

VAGO

Victorian Auditor-General's Office

**VAGO Position on the Assessment
of Public Private Partnership
Arrangements for Financial
Reporting Purposes**

June 2006

Introduction

The objective of this position paper is to describe how the Victorian Auditor-General's Office intends to apply existing Australian Accounting Standards and Interpretations to reflect the economic substance of Private Public Partnership (PPP) arrangements. This is to ensure that information contained in general purpose financial reports in relation to PPPs are accounted for and disclosed appropriately and therefore are useful for decision-making and for discharging the accountability of management.

This position paper does not address the evaluation of the alternative methods for selection of infrastructure projects, nor evaluate the economic and financial issues associated with PPPs. Also it does not address the valuation issues associated with PPPs, nor the measurement and recognition of emerging assets.

Definition of Private Public Partnership Arrangement

PPPs are “arrangements that involve the provision of public infrastructure such as roads and hospitals under a contractual agreement between at least two entities - a private sector provider and a public sector recipient.”¹

PPP projects may include the following features:

- A contract which requires payment to be made by the concession provider to the concession operator for the provision of a service(s) to specified standards
- Service delivery typically depends on properly functioning infrastructure structures of some kind e.g. a special purpose property such as a hospital, a water treatment plant, a freeway etc. These structures are legally owned by, or leased to the concession operator. Often the structures are situated on Crown land provided under a peppercorn rental
- The services arrangement contract may specify features or standards required of the structures
- The service arrangement contract will usually specify options for the structures at the end of the contract term, which may include legal title passing to the concession provider for a fixed or nominal price.

GAAP Hierarchy

AASB 108 'Accounting Policies, Changes in Accounting Estimates and Errors' objectives includes criteria for selecting accounting policies. Accordingly, 'when an Australian Accounting Standard specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Australian Accounting Standard and considering any relevant Implementation Guidance issued by the AASB for the Australian Accounting Standard' (AASB 108.7).

When assessing whether accounting policies are appropriate, emphasis should be given to the substance over form principle outlined in the 'Framework for the Preparation and Presentation of Financial Statements', that is:

¹ Source: FRD 19 *Private Provision of Public Infrastructure (June 2003)* which has now been withdrawn.

'If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).'

AASB 101 'Presentation of Financial Statements' now requires an entity to disclose the judgements that management has made in the application of its accounting policies. Specifically, AASB 101 requires *'An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 116), management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial report'* (AASB 101.13). This would include judgements made by management in determining the accounting for PPP arrangements, e.g., the classification of the asset financing component as either a finance or operating lease or whether the PPP arrangement was controlled by the public sector entity concerned.

While there is no specific Australian Accounting Standard addressing PPP arrangements, individual accounting standards apply to parts of such arrangements. AASB 117 'Leases' applies to *'agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other'* (AASB 117.3).

A lease is defined as *'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments, the right to use an asset for an agreed period of time'* (AASB 117.4). In this context, Interpretation 4 'Determining whether an Arrangements contains a Lease' and Interpretation 127 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease' are relevant for consideration.

While Interpretation 4 is operative for annual reporting periods beginning on or after 1 January 2006, it can be subject to early adoption. An entity may enter into an arrangement that does not take the legal form of a lease but conveys a right to use an asset in return for a payment or series of payments. Interpretation 4 provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with AASB 117. Interpretation 4 effectively provides that an arrangement is in substance a leasing arrangement when the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset, including the ability or right to direct others to operate the asset in a manner such that the purchaser obtains or control more than an insignificant amount of the output or other utility of the asset.

As most PPP arrangements, in substance, involve the financing of specific infrastructure assets over a substantial period for a series of periodic payments that is integral to delivering the service objectives of the public sector entity concerned, the leasing standard provides ‘the basis for determining whether a party to an agreement was required to recognise an asset (and corresponding liability) as a result of holding the balance of the risks and benefits associated with the ownership of an asset’.

Consideration should also be given as to whether Interpretation 112 ‘Consolidation – Special Purpose Entities’ (previously Abstract 28) provides a basis for accounting of the PPP arrangement as a whole. Interpretation 112 provides rules on the application of the concept of control as described in AASB 127 ‘Consolidated and Separate Financial Statements’ in the specific context of special purpose entities (refer Appendix B).

It should also be noted that Interpretation 129 ‘Disclosure – Service Concession Arrangements’ requires each entity to disclose, in the notes to the financial report, details of each PPP arrangement in addition to those already required by existing Australian Accounting Standards (e.g., AASB 116 *Property, Plant and Equipment* applies to acquisitions of items of property, plant and equipment, AASB 117 *Leases* applies to leases of assets, and AASB 138 *Intangible Assets* applies to acquisitions of intangible assets).

As the GAAP hierarchy contains generic accounting rules applicable to PPP agreements at the Australian Accounting Standards and Interpretations level of the hierarchy, other parts of the hierarchy are not required to be considered.

AASB 117 ‘Leases’

AASB 117 ‘Leases’ (July 2004) requires a lessee and a lessor to each classify the lease as either a finance lease or an operating lease according to its economic substance (AASB 117.10). Underpinning the substance test is classification based on the extent to which risks and rewards incidental to ownership lie with the lessor or the lessee, with an inclusive list of examples of risks and rewards.

AASB 1008 ‘Leases’ (October 1998) also contained economic substance as a fundamental principle, and classification based on risks and benefits incidental to ownership. A presumptive quantitative test formed part of AASB 1008, i.e., non-cancellable; lease term was for 75% or more of the remaining life of the leased assets, or the present value at the beginning of the lease term of the minimum lease payments equalled or exceeded 90% of the fair value of the leased asset at the inception of the lease. In these circumstances, the lease was a finance lease.

In contrast, AASB 117 ‘Leases’ includes more emphasis on economic substance, as evidenced by the ‘situations’ and ‘indicators’ inclusions, removal of the presumptive test (including the 75% or 90% thresholds), and ‘cancellation’ of itself not being a definitive test. The changes from AASB 1008 ‘Leases’ to AASB 117 ‘Leases’ is an issue for consideration in the transition to Australian equivalents to International Financial Reporting Standards. Lease classification decisions may well change between AASB 1008 ‘Leases’ and AASB 117 ‘Leases’, and related Interpretations.

Application of AASB 117 ‘Leases’

To apply AASB 117, an arrangement must first be considered in the context of a finance lease definition and economic substance. It is only after these have been considered, and the lease fails the definition of the finance lease, that the lease is an operating lease.

AASB 117 ‘Leases’ provides a framework for making judgements on economic substance. Five situations are provided ‘that individually or in combination would *normally* lead to a lease being classified as a finance lease’ (AASB 117.10), and three indicators of situations ‘that individually or in combination *could* also lead to a lease being classified as a finance lease’ (AASB 117.11). Consideration of ‘other factors’ are also identified (AASB 117.12). This framework is encapsulated in the table below:

Hierarchy of Economic Substance	Indicator
<i>Normally would</i> (Level 1)	<ol style="list-style-type: none"> 1. Lease transfers ownership of the asset to the lessee by the end of the lease term 2. Lessee has option to purchase the asset at a price that is expected to be sufficiently lower than the FV at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised 3. Lease term is for the major part of the economic life of the asset 4. At the inception of the lease, the PV of the minimum lease payments amounts to at least substantially all of the FV of the leased asset 5. Leased assets are of such a specialised nature that only the lessee can use them without major modifications
<i>Could</i> (Level 2)	<ol style="list-style-type: none"> 1. If the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee 2. Gains or losses from fluctuations in the FV of the residual accrue to the lessee 3. The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent
<i>Other</i> where Level 1 and Level 2 are not conclusive (Level 3)	Clear from other features of the lease that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is an operating lease.

In relation to Level 1 and Level 2 indicators, the existence of one situation or a combination can be the determining factor for lease classification as a finance lease. The application of these factors varies on whether the PPP arrangement is a BOO (Build, Own and Operate) or BOOT (Build, Own, Operate and Transfer) arrangement.

It should also be noted that a number of assets are purpose built and specialised. Some of the facilities can be located in rural and regional areas and some of the BOOT agreements also involve a transfer of existing facilities as well as the construction of new facilities.

The economic substance should be used as the threshold test for the classification of leases as either finance leases or operating leases. Applying professional judgement based on an individual factor (e.g., specialised asset) or a combination of factors (specialised asset and transfer of ownership) is a ready means of classification decision-making. One could adopt the position for the purpose of assessment that the specialised nature of the assets used by, or constructed for, an entity which is central

to its legislative mandate is sufficient economic substance for classification as a finance lease. Where such circumstances were not evident, the other factors concerning economic substance would then be considered.

It is our view that this approach is more appropriate than a detailed analysis of individual risks and rewards. The latter may lead to arbitrary weightings on individual risks and rewards, or inclusion or exclusion of particular risks and rewards, which may result in fine judgements as to the finance or operating lease classification. Such judgements are open to individual interpretation and challenge.

AASB 117 does not require or prohibit the use of quantitative analysis of risk and rewards to help with determining the economic substance. Any such analysis should, however, be consistent with the principle of economic substance, and not permit form to dominate the decision-making process.

Economic substance is easily understandable, readily applied and robust. Decisions on lease classification applying an 'in substance test' permits a broader understanding and ownership of lease classification decision-making by accountants, auditors, management, those charged with governance and central agencies.

Continuing Management Involvement

Given the nature of PPP arrangements a further factor to consider in relation to economic substance, not specifically identified in AASB 117 as an indicator, is the extent of continuing management involvement with the maintenance and enhancement of the service potential of the facility usually associated with ownership interest. It is considered that this is another important consideration in determining economic substance. Continuing management involvement is a principle reflected in the newer standards on revenue and financial instruments, and also in Interpretation 112.

The more management involvement (e.g., pre-determined and/or ongoing with the facility), the more likely the economic substance of the transaction is akin to an ownership interest. The lessee's management involvement is directed to the preservation, and the enhancement of the utility of the facility throughout the term of the agreement until the facility is returned, or the agreement is renegotiated, or allowed to lapse. Continuing management involvement with the facilities can be evidenced by, for example:

- establishing and monitoring predetermined performance levels and maintenance plans
- consent for activities (e.g., sub-contracting, dealing with the assets)
- coordination with entity's activities
- approval of insurers
- involvement in the acquisition and replacement process
- rights of access to sites and information
- established mechanisms for ongoing consultation process about the facility
- extent of reporting by the contractor.

For a BOOT agreement, the facility has its service potential substantially in tact at the date of transfer, some 20 to 25 years hence. In relation to a BOO agreement, the service potential in the facility is again substantially in tact at the end of the term, normally 20 years hence, and available to the lessee should the agreement be renegotiated.

Office Position – In Summary

The Victorian Auditor-General's Office will apply existing Australian Accounting Standards and Interpretations to reflect the economic substance of PPP arrangements in the following manner.

The principles for the accounting for PPP arrangements are contained within existing Australian Accounting Standards, in particular AASB 117 'Leases' and other related interpretations. Therefore, the determination of whether a PPP arrangement is in substance a finance or operating arrangement should be undertaken in the context of AASB 117, rather than referring to other levels of the GAAP hierarchy, such as consideration of the 'Framework for the Preparation and Presentation of Financial statements' or pronouncements of other standard setters (e.g. the UK accounting standard FRS 5 'Substance of transactions') (refer Appendix C).

VAGO will make its determination on PPP agreements based on economic substance.

Whether a PPP arrangement contains a finance arrangement or an operating arrangement depends on the *substance of the transaction* rather than the form of the contract.

The decision on economic substance should be made in the context of the framework in AASB 117, which provides five situations 'that individually or in combination would *normally* lead to a lease being classified as a finance lease' (AASB 117.10), namely:

- lease arrangement transfers ownership of the asset to the lessee by the end of lease term
- the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised
- the lease term is for the major part of the economic life of the asset, even if title is not transferred
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

All five indicators must be evaluated. It is important that all necessary information is obtained in determining the substance of a PPP arrangement. This would include, in particular, obtaining information in relation to the present value of the minimum lease payments, the economic life and the fair value of the asset(s) being constructed for the PPP arrangement.

VAGO considers that any of the factors is of itself sufficient to substantiate classification of the financing component of the asset as a finance lease. The existence of more than one indicator may add further weight that the arrangement contains in substance a finance lease component.

The application of these factors varies depending on whether the PPP is a BOO or BOOT arrangement. AASB 117 also provides other indicators that *could* also lead to

a lease being classified as a finance lease, however considerations of these other factors is unlikely to alter the outcome of the assessment.

A high-level economic substance test should be considered before any detailed risks and rewards test. The above indicators are intended to assist with the assessment of 'the transfer of risk and rewards incidental to ownership' principle that is of itself an issue of professional judgement on the substance of the transaction, rather than the form. Therefore, if the high-level economic substance tests results in the classification of an arrangement as a finance lease, a detailed analysis of the risks and rewards would not be required.

An important factor to be considered in relation to economic substance is the extent of continuing management involvement with the maintenance and enhancement of the service potential of the facility usually associated with ownership interest. The more management involvement (e.g., pre-determined and/or ongoing with the facility), the more likely the economic substance of the transaction is akin to an ownership interest. Continuing management involvement should also be considered as a factor that individually or in combination would *normally* lead to a lease being classified as a finance lease.

In addition, the nature and terms of any lease that an agency or the Government entered into with the promoter or contractor, such as the period of the lease and its terms, including restrictions on use of the leased land, could also provide further evidence as to the economic substance of the PPP arrangement.

Where the PPP agreement results in the public sector agency having the power to govern the financial and operating policies of an entity² so as to obtain benefits from its activities, that entity should be consolidated under AASB 127 'Consolidated and Separate Financial Statements' and Interpretation 112 'Consolidation – Special Purpose Entities'(refer Appendix B).

An entity is now required by AASB 101 'Presentation of Financial Statements' to disclose the judgements that management has made in the application of its accounting policies. Accounting policy decisions made regarding PPP agreements need to be fully disclosed in this context.

The decision tree has been provided in Appendix A to assist in the determination of asset (and liability) implications of the private provision of public services (BOO(T) schemes).

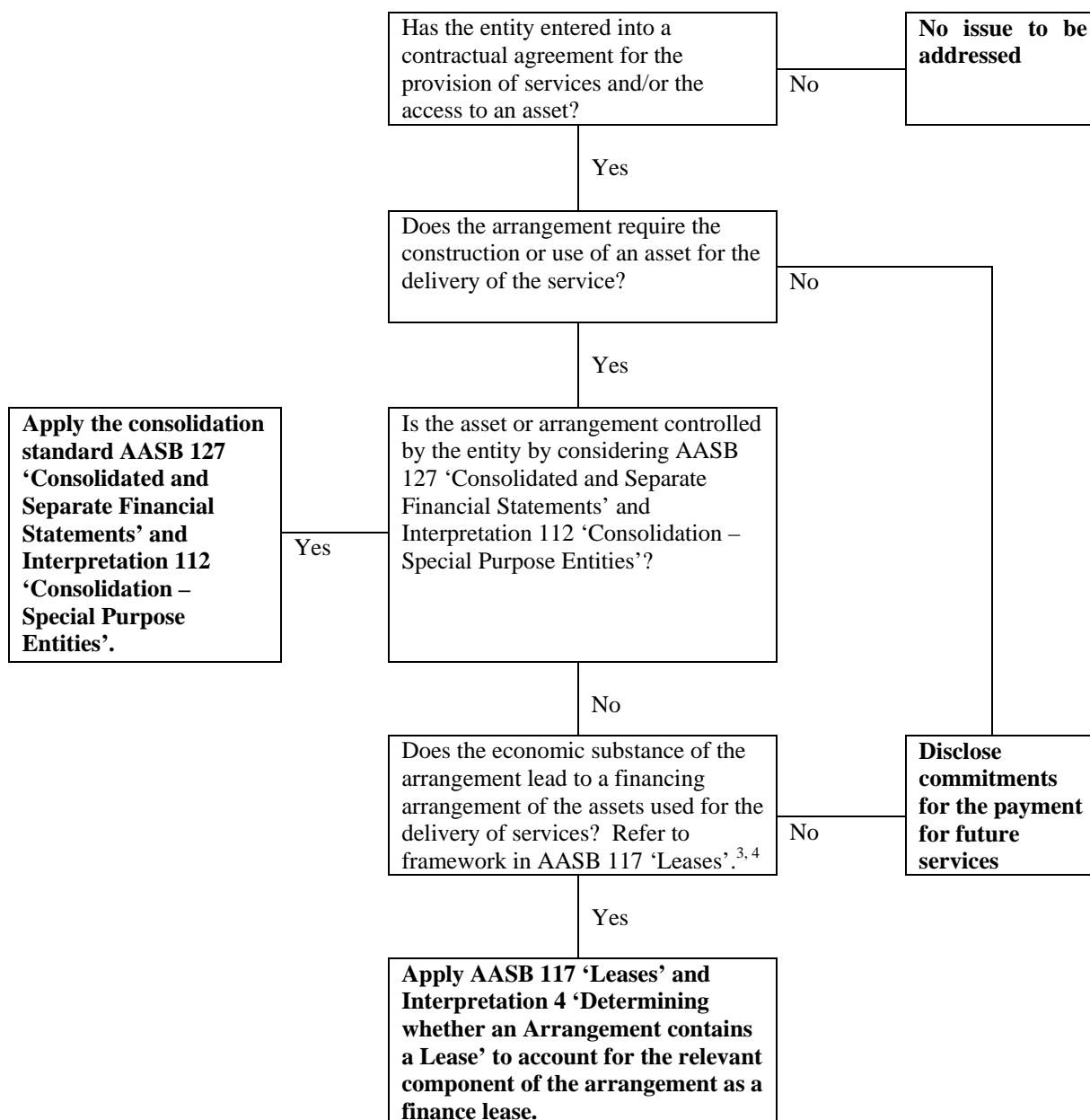
Regardless of the classification of the PPP arrangement, an entity is required to disclose details of each PPP arrangement in the notes to the financial report in accordance with the requirements of Interpretation 129 'Disclosure - Service Concession Arrangements'.

² An entity includes any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives. This would include a public private partnership arrangement.

APPENDIX A

Decision tree for the determination of asset (and liability) implications of the private provision of public services (BOO(T) schemes)

The following table details the decision tree to be followed when assessing the asset implications resulting from the entering into a contract for the provision of services.



³ AASB 117 'Leases' provides five situations that would normally result in a classification of a lease as a finance lease, as well as other indicators that could result in such a classification.

⁴ AASB 101 'Presentation of Financial Statements' requires management to disclose in the financial report judgements made in relation to the classification of its arrangements that have a significant effect on the amounts recognised in the financial report.

APPENDIX B: Interpretation 112 ‘Consolidation – Special Purpose Entities’

The Office position is premised on AASB 117 ‘Leases’ as being the basis for decision making over the leasing component of the PPP arrangement, i.e., financing or operating lease. Consideration should be given as to whether Interpretation 112 ‘Consolidation – Special Purpose Entities’ (previously Abstract 28) provides a basis for accounting of the PPP agreement as a whole. Interpretation 112 provides rules on the application of the concept of control as described in AASB 127 ‘Consolidated and Separate Financial Statements’, in the specific context of special purpose entities.

Interpretation 112 describes a Special Purpose Entity (SPE) in the following context:

- May be created to accomplish a narrow and well-defined objective
- May take the form of a corporation, trust, partnership or unincorporated entity
- Often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee, or management over the operations. Frequently, these provisions specify that the policy guiding its ongoing activities cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so-called ‘autopilot’).

Interpretation 112 requires the following accounting to be applied:

- An SPE is consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. Control may arise through the *predetermination* of the activities of the SPE (operating on ‘autopilot’), or otherwise. The application of the control concept requires judgement in the context of all relevant factors
- The following circumstances may indicate a relationship in which an entity controls an SPE:
 1. The activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operation; or
 2. The entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an ‘autopilot’ mechanism, the entity has delegated these decision-making powers; or
 3. The entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
 4. The entity retains the majority of the residual or ownership risks related to the SPE, or its assets to obtain benefits from its activities.

The application of Interpretation 112 should be considered where there is evidence that the PPP agreement results in the public sector authority having the power to govern the financial and operating policies of an entity⁵ so as to obtain benefits from its activities, in which case, that entity should be consolidated under AASB 127 ‘Consolidated and Separate Financial Statements’ and Interpretation 112 ‘Consolidation – Special Purpose Entities’.

⁵ An entity includes any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives. This would include a public private partnership arrangement.

APPENDIX C: International and Australian Initiatives to develop an accounting policy for PPPs

Introduction

The purpose of this appendix is to describe some of international and Australian initiatives to develop an accounting policy for PPP agreements. This appendix is intended for information purposes only. The accounting requirements of PPP agreements under GAAP hierarchy are contained in the body of this Paper.

FRS 5 Reporting the Substance of Transactions

In 1994, the UK Accounting Standards Board (ASB) issued Financial Reporting Standard 5 - *Reporting the Substance of Transactions* (FRS 5). Since its issuance, FRS 5 has become the main authority in the United Kingdom for assessing which party to a PPP arrangement should recognise the property created for the purpose of the project as an asset on balance sheet. However, a need was identified to clarify how the principles and requirements of FRS 5 should apply to transactions conducted under the UK government's Private Finance Initiative (PFI) (being the UK equivalent of Australian PPP's). In response, the UK ASB added application Note F '*Private Finance Initiative and similar contracts*' to FRS 5.

HoTARAC Guidance on FRS 5

In January 2004, PriceWaterhouseCoopers (PWC), under a consultancy to Heads of Treasury Accounting and Reporting Advisory Committee (HoTARAC) issued additional guidance on the application of FRS 5 to determine control of infrastructure assets used in the Australian public sector. The guidance was a result of extensive deliberations on the appropriate use of FRS 5 methods in Australia, following the establishment of a joint HoTARAC - PPP working group. The working group was charged with reviewing accounting policies and frameworks, and then to recommend a robust method for application to the infrastructure projects entered into by Australian governments.

HoTARAC has endorsed the PWC document and has encouraged Federal and State Treasuries to adopt the guidance as policy for their respective jurisdictions. Under the guidance, seven key risks must be quantified, namely: demand risk, third party revenue risk, design risk, under-performance/non-availability risk, operating cost risk, obsolescence risk and residual value risk.

IFRIC on Service Concessions

The current work of the International Financial Reporting Interpretations Committee (IFRIC) on service concessions, which has specifically excluded addressing the grantor perspective on PPPs (service concessions), does not rely on a risk/benefits assessment criteria, but depends more on an assessment of the ultimate control of the assets to determine the accounting treatment. Support for an overriding "control" criterion to apply is also contained in an Exposure Draft, released in September 2005 by the South African Accounting Standards Board, entitled *ED 24 – Proposed Guideline on Accounting for Private Public Partnerships* (ED 24).

In 2005 IFRIC issued a series of draft interpretations on service concession arrangements, namely:

- D12 *Determining the Accounting Model* (provides the overriding framework for determining which party has control of the property of a Service Concession during the term of the contract)
- D13 *The Financial Asset Model* (where the grantor has the primary responsibility to pay the operator for the Concession Services)
- D14 *The Intangible Asset Model* (where the users have the primary responsibility to pay the operator for the Concession Services).

HoTARAC in commenting of the IFRIC draft interpretations recommended that the accounting for Service Concessions project be broadened to cover both the private and public sectors, and proposed that (in order of preference):

- a *risk-rewards* approach, as set out in FRS 5, be explored further instead of the approach proposed in D12
- a *Rights and Obligations* model which takes into account the actual substance of a Service Concession arrangement, rather than the narrow *IFRIC Control* model, with due consideration of risks where relevant.

HoTARAC, in its submission to IFRIC, considered that the “Rights and Obligations” model, even though more complex, takes into account the actual substance of a Service Concession arrangement, whereas the blunt IFRIC Control model is far too simplistic and ignores the diversity of individual arrangements. While the topic of service concessions has been afforded significant recognition on the agenda of the International Public Sector Accounting Standards Board (IPSASB), a decision to issue either a discussion paper or an exposure draft of a proposed accounting standard on the topic has been delayed until the outcome of the draft interpretations of IFRIC has been resolved.

ED 24 as released by the South African Accounting Standards Board, defined a PPP as “a contract between a public sector entity and a private party, in which the private sector entity assumes substantial financial, technical and operational risk in the design, financing, building and operation of a project.” ED 24 states that “the main objective of a PPP agreement is to provide high quality service that will result in a net benefit to the entity defined, in terms of cost, price, quality, or risk transfer, or a combination thereof, that will result in value for money to the taxpayer.” ED 24 proposed that where control and ownership of the asset developed or constructed will revert back to the public sector entity, the payments from the entity towards the development or construction of immovable assets will fall within the definition of a finance lease.