split equally between the partners.

63 In local authority accounts, interests in jointly controlled entities are accounted for under what is termed the equity method, whereby the investment is initially recognised at cost (the value of the assets subscribed) and adjusted thereafter for the post-acquisition change in the authority's share of net assets of the jointly controlled entity. The effect of this is that the gross liabilities of the entity are not recognised on the authority's balance sheet. The authority will also account for its share of the profit or loss of the jointly controlled entity.

64 The decision about whether an entity belongs to the public or private sector for the purposes of National Accounts is based on an assessment of "control of general corporate policy". Where the Office for National Statistics determines that the local authority has control over an entity, then the entity is considered public sector and thus all its assets, liabilities and transactions affect the Public Sector Finance statistics, and hence HM Treasury's performance against the fiscal position. However, where joint control can be demonstrated, then the entity may not be classified within public sector.

8 *International Financial Reporting Standards.*

Figure 6
Example jointly controlled entity



Steps

1 Contribution of assets by local authority in return for interest in the partnership.

2 Cash paid into jointly controlled entity by the private sector partner in return for an equal interest in the partnership.

3 External finance raised.

4 Jointly controlled entity disposes of redeveloped properties or rents those properties out.

5 Returns generated by jointly controlled entity (above those required to service external debt) transferred to partners.

The following would be recognised in the consolidated financial statements of the local authority with respect to the jointly controlled entity:

- income and expenditure account shows 50 per cent of operating profit/loss and interest receivable and payable of the jointly controlled entity; and
- balance sheet shows 50 per cent of the net assets of the jointly controlled entity.

Source: Deloitte LLP