New South Wales

TREASURY

ACCOUNTING POLICY

ACCOUNTING FOR PRIVATELY FINANCED PROJECTS

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PREFACE

This accounting policy provides guidance for public sector entities for accounting for Privately Financed Projects (PFPs). Such projects are often complex and may not fall within the scope of existing Australian accounting standards.

The aim of the policy is to ensure a consistent approach to accounting for PFPs across the NSW public sector.

This policy adopts the requirements of Application Note F *Private Finance Initiative and Similar Contracts* issued in 1998 by the United Kingdom Accounting Standards Board as an amendment to its Financial Reporting Standard 5 *Reporting the Substance of Transactions*.

The policy also provides guidance on matters not specifically covered by Application Note F:

- Up-front contributions
- The residual interest in the infrastructure
- Associated leases of land.

This policy is applicable to all NSW public sector entities (including statutory State owned corporations) for financial years beginning on or after 1 July 2005.

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CONTENTS

EXECUTIVE SUMMARY

A Privately Financed Project (PFP) is a contractual arrangement under which the private sector is responsible for supplying and operating infrastructure that traditionally would have been provided by the public sector. Under a PFP a public sector entity (the concession provider, termed in this paper 'the purchaser') arranges for the private sector (the operator) to provide the infrastructure and associated services for an agreed period (the concession period).

It is integral to most PFPs that the private sector operator designs, builds, finances and operates infrastructure in order to provide the contracted service. Examples of such infrastructure include roads, railway stations, hospitals, water treatment plants, prisons and car parks.

Service provision models range from private sector control (eg toll roads), where the private sector builds, owns and operates the infrastructure asset, to a model in which the private sector builds and supplies the asset and public sector specialists operate the service, eg schools operated by the public sector.

This policy provides guidance to aid in analysing whether the public sector purchaser or the private sector operator has an asset of the infrastructure that is the subject of the PFP.

Where a PFP contract can be separated into elements that operate independently of each other, and where some of those elements relate only to services rather than the infrastructure, any such service elements are excluded from the analysis as they are not relevant to determining which party has an asset of the infrastructure.

Once any separable service elements have been excluded, PFPs can be classed into those where the only remaining elements are payments for the infrastructure and those where the remaining elements include some services. Where the only remaining elements are payments by the public sector purchaser for the infrastructure, the PFP should be accounted for as a lease in accordance with Accounting Standard AASB 117 *Leases*. Where the remaining elements include some payments for services, the PFP should be accounted for in accordance with this policy as set out below.

For those PFPs that fall directly within this policy, the question of which party should recognise the infrastructure as its asset should be determined by considering which party has the majority of the risks and benefits in relation to the infrastructure.

Depending on the particular circumstances, a range of factors may be relevant to this assessment. The principal factors to be considered, where relevant, are:

- demand risk
- the presence, if any, of third-party revenues
- who determines the nature of the property
- penalties for underperformance or non-availability
- potential changes in relevant costs
- obsolescence, including the effects of changes in technology
- the arrangements at the end of the contract and residual value risk.

Where it is concluded that the public sector purchaser has an asset of the property and a liability to pay for it, these should be recognised in its balance sheet.

Where it is concluded that the public sector purchaser does not have an asset of the property, there may be other assets or liabilities that require recognition. These can arise in respect of up-front contributions, the residual interest in the infrastructure, and associated leases of land.

In relation to up-front contributions, the accounting treatment depends on whether the contributions give rise to future benefits for the purchaser. If they do, they should be deferred and recognised in the operating statement progressively over the period of the benefits. If they do not, they should be recognised in the operating statement immediately.

In relation to the residual interest in the infrastructure, the accounting treatment depends on the amount at which the infrastructure will transfer to the purchaser at the end of the PFP. Where the contract specifies the amount (including zero) at which the property will be transferred to the purchaser at the end of the contract, any difference between that amount and the expected fair value of the residual estimated at the start of the contract should be recognised progressively over the term of the contract. Conversely, where all or part of the property will pass to the purchaser at the end of the contract at its then market value, no accounting is required until the date of transfer as this represents future capital expenditure for the purchaser.

Any land leased by the purchaser to the operator as part of the PFP should be accounted for as an operating lease in accordance with Accounting Standard AASB 117 *Leases*.

1 INTRODUCTION

1.1 BACKGROUND

A Privately Financed Project (PFP) is a contractual arrangement under which the Government grants a concession to the private sector to supply and operate economic or social infrastructure that would traditionally have been acquired and operated by the public sector. Examples include toll roads, railway stations, hospitals, water treatment plants, prisons, and car parks[1].

Under a PFP, a public sector entity (the purchaser) arranges for a private sector entity (the operator) to provide the infrastructure and associated services for an agreed period (the concession period).

It is integral to most PFPs that the private sector operator designs, finances, builds and operates the infrastructure needed to provide the contracted service for the concession period. PFPs typically include both a capital component and a continuing service delivery component. They are generally complex and involve high capital costs, lengthy contract periods that create long-term obligations, and a sharing of risks between private and public sectors[2].

PFPs can take various forms, including Build, Own, Operate (BOO); Build, Own, Operate, Transfer (BOOT); and Build, Operate, Transfer (BOT). They are sometimes called Public Private Partnerships (PPPs)[3] or Service Concession Arrangements[4] or referred to as Private Provision of Public Infrastructure (PPPI).

Accounting for PFPs has not been specifically dealt with in Australian accounting standards. Some PFPs fall within the scope of Accounting Standard AASB 117 *Leases* but many do not. In the absence of specific authoritative guidance, diverse or unacceptable practices may occur or develop in accounting for PFPs. This will undermine the relevance and reliability of general purpose financial reports.

This Policy is therefore issued to provide guidance for NSW Public Sector entities in accounting for PFPs.

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1 *Working with Government, Private Financing of Infrastructure and Certain Government Services in NSW*, NSW Government Green Paper, November 2000, p 9

2 *Working With Government, Guidelines for Privately Financed Projects*, NSW Government White Paper, November 2001, p iv

3 *Working With Government, Guidelines for Privately Financed Projects*, NSW Government White Paper, November 2001, p 2

4 Urgent Issues Group Interpretation 129 *Disclosure – Service Concession Arrangements*

1.2 PRINCIPAL ACCOUNTING ISSUES

The principal accounting issues relating to PFPs are:

(a) Does the PFP fall within the scope of Accounting Standard AASB 117 *Leases*?

(b) Where the PFP does not fall within the scope of AASB 117, which entity, the public sector purchaser or private sector operator, should recognise the infrastructure as an asset?

(c) How should any up-front contributions made by either the purchaser or the operator be treated?

(d) How should the residual interest in the infrastructure at the end of the concession period be treated?

(e) How should any land leased by the operator from the purchaser be treated?

1.3 APPLICATION

This Policy is issued as a Treasurer's Direction under section 9 and section 45E of the *Public Finance and Audit Act 1983* and therefore applies to entities that are required to prepare general purpose financial reports under the Act. The Policy is also mandatory for statutory State owned corporations. A specific reference to the Policy will be included in the Statements of Corporate Intent of those entities.

This Policy applies to financial years beginning on or after 1 July 2005.

2 MANDATING OF UNITED KINGDOM ACCOUNTING STANDARD

2.1 ADOPTION OF APPLICATION NOTE F

Paragraph 21 of Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides, inter alia, that in the absence of an Australian Accounting Standard that specifically applies to a transaction, other event or condition, an entity may, in certain circumstances, apply an accounting policy from the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards.

The United Kingdom Accounting Standards Board (ASB) has issued an authoritative pronouncement that deals with the accounting for PFPs.

The ASB's Financial Reporting Standard 5 *Reporting the Substance of Transactions* (FRS 5) requires a reporting entity's financial statements to report the substance of the transactions into which it has entered rather than merely their legal form. FRS 5 includes Application Notes that specify how the requirements of the standard are to be applied to transactions that have certain features.

Application Note F *Private Finance Initiative and Similar Contracts*, issued in September 1998, deals specifically with accounting for transactions resulting from the United Kingdom Government's Private Finance Initiative (PFI) and other contracts of a similar nature. As PFPs are similar in nature to the contracts resulting from the Private Finance Initiative, Application Note F can be applied.

This Policy mandates the use of Application Note F *Private Finance Initiative and Similar Contracts* contained in the United Kingdom Accounting Standards Board's Financial Reporting Standard 5 *Reporting the Substance of Transaction*, by NSW public sector entities when accounting for Privately Financed Projects (PFPs).

Application Note F is set out in Appendix 1 and discussed below.

The terminology in Application Note F will need to be modified where necessary to enable it to apply in Australia. References to the Private Finance Initiative (PFI) should be read as references to PFPs; references to property should be read as references to infrastructure, references to SSAP 21 *Accounting for leases and hire purchase contracts* should be read as references to Accounting Standard AASB 117 *Leases*; and general references to FRS 5 *Reporting the Substance of Transactions* should be read as general references to current Australian accounting standards.

Application Note F and Financial Reporting Standard FRS 5 are also available at www.frc.org.uk/asb/technical/standards/pub0100.html. Application Note F is the only part of FRS 5 that is relevant to this Policy

2.2 SUMMARY OF THE REQUIREMENTS OF APPLICATION NOTE F

Based on the requirements of Application Note F, the principles to be followed in determining the appropriate accounting for PFPs are as follows:

1. Where a PFP can be separated into elements that operate independently of each other, and where some of those elements relate only to services rather than the infrastructure, ignore any such service elements as they are not relevant to determining whether each party has an asset of the infrastructure.

2. Once any such separable service elements have been excluded, determine whether all of the remaining elements of the PFP are payments for the infrastructure (in which case they are akin to a lease and can be dealt with under Accounting Standard AASB 117 *Leases*) or whether they include some services (in which case they need to be analysed further).

3. Where the remaining elements do not fall wholly within the scope of AASB 117, analyse them to determine, on the basis of which entity has the majority of the risks and benefits, whether the purchaser or operator should recognise the infrastructure as an asset.

4. In determining the accounting treatment, give greater weight to those features that are more likely to have a commercial effect in practice.

5. In analysing the remaining elements, consider such factors as:
    - demand risk
    - the presence, if any, of third-party revenues
    - who determines the nature of the property
    - penalties for underperformance or non-availability
    - potential changes in relevant costs
    - obsolescence, including the effects of changes in technology
    - the arrangements at the end of the contract and residual value risk.

These principles are discussed in greater detail in Application Note F which is attached here as Appendix 1.

Where it is concluded from the analysis that the public sector purchaser has an asset of the infrastructure and a liability to pay for it, record these in its balance sheet.

Where it is concluded that the public sector purchaser does not have an asset of the property, there may nevertheless be other assets or liabilities that require recognition. These can arise in respect of up-front contributions, the residual interest in the infrastructure at the end of the concession period, and other obligations of the purchaser.

Detailed guidance on applying the requirements of Application Note F to Australian PFPs has been prepared by a working party established under the sponsorship of the Heads of Treasuries (HoTs) of Australian Governments and issued in June 2005. This document builds on Technical Note No 1 *How to Account for PFI Transactions*, issued by the United Kingdom Treasury Task Force in relation to Application Note F. These documents are available on the NSW Treasury website together with this paper.

3 ADDITIONAL GUIDANCE

Although Application Note F deals with most of the relevant aspects of PFPs, there are three matters where additional guidance is required:

(a) up-front contributions
(b) the residual interest in the infrastructure
(c) associated leases of land.

3.1 UP-FRONT CONTRIBUTIONS

Some PFPs involve an initial contribution of assets by one party.

Application Note F indicates that contributions to a PFP by the purchaser may take a number of forms, including an up-front cash payment or the contribution of existing assets for development by the operator and that the accounting treatment of such contributions depends on whether they give rise to future benefits for the purchaser.

If the contribution of property by the purchaser results in lower service payments, the carrying amount of the contributed property should be reclassified as a prepayment and subsequently charged as an operating cost over the period of the reduced payments. If the contribution does not give rise to a future benefit for the purchaser, it should be charged as an expense when the contribution is made. For example, a capital grant might be given for which the operator would have qualified even if the transaction had not been part of the PFP, or short-life assets might be donated for no value. However, because PFPs represent a fair value exchange, it is unlikely that an up-front payment would be a grant.

Although Application Note F only deals with contributions by the purchaser to the operator, the same principles equally apply to contributions by the operator to the purchaser. This acknowledges that PFPs represent a fair value exchange and that all payments or other contributions ***by either party***, either initially or over time, are part of the agreed exchange 'price'.

This principle is supported by analogous or otherwise relevant pronouncements:

- Accounting Standard AASB 117 *Leases* requires operating lease payments or income to be recognised as an expense or income on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the benefits arising from the leased asset (paragraphs 33 and 50).

- UIG Interpretation 115 *Operating Leases – Incentives* requires lease incentives under operating leases to be recognised, by both lessors and lessees, as a reduction of rental income or rental expense (respectively) over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the benefits arising from the leased asset (paragraphs 4 and 5).

- The Appendix accompanying Accounting Standard AASB 118 *Revenue* notes that franchise fee revenue in relation to the use of continuing rights is recognised as the rights are used (paragraph 18(c)) and that licence fee and royalty revenue is recognised in accordance with the substance of the agreement which, as a practical matter, may be on a straight-line basis over the life of the agreement (paragraph 20).

- UIG Interpretation 127 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* requires a linked series of transactions involving the legal form of a lease to be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole (paragraph 3).

Therefore this policy requires that where an up-front contribution, that is in substance part of a PFP, is made by one party to another, the contribution should be recognised progressively over the period of the reduced payments (ie the concession period), regardless of whether the contributor is the purchaser or the operator.

A public sector purchaser should initially treat up-front cash contributions ***from*** a private sector operator as unearned income (a liability) and subsequently recognise them progressively as income over the concession period.

A public sector purchaser should initially treat up-front cash contributions ***to*** a private sector operator as a prepayment (an asset) and subsequently recognise them progressively as an expense over the concession period.

3.2 THE RESIDUAL INTEREST IN THE INFRASTRUCTURE

Many PFPs provide for the infrastructure to transfer to the public sector purchaser at the end of the concession period for its then market value or for a nominal sum (including zero).

Where the transfer is to take place at market value, no accounting is required until the date of transfer as this represents future capital expenditure for the purchaser.

Where the purchaser has a right to receive the infrastructure at a nominal sum (including zero), the right represents consideration receivable by the Government in exchange for its granting a concession to the operator as part of the PFP. The right is an asset of the Government as it represents future economic benefits.

Application Note F requires the difference between

(i) the contractually-specified amount (including zero) at which the property will be transferred to the purchaser at the end of the contract and

(ii) the expected fair value of the residual estimated at the start of the contract,

to be built up over the life of the contract (see paragraph F56).

In other words, the right to receive the infrastructure for a nominal sum (including zero) at the end of the concession period is to be recognised as revenue and an asset whose value emerges during the concession period. The accumulated value of the right at the end of the concession period equates to the written down replacement cost of the infrastructure at that time.

Application Note F does not specify how the emerging interest is to be built up. Therefore, further guidance is needed.

While it might appear that such a right is an intangible asset within the scope of Accounting Standard AASB 138 *Intangible Assets*, that standard cannot practicably be applied to a right that will have a significant, quantifiable value at the end of its useful life and is likely to have an appreciating value in the interim.

It might appear that the right should be treated as a financial instrument within the scope of Accounting Standards AASB 132 *Financial Instruments: Disclosure and Presentation* and AASB 139 *Financial Instruments: Recognition and Measurement*. However, as the receivable is for infrastructure rather than cash it does not meet the definition of a financial asset. Where a nominal payment is required for the infrastructure, a financial liability may arise but it would be immaterial.

The right to receive the infrastructure could be recognised at its present value, which would increase in each year of the concession period until it equated to the written down replacement cost of the infrastructure at the end of the concession period. However, as the right to receive the infrastructure arises in exchange for the concession granted to the operator by the Government, it is part of the 'price' of the arrangement and relates to the entire concession period. Therefore, rather than determining the present value each year, it would be more appropriate to allocate the expected fair value of the right on a systematic basis over the concession period.

A straight line method could be used, thereby allocating an equal portion of the estimated future fair value to each year of the concession period. However, as the right typically has a long life and the value of money is likely to diminish substantially over that period, it would be desirable for the allocation method to correct for that decline. The use of an annuity formula achieves this.

Under an annuity approach, the ultimate value of the right to receive the property is treated as the compound value of an annuity that accumulates as a series of equal annual receipts together with notional compound interest thereon. The discount rate to be used is the NSW government bond rate applicable to the purchaser at the commencement of the concession period.

The annual annuity sum is determined by the formula:

$$\mathbf{a = S_t / CVIF_a}$$

where:

- a is the annual sum
- S_t is the expected value of the infrastructure at the end of the concession period of *t* years
- $CVIF_a$ is the compound value interest factor for an annuity (from tables) for a given discount rate and concession period.

The accumulated value of the right as at any particular year during the concession period can be determined as the compound value of the annuity for that number of years, by using the following formula:

$$\mathbf{S_n = a \times CVIF_a}$$

where:

- S_n is the value of the infrastructure after *n* years of the concession period have elapsed
- a is the annual sum (calculated in the previous formula)
- $CVIF_a$ is the compound value interest factor for an annuity (from tables) for a given discount rate and elapsed portion of the concession period.

This policy requires that a right to receive infrastructure for a nominal sum (including zero) at the end of a Privately Financed Project (PFP) concession period is to be recognised as revenue and an asset whose value emerges during the concession period. The value is to be allocated during the concession period as if it were the compound value of an annuity discounted at the NSW government bond rate applicable to the purchaser at the commencement of the concession period.

The asset may also need to be revalued during the term of the PFP. Accounting Standard AASB 116 *Property, Plant and Equipment* provides an appropriate model for revaluing.

Where, during the concession period, the fair value of the right to receive infrastructure increases or decreases, the movement is to be recognised as a revaluation in accordance with Accounting Standard AASB 116 *Property, Plant and Equipment* as if the right were an item of property to which that standard applied.

3.3 ASSOCIATED LEASES OF LAND

PFPs often involve the public sector purchaser leasing land to a private sector operator, invariably at a nominal rental, for the duration of the concession period.

Application Note F does not specifically address the appropriate treatment of such leases.

Accounting Standard AASB 117 *Leases* states that a characteristic of land is that it normally has an indefinite life and, if title is not expected to pass to the lessee at the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership in which case the lease of land will be an operating lease (paragraph 14).

A land lease in connection with a PFP is normally for a finite term until the end of the concession period and so the private sector operator does not receive substantially all of the risks and rewards of ownership of the land. Therefore the lease should be treated as an operating lease.

A land lease in connection with a Privately Financed Project (PFP) should be treated as an operating lease.

The lessor should measure the leased land at its fair value in accordance with applicable accounting standards and NSW Treasury's accounting policy TPP 05-3 *Valuation of Physical Non-current Assets at Fair Value*. This would normally result in the land being measured in accordance with the revaluation model in Accounting Standard AASB 116 *Property, Plant and Equipment*.

4 REFERENCES

Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*

Accounting Standard AASB 116 *Property, Plant and Equipment*

Accounting Standard AASB 117 *Leases*

Accounting Standard AASB 118 *Revenue*

Accounting Standard AASB 138 *Intangible Assets*

Australian Accounting Standard AAS 29 *Financial Reporting by Government Departments*

Additional Guidance on the Application of FRS 5: Methods to Determine Control of Infrastructure Assets Used in the Australian Public Sector and Recognition of Emerging Assets, Up-Front Contributions and Leased Land, Heads of Treasuries, June 2005 (Available on the NSW Treasury website together with this paper.)

Technical Note No 1 *How to Account for PFI Transactions*, United Kingdom Treasury Task Force. (Available at www.hm-treasury.gov.uk/media/D75/C6/PPP_TTF_Technote1.pdf Available on the NSW Treasury website together with this paper.)

UIG Interpretation 4 *Determining whether an Arrangement contains a Lease*

UIG Interpretation 115 *Operating Leases – Incentives*

UIG Interpretation 127 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

United Kingdom Financial Reporting Standard FRS 5 *Reporting the Substance of Transactions* including Application Note F *Private Finance Initiative and Similar Contracts* (Available at www.frc.org.uk/asb/technical/standards/pub0100.html and reproduced as Appendix 1 to this policy).

5 ACKNOWLEDGEMENT

Application Note F is reproduced with the permission of the United Kingdom Accounting Standards Board whose generosity is gratefully acknowledged.

APPENDIX 1 APPLICATION NOTE F

This Appendix sets out a copy of Application Note F *Private Finance Initiative and Similar Contracts* issued in 1998 by the United Kingdom Accounting Standards Board as an amendment to its Financial Reporting Standard 5 *Reporting the Substance of Transactions*.

APPENDIX

APPLICATION NOTE F - PRIVATE FINANCE INITIATIVE AND SIMILAR CONTRACTS

NB In this Application Note the following terminology is used:

(a) the entity (usually a public sector body) that acquires services under the Private Finance Initiative (PFI) contract is referred to as the 'purchaser'.

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

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

Features

F1 Under a PFI contract, the private sector is responsible for supplying services that traditionally have been provided by the public sector. It is integral to most PFI contracts that the operator designs, builds, finances and operates a property in order to provide the contracted service. Examples of such properties are roads, bridges, hospitals, prisons, offices, information technology systems and educational establishments.

F2 The main features of a PFI contract are as follows:

(a) A contract to provide services is awarded by the purchaser (a public sector entity) to the operator (a private sector entity). The contract will specify the level of service required over the period of the contract.

Usually, the contract also provides for a single ('unitary') payment to be made in each period, linked to factors such as availability, performance and levels of usage.

(b) A property, which is legally owned by or leased to the operator, will usually be necessary to perform the contracted service. Such properties include buildings (eg a prison or hospital), roads, railways, bridges, vehicles, and computer systems. Under the PFI contract, the operator will typically design, build, finance and operate the property. The contract may specify features or standards required of the property, for example, in order to satisfy statutory obligations of the purchaser. The property may or may not have potential for third-party use during the term of the PFI contract.

(c) The PFI contract will specify arrangements for the property at the end of the contract term (which may include various options available to one or both parties). Legal title to the property may pass to the purchaser for a fixed, perhaps nominal, price. Alternatively, or in addition, there may be provision to re-tender the PFI contract for a further term and for the property to pass to the successful new operator. In either of these cases the PFI contract may require the property to be maintained to a minimum standard or to have a stated remaining useful economic life at the end of the contract term. Further possibilities are that the operator retains legal title to the asset at the end of the PFI contract or that the purchaser acquires legal tide to the property for its market value at the time.

(d) As a public sector body, the purchaser is required to demonstrate that the involvement of the private sector offers value for money when compared with alternative ways of providing the services. This is generally achieved by a transfer of risk from the public to the private sector.

F3 Contracts of a similar nature to PFI contracts exist between entitles in the private sector, for example some contracts for warehousing and distribution services, where a property is necessary to perform the contracted service. This Application Note is relevant to such contracts.

Analysis

Overview of basic principles

F4 Present practice is not to capitalise contracts for services. However, where a property is needed to fulfil a contract for services, present practice may require the property to be recognised as the purchaser's asset. (For example, this is the case for some take-or-pay contracts where the operator builds a specialist property with little alternative use.) The purpose of the analysis below is to determine:

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

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

F5 Under the general principles of the FRS, a party will have an asset of the property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits. If that party is the purchaser, it will have a corresponding liability to pay the operator for the property where the commercial effect of the PFI contract is to require the purchaser to pay amounts to the operator that cover the cost of the property.

F6 In some cases the contract may be separable, ie the commercial effect will be that elements of the PFI payments operate independently of each other. 'Operate independently' means that the elements behave differently and can therefore be separately identified. Where this is the case, and where some elements relate only to services (such as cleaning, laundry, catering etc) rather than to the property, any such service elements are not relevant to determining whether each party has an asset of the property and should be ignored. A contract may be separable in various circumstances (see paragraph F10).

F7 Once any separable service elements have been excluded, PFI contracts can be classed into:

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

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

F8 For those contracts that fall directly within the FRS, the question of whether a party has an asset of the property should be determined by looking at the extent to which each party would bear any variations in property profits (or losses). There are three important principles to be considered when undertaking such an analysis:

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

(b) However, any potential variations in profits (or losses) that relate purely to a service should be excluded since it is only the property that may be included on the balance sheet of one of the parties, not the capitalised value of the whole service contract. Consequently, potential variations relating to the provision of services are not relevant to determining whether each party has an asset of the property.

(c) Paragraph 14 requires that, in determining the appropriate accounting treatment, greater weight should be given to those features that are more likely to have a commercial effect in practice. Where there is no genuine commercial possibility of a particular scenario or cash flow occurring, this scenario/cash flow should be ignored.

F9 The principles outlined above are considered in more detail below, under the following headings:

- Separation of the contract
- Should SSAP 21 or the FRS be applied?
- How to apply SSAP 21
- How to apply the FRS

Subsequently, the required accounting is explained.

Separation of the contract

F10 In some cases the contract may be separable, ie the commercial effect will be that elements of the PFI payments operate independently of each other. 'Operate independently' means that the elements behave differently and can therefore be separately identified. Any such separable elements that relate solely to services should be excluded when determining whether each party has an asset of the property. In establishing whether the contract is separable, regard should be had to the terms of the contract and how the payments vary under different scenarios: it will not be relevant that the contract designates the payments as ‚unitary' or, indeed, what labels they are given. In particular, where the PFI contract includes ancillary services, such as catering and cleaning, the payments for these services may be separable. A contract may be separable in a variety of circumstances, including but not limited to the following.

(a) The contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services.

(b) Different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract.

(c) Different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the purchaser in such a way that the part of the payment by the purchaser that relates specifically to that service can be identified.

Should SSAP 21 or the FRS be applied?

F11 Paragraph 13 requires that where a transaction falls within the scope of both this FRS and another FRS or a SSAP, the standard that contains the more specific provision(s) should be applied. As explained in paragraph 45, for transactions that contain a stand-alone lease, SSAP 21 will be the relevant standard. Other transactions, in particular those containing a lease as an element of a larger arrangement, will fall within the FRS.

F12 A PFI contract will contain a stand-alone lease (so that SSAP 21, interpreted in the light of the FRS, should be applied) where the only elements remaining after excluding any separable service elements are payments for the property.

F13 Other PFI contracts, ie those where there are some non-separable service elements, will fall directly within the FRS.

How to apply SSAP 21

F14 In applying SSAP 21, the key question is whether the lease is a finance lease, ie one that "transfers substantially all the risks and rewards of ownership of an asset to the lessee."* One indication of this is given by comparing the present value of the minimum lease payments with the fair value of the asset (often referred to as the '90 per cent test'). However, in many cases such a numerical test will not be required. The principal risks and rewards of ownership in a leasing context are usually demand and residual value. Where substantially all of the risks and rewards associated with these lie with the purchaser, it will be clear, without performing any calculations, that the lease is a finance lease (ie that the property is an asset of the purchaser). Only where there is a sharing of risk will a 90 per cent test be required.

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* SSAP 21, paragraph 15

F15 Even where a 90 per cent test is used, it is important neither to apply this as the only test nor to apply a 90 per cent cut-off in a mechanistic way. The overriding principle is to establish whether the purchaser has substantially all of the risks and rewards of ownership.

F16 Where a 90 per cent test is used, the question arises what rate should be used to discount the minimum lease payments. The principles underlying SSAP 21 require a discount rate that relates only to the property. A rate based in some way on the return from the entire PFI contract may not be a suitable rate to use since it will include an allowance for the risk relating to the service element of the contract. Where the service element is perceived as being riskier, relative to the property, this will give rise to a rate that is too high. Since a prerequisite for using SSAP 21 is that the payments for the property have been separated from those for services, it will usually be possible to derive such a property-specific rate from the PFI contract. Where sufficient information is not available, the rate should be estimated by reference to the rate that would be expected on a similar lease ie a lease of a similar property in a similar location and for a similar term). The estimate of the rate should be reviewed together with (i) the present value of the lease payments, (ii) the assumed fair value of the property, and (iii) the assumed residual value, to ensure that all figures are reasonable and mutually consistent.

F17 In determining what are the minimum lease payments, regard should be had to what is likely to have a commercial effect in practice. It follows that the minimum lease payments will comprise the expected PFI payments for the property, less any amount for which there is genuine possibility of non-payment.

F18 A further factor to be taken into account is residual value risk. Where this risk both is significant and lies with the purchaser, it is normally evidence that the PFI contract in substance contains a finance lease and the property is an asset of the purchaser. An example is where the property has a material remaining useful economic life at the end of the PFI contract and is passed to the purchaser for a nominal or substantially fixed amount.

How to apply the FRS

What variations are relevant?

F19 For those contracts that fall directly within the FRS, whether a party has an asset of the property will depend on whether it has access to the benefits of the property and exposure to the associated risks. This will be reflected in the extent to which each party bears the potential variations in property profits (or losses). The principle here is to distinguish potential variations in costs and revenues that flow from features of the property - which are relevant to determining who has an asset of the property (see paragraphs F22-F50) from those that do not - and which are therefore not relevant to determining who has an asset of the property (see paragraph F20).

F20 There may be features that could lead directly to profit variations for reasons that relate purely to a service. Such variations may take the form of potential penalties for under-performance, or potential variations in revenues or in operating costs. These should be ignored when assessing who has an asset of the property, irrespective of their size. For example, a penalty may arise in a PFI contract for a prison because the security staff have not been trained satisfactorily, or in a PFI contract involving a catering facility because the food purchased is not up to standard. Similarly, potential variations in operating costs may relate purely to a service, for example the cost of raw materials and consumables in a catering facility. Such potential variations are irrelevant to determining which party has an asset of the property.

F21 There may be a significant number of property factors (for example, those listed in paragraph F22). It will be important to assess the effect of all relevant factors and the interaction between them, giving greater weight to those that are more likely to have a commercial effect in practice. It will not be appropriate to focus on one feature in isolation. It will be necessary to consider both the probability of any future profit variation arising from a property factor and its likely financial effect. Additional costs may be incurred to correct a problem rather than risking the imposition of a much greater penalty, in which case the relevant variation to consider is the likely increase in costs rather than the possible penalty. Similarly, a possible increase in future costs may be avoided by altering some feature of the property at a lower net cost, in which case the variation to consider is the cost of altering the property.

Factors relevant to the property

F22 As noted in paragraph F19, in applying the FRS the key test is to establish who will bear any variations in property profits (or losses). Depending on the particular circumstances, a range of factors may be relevant to this assessment of profit variation. The principal factors that, depending on the particular circumstances, may be relevant are:

- demand risk (see paragraphs F24-F31)
- the presence, if any, of third-party revenues (see paragraphs F32-F34)
- who determines the nature of the property (see paragraphs F35-F37)
- penalties for under-performance or non-availability (see paragraphs F38 and F39)
- potential changes in relevant costs (see paragraphs F40 and F41)

- obsolescence, including the effects of changes in technology (see paragraphs F42 and F43)
- the arrangements at the end of the contract and residual value risk (see paragraphs F44-F48).

F23 The above list of the factors to be considered should be applied only with reference to the analysis given in paragraphs F24-F50. The key features of the analysis are summarised and illustrated in the table at the end of this Application Note.

DEMAND RISK

F24 Demand risk is the risk that demand for the property will be greater or less than predicted or expected. Where demand risk is significant, it will normally give the clearest evidence of who should record an asset of the property. Demand risk is imposed by the economic conditions of the market in which the PFI contract is written. Its existence and significance cannot be altered by the terms of the contract; the contract can only allocate demand risk between the parties to the contract, for example by allowing renegotiation of the contract at certain demand levels.

F25 The first step is to identify whether demand is a significant risk. There may be instances where there is little genuine uncertainty about the level of future demand for the services provided by the property. For example, in a short-term IT contract there may be very little likelihood of demand varying greatly from the levels predicted under the contract. In such a case, demand risk is not significant and little weight should be given to this test. In other cases there may be much genuine uncertainty over the extent to which a property will. be used-for example, a new road to be built in a newly developed area. In these cases demand risk will be significant and who bears it will be highly relevant to determining the appropriate accounting treatment.

F26 The length of the contract may influence the significance of demand risk. In general, demand risk will be greater the longer the term of the contract, since it is usually more difficult to forecast for later periods.

F27 It is also important to distinguish where demand risk is insignificant from where the terms of the contract are such that it is passed to one or other party For example, there may be much uncertainty over the demand for a certain type of property in the long term. However, the terms of a long-term PFI contract for such a property may be such that the purchaser would fill the PFI property in preference to properties not subject to PFI, with the effect that it is very unlikely that the PFI property will not be full. In such a case, the purchaser has retained demand risk.

F28 Where it is established that demand risk is significant, it is necessary to determine who will bear it, ie who will bear the effects of reasonably likely changes in demand. This will depend on the answers to two interrelated questions:

(a) Will the payments between the operator and the purchaser reflect the usage of the property or does the purchaser have to pay the operator regardless of the level of usage (paragraphs F29 and F30)?

(b) Who will gain if demand is greater than expected (paragraph F31)?

F29 Where the PFI payments do not vary substantially with demand or usage of the property (although they may vary with other factors), the purchaser will be obliged to pay for the output or capacity of the property (eg prison places, hospital beds) whether or not it is needed ie whether or not there are sufficient prisoners or patients). This is evidence that the property is the purchaser's asset and the purchaser has a liability to pay for it. In particular, if the purchaser, in substance, is obliged to pay a minimum amount (ie there is no genuine commercial possibility of non-payment) whether or not it will need the property, and the minimum amount more than covers the cost of the property, this is evidence that the property is an asset of the purchaser. In making this assessment of demand risk, any penalties or reductions in payments for non-availability of the property should be ignored: these relate to whether the property is in a state fit for use and do not affect the incidence of demand risk.

F30 Conversely, where the PFI payments will vary proportionately over all reasonably likely levels of demand, the purchaser will not be obliged to pay for the property to the extent it is not needed, which is evidence that the property is the operator's asset.

F31 In addition, the party that bears demand risk will gain if demand is greater than expected. If the purchaser bears demand risk, it will benefit from additional usage of the property at little or no extra property cost (for example, if payment for a hospital outpatients facility is largely independent of its usage, the purchaser will benefit from additional patients being treated when usage is high at little or no extra cost). This is evidence that the property is an asset of the purchaser. Conversely, if the operator bears demand risk, it will benefit from the increased payments that result from any additional usage of the property (for example, if payment for a hospital outpatients facility is based on throughput, the operator will benefit from additional usage payments when usage is high, although it may bear little or no extra cost). This is evidence that the property is an asset of the operator.

THE PRESENCE, IF ANY, OF THIRD-PARTY REVENUES

F32 A feature of some PFI contracts is that the property is expected to be used by third parties. Where the operator relies on revenues from third parties to cover its property costs, this is evidence that the property is an asset of the operator.

F33 Conversely, where third-party usage is minimal or merely a future possibility, it is more likely that the property is an asset of the purchaser. This would particularly be the case where the purchaser in some way guarantees the operator's income from the property or where there is genuine scope for significant third-party use of the property but the purchaser significantly restricts such use.

F34 The existence of third-party revenues may be linked to the incidence of demand risk. For example, the purchaser may have the option to reduce its usage of the property, in which case the operator will attempt to find third parties to use the resulting spare capacity. If the purchaser's option is a genuine one with a real possibility of exercise, and if the operator bears a significant risk of a large fall in property income as a result, this is evidence that the property is an asset of the operator.

WHO DETERMINES THE NATURE OF THE PROPERTY

F35 This factor relates to who determines how the PFI contract is to be fulfilled and, in particular, what kind of property (road, hospital etc) is to be built. Where in essence the purchaser 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, this is evidence that the property is its asset. The purchaser may determine the key features of the property explicitly by agreeing them as terms of the PFI contract or, for example, through a contractual acceptance provision at the end of the construction phase. Alternatively, the purchaser may implicitly determine the key features of the property. For example, a contract for a road may specify that the road will revert to the purchaser in a predefined state after a relatively short period: this may have the effect that the operator has little discretion over the standard of road to build in the first instance or how it is maintained subsequently.

F36 Conversely, where the operator has significant and ongoing discretion over how to fulfil the PFI contract and makes the key decisions on what property is built and how it is operated, bearing the consequent costs and risks, this is an indication that the property is the operator's asset. For example, this would be the case if the operator 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. Similarly, in a PFI contract to design, build and operate a road, the operator may have complete discretion over the balance between the quality of the original road built and the consequent level of maintenance costs.

F37 Design risk is the risk that the design of the property is such that, even if it is constructed satisfactorily, it will not fully meet the requirements of the contract. This is part of the question of who determines the nature of the property, discussed above. In contrast, construction risk refers to who bears the financial implications of cost and time overruns during the construction period (and related warranty repairs caused by poor building work after the asset has been completed). Construction risk is not generally relevant to determining which party has an asset of the property once construction is completed, because such risk normally has no impact during the property's operational life. However, construction risk may be relevant where it calls into question the other evidence. In particular, if the purchaser is bearing construction risk in a project in which the property is claimed to be that of the operator, it will be necessary to look closely at the other terms of the transaction to determine whether the property really is the operator's asset and is not actually an asset of the purchaser.

PENALTIES FOR UNDER-PERFORMANCE OR NON-AVAILABILITY

F38 Many PFI contracts provide for penalties if the property is below a specified standard or is unavailable because of operator fault. (Penalties relating purely to services, however, are not relevant and should not be brought into the assessment.) These penalties may take the form of either cash payments or reductions in revenue. It will be important to assess both the likelihood of the penalty occurring in practice and whether the likely payments are significant. For example, a penalty may have little impact in practice because the contract gives the operator ample time to rectify the fault or the penalty is invoked only if the property is completely unavailable. Where, as in this example, potential penalties are either not significant or are unlikely to occur, this is evidence that the property is an asset of the purchaser.

F39 Conversely, the penalty mechanism may have the effect that the operator's profits associated with the property are genuinely subject to significant potential variation. For example, a PFI contract for a road may contain penalty clauses if lanes are closed for more than a minimal period for maintenance, with the penalty being significant and having a reasonable possibility of occurring. This would be evidence that the property is an asset of the operator.

POTENTIAL CHANGES IN RELEVANT COSTS

F40 Potential changes in relevant costs may be dealt with in different ways under a PFI contract. (Only changes in property costs are relevant; changes in service costs are not relevant and should not be brought into the assessment.) The contract may have the effect that any significant future cost increases can be passed on to the purchaser, which would be evidence that the property is an asset of the purchaser. For example, this would be the case where the PFI payments will vary with specific indices so as to reflect the operator's costs.

F41 Conversely, where the operator's costs are both significant and highly uncertain, and there is no provision for cost variations to be passed on to the purchaser, this is evidence that the property is an asset of the operator. For example, this would be the case where the payments are fixed or vary in relation to a general inflation index such as the Retail Prices Index. Similar considerations apply to any cost savings and how they are shared between the parties.

OBSOLESCENCE, INCLUDING THE EFFECTS OF CHANGES IN TECHNOLOGY

F42 Whether obsolescence or changes in technology are relevant will depend on the nature of the contract. In contracts for the introduction of information technology systems, it will be of great significance who bears the future costs and any benefits associated with obsolescence or changes in technology: in other cases (eg a roads contract) it is likely to be of much less significance.

F43 Where the potential for obsolescence or changes in technology are significant, the party that bears the costs and any associated benefits will be the one for whom there is evidence that the property is its asset.

THE ARRANGEMENTS AT THE END OF THE CONTRACT AND RESIDUAL VALUE RISK

F44 Residual value risk is the risk that the actual residual value of the property at the end of the contract will be different from that expected. This risk is more significant the shorter the PFI contract is in relation to the useful economic life of the property. Where it is significant, residual value risk will normally give clear evidence of who should record an asset of the property. In part, residual value risk stems directly from the economic conditions of the market for the property, ie the rise or fall of prices relevant to the property. The price aspects of residual value risk cannot be reduced or increased by the contract. The contract can only influence those aspects of residual value risk relating to the condition of the property at the end of the contract.

F45 Where this risk is significant, who bears it will depend on the arrangements at the end of the contract. For example, the purchaser will bear residual value risk (providing evidence that the property is its asset) where:

(a) it will purchase the property for a substantially fixed or nominal amount at the end of the contract;

(b) the property will be transferred to a new operator, selected by the purchaser, for a substantially fixed or nominal amount; or

(c) payments over the term of the PFI contract are sufficiently large for the operator not to rely on an uncertain residual value for its return.

F46 Where the purchaser has an option to purchase the property or, alternatively, an option to 'walk' and leave the property with the operator, the practical effect of the option should be carefully analysed. In particular, where there is no genuine possibility that a purchase option will not be exercised (or, alternatively, that a 'walk' option will be exercised), the option will not transfer residual value risk to the operator.

F47 The significance of a minimal payment for the residual interest at the end of the contract depends on other features of the contract. If the property has a significant remaining useful economic life, such minimal payment will be evidence, in the absence of evidence to the contrary, that the purchaser paid for the property over the term of the PFI contract. This in turn is evidence that the property was an asset of the purchaser throughout.

F48 Conversely, the operator will bear residual value risk (providing evidence that the property is its asset) where:

(a) it will retain the property at the end of the PFI contract; or

(b) the property will be transferred to the purchaser or another operator at the prevailing market price.

Assessment of relevant factors

F49 In determining whether each party has an asset of the property, it will not be appropriate to focus on one feature in isolation. Rather, the combined effect of all relevant factors should be considered for a range of reasonably possible scenarios, with greater weight being given to those outcomes that are more likely to occur in practice.

F50 In addition, it will often be useful in weighing all the evidence to consider the position of the various parties to the transaction, including their apparent expectations and motives for agreeing to its various terms. For example, an assessment of the operator's financing* may indicate a level of debt funding that could be credible only if another party stood behind the operator. In such circumstances the PFI contract would be deemed a financing arrangement and thus indicate that the property is an asset of the purchaser. Similarly, a financing arrangement would be indicated where, in the event that the contract is terminated early, the bank financing will be fully paid out by the purchaser under all events of default, including operator default.

** All aspects of the financing arrangements should be taken into account, eg the use of senior or subordinated debt and the presence of any guarantees.*

Required accounting

Purchaser has an asset of the property

F51 Where it is concluded that the purchaser has an asset of the property and a liability to pay for it, these should be recorded in its balance sheet. The initial amount recorded for each should be the fair value of the property.+ Subsequently, the asset should be depreciated over its useful economic life and the liability should be reduced as payments for the property are made. In addition, an imputed finance charge on the liability should be recorded in subsequent years using a property-specific rate (paragraph F16 discusses how to determine such a rate). The remainder of the PFI payments (ie the full payments, less the capital repayment and the imputed financing charge) should be recorded as an operating cost. If the purchaser has any other obligations in relation to the PFI contract, these should be accounted for in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.*

+ For a lease the sum to be recorded both as an asset and as a liability in the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease.

** FRS 12 will be issued in September 1998 and it will be effective for accounting periods ending on or after 23 March 1999.*

F52 Generally, the purchaser should recognise each property when it comes into use. An exception is where the purchaser bears significant construction risk, in which case it should recognise the property as it is constructed.

Purchaser does not have an asset of the property

F53 Where it is concluded that the purchaser does not have an asset of the property, there may nevertheless be other assets or liabilities that require recognition. These can arise in respect of contributions, acquisition of the residual and other obligations of the purchaser.

Contributions

F54 Contributions to a PFI contract by the purchaser may take a number of forms, including an up-front cash payment or the contribution of existing assets for development by the operator. The accounting treatment of such contributions depends on whether they give rise to future benefits for the purchaser. For example:

- If the contribution of an existing property results in lower service payments, the carrying amount of the property should be reclassified as a prepayment (current asset) and subsequently charged as an operating cost over the period of reduced PFI payments. If there is in effect a sale of part of the contributed asset (for example, a parcel of surplus land that is not used in the PFI contract), any profit should be recognised in accordance with paragraphs 23 and 24 (as explained in paragraphs 70-74).
- If the contribution does not give rise to a future benefit for the purchaser, it should be charged as an expense when the contribution is made. For example, a capital grant might be given for which the operator would have qualified even if the transaction had not been part of the PFI, or short-life assets might be donated to the contract for no value.

Acquisition of the residual

F55 In some PFI transactions, all or part of the property (eg the land element) will pass to the purchaser at the end of the contract. Where the contract specifies that this transaction should take place at market value at the date of transfer, no accounting is required until the date of transfer, as this represents future capital expenditure for the purchaser.

F56 Where the contract specifies the amount (including zero) at which the property will be transferred to the purchaser at the end of the contract, the specified amount will not necessarily correspond with the expected fair value of the residual estimated at the start of the contract. Any difference must be built up over the life of the contract in order to ensure a proper allocation of payments made between the cost of services under the contract and the acquisition of the residual. At the end of the contract the accumulated balance (whether positive or negative), together with any final payment, should exactly match the originally estimated fair value of the residual. For example, if the expected residual value at the end of a 30-year contact is £20 million, but the contract specifies that £30 million should be paid by the purchaser for that residual at that date, then 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 value of the residual.

F57 If, during the life of the contract, expectations change so that the expected value of the residual falls (but there are no changes to the payments scheduled under the contract), then consideration should be given to whether there has been an impairment. Ultimately, a positive difference may become negative, in which case a provision is required. Using the example in paragraph F56, if the expected residual value fell to zero after five years, then an expense and a liability of £20 million would be recorded immediately. The remaining £10 million is still accrued over the life of the contract, giving a final liability of £30 million which is paid at the end of the contract.

Other obligations of the purchaser

F58 If the purchaser has any other obligations in relation to the PFI contract, these should be accounted for in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.*

** FRS 12 will be issued in September 1998 and it will be effective for accounting periods ending on or after 23 March 1999.*

Operator has an asset of the property

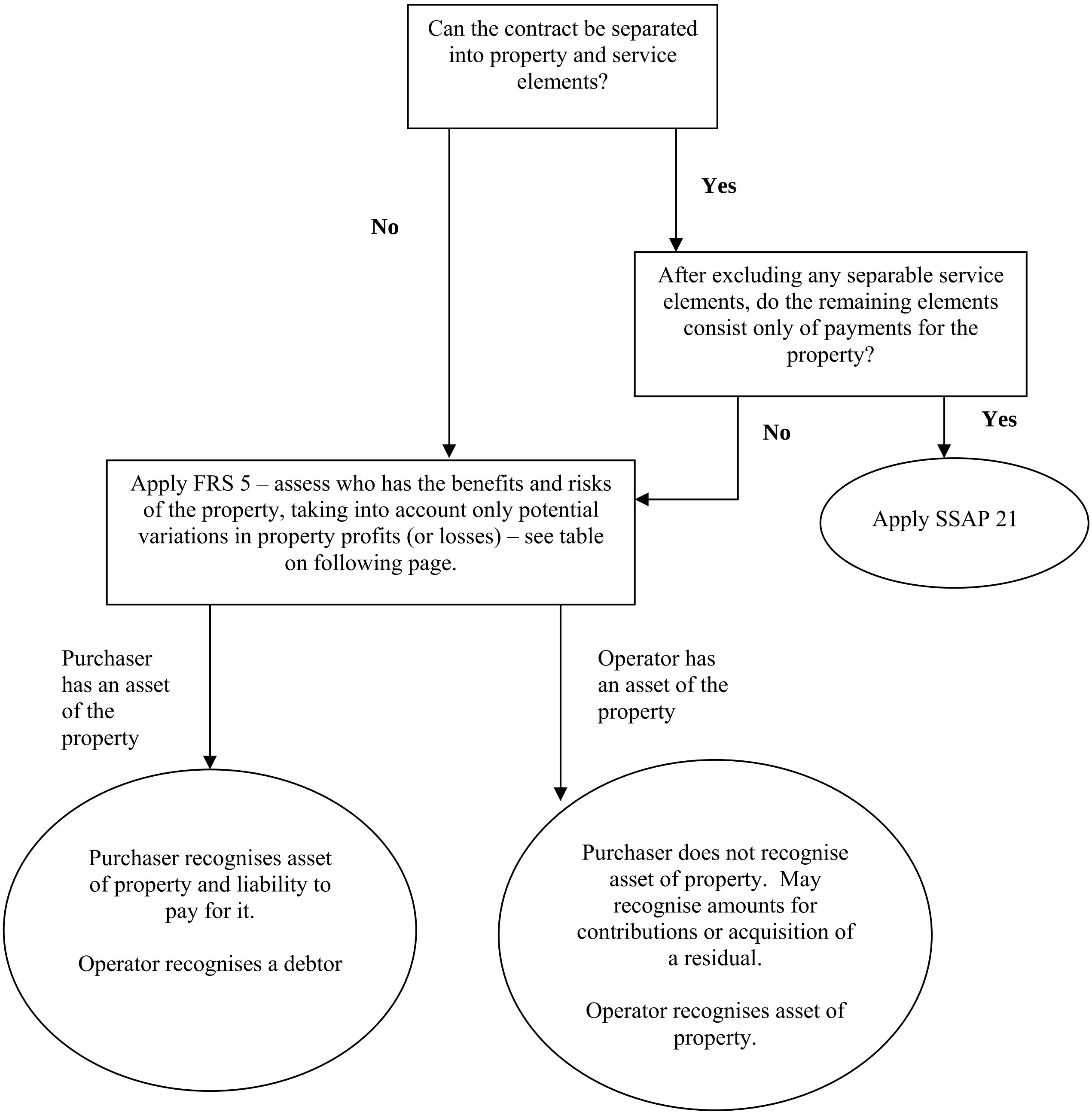
F59 Where it is concluded that the operator has an asset of the property, it should record this asset in its balance sheet. The asset should initially be recorded at its cost and then depreciated to its expected residual value over its useful economic life (which, unless the property is to be retained by the operator on the expiry of the PFI contract, will be constrained by the term of the PFI contract). Where the contract specifies a sum for which the residual value will be transferred to the purchaser, the difference between the amount payable and the expected residual value should be accounted for in a similar way to the accounting treatment adopted by the purchaser (see paragraph F56), on the assumption that the difference is accounted for by higher or lower PFI payments during the life of the contract. If the operator is obliged to meet any liabilities as a result of the contract (eg environmental clean-up costs), these should be recorded separately, within liabilities.

Operator does not have an asset of the property

F60 Where it is concluded that the operator does not have an asset of the physical property, it will, instead, have a financial asset, being a debt due from the purchaser for the fair value of the property. This asset should be recorded at the outset and reduced in subsequent years as payments are received from the purchaser. In addition, finance income on this financial asset should be recorded in subsequent years using a property-specific rate (paragraph F16 discusses how to determine such a rate). The remainder of the PFI payments (ie the full payments, less the capital repayment and the imputed financing charge) should be recorded within operating profit.

Flow chart

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



Table

<table>
<tr><td colspan="2">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:
▪ only variations in property profits/losses are relevant.
▪ the overall effect of all of the factors taken together must be considered.
▪ greater weight should be given to those factors that are more likely to have a commercial effect in practice.</td></tr>
<tr><th>Indications that the property is an asset of the purchaser</th><th>Indications that the property is an asset of the operator</th></tr>
<tr><td>Demand risk is significant and borne by the purchaser, eg
(a) the payments between the operator and the purchaser will not reflect usage of the property so that the purchase 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.</td><td>Demand risk is significant and borne by the operator, eg

(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.</td></tr>
<tr><td>There is genuine scope for significant third-party use of the property but the purchaser significantly restricts such use.</td><td>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.</td></tr>
<tr><td>The purchaser determines the key features of the property and how it will be operated</td><td>The operator has significant ongoing discretion over what property is to be built and how it will be replaced.</td></tr>
<tr><td>Potential penalties for underperformance or non-availability of the property are either not significant or are unlikely to occur.</td><td>Potential penalties for underperformance or non-availability of the property are significant and have a reasonable possibility of occurring.</td></tr>
<tr><td>Relevant costs are both significant and highly uncertain, and all potential material cost variations will be passed on to the purchaser.</td><td>Relevant costs are both significant and highly uncertain, and all potential material cost variations will be borne by the operator.</td></tr>
<tr><td>Obsolescence or changes in technology are significant and the purchaser will bear the costs and any associated benefits.</td><td>Obsolescence or changes in technology are significant, and the operator will bear the costs and any associated benefits.</td></tr>
<tr><td>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.</td><td>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.</td></tr>
</table>

Indications that the property is an asset of the purchaser	**Indications that the property is an asset of the operator**
The position of the parties to the transaction is consistent with the property being an asset of the purchaser, eg (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, eg (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.