Public Sector Accounting for Public-Private Partnership Transactions in Canada

A Position Paper by the Accounting Task Force of
The Canadian Council for Public-Private Partnerships
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The Canadian Council for Public-Private Partnerships

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1. Executive Summary

1.1. Overview of CCPPP’s Position

Accounting plays an important role in the success or failure of a PPP project. It affects the outcome of three important documents in the life of a PPP project: the Public Sector Comparator, the Value for Money Report, and the Financial Accounting. Using different accounting bases will result in incomparable, inconsistent analysis of the transaction.

This position paper is the result of over two years of focus on the issue of public-sector accounting for Public-Private Partnership (PPP) transactions by the Canadian Council for Public-Private Partnerships (CCPPP). It reflects practical experiences and concerns of both public- and private-sector members of CCPPP and has benefited from the input of a wide variety of accounting and PPP stakeholders in Canada and internationally.

The objectives of this position paper are to:

- Educate decision-makers on the implications of budgetary and accounting treatment for PPP delivery;
- Achieve a degree of consistency in treatment across Canada and between transactions;
- Ensure that auditors have access to appropriate accounting standards; and
- Ultimately achieve clear, specific PPP accounting standards for Canada, consistent with international best practices.

Achieving these objectives is important because:

- With the rapid growth of PPP as a delivery method in Canada, it is apparent that there is a lack of understanding of the relationships between PPP delivery and the public-sector budgetary process. This leads to uncertainty and, at times, unexpected accounting outcomes which can have significant implications for the public accounts.
- Inconsistency in treatment of similar transactions among industry sectors and among provinces or other jurisdictions can lead to a loss of public confidence in the benefits of PPP delivery or in public-sector accounting. This is particularly the case when accounting treatment is inconsistent with the value-for-money reports used to demonstrate the business case for a PPP.
- A lack of clear standards can lead to “gaming” accounting treatment; for example, structuring transactions in order to achieve favourable accounting treatment rather than based on the commercial merits of the approach.
- A lack of clear standards can also lead to lengthy and costly debate over the appropriate treatment which can also necessitate process delays or revisions.

This position paper finds that all of the above are material concerns and concludes that:

- There is currently no consistent accounting treatment for PPPs in Canada;
- Lease accounting standards are often applied in the absence of a specific Canadian PPP accounting standard and that these are often unclear, inappropriate or insufficiently flexible;
- Inappropriate standards can result in PPP transactions being more “expensive” in terms of their impact on the public-sector budgetary position than conventional government delivery, even when there are clear commercial advantages to the PPP; and
• This risks distorting transaction structures, which has the potential to limit the efficiency and level of risk transfer in PPP delivery. This may not allow the full potential of PPP to be reached in delivery of public services.

The PPP accounting issue is often simplified to the question of whether the PPP transaction should be on or off the balance sheet of government. Although this remains a very valid question, there is a significant number of types of PPP transactions for which the consensus is that they should be recorded on balance sheet. The challenging questions then become how the transactions should be characterized, what values should be recorded, on the asset and liability sides of the balance sheet respectively, when these values should be recorded and how they should be written down or revalued over the life of the concession.

In general, government officials and private-sector business people agree with accountants and auditors that accounting should not drive PPP transactions. Such transactions should be driven by the commercial merits of the deals. Accounting should then follow, to fairly present the economic substance of the transaction. However, in an environment where accounting treatments are almost always controversial, the pragmatic approach taken by partners is to ask upfront what the likely accounting treatment should be. Naturally, the response influences, or even shapes, business decisions. Accounting treatment cannot produce commercial innovation; but, in affecting the optimization of capital and long-term lifecycle costs, it can certainly work against it. This paper concludes that, unless guidance is clear, accounting uncertainties are likely to reduce commercial innovation.

Commercially, PPPs developed in response to three key failings of conventional procurement:

1. The public sector did not value or manage risk well and wasn’t sensitive to the time value of money, resulting in projects that often exceeded their defined budgets and had a larger impact on the public-sector accounts than expected. PPPs are intended to deliver greater cost certainty; and

2. The public sector’s outlook was too short-term and focused on reduction of upfront capital costs (which are capitalized on the balance sheet) at the expense of future operating, maintenance and rehabilitation costs (which are expensed only as and when they are incurred). PPPs viewed an asset on a “lifecycle” basis and optimized the mix of capital and operating and maintenance expenditures to achieve the best long-term result, unconstrained by the differing accounting treatments. In some cases, governments undertook PPPs to ensure that operating and maintenance funds would be available when needed.

3. In the recent past, PPPs developed because under cash accounting practices many governments would fully expense the cost of the asset in the year of acquisition. This meant that projects were often delayed until budgetary resources were available to fund them. Although all Canadian governments have now moved to accrual accounting, many of their budgetary procedures are still influenced by practices carried over from cash accounting days. PPPs can therefore still be seen as a way of avoiding budgetary constraints.

One concern expressed in this paper is that if PPP transactions are accounted for in exactly the same way as conventional government procurement, then they will start to suffer from some of the same problems as conventional procurement. For example, government budgetary constraints will favour PPPs with the lowest upfront costs rather than those which have the lowest net present value over the full life of the concession.
This can best be seen in this very simplified example of two separate operators bidding for the same project.

<table>
<thead>
<tr>
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<th>Bidder A</th>
<th>Bidder B</th>
<th>Public Sector Comparator</th>
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</thead>
<tbody>
<tr>
<td>Construction Costs</td>
<td>$150,000,000</td>
<td>$100,000,000</td>
<td>$80,000,000</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>8%</td>
<td>10%</td>
<td>6%</td>
</tr>
<tr>
<td>Annual Capital Payments</td>
<td>$27,000,000</td>
<td>$20,000,000</td>
<td>$12,800,000</td>
</tr>
<tr>
<td>Annual O&amp;M Payments</td>
<td>$3,000,000</td>
<td>$10,000,000</td>
<td>$15,000,000</td>
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<tr>
<td>Annualized Rehabilitation Payments</td>
<td>$2,000,000</td>
<td>$5,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Total Annual Payments</td>
<td>$32,000,000</td>
<td>$35,000,000</td>
<td>$37,800,000</td>
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</table>

Bidder A chooses a more capital-intensive solution to meeting the performance requirements than Bidder B, and enjoys a lower cost of capital as a result of the lower risks of this approach. Under the capital lease based approach to accounting, if Bidder A is selected as the operator, the grantor will capitalize on its balance sheet a much higher amount than if Bidder B is successful. Although in theory the total budgetary impact of the two bidders may be the same, many grantors have debt limits in addition to annual budgetary constraints. Accounting treatment may influence the grantor to select Bidder B in preference to Bidder A, despite Bidder B being more expensive overall.

However both bidders could appear to be more expensive than the conventional delivery alternative indicated by the Public Sector Comparator as the NPV of the future payments from PPP delivery could far exceed the cost of the asset which would be capitalized under conventional delivery (because of the O&M and rehabilitation payments implicit in the total payments, the risk transfer costs, and the higher costs of private financing relative to the cost of government borrowing).

Many of the recommendations made in this paper espouse a risk rather than a control approach to who recognizes assets and, in some cases, liabilities. We acknowledge that IASB’s Interpretations Committee (IFRIC) has taken a control approach in addressing service concession accounting by operators when it issued Interpretation 12. Also, IPSASB has now issued a consultation paper that proposes a control approach to accounting by the (government) grantor.

In some cases, CCPPP recommendations include supplementary disclosure about contingent assets or liabilities. Some commentators believe that IASB may be looking to abandon the concept of a contingent asset or liability, which CCPPP believes would not be an appropriate step in the context of PPP transactions.

Our objective for an accounting policy regime is to see all projects treated consistently so that accounting does what it should: measure activity but not distort economic choices or the substance of transactions. This is, of course, easier said than done.

One of the challenges is to distinguish between the wide variety of P3 models and projects being created.

In consultation with its members, associates and other stakeholders, the CCPPP has now established its position on the need for better accounting guidance to enable partners in a PPP to record and report financial activities based on the essence and substance of their transactions. In this effort, CCPPP is committed to PPP reporting and disclosure that is fair and transparent.

CCPPP believes that there is a pressing need for greater clarity of accounting guidance for PPP transactions, and recommends that specific PPP accounting standards be developed and adopted in Canada. There are serious shortcomings in current accounting guidance which are not necessarily the result of the complex
structure of these deals. Canadian accounting guidance for recording and reporting PPP transactions is simply inadequate. That is why practitioners engage in debates and speculation to resolve the many accounting issues they encounter. Encouragingly however, the general nature of the accounting challenges (if not always the solutions), are more or less widely known and agreed upon.

This position paper is timely because the world is moving towards greater standardization of accounting across jurisdictions with the introduction of International Financial Reporting Standards (IFRS). On the private-sector side, the International Financial Reporting Interpretations Committee (IFRIC), which is the interpretative body of the International Accounting Standards Board, has recently provided guidance for PPP accounting (SIC 12- Service Concession Arrangements). The International Public Sector Accounting Standards Board (IPSASB) is in the early stages of a consultative process on guidance on accounting for service concession arrangements to be completed in 2008. It is expected that the IPSASB will adopt guidance congruent with IFRIC SIC-12. The Canadian Institute of Chartered Accountants (CICA) and its Public Sector Accounting Board (PSAB) are expected to consider IPSASB’s guidance in setting standards for Canada.

CCPPP hopes that this position paper, which is based upon the extensive PPP experience of our broad membership, will help inform these important developments. CCPPP will be available to support and review the work of accounting standard-setters in this area, and to facilitate a strong dialogue between PPP practitioners and accounting standard-setters.
1.2. Summary of Issues and Recommendations

PPP accounting treatment in Canada is currently evolving. The lack of appropriate accounting standards leads to inconsistency and transactions that do not follow international best practices. In the worst case, the incentives driving efficient PPP delivery may be perverted and effective risk transfer undermined.

Governments may be faced with one of two outcomes:

1. PPP transactions may have accounting and budgetary implications which – independent of the value for money they offer – are worse than the implications of equivalent conventional government delivery, at least in the short-term. In this scenario the political willingness of governments which are debt or balanced budget constrained to undertake PPP projects is likely to be affected.

2. PPP transactions may be distorted to meet conventional government accounting and budgetary constraints rather than optimizing cost and value for money over the long term. The risk here is that governments may lose interest in PPP solutions which, because they have the same drivers as conventional delivery, achieve the same outcomes.

The public accounting and budgeting approach chosen can clearly have a significant effect on the range of PPP transaction structures available to governments and accordingly both the efficiency of PPPs and private-sector appetite for them.

The issues are complex. This position paper focuses on major practical issues identified by the CCPPP membership and associates and, after discussion of the different sides of the debate, offers recommendations based on the views of the majority of the membership.

These major issues and recommendations are summarized below.

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<thead>
<tr>
<th>Issue</th>
<th>Explanation</th>
<th>Recommendation</th>
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<tbody>
<tr>
<td>Full value of PPP not capitalized</td>
<td>If PPP accounting capitalizes operating and maintenance costs over the asset life then PPP delivery will artificially look much less competitive than conventional delivery.</td>
<td>That formal accounting guidance should be issued to ensure that the operating and maintenance costs of a PPP are not capitalized as an asset or liability of government.</td>
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<td>Capital leases</td>
<td>Canadian PPP accounting defaults too quickly to capital lease treatment without fully considering the substance of the transaction.</td>
<td>That PSAB guidance be amended so that PPP transactions are not automatically assumed to be a capital lease with a capital asset, and that Canada adopts emerging international practice in respect of service concession arrangements as early as possible.</td>
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<td>Identifying built cost</td>
<td>PPP accounting often attempts to compare the built cost under a PPP (which may include provision for long-term operations and maintenance type risks) with the equivalent cost under conventional delivery.</td>
<td>That where the built cost of an underlying asset is used to reflect the amount to be capitalized, the higher costs of a PPP in terms of risk transfer and lifecycle costs are not penalized.</td>
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<td>Issue</td>
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<td><strong>Unitary payments</strong></td>
<td>A single &quot;unitary&quot; payment for both the capital and operating and maintenance components of a PPP is important in ensuring that bidders optimize their mix of capital and operating inputs (which may be unique to each bidder) in delivering the required service.</td>
<td>That the concept of a Unitary Payment is important to the efficiency of PPP delivery and that accounting guidance should limit attempts to separate different components of a PPP transaction</td>
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<td><strong>Fair value</strong></td>
<td>If a PPP transaction is to be recognized as a capital lease, it should be noted in the financial statements that there is a significant difference between the capital value of the asset created and the fair value of the transaction itself.</td>
<td>The fair value of the transaction should not be assumed to be the same as the capital value of the asset and capitalized on the government’s balance sheet.</td>
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<td><strong>Minimum lease payments</strong></td>
<td>PPP accounting will often attempt to identify and capitalize a stream of minimum payments which the public sector is likely to make in all circumstances. In practice it is rare for a PPP to enjoy a guaranteed payment which is not subject to abatement for non-performance.</td>
<td>That great care needs to be taken in identifying a minimum lease payment stream in the majority of PPP transactions and that, where this is considered appropriate, a risk-adjusted stream of payments should be calculated using information from the value-for-money analysis.</td>
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<tr>
<td><strong>Discount rate</strong></td>
<td>There is lively debate over the appropriate discount rate used to capitalize future payment obligations, with the marginal cost of government borrowing often recommended. This, however, does not reflect the project risk.</td>
<td>The Project IRR or Weighted Average Cost of Capital of the private-sector partner should be utilized as the discount rate that reflects the project risk.</td>
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<td>Issue</td>
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<td>Asset capitalization</td>
<td>There are two broad ways to identify the appropriate cost to be capitalized: the equivalent built cost of the asset or the discounted stream of future government payments.</td>
<td>If an asset is capitalized, the value recorded should be determined via the Design Build contract, not through an attempt to break down the unitary payment, which cannot be accomplished effectively.</td>
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<td>To avoid skewing the assessment, it may be appropriate to use the average of the bidder’s Design –Build Contracts rather than just that of the preferred bidder.</td>
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<td>Capitalized interest during the construction period should not be included in the appropriate cost to be capitalized.</td>
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<td>Timing of asset recognition</td>
<td>There is lively debate over whether a PPP asset should be recognized by government upon signing of the concession (at which stage full Design-Build cost and schedule risk will typically sit with the private sector) or upon construction completion (which typically triggers the start of government payments).</td>
<td>Guidance is needed on the timing of recognition of assets and liabilities under PPP delivery. The focus should typically be on recognition at Substantial Completion or the point at which significant government payments commence. Care needs to be taken that accounting treatment does not unduly penalize the commercial advantages of PPP transactions in early delivery. A contingent liability could be recorded prior to Substantial Completion.</td>
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<td>Termination provisions</td>
<td>The government will typically have an obligation to pay out the market value of the asset (which could be impaired as a result of non-performance) in the event of a termination, including for default. It is often argued that this is indicative of government control and a reason for on-balance-sheet treatment.</td>
<td>Termination provisions, unless they explicitly provide for repayment of debt (which is now rare in PPP transactions), should be treated as a contingent and unquantifiable obligation and should not be determinant in establishing accounting treatment.</td>
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<td>Issue</td>
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<td>Non-recourse financing</td>
<td>PPPs differ from conventional delivery by using project finance debt which does not have recourse to the project sponsors or to the government. It is sometimes argued that the project debt should be treated as an obligation of government.</td>
<td>That CICA issues specific guidance for treatment of non-recourse debt to ensure that the non-recourse debt of PPPs is not recorded on the government balance sheet and does not distort the government’s Net Debt figure. If the project is determined to be on the government’s balance sheet, it should be the capital asset value that is recorded, rather than the SPV debt.</td>
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<td>Payment mechanism</td>
<td>The PPP payment mechanism is typically the primary driver of risk transfer but is not always given much weight in accounting treatment.</td>
<td>Payment mechanism details should be carefully reviewed in determining accounting treatment to ensure that risk transfer is taken into account. In addition, capital lease accounting rules do not necessarily reflect actual risk transfer, and so the substance of the transfer needs to be reviewed</td>
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<tr>
<td>Risk transfer</td>
<td>The business decision for PPP delivery is driven by whether risk is effectively transferred from government to the private sector. Current accounting guidance does not necessarily examine the degree of risk transfer.</td>
<td>Risk transfer must be taken into account in the accounting treatment of PPP transactions and a PPP transaction with materially greater and more effective risk transfer should enjoy more favourable accounting treatment than a weaker PPP structure. Guidance needs to be developed on how to value risk transfer. This could be drawn from value-for-money assessment techniques</td>
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<tr>
<td>Off-balance-sheet treatment</td>
<td>There is concern in the accounting world about transactions “disappearing” from accountability if they are not recorded on the government balance sheet, especially in circumstances where they also do not appear on a private-sector balance sheet.</td>
<td>Off-balance-sheet treatment should not be ruled out for appropriate PPP transactions. Clear guidelines must be developed that take into account the balance of risks and rewards in a transaction. Contingent obligations should be noted in the financial statements.</td>
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<td>Issue</td>
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<tr>
<td>User pay</td>
<td>There is debate over whether PPP transactions in which all of the revenues are paid directly by users (e.g.: a toll road) should be recorded on the government balance sheet because of control, residual termination obligations and the handback of the asset at the end of term.</td>
<td>User-pay transaction should prima facie not be recognized as an asset and liability of government.</td>
</tr>
<tr>
<td>Emerging assets</td>
<td>There is debate over how the handback of an asset to government at the end of the concession term should be treated where the government has not made any direct payments for such assets.</td>
<td>Accounting guidance should be issued on recognition of government’s reversionary interest in user-pay transactions on an emerging asset basis.</td>
</tr>
<tr>
<td>Public/private accounting asymmetry</td>
<td>There are a number of reasons why a PPP transaction may not appear on a private-sector balance sheet. Government will sometimes take the view that it must be recorded on a government balance sheet if it is not recorded anywhere else.</td>
<td>Asymmetry of accounting treatment between public and private partners should not in itself be cause for concern. The fact that a PPP is not consolidated on the private-sector balance sheet should not be taken as prima facie evidence that the transaction should be consolidated on government’s balance sheet. The same PPP transaction should not be consolidated on both the public- and the private-sector balance sheets.</td>
</tr>
<tr>
<td>Value for money</td>
<td>Governments typically invest resources in analyzing and demonstrating the value for money offered by PPP transactions compared to conventional delivery. This will typically involve a detailed risk assessment. This work can be undermined by accounting treatment which does not reflect the value-for-money conclusions.</td>
<td>That consistency between accounting treatment and value-for-money assessments is a desirable and important objective and that accounting treatment should draw upon value-for-money techniques.</td>
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Public Sector Accounting for Public-Private Partnership Transactions in Canada

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<tr>
<th>Issue</th>
<th>Explanation</th>
<th>Recommendation</th>
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</thead>
<tbody>
<tr>
<td><strong>Need for specific PPP guidance</strong></td>
<td>PPP accounting guidance in Canada is drawn from a variety of guidelines for other types of transactions with no PPP-specific provisions. There is debate over whether PPP transactions are sufficiently unique to merit specific guidance. The risk is that the application of guidance for other transactions to individual components of a PPP transaction may miss the substance of a PPP in its entirety.</td>
<td>That current accounting guidance in Canada is not well suited for the features and complexity of PPP transactions and that PPP-specific guidance should be developed in conjunction with international standards.</td>
</tr>
<tr>
<td><strong>PPP sectors</strong></td>
<td>PPP accounting tends to apply the same treatment to transactions with very different characteristics because they are within the same sector of the PPP market.</td>
<td>That accounting guidance for PPP transactions should be sector neutral.</td>
</tr>
</tbody>
</table>
1.3. Involvement Strategy

As of this paper’s writing, the CICA has not included development of PPP accounting principles as a priority in its official work-plan. CCPPP strongly believes, however, that the PSAB is aware of the need. It may be suggested that working on this concurrently with the IPSASB would be duplicating effort; however, the consequences of not doing so must be recognized. Most notably, non-action may result in the Canadian viewpoint being insufficiently addressed as international standard-setters develop guidance. To ensure that the Canadian PPP industry’s experience and concerns are adequately heard we must become involved in the process either directly or through the CICA.

Direct involvement may be possible by offering IASB and IPSASB our commitment to allocate time and effort to reviewing its work from the Canadian PPP industry’s perspective. This is an effective and relatively low-cost engagement in standard-setting process.

An early involvement through the CICA – and its PSAB – will be much more effective. It will help give priority to the topic domestically while also being a conduit for involvement in the IASB and IPSASB. Success in engaging CICA in the process may require explaining the financial and economic importance of the growth in PPP arrangements to them and to the body that oversees the CICA, and soliciting their acceptance of the need for developing better accounting guidance for PPPs.

The body overseeing the CICA is the Accounting Standards Oversight Council (AcSOC). The AcSOC is an independent body established by the Canadian Institute of Chartered Accountants to oversee the activities of the Accounting Standards Board (AcSB) and Public Sector Accounting Board (PSAB). Reporting to the public and consisting of twenty-five prominent business and government leaders, the Council brings a broad perspective to complex issues facing standard-setters, and supports the AcSB and PSAB in setting accounting standards. AcSOC’s responsibilities include appointing AcSB and PSAB members and providing input on strategic priorities.
1.4. Acknowledgments

The CCPPP Board of Directors acknowledges the invaluable assistance provided in preparing this position paper by a large number of CCPPP members and associates, including:

- Dale Richmond, President and Jane Peatch, Executive Director of CCPPP for their leadership and guidance
- The members of CCPPP’s accounting task force: Nicholas Hann, Macquarie Capital Markets Canada Ltd. and Tim Philpotts, Ernst & Young Corporate Finance.
- Keyvan Ahmadi CA, who provided expert consulting advice to the task force.
- Andrew Grieve, Douglas Beaton, Zahra Hussein and Kristi MacBey of Macquarie Capital Markets Canada Ltd. who provided editorial and production assistance.

Earlier drafts of this position paper have benefited from review by a wide selection of the CCPPP membership and we would like to thank in particular the following for their comments.

- Tom Ross, University of British Columbia
- Michael Rolland, Borealis
- Jim Ferguson, State of Victoria, Australia
- Mark Bain, Bennett Jones LLP
- Robert Marsh, PriceWaterhouse Coopers
- Catherine Deluz, Moody’s Canada Inc.
- Loraine McIntosh, Deloitte & Touche LLP
- Cliff Inskip, CIBC World Markets
- Shokat Kermalli, Bilfinger & Berger
- Alberta Treasury Board
- Department of Treasury and Finance, State of Victoria, Australia
- Statistics Canada
- Infrastructure Ontario
- Partnerships BC

The views expressed in this position paper do not necessarily reflect the views of any of the individuals or organizations mentioned above but are reflective of the collective views of the CCPPP membership.
2. Background

The Canadian Council for Public-Private Partnerships (CCPPP) was established in 1993 as a member-sponsored non-profit organization, with representatives from both the public and private sectors. As proponents of the concept of public-private partnerships (PPPs), the Council conducts research, publishes findings, facilitates forums for discussion and sponsors an annual conference on topics related to PPPs both domestic and international. The objective of the Canadian Council for Public-Private Partnerships is to foster innovative forms of co-operation between the public sector – at the municipal, regional, provincial and federal levels – and the private sector in the pursuit of addressing the public infrastructure requirements in Canada.

2.1. CCPPP’s Interest in Accounting for PPPs

The CCPPP’s interest in, and concern regarding, the accounting treatment for PPP transactions has grown over recent years as a large number of PPP transactions have gone from planning stages to financial close and implementation. CCPPP has consistently heard concerns from its membership, representing both private and public bodies, that accounting issues are having a significant influence on PPP delivery structures and that there is a lack of clarity on the ultimate accounting outcomes associated with PPPs. In response to this, the Council has facilitated extensive discussion and analysis of key accounting issues over the last three years.

The CCPPP believes that well-structured and implemented public-private partnerships can enhance the capacity of government to meet its current and future infrastructure and service obligations. Based on this belief, CCPPP has been actively encouraging dialogue among public- and private-sector decision-makers on important accounting issues that influence the effective use of partnerships in providing better service to the public.

CCPPP has conducted the following market soundings amongst its membership and related stakeholders in developing this position paper:

- Various sessions on accounting and auditing of PPPs were held for hundreds of practitioners who attended the CCPPP’s last three annual conferences in Toronto. In these sessions panels of experts from Canadian public and private sectors, United Kingdom, Ireland, and Australia shared their accounting and auditing experiences with interested practitioners and answered their many questions.

- In 2005, CCPPP formed a task force of key stakeholders to examine key PPP accounting issues and advise the CCPPP. The task force conducted two large workshops (in November 2005 and November 2006) to discuss and where possible reach consensus on PPP accounting issues, with the objective to:
  - Educate decision-makers on the implications of budgetary and accounting treatment for PPP delivery;
  - Achieve a degree of consistency in treatment across Canada;
  - Ensure that auditors have access to appropriate accounting standards; and
  - Ultimately achieve a PPP accounting standard for Canada, as has occurred in the United Kingdom with the introduction of FRS 5.

- In 2006, the Council engaged a PPP accounting and auditing consultant, Mr. Keyvan Ahmadi, CA – former Senior Principal, Office of the Auditor General of British Columbia – to assist the CCPPP’s Task Force with this effort.
Based on these activities and in consultation with its members, associates and other stakeholders, the Canadian Council for Public-Private Partnerships (CCPPP) has now established its position on the need for better accounting guidance to enable partners in a public-private partnership (PPP) to record and report financial activities based on the essence and substance of their PPP transactions. The Council has concluded that:

1. There is a lack of consistent accounting treatment for PPPs in Canada.
2. In the absence of a Canadian PPP accounting standard (equivalent, for example, to FRS 5 in the United Kingdom), Canadian PPP partners risk applying lease accounting rules or other guidance to PPP transactions, with inappropriate and sometimes misleading results.
3. Potentially inappropriate accounting rules can result in the structuring of PPP transactions on an inefficient basis; for instance, by limiting levels of risk transfer to the private sector. This may not allow the full potential of PPP to be reached in delivery of public services.

2.2. Objectives of this Position Paper

The primary objective of this position paper is to identify the major accounting issues experienced within Canadian jurisdictions and, where possible, to determine the required type of clarification.

Senior governments in many Canadian jurisdictions have now adopted Generally Accepted Accounting Principles (GAAP) as their basis of accounting. For these governments, it is the CICA and its Public Sector Accounting Board (PSAB) – as standard-setters – who must provide the necessary guidance to resolve accounting issues. Currently, review of PPP accounting issues is not a priority within the published work-plan of PSAB. However, CICA’s due process for planning its work is based on its annual survey. Therefore, our objective is to bring attention to these issues and to inform PSAB of the extent that Canadian PPP accounting practitioners responsible for preparing and auditing government financial statements are seeking authoritative guidance on identified issues; issues that, in our opinion, could adversely affect fair presentation of government’s financial statements.

As a service to both the private- and public-sector organizations that are currently engaged in or considering participating in PPPs, the CCPPP has undertaken the task of facilitating dialogue amongst PPP accounting practitioners. We recognize the value of what has already been achieved nationally and internationally on improving PPP accounting; however, we are convinced that the current accounting issues and controversies could negatively affect progress in the efficient development of PPPs in Canada.

CCPPP is committed to keeping the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants (PSAB), and International Public Sector Accounting Standards Board (IPSASB), informed of its progress in this matter. CCPPP will seek stakeholders’ endorsement and support to formally inform PSAB of the positions set out in this paper and ask that PSAB, or other relevant CICA Boards, provide needed standards or accounting guidance. (PPP stakeholders are defined in Appendix B.)

Accordingly, in response to the needs of its members and associates, the Council is committed to playing an active role in ensuring that accounting standard-setters:

- Receive clear and accurate information about the underlying principles and complexities of PPPs and the significance of this industry in serving the Public;
- Gain a better understanding of the complex characteristics of PPP transactions, particularly those distinguishing PPP transactions from leases. These characteristics emphasize the need for specific PPP accounting standards;
• Receive confirmation of the Council’s support and encouragement while improvement in accounting guidance is in progress. For this purpose CCPPP offers to collect and analyze the PPP industry’s comments on developmental material and exposure drafts; and

• Make available new accounting guidance to govern fair presentation of PPP transactions.

This paper intends to clearly communicate these objectives to all CCPPP members, associates, and other stakeholders with the view to solicit support in expediting improved guidance on PPP accounting.

There are a number of stakeholders involved in the accounting treatment of PPP transactions, all of whom CCPPP believe need to become engaged in the dialogue regarding appropriate accounting guidance. These include:

• Canadian Institute of Chartered Accountants, including its Public Sector Accounting Board;
• Accounting Standards Oversight Council;
• Federal Government (policy on Alternative Service Delivery);
• Statistics Canada;
• Canadian Revenue Agency;
• Auditors General;
• Comptrollers General;
• Private-sector Proponents, their auditors, tax advisors and debt providers; and
• Rating Agencies.

The following section outlines the reasons why the accounting guidelines that are currently available to PPP practitioners are considered inadequate.
2.3. Outline of Current Guidance for Government’s Contractual Arrangements

Applying Accounting Guidance to Government’s Contractual Arrangements

The starting point of existing guidance is to determine the type of PPP contractual arrangement. PSAB identifies three major types of contractual arrangements:

1. A government partnership;
2. A joint venture;
3. A lease.

Other business activities:

A fourth category has recently been added to accounting guidance in the form of Variable Interest Entities, which may reflect none of the above contractual arrangements or may be a subset of a government business partnership. By default, it seems that the remaining contractual arrangements entered into by government would fall into the common procurement sphere.

Related party transactions:

The explicit reference in accounting pronouncements for the need to reflect the essence of an economic activity has resulted in the emergence of accounting guidance that probes the relationship between entities and investors from a perspective of risk, reward, control and influence. These guidelines may have significant effect in making a decision whether an asset is “on” or “off” balance sheet.

Government Partnerships:

A government partnership is a contractual arrangement between the government and a party or parties outside of the government reporting entity that has all of the following characteristics:

a) The partners cooperate toward achieving significant clearly defined common goals;

b) The partners make a financial investment in the government partnership;

c) The partners share control of decisions related to the financial and operating policies of the government partnership on an ongoing basis; and

d) The partners share, on an equitable basis, the significant risks and benefits associated with the operations of the government partnership.

The contractual arrangement establishes that the parties have shared control over the government partnership regardless of the difference in their ownership interest. Nevertheless, overall, there must be an equitable relationship between the financial investment of the government in the government partnership, the extent of control it is able to exercise over the activities of the government partnership, and the risks and benefits that accrue to the government from the government partnership. Government partnerships may be structured as operations under shared control, assets under shared control or organizations under shared control.

Despite their name, public-private partnerships are rarely treated as partnerships for accounting purposes, because they do not usually meet condition (d) above.

A government business partnership is a government partnership that has all of the following characteristics:

- It is a separate legal entity with the power to contract in its own name and that can sue and be sued;
• It has been delegated the financial and operational authority to carry on a business;
• It sells goods and services to individuals and organizations other than the partners as its principal activity; and
• It can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources other than the partners.

Government financial statements should recognize the government’s interest in government partnerships using the proportionate consolidation method. Government business partnerships are treated on a case-by-case basis depending upon the details of the partnership.

Joint Ventures:
A joint venture (“JV”) is an economic activity resulting from a contractual arrangement whereby two or more venturers jointly control the economic activity. A venturer is a party to a joint venture, has joint control over that joint venture, has the right and ability to obtain future economic benefits from the resources of the joint venture and is exposed to the related risks. Joint control of an economic activity is the contractually agreed sharing of the continuing power to determine its strategic operating, investing and financing policies.

PPP transactions are rarely treated as joint ventures between the government and the private-sector partner for accounting purposes because typically there is not joint control of economic decision-making.

Accounting treatment for JVs:
In Canada, interest in joint ventures is recognized in the accounts of each venturer based on proportionate consolidation, reflecting the substance and underlying economic reality of their respective interests, regardless of the structures or forms under which the joint venture activities take place. A joint venture requires joint control, even if venturers’ interests were unequal. The following treatments reflect the essence of accounting rules for JVs where “operations”, or “assets” or the “enterprise” are jointly controlled.

Accounting for an interest in jointly controlled operations using the proportionate consolidation method results in the venturer recognizing:
• in its balance sheet, the assets that it controls and the liabilities that it incurs; and
• in its income statement, its share of the revenue of the joint venture and its share of the expenses incurred by the joint venture.

Accounting for an interest in jointly controlled assets using the proportionate consolidation method results in the venturer recognizing:
• in its balance sheet, its share of the jointly controlled assets and its share of any liabilities incurred jointly with the other venturers in relation to the joint venture; and
• in its income statement, any revenue from the sale or use of its share of the output of the joint venture, and its share of any expenses incurred by the joint venture.

Accounting for an interest in a jointly controlled enterprise using the proportionate consolidation method results in the venturer recognizing:
• in its balance sheet, its share of the assets and its share of the liabilities of the jointly controlled enterprise; and
• in its income statement, its share of the revenue and its share of the expenses of the jointly controlled enterprise.
Leases:
Current Canadian GAAP indicates that, in form if not in substance, many PPPs will fall within this category of business arrangement.

The CICA defines a lease as the conveyance, by a lessor to a lessee, of the right to use a tangible asset, usually for a specified period of time, in return for rent. This definition does not get into “capital” and “operating” classification of a lease, which though using different terminology are understood to be the two major classification of leases by the Canadian standard-setters and their international brethren. CICA and IAS accounting standards for leases are converged, except that: (i) IAS uses the term “finance lease” in the same manner as CICA uses “capital lease”; (ii) IAS does not subdivide finance leases into sales-type leases and direct financing leases; and (iii) disclosure requirements vary.

International and USA accounting standards Boards have commenced a project on lease accounting, likely to result in an accounting model different from what we now have.

Variable Interest Entities
Existing Canadian accounting guidance on what types of contractual arrangements should be consolidated has been extended to include Variable Interest Entities (VIE). AcG-15 “consolidation of variable interest entities” provides guidance on accounting for contractual, ownership, or other interests in an entity that exposes its holders to the risks and rewards of the entity. Variable interests include equity investments, loans, leases, derivatives and other instruments whose value changes with changes in the VIE’s net asset. AcG-15 and EIC 157 help distinguish a VIE from other business enterprises based on the substance of its activities, the size of the equity investment in it and rights and obligations of the equity investors.

Previously only subsidiaries were expected to be consolidated. Including VIEs in consolidated financial statements is a strong indication of the importance of risks and rewards in recognition of assets and liabilities that are not necessarily controlled by a consolidated entity. Conceptually this new paradigm is relevant to PPPs because allocation of risks and rewards is an essential feature of these arrangements.

The structure of PPP entities also resemble many VIEs, as both are often created as a single-purpose entity whose activities were predetermined by arrangements between related parties. This is another reason why an understanding of accounting guidance for VIEs could help PPP accounting.

A VIE could be a corporation, a partnership, or a trust. With few exceptions, the VIE Guideline applies to all entities, including government business enterprises. The party who is expected to bear the largest portion of expected losses (and benefits from the majority of expected residual returns) is the VIE’s primary beneficiary and is required to consolidate the VIE.

Service and management contracts, too, could be “variable interests” if the compensation is not market-based. According to AcG-15 a party with no exposure to expected losses may still be the VIE’s primary beneficiary through a management contract.

VIEs usually do not start with sufficient equity investments. To attract new equity holders (lenders, etc.) the VIEs allow them to participate significantly in the entity’s financial results. Equity in VIEs is therefore inherently at risk. The equity holders who take such risk are not given controlling interest, but they agree to absorb expected losses and to receive residual returns. This makes “expected losses” the benchmark for determining if an entity is a VIE. In a VIE, votes are not proportional to economic activities and investors do not participate in conducting the VIE’s activities.

Equity investment does not include subordinate and convertible debt, and other investment such as commitment to fund losses. Financial Statement disclosure depends on whether the primary beneficiary is or is not the potential discloser.
General Concerns on Existing Accounting Guidance

Throughout the world, the general direction of public-sector accounting standards is to move financial reporting towards whole-of-government financial statements that provide understandable, transparent, and comparable information on an accrual accounting basis. Canada has been a leader in public-sector accounting, in that in almost all its jurisdictions senior governments have adopted both the accrual accounting and reporting annually using Summary Financial Statements. To improve the overall quality of financial reporting in Canada the CICA has in recent years embarked on issuing standards and guidelines that place visible emphasis on such attributes as the economic substance of transactions, transparency, and conservatism – all of which had already been implicit in Canadian GAAP. The explicit emphasis on these attributes helps accountants in making judgments. Pragmatically, however, it has also opened new doors for controversial interpretations.

Accountants and auditors who are involved in financial reporting of PPPs are looking for clarification and better guidance to ensure consistency of accounting treatment of PPP projects in Canada. Determining the “substance” of a transaction and exploring the level of control over operations of the private partner play central roles in accounting for PPPs. In recognizing these pivotal issues, some flexibility has already been
Public Sector Accounting for Public-Private Partnership Transactions in Canada

built in Canadian standards for capitalization of PPP assets. For instance, in some circumstances, they could be recognized in government financial statements even though they are owned by a third party. As well, in certain cases the private sector may not be permitted to book as tangible capital assets the property, plants, or equipment it owns. With a number of alternative methods to account for transactions, we intend to present the degree to which these alternatives actually represent the underlying commercial agreement of a transaction.

Whether or not the cost of services or value of assets are recorded in the books of the government or the private sector, they must be appropriately valued. Most accounting practitioners involved in PPP accounting are of the opinion that Canadian guidance on valuation is inadequate. They look to other members of the accounting community, for instance FASB, for better guidance. We intend to present alternative methods of accounting treatment and demonstrate the appropriateness of each method for PPP transactions.

Improving financial disclosure of the economic substance of PPP arrangements in government financial statements is already underway in Canada. PPPs in Canada have reached the critical mass to justify PPP specific accounting standards rather than applying surrogate standards for them. Sharing experiences and participating in constructive discussion of accounting issues with standard-setters is an objective of this paper.

The concerns expressed by CCPPP members are shared by national statistics bodies, who are keen to see:

- **Consistency in PPP accounting:** Since any new standards will need to accommodate very different kinds of transactions, there should be homogeneity in accounting in order to ensure proper statistical treatment. This would not be accomplished if there is wide variance in interpretation.

- **Comparability:** Users will need to be able to use financial information produced under these standards to compare the effectiveness of one PPP project vs. another. Ideally, for statistical purposes this information needs to be uniform enough to allow for the aggregation of data.

A key question is whether the information produced permits adequate comparison between projects run only by government under conventional delivery, projects administered only by the private sector as well as those in the form of PPPs.

*Appendices A, B and C present information on sources of accounting guidance, application of currently available guidance to public-sector contracts, and major international accounting pronouncements. A review of these appendices helps better understanding of major accounting issues presented in Section 4.*

### 2.4. Features and Benefits of a PPP

Some jurisdictions require that PPPs achieve off-balance-sheet treatment for government while others, including all Canadian jurisdictions, are indifferent as to the accounting outcome, focusing instead on value for money. The latter is certainly the approach taken by most advanced economies, particularly where governments are committed to transparency and public accountability.

There is a real concern that if exactly the same accounting treatment is used for PPPs as for conventional government delivery, then this will impose the same constraints and restrictions on the efficiency of PPP delivery as for conventional government delivery. In other words, in practice, accounting treatment can positively or negatively affect the commercial features of the PPP.

The ideal PPP transaction provides incentives to the partners to freely make appropriate choices in respect of risks and in the design, construction, financing, operations and maintenance. In accounting terms this would mean an ideal PPP transaction in which the private sector provides a performance-based service to the public sector (independent of any assets necessary to provide the service) for which government pays
only as and when it receives the service. No assets or liabilities would be created on the government’s balance sheet and performance payments would be expensed only in the time period in which the services are delivered. Accounting should enable partners to properly measure, record and report these features and the benefits derived from them.

In practice, PPPs give rise to three general transaction types:

- Asset transfers (government transfers existing assets to private sector);
- Asset acquisitions (private sector creates new assets which pass to government); and
- Government service payments.

All of these transactions can occur in a single PPP project.

At a high level there are several arguments why PPP delivery is more efficient than conventional government delivery.

First, government delivery is often greatly affected by the prevailing budgetary environment. When constrained by capital costs and capital budgets it can result in an excessive focus on the reduction of upfront capital costs. Alternatively, when unconstrained, it can lead to an overbuilding of an asset. This is often at the expense of whole-of-life cost analysis. In other words, government may spend significantly more on operations, maintenance and rehabilitation over the life of an asset because of initial under-investment in design and construction. These costs are expensed in the year in which they are incurred – rather than being balance sheet items – and arguably receive less attention in government’s budgetary process.

Later in the asset’s life, when faced with constraints in their operating budget, governments will often defer maintenance, leading to more rapid deterioration of the asset and higher rehabilitation costs. This “infrastructure maintenance deficit” is common; however, it is not typically reported in governments’ accounts or budgetary process.

By under-investing in capital (or underestimating costs and timetables); failing to integrate design, construction and operations; and deferring maintenance and not rehabilitating assets at the most appropriate time; governments will often substantially underestimate or exacerbate the risks associated with delivery. These risks are typically not taken into account in the accounting or budgetary process, except with the benefit of hindsight when risks have materialized and governments either incur higher expenses, write down asset values and/or incur higher debt.

Hence, governments have few accounting or budgetary incentives driving them towards the most efficient delivery of infrastructure. PPP delivery, by focusing on effective risk transfer and whole-of-life performance, can provide much better value for money. This risk transfer also leads to further advantages, such as providing incentives for consortia to innovate with better designs – integrating all components, to take a service perspective regarding how to best deliver the services to the prescribed key performance indicator regime, and to look for more efficient use of the underlying assets such as third-party revenues.

These reasons were, and remain, particularly significant where governments follow cash-based accounting policies. They remain relevant under accrual accounting currently in use in the majority of senior governments in Canada. It is also important to note that even those governments which have adopted accrual accounting still organize many of their internal processes around their historic cash accounting practices and are in the process of understanding fully how accrual accounting affects the way they transact.
2.5. The Need for Separate PPP Accounting Standards

PPP transactions are relatively unique transactions which it can be argued, are not well described by current accounting guidance in Canada. As a result, there is a tendency to default to lease accounting standards to determine that a tangible capital asset exists, which would then be recorded on balance sheet. Then the challenge is to attempt to value that asset in a way which can be recorded and does not include costs which are of a variable nature and would normally be expensed.

Accounting Guidance

Accounting guidance varies between jurisdictions; however, a growing trend towards specific or supplemental guidance for PPP transactions is apparent.

The United Kingdom has been following the Financial Reporting Statements (FRS) 5 in accounting for its Private Finance Initiative program. FRS 5 presents standards which are better suited towards PPP transactions than UK GAAP. FRS 5 standards have stood the test of time so far, and are not expected to change radically in the future. As we understand it, the UK accounting framework FRS 5 Application Note F (1998) was developed to fill the policy vacuum on accounting for service concessions but importantly its architects recognized the necessity to address:

- The existence of non-separable linkages between service outcomes and the underlying infrastructure assets. For many PPPs, it makes little commercial sense to try and strip away every service obligation so as to attempt to make an unencumbered assessment of the risks and benefits of a stand-alone asset(s). For example, the PPP may involve a genuine abatement regime which has the effect that service failures impact the debt service components of the payment stream, and hence commercial separability is not possible.

- The implications of risk transfer and the desirability of examining a specific group of risks before making a judgement based on all the evidence. Until FRS 5 F, it appeared that some in the accounting profession were only interested in two risks: demand and residual value. One of the key risks that is typically transferred out is design risk. Its importance varies with the PPP model adopted and the nature of the service concession. The rationale is that assigning design risk allows for innovation; it does not constrain the way that the (service) outputs are to be delivered. Simultaneously, the service provider is able to integrate construction, design and operational phase requirements such as augmentations, and ongoing maintenance, and thus have the potential to deliver a lower “whole-of-life” service cost. Clearly, the design solution could significantly impact the nature of the underlying infrastructure asset base.

Australia and New Zealand have adopted International Accounting Standards (IAS), which include the recently revised accounting guidance on service concession arrangements.

Although Australia has adopted the International GAAP, it still argues that existing accounting tools e.g. the Leasing Standards, simply do not contemplate the more complex and interwoven rights and obligations that characterize the sort of PPPs that they implement under their Partnerships Victoria (Australia) policy. Therefore, other standards (such as the leasing standards) should not be considered as a viable alternative to standards tailored to PPPs.

For example, in Australia, Partnership Victoria has indicated that it believes that the Leasing Standard is fine for an asset supply, but it is a “blunt tool” to apply to a modern PPP. Most Partnerships Victoria PPPs are service arrangements underpinned by infrastructure assets. The key point is that the asset supply is subservient to the delivery of contracted services. The contingency of payment on service outcomes distinguishes PPPs from asset leasing where payment is generally dependent on the supply of functional capacity, as in for example, a dry lease of an aircraft.
The Australian Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC — an intergovernmental Committee that advises Australian Heads of Treasuries on accounting and reporting issues) has produced guidance for the public sector on accounting for PPPs. This guidance is based on the UK accounting Standard FRS-5 (Application Note F). Victoria has endorsed the HoTARAC guidance, but HoTARAC has advised caution in its application to new PPPs until clearer guidance is received from the AASB on the possible impact of any forthcoming IPSASB standard.

International: The International Accounting Standards Board defines a “service concession arrangement” as an arrangement whereby a government or other body grants contracts for the supply of public services — such as roads, energy distribution, prisons, or hospitals — to private operators. These arrangements cover most PPP-type arrangements, including where the operator provides infrastructure or other consideration in exchange for the right to the service concession. The International Public Sector Accounting Standards Board is developing guidance for the “grantor” of such a “service concession arrangement”, which is usually a government.

Canada expects PPP accounting practitioners to use the Canadian GAAP in accounting for PPP projects. No specific set of guidance is available.

United States: A Memorandum of Understanding between the International Accounting Standards Board and US standard-setters FASB explains the convergence project. The aim is to make measurable progress in 2008, and the completion of a few projects indicates the success of this joint effort thus far.

Arguments in Favour

Those favouring separate accounting guidance say that the answer to need for PPP-specific accounting guidance is an unqualified “yes” because accounting guidance is needed to answer the fundamental balance sheet question of who controls the infrastructure assets and therefore should recognize it on their balance sheet.

Proponents of separate accounting guidance say that PPPs are both significant and often complex transactions that provide value to the public. They deserve to have their own accounting guidance, similar to that followed in other countries, rather than having proxy standards.

PPP arrangements promote innovative business structures and performance-based rewards. Surrogate standards, such as “in-substance leases” are too rigid to be able to reflect the substance of PPPs.

It is too simplistic to develop and apply a rule whose practical result may be such that all toll road PPPs are not recognized in State accounts while all hospital PPPs (assets and liabilities) must be on State balance sheet. There has to be a role for professional assessment — to examine the drivers of each major PPP, weigh up the respective obligations, and form a conclusion on the specifics of each contract (substance over form).

All assets and liabilities should be reported correctly, as a matter of good corporate governance and compliance. Without specific guidance, PPP assets and liabilities may be incorrectly classified.

Public confidence and stakeholder buy-in are also compelling reasons for separate accounting guidance. Inconsistent application of various standards may lead to diverse classifications (and reclassifications) and erode the general public’s confidence in PPPs.

It is difficult to describe the knock-on effects of any reclassifications. Any large public-sector investment attracts critics and is subjected to considerable scrutiny. Public acceptance is often fragile. PPPs are no different, but perhaps not well understood. Even if a project is running smoothly such as, for example, the Melbourne County Court PPP commissioned on May 31, 2002, a balance sheet reclassification may be viewed by sections of the local media in the same way as a negative profit warning from a Rating Agency. Some commentators choose to interpret the news as delayed “proof” that the deal could not have shifted the risks that were claimed under the original contract…in effect the State must have paid too much! Of
course a change in financial reporting does not alter the project agreement. The risk transfer achieved under the PPP contract remains, but the local media only mentions the change in classification.

Another possible spill-over concerns the tax treatment of a PPP project. In a federation such as Canada or Australia, any income tax leakage from the project is at the net cost to the sponsor State.

The income tax treatment of infrastructure also depends on the identification of the owner (for tax depreciation purposes). Indeed, part of the Australian Income Tax Assessment Act relies on tests for eligibility that are remarkably similar to some of the tests in the old accounting standard on leasing. Although different regulatory bodies and jurisdictions are involved, there may be some possibility that a reversal in accounting ownership has implications for tax ownership (and therefore the final cost of service delivery – if not in the project at hand, then in the next one).

At this point it is appropriate to emphasize that the Victorian Government agencies in Australia have no qualms with on State balance sheet classifications per se. Indeed, the great majority of the PPPs delivered in the State of Victoria under the current State Government’s policy platform – titled Partnerships Victoria – have always been on State balance sheet.

Accounting should not drive anything to do with public-sector procurement choice; rather the accounting recognition of the project should *ex post* flow out of the nature of the deal signed.

**Arguments Against**

Those who oppose the need for separate guidance emphasize that Canadian GAAP is principle-based and there are ample accounting principles already in existence that collectively are able to result in proper accounting of PPP transactions. They therefore believe that existing GAAP provides adequate accounting solutions for PPPs. Relaxing them may open financial reporting to off-balance-sheet treatment of public assets.

“Control” drives international accounting guidance for PPP-type transactions, while “risks and rewards” drive the UK guidance. A combination of accounting guidance for leases and variable interest entities cover both attributes.

Applying lease standards to PPP arrangements in which the right of use of a concessionaire’s property is given to the government for the duration of the PPP contract ensures that a government is accountable for the total tangible capital assets available for its use. It also ensures that all types of long-term financing arrangements of the government are reported.

**Commercial Implications**

Lack of clear accounting guidance which appropriately portrays the substance of PPP transactions, particularly those which are performance-based arrangements (which include service concession arrangements), has a number of significant commercial implications:

- There is a lack of certainty for both public and private partners in PPP transactions.
- The terms of a transaction can and often do change at a late stage in the development of the transaction to meet accounting requirements.
- The desire to achieve certain accounting implications can distort the commercial incentives in the PPP transaction.
Recommendation

Current accounting guidance in Canada is not well suited for the features and complexity of PPP transactions. PPP-specific guidance should be developed in conjunction with international standards.

The CCPPP is in favour of a purpose-built standard similar to the UK’s FRS 5 that presents accounting guidance for PPPs. Such guidance should be sector neutral and apply equally to all similar types of PPP structure. In this regard, while we welcome the developmental work of IFRIC regarding service concessions, we are concerned with IFRIC’s narrow terms of reference. Presumably more robust guidance will emerge when the needs of all primary stakeholders are considered simultaneously, leading to a judgment that balances all legitimate claims.
3. PPP Accounting Issues

3.1. Introduction

PPPs can provide a powerful mechanism for the delivery and provision of public infrastructure and services. They can also have significant impact on public accountability as well as on budgetary and other public policies. In particular, PPPs can affect:

- The budget;
- The level of public debt;
- The level of public ownership and control of assets; and
- The structuring, cost and risk of projects.

This makes the accounting and budgetary treatment of PPPs important, both as a motivation for governments to chose PPP as a mode of service delivery, and in ensuring that the PPP itself provides significant public benefits. However, while these are important, PPPs are fundamentally chosen as a delivery method because they provide value for money.

The conventional procurement involving acquisition of property usually results in transfer of ownership from the seller to the buyer. In such transactions, making a decision on how to account for the assets is generally simple. However, PPPs often result in complex arrangements between government and its private partners. The tangible assets used in a PPP may be owned by government or by its private-sector partner; intangible assets may also be recorded regardless of ownership. In these circumstances, evidence of ownership alone would not be sufficient for making an accounting decision. Applying existing accounting practices may result in two classes of PPP assets: those which end up being reported in a partner’s financial statements (on balance sheet) and those which do not (off balance sheet).

Certainty in whether assets should be “on” or “off” balance sheet plays a very important role in government financial planning and reporting. Considering the large value of some PPP assets, disagreements amongst accountants in application of accounting standards could significantly affect the measurement of a government’s net debt and other financial indicators which, when occurring frequently, could diminish public trust in government financial performance and reporting. Clearly, for politicians, government management and auditors disagreement on accounting issues is not a desirable outcome.

3.2. Our Reporting Approach

In an ideal situation government conducts its business in a way that is most beneficial to the public, and accounting reflects the substance of the business transaction. In practice, however, if there is a choice, government prefers to choose the accounting practices that best reflect the substance of the transaction based on its stated public policy. In these circumstances, opposing views could be expressed by public-sector accountants and their auditors.

Accounting issues which could result in opposing views would generally fall into two categories: those which are the outcome of applying different guidance to a certain transaction, and those which are the result of interpreting the same accounting guidance differently. Surprisingly, there is often a viable explanation supporting both views. Nevertheless, in practice, even when both opposing views can be technically supported the prospects of having a qualified auditor’s report may press the government to adopt the auditor’s view. Sometimes, it is doubtful if the adopted accounting treatment constitutes the best practice.
To provide complete discussion and analysis of identified accounting issues expressed to date by PPP accounting practitioners amongst the CCPPP membership, for each issue this paper considers:

- **Features and Expected Benefits of a PPP** – describes what a PPP transaction is expected to deliver. (It is beyond the scope of this position paper to analyze the degree to which PPPs achieve this in practice.) Accounting treatment should be flexible enough to record and report the benefits of innovative and complex PPP transactions.

- **Accounting Guidance** – describes, at a generalist level, the guidance currently available and in frequent use for PPPs in Canada.

- **Different Interpretations** – analyses examples of the often substantially different ways in which the currently available accounting guidance is applied in similar Canadian PPP transactions.

- **Commercial Implications** – describes inappropriate effects that inconsistencies of accounting treatment can have on the commercial incentives for efficient PPP delivery. In presenting commercial implications we have used feedback received from the CCPPP membership (both public- and private-sector organizations.)

- **Recommendations** – sets out CCPPP’s position.
3.3. **Accounting Issues Addressed in this Position Paper**

The following is a list of the major accounting issues discussed in this paper. Efforts have been made to include all identified major accounting issues; however, there are a number of other potential issues which were considered beyond the scope of this initial position paper but will also need to be addressed as PPPs develop in Canada. In particular, this paper does not address the complexities of private-sector accounting for PPPs in detail.

**Issue 1:** Should the entire costs of the PPP transaction be recorded as a liability on the government balance sheet?

**Issue 2:** Does a PPP transaction create a capital asset, and should Capital Lease accounting guidance be followed?

**Issue 3:** Should PPP accounting recognize the Unitary Payment and not distort the choices between capital and operating inputs to provision of a service? How should fair value be recognized?

**Issue 4:** If a Capital Asset is identified how should it be valued?

**Issue 5:** Is there a need for guidance on the timing of recognition of PPP assets, and should accounting treatment reflect the value of early completion of a project?

**Issue 6:** Should step-in and termination payout provisions determine capital lease treatment?

**Issue 7:** Should PPP Accounting recognize the principle of limited-recourse financing?

**Issue 8:** Should different PPP payment structures be recognized in different ways for accounting purposes?

**Issue 9:** Does risk allocation have a value that must be considered in asset valuation for accounting purposes?

**Issue 10:** Should off-balance-sheet accounting treatment be ruled out?

**Issue 11:** Should the government recognize capital property, designed, financed, built and operated by its private partner, based on the value of granted rights and the asset’s residual value?

**Issue 12:** Should financial reporting of partners in PPP arrangement apply a similar basis of asset valuation?

**Issue 13:** Should accounting standards be applied consistently in financial and performance (value-for-money) reporting of PPP projects

Issues 1 through 6 deal mainly with the complexity of trying to apply lease accounting standards to PPP transactions which have very different commercial and risk drivers.

Issues 7 through 11 examine the arguments for PPP transactions being treated on a different basis without recognition of a tangible capital asset.

Issues 12 and 13 discuss the need for consistency and clarity between the different accounting and value-for-money approaches noting that some of CCPPP’s recommendations in this area may be outside the scope of the accounting standard-setting bodies that would address standards for financial reporting alone.

The diagram below illustrates the decision tree which PPP accounting needs to go through, and provides a roadmap for the issues discussed.
4. Detailed Discussion, Analysis of and Recommendation on Accounting Issues

Issue 1: Should the entire costs of the PPP transaction be recorded as a liability on the government balance sheet?

Features and expected benefits of a PPP

A PPP will typically be a contractual commitment by a government to procure a service from the private-sector partner over an extended time period, frequently as long as 30-40 years. Payment for the service can be in the form of direct government payments (Availability transactions) or the right to collect payments from third-party users (User-pay transactions). Provided the private-sector partner delivers the service to the agreed specifications, the government is obliged to pay. The payment obligations typically bundle the costs of building and financing whatever capital asset is required with the costs of ongoing operations and maintenance.

The advantage of this is that it provides certainty of outcomes for transactions which have a life well beyond normal public-sector budget periods and ensures that long-term operating and maintenance costs are taken into account from the outset of the transaction.

Accounting Guidance

It is sometimes argued that the entire PPP contractual commitment should be treated as a government obligation and be reflected on its balance sheet as a liability. Supporters of this view refer to Public Sector Accounting Standard 3200-03 that requires that liabilities be recognized in the financial statements when:

- There is an appropriate basis of measurement; and
- A reasonable estimate can be made of the amount involved.

According to PS 3200, obligations are liabilities if they meet the following three characteristics:

- They embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;
- The duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
- The transactions or events obligating the government have already occurred.

Different Interpretations

It is rare for accountants to insist on such treatment for all future payments. PPP transactions will typically have a number of features which provide support for not treating future payments, amongst other elements, for operations and maintenance as a liability.

1. The payments by government are typically contingent and variable. For example, they are only made if the private sector continues to provide the service and are frequently subject to performance deductions which reduce payments if the service is not delivered to desired standards. Typically this variability applies both to operating and maintenance payments and to underlying payments for any capital asset.

2. The government will typically have a right to terminate the PPP arrangement “for convenience”. In this event the government will usually be required to make a payment equivalent to the financed
capital value of the asset, but normally not including future operations and maintenance costs. See Issue 6 for further discussion of the termination provisions of PPPs.

These issues typically lead to an effort on the part of accountants to try to separate capital from operating and maintenance components of a PPP transaction. This issue is discussed in Issue 3.

Commercial Implications

Applying this standard would lead to accounting treatment for a PPP which would be substantially different from that under conventional government delivery. Conventionally government would construct the capital asset required to provide the service and recognize this as an asset on its balance sheet with any debt used to fund the asset creating an offsetting liability. The asset would be amortized over its useful life creating an annual expense to the budget under accrual accounting, and the debt liability reduced as and when it is repaid. The ongoing operating and maintenance costs of the asset would not be recorded as a liability on government’s balance sheet and would be expensed only in the years in which they are incurred.

Hence a requirement to treat the entire payment stream under a PPP as a liability would make a PPP transaction significantly more “expensive” in accounting terms (unless a corresponding asset – perhaps a prepayment – was recognized to offset some of the liability). The key issue is that governments care about the size of their debt because a government’s net debt is a key performance indicator. This issue is discussed in more detail in Issue 7. A PPP transaction for which a larger debt is recorded on a government’s balance sheet than for an identical conventional transaction would not be desirable. Hence a requirement to capitalize the entire payment stream, including operating and maintenance costs, would make it highly unlikely governments would pursue PPP delivery, despite advantages it could bring.

The fact that operating and maintenance costs of a PPP are not capitalized as an asset would also be compliant with the concepts used in the Capital Expenditure Survey conducted by Statistics Canada, which is that operation and maintenance costs are not accounted for in the gross capital formation numbers.

Recommendation

CCPPP recommends that:

1. Formal accounting guidance should be applied to PPP transactions to ensure that costs such as operating and maintenance costs, which would not usually be capitalized on government’s balance sheet, are not capitalized under PPP delivery.

2. Accounting guidance should be issued to formalize the extent to which a transaction should be recorded on balance sheet, and risk transfer should be taken into account in this determination.
**Issue 2:** Does a PPP transaction create a capital asset, and should Capital Lease accounting guidance be followed?

**Features and Expected Benefits of a PPP**

At the theoretical level, the ideal PPP transaction is one in which government specifies a service which it wants to buy over the life of a concession. The choice of how to provide that service and what capital and operating inputs to use is left entirely to the private-sector partner.

An example would be government specifying that it wants the capacity to move say 3,000 vehicles an hour over a river. The private-sector partner would have the choice of building a bridge or a tunnel or perhaps using ferries. These different approaches could have very different implications for the capital assets employed in delivering the service, and in the cost of operating them.

In practice there is rarely such complete flexibility, and the government plays a large role in specifying the type of capital asset which is required to provide the service. This role will often lead to accountants seeing government control of a tangible capital asset.

**Accounting Guidance**

Current PPP accounting guidance tends to pivot around the asset component of the transaction rather than the service component. The accounting standards used as guidance focus primarily on whether a tangible capital asset is used in creation of the service and seek to apply accounting rules developed for leases.

PPPs are complex business arrangements in which, contractually, the risks and rewards have been allocated to PPP partners. The logic used to determine whether PPP arrangements are leases and not service agreements is based on the new Emerging Issues Circular 150 – Determining Whether an Arrangement Contains a Lease issued by the Emerging Issue Committee of PSAB. It helps a practitioner decide if it is appropriate to apply GAAP for leases, using CICA Handbook – Accounting, Section 3065 and CICA Public Sector Handbook Guidance – PSG-2. Guidance from the EIC is the primary source of GAAP for commercial businesses. EIC-150 also includes references to other standard-setters for the commercial sector.

This guidance, which is observed by Canadian governments, directs that most agreements involving the use of capital assets are leases and makes no reference to the fact that most jurisdictions have different lease rules. Unfortunately, governments in Canada must use PSAB (Red Book PSG-2) guidance, which provides severe rules for the capitalization of leases. There is, however, some room for interpretation of PPP-type concession contracts within EIC 150 itself.

Once it has been concluded that lease accounting is appropriate, then the practitioner must decide whether the arrangement is, in substance, a **capital** or an **operating** lease.

**Capital lease** is a lease that, from the point of view of the lessee, transfers substantially all the benefits and risks incident to ownership of property to the lessee. A capital lease requires government to record the asset as a capital asset and to recognize the payment liability as long-term debt. This is of concern to governments which are under debt cap limits: the more debt assumed, the less room there is for other projects under the cap.

Where a senior government is a lessee, accounting for a PPP as a capital lease results in the recognition of an asset and a liability in the summary financial statements equal to the present value, at the beginning of the lease, of the “minimum lease payments”, less certain costs. Under no circumstance can the value recorded for the asset and liability be greater than the leased asset’s fair value. An appropriate discount rate must be applied in calculating the present value of the minimum payments. Local governments can account for leased property that meets the definition of a leased tangible capital asset as an expenditure and a liability.
At least one or more of the following conditions must be met for a transaction to be treated as a capital lease:

1. There is a reasonable assurance that the lessee will gain ownership of the leased property or a bargain purchase option is present. This will typically be the case with a PPP where underlying assets will usually revert or transfer to government at the end of the concession term. It is important to note, however, that an increasing number of PPPs leave some residual risk of the asset with the private-sector partner. Another feature of PPPs which is often interpreted as representing a bargain purchase option, is that government will typically have the right to acquire the asset under a variety of termination events. This issue is covered in more detail in Issue 6 below.

2. Lessee receives substantially all of the economic benefits of the lifespan of the asset during the life of the lease. This is considered to be met when the term of the lease is greater than 75% of the economic life of the leased property. PPP concession terms are usually shorter than the economic life of the asset. For example, a bridge with a design life of 75 years may form part of a PPP concession with a 30-40 year term. Government will typically protect its interest in the residual value of the asset at the end of the PPP concession by specifying hand-back conditions and using end-of-term payments or holdbacks over the final years of the concession to ensure the condition standards are achieved. PPPs will not usually therefore fall into this condition for a capital lease, although it should be noted that PPP concession terms are increasing, often to reflect closer to the full economic life of the asset.

3. Lessee is assured of recovering its investment. The condition is considered to be met when the present value of the minimum lease payments is equal to 90% or more of the fair value of the leased property (using the lower of the lessee’s rate of incremental borrowing for a term equal to the initial lease term and the interest rate implicit in the lease). This is probably the most contentious issue and is described in more detail in Issue 3 below.

Additionally, the lease can be accounted for as a capital lease even though none of the above criteria are met. If substantially all of the benefits and risks are transferred to the lessee, the lease should be accounted for as a capital lease. Both the public and private sector shares the risk to some degree in a PPP project. Initially, the private sector will bear the majority of the risks due to the many operational and usage uncertainties present. The government typically shares in risks associated with extreme uninsurable events affecting services, takes or shares in utilization risks and takes risk on the performance by the private-sector partner of their contractual obligations. The government occasionally accepts more risk through various types of direct or indirect government support.

In many PPP projects, the asset is transferred to or acquired by the government entity. The approach in the recognition of the acquisition will have material impact on both the private and public party. Whether the asset acquisition/transfer is recognized throughout the life of the concession or at the conclusion will also have a material impact on both parties.

Operating lease is a lease in which the lessor does not transfer substantially all the benefits and risks incident to ownership of property. An operating lease allows government to expense the performance payments. Where a senior government is the lessee, accounting for operating leases results in the recognition of a contractual obligation and an annual expenditure in the summary financial statements.

However, once classified as a lease, it is difficult for a typical PPP transaction to be treated as an operating lease. This is because the accounting rules in respect of leases are very rigid and allow little flexibility.

This rigid treatment in Canada is inconsistent with the treatment in more mature PPP jurisdictions, notably the United Kingdom. The United Kingdom avoids rigid operating versus capital lease rules by using a “PPP accounting standard” FRS 5, which while considering many of the same issues as the lease rules, considers
the substance of the transaction not its form. A PPP transaction is therefore not consolidated on the
government balance sheet in the UK if substantially all of the benefits and risks incident to ownership are in
substance borne by the private-sector partner. This treatment is supported by, amongst other stakeholders,
Eurostat, which while not itself an accounting standard, applies similar principles to determining how PPP
transactions should be recognized in calculating the financial position of EEC governments. International
guidance is described in more detail in Appendix A of this position paper.

A PPP transaction will often look in substance like an operating lease in terms of the transfer of benefits
and risks of ownership, but will often take the form of a capital lease in terms of meeting the three tests
described above.

Service Concession Arrangements

The complexity of PPP-type service concession arrangements poses significant accounting challenges for
both the private- and public-sector practitioners. To improve guidance for the private-sector partners in a
concession, on November 30, 2006, after a very lengthy process, the International Accounting Standards
Board (IASB) issued guidance titled IFRIC 12 – Interpretation on service concession arrangement. In issuing
this guideline the IASB amended the scope of an earlier interpretation, IFRIC 4 – Determining whether an
arrangement contains a lease, such that if the scope criteria of both IFRIC 4 and IFRIC 12 are met IFRIC 12
will prevail. In other words, the private-sector partners need not consider accounting for leases if the
arrangements meet IFRIC 12’s criteria. International Public Sector Accounting Standards Board (IPSASB) has
also started its own project on service concession arrangements which will consider accounting by the
public partner (i.e. government). IPSASB intends to consider the principles applied in IFRIC 12 as part of its
project.

The outcome of this project may considerably affect the application of lease accounting for PPPs. As
IPSASB’s project has not yet been finalized, we continue to address our concern about adopting accounting
standards for leases for PPP arrangements.

Commercial Implications

A key problem in focusing on the creation of a capital asset in a PPP is that the capital asset produced
under PPP delivery may be different from that produced under conventional delivery due to the flexibility
provided in how the service is delivered. Furthermore, in a PPP competitive process the type and cost of
capital asset used by different proponents may differ substantially.

Where a government is experiencing balance sheet or budgetary constraints, accounting treatment could
very easily become an implicit evaluation criterion both in whether or not to utilize PPP delivery and also in
distinguishing one PPP proponent from another. Prejudicing a decision on the basis of inadequate
accounting guidance in Canada is harmful to the both the public interest and the growing PPP industry.

Feedback from the CCPPP membership strongly suggests that these issues are not just theoretical
possibilities, but have occurred in PPP delivery processes in Canada.

There is often a significant difference in the capital value of different PPP proposals. The proposal with the
higher capital value is not necessarily the most expensive solution (measured by the NPV of the total stream
of payments including operations and maintenance). Government procurement agencies have been known
to try to influence proponents to keep the capital cost component of their solution to the minimum to limit
balance sheet impact.

This has consequences for efficiency of delivery. CCPPP members have indicated that this leaves open the
possibility of manipulating the allocation of costs between capital expenditures and operating and
maintenance costs if it leads to desirable outcomes for government.
The ideal PPP transaction is one in which the private sector is free and incentivized to make appropriate choices in respect of risks and the design, construction, financing, operations and maintenance solutions to those risks.

In accounting terms this would mean an ideal PPP transaction is one in which the private sector provides a performance-based service to the public sector (independent of any assets necessary to provide the service) for which government pays only as and when it receives the service. No assets or liabilities would be created on the government’s balance sheet and performance payments would be expensed only in the time period in which the services are delivered.

Recommendation

CCPPP recommends that:

1. PSAB guidance be amended so that PPP transactions are not automatically assumed to be a capital lease with a capital asset.

2. Canada adopts emerging international practice (as represented by IFRIC) in respect of service concession arrangements as early as possible.
Issue 3: Should PPP accounting recognize the Unitary Payment and not distort the choices between capital and operating inputs to provision of a service? How should fair value be recognized?

Features and Expected benefits of a PPP

As previously discussed, a great deal of accounting attention is often given to separating capital expenditure from operations and maintenance aspects of a PPP transaction. Unfortunately, this separation can distort the commercial advantages of a PPP.

Many combinations of tangible capital assets and operating activities may result in projects capable of providing the required services for which the private partner is paid. From a business perspective, the revenue is received in return for providing the service. The payment is not an instalment for acquiring a portion of the capital asset and for operating and maintaining it. However, the current accounting guidance forces the practitioner to split the unitary payment into the amount paid for each component. In doing so, the accounting fails to reflect the substance of the transaction.

The concept of a “Unitary Payment” was initially developed in the UK as the service payment to cover the full costs of design, construction, financing, operations, maintenance and rehabilitation, without breaking these down into separate component parts. This concept of inseparable components is an extremely important substance of a unitary payment; ignoring it increases the risk of arbitrary accounting of different components of the payment and manipulation. This issue goes to the heart of the commercial advantages of PPP delivery. The unitary payment concept is not as consistently applied in Canada, as some jurisdictions require proponents to bid a separate stream of capital and O&M payments.

Accounting Guidance

Applying accounting guidance PSG-2 Determining whether an arrangement contains a lease to PPPs often presents technical challenges; this is because some of the risks associated with PPPs are “allocated” rather than “transferred”, and also because the substance of “unitary payments” in PPPs is not the same as rental payment in leases. PPP arrangements are frequently much more complex than leases. Therefore, if existing GAAP is to be applied to PPPs it may become necessary to find equivalent PPP-related meanings for important terminologies used for leases, notably: “minimum lease payments”, “fair value”, “discount rates,” and “inception of the lease”. These are considered below.

“Minimum lease payments” from the point of view of the government (for details see CICA Handbook Section 3065 or Public Sector Accounting Guideline PSG -2) is essentially the total of all the minimum rental payments called for by the lease over the lease term plus the value of bargain purchase option, or that of guaranteed residual value of the leased property payable by government at the end of the lease term. For leases, “minimum lease payments” from the point of view of the government is essentially the total of all the minimum rental payments called for by the lease over the lease term plus the value of bargain purchase option, or that of guaranteed residual value of the leased property payable by government at the end of the lease term.

CICA defines “fair value”. In addition, FASB has recently issued a comprehensive guidance Statement of Financial Accounting Standards No. 157 on Fair Value Measurement. This statement defines “fair value” as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.
Different Interpretations

Unitary Payment

If a PPP transaction designed in accordance with the best practice of a unitary payment is classified as a capital lease, there are few precedents for determining the detailed accounting treatment. A challenging aspect of this treatment is the establishment of the asset capital value. There are two approaches available to auditors to accomplish this, both of which present difficulties.

1. Under the first approach, the auditors attempt to identify "minimum lease payments"; however, as typically all payments are variable and contingent upon availability, demand and performance, often there is no minimum payment. The present value of the determined minimum payments are calculated utilizing a discount rate equal to the government's incremental cost of borrowing and then recorded on both the asset and liability side of the government's balance sheet. As the payments are a unitary payment, it is difficult to separate the capital components of the payment from the operating components to establish the "minimum payment".

The accountant should arguably also separate out a component best described as payment for risk, because this can be seen as an insurance cost which should be expensed over time rather than capitalized. Risk is considered further in Issue 6 below.

2. Under the second approach – discussed further in Issue 4 – the auditors would attempt to establish the capital cost of the assets either from the private-sector proposal or from an "equivalent" capital cost of government delivery. This capital cost would then be treated as an asset in government's balance sheet matched by an equivalent liability, which could be derived from the net present value of part of the future obligation to make performance payments. It is clear that this amount may not represent the true capital costs and may distort the transaction.

Those in favour of breaking down a unitary payment into its capital and operating components argue that the component information is available to the concessionaire given that they required the information to bid for the concession. They argue that its therefore possible to break down the payment into its pure service component and other business activities. Using this information would allow the government to separately account for each component and report on them publicly.

Those who oppose breaking down the unitary payment argue that in complex PPP arrangements the concessionaire is aiming to have an overall return, based on the premise that risk is accompanied by uncertainty. Therefore, even if certain assumptions have been made on the components of the PPP, they could be arbitrary. It serves no purpose to insist on this breakdown based on untested assumptions.

It may seem contradictory for CCPPP to take the view that operating and maintenance costs over the life of the asset should not be capitalized while simultaneously supporting the use of a “unitary payment” which cannot easily be split. If unitary payments cannot easily be split then asset and liability values cannot be reliably measured separate from concession payments. However, CCPPP firmly believes that efforts to make the accounting treatment for PPPs simpler and easier also undermine the commercial incentives which make PPPs an improvement over conventional delivery. The accounting profession may want to separate capital payments from operating and maintenance payments and deal with them in different ways, but the essence of a good PPP transaction is that decisions on what mix of capital and operating inputs to use should be neutral.

It would be useful to calculate the present value of total capital, operating and maintenance payments – under both the PPP arrangement and a conventional build-finance-operate-maintain approach – as a comparator.)
**Terminology**

If the first approach described above, identifying minimum lease payments, is applied, it results in several interpretation issues. Practitioners’ judgment on whether current terminology is adequate depends on whether they view lease accounting as appropriate.

Those who see the current accounting guidance for leases as inappropriate for PPPs argue that its application may lead to shoehorning PPPs into lease standards and may result in misrepresentation in government financial statements. If lease guidelines ought to be used, then clear definition of what is meant by “minimum lease payments”, “fair value” and “discount rates”, as well as “inception of the lease” (in the context of PPPs) would make accounting for PPPs less cumbersome.

Those who seek to apply lease standards – usually because they are generally accepted rather than because they are actually appropriate – believe that defining terminology is unnecessary because once it is established that a PPP in substance is a lease, it should be accounted for as such. They argue that key lease terminologies have been adequately defined and further definition risks creating confusion. They further argue that PSG -2 is clear regarding the application of Government’s rate for incremental borrowing in calculating the present value of minimum payment and therefore there is no reason for any other discount rate to be employed. Proponents of this argument go on to argue that this discount rate should also be used in developing the Public Sector Comparator – the benchmark developed by government against which it measures the private partner’s proposals.

The following describes the interpretation problems identified regarding isolating minimum lease payments in the presence of unitary payments:

**Identifying Minimum Payments**

Identifying a minimum lease payment in a PPP arrangement utilizing a unitary payment is challenging. Often, a PPP transaction will not contain any minimum payment provision; for example, there is no guaranteed minimum payment for such items as debt servicing. However, accountants have often analyzed the deduction regime to conclude that under most circumstances the deductions are unlikely to lead to a complete abatement of the payment and therefore conclude that there is an implicit minimum payment.

While it is appropriate to conclude that there is usually some kind of implicit minimum payment that will be paid, there are significant problems with quantifying this minimum payment. In addition, there are a number of risks faced by the private sector that could lead to no payment being received. Determining minimum lease payments by breaking down unitary payments, for instance, to its major components in order to calculate availability-related costs, demand-related costs, performance-related costs, and executory costs such as repairs and maintenance, taxes, and insurance, can be quite arbitrary.

Inclusion or exclusion of the demand-related costs at the inception, for example, hinges on the likelihood of payments in the most conservative demand cases, which often goes far beyond the realm of future uncertainty.

A practical definition of minimum payments is required if guidance for leases is to be used for PPP arrangements. Though some may conclude that is possible, it is inappropriate to conclude:

- That the minimum lease payment determined by accountants is actually committed by the government. While accountants may determine that “under most circumstances the deductions are unlikely to lead to a complete abatement” this does not mean that those actually entering into the agreement have come to the same conclusion and not priced the risk of the elimination of those payments into their evaluation of the project. The high-value, low-probability, uninsurable outcomes are often those that cause the most consternation to those entering into PPP arrangements from the private sector; and
That the minimum lease payment is representative of only the capital portion of the agreement. This is important if the minimum lease payment is to be used in determining the portion of value that can be attributed to the “capital lease”, if that is how the arrangement is being described for accounting purposes.

While a “minimum lease payment” can be determined for the project, it is not likely representative of all of the risks considered by the private sector when contemplating the project, and is certainly not representative of only the capital portion of the agreement.

**Discount Rate**

Deciding what discount rate is appropriate for calculating the present value of future payments in a PPP is a challenging task. There are currently two available definitions of discount rate that can be utilized in the calculation of present value: the rate implicit in the lease and the government’s rate for incremental borrowing – both pose difficulties.

The “discount rate” used for leases is the *interest rate implicit in the lease*. This is essentially the discount rate that, at the inception of the lease, causes the minimum lease payments, from the standpoint of the lessor – minus certain costs, plus residual value of the property – to be equal to the fair value of the leased property to the lessor. This could become problematic in assessment considering difficulties relating to the definition in PPPs of “minimum payment”, “fair value” and “inception”.

The other available method is to use the *government’s rate for incremental borrowing*. This is essentially the interest rate that, at the inception of the lease, the government would have incurred to borrow the funds necessary to purchase the leased property over a similar term and with similar security for the borrowing. Applying the *interest rate implicit in the lease or government’s rate for incremental borrowing* could drastically affect present value calculations.

The *government’s rate for incremental borrowing* is a preferential rate which is lower than the cost typically available to the private-sector market. Using it as the discount rate in calculating the present value of the minimum lease payment will result in a value which exceeds “fair value”. Essentially, the government is borrowing at a significantly reduced rate relative to the private sector for the actual risk of the asset, and is essentially backing the risks of the asset with the low risk of their taxpayer funding. While that appropriately measures the risk of the funds that the government could utilize to fund the project, it does not appropriately reflect the actual risk of the project itself.

For example, a large corporation such as Microsoft could borrow a significant amount of money at a relatively low rate and utilize it to fund an extremely risky venture capital project. If Microsoft had the misconception that the required return for the venture capital project was their incremental rate of borrowing, it would consistently make poor decisions when considering projects, therefore undertaking projects with considerable risk due to incorrect valuation. In the same way, the government could rationalize undertaking a number of risky venture capital projects if they valued the projects using the *government’s rate for incremental borrowing*, but that would incorrectly measure the actual value of the projects, leading to an obviously incorrect decision.

Of course the use of the *government’s rate for incremental borrowing* to value a transaction for accounting purposes need not mean that this is the same assumption used to make the investment decision. However, having a significant difference between the accounting valuation and the business case can lead to significant political and administrative challenges as described elsewhere in this paper.

Using *government’s rate for incremental borrowing* for accounting purposes can undermine the reason for undertaking a PPP transaction in the first place. The PPP arrangement presumably makes economic sense and is expected to benefit the public precisely because it transfers project risks which are unable to be effectively managed by the public sector to the private-sector partner. Therefore, a discount rate should be
used which reflects the risk profile of the transaction. The difference in most cases will be significant. This is considered further in Issue 7.

**Identifying Fair Value**

When a PPP has utilized the best practice of a unitary payment it makes determination of fair value difficult. As the unitary payment includes all elements of the service being provided, it can be used to determine the fair value of the transaction; but this is usually very different from the fair value of the asset, which is required for lease accounting.

Accounting standards set a limit of fair value for the value of the leased asset recorded. Fair value is essentially the amount of the consideration that would be agreed upon in an arm’s-length transaction between knowledgeable, willing parties who are under no compulsion to act. This depends on whether the lessor is or is not a manufacturer or a dealer. If it is, the fair value of the property at the inception of the lease will usually be its normal selling price. If it is not, the fair value of the property at the inception of the lease will usually be its cost to the lessor. In both cases the determination of fair value would be made in light of market conditions prevailing at the time. Would conditions such as “arm’s length” or “market conditions at the time” be relevant in PPP arrangements, where there may not be a market for the PPP asset at the conclusion of the contract? One challenge of using the government discount rate to recognize the value of future payments is that it results in a valuation significantly higher than the “fair value” to the private investor. Fair value is typically a difficult concept to apply in PPP transactions because of the “one-off” nature of the asset and its marketability.

**Commercial Implications**

It is clear that these options lead to imprecise dismembering of the PPP transaction, which could provide poor incentives. If it is known in advance that this accounting treatment will be followed, it would likely lead to governments departing from the best practice of a unitary payment and focusing on minimizing capital portions of the payment. Even if this does not occur, private-sector participants may be tempted to minimize capital cost components in order to be more appealing to government from a budgetary viewpoint. Both of these outcomes could be at the expense of the lower lifecycle costs over the term of the concession which PPP delivery is. In other words, all the wrong short-term incentives driving conventional government delivery may become apparent in PPP delivery as well.

This can best be seen in this very simplified example of two separate operators bidding for the same project.

<table>
<thead>
<tr>
<th></th>
<th>Bidder A</th>
<th>Bidder B</th>
<th>Public Sector Comparator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction Costs</td>
<td>$150,000,000</td>
<td>$100,000,000</td>
<td>$80,000,000</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>8%</td>
<td>10%</td>
<td>6%</td>
</tr>
<tr>
<td>Annual Capital Payments</td>
<td>$27,000,000</td>
<td>$20,000,000</td>
<td>$12,800,000</td>
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<tr>
<td>Annual O&amp;M Payments</td>
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<td>$10,000,000</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Annualized Rehabilitation Payments</td>
<td>$2,000,000</td>
<td>$5,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Total Annual Payments</td>
<td>$32,000,000</td>
<td>$35,000,000</td>
<td>$37,800,000</td>
</tr>
</tbody>
</table>

Bidder A chooses a more capital-intensive solution to meeting the performance requirements than Bidder B and enjoys a lower cost of capital as a result of the lower risks of this approach. Under the capital lease based approach to accounting, if Bidder A is selected as the operator, the grantor will capitalize on its balance sheet a much higher amount than if Bidder B is successful. Although in theory the total budgetary impact of the two bidders may be the same, many grantors have debt limits in addition to annual budgetary...
constraints. Accounting treatment may influence the grantor to select Bidder B in preference to Bidder A, despite Bidder B being more expensive overall.

However, both bidders could appear to be more expensive than the conventional delivery alternative indicated by the Public Sector Comparator, as the NPV of the future payments from PPP delivery could far exceed the cost of the asset which would be capitalized under conventional delivery (because of the O&M and rehabilitation payments implicit in the total payments, the risk transfer costs, and the higher costs of private financing relative to the cost of government borrowing).

Debt or long-term liabilities associated with a PPP in the accounts of the private-sector concessionaire may also not accurately reflect the government’s real liability and may understate the financial position of the government. It is also likely to prove more challenging to separate the portions of any liability recorded under a PPP transaction into general and self-supporting debt as is commonly done for Crown corporations.

The example above is not hypothetical. A recent PPP transaction clearly demonstrates the significant potential for variance in valuation of certain capital assets. A number of different valuation methods were used and compared.

1. The first was to determine the capital asset value by breaking down the unitary payment between capital and operating components, and then calculating the present value of the minimum lease payment discounted at the government’s rate for incremental borrowing. The result was a value of $784 million. The Auditor General believes that this valuation is appropriate because it is in accordance with the current CICA guidance.

2. In the second, the value of the capital asset was computed using the fixed-price contract entered into by the private-sector concessionaire adjusted by:
   a) Any ongoing operations required to be undertaken by the design-build contractor for an existing facility during construction;
   b) The insurance and executory cost component of the design-build contract, which can be disclosed by the contractor; and
   c) The monetary value of any specific, additional requirements placed on the design-build contractor by the private-sector developer beyond the scope of the government requirements. Note: the monetary value of these requirements should be lower than or equivalent to the present value of future operating and maintenance payments that would otherwise have been required if not for the intervention of the private-sector developer.

   The resulting value was $406 million.

3. The valuation in Point 2 above is close to a crude estimate of the asset value of $430 million, using present value of the minimum payment discounted based on the Internal Rate of Return of the private-sector concessionaire.

4. The valuation in Point 2 is also close to the more reliable fair value assessment of the assets of $420 million provided by the insurer of the project.

The average of the three valuations in Points 2-4 is $419 million, in sharp contrast with the $784 million which resulted in Point 1 above.
Recommendations

CCPPP recommends that:

1. On Unitary Payment

CCPPP believes that the concept of a unitary payment is important to the efficiency of PPP delivery, and recommends that accounting guidance recognize the unique characteristic of a PPP unitary payment in which the capital and operating components are inseparable. CCPPP endorses the provision, in the government financial statements, of information required for transparency and accountability of PPP transactions involving unitary payments (such as the nature of partnership, estimated value of assets employed for the purpose, and estimates of operating, maintenance, and eventual overhaul expenditures). However, CCPPP believes that such information serves the reader of financial statements best if fully described in the notes to the financial statements.

2. On Minimum Lease Payments

In general, CCPPP believes that in cases where a PPP transaction has been “shoehorned” into a lease form – particularly in PPPs involving unitary payments – the government financial statements may be substantially misrepresenting the nature of the transaction. For this reason CCPPP does not endorse the attempt to identify a minimum payment in the majority of PPP transactions involving unitary payments. In essence, for these PPP transactions, a minimum lease payment is arbitrary, in that it does not necessarily recognize the substantial risks that are often the focus of the private sector, and it is not representative of the capital component of the project because the payments for the service cannot be appropriately separated from the unitary payment.

However, if lease accounting utilizing the minimum lease approach continues to be the generally accepted accounting principle for PPPs, CCPPP recommends that a risk-adjusted stream of payments be calculated. The value-for-money report on a transaction will typically provide an assessment of the likely lease payments following abatement (performance and availability deductions under the transaction). The likely lease payment following abatement should also have all potential performance values, for risks such as utilization and traffic, removed. Issue 4 provides further discussion of this issue, reasoning that using the fixed design-build contract is more appropriate.

3. On Discount Rate and Fair Value

CCPPP recommends that the Weighted Average Cost of Capital (WACC) or more accurately, the Project Internal Rate of Return (IRR) of the private-sector partner (or the average of the various private-sector bidders for a transaction) be utilized as the appropriate discount rate for determining the project fair value. Provided there has been a fully competitive process determining the PPP partner and there is no element of cross-subsidy between constructors, operators and equity providers who are not independent of each other, the Project IRR should be an accurate market or arm’s-length valuation of the project risk.

The Project IRR is a very transparent figure in the majority of PPP transactions, as it is essentially the discount rate that would be necessary for all of the government payments over the term of the concession to equal the costs of providing the services over the life of the project. This is the same as the internal rate of return on all of the cash-flows in and out of the project.

Calculating the fair value of the contract, even using the Project IRR does not necessarily indicate the appropriate capital value of the contract. Government recognizing the fair value of the contract as a liability would in essence be recognizing future expenses for maintenance of the road as a liability, which is inconsistent with the accounting standards applied to conventional delivery. If government were to engage a separate contractor to maintain the road, they would not recognize...
the thirty-year operations and maintenance contract as a liability, just as a private-sector company would not recognize the future profit they may earn as current profit.

Therefore, Project IRR can be utilized to determine the fair value of the transaction in regard to every component of the transaction, and should be used to present to the public the full value of the transaction, but should not be misconstrued as representative of the capital value of the transaction.

4. On Determining Capital Value of Assets

CCPPP recommends that the value of a capital asset for government accounting purposes (if it is to be recorded on balance sheet) should be determined in a manner that attempts to reflect the actual commercial capital value.

This is considered in more detail in Issue 4, which presents methods of establishing the capital value.

Valuing PPP assets should not be based on the present value of minimum payments using government’s rate for incremental borrowing because this may result in an unreasonable and potentially misstated valuation; firstly because such payments will likely include operating, maintenance and rehabilitation costs which should not form part of the initial capital costs, and secondly because the use of the government’s rate for incremental borrowing overstates the capital value by discounting future payments at a lower discount rate than the risk of the project justifies.

If a PPP transaction is to be recognized as a capital lease it should be noted in the financial statements where there may be a significant difference between the capital value of the asset created and the fair value of the transaction itself.
**Issue 4:** If a Capital Asset is identified how should it be valued?

**Features and Expected Benefits of a PPP**

For the reasons described in Issue 1, PPP accounting will rarely look simply to the payment stream made by government to value the asset, because a typical PPP payment stream includes operating and maintenance costs which would not normally be capitalized. As a result, the focus is often on trying to identify and separate the value of the capital asset.

**Accounting Guidance**

Assuming there is an underlying capital asset controlled by government in a PPP transaction, there are then several different approaches which can be taken to valuing that asset. Canadian accounting guidance does not specify which approach to use, although other jurisdictions, notably Australia, do. The two main approaches are:

1. Set the aggregate asset value equal to the present value of the minimum payments due under the implicit finance lease (per AASB 117). As discussed in Issue 3, this approach is extremely challenging and is not widely used in practice.

2. Determine the “built cost” (per AASB 116).

Importantly, both methods for striking opening value are in use in Australia, and to date the Victoria Auditor General has accepted both approaches. The two methods can also be compared to one another to gauge accuracy. The focus of this issue is the second approach.

**Different Interpretations**

The application of capital lease standards creates a number of interpretation problems on the built cost to be recorded on the government balance sheet. These include:

**Definition of Built Cost:** the definition of capital cost or built cost is often difficult even under conventional government delivery. A government will typically have a very detailed set of accounting policies determining which costs associated with a project should be expensed immediately and which should be capitalized and over what period. Costs may include:

- Consideration paid including taxes and (non-refundable) duties, but net of rebates and trade discounts; plus
- Certain costs directly attributable to bringing the asset to the location and condition necessary to use the asset for its intended purpose. These can include: installation, assembly, professional fees, and testing costs. Note that some PPP assets may be acquired at no cost or for a nominal cost. Hence the operative rule is fair value.

Government is unlikely to have the same level of detail in the costs associated with a PPP and accounting policies in terms of useful life may not be as relevant for PPP delivery.

**Actual private-sector capital cost:** It is often argued that the built cost should reflect that actual private-sector capital cost. However, the accuracy of the process of separating out the capital components may be challenging. The government is effectively relying on data sourced from the private-sector counter-party. Auditors will often try to delve into the private-sector partner’s financial models or contractual arrangements to try to determine the actual capital costs incurred. The starting point will often be the value of the design-build contract (DB Contract) which is typically entered into between the PPP concession company and its construction subcontractor(s). The DB Contract will include a number of costs which would not occur under conventional government delivery or which would not be capitalized by government. These include:
1. Insurance;
2. Executory costs;
3. Risk; and
4. Upfront lifecycle costs (i.e.: costs over and above the minimum performance standards which reduce operation, maintenance and rehabilitation expenses later in the concession term).

Public-sector accountants will often attempt to go beyond the estimated capital value of the asset and look through to the actual “as built” costs of the asset following construction completion. While this is the normal approach under conventional public-sector accounting, it is not appropriate under PPP delivery because the risks of cost overruns and the benefit of any cost savings accrue to the PPP concessionaire or its design-build contractor and not to the government. In other words, the PPP payment stream does not change with any change in the as-built costs.

An additional challenge is that the as-built costs under a design-build contract are rarely transparent. If the contractor experiences a cost overrun this is simply absorbed and if they achieve cost savings then they simply achieve a higher profit margin on the contract than they expected. These numbers are not disclosed, usually even to the PPP concessionaire.

The following example may help clarify:

A PPP design-build contract for $100 million experiences a 50% cost overrun which is absorbed by the PPP concessionaire or its DB contractor. The public-sector payment stream does not change and therefore the liability of the government does not increase. There is potentially an argument to suggest that the asset side of the government financial statements could increase if, for example, the asset was valued on a replacement cost basis and the cost overrun reflected the market costs rather than any error. However this would not be a very conservative assumption.

Public-sector accounts will also attempt to determine the asset value from the capital costs shown in the proponent financial model. In doing so, they will often seek to add the imputed financing costs of the PPP over and above the government incremental cost of capital. This is commonplace for financing costs during the construction period (interest during construction “IDC”) which under both government and private-sector accounting standards are capitalized as part of the asset value and then amortized over the life. However, public-sector accounts will often try to impute the additional cost of finance over the life of the asset.

This is logical in order to achieve the same result as that achieved by discounting the future values of a government “capital” payment stream at a discount rate equal to the government’s incremental cost of borrowing. This has many problems associated with the lack of recognition of the risk transfer implicit in the higher private-sector cost of borrowing described in Issue 3.

However, this methodology also has a number of technical challenges associated with the fact that the internal rate of return of a private-sector investor reflects an average over the life of the concession. A 15% return is therefore likely to reflect negative annual returns for a lengthy period of time followed by annualized returns well above 15% towards the end of the concession. An imputed cost to government spread evenly throughout the concession would misrepresent both the payments being made by government and the risk associated with timing.

**Assessing additional upfront capital expenditure:** These are expenditures that result in a reduction in ongoing operating and maintenance cost in the future.

**Government’s hypothetical capital cost:** For the reasons described above, PPP transactions will often result in higher capital expenditure upfront than conventional government delivery for the simple reason
that the private sector is not typically constrained in the same way by budgets. Hence many jurisdictions argue that it is the equivalent government capital cost which should be recorded as an asset. This by its nature is hypothetical; however, the number is usually calculated for the Public Sector Comparator which forms part of the value-for-money report.

**Level of aggregation:** Another spin on the valuation issue concerns the level of aggregation. One of the positive features of FRS 5 F in the United Kingdom is that the PPP project is considered as a whole – at the level of the entire deal (excluding associated commercial developments). Following FRS 5 F there is no requirement to consider the elements of the core PPP project separately, such as a floor of a new public hospital building that is intended to be leased out for private purposes (e.g. consulting suites). If the new hospital is on government balance sheet, then that's the FRS 5 F classification for the whole asset base. Other frameworks, such as IFRIC, appear to propose making a separate call on components of the overall project, such as the assets underpinning unregulated activities undertaken by different operators.

Currently, once the “built” cost is determined, government may recognize it as a government asset (based on notion of control) even if it does not own the asset. There will of course be a liability equal to the contractual obligation to pay for the built cost.

**Capitalized Interest:** There are also widely differing views on whether capitalized interest during the construction period (IDC) should be included in the capital value of the asset or not, and if it is included how it should be valued. The value of IDC is, of course, included in the capital portion of the payments made post-completion and therefore lease valuations which discount the amount of these payments will incorporate IDC.

Where the capital value is determined on the basis of built value the answer in part depends upon whether the asset and corresponding liability is recognized at execution of the concession agreement or at completion of construction. In the first case IDC will be recognized through depreciation of the asset during the construction period. In the second it may not be recognized.

Some jurisdictions will base any inclusion of IDC on the actual amounts shown in the financial model of the private bidder. This may be misleading because as described under this issue, the capital costs upon which IDC are based may actually include some lifecycle costs which should be split out of the capital cost. Other jurisdictions will apply an interest rate to the capital value established for accounting purposes. This interest rate itself can vary from the incremental cost of government borrowing, to the actual cost of private-sector debt to the full private sector WACC (inclusive of equity returns). These different potential treatments lead to very different potential calculations of IDC.

**Commercial Implications**

Under conventional delivery it is usual for IDC to be excluded from capital as any interest on debt raised is expensed during the construction period. This opens up potential for commercial differences between PPP and conventional delivery which may make the capital asset associated with a PPP appear to be more expensive than under conventional delivery (for those observers who neglect to include the expensed interest in the calculation).

CCPPP therefore believes that IDC should be excluded from the calculation of as-built costs.

The commercial implications of capital asset valuation are similar to those identified in Issue 2. PPP proposals often differ significantly; one with a higher capital value under inadequate accounting treatment is not necessarily the most expensive in terms of NPV. In addition, lack of guidance can lead to a wide range of valuations. These issues could result in capital value becoming an implicit evaluation criterion, which could be a disincentive to implementing the best solution and therefore harmful to the public interest.
**Recommendation**

CCPPP recommends that:

If an asset is capitalized, the value recorded be determined via the design-build contract, not through an attempt to breakdown the unitary payment, which cannot be accomplished effectively. Consideration should also be given to the value of risk transfer and lifecycle costs (discussed in Issue 6) in order to ensure that any higher costs for a PPP are not.

It is recognized that these adjustments can be difficult. The following is a suggested method for determining real comparative asset value.

1. The fixed-price design-build contract entered into by the private sector may be actually representative, to a significant extent, of the capital asset value being generated, but should be adjusted for the following:
   a) Any ongoing operations required to be undertaken by the design-build contractor for an existing facility during construction;
   b) The insurance and executory cost component of the design-build contract, which can be disclosed by the contractor; and
   c) The monetary value of any specific, additional requirements placed on the design-build contractor by the private-sector developer beyond the scope of the government requirements. The monetary value of these requirements should be lower or equivalent to the present value of future O&M payments that would have otherwise been required if not for the improved capital works undertaken by the private-sector developer.

2. The capital asset value can then be compared to a crude estimate of the capital asset value that could be generated by breaking down the unitary payments into their capital and operating components and then discounting the capital component of those payments at the Project IRR. The present value of these payments will not, of course, be entirely representative of the capital value of the project due to the distortions discussed above, but should be comparable to the design-build contract value and prove the validity of the above methodology; and

3. The fair-value assessment of the capital value of the assets provided by the insurer of the project can also be compared to the above to ensure validity.
This recommendation can be quantified using a recent Canadian PPP example:

(Values in millions of CAD)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Design-Build Contract Value</td>
<td>498.0</td>
</tr>
<tr>
<td>(1) Less: Ongoing traffic management</td>
<td>-25.5</td>
</tr>
<tr>
<td>(1) Less: Traffic management office costs</td>
<td>-1.5</td>
</tr>
<tr>
<td>(2) Less: Contractor executory costs</td>
<td>-3.0</td>
</tr>
<tr>
<td>(2) Less: Contractor insurance costs</td>
<td>-3.0</td>
</tr>
<tr>
<td>(3) Less: Contractor costs for upgrading existing pavement</td>
<td>-59.3</td>
</tr>
<tr>
<td><strong>Total Capital Value (a)</strong></td>
<td><strong>405.7</strong></td>
</tr>
<tr>
<td>b. NPV of maximum capital payment under Project Agreement:</td>
<td>499.0</td>
</tr>
<tr>
<td>b. (2) NPV of minimum capital payment under Project Agreement:</td>
<td>362.0</td>
</tr>
<tr>
<td><strong>Total Capital Value (b)</strong></td>
<td><strong>430.5</strong></td>
</tr>
<tr>
<td>c. Capital value of assets as determined by insurance assessor:</td>
<td>450.0</td>
</tr>
<tr>
<td>c. (2) Capital value as determined by assessor less upgrades:</td>
<td>390.7</td>
</tr>
<tr>
<td><strong>Total Capital Value (c)</strong></td>
<td><strong>420.4</strong></td>
</tr>
<tr>
<td><strong>Average of above:</strong></td>
<td><strong>418.9</strong></td>
</tr>
</tbody>
</table>

As can be seen, the estimates of the capital value above are relatively close to one another, though they vary significantly from the original estimate of $784 million. This illustrates the challenges of dissecting a unitary payment to identify the underlying capital costs capable of being compared to conventional delivery. To avoid skewing the assessment, it may be appropriate to use the average of the bidders’ design-build contracts rather than just that of the preferred bidder. Capitalized interest during the construction period should not be included in the appropriate cost to be capitalized. CCPPP recommends the importance of a public authority establishing its accounting treatment for a transaction prior to receiving bids from the marketplace, to avoid accounting treatment prejudicing one bidder’s approach over another’s. This means the following types of solutions:

- using a hypothetical mix of construction and service inputs based on the grantor’s own public sector comparator approach; or
- using the average mix of construction and service inputs of all the bids received;
- using the average of the design-build costs (adjusted as described above) of each of the bidders to ascertain the built value.
Issue 5: Is there a need for guidance on the timing of recognition of PPP assets, and should accounting treatment reflect the value of early completion of a project?

Features and Expected Benefits of PPP Delivery
The economic benefit of completing a project early or on time is one of the most frequently cited advantages of PPP delivery over conventional government delivery. Reasons that contribute to this valuable feature of PPP projects include:

1. PPP projects are more likely to be completed in one contractual iteration rather than in phases over a long time;
2. PPP projects are likely to open for use earlier than conventional government projects; and
3. PPP delivery typically does not require payments by government unless and until the capital assets underlying the project are completed and service delivery has commenced. This is typically very different from conventional government service delivery where the government is making progress payments for the asset throughout the construction period and is committed whether or not the project actually achieves completion.

Often, these economic benefits are not transparent in the government financial statements unless PPP contracts demand recognition through being explained in greater detail in the financial statements.

Furthermore, the appropriate timing of recognition of the asset and corresponding liability in a PPP situation has been a subject of much discussion. Part of the difficulty is in how to interpret “inception”.

Accounting Guidance
PPP transactions are relatively unique in their characteristics, in that each may have a number of starting points, which makes it difficult for the public partner to decide when (if at all) to recognize the underlying assets in its financial statements. There is limited accounting guidance available on timing of recognition of PPP assets. Accounting guidance is also not available to ensure the economic benefits of early project completion be recognized.

Different Interpretations

On the value of early completion
The CCPPP membership has provided a number of examples of cases in which the commercially appropriate incentives for early completion have been nullified by restrictions on the payment mechanism imposed by government accounting concerns. In very few cases in Canada (outside of user-pay examples) has there been any “bonus” available to a private-sector partner for early completion.

On timing of recognition
Canadian PPP practitioners who have no objection to adopting lease accounting for PPP transactions argue that there is no uncertainty about the timing of asset recognition. They cite the CICA Handbook Section 3065 which defines “the inception of the lease” to be the earlier of the date of the lease agreement and the date of a commitment that is signed by the parties to the lease transaction and includes the principal terms of the lease (this is the effective date used for classification of the lease). They conclude that assets and liabilities must be recognized at the time that the PPP contract (or a commitment agreement) is signed. They say assets must be recognized by government as soon as the PPP contract is signed, because this event gives rise to future benefit from the capacity being created, and establishes the public sector’s control. The public-sector entity typically controls access to the underlying asset and will typically acquire the asset from an ownership perspective as the infrastructure is being constructed. Under these arguments, accounting should recognize work in progress and a long-term liability.
However, many practitioners who question the appropriateness of lease accounting for PPPs disagree with the above interpretation and refer to the many difficulties caused by applying lease accounting in determining the timing of asset recognition. They propose that there is a marked difference between the timing of recognition of a lease asset and that of a PPP asset, because in leases the date of contractual agreement nearly always coincides with the availability of the asset. In PPPs this is not necessarily the case.

Such practitioners refer to at least three inceptions in PPPs:

1. Signing of the PPP contract;
2. When construction resulting in PPP asset begins; and
3. When the asset becomes available.

They emphasize that timing differences may have a significant effect on government financial statements. They also present the following arguments:

- In the case of service concessions in which the operator provides the property, usually the payment formula evolves around availability. Recognizing an asset that does not exist (and certainly has not yet become available for use) in the financial statements of the government, because a PPP contract has been signed, makes little sense. There is a need for further clarification of the timing of recognition of PPP assets and liabilities.

- In a PPP arrangement the signing of a contract will not typically create an obligation for the government until assets are completed. All performance is expected in the future and at signing no asset exists to which rights are being transferred. Where there are contract provisions in a P3 that incur obligations prior to asset completion; for example, compensation upon termination, these obligations tend to be contingent in nature.

- At the time of signing the PPP contract, all arrangements are executory since neither party has performed any of their obligations.

- The public sector, if they acquire the asset, does so only upon completion of construction. If construction is not completed, the public sector will not have an obligation to the private-sector partner other than contingent obligations to pay for the value of works undertaken if an event of default is declared and the public sector is obligated to make a termination payment. Without a functioning asset, there will be no service payments.

The following example from Australia supports the argument presented by those who question the appropriateness of applying lease accounting to PPPs.

**Example – Southern Cross Station Re-development, Victoria, Australia**

The objective in this PPP project was to redevelop a very old, major railway station into a transport hub with commercial and retail facilities. All existing rail services were to continue uninterrupted during the build phase.

Contractually, the State of Victoria had legal rights to refuse to “take” the assets until they passed muster. Accordingly, in Victoria “commercial acceptance” marks the commencement of recognition of the facility assets in the Government’s financial statements. Ordinarily, commercial acceptance coincides with operational commencement. Post financial close, but pre commercial acceptance, the PPP assets and liabilities are not included in the financial statements of the State; rather, they are merely reported below the line. The current policy is to note these projects under construction as “commitments for expenditure”.

Considering the requirement for continuity of services in this project some commentators queried the significance of commercial acceptance. The State Treasury declined to alter its policy indicating that continuing services were being provided from the “old” assets.
Commercial Implications

The commercial implications of timing of recognition of PPP assets are potentially significant, as they affect government’s indicators of financial performance which, as discussed elsewhere, are often reflected by debt levels. As described above under conventional delivery, the government will typically recognize the asset and corresponding liabilities of a project as work is proportionally completed during the construction period. The impact on the level of public-sector debt is accordingly spread over a number of years. In addition, conventional delivery construction timeframes are typically longer than PPP construction timeframes, often deliberately in order to spread the budgetary and debt impact over a longer period of time.

An accounting standard which requires the full asset and liability associated with a PPP to be recorded upon signing of the concession agreement is therefore likely to be less attractive than conventional delivery to a government experiencing short-term debt or budgetary constraints. Similarly a government may be conflicted between its desire to have the asset completed to provide the desired service to the public early compared to its desire to backend the financial and budgetary impacts as much as possible. In this way current accounting considerations have the potential to significantly undermine many of the economic benefits of early PPP delivery and not reflect the typical risk transfer under which the government does not commence making any payments until construction completion is actually achieved.

Recommendation

CCPPP recommends that:

1. Guidance be provided on:
   a) The timing of recognition of assets and liabilities under PPP delivery as there is currently very limited guidance available; and
   b) A method of ensuring economic benefits of early completion (earlier than when the public sector would have achieved completion under conventional delivery) are transparent in government financial statements.

   The underlying asset of a PPP and its corresponding liability should be recognized, if they are to be recognized, at “substantial completion” or at the point at which significant government service payments commence, rather than at the time the PPP contract is signed. Provision is necessary for situations in which government makes progress payments during the construction phase.

2. A contingent liability should perhaps be recorded prior to the substantial completion date to reflect the fact that there is likely to be a future obligation but, for the time being, asset completion and therefore payment remains uncertain.
Issue 6: Should step-in and termination payout provisions determine capital lease treatment?

Features and Expected Benefits of a PPP

To ensure continuity in public services subject to a service concession arrangement, PPP transactions typically allow the government certain step-in rights to take over the asset or provide the service if performance standards are not met. For the same reason, agreements also often include the ability for the government to terminate the concession agreement. This is an important commercial and political feature.

Termination rights are safety measures. They typically fall into three categories, with differing financial implications for government for each:

1. Termination for default by the private-sector partner;
2. Termination for force majeure;
3. Termination for convenience by the government.

The ability of government to acquire the underlying assets in the event of termination has often led accountants to take the position that the ultimate risks and rewards of ownership rest with government.

Discussion

This is a point upon which an entire paper could be written. We have therefore only dealt in summary form with the issues as they pertain to public accounting.

There are several potential avenues of step-in and termination payout, all of which are addressed separately below.

An additional issue that has relevance when dealing with termination is whether periodic reviews, and potential termination as a result of periodic reviews, should have a bearing on accounting treatment.

Periodic reviews: These have been identified by the government as an essential element where existing assets are being transferred by the public sector to the private operator. Periodic reviews may be utilized to take back an asset that had been previously transferred to the private sector if the private sector is not meeting service standards.

The application of periodic reviews is commercially appropriate where government is transferring an existing asset and wants to ensure standards are met. Periodic reviews could potentially include a review of both the operating performance and financial performance of the assets under review. In practice, it may be better from a commercial perspective to limit the periodic review to operating performance and asset condition reports, rather than to take into account the financial performance of the assets.

Regardless of the nature and result of the reviews, the private-sector financing should remain in place even if government chooses to transfer the asset back to itself. This will allow the asset to be financing on an efficient, long-term basis, rather than on a short-term basis, to contemplate potential retention of the asset by government through the periodic review process.

If the public sector has the right to terminate the private-sector use of the assets either for performance default or at the convenience of the public sector, then it may be more difficult to characterize the original transfer as a disposal of the assets. In actuality, the assets were transferred to the private sector but a purchase option on the assets was retained by the government. To the extent that the periodic review and potential termination is the only method of returning the asset to government control, government is not retaining overall responsibility for the asset.

Because the periodic review is essentially another form of termination that merely creates an option on the part of government, the periodic review should be treated the same as any other form of discretionary government termination for accounting purposes. If government is able to terminate for convenience at any
time, creating an explicit periodic review process does not give the government additional rights beyond their existing termination-for-convenience rights; rather, it merely creates a process by which that right is explicitly reviewed with the full knowledge of the private-sector counterparty. The accounting treatment of discretionary government termination is discussed below.

**Termination:** Clearly there will be cases where termination of the concession is required. It would be inappropriate to assume that the public sector has no liability in the event of termination, even where that termination is for cause. The extent of any liability can vary considerably from one PPP transaction to another. This is fundamentally because in most PPP transactions the public sector requires rights to deal with the assets in the event of any default. As a generalization, the greater the flexibility the public sector wants to deal with the assets, the greater the proportion of the liabilities the public sector is likely to assume.

**Termination for Default by Private-Sector Partner:** It is useful to think of termination for default by the private-sector partner in various stages.

Stage One would be termination of the operating contract. Either the public sector, the debt providers, or equity providers would normally, in consultation with each other, have the right to replace the operator for non-performance or at periodic reviews. Operating default would not normally result in the termination of financial interests in the transaction, but could result in the calling of any operator performance bonds and possibly the transfer of any operator-owned assets.

Stage Two would be insolvency of the special purpose entity and effective termination of the ownership rights of private-sector equity. This could occur, for example, if the private sector had severely misforecasted revenues or costs or if the penalty payments associated with operating failures lead to a financial default. Insolvency would usually be a trigger of termination of the concession agreement or lender step-in.

Stage Three would be a negotiation around the debt providers’ step-in rights. Debt providers will typically have defined rights to step in to try to resolve the insolvency of the special-purpose vehicle and to continue the concession. This may include the “sale” of the concession rights to another party, with the agreement of the public sector, or a restructuring of the financing arrangements. However if lenders do not step in or resolve the default issues then the government may put the concession up for tender, with the winner of the tender performing the future obligations of the private-sector partner and the proceeds of the sale going to the private-sector lenders.

Stage Four would be abandonment of the assets by the private sector or the buyout of the assets by the public sector. In most PPP transactions, it is politically unacceptable for the public sector to allow the abandonment of the assets or the discontinuation of services. However, in Australia, the Victorian Treasury does not subscribe to the argument that since public services are involved, the State ultimately carries the major risks of service provision. The concession agreement should therefore ideally be explicit on this and, accordingly, the public sector should be able to resist any requirement to buy out the assets. An example of government successfully resisting any obligation to buy out the assets of a defaulting PPP is the New Southern Railway (Sydney Airport Rail Link).

Ultimately there may be cases where the public sector is required or chooses to buy out the assets and terminate the concession. This can be on the basis of a pre-agreed residual value formula (e.g. Melbourne trains and trams or some British Columbia PPP agreements), an independent fair market valuation or by negotiation.

While buyout requirements with pre-agreed residual value formulas or independent fair market valuations are certainly purchase obligations, commercially they are purchase obligations with no certainty of timing or value. The question that must be answered is whether the ultimate risks and rewards rest with government as a result of such a buyout provision. The answer is dependent on the mechanics of the buyout provision.
If a buyout provision is based on the projected residual cash flow available for debt service in the service period (Sea-to-Sky Highway Improvement Project is an example of such a provision), then the ultimate risks and rewards of ownership do not rest with the government. Essentially, government is required to make an upfront payment for the discounted value of the projected residual cash flows available for financing after performing the contracted services to the required standard.

If the cash flows were not sufficient to perform the contracted services required to standard, then government would not make any payment and would take control of the asset. If the cash flows were sufficient to perform the contracted services required to standard, then government would only pay for the residual cash flows. Government is therefore close to ambivalent to the performance of the asset up to the point of default. If the asset performed poorly and there is no residual cash flow payment, then government is paying more than they expected for the service over time, but is still receiving the same service. This is extremely unlikely, given the significant capital component of most PPP transactions. More likely, the lenders decided not to step in, and therefore government will make a payment for the residual cash flows of the project and then will enter into a contract for the performance of the contracted services in the future. Under such a situation, government is receiving equivalent services to their expectation for their expected cost (although the duration of the cost is brought forward). This is another feature of PPPs that lends them to essentially being a payment for a service, rather than payment for the underlying capital asset.

There is therefore no risk or potential benefit of ownership to the government up to and including the point of default. Regardless of the financial performance of the private-sector partner, the government will receive their expected service at their expected price. If the private-sector partner performs well, government receives no benefit; if the private-sector partner performs poorly, government receives no benefit. Only once the payment for residual cash flows has been made does government begin to take risk of ownership.

Evaluation of the future cost of services to determine the residual cash flow will also likely be done by entering into fixed rate contracts for the services. As a result, a significant amount of risk of ownership is eliminated at the time the residual cash flow payment is made. At the point government takes the project on balance sheet, there should be a significant reduction in risk so long as construction is complete.

A residual value purchase formula should be similar to a fair market value assessment, although the fair market value assessment will likely result in a higher payment from government because of lower market discount rates on residual cash flows once construction is complete relative to the discount rate agreed upon in the Project Agreement. Regardless, a fair market value provides the equivalent commercial effect of the residual value formula by taking risk of ownership away from the government until after the termination payment is made.

If the buyout provision did not have a method of adjusting the required payment from government based on actual performance, then it would really be a put option in the case of default, which would place the risks and rewards of ownership with government.

Termination for Force Majeure: Termination for force majeure is essentially the provision of insurance by the government for certain unlikely risks that are difficult to insure on the private market. It is important to note that while these risks are difficult to insure on the private market, they are risks that face all private-sector businesses. For example, civil war is generally “insured” through termination for force majeure provisions in PPP transactions, but private businesses do not obtain civil war insurance. The decision by the government to insure these risks, therefore, is essentially an effort by the government to reduce risks and costs to the private sector by providing government-backed insurance. The provision of this insurance, however, is not a guarantee of the project in the same way that fire insurance for a business is not a guarantee of the business by the insurance company.

Termination for Convenience by the Government: Termination for convenience is clearly a purchase option by the government. It is also potentially a purchase option at a premium to the market value of the
assets. As a purchase option, termination for convenience options do not hold any future obligations. Government can always choose not to exercise the purchase option.

**Accounting Treatment:** The nature of the termination provisions discussed above have been significant factors in formation of views on the appropriate accounting treatment for a transaction. However, such provisions should only be one of several factors that could be used to determine the accounting treatment.

The most obvious implication is that if termination provisions are regarded as purchase obligations by the public sector, the transaction is classified as a Capital Lease, with the public sector thereby assuming all of the liabilities on balance sheet. A fixed purchase obligation, however, is extremely different from buyout provisions in PPP transactions, as discussed above. A fixed purchase obligation leaves the risk and reward of the asset with the lessee (government), whereas a PPP buyout leaves the risk and reward of the asset with the concessionaire. Rather, the buyout provision is a contingent liability for the upfront purchase of the contracted services.

It is important to ensure that the contingent liability is not a government guarantee. In some instances, such as the London Underground, government has actually provided a guarantee of the private-sector liabilities. This contrasts sharply with the termination provisions for modern Canadian PPP transactions, which do not provide a guarantee of private-sector lending.

The best accounting representation of the actual commercial agreement for each of the termination provisions is as follows:

1. **Termination for Default by Private-Sector Partner:** This provision is essentially not different from the actual PPP agreement in itself. If structured appropriately, as with the Sea-to-Sky Highway Improvement Project, it leaves no risk on the government until the actual purchase takes place and government takes over the asset. Until that point, such a provision does not deserve independent representation on a balance sheet;

2. **Termination for Force Majeure:** This is essentially the public sector providing insurance to the private-sector partner, and should be accounted for as an insurance transaction, rather than as a liability for the entire project; and

3. **Termination for Convenience:** This is a purchase option for the government, but it is a purchase option at market value, and therefore does not deserve to be represented as an asset.

**Commercial Implications**

The best way to describe effective termination buyout provisions under a well-structured PPP concession is that the buyout by the public sector of debt (or a portion of debt) in the project is not a guarantee of that debt. It is a call option by the public sector, exercisable if the public sector believes that the public interest is best served by taking back full control over the asset. It should not, importantly, be a put option by private-sector investors or their lenders to the public sector.

Similarly, termination for force majeure is not a blanket guarantee of a project, but rather the provision of insurance by the public sector for the private sector for a limited set of risks that have been deemed uninsurable.
Recommendation

CCPPP recommends that:

Termination buyout provisions, unless they explicitly provide for repayment of debt (which is now rare in PPP transactions), should be treated as contingent and unquantifiable obligations and should not be construed as “control”, as they do not move the risk and reward of ownership of the asset to the public sector. As a result, they should not have an impact on the accounting treatment of the overall transaction, and should not impact whether or not the transaction should be placed on the balance sheet. They should certainly not be used as a justification for recording of the transaction as an asset and a liability on the balance sheet.
Issue 7: Should PPP Accounting recognize the principle of limited-recourse financing?

Features and Expected Benefits of PPP Transactions

The majority of PPP transactions are structured through a Special Purpose Vehicle (SPV) which is established solely to undertake the project and is “bankruptcy remote” from any other activities undertaken by the sponsors or contractors of the project. Debt is raised at the SPV level and typically has no, or only limited, recourse beyond the project. In other words, the sponsors’ risk exposure to repay the debt is typically limited to the amount of equity they have contributed plus any other limited guarantees or forms of financial support they have offered.

The public-sector sponsor is also rarely liable to repay the debt associated with the transaction. While very early PPP transactions often offered significant public-sector support for any outstanding debt in the event of default, it is now typical for lenders to take the risk on whether there is sufficient equity and performance guarantee coverage to ensure their repayment. Government liability is limited to the termination provisions (described in Issue 4), which are generally based on the market value of the project and are not directly linked to outstanding debt.

The ability to finance PPPs with limited recourse debt is an important differentiating feature from conventional government delivery. Governments typically cannot, or do not, borrow on a limited recourse basis. Even government borrowings through Crown corporations on an arm’s-length basis will typically benefit from the implicit guarantee of the public-sector ownership.

PPPs therefore offer a benefit in that the debt is sized and raised based on a true market-based assessment of the risk, and priced on this basis; whereas, under conventional government delivery, debt may be inappropriately sized or inappropriately priced based on the explicit or implicit public-sector guarantee.

Therefore, it is reasonable to expect that the non-recourse debt liability associated with a PPP project should reflect this differentiating feature.

Accounting Guidance

Measuring “net debt” (the difference between total liability and financial assets) and including information on net debt to GDP (Gross Domestic Product) in the Management Discussion and Analysis Report of the Government is required in the public-sector accounting and reporting guidance.

The financial statements of governments and corporations are main inputs in producing economic statistics for the government and corporate sectors. The possibility that PPP transactions are not reflected in their entirety and consistently on the financial statements of governments and corporations could lead to understating or overstating the assets, liabilities, revenues and expenditures of the government and corporate sectors within the CSNA. In order to properly assign assets and liabilities associated with a PPP to the government and corporate sectors, CSNA needs to know who bears the risk and what the value of the risk is in terms of both the government(s) and the corporation(s) involved. A possible solution is the addition of a mandatory disclosure qualifier for PPP off-balance-sheet assets or liabilities greater than a certain percentage of on-balance-sheet assets.

Most PPPs are structured through an SPV that sometimes takes debt to finance project that is often without recourse against the government. This paper proposes not to consolidate the debt into the government’s financial statements but to include the capital asset value in these statements. Even though it benefits the net debt figure, it may not provide enough relevant information regarding debt incurred by the government indirectly through the PPP, even if there is not a direct recourse.

The liability of government would likely decrease by the proportion of the payments that could be characterized as contingent and variable (operating and maintenance expense). The off-balance-sheet treatment and use of special purpose vehicles for PPP transactions could mean that the financial transaction...
is not transparent to users of the financial statement information. For example: if the counterparty to a special purpose vehicle is located off-shore, the contents of the complete transaction will likely be unknown.

**Different Interpretations**

Accounting interpretation of “net debt” is not subject to much opposing interpretation in Canada, but it was in the past when governments were not expected to follow GAAP for the public sector.

Canadian public-sector GAAP allows government commercial enterprises (those substantially selling their services to parties outside government reporting entity) to be consolidated on an equity basis. Consequently, non-guaranteed self-supported debt of these enterprises does not directly affect the government net debt.

Classifying debt between taxpayer-supported and self-supported is mostly a management reporting issue. While there is guidance on the need for classification, the distinction is not considered to require accounting standards, other than the general accounting principles for consolidation. Many government accountants, for example, argue that debt used for financing student loans should be self-supporting. Others present opposing arguments based on the fact that many governments do not borrow for specific programs and therefore it is almost impossible to demonstrate how government financing relates to specific programs.

In BC for example, debt is often viewed on a consolidated basis. The Province has an objective to keep the Province’s consolidated debt level stable while the economy is growing. Consolidating non-recourse PPP debt will have an adverse affect on debt management results. However, for analysis purposes, self-supporting provincial debt is distinguished from the Province’s taxpayer-supported debt. Taxpayer-supported debt as a percentage of GDP is the key indicator used to assess the ability of a province to service their debt. Rating agencies such as DBRS often use this evaluation technique when assessing a province’s investment quality. With the exception of toll roads or bridges, PPPs such as schools, hospitals and transit systems are not likely to generate sufficient cash to fully meet their liabilities. Therefore, the debt attributed to PPPs could be classified as taxpayer-supported debt, which could negatively impact the Province’s credit ratings and would not reflect the true nature of the debt.

**Commercial Implications**

As has been argued elsewhere in this position paper, it is considered inappropriate for contingent government performance payments to be accounted for and treated in the same way as irrevocable long-term debt obligations of government. However, such PPP payments do also represent long-term liabilities of government provided, that the PPP concessionaire performs.

**Private-Sector Issues**

It has long been a source of frustration in the private sector that limited recourse debt is not recognized any differently from corporate debt supported by the balance sheet. PPP transactions are often unattractive to hold in corporate structures as they will often result in accounting losses for extended periods of time despite producing positive cash flows. Consolidation of the debt associated with the transactions is also unattractive. Private-sector sponsors accordingly often prefer to structure their ownership of the PPP special-purpose vehicle (SPV) in “flow through” vehicles such as partnerships and in such a way that the debt associated with the project is not consolidated on any sponsor’s balance sheet.

A full discussion of this issue is beyond the scope of this position paper, which focuses primarily on public-sector accounting issues.

**Public-Sector Issues**

For governments, “debt management” is typically a key objective and a performance measurement criterion.
The circumstances around non-recourse debt of PPPs are different from both equity method consolidation of government commercial enterprises (perhaps other than toll roads) and government’s general deficit financing. Government management should examine the classification of non-recourse debt for performance reporting.

**Recommendation**

CCPPP recommends that:

1. CICA issues specific guidance for treatment of non-recourse debt in governments’ Management Discussion and Analysis Report to ensure that the non-recourse debt of PPPs, which the government is not actually supporting, is not recorded on the government balance sheet and not distorting the government’s net debt figure.

2. If the project is determined to be on the government’s balance sheet, it should be the capital asset value that should be recorded, not the SPV debt.

CCPPP endorses government’s public reporting of its performance, including measurement of net debt in its consolidated financial statements.
**Issue 8:** PPPs have different payment structures which should be recognized in different ways for accounting purposes.

**Features and Expected Benefits of a PPP**

To reflect the unique objectives of each project, payment arrangements for PPP projects come in many forms. Each type of payment may cover many components.

In the early days of PPP development, the payment stream often included a “guaranteed minimum” sufficient to service the debt finance associated with the project. Any payment risks were accordingly accepted by equity investors. As the PPP market has matured worldwide, lenders are increasingly willing to take significant risk on the payment stream and it is now very unusual for any portion of the payments to reflect a minimum guarantee.

There are typically three major components for which the public sector makes payment:

1. Availability;
2. Demand; and

*Availability-related payments* account for the periods in which the expected services are provided. The operator may be penalized for unavailable service periods. Though ordinarily the contract states an expected level of availability, it cannot foresee closures and other interruptions. Availability-related payments are, therefore, contingent in nature. An example would be the Sea to Sky Highway Improvement Project in BC, where monthly availability payments comprise approximately 83% of the net present value of the total payments from government. These availability payments commence only upon completion of the required improvements for each major section of the highway and are subject to deductions for any lane closures. These availability payments also have a performance payment element as they are subject to deductions for weaknesses in operations and maintenance.

*Demand-related payments* (for example, shadow toll payments) are also contingent in nature because they are dependant on future use of the property. Shadow tolling has been identified in a number of jurisdictions as being an attractive way for the public sector to make performance-based payments to support delivery of transportation infrastructure in a way which is neither strictly an availability nor a usage payment (in respect of its coverage of the costs of providing the service). In the case of the Sea to Sky Highway Improvement Project, some 13% of the total net present value of government payments was a traffic volume payment linked directly to the number of vehicles using the road and hence transferred an element of demand risk.

A shadow toll, in our view, should ideally be: “a temporary and adjustable payment by the public sector of the difference between a commercially viable toll and a politically acceptable toll for the use of a facility.” Of course, many shadow tolls in practice do not meet this strict definition. Nevertheless, a unitary payment based on the shadow toll concept occurs when a contractual arrangement exists but payment is only required as and when service is provided and therefore need not be recognized in public-sector statements of financial position until the service is provided.

In the context of an economic event it would be difficult to argue the contrary position:

- That the shadow toll represents a fixed or determinable amount;
- That the shadow toll reflects a time-based payment for right of usage such as is conveyed by a lease; or
- That the shadow toll conveys possession of the asset to the public sector for the duration of the arrangement (i.e. that it creates a contract of bailment which is the technical legal classification of a lease).
Accordingly, shadow tolls are attractive from a public-sector accounting viewpoint.

A shadow toll is obviously only appropriate where one of the major public policy objectives is to encourage maximum utilization of the infrastructure. It should in most cases be supplemented by other performance measures which could be reflected in other payment streams, in penalties or in termination provisions. Public-sector support by means of a shadow toll naturally increases the risk transfer to the private sector, particularly if the private sector is already taking a level of direct toll collection risk (i.e. if the shadow toll is a “top up” as in our strict definition) and increases the cost of capital.

Performance-related payment components are similar in nature to demand components in that they are directly related to future performance. They are also typically considered contingent in nature. In the case of the Sea to Sky Highway Improvement Project, the full availability payments are subject to performance-related deductions. In addition there were highly targeted and specific performance-related payments to provide direct financial incentives in key areas of the Project. These were safety performance payments (comprising 1.7% of the NPV of total payments) and traffic management payments during construction (0.3% of total payments).

Placing a dollar sign on performance-related payments also comes with similar difficulties explained above for the availability-related payments. Furthermore, it is possible that some executory costs may also be included in the availability component.

The main focus of this issue is to determine whether attaching a dollar amount to factors which are contingent and probable at best serves a meaningful purpose in reflecting the substance of a PPP transaction. The mix of these different payment mechanisms can reflect very different risk transfers, and should not necessarily have the same accounting treatment.

Accounting Guidance

Issue 3 discusses in detail the criteria and challenges for establishing minimum lease payments. There is limited direct guidance on how to treat various components of the payment mechanism, thus leaving it open to the interpretation of individual practitioners.

According to FRS 5 in the United Kingdom, significant “demand risk’ of the type transferred by shadow payments and/or “residual value risk” will normally give clear evidence of who should record an asset of the property.

Guidance provided by EIC -19 by the CICA defines contingent rentals and recommends they should not be included in minimum payment. However, for property which is a social infrastructure, e.g. roads and bridges, the public sector may be able to include a level of contingent rentals in the minimum payment. Though this is currently an accepted principle, many practitioners argue that it is fundamentally flawed since any estimation depends on a high level of probability – a very difficult undertaking.

Different Interpretations

The challenges of accounting interpretation regarding various types of payment mechanisms occurring in PPP transactions have lead to very inconsistent outcomes.

With the use of lease accounting in reporting on PPP transactions, the value of assets involved in PPP transactions could be shown as the net present value of the minimum lease payments, which will not necessarily be the actual market value of the assets. Giving the significance (high value) of assets normally involved, appropriate valuation is crucial. For economic statistical purposes, both book and market values are preferred, with market values potentially being the most appropriate place to take account of risk allocation which would have an impact on data reported to Statistics Canada.
Commercial Implications

The complexity of the payment mechanism is generally driven by the desire to effectively transfer risk. More complex and risky payment mechanisms will increase the cost of the PPP arrangement (in terms of higher capital and OMR costs to mitigate the risks and higher financing costs, both debt and equity, to act as compensation for risks which are not fully mitigated).

As we have discussed under other issues, PPP accounting treatment which does not "reward" the more effective transfer of risk, is unlikely to encourage this transfer through the payment mechanism.

There have undoubtedly been PPP (and other public-sector) transactions in the past which have deliberately created a more complex payment mechanism in order to justify operating leasing treatment without there being much commercial underpinning to the risk transfer associated with this complexity. However, it is inappropriate to penalize the majority of current PPP transactions — which do effectively transfer risk — because of this possibility.

A PPP transaction that experiences significant performance deductions that are accounted for under capital lease standards could result in an annual expense recorded by government greater than the actual cash payment made in any particular period. In a less extreme example, where the payment deductions are only reducing the OMR of the payment and not the capital portion, government could have a perverse incentive to continue with an underperforming partner if the government was at the time experiencing budgetary constraints.

Note that the specific issues associated with direct user-pay assets are addressed under Issue 11.

Recommendation

CCPPP recommends that:

1. The details of the payment mechanism should be carefully reviewed in determining appropriate accounting treatment, with effective risk transfer through the payment mechanism “rewarded” in more favourable accounting outcomes.

2. The capital lease accounting rule of the NPV of payments less than 90% of the fair value of the asset is a useful benchmark for consideration but is too rigid for PPP transactions and may encourage payment mechanisms deliberately designed to meet this test. Therefore, CCPPP recommends that the substance of the risk transfer needs to be reviewed.

3. Accounting guidelines should be developed to provide assistance with the analysis of payment mechanisms with emphasis on performance risk and demand risk transfer. This can be drawn from value-for-money assessment techniques.
Issue 9: Does risk allocation have a value that must be considered in asset valuation for accounting purposes?

Features and Expected Benefits of a PPP

The primary focus of PPP delivery is risk transfer. It is argued that this makes PPP delivery more efficient than conventional government delivery and justifies a higher cost of financing and, less frequently, higher capital and/or operating costs under PPP delivery.

A recognizable feature of an asset is its potential to generate future economic benefit or a service. The net economic benefit derived from an asset (or the value of future service) depends on expected income (or on service value) from that asset, less anticipated costs/expense needed to produce the benefit. There is a cost associated with each risk (e.g. insurance premium). All other factors being equal, the market value of an asset that comes with fewer risks must be higher than one that comes with many risks.

Recently, there has been much discussion about the relative absence of risk values in PPP asset valuation. The premise is that every risk has an economic value. For example, a banker charges interest on loans (the bank’s assets) based on the degree of risk the bank assumes for each loan. The difference between a loan made at “prime” and the one made at “prime plus one” is the incremental value of the higher risk attached to the latter bank asset.

The focus of this issue concerns whether the valuation of a PPP asset should consider the value of the accompanying risks if the accounting is to reflect the economic substance of a transaction.

Accounting Guidance

The accounting guidance around recognition of risk is mainly encapsulated in the requirement to consider the substance of a transaction rather than its form. Hence, government should only recognize an asset on its balance sheet if a significant portion of the risks and rewards of ownership remain with it.

Different Interpretations

Those in favour of attaching value to risk transfer in valuation of a PPP asset argue that the value of PPP assets and the related liabilities recorded on the Summary Financial Statements must make sense. The valuation decision must recognize the economic value of the bundle of risks that comes with an asset. Otherwise, identical assets with different level of risks attached to them (e.g. the extent of demand risk) would bear similar values.

On the other hand, those who apply the lease accounting to PPP transactions because it is the current GAAP argue that for leases “fair value” is essentially the amount of the consideration that would be agreed upon in an arm’s-length transaction between knowledgeable, willing parties who are under no compulsion to act. This depends on whether the lessor is or is not a manufacturer or dealer. If it is, the fair value of the property at the inception of the lease will usually be its normal selling price. If it is not, the fair value of the property at the inception of the lease will usually be its cost to the lessor. In both cases, the determination of fair value would be made in light of market conditions prevailing at the time. Once it was determined that a PPP arrangement contains a lease, it should be accounted for as such. Thus, they say, there is no requirement to account for risks in calculating the fair value of a leased asset.

As discussed earlier, however, the concept of fair value in a PPP transaction is itself a challenging one.

The biggest challenge to valuations based on risk transfer is that such valuation may be deemed too subjective and onerous by the accounting profession. However, CCPPP believes that in practice there is considerable subjectivity in the determination of fair value in the context of PPP transactions.
Commercial Implications

Understanding the interrelationship between PPP accounting treatment and risk transfer is critical in fair presentation of the transaction. Experience from the United Kingdom and other jurisdictions, including Canada, indicates that at first the desire to obtain off-balance-sheet accounting treatment has been a very important factor in transferring risk to the private operator. The desire for off-balance-sheet accounting treatment was, itself, driven by budgetary restrictions and the desire to keep net debt down. Today, however, although many governments have put deficit financing behind them, it is the desire for improving value for money that justifies transferring risks to the private partner. While the motives for risk transfer may have changed over time, it seems that the outcome has remained unchanged. In these circumstances, commercially it makes a great deal of sense that PPP transactions for which the government bears only few risks stay off balance sheet. Many PPP-type arrangements in which unitary payments ensure value for money would be good candidates for off-balance-sheet accounting treatment.

Pragmatically, government departments and agencies are, in general, very reluctant to effectively transfer risk to the private sector, because in transferring risk and responsibility they weaken the traditional levers of bureaucratic control over projects. Better accounting guidance on risk valuation is needed to justify risk transfer to obtain value for money and therefore to strengthen the partnership with the private sector.

Not all PPP transactions will or should achieve off-balance-sheet treatment; but if on-balance-sheet treatment is pre-determined from the outset of a transaction, there will be little incentive to transfer risks. In the worst case, appropriate commercial structures can be perverted by excessive structuring to try to get around rigid capital lease rules, causing form to overshadow the substance of the PPP transaction.

Feedback from the CCPPP membership indicates the need for creating examples of robust risk transfer models and their associated “rewards”.

Recommendation

CCPPP recommends that:

Guidance on valuation of risks and rewards be provided to ensure that the value of risks transferred in the PPP transactions be taken into account in deciding whether or not an asset and its related liability is to be accounted for in the government financial statements. Guidance for the valuation of risk transfer can be drawn from value-for-money assessment techniques.
Issue 10: Should off-balance-sheet accounting treatment be ruled out?

Features and Expected Benefits of PPP Delivery

As the issues discussed above indicate, the key question in PPP accounting is increasingly not whether to record the asset and liability on balance sheet, but what is recorded on balance sheet?

In the post-Enron era, a movement has been initiated by many standard-setters and their oversight bodies to enhance transparency and accountability in financial reports.

There is a legitimate concern that a government’s PPP obligations should not be allowed to go unreported. Reporting, however, needs not always be in form of an accounting record. Notes and explanations constitute an integral part of financial reporting and are very effective when used appropriately.

In 2003, in the opening paragraph of an article titled *PFI & PPP – Enron UK?*, Michael Mainelli, FCCA, a long-time partner in a large international accountancy practice and corporate development director of Europe’s largest R&D organization wrote:

“Know the one about the £billion organization with off-balance sheet finance? Wouldn’t you like to know about special purpose entities, off-shore accounts, strange sale and buy-back arrangements or arcane percentage ownership and disclosure rules before investing? … Welcome to the world of PFI, PPP and the UK government”.

Sentiments like this are regularly expressed by authoritative players in the accounting field to the extent that it is almost a blasphemy to think of a PPP arrangement as an off-balance-sheet transaction. “Book it in government financial statement if in doubt” may be the ultraconservative accounting marching order these days.

However, as discussed above, in the absence of clear guidance on what to put on balance sheet and when, this desire may translate into an excessive focus on form rather than substance, and into penalizing PPP delivery relative to other procurement methods.

The focus of this issue is to discuss whether or not there is still an appropriate place for off-balance-sheet PPPs.

Accounting Guidance

The most frequently invoked accounting guidance in this area is the requirement, particularly strong in government accounting, to err on the side of cautiousness. This is because most Canadian accounting guidance currently available, and the international guidance for private-sector accounting of service concessions, is “control-oriented”. Because of such strong orientation, acceptance of off-balance-sheet treatment is tantamount to giving up control. Politically the concept of giving up control of public assets is not easily explainable even if it is well supported by the size of risks transferred to the private partner. Because of this pragmatic difficulty, in reality, the references in accounting guidelines to the importance of risks transfer could become somewhat irrelevant, unless a dollar amount could be placed on such transfers.

Different Interpretations

Those who apply the current guidance, due to the lack of better guidance, say that although *AcG-15* and *EIC 157* “Implicit Variable Interests Under AcG-15” are part of the CICA Handbook – Accounting, interpreting the concepts introduced by them may have far-reaching implications for the public sector as well as for its private-sector partners. Conceptually, if a government is the primary beneficiary (as defined in *AcG-15*) of a Variable Interest Entity (VIE), even though it does not control that entity, it may have to consolidate the VIE into its summary financial statements. Conceivably this could occur if the PPP assets and liabilities are accounted for in an entity which is a VIE. (For example, having the concessionaire charge a toll over the life of a concession may be sufficient for a PPP entity, on its own volition, to raise needed financing for building a road.) Therefore, even though the government does not pay a shadow toll or any other
unitary payment, or control the operator’s business, the mere fact that it has the right of use of specific underlying tangible assets, for substantially all their useful life, should be sufficient for the government to consolidate the PPP Entity.

However, many participants argue that there are instances when an off-balance-sheet accounting treatment may present best practice. An example would be the common PPP structure in which the private-sector service operator:

1. recoups its cost of the PPP property (e.g. a toll bridge) directly from users;
2. pays the government for the use of public property on which the infrastructure is built; and,
3. provides the public sector with consideration for the concession granted to it, in the form of transferring, in good condition, the infrastructure to the government at no cost at the termination of the concession.

In this scenario, the government only grants to the private-sector partner for a reasonable consideration the right to provide a service that is essentially its prerogative. The operator accepts all availability risks, demand risks and other major risks. Like many other services provided to the public, such as utilities, the government fulfills its responsibility to protect the public by regulating the operator’s business.

UK FRS 5 allows certain assets and their associated liabilities to be kept off the balance sheet.

**Commercial Implications**

The private sector’s expectation of return relates directly to the level of risk it is able to take. Often, the private partner is denied the return it wishes to aim for because the public partner has no incentive to transfer risks. This happens when there is no alternative for the government but to account every PPP asset on balance sheet. This hampers growth in an otherwise efficient industry that produces significant public benefit.

**Recommendation**

CCPPP recommends that:

For the reasons set out above and in the risk transfer section (Issue 6),

1. Clear guidelines related to risk transfer and certain other criteria should be provided which, if met, should guide whether a PPP is on or off balance sheet.
2. That such guidelines should reflect the balance of risks and rewards in any individual PPP transaction and avoid balance sheet treatment based on the form of the transaction.
3. Many public-sector commitments in respect of PPPs should be recognized as contingent obligations, which should be noted in the financial statements.
Issue 11: Should the government recognize capital property designed, financed, built and operated by its private partner, based on the value of granted rights and the asset’s residual value?

Features and Expected Benefits of a PPP

In most cases, at the termination of a PPP, the underlying capital asset built by the private partner is taken over by government either at no cost or at fair market value (FMV). In rare cases, particularly where construction is on public property, the PPP contract calls for dismantling and removal of the asset. In almost all cases the PPP contract requires that the private partner (the operator) maintain the asset in good working order throughout the term of the PPP contract.

Transferring the asset at termination of contract to government at no cost could mean that the government has at some point become the owner of the asset (though not necessarily the holder of the title). The economic substance of this scenario is that the private partner was substantially paid for the asset, through user-pay revenue or direct payment by government (in cash or in kind, in lump sum or as a portion of unitary payments).

A purchase option at FMV, at the termination of contract, means that the asset’s title and ownership have stayed with the private partner until transferred to the buyer. Under this scenario, it is reasonable to assume that though the private partner had earned revenue from the capital asset, no payment (in cash or in kind, a lump sum or as part of unitary payments) was made towards buying it from the private-sector partner.

How the capital asset built by the private partner is expected to be transferred to the government at the termination date is, therefore, an important factor in making a judgment as to whether the value of a PPP capital asset should be recognized in the government’s financial statements.

Another useful distinction can be made between a user-pay service and an availability payment by government. The challenge is that PPP transactions do not always fall into this neat categorization, and hybrid models, which are a combination of user-pay and availability style payments, are common.

Accounting Guidance

Canadian accounting guidance is quite inadequate in capturing the essence of a transaction that involves granting to the private sector by a government the right to collect revenue directly from users for services that are the government’s prerogative, such as tolls on public highways. The International Accounting Standards Board has issued guidance for the private-sector partner (the operator), but no guidance is available for governments in this area.

The International guidance for the operator recognizes three scenarios based on the source of payments received by the operator in a service concession arrangement.

1. Financial Asset

If governments have the primary responsibility to pay the operator for the concession services, then the operator must treat this payment as receiving a financial asset from government in exchange for the construction or other services it provides to the public.

During the construction phase, revenue and costs relating to the construction are recognized as income. Afterwards, the operator will account for a financial asset in the form of a loan or receivable, an available-for-sale financial asset (similar to inventory), or a financial asset at its “fair value”.
2. Intangible Asset

If users have the primary responsibility to pay the operator for the concession services, then the operator must treat this right as receiving an intangible asset from government in exchange for the construction or other services it provides to the public.

During the construction phase, the operator creates an intangible asset whose value increases in line with the corresponding revenue. The intangible asset thereafter generates revenue for the operator in the form of user-pay or availability payment by the government.

3. Bifurcated model

This is where the operator receives both a financial asset and an intangible asset. The initial recognition of the asset will be at FMV. Later, any excess of the FMV of the financial asset will be recognized as an intangible asset.

Though they do not apply to public-sector accounting, these new International Accounting Standards (IFRIC 12 Service Concession Arrangements) are very important for accounting treatment of PPP transactions because they recognize:

- That a “right” (government’s prerogative) has a measurable financial value when granted to the operator (e.g. collecting user-pay); and
- That constructing a capital asset for a service concession is secondary to the service delivery.

These standards address the substance of capital property rather than their legal form.

The International Public Sector Accounting Standards Board (IPSASB) has started its own project to develop similar guidance for the government side of service concession arrangements, which will give serious consideration to the accounting by grantors (usually governments).

Different Interpretations

Who pays for the asset? – One of the practical challenges of accounting guidance in this area is that revenues generated from user-pay and from government’s availability pay are pooled, and their role in providing value for the residual asset will not be easily determinable. Further, as the concept of control drives most current accounting guidance on asset recognition, this practical difficulty could become important in deciding who has effective control over the capital asset.

Who bears “demand risk”? – The presence of substantial demand risk (indicated by direct user-pay charge or through a government “shadow” payment) is sufficient in some jurisdictions to support off-balance-sheet treatment of capital assets built by the private partner (operator). However, this is by no means the generally accepted position in Canada.

Political considerations – A PPP contract which calls for availability payment by government could be converted into a user-pay facility during its life and likewise a user-pay facility could be taken back by the public sector (as was the case with the Fredericton-Moncton Highway). In other circumstances, government may decide that it collects tolls (and take some or all of the demand and collection risks) and make an availability payment to a PPP concessionaire, transferring design, construction, and asset performance risk to the private partner. This was the case with both the Golden Ears Bridge PPP and the Richmond Airport—Vancouver Rapid Transit Project PPP (RAVP). A hybrid model (with the government and private-sector partner sharing in a range of capital, operating and demand risks) rather than clear risk allocation, may be politically favoured, resulting in different views on whether the PPP should be consolidated. An example of this could be the accounting treatment of track investment in UK’s Network Rail where arrangement involves government guarantees and thus sharing risks and capital. The result is that there exists an ongoing disagreement on whether Network Rail Inc. is private or should be consolidated.
Residual asset considerations – Opposing interpretations are cited by PPP practitioners as to the accounting treatment of residual assets. This is particularly the case where, as outlined above, the contract provides for capital assets which were financed, designed, and built by the private partner to be transferred to government at no cost. Many practitioners argue that over the life of a PPP contract the unitary payments made by the government have paid for the asset. Interpretations become less clear where the government reversionary interest exists even though the private partner recouped its cost of construction from third-party users. The standard argument for government’s right to the residual asset is that government grants a concession to a private-sector partner to design, build and operate a new toll road in return for the right to collect tolls.

Residual gain consideration – At the end of the concession the underlying capital asset which was financed, designed, and built by the private partner will revert to government for no consideration with a significant residual useful life. If government chooses to recognize the value of its reversionary interest when the concession ends, there could be a significant financial gain at that time. Many practitioners see this accounting treatment as inappropriate because they believe the asset was, in substance, the government’s at the time it entered into the PPP contract. Australia has moved towards treating the residual asset as an “emerging asset” by gradually accruing value of its reversionary interest as the concession matures. It must be noted that despite extended dialogue on emerging assets including deliberations by an inter-Treasury working party examining PPP accounting policies, it has not been possible to reach agreement on the valuation (and hence revenue recognition aspects) of emerging assets. Consequently, the Public Accounts of Victoria, Australia do not yet record emerging assets although this concept has been applied in the State of New South Wales.

Commercial Implications
It is generally recognized that commercially the underlying capital property (usually financed, designed, built, operated, and transferred) are “cruel” assets for the private sector. In most cases, in the construction period as well as in the first half of the concession period they are dead weight carried by the enterprise. This is not a true reflection of the economic substance of the transaction, because the “asset” drains the enterprise with its ability to show profit. This is a harsh reality that the new IASB has acknowledged by developing the IFRIC 12. By accounting for them as financial or intangible assets, the private partner treats amounts received (both during and after the construction period) as revenue. As explained above, this development in accounting paradigm helps private corporations to reflect the substance of PPP transactions rather than their legal forms.

Governments are also quite concerned about accounting guidance that is not sensitive to the commercial implications of a PPP. They see in PPPs the ability to expand public services and obtain better value for their tax money. At the same time, they are aware that complex PPP arrangements must not result in abdicating the duty to protect public interest, and so they build into those arrangements strong preventive controls (some of which may never be exercised). However, because accounting standards are insensitive to these formalities, they will be penalized by inaccurate accounting results.

Recommendations
CCPPP endorses the direction of International Accounting Standards Board’s IFRIC 12 – Service Concession Arrangement; in particular, the recognition that rights granted by government to its private partner have measurable value, and that appropriate accounting guidance must be sensitive to the commercial implications of concessionary arrangements.

CCPPP recommends that:
1. Accounting for PPP-type arrangements should include guidance on recognition of value of rights granted by government to its private partner. In doing so, the concepts of “control”, “right of
access”, and “legal title” to capital property should be re-examined with respect to government’s residual interest in capital property designed, financed, built and operated by the private partner.

2. User-pay transactions should not be recognized as an asset and liability for the government upon substantial completion of the project because no demand risk is borne by the public sector, and the government is not receiving the benefits and risks of the asset. Over time, however, where the government will be receiving a reversionary interest at a bargain or in a certain condition, accounting guidance should be issued to ensure that assets are recognized on an emerging asset basis.
Issue 12: Should financial reporting of partners in a PPP arrangement apply a similar basis of asset valuation?

Features and Expected Benefits of a PPP

GAAP requires the private sector to use accounting standards outlined in the CICA Handbook. GAAP also requires the Summary Financial Statements be prepared using PSAB accounting standards for senior governments. The PSAB standards are in line with the CICA Handbook. Nevertheless, the value of a PPP asset may be different from the point of view of the private-sector partner who constructs the infrastructure and the public-sector partner who records it as an asset.

Currently, because accounting standards for leases are applied to PPP-type arrangements, discussion over asset valuation inevitably moves to the definition of “minimum payments”, measurement of “fair value” and computation of Net Present Value. These are grouped together under Issue 3. In discussing this issue our focus is on the relationship between the two sides of a single transaction, and whether or not there should be similarity between them.

Accounting Guidance

Applying Variable Interest Entities to PPP Arrangements

Existing Canadian accounting guidance on what should be consolidated has been extended to include Variable Interest Entities (VIE). AcG-15 Consolidation of variable interest entities provides guidance on accounting for contractual, ownership, or other interests in an entity that exposes its holders to the risks and rewards of the entity. Previously, only subsidiaries were expected to be consolidated. Including VIEs in consolidated financial statements is a strong indication of the importance of risks and rewards in recognition of assets and liabilities that are not necessarily controlled by a consolidated entity. Conceptually this new paradigm is relevant to PPPs because allocation of risks and rewards are essential features of these arrangements.

The structure of PPP entities also resemble many VIEs, as both are often created as a single-purpose entity whose activities were predetermined by arrangements between related parties. This is another reason why an understanding of accounting guidance for VIEs could help PPP accounting.

Variable interests include equity investments, loans, leases, derivatives and other instruments whose value changes with changes in the VIE’s net asset. AcG -15 and EIC 157 help distinguish a VIE from other business enterprises based on the substance of its activities, the size of the equity investment in it, and rights and obligation of the equity investors.

A VIE could be a corporation, a partnership, or a trust. With few exceptions, the VIE guideline applies to all entities, including government business enterprises. The party who is expected to bear the largest portion of expected losses (and benefits from the majority of expected residual returns) is the VIE’s primary beneficiary and is required to consolidate the VIE.

Service and management contracts, too, could be “variable interests” if the compensation is not market-based. According to AcG -15 a party with no exposure to expected losses may still be the VIE’s primary beneficiary through a management contract.

VIEs usually do not start with sufficient equity investments. To attract new equity holders (lenders, etc.), the VIEs allow them to participate significantly in the entity’s financial results. Equity in VIEs is therefore inherently at risk. The equity holders who take such risk are not given controlling interest, but they agree to absorb expected losses and to receive residual returns. This makes “expected losses” the benchmark for determining if an entity is a VIE. In a VIE votes are not proportional to economic activities, and investors do not participate in conducting the VIE’s activities.
Equity investment does not include subordinate and convertible debt, and other investment such as commitment to fund losses. Financial statement disclosure depends on whether the primary beneficiary is or is not the potential discloser.

**Taxation considerations**

The private-sector taxation implications of PPP transactions would merit a paper all to itself. We have no evidence of how Canada Revenue Agency may act in respect of PPP-type transactions, and would not wish to prematurely spark an issue where one may not exist. However, based on what happens elsewhere in the world we know taxation may have a substantial impact on PPP structures. An example of the importance of taxation consideration to this issue is the usual lack of congruence in definition of assets in accounting and taxation in the tax-paying private partner and the tax-exempt public partner.

The ability of private-sector investors in infrastructure to obtain favourable tax treatment is typically of great importance both to private-sector appetite and to achieving a sensible cost of private-sector capital relative to public-sector funding. Conversely, any PPP transaction characterized by Canada Revenue Agency as a lease will result in the private sector being unable to claim tax depreciation in respect of the asset. This is likely to seriously impact the cost-effectiveness of PPP transactions.

The Australian Tax Office plays a major role in any PPP through its ability to deny deductions and tax depreciation to the private-sector owner of an asset, where the public sector has the ability to “use or control” the asset.

The UK Treasury and Inland Revenue have not acted to restrict the taxation efficiency of PFI structures, and it could be argued they have, in fact, encouraged greater taxation efficiency.

**Service Concession Arrangements**

International Accounting Standards Board’s *IFRIC 12 Service Concession Arrangements* provides guidance that may result in different classes of assets in the private- and public-partner’s books. Similar guidance is being developed for public-sector accounting of service concession arrangements (discussed in detail in Issue 3).

**Different Interpretations**

Those who advocate for similarity of asset valuation argue that it stands to reason that the fair market value of an asset is the same irrespective of who the owner may be. Every specific property used in a PPP arrangement, they say, must have an owner. The owner must record the asset in its books unless all the benefits and risks incident to ownership of property are transferred to someone other than the owner, or if the other party has substantially all the right of use of the property, in which case the other party must record the fair value of the asset in its books. The asset is of the same property with a unique economic benefit whether it is recorded in the government’s accounts, or in the private-sector partner’s books. It stands to reason that it is valued in the same way notwithstanding who records it.

In valuing a PPP asset based on minimum payment, both partners should consider the fair value to ensure the result is reasonable and internally consistent.

Those opposing would argue that PPP assets are not necessarily valued similarly in the government accounts and in the private partner’s books. For example the fair value of a lease asset depends on the minimum lease payments which may be different from the point of view of the lessee and lessor.

*CICA Accounting Handbook Section 3065* states that the minimum lease payments, from the point of view of the lessee, comprise the minimum rental payments plus guaranteed residual value of the property at the end of the lease term and any penalty for failure to renew or extend the lease. If a lease contained a bargain purchase option, only the total of the minimum rental payments over the lease term and the payment called for by the bargain purchase option would be included in minimum lease payments.
From the point of view of the lessor, however, *minimum lease payments* essentially comprise minimum lease payments for the lessee as described above, plus any guaranteed residual value.

**Commercial Implications**

Tax implication (if any) aside, different valuations of the same asset could result in inconsistent government accountability reports that erodes public confidence in the institution of government. For instance, if the public sector comparator reports a value based on the operator's estimate, and the government financial statements affix to it a different value based on the PV of future payment, the public will have difficulty to understand why the two are not the same.

There are other potential implications. For example, in the production of economic statistics. At any during the life of a project, if there are tangible or intangible assets present, ownership needs to be established and the owner should include these assets and any corresponding liabilities in its books. Some of the proposed rules seem to imply that there will be periods of time where assets would not be on either the government or private corporation balance sheets and they would be relegated to disclosure notes. Similar problems exist where the same asset is recorded on both the government and the private-sector financial statements, and risks double counting of the asset for statistical purposes. The effect for economic statistics bodies like Statistics Canada is the difficulty or inability to account for some significant assets or that there will be significant fluctuations in the data in the context of a time series.

It is also important to note that, aside from tax implications, the accounting treatment of PPP transactions is not generally seen as relevant to the private-sector operators, who are not responsible to the public for their accounting statements. As such, if accounting congruence is deemed essential and there are no tax implications, there will be little or no commercial implications for the private-sector operators to changing their accounting treatment.

**Recommendations**

CCPPP recommends that:

1. The same PPP transaction should not be consolidated on both the public- and the private-sector balance sheets.

2. The fact that a PPP is not consolidated on the private-sector balance sheet should not be taken as prima facie evidence that the transaction should be consolidated on government's balance sheet. The absence of consolidation should not in itself be a cause for concern.

While asymmetry of accounting treatment between public and private partners should not in itself be cause for concern, the public reporting of the valuation should, to the extent possible, be consistent with that of the private partner in situations where, contradictory to our recommendation (1) above, there is recognition on both the public- and the private-sector balance sheets.
Issue 13: That accounting standards should be applied consistently in financial and performance (value-for-money) reporting of PPP projects

Features and Expected Benefits of a PPP

Accounting plays an important role in the success or failure of a PPP project. It affects the outcome of three important documents in the life of a PPP project: the public sector comparator, the value-for-money report, and the financial accounting. Using different accounting bases will result in incomparable, inconsistent analysis of the transaction.

The focus of this issue is to discuss whether or not accounting should be used in all aspects of reporting on a PPP arrangement.

Accounting Guidance

Though consistency in accounting is expected in the preparation of financial statements and any management discussions or analysis reports, there is no specific accounting guidance earmarked for use in value-for-money reporting. In practice, the stringent requirements of financial reporting are often not followed in preparation of the public sector comparator or the value-for-money reports.

Different Interpretations

Those in favour of consistency argue that consistency in accounting and reporting on a PPP must be observed from inception (the preparation of the public sector comparator) to its financial statement presentation. It would not be possible to report publicly on the value-for-money aspect of a PPP arrangement in a meaningful way if accounting rules were not applied consistently.

Those who are not concerned about consistency say that financial accounting and reporting are subject to stringent rules that do not necessarily result in portrayal of the substance of a PPP. There is no legal requirement to apply GAAP, for instance, in the preparation of value-for-money reports on PPP projects. The flexibility allows better analysis based on best practices where current accounting rules are inflexible and often inappropriate.

Commercial Implications

Both government and private-sector partners have a strong interest in consistency between value-for-money valuations, which tend to drive performance evaluation criteria, and accounting treatment, which can quickly become an implicit evaluation criterion.

Those who are not concerned about consistent public reporting may refer to a much more serious shortcoming in accounting guidance when they say that "the contingent rules adhered to by financial accounting do not necessarily result in portrayal of the substance of a PPP."

Recommendations

CCPPP recommends that:

1. Substantive differences between value-for-money reporting and accounting treatment are undesirable and that consistency between accounting treatment and value-for-money assessments is a desirable and important objective.
2. Accounting treatment should draw upon value-for-money techniques, rather than value for money being derived from accounting.
3. Given the shortcomings in current accounting rules, utilizing accounting rules in determining value for money, as discussed in Issue 3 on fair value, would misrepresent the commercial substance of the transaction.
5. Appendices

5.1 Available Sources of Accounting Guidance and Recent Developments
5.2 Important International Pronouncements
5.3 PPP Financial Model – Generic Values Equation of a PPP Transaction
5.4 References
5.1. **Available Sources of Accounting Guidance**

In Canada, the main source of Generally Accepted Accounting Principles (GAAP) is the CICA’s accounting pronouncements. The *CICA Handbook – Accounting*, and the *PSAB Accounting Handbook* provide accounting standards, guidelines and authoritative interpretations on financial accounting and reporting. Where such pronouncements are deemed inadequate or unclear, Canadian accountants are permitted to consult useful sources in other jurisdictions. Accounting pronouncements published with the authority of the US Financial Accounting Standards Board (FASB), or the International Accounting Standards Board (IASB), are often important sources to consult on matters not covered by primary sources of GAAP or to assist in applying a primary source of GAAP to specific circumstances.

*PSAB Accounting Handbook* is the primary source of GAAP for the public sector. When seeking further assistance in applying accounting standards to transactions, the first point of reference is the *CICA Handbook – Accounting*.

Neither *CICA* nor *PSAB Accounting Handbooks* provide accounting standards or guidelines explicitly for PPPs. As a basis for their professional judgment, Canadian accountants and auditors select the best fit for a PPP arrangement from existing standards and guidelines.

A thorough understanding of relevant accounting pronouncements in Canada and internationally, is therefore, the necessary starting point in determining how to account for PPP transactions.

**Canadian GAAP**

PSAB recognizes four types of government contractual arrangements. These are:

1. Government partnerships including government business partnerships – covered by *PS 3060*,
2. Executory contracts which are largely lease-type arrangements, including, for example, build-own-operate, or build-own-operate-transfer arrangements – covered by *PS3390* and *PSG-2*,
3. Purchase/sale transactions which include management contracts, outsourcing of services and privatization – covered by *PS 1200* and *PS 1800*, and
4. Transfers/grants which include shared cost arrangements, loans, and loan guarantees – covered by *PS4310*, *PS 3050*, and *PS 3310*.

As well as the above standards, PSAB accounting guideline *PSG-2* provides guidance on leased tangible capital assets.

Governments may also enter into joint ventures – where they jointly control a project – covered by *CICA Handbook Section 3055*.

*CICA Handbook* also provides standards for leases under its *Section 3065*, accounting guidance on variable interest entities (*AcG-19*) and record of the Emerging Issues Committee’s consensus EIC 150 on whether an arrangement contains a lease.

**International Sources**

Relevant international guidance issued by authoritative accounting bodies could be of assistance in applying GAAP to a particular situation. A list of these pronouncements would include accounting pronouncements from:

- International Public Sector Accounting Standards Board (IPSASB). IPSASB is an independent standard-setting board of the International Federation of Accountants (IFAC). IPSASB is committed to ensuring its standards, guidelines and interpretations are in line with those of the International...
Accounting Standards Board. A new project for developing guidance for “service concession arrangements” has been recently proposed to the Board, to cover public-sector accounting issues related to service concession arrangements.

- IASB is an independent standard-setting board of the IFAC. Accounting pronouncement by this organization includes: International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), and Interpretations (SICs) and (IFRICs). Pronouncements most relevant to PPP arrangements published by IASB are:
  
  IAS 11 Construction Contracts  
  IAS 16 Property Plant and Equipment  
  IAS 17 Leases  
  IAS 24 Related Party Disclosures  
  IAS 28 Investment in Associates  
  IAS 31 Interest in Joint Ventures  
  IFRS3 Business Combinations  
  SIC-12 Consolidation, Special Purpose Entities  
  SIC-13 Joint Controlled Entities, Non-monetary Contributions by Venturers (IAS31)  
  SIC-15 Operating Leases  
  SIC-29 Disclosure, Service Concession Arrangement (being amended – draft D12, D13, and D14 – “control”)  

- UK standards related to Private Financing Initiative (PFI) — an equivalent term for PPP — are included in Financial Reporting Standards 5 (FRS 5) and the HM Treasury Technical Note, a “risk” and “reward” approach.

- Europe: SNA93 and ESA95 provide broad framework and principles for statistically-based National Accounts, including various measures of public debt. European standards have legal force in the UK.

- US accounting standard-setters Financial Accounting Standards Board (FASB) has recently issued guidance on “Fair Value Measurement”.

- International auditing and assurance authorities are not standard-setters; however, they have been helpful in the development of a globally uniform financial reporting system. These organizations are:
  
  - International Organization of Supreme Audit Institutions (INTOSAI). INTOSAI sits as an observer to the IPSASP meetings. It has indicated its commitment to endorse International Financial Reporting
  - International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

Recently the World Federation of Exchanges (WFE) formally endorsed the processes for establishing International Standards on Auditing (ISAs), viewing ISAs as key to the development of a globally uniform financial reporting system.
5.2. **Important International Pronouncements Relevant to PPP Accounting**

There is a concerted effort and expressed desire by accounting standard-setting institutions in various jurisdictions to homogenize financial accounting and reporting standards. There are, however, a number of significant variations worth reviewing.

**International Accounting Standards Board and International Public Service Accounting Standards Board**

*SIC 29 “Disclosure – Service Concession Arrangements”* issued by International Accounting Standards Board (IASB) which first came into effect on December 31, 2001 is now being revised. The near-final draft of the amendment of this interpretation adds additional disclosures about service concession arrangements. *SIC 29* specified disclosures required in financial statements of the private operators about the concession arrangements.

Service concession arrangements are arrangements whereby a government or other body grants contracts for the supply of public services, such as roads, energy distribution, prisons or hospitals, to private operators.

**Service Concession Arrangements – Determining the Accounting Model**

The operator may construct or acquire such infrastructure for the purpose of the concession. It is proposed that if, as often happens, the grantor (usually the government) continued to control how the infrastructure was used both during and after the concession, the operator should not recognize that infrastructure as its own property, plant, and equipment. Rather, it should account for having provided construction services to the grantor under a construction contract and should account for the rights it receives in exchange for constructing the infrastructure using one of two accounting models:

- **The financial asset model** – if the grantor has the primary responsibility to pay the operator for the concession services. Under this model, the right received by the operator in exchange for construction services or other consideration is accounted for as a financial asset, measured at fair value. Obligations under contracts shall be measured on the basis of the consideration received for their performance; or

- **The intangible asset model** – if users have the primary responsibility to pay the operator for the concession services. Under this model the service concession operator is regarded as receiving an intangible asset from the grantor in exchange for the construction or other services it provides to the grantor. The operator should recognize revenue and profit or loss on that exchange, measured at the fair value of the intangible asset received, adjusted by the amount of any cash or cash equivalents transferred.

It should be noted that this guidance is for accounting of Service Concession Arrangements in the books of the “Operator” who is usually the private-sector partner in a PPP. No such guidance has yet been issued for the public sector, who is usually the “Grantor” of the concession.

The International Public Sector Accounting Standards Board (IPSASB) has, in early November 2006, considered a proposal by staff to develop parallel guidance for the “Grantors”. It is anticipated that the guidance on accounting for service concession arrangements be ready in 2008. The IPSASB is committed to developing its guidance in line with that of the IASB. Consequently, one would expect to see similar concepts put forward by the IASB for service concession arrangement to be adopted by the IPSASB. Accordingly, it is expected that, based on concept of “control” rather than “risks and rewards” if grantor (usually the public-sector partner) controls or regulates the services the operator provides, and has the
residual interest which is significant, then property would be accounted as an asset on the grantor’s balance sheet.

The Canadian Public Sector Accounting Board (PSAB) is expected to consider IPSASB’s pronouncement in its project, when it decides to provide accounting guidance for service concession arrangements.

**Australia and New Zealand**

Since 2005, Australia and New Zealand have based their national accounting practices on international standards.

**United Kingdom**

The UK government develops its own accounting policies.

There are two major pronouncements on accounting for PPP-type projects (referred to in the UK as Private Financing Initiatives or PFIs). These are: (a) the old Financial Reporting Standards (FRS 5) and (b) the recently issued HM Treasury Technical Note – a “risk and rewards approach”.

FRS 5 was designed to allow the accounting of the PFI projects to reflect the substance of a transaction. A major breakthrough of the FRS 5 was the distinction it made between a “property” and an “asset”. It stated that the risks inherent in the benefits provided by a property would determine which entity has the asset. It also presented accounting solutions by separating the “pure service” components of a PFI and applying risk analysis to the remainder, but only taking account of the potential variations in profits/losses that relate to the property. It also demanded the accountant to assess which party bears the majority of any variations in profit/losses related to the property.

To decide who should record the PFI property as an asset, the FRS 5 presented these principal factors: demand risk, third-party revenue, design risk, penalties for underperformance or non-availability, changes in property-related costs, obsolescence, and residual value risk.

According to FRS 5, significant “demand risk” and/or “residual value risk” will normally give clear evidence of who should record an asset of the property.

HM Treasury Technical Note – a “risk and rewards approach” was introduced to provide some additional practical guidance. However, it is now viewed by many users as alternative guidance to FRS 5.

It encourages use of quantitative technique “Monte Carlo” analysis to assess which party has majority of risk. Many stakeholders, including auditors, believe it can be manipulated to give the desired result.

It seems that the pressure is building to encourage HM Treasury to withdraw its Technical Note.

UK is expecting significant changes in government accounting policies, including “whole-of-government” accounting (similar to the Canadian Summary Financial Statements). UK National Audit Office expects to see many more assets on the government financial statements as a result. PFI assets such as new toll roads and government buildings which revert to the public sector are likely to be on balance sheet while moveable assets (such as aircraft) are expected to continue to stay off balance sheet.

The expression of hope in resolving accounting issues is by no means unfounded. The outlook is quite promising as, for instance, worldwide awareness and understanding of accounting concerns has significantly increased in recent years. Consensus has been reached on the nature of major accounting issues, and accounting standard-setters have reacted – albeit slowly and cautiously – to the need for clarity. The time for voicing the PPP industry’s concern directly to standard-setters, and for offering CCPPP’s participation in developing appropriate guidance, has arrived.

The main players at this stage will have to be the accounting standard-setters (national and international), and the real stakeholders, i.e. PPP practitioners who could collectively be represented by the CCPPP.
For this purpose, the most important accounting standard-setters are the International Accounting Standards Board (IASB), the International Public Sector Accounting Standard Board (IPSASB) and the Canadian Institute of Chartered Accountants (CICA) including its Public Sector Accounting Board (PSAB).

The IASB is an independent, privately-funded accounting standard-setter based in London, UK. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. The IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

The interpretative body of IASB is the International Financial Reporting Interpretations Committee (IFRIC). The IFRIC reviews, within the context of current International Financial Reporting Standards and the IASB Framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. In developing interpretations, the IFRIC works closely with similar national committees.

A little more than five years ago the IASB issued a guidance titled Disclosure – Service Concession Arrangements. This document, which became known as SIC 29, specified disclosure required in the financial statements of private operators about concession arrangements. The emphasis on "concession" was not accidental. Ever since governments, worldwide, began to structure PPP-type arrangements with private-sector businesses, the accounting standard-setters noted the inadequacy of accounting principles specifically developed to deal with fair presentation of concessions as an economic event. SIC 29 was a "quick fix". It provided for the explanatory disclosure in notes to the private-sector financial statements. In October 2006 the IASB’s affiliated committee, IFRIC (see above), issued a near-final draft of an amended SIC 29 which outlined, for private-sector firms, the accounting treatment of service concession arrangements. IFRIC Interpretation 12 has now been issued and has substantially clarified the accounting principles specifically addressing service concession arrangements.

The definition of the "Service Concession Arrangements" presented in the near-final draft of amended SIC 29 resonates closely with the definition of a result-oriented PPP arrangement which was referred to, earlier, as the flagship model of PPPs. Service Concession Arrangements are defined as being arrangements whereby a government or other body grants contracts for the supply of public services, such as road, energy distribution, prisons, or hospitals, to private operators. It continues to say that the operator may construct or acquire such infrastructure for the purpose of the concession.

Internationally, a similar pronouncement for the public sector is at a very early stage of development. The International Public Sector Accounting Standards Board approved the project to go ahead at the end of the calendar year 2006.

The International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) is an independent standard-setter based in New York, USA, working to improve both the quality and uniformity of financial information reported by public-sector entities around the world.

IFAC is the worldwide organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC’s current membership consists of approximately 160 professional accountancy bodies in 120 countries including Canada.

There is no equivalent CICA Accounting Handbook section covering the service concession arrangements. Nor is there an official schedule that the CICA intends to develop guidance on this topic. However, it appears that the Public Sector Accounting Board (PSAB) of the CICA will be watching the IPSASB’s work on this topic closely.

To sum up, there is positive action internationally, but little as yet in Canada.
5.3. **Financial Model – Generic Values Equation**

<table>
<thead>
<tr>
<th>Private Partner’s Elements of Value</th>
<th>Public Partner’s Elements of Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executory costs</td>
<td>All rights granted to the Private Partner, particularly to:</td>
</tr>
<tr>
<td></td>
<td>• Build capital assets on public property</td>
</tr>
<tr>
<td>+ Estimated FMV of the built underlying capital asset (including finance charges)</td>
<td>+ Collect revenue from users</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>- Fair Market Value of the built asset at the end of the PPP term (residual asset value)</td>
<td>+ Any payment (in cash or in kind) towards the underlying capital asset</td>
</tr>
<tr>
<td>+ Estimated cost of future operation</td>
<td>+ Estimated guaranteed unitary payments to the Private Partner</td>
</tr>
<tr>
<td>+ Expected return (before taxes)</td>
<td>+</td>
</tr>
<tr>
<td>+ Estimated loss on transferring residual asset to the Public Partner at termination of contract</td>
<td>+ Estimated payment as capital asset is reverted to the government at termination of contract</td>
</tr>
<tr>
<td>+ All taken risks</td>
<td>+</td>
</tr>
<tr>
<td></td>
<td>All taken risks</td>
</tr>
</tbody>
</table>

To account for the substance of a PPP transaction, accounting guidance should clearly recognize the importance of all elements of value in a PPP transaction.

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* Note: All value elements are included in this equation at present values (PV) at the date of the PPP contract.
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Extra copies of this publication may be purchased by contacting:

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