

# ACCOUNTING FOR PFI UNDER IFRS

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## Section 1: Introduction & Background

# Section 1: Introduction & Background

The section explains why accounting guidance is needed for PFI under IFRS.

## Key Points:

- This document has been prepared for finance staff at NHS bodies, and other practitioners, to provide detailed guidance on the accounting requirements for PFI schemes under International Financial Reporting Standards.
- It aims to assist users in addressing the key accounting areas; to provide guidance on particular accounting issues and to identify the information needed by NHS bodies to comply with the accounting requirements.
- It also provides guidance to NHS bodies on how to restate existing 'off-balance sheet' PFI schemes to the new 'on-balance sheet' treatment.

## Purpose and Background

### What does this guidance cover?

1. This guidance sets out the accounting requirements for NHS Trusts, PCTs and SHAs in respect of Private Finance Initiative (PFI) and similar schemes when preparing their accounts under International Financial Reporting Standards (IFRS).
2. It is based on the existing accounting principles set out in the HM Treasury IFRS-based 2009/10 Financial Reporting Manual for central government entities (the 'I-FReM'). It provides guidance on detailed features of PFI accounting that are not addressed in the I-FReM.

3. The guidance explains:
  - which types of contracts need to be accounted for as service concessions;
  - the recognition of the assets and liabilities in the Statement of Financial Position; and
  - the annual transactions to be recognised in the Statement of Comprehensive Income or Operating Cost Statement, as appropriate.
4. It also identifies the information that NHS bodies need in order to determine the accounting entries, and explains how this information should be analysed and converted into the accounting entries. It also identifies the issues and information requirements which NHS bodies will need to address to manage their accounting entries in the future.
5. This guidance is complemented by a 'Universal Model' and a Manual. The spreadsheet model enables NHS bodies to enter the relevant amounts for their schemes and to generate the required accounting entries for an 'on-balance sheet' treatment. The manual provides guidance on how to use this model and includes a full worked example.

### Who should read this guidance?

6. This guidance is relevant for:
  - Finance staff at NHS Trusts, PCTs and SHAs who are responsible for preparing financial statements and budgetary information.
  - NHS Trust, PCT and SHA Finance Directors and other Board members, to the extent that they need to understand the impact that the changes will make to their financial statements and budgets.

# Section 1: Introduction & Background

- Department of Health staff involved in PFI; budgeting or financial reporting matters.
- PFI advisors to NHS Trusts, PCTs and SHAs.

## What are the key objectives of this guidance?

7. The aims and objectives of this guidance are principally to:
- assist NHS bodies to identify which of their contractual arrangements need to be accounted for as service concessions under IFRS;
  - provide details of the accounting requirements for 'on-balance sheet' service concessions;
  - provide methods for calculating and estimating elements of the transactions;
  - aid NHS finance staff in converting an existing off-balance sheet arrangement to an 'on-balance sheet' treatment; and
  - assist NHS bodies to manage their accounting requirements for the remaining life of their scheme

## Why is the Department issuing guidance?

8. The new accounting standards that apply to PFI schemes under IFRS are very different to the UK standards that they replace in both their scope and their approach to determining the appropriate accounting treatment. Furthermore, it is likely that these new requirements will result in most, perhaps all, PFI schemes needing to be recognised as 'on balance sheet' by NHS bodies.
9. Whereas in the past the accounting entries for PFI schemes were relatively straightforward where they were off-balance sheet, the change in treatment requires the transaction to be broken down into a number of component elements, with each then being accounted for in a different manner.

10. This aim of this guidance is to:
- ensure that NHS bodies take a consistent approach to identifying which of their contracts they should account for as service concessions;
  - ensure that NHS bodies then account for such schemes in as consistent a manner as possible; and
  - strike a balance in the accounting requirements between reflecting the substance of the transaction and minimising the complexity.

## From when does this guidance apply?

11. This guidance applies to financial statements prepared by NHS bodies on an IFRS basis with effect from the 2009/10 financial year. In practice, the requirement to restate comparative amounts in these first IFRS financial statements means that the requirements apply from the Date of Transition to IFRS that for NHS bodies is 1 April 2008.
12. The new accounting requirements are applied in the IFRS financial statements as a change in accounting policy. Therefore existing PFI schemes as at 1 April 2008 are restated as if the new accounting requirements had been applied to the transaction from the inception of the contract.

## Key Contacts

### Who do I need to talk to?

13. Whilst this guidance seeks to address all elements relevant to accounting for PFI under IFRS it is inevitable that not all project-specific circumstances can be addressed.

## Section 1: Introduction & Background

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14. Organisations with PFI projects should discuss the detailed accounting treatment of their scheme with external auditors and where necessary seek further guidance from external advisors.
15. Any queries about positions set out in this guidance may be raised with the Department of Health Private Finance Unit who can be contacted on:
  - 0113 254 5533
  - 020 7633 7706

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## **Section 2: The scope of Service Concessions and IFRIC 12**

## Section 2.1: What is a service concession?

**This section provides guidance to NHS bodies on selecting the relevant accounting standards to apply to their PFI contracts. It discusses in detail the features of service concessions under IFRS 12 and how these apply to PFI contracts.**

### Key Points:

- Identifying the types of infrastructure assets that fall within the scope of service concessions.
- How to determine whether the PFI arrangement is a service concession
- Identifying PFI arrangements that are not service concessions
- Identifying which accounting requirements might apply to service concessions.

### Which accounting requirements apply?

16. Where an NHS body has a contractual arrangement to receive goods or services from another party (the 'operator'), and in providing the services the operator has to use an asset, the NHS body needs to consider whether it should recognise that asset in its own accounts.
17. The IFRS accounting standards which might apply to such contracts are:

- IFRIC 12 Service Concessions<sup>1</sup>
- IFRIC 4 Determining whether an arrangement contains a lease
- IAS 17 Leases
- IAS 16 Property, Plant and Equipment.

18. In determining which standard to apply, it is necessary to consider the substance of the transaction. Where the contract is clearly solely for the construction of an asset then IAS 16 should be applied. Where the contract is clearly for the lease of an asset then it should be accounted for as either a finance lease or an operating lease, as appropriate, under IAS 17.
19. Where the contract involves solely the provision of services without the operator using any underlying assets to provide them, then these should be accounted for as operating expenses. However, the situations in which this might happen are likely to be few, as virtually all services that an NHS body receives will involve the provider using assets in some way to deliver them.
20. In practice, therefore, wherever an NHS body receives a service, it should in the first instance consider whether it is in substance a service concession in accordance with IFRIC 12, and if not, whether it is an arrangement containing a lease under IFRIC 4. The rest of this guidance covers only IFRIC 12 (as interpreted by HM Treasury in the I-FReM).
21. When considering the appropriate accounting treatment for a transaction, it is important to understand its substance.

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<sup>1</sup> IFRS does not contain any accounting guidance for public sector bodies in accounting for PFI-type transactions because IFRIC 12 specifically removes this from its scope and instead specifies only the required accounting for the private sector operator. However, in the absence of any IFRS guidance, the Treasury has adopted the principles of IFRIC 12 in its I-FReM, with a few interpretations.

## Section 2.1: What is a service concession?

22. In order for a PFI contract to fall within the scope of IFRIC 12, the answer to all of the following questions must be 'yes':
- Is the contract, in substance, a service concession?
  - Is an asset used to provide the services and which qualifies as 'infrastructure'?
  - Can the NHS body control or regulate:
    - a) The services provided using the asset?
    - b) To whom the services are provided?
    - c) The price charged for the services?
  - Does the NHS body control the residual interest in the asset at the end of the concession?
23. In practice, for most PFIs, the answers to all of these questions is likely to be 'yes'.
24. The guidance below describes a number of areas where judgement must be exercised, based on the individual facts of the scheme. There are no 'bright lines' or quantitative thresholds which clearly define one treatment or another – it is down to professional judgement, taking all relevant features into account.

### The substance of a service concession

#### How do we determine whether a contractual arrangement should be accounted for as a service concession under IFRIC 12?

25. For a contract to fall within the scope of IFRIC 12, there are features which it must possess, the first two of which are that:
- the private sector provider provides services to the NHS body and/or services to other parties on behalf of the NHS body; and

- the contract involves the use of an asset that is dedicated to the arrangement in providing those services.

26. These two features seek to identify whether the contract is, in substance, a service concession i.e. the provision of services involving the use of an asset. The services are usually restricted to managing and operating the asset but may also include provision of the public service required under the arrangement.

#### What is a service concession?

27. IFRIC 12 does not define a service concession, but instead describes the typical characteristics.
28. It notes<sup>2</sup> that a service concession:  
"typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining it for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes".
29. The IFRIC goes on to say<sup>3</sup> that service concessions often include the following features:
- The procuring entity is normally a public sector body, or in some cases is an entity to which the responsibility for the function has been devolved.
  - The operator is responsible for managing at least some of the assets and services i.e. it is not acting merely as an agent.

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<sup>2</sup> IFRIC 12, paragraph 2

<sup>3</sup> IFRIC 12, paragraph 3

## Section 2.1: What is a service concession?

- The contract sets the initial price and the mechanism through which future prices are to be set or regulated.
  - The operator is obliged to transfer the asset to the public sector body at the end of the contract, in a specified condition for little or no additional consideration.
30. The IFRIC's avoidance of a strict definition of a service concession is a reflection of the great variety of forms that public-private arrangements can take in different countries around the world. By focusing instead on the typical features, a wide variety of schemes could fall within the scope of the IFRIC. Therefore, the decision as to whether a particular contractual arrangement is a service concession should be based on the substance of the transaction i.e. "does it feel like a service concession?"

### What about contracts for the provision of an asset which also involve some services – such as a landlord-repairing operating lease – are these service concessions?

31. Not necessarily. The provision of services in connection with an asset could fall outside of the scope of service concessions but it will depend on the nature of the services being received and their value relative to the value of the asset being provided.
32. For example, an NHS body leases an office building for 10 years and under the lease, the lessor is responsible for general maintenance and keeping in the building in working order. This lease could well fall outside of the scope of a service concession because it is an arrangement that is commonly found in the private sector i.e. it is not something peculiar to the public sector. Furthermore, the services are directly related to the property itself rather than encompassing other aspects of the activity that takes place inside it e.g. security or cleaning services. An arrangement of this sort could be considered to be a normal landlord-repairing lease and be accounted for under the leasing standard - IAS 17.

33. The decision as to whether an arrangement involving the provision of services is a service concession will, therefore, depend on the substance of the arrangement. Factors which might lead to a conclusion that the arrangement is not a service concession include:
- The assets used in providing the services are not specified or implicit in the contract and the private sector party can substitute other assets or use them to provide services to others; or
  - the services are solely or directly related to the upkeep and maintenance of the property.
34. Where the value of the services received is considered to be incidental to the contract, then it is likely to be considered as a lease rather than a service concession. Likewise, where the value of the underlying asset is incidental to the contract, the arrangement is likely to be considered as a contract for services.

### Infrastructure assets

#### What types of assets fall within the scope of 'service concessions'?

35. IFRIC 12 covers 'infrastructure' assets for public services. A definition is not provided in the IFRIC, but it does instead provide a list of the types of assets which have traditionally been constructed, operated and used by the public sector<sup>4</sup> and therefore are considered to be within scope of the IFRIC:
- "..roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks...."**
36. It can therefore be seen that hospitals are clearly within the scope of the standard. In practical terms for NHS bodies 'hospitals' would include any type of asset used to provide healthcare.

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<sup>4</sup> IFRIC 12, paragraph 1

## Section 2.1: What is a service concession?

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37. The IFRIC notes that a feature of service concessions is the public service nature of the obligation, whereby the infrastructure asset is used to provide services to the public – either by the operator or by the public sector body. This is generally interpreted to mean that in order for an asset to qualify as ‘infrastructure’ the public must somehow ordinarily have access to it. In most cases, hospitals will be accessible to the public and therefore would meet this requirement.
38. However, the Treasury I-FReM<sup>5</sup> extends the scope of infrastructure assets to include also:
- permanent installations for military etc. operations; and
  - non-current assets used for administrative purposes in delivering services to the public.
39. Of these two additional categories, ‘non-current assets used for administrative purposes in delivering services to the public’ is likely to be most relevant to NHS bodies. Effectively it means that virtually all PFI assets used to provide services to the NHS body may fall within the scope of ‘service concessions’, including, for example:
- administrative buildings procured under a PFI; and
  - PFI IT assets used by the NHS body.
40. The scope of ‘infrastructure’ assets under the Treasury I-FReM is therefore wide and most PFI assets are likely to fall within it.

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<sup>5</sup> Chapter 6, paragraph 6.2.34, 2009/10 HM Treasury Financial Reporting Manual

## Section 2.2 Is the service concession within the scope of IFRIC 12?

This subsection examines whether the service concession is within the scope of IFRIC 12.

### Key Points:

- Identifying which service concessions should be accounted for under IFRIC 12.
- Examining what constitutes control of the asset during the concession.
- Examining what constitutes control of the residual interest in the asset.
- Dealing with additional features such as control shared between NHS bodies, and the presence of additional contracts such as managed equipment services.

### Which service concessions are accounted for under IFRIC 12?

41. Most service concessions will be accounted for under IFRIC 12, however there may be some schemes that will fall outside its scope because they do not provide the NHS body with 'control' of the asset, as described below.
42. The schemes which fall to be accounted for under IFRIC 12 are those where the answer to both of the following two tests is 'Yes':
  - Does the NHS body control or regulate the services that the operator must provide during the concession? and
  - Does the NHS body control any significant residual interest in the asset at the end of the concession?

43. These two tests are considered in further detail below. One effect of applying these tests will be to remove contracts whose nature is not specific to the NHS body or the public sector and instead is of a type commonly found in the private sector e.g. provision of cleaning services by a private company.

### Control of the services during the concession

#### What is meant by control or regulation of the services during the concession?

44. The relevant test is set out in paragraph 5 (a) of the IFRIC, as follows:

**“the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price;”**

45. As can be seen from the wording in the test, there are three elements. The overall test will be met only where all three of these elements are present in the service concession.

#### Regulating the services which the operator must provide

46. In most PFI schemes, the assets to be used are clearly identified in the contract. The contract will also specify the services to be provided to the NHS body. Where the assets are not specified in the service concession, the NHS body will need to consider the substance of the arrangement and whether in practice the service provider is using dedicated assets to provide the services being received.

#### Regulating to whom the services must be provided

47. Where the NHS body can control or regulate to whom the services are provided, then this element will be met. In most cases, such control or regulation will be achieved through the contract. For PFI,

## Section 2.2 Is the service concession within the scope of IFRIC 12?

the contract taken as whole will normally provide such control by requiring the asset to be built on an agreed site (which may also be specified by the NHS body, e.g. an existing NHS site) and to be available i.e. open for access by patients, staff and others during set times.

48. The NHS body is therefore requiring the services to be provided to those users which fall under its control i.e. NHS staff and patients, together with private patients with whom the NHS body has contracted. There is limited scope for the operator to make the asset and services available to users of its own choice i.e. to generate third party income, except where such use has been agreed by the NHS body, for example, where it is a feature of the contract.

### ***Can services be controlled in service concessions that principally have third-party users?***

49. For PFI schemes where the users are principally third parties, the NHS body may well exercise control over who uses them unless the contract is of a purely commercial nature.
50. For example, a car park service concession may well use land and/or other relevant assets belonging to the NHS body. The contract is likely to require the operator to restrict the use of the car park to NHS staff, patients and visitors. While neither party may be able to completely eliminate use of the car park by others, the operator is likely to be restricted from promoting the car park for general users and entering into arrangements such as selling season tickets for general users. This element of the test would therefore be met where these or similar conditions are imposed through the contract.
51. For staff accommodation schemes, the NHS body may control the users through the contract by requiring the operator to offer the facilities to certain categories of users in priority over the operator's own choice. For example, the contract may specify that the facilities are offered in the following order: (a) to the NHS body's medical staff; (b) to its other staff, (c) to staff from other NHS

bodies; (d) to other public sector staff; and (e) to other users whom the operator is then free to select.

52. Where restrictions such as these occur, then the NHS body will control or regulate to whom the services must be provided.
53. In contrast, if no such restrictions are in place then the test would not be met and would fall outside of IFRIC 12, although in practice such arrangements are anyway more likely to be genuine commercial ventures by the private sector provider hoping to attract custom from NHS users, rather than service concessions.

### **Controlling or regulating the price**

54. The price in this context is referring to the amounts that the NHS body pays to the operator through the annual unitary payment or, in the case of third party users, the amount that the operator charges to the public for the services provided.
55. In most cases, where the contract contains a mechanism for determining the price, this will meet the requirement for this element. The price need not be fixed – the presence in the contract of a pre-agreed mechanism for adjusting the price in future years, for example to take account of inflation, will be sufficient to represent 'control' for the purposes of this test. The presence of an agreed formula, for example to increase the unitary payment by the movement in RPI, prevents the operator from charging a different price in the event that its cost base suffers an unpredictable change such as cost increases above RPI or additional unplanned lifecycle replacement costs. The use of a payment formula in the contract is sufficient, therefore, to give the NHS body control over the price for the purposes of the IFRIC.

### ***How does periodic market testing of services affect control or regulation of the price?***

56. Where market testing takes place in PFI contracts, it is normally in respect of 'soft' facilities management (FM) services such as catering, cleaning, security etc. The purpose of the market testing exercise to rebase the price for those services to market rates,

## Section 2.2 Is the service concession within the scope of IFRIC 12?

with some or all of the cost saving being passed on to the NHS body through a step change in the price of the services element of the unitary payment.

57. On the face of it, this might indicate that the NHS body does not control the price through the contract. However, the NHS body will still have control of the price for the other parts of the service concession throughout the contract's life. The presence of market testing would not be sufficient to override the overall conclusion that the NHS body controls the price that the operator can charge under the service concession because the operator is not free to charge whatever price it wishes.

### ***Can the price be regulated or controlled in service concessions whose users are mainly third parties?***

58. Service concessions involving third-party users e.g. car park or staff accommodation schemes, normally involve the NHS body making assets available to the operator. This could include land on which the car park or accommodation block is to be built, and might include other assets to be refurbished and used in the concession. In some cases, the NHS body may include surplus assets, e.g. land, and gives the operator freedom to dispose of them as it sees fit.
59. Where such assets are contributed to the deal, the operator's project costs will be lower than if it had to source the assets itself. The NHS body may require the operator to charge a price to users that is below the market amount, to reflect the 'subsidy' that the NHS body has provided. Such contractual restrictions will constitute control or regulation of the price for the purposes of the control test.
60. If however, the NHS body permits the operator to charge amounts based on market prices for the life of the contract (for example because it receives the benefit from the contributed assets in some other form) then the NHS body will not control or regulate the price and this element of the test will not be met.

### ***What if the contract does not include any controls over the price?***

61. Where the price is entirely open to market forces it is not deemed to be controlled or regulated by the NHS body and therefore would not meet the requirement of this element. This would include a contract that stated that the price to be charged was the market price, although the mere presence of such a clause in a contract should prompt further analysis to identify any other contract terms that might nevertheless alter this in some way.

## Control of any significant residual interest in the asset at the end of the concession

### **What is meant by control of any significant residual interest in the asset at the end of the concession?**

62. The test is set out in paragraph 5 (b) of the IFRIC, as follows:
- “the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.”**
63. Where a service concession involves a specialised asset, the operator will normally have little use for it at the end of the concession because there are few, if any, other parties who may wish to acquire it (unless it can readily be converted to an alternative use for minimal cost). Consequently, the financial arrangements in the concession will normally involve the operator recovering the cost of the asset, together with the financing costs, from the price charged over the life of the contract.
64. In such circumstances, the NHS body will have paid for the asset over the life of the scheme. Consequently, the contract will normally include a clause whereby the NHS body acquires the asset automatically at the end of the scheme for either a nil or a token payment. In some cases, this may take the form of an option

## Section 2.2 Is the service concession within the scope of IFRIC 12?

for the NHS body to acquire the asset for a token payment. In all of these cases, the NHS body is considered to have control over the residual interest in the asset and therefore this test will be met.

### **What does 'significant residual interest' mean and what happens if the asset does not have one?**

65. IFRIC 12 states that the residual interest of the asset is the "estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement."
66. The term 'significant' is a matter of judgement, but in most cases it should be fairly clear whether the assets have a significant residual value, as illustrated in the examples below:

#### **Example 1:**

An NHS body has a 35-year PFI contract involving the provision of a large hospital. The estimated remaining economic life of the hospital at the end of the concession is 25 years.

In this example, the asset clearly has a significant residual value at the end of the contract.

#### **Example 2:**

An NHS body has a 10-year service concession for the provision of medical equipment. At the end of the contract, the equipment is estimated to have a remaining life of 2 years

The residual value of these assets is likely to be significant.

67. In practice, most PFI schemes include 'hand-back conditions' in the contract, whereby the operator is required to ensure that the

assets transferred to the NHS body are in sufficiently good condition to continue in operation for a specified period. In many cases, the presence of such a clause may lead to the conclusion that the assets will have a significant residual value, unless the additional period is extremely short e.g. 6 months.

#### **Example 3:**

An NHS body has a 15-year service concession for the provision of medical equipment. At the end of the contract, the assets will transfer to the NHS body for nil consideration.

The contract contains a hand-back provision that requires that these assets continue to meet the operational specification for a period of twelve months after the end of the contract. The assets are not expected to continue to function after this hand-back period.

The residual value of the assets in this situation is likely to be significant.

#### **Example 4:**

As with example 3, but here, the hand-back period at the end of the contract is three months. The assets are not expected to continue to function after this hand-back period.

The residual value of the assets in this situation is not likely to be significant.

68. If it is considered that the residual value of the asset will be insignificant because the asset's entire economic benefits will be consumed during the concession (a 'whole life asset'), then this does not mean that the answer to this second test is 'no'. Instead, the IFRIC requires that this second test is simply ignored and that only the first test above i.e. 'control of the asset during the concession' is used to determine whether the contract is within the scope of the IFRIC.

## Section 2.2 Is the service concession within the scope of IFRIC 12?

69. The rationale for ignoring the second test for these 'whole-life' assets is that the NHS body has received all of the benefits arising from the asset and in practice, it is likely that no one else will have access to them in future. There is a parallel here with the requirements of lease accounting, whereby an asset whose lease term is for the major part of the asset's useful economic life is an indicator of a finance lease.

### Service concessions with accompanying contracts

#### How do we deal with managed equipment contracts?

70. In some PFI schemes for hospital facilities there may also be one or more other contracts connected with managed equipment services (MES). These MES contracts typically run for a significantly shorter period to the main contract and in substance are separate arrangements to the main contract.
71. Where an NHS body has a service concession with accompanying contracts of this nature, it should consider them separately to the main scheme. The substance of these MES contracts will need to be considered to determine whether they are, for example, service concessions within the scope of IFRIC 12; arrangements containing a lease within the scope of IFRIC 4; or revenue service contracts.

### Service concessions with multiple assets and mixed control

72. Some PFI schemes may have multiple assets where the control that the NHS body exercises over them may be different, for example because some assets will remain with the operator at the end of the concession.
73. Where these assets, and the cashflows attributable to them within the overall unitary payment, can be separated, then they should be

assessed separately from the remaining assets. The balance sheet treatment determined for these assets may be different to that of the main PFI assets.

74. Where the assets or their cashflows cannot be separated, then the NHS body's degree of control will need to be considered as part of the assessment for the overall PFI asset:
- If these assets form a minor element of the overall assets, then the accounting treatment for them should normally follow that determined for the overall asset.
  - If these assets form a major element of the overall asset, then the treatment for these assets will normally decide the treatment for the overall PFI asset.
75. Reaching a conclusion on the extent to which one group of assets governs the treatment of all of the assets is a matter of professional judgement.

### Concluding whether IFRIC 12 applies

76. Having considered the nature of the scheme and whether the NHS body has control of the asset in accordance with the tests within the IFRIC, the asset will fall within the scope of the standard where:
- The scheme is a service concession involving the provision of services and an underlying asset which qualifies as 'infrastructure'; and
  - The NHS body controls the services which are provided using the asset; to whom they are provided; and the price charged; and

## Section 2.2 Is the service concession within the scope of IFRIC 12?

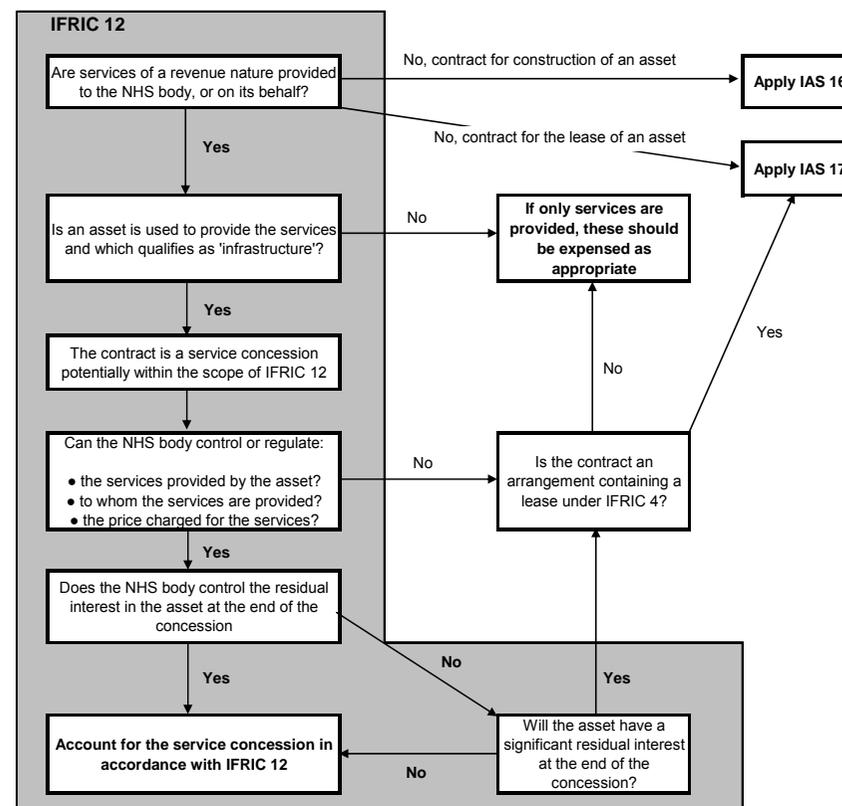
- Either:
  - a) The NHS body controls the significant residual interest in the asset; or
  - b) The asset will have no significant residual value at the end of the concession.

77. This is summarised in the decision tree in figure 1.

78. Where the service concession is to be accounted for under IFRIC 12, the NHS body will have to follow an 'on-balance sheet' accounting treatment, recognising the asset and an obligation to pay for it. Section 3 of this manual describes how NHS bodies should do this in practice.

79. As described earlier, when concluding which accounting standard applies, NHS bodies should consider the substance of the transaction. IFRIC 12 should be applied where the transaction is a service concession. However, where the substance is clearly a different arrangement e.g. a Landlord-repairing lease, then another standard (in this case IAS 17) should be applied.

**Figure 1 – Summary of approach to determining the relevant accounting standard**



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## **Section 3: Accounting for an 'on-balance sheet' service concession**

# Section 3.1: Overview of the accounting requirements

This subsection provides an overview of the accounting requirements and general principles.

## Key Points:

- A general outline of the need to recognise and measure the PFI asset and an accompanying liability to pay for it; and
- the requirement to split the unitary payment into its key components: payment for services; payment for the asset and lifecycle replacement.

## Introduction

### Accounting for new and existing PFI schemes

80. Sections 3 and 4 of this guidance set out the accounting requirements for new PFI schemes that are determined to be within the scope of IFRIC 12 and therefore need to be accounted for as 'on-balance sheet'.
81. The accounting treatment of existing PFI schemes needs to be considered afresh as part of the adoption of IFRS. Where the scheme is determined to be within the scope of IFRIC 12 and the existing accounting treatment is 'off-balance sheet' then this will need to be amended. The accounting approach set out in sections 3 and 4 will need to be applied as if the scheme had always been on-balance sheet. The previous accounting entries will need to be reversed and replaced with the new 'on-balance sheet' entries. Section 5 describes how these entries should be amended and provides a worked example.
82. This guidance assumes that the NHS body has access to a copy of the full final contract and the final version of the operator's financial

spreadsheet model. Both of these documents are necessary in order to determine the components of the contract, and to calculate the amounts that need to be recognised in the NHS body's accounts.

83. If the NHS body does not have copies of the documents and is unable to obtain copies, then it will need to make estimates of the necessary amounts. In such circumstances, it should consider obtaining specialist assistance and should discuss proposed approaches with its auditor.

### The on-balance sheet treatment

84. Where the scheme falls within the scope of IFRIC 12, the HM Treasury I-FReM<sup>6</sup> sets out the accounting principles to be followed by the NHS body. The I-FReM requires the NHS body to recognise the infrastructure as its own asset together with a corresponding liability to pay for it. It requires application of specific accounting standards for recognition and measurement of the transaction, as described below.

### Recognising the asset

85. The asset is initially recognised and measured at its fair value in accordance with IAS 17 'Leases' and is subsequently measured at fair value in accordance with IAS 16 'Property, Plant and Equipment' (PPE). It is the same way as other PPE assets of the NHS body. Section 3.3 provides further guidance on accounting for the asset.

### Recognising the liability

86. Where there is an annual unitary payment from the NHS body to the operator, a finance lease liability is recognised for the same amount as the fair value of the asset (less any NHS payments such

<sup>6</sup> Chapter 6, 2009/10 HM Treasury Financial Reporting Manual

## Section 3.1: Overview of the accounting requirements

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as capital contributions). It is subsequently accounted for as a finance lease in accordance with IAS 17 Leases and, as such, revaluations of the asset following the initial recognition at cost do not affect the carrying value of the liability. This is addressed in section 3.4.

### Dividing up the annual unitary payment

87. The annual unitary payment needs to be allocated between a number of elements:
- **payment for services** – this reflects the fair value of the services received each year under the concession;
  - **payment for the property** – this represents the annual lease rental for the asset. In turn it is split between a repayment of the finance lease liability, an annual finance charge on the outstanding liability, and contingent rental; and
  - **lifecycle replacement** – service concessions typically require the operator to maintain the asset in the required condition throughout the life of the contract. This usually requires the operator to replace individual capital assets during the contract. To the extent that this is predicted beforehand, the operator factors the cost of this into the unitary payment, and therefore an element of the unitary payment represents payment for future capital expenditure. Section 3.5 provides guidance in this area.
88. The above principles are relatively simple in concept. However, the complexity of PFI and similar schemes and the variations between schemes mean that applying them in practice can be difficult. The remainder of Section 3 describes how to apply the principles to most schemes. Section 4 then provides additional guidance on particular features that may be found only in a few schemes.

89. Section 4.1 provides detailed guidance on accounting for schemes where there is no unitary payment because the operator is obtaining its income directly from users e.g. car park and staff accommodation schemes.

**What do we do when there is no unitary payment?**

**NHS Finance, Performance & Operations**  
**Accounting for PFI under IFRS – October 2009**

## Section 3.2: Allocating the Unitary Payment into its component parts

**This subsection describes how the unitary payment can be split into its component parts.**

### Key Points:

- The principles of splitting the unitary payment into its component parts;
- accounting for interim services; and
- determining the fair value of services during the operational period.

### Introduction

90. As noted in the previous section, the unitary payment needs to be split into three elements:
- payment for services;
  - payment for the property (comprising repayment of the liability, finance cost and contingent rental); and
  - payment for lifecycle replacement.

### Interim services

91. Some contracts may also include a unitary payment for interim services provided by the operator using existing assets of the NHS body until such time as the new assets are made available. These interim services will not usually include any property costs and therefore should simply be expensed as incurred, provided that the payment is “reasonable” for the services being provided.
92. However, if the interim unitary payment exceeds the fair value of the interim services, this may indicate that this payment includes amounts that are being used by the operator to fund partly the cost of the new assets in place of an element of project debt. This

element of the payment will need to be separated and treated as an initial capital contribution by the NHS body. It should then be accounted for in the same way as other initial contributions as described in section 3.4.

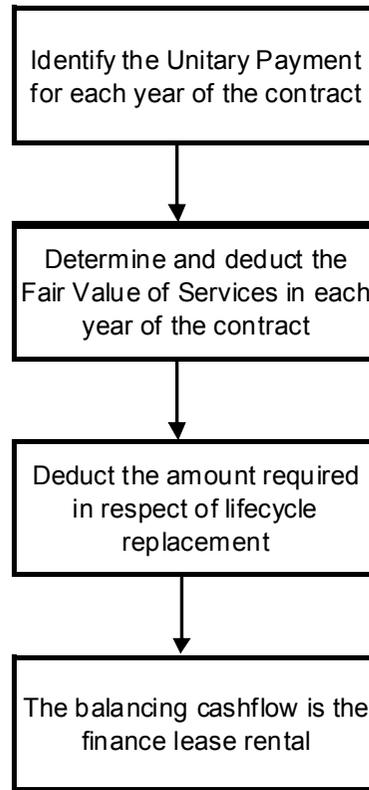
93. Where there is a phased introduction of new assets, there may be periods where the unitary payment comprises both some interim services and payment for the new assets and associated services. The interim services will need to be split out and expensed as previously, and the new payment will need to be analysed between the three components above. It can be further complicated where the higher payment also includes pre-funding of the cost of assets in later phases. If this is present, then this pre-funding element will need to be separated and accounted for as an initial contribution, as described above.

### How to split the Unitary Payment during the operational period between its three components

94. Once any interim services and pre-funding of later assets is removed, the remaining unitary payment needs to be split into its components as shown in figure 2 below.

## Section 3.2: Allocating the Unitary Payment into its component parts

Figure 2 – Approach to splitting the unitary payment



95. The rest of this section, together with sections 3.4 and 3.5 describes the principles to be followed in calculating this split. For more detailed guidance, users should refer to the manual and its worked example.

### How do we determine the Fair Value of the Services?

96. The contract and operator's financial model should specify the relevant services provided under the contract for the new asset. These may typically include things such as:
- Cleaning;
  - Catering;
  - Grounds maintenance;
  - Management;
  - Fire safety systems;
  - Waste management; and
  - Building maintenance (including lifecycle replacement that is revenue in nature).
97. The fair value of these services can normally be determined from the operator's financial model. There are a number of ways in which this can be done, but the preferred approach is to identify the real i.e. un-inflated, service costs in each year of the contract. Another possible approach is identify the costs for the first operational year of the contract and then assume these remain constant in real terms, but a weakness in this is that the costs in the financial model may vary in later years for reasons other than inflation. Therefore, using the actual real costs from the model for each year is more accurate and such real costs are generally visible in the model.
98. The above approach is used to determine the services for the purposes of the initial split of the unitary payment. The subsequent accounting for the services element during the contract is described further below.

## Section 3.2: Allocating the Unitary Payment into its component parts

### ***How do we deal with volume-related services?***

99. Some contracts contain volume-related payments for certain services e.g. laundry services where the amount of work is unpredictable at the outset and therefore the NHS body has agreed to retain the volume risk.
100. These payments will usually form a payment stream separate from the annual unitary payment both in the contract and in the financial model or there is an explicit adjustment in the payment mechanism. It should not therefore be necessary to separate them from the unitary payment. The NHS body simply accounts for these costs as operating expenditure as they are incurred. It should be straightforward to identify volume-related costs as they will be separately identified in the contract (normally in a separate contract schedule) and may also be shown separately on the operator's contract invoices.
101. Volume –related services can also include energy costs such as electricity. These costs may be included in the contract on a pass-through basis so that the NHS body bears the risk and reward on volume and price by paying for the actual consumption. The NHS body should include these costs in operating expenses as and when they are incurred.

### ***How do we deal with income from third parties?***

102. Where third party revenues are a major element of the contract and are being used to pay for the asset, or a major part of it, then the scheme should be treated in the manner described in section 4.1
103. Where third party revenues are incidental in the context of the contract, then any amounts guaranteed by the operator in the financial model i.e. used to reduce the unitary payment charged, are factored into the calculation of the finance lease rental and implicit interest rate i.e. they are used to reduce the interest rate.

104. Any unguaranteed third party income is recognised as income by the NHS body if and when it is received.

### **Determining the deduction for lifecycle replacement**

105. For each year of the contract, an amount needs to be deducted in respect of lifecycle replacement. The related costs are generally visible in the model in both real and nominal (i.e. inflation-indexed) terms. Section 3.5 describes how these amounts should be derived.

### **The finance lease rental**

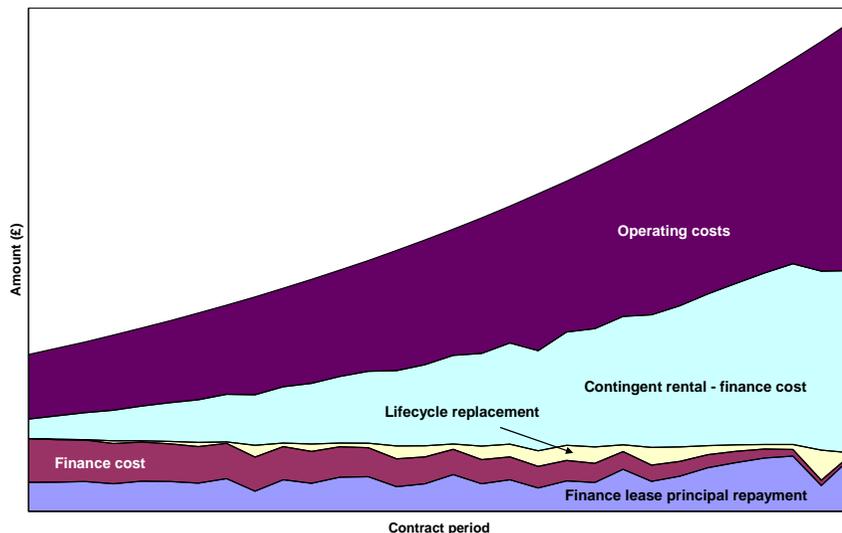
106. Once the service and lifecycle components have been deducted from the unitary payment, the balancing cashflows represent the finance lease rental element. This is split into three further components: repayment of the finance lease principal, a finance cost and contingent rental representing the inflation increases. These elements should be determined and accounted for in the manner described in section 3.4.

### **Overall result**

107. The allocation of the unitary payment should, in most cases, produce a result similar to that shown in figure 3.

## Section 3.2: Allocating the Unitary Payment into its component parts

Figure 3 – Example analysis of components of the unitary payment over the contract term, in nominal amounts



108. The operating costs will normally be non-volatile and increase in cash terms over time due to inflation increases. The finance cost, finance lease principal and lifecycle expenditure together should normally be fairly constant in cash terms over the life of the contract, but within this, there are likely to be significant variations between the components due to the treatment of lifecycle costs. The contingent rental is the remaining component after deducting the other four elements from the total unitary payment.

### Subsequent accounting for the services element

109. In each year of the operational period, the actual service cost will need to be accounted for within operating expenses. This will be the real terms service cost from the financial model as increased by the cumulative effect of actual indexation of the unitary payment.

110. How much of the indexation of the unitary payment is applied to the service cost will depend on the indexation factor. In some schemes, the total unitary payment is indexed by a proportion of an inflation index (commonly RPI).

111. This proportion should, in theory, correspond to the proportion of the total unitary payment that the service costs represent i.e. with an indexation factor of  $0.6 \times \text{RPI}$ , service costs and lifecycle replacement elements would normally be expected to represent about 60% of the total cost in the first operational year. The remaining element of the unitary payment covers the debt cost, which in these scenarios is usually considered to be fixed in cash terms over the life of the contract. As such, where a scheme uses proportionate indexation it may be appropriate to allocate the entire annual indexation amount of the unitary payment to the service costs element and lifecycle costs.

112. In other schemes (and more commonly in acute care PFI projects), the total unitary payment is indexed by the relevant index e.g. RPI. In these schemes, the unitary payment in the early years of the contract is lower than might otherwise be the case and rises, by the end of the project, to a level that is higher than might otherwise be the case. The part of the indexation that covers the debt costs is, in effect part of the finance cost. In these schemes, a judgement will need to be reached as to how much of the annual indexation of the unitary payment is applied to the service cost and how much to the finance lease rental and lifecycle costs elements. The RPI increase would normally be allocated amongst the components in proportion to their relative costs.

113. During the contract, deductions may be made to the unitary payment if there is sub-standard service performance. Section 3.6 describes the accounting treatment for these deductions.

## Section 3.2: Allocating the Unitary Payment into its component parts

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**Where should the service expenditure be recorded in the Statement of Comprehensive Income?**

114. The costs of the individual services should be included within the appropriate expenditure lines in the subjective analysis of operating expenses in the notes to the financial statements.

## Section 3.3: Accounting for the asset

This subsection describes how to account for the asset.

### Key Points:

- When to recognise the asset, and at what amount.
- Subsequent measurement of the asset.
- Depreciation of the asset and splitting it into components.

115. One of the simpler areas of accounting is in respect of the asset. Following initial recognition under IAS 17, it should be accounted for subsequently in accordance with IAS 16, as with any other type of PPE that the NHS body holds.
116. It should therefore be depreciated over its useful economic life, revalued as necessary and, where an indication of an impairment occurs, it should be subject to an impairment review and subsequent impairment if required.

### Initial recognition of the asset

#### When do we recognise the asset?

117. In accordance with the requirements of the Treasury I-FReM<sup>7</sup>, the asset should be recognised when it is first made available to the NHS body.
118. In schemes with a phased implementation, i.e. where some assets are made available at one point in time and others are made

<sup>7</sup> Chapter 6, paragraph 6.2.39 of the 2009/10 HM Treasury Financial Reporting Manual

available later, then the NHS body should reflect this in its recognition of the assets in its accounts.

#### At what amount do we recognise the asset?

119. The Treasury I-FReM requires that the asset should initially be recognised at its fair value<sup>8</sup>.
120. For existing and new schemes, NHS bodies should determine at the inception of the arrangement (which in most cases is likely to be the point of 'financial close' of the scheme) the initial fair value of the PFI asset. The fair value so determined may be based on the capital cost of the asset in the operator's financial model where this can be justified to reflect the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

#### *Determining the capital cost from the operator's financial model*

121. Where cost is used to determine the fair value of the assets NHS bodies will need to determine which cost elements in the financial model should be included in the measurement of the fair value of the asset. In doing so, NHS bodies may wish to consider the costs that the NHS body itself would capitalise if it were procuring the asset directly instead of the operator.
122. There is, however, a need to have an understanding of the key components that make up the overall asset in order to apply component depreciation. This is discussed in more detail below.
123. When recognising individual assets, NHS bodies should apply the standard NHS accounting policies, for example grouped and other assets below the capitalisation threshold.

<sup>8</sup> Chapter 6, paragraph 6.2.40(a) of the 2009/10 HM Treasury Financial Reporting Manual

### Subsequent measurement

#### Valuation

124. Following initial recognition, the asset is treated as any other item of PPE. Its fair value will need to be kept up to date in accordance with the NHS body's selected approach to keeping its asset valuations up to date.
125. Most assets recognised under service concessions will be held for future service potential rather than income generation. Where the fair value cannot be determined by reference to market values – because, for example, the asset is specialised – then the value should be determined by another method such as depreciated replacement cost.
126. The NHS Manual for Accounts does not include PFI or service concession assets as a separate class of asset. This means that the asset should be recognised in whichever is the appropriate class for the type of asset e.g. 'buildings excluding dwellings' or 'plant and machinery', and components of the infrastructure acquired should be revalued when all assets in that class are revalued.

#### Depreciation

127. In accordance with IAS 16<sup>9</sup>, the asset should be depreciated over its estimated useful economic life in a manner that reflects the pattern of economic consumption. The fact that the asset is being maintained to a specified contractual requirement does not negate the need to depreciate it.
128. Where the NHS body automatically acquires the asset at the end of the service concession, the estimated economic life is not

restricted to the life of the service concession, but should instead reflect the expected life of the asset itself.

129. Component depreciation may need to be applied to elements within an overall asset. Where this is done, the estimated economic lives of these components may be less than the life of the service concession.

### Component depreciation

#### What is component depreciation?

130. Component depreciation seeks to acknowledge the fact that not all elements of an asset will be consumed at the same rate and that this should be reflected in the depreciation profile of the asset. It is also a matter of economic reality, as reflected in the significant amounts of lifecycle replacement that service concessions have.
131. IAS 16's approach to component depreciation requires the asset to be analysed and where there are components that have a cost that is significant in comparison to the cost of the overall asset, that these should be identified and treated separately for depreciation purposes<sup>10</sup>. In practice, this means having to be treated as separate assets in the asset register.
132. The standard does allow components with similar lives to be grouped together, so that in effect separate accounting for a component is only needed where the component has both a significant cost *and* a significantly different life from the rest of the asset.

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<sup>9</sup> IAS 16, paragraph 50

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<sup>10</sup> IAS 16 paragraphs 43 to 49

### Do we have to apply component depreciation?

133. Component depreciation is a requirement of IAS 16 and therefore NHS bodies do need to comply. There is also something of an incentive to comply, insofar as any subsequent expenditure on an asset or one of its components cannot be capitalised unless the existing item being replaced is written-out of the PPE balance. It is therefore necessary for NHS bodies to have sufficient information on the carrying amount of these components in order to achieve this.
134. In practice, as with other items of PPE, NHS bodies should take a common sense approach and apply component depreciation only to elements of an asset with significantly different lives and whose cost is significant in relation to the overall asset. In the case of buildings, the relevant components may often be limited to items of plant and machinery:
- If the asset is a large hospital, then the only significant components may be large items of plant and equipment e.g. lifts, central heating boilers etc. However, components such as windows, kitchens and roofs (especially flat roofs) should also be considered;
  - If the asset is a relatively small property it may not have any significant components; and
  - If the asset is an item of equipment and the service concession is for a short period, there may not be a need to replace any components.
136. If the information is not readily obtainable from those sources, then the NHS body will need to discuss the problem with the operator and try to obtain the information directly from them. The Department of Health expects PFI operators to be helpful and assist their NHS bodies by providing the necessary information.

### Where do we get the information?

135. In the first instance, some information should be available from the NHS body's technical advisors, the final version of the operator's financial model and the contract.

## Section 3.4: The liability and the finance rate

**This subsection describes how to account for the finance lease liability and how to determine the finance rate used in splitting the minimum lease payments.**

### Key Points:

- When to recognise the finance lease liability and at what amount;
- Determining the finance lease rental and splitting it down into its component parts;
- Dealing with payments at the end of the scheme to acquire the asset;
- Dealing with bullet payments and other assets contributed to the contract; and
- The accounting entries required during the contract.

### The general principles

137. From a cashflow perspective, the general approach is to separate out part of the annual unitary payment and treat it as a finance lease rental. The initial finance lease liability is recognised, and then the annual rental is apportioned between repayment of the liability and a finance charge. The annual finance charge is calculated so as to produce a constant finance rate on the outstanding liability over the course of the contract. This rate is referred to in this guidance as the finance rate. Note, this is not the same as the implicit interest rate which is calculated in a different manner and is used to determine the present value of the minimum lease rentals at the inception of the contract. In most PFIs, the asset is paid for in full over the life of the contract and

therefore this present value at inception will match the fair value of the asset. Consequently it should not be necessary to calculate the implicit interest rate in such cases. For more information, see section 3.4 of the 'Accounting for NHS LIFT Under IFRS' guidance.

### Recognising the finance lease liability

#### When do we recognise the liability?

138. The liability is recognised at the same point in time as the asset is recognised i.e. when the asset is first made available for use by the NHS body.
139. As such, if the related asset is recognised in phases then the related liability will also be recognised in phases.

#### At what amount do we recognise the liability?

140. The liability should be recorded at the same amount as the initial fair value of the asset. The accounting entries are therefore:

Dr	Property, Plant and Equipment	£xm
Cr	Finance lease liability	£xm

141. The amount that the NHS body recognises as the finance lease liability will often not be the same as the total amount of initial project debt financing which the operator records as a liability in its accounts.
142. One reason for this is that the operator will often use part of the initial project debt to finance part of its reserve for future lifecycle replacement costs. Thus, their project debt is financing more than just the initial cost of the asset.
143. Another reason is that where the NHS body has contributed cash or assets to the operator to help finance the asset, this will reduce

## Section 3.4: The liability and the finance rate

the amount of debt that the operator needs to raise. NHS bodies therefore should ensure that they do not simply record their finance lease liability at the amount of debt in the operator's financial model.

144. The liability is simply the obligation the NHS body has to pay for the asset as at the point of its recognition in the Statement of Financial Position.
145. The treatment by the NHS body of contributed assets and final payments is addressed later in this section.

### Determining the finance lease rental

#### How do we determine the finance lease rental?

146. As described in section 3.2, the finance lease rental is the remaining cashflow from the unitary payment remaining once the fair value of the services and the lifecycle costs have been deducted from the overall unitary payment.
147. These cashflows need to be expressed in real terms i.e. undiscounted. This is because the finance rentals should represent the minimum payments under the lease.

#### ***The finance lease rental will increase in cash terms as the contract proceeds due to the indexation of the unitary payment – how do we deal with this?***

148. IAS 17<sup>11</sup> is clear that when splitting the lease rental between the finance cost and repayment of the liability, only the 'minimum lease payments' should be used. Where the lease rental might increase in the future due to uncertain factors, the standard considers these

increase to be 'contingent rentals' and requires them to be excluded from the amounts in the finance lease calculation.

149. Therefore, the finance lease calculation should always be based on the real cashflows and should not anticipate future increases in the unitary payment due to indexation because these are contingent rentals.

#### ***How do we account for the contingent rentals?***

150. IAS 17 requires that as and when contingent rentals are incurred, they should be recognised as an expense in the year in which they are incurred.
151. The contingent rentals due to indexation will only represent a part of the annual inflation increase to the overall unitary payment. The elements of the indexation that have been applied to the services and lifecycle elements are simply included within those amounts recognised as revenue or capital expenditure respectively. They are not therefore considered to represent contingent rentals under IAS 17, as they are non-lease costs.
152. IAS 17 is not specific about where the contingent rental expense should be recognised. The proportion of the overall unitary payment indexation allocated to the finance lease element is, in substance, a finance cost expense and/or repayment. NHS bodies should therefore present this element of contingent rental in their annual accounts as a finance cost. However, it must be shown separately from the main finance cost on the lease itself so as to comply with the requirements of IAS 17 to maintain a constant rate of finance on the liability. The worked example in the manual shows this presentation of contingent rental in the Statement of Comprehensive Income (Operating Cost Statement for a PCT).

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<sup>11</sup> IAS 17 Leases, paragraph 4: definition of 'minimum lease payments' and 'contingent rent'.

## Section 3.4: The liability and the finance rate

### Should we not use IAS 39 to measure the financial liability?

Where an operator accounts under IFRIC 12 for a service concession that involves an annual unitary payment from the grantor, it recognises this receivable as a financial asset under IAS 39 'Financial instruments: Recognition and Measurement' rather than as a finance lease receivable under IAS 17. The financial asset is measured at amortised cost that is based on the discounted future cashflows. These cashflows in turn are those amounts which the operator expects to receive and will therefore reflect anticipated future increases due to RPI movements.

Were the NHS body to recognise the liability to pay for the property as a financial liability under IAS 39 it would also measure it at amortised cost. The future RPI increases would thus be reflected in the finance rate and finance cost, and there would be no need to have separate contingent rentals.

In developing this guidance, the Department, has consulted with HM Treasury (HMT) on the possibility of measuring the liability under IAS 39 instead of IAS 17. However, HMT are clear that the liability should be measured under IAS 17 and this is reflected in the wording in the I-FReM.

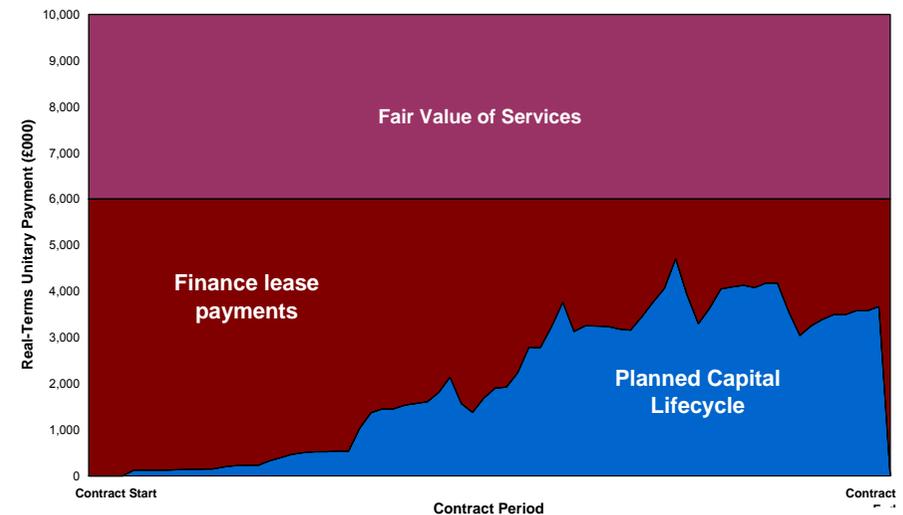
The IASB has recently issued a discussion paper in respect of their leasing project. In due course, IAS 17 may be altered or replaced and the required accounting treatment for contingent rentals may change to reflect more closely the IAS 39 basis for measurement. Unless and until such a change occurs, NHS bodies should measure the liability in accordance with IAS 17 and therefore contingent rentals should be separated-out.

### Splitting the finance lease rental

#### How do we split the finance lease rental between the finance cost and the repayment of the liability?

153. Under paragraph 25 of IAS 17, the rental needs to be split in such a way as to generate a constant rate of finance on the outstanding liability over the life of the contract (the 'finance rate'). The cash amount of finance cost and principal repayment need not remain constant from period to period.
154. The starting point for this is to use real cashflows from the financial model. Figure 4 below illustrates how the total real unitary payment (i.e. un-indexed) over the life of the contract can be broken down into its underlying components.

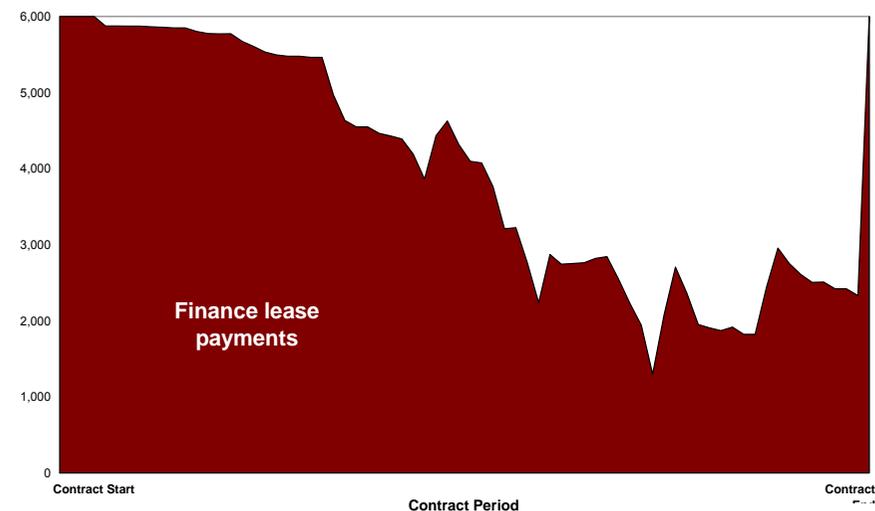
**Figure 4 – Determining the finance lease payments by separating the services and lifecycle elements from the total unitary payment, in real terms**



## Section 3.4: The liability and the finance rate

155. The fair value of services in real terms is identified from the financial model in the manner described in section 3.2 above. The fair value of planned lifecycle replacement, again in real terms, is identified from the financial model in the manner described below in section 3.5.
156. The real terms fair values of the services and planned lifecycle replacement are then deducted from the real terms fair value of the total unitary payment. This calculation is done for each individual year of the contract.
157. The amounts remaining for each contract year after these deductions have been made is the amount of the unitary payment available for the finance lease rental (principal and interest) for the asset. Unlike most leases, this rental profile will be 'lumpy' in nature due to the similar - but opposite profile of the planned lifecycle costs, as shown in figure 5.

**Figure 5 – The real-terms finance lease payments over the life of the contract**



158. These rental amounts in each year are then discounted so that their present value equals the amount of the initial finance lease liability (i.e. and also the initial fair value of the asset) as at the commencement of the lease i.e. the point at which the asset is brought into use.
159. The principles of discounting are described in Appendix 2, but a spreadsheet is likely to be needed for this calculation. If using Microsoft Excel, the NPV function can be used for the discounting calculation (with the discount rate entered in a separate cell rather than directly in the formula). The GoalSeek function in Excel can then be used to alter the interest rate so that the NPV returns a value equal to the initial finance lease liability. The interest rate thus found is the finance rate.

## Section 3.4: The liability and the finance rate

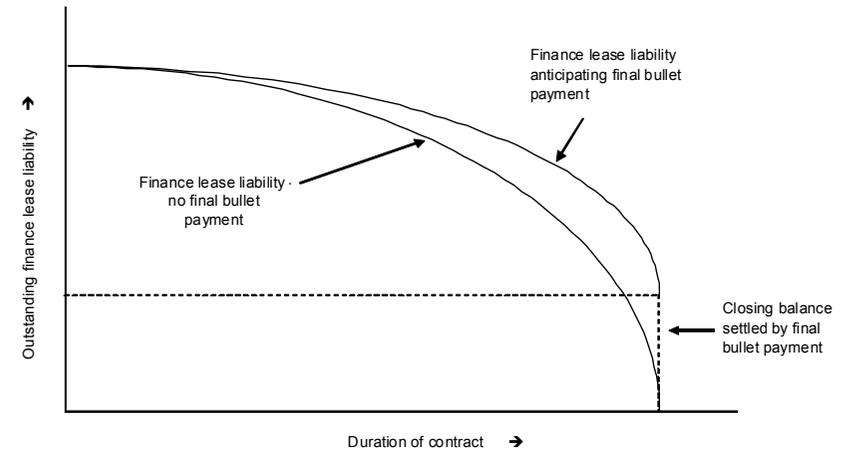
160. Having determined the finance rate, this is then applied each year to the opening finance lease liability to generate the finance cost. The difference between the finance cost and the total lease payment derived from the above calculation is the amount of the liability repaid in the year. The increase in the rental component due to inflation of the unitary payment is treated as contingent rental. The subsequent accounting for the lease rental is described in more detail later in this section.

### Payments made at the end of the scheme to acquire the asset

#### How do we account for payments of a fixed amount made at the end of the scheme to acquire the asset?

161. In some cases, the unitary payment may be profiled over the life of the contract so that the NHS body pays a significant final payment (sometimes known as a final bullet payment).
162. Such payments are included within the minimum lease payments where the NHS body must pay them or where they are below fair value and therefore there is a presumption that the NHS body will pay them.
163. When calculating the allocation of the finance lease rentals between the finance charge and the repayment of the liability, an adjustment is made so that by the end of the contract but prior to the final payment, the finance lease liability has reduced to this final amount rather than to zero. This remaining balance is then discharged when the NHS body makes the final payment. Figure 6 illustrates the point.

Figure 6 – Profiling the finance lease repayment to include a final bullet payment



### Initial contributions by the NHS body to the operator

#### What are these contributions?

164. It is quite common for a service concession to include a contribution of asset by the NHS body to the operator. Such contributions usually fall into the following categories:
- Contributions of assets e.g. land, buildings or equipment for use by the operator in the scheme;
  - Upfront cash payments to the operator; and
  - Contribution of surplus assets e.g. land, buildings or equipment with which the operator is free to do as it wishes.

## Section 3.4: The liability and the finance rate

### How do we account for assets that we have contributed to the operator for subsequent use in the scheme?

165. The contribution of assets for subsequent use is very common in service concessions, particularly those involving land and buildings. The example encountered most frequently is where the NHS body provides land on which the operator is to build the new asset. Where the land also has buildings on it, these will sometimes be refurbished and used by the operator in the scheme, and in other cases, the operator will demolish them in order to clear the site for the new facility. The legal form of the contribution normally takes the form of a lease to the operator for the life of the concession.
166. Where **land** is contributed for subsequent use, it should continue to be recognised as an item of PPE in the accounts of the NHS body. This reflects the fact that the NHS body retains the residual interest in the land and therefore follows the treatment for land leases under IAS 17. This treatment is identical to that followed by NHS bodies previously under UK GAAP.
167. Where **other assets** (e.g. buildings, equipment) are contributed for subsequent use in the service concession, then their treatment in the Statement of Financial Position should follow that of the concession assets themselves. Where a scheme falls within the scope of IFRIC 12, the concession assets will be 'on-balance sheet' and therefore the contributed asset should remain as an item of PPE in the Statement of Financial Position of the NHS body.

### How do we account for upfront cash payments that we have made the operator?

168. Such payments are normally for a significant sum and occur during the construction phase of the service concession. Their purpose is to provide a contribution towards the capital cost of the operator in

order to reduce its required debt funding with a consequent reduction in the annual unitary payment.

169. Initial cash contributions should not be confused with payments for interim services (where the operator has taken over the existing assets and operates them until the new asset is available) or payments resulting from phased completions. However, care must be taken to isolate the amount of any such payments that exceed the cost of providing the interim / phased-in services and so in substance represent an upfront cash payment for the main asset and/or services. Section 3.2 describes how to account for interim services.
170. Where the NHS body has made an initial cash payment to the operator it should be accounted for as follows:
- Until the concession asset is made available to the NHS body and recognised as an item of PPE, the cash payment should be treated as a prepayment in the Statement of Financial Position of the NHS body; and
  - once the asset is made available, and is recognised in the Statement of Financial Position together with the finance lease liability, the cash payment should be transferred from prepayments and debited against the finance lease liability. The cash payment therefore its treated as an initial payment against the finance lease liability.
171. In the unlikely event that the cash payment is demonstrated to be a prepayment for future services rather than mitigating the operator's debt financing needs, then the cash prepayment should not be netted-off the lease liability. Rather, such payments should instead continue to be recognised as a prepayment and amortised to operating expenses in line with the benefit received.
172. In schemes where the NHS body does not have a finance lease creditor because the operator is recovering its income from third

## Section 3.4: The liability and the finance rate

party users, the treatment of upfront cash payments is slightly different. Section 4.1 discusses how they should be treated in this instance.

### What are the initial accounting entries required?

173. The entries required are set out in the example below.

#### Example:

An NHS Trust has entered into a PFI contract for the provision of a £60m hospital and services. The scheme is being accounted for as on-balance sheet under IFRIC 12. At the start of the contract, the Trust makes a cash payment to the operator of £5m as a contribution towards the capital cost of the hospital. Following the construction period, the asset is made available to the Trust at the start of the fourth year of the contract.

#### Year 1:

The cash payment by the Trust is treated initially as a prepayment because the hospital asset is not yet available.

Dr	Prepayment	£5m
Cr	Cash	£5m

#### Years 2-3:

No entries (as no phases have been handed over).

#### Year 4:

On completion, the Trust recognises the hospital asset and a corresponding finance lease liability:

Dr	Property, Plant and Equipment	£60m
Cr	Finance lease liability	£60m

The Trust then transfers the prepayment to treat it as an initial payment against the finance lease liability:

Dr	Finance lease liability	£5m
Cr	Prepayment	£5m

As a result of this, the finance lease liability value is £5m less than that of the asset, reflecting the portion of the asset's cost which has been funded by Trust prepayment rather than project borrowing.

### How do we account for a contribution of surplus assets to the operator that they are free to use as they wish?

174. Such asset contributions are less common but are the same in substance as an upfront contribution of cash. Where they do occur, they tend to be contributions of surplus land.
175. The value of the contribution will be agreed between the parties and set out in the contract and/or the operator's financial model.
176. The required accounting is the same as for cash payments above. The prepayment is recognised at the agreed value of the assets in the contract, representing the amount of 'payment' recognised by the operator in its financial model and therefore 'passed-back' to the NHS body in the form of lower future unitary payments charged.
177. Prior to disposal, the surplus assets are likely to fall within the scope of IFRS 5 'Non-current assets held for disposal etc' and will need to be measured in accordance with that standard. The agreed value of the asset in the contract will represent the 'sale proceeds' when the assets are transferred and written-out of the NHS body's accounts as items of PPE and therefore any difference between this and the final carrying value will reflect the profit or loss on disposal.

## Section 3.4: The liability and the finance rate

178. As with cash payments above, in the event that the assets fund ongoing services, then the transfer would continue as a prepayment, amortised over the period of the benefit received.
179. Again, as with the cash payments, if the NHS body does not have a finance lease liability because the operator receives its income from third party users, then the treatment of the contributed assets if slightly different, as described in Section 4.1.

### What initial accounting entries are required?

180. The entries required are set out in the example below.

#### Example:

An NHS Trust has entered into a PFI contract for the provision of a £60m hospital and services. The scheme is being accounted for as on-balance sheet under IFRIC 12.

At the start of the contract, the Trust contributes some surplus land to the operator as a contribution towards the capital cost of the hospital and which the operator will **not** use to deliver the PFI services. The land has an agreed value in the contract of £6m. The carrying value of the land in the Trust's Statement of Financial Position immediately prior to transfer is £4m.

Following the construction period, the PFI asset is made available to the Trust at the start of the fourth year of the contract.

#### Year 1:

The Trust records the disposal of the land:

Dr	Profit/Loss on disposal of PPE	£4m
Cr	Property, Plant and Equipment	£4m

The Trust records the transfer as a prepayment because the hospital asset is not yet available. The value which the contract places on the asset is treated as the proceeds of disposal:

Dr	Prepayment	£6m
Cr	Profit/Loss on disposal of PPE	£6m

The Trust thus records a profit on disposal of £2m, a prepayment of £6m and a reduction in PPE of £4m.

#### Years 2-3:

No entries (as no phases have been handed over).

#### Year 4:

The Trust recognises the hospital asset and a corresponding finance lease liability:

Dr	Property, Plant and Equipment	£60m
Cr	Finance lease liability	£60m

The Trust then transfers the prepayment to treat it as an initial payment against the finance lease liability:

Dr	Finance lease liability	£6m
Cr	Prepayment	£6m

### Subsequent accounting for the finance lease transactions

#### What accounting entries do we need to make each year?

181. Once the finance lease rental, finance cost and liability have been calculated, the entries in subsequent years are relatively simple. Each year, the actual cash rental payment is split between the

## Section 3.4: The liability and the finance rate

finance cost, the repayment of principal and the contingent rental  
(as described in paragraph 152):

<b>Dr</b>	<b>I&amp;E: Finance Cost (on o/s liability)</b>	<b>a</b>
<b>Dr</b>	<b>I&amp;E: Finance cost (contingent rental)</b>	<b>b</b>
<b>Dr</b>	<b>Finance lease liability</b>	<b>c</b>
<b>Cr</b>	<b>Cash</b>	<b>(a+b+c)</b>

182. The finance cost on the outstanding liability is calculated as the brought forward liability for the year, multiplied by the finance rate.

183. The reduction in the finance lease liability is the difference between the real-terms finance lease rental and the finance cost. It will have been calculated for each year as part of the calculation of the finance rate.

184. The contingent rental element is the additional amount payable through the unitary charge attributable to the finance lease component as a result of cumulative indexation since the start of the contract. It is effectively the balancing item as follows:

Nominal Unitary Payment

Less:	Nominal Fair Value of Services
	Nominal Lifecycle expenditure
	Real terms finance lease rental
=	Contingent rental

## Section 3.5: Treatment of lifecycle replacement

This section describes how the NHS body should account for replacement of capital items by the operator during the concession – ‘lifecycle replacement’.

### Key Points:

- Identifying the part of the Unitary Payment that relates to lifecycle replacement.
- Determining which elements of lifecycle replacement should be capitalised and which should be expensed by the NHS body.
- Accounting for lifecycle expenditure by the operator.
- The actual lifecycle expenditure is likely to be different to the plan.
- How to deal with the lifecycle implications of other agreed capital variations to the contract, both publicly and privately funded.

### Background

185. A key feature of PFI schemes is that the operator is responsible for ensuring that the property is maintained to an agreed standard for the entire life of the contract. The cost which the operator expects to incur in doing this is therefore reflected in the project financial model and in the resulting unitary payment from the NHS body which reflects two elements:

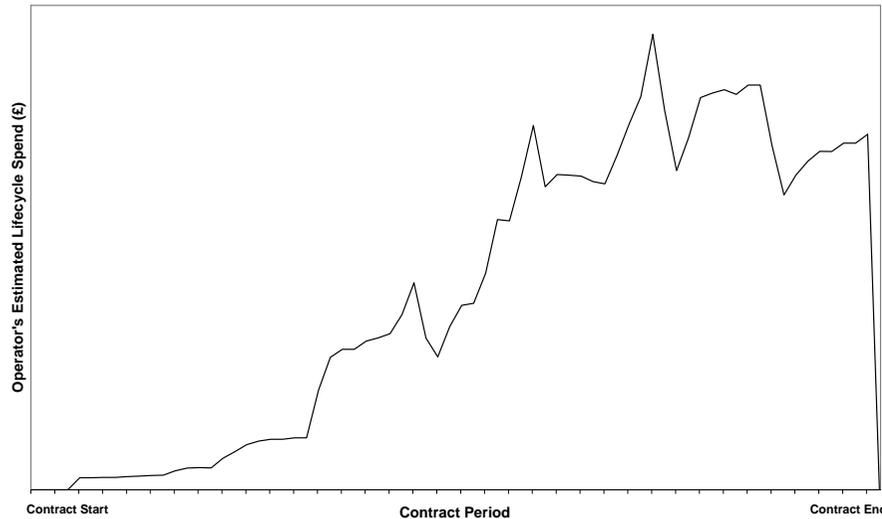
- maintenance (planned and reactive); and
- replacement of components as they wear out during the contract – this is known as lifecycle replacement.

186. Maintenance costs are revenue in nature and should be included within the ‘Services’ element of the unitary payment as described above. The lifecycle costs, however, represent a fifth element of the unitary payment<sup>12</sup> and therefore need to be taken into account when separating out the unitary payment.
187. The operator’s financial model includes the estimated requirement for lifecycle replacement. The nature of these costs varies, but in general lifecycle costs:
- i) follow a much “lumpier” profile than other project costs given the large and infrequent nature of the works e.g. lift replacement; and
  - ii) start low and then increase over time as the asset ages.
188. As such, the shape of the lifecycle cost profile tends to differ considerably from most of the other costs in the Operator’s Model that tend to be more constant (in real terms). An example profile of lifecycle costs is shown in figure 7.

<sup>12</sup> As distinct from service costs, finance lease liability repayment, finance costs and contingent lease rental.

## Section 3.5: Treatment of lifecycle replacement

Figure 7 – Example lifecycle replacement cost profile over contract term



### How should we account for lifecycle costs?

189. There is no specific accounting treatment prescribed for PFI lifecycle costs within IFRS or other government accounting guidance.
190. Given that this represents an additional payment stream within the overall Unitary Payment, the practical issue is how should the NHS body account for it?
191. NHS bodies should follow the approach set out in this section of the guidance, which in summary is as follows:
- For each year of the contract, an element of the unitary payment is allocated to lifecycle replacement based on the capital costs that the operator expects, at financial close, to incur for that year.
192. This accounting requires the NHS body to obtain information about actual lifecycle replacement from the operator. The NHS body needs to know:
- The changes which the operator expects to make to the planned replacement schedule during the contract. This is needed to make any consequent changes to the expected useful economic lives of the items to be replaced; and
  - The actual lifecycle replaced in each year of the contract, as measured at the prices prevailing at that time.
193. In many cases, this information is not currently provided by the operator. NHS bodies will therefore need to explain to the operator the information they need in order to comply with the accounting requirements.
- Subsequently in each year, the actual capital cost incurred by the operator is recognised as an asset and, to the extent that the capital is funded by the unitary payment, an equivalent amount of the unitary payment is treated as a cash payment by the NHS body to pay for the asset.
  - Where all or part of the capital cost is unanticipated and ultimately borne by the operator itself e.g. because it has had to replace a component of an asset which it had not planned to do; or the cost of the asset is greater than anticipated, the NHS body treats it as a 'free' asset.
  - Where the operator replaces lifecycle components earlier or later than planned but the cost of the replacement was anticipated in the operator's model, the NHS body recognises this as a temporary liability (separate from the main finance lease liability) or temporary prepayment respectively.

## Section 3.5: Treatment of lifecycle replacement

194. In doing so, NHS bodies should generally focus on the major elements of lifecycle replacement. They should also discuss their approach and assumptions with their auditors to ensure that it is acceptable to them.

### How do we go about this?

#### Revenue costs v. capital costs

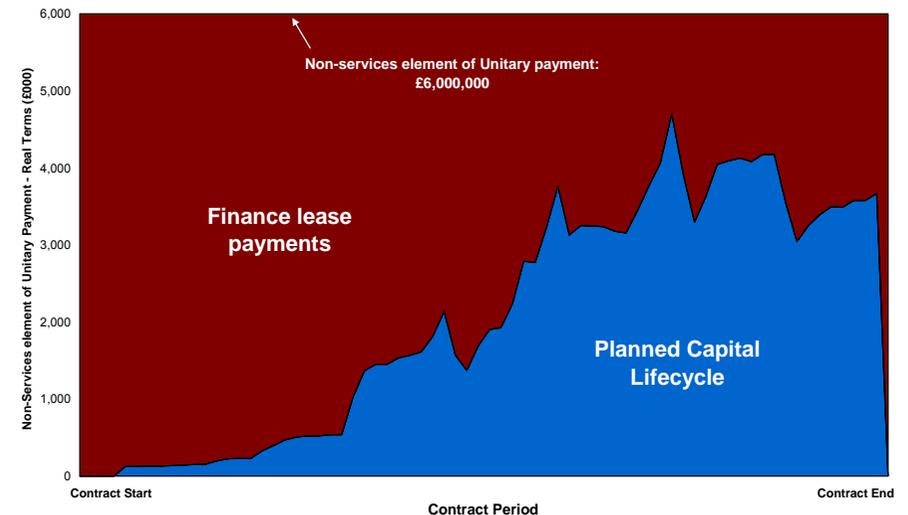
195. The first stage is to distinguish between revenue lifecycle costs (i.e. maintenance) and capital lifecycle costs. This should be based on the NHS body's accounting policies for capitalisation, in the same manner as for other types of assets. It will also need to be linked in with the NHS body's approach to component depreciation. The reason is that in order to recognise and capitalise a replacement component, the existing item needs to be written-out of the NHS body's accounts. The degree to which lifecycle costs can be capitalised will therefore depend on the extent to which the NHS body is applying component depreciation to the asset.
196. Lifecycle costs that are determined to be of a revenue nature are treated as an operating expense in the same way as other services received under the contract. The remainder of this section describes the treatment of lifecycle replacement that is capitalised.

### How do we determine the planned capital lifecycle payment schedule?

197. The planned lifecycle expenditure amounts in real terms need to be determined from the operator's financial model. It is the amounts that the operator expects at the outset to spend on lifecycle replacement in each year of the contract. The amounts for each year can normally be determined from the cashflow information within the model, and will often be highly variable in nature, for example as shown in Figure 7.

198. The lifecycle replacement expenditure profile interacts closely with the finance lease rental element of the unitary payment because the two together comprise the non-services element of the unitary payment that is relatively flat in real terms. The 'lumpy' lifecycle profile thus generates a similarly lumpy profile of finance lease rental, as illustrated in figure 8 below:

Figure 8 – Example Finance lease and lifecycle profile



199. As described in section 3.4, the finance lease rental needs to exclude amounts relating to inflation because these are considered to be contingent rental. The direct interaction between the lifecycle amounts and the finance lease rental means the former's separation must also be calculated using real amounts in order to be consistent. Hence the need to identify the lifecycle expenditure in real terms.
200. The nominal terms lifecycle expenditure is also required because for the subsequent accounting during the contract period, these

## Section 3.5: Treatment of lifecycle replacement

amounts are compared with the actual lifecycle expenditure of the operator (which will of course also reflect inflation) in order to identify any differences in timing or cost between the planned and actual cost. This is explained in more detail below.

### Accounting for actual lifecycle replacement

#### How do we account for lifecycle replacement where the actual timing and amounts are identical to the planned timing and amounts?

201. Although it is highly unlikely that the actual lifecycle replacement will match that planned in the contract (as measured in nominal terms), it is necessary to describe the accounting requirements in order to establish the basic principles.
202. In this scenario, when actual lifecycle expenditure is incurred by the operator, it will match the nominal lifecycle amount earmarked in that year's unitary charge. The NHS body treats the transaction in the same manner as when it incurs normal capital expenditure:
- Dr    Property, Plant and Equipment
- Cr    Cash (as part of the unitary charge)
203. In practice, it is virtually certain that the actual lifecycle expenditure incurred by the operator will be different to the profile of expenditure planned in the operator's financial model. Variations can occur for one or more of the following reasons:

- Additional lifecycle events may occur which are not planned in the contract;
- timing differences are likely - where purchased lifecycle is replaced earlier or later than expected;
- where lifecycle replacement occurs it may cost less or more than planned; and

- planned lifecycle replacement may not in fact be needed.

204. The rest of this section describes how to account for these variations – individually, and in combination. All references to amounts are in nominal terms unless stated otherwise

### Accounting for additional lifecycle which is not planned in the contract

#### What is meant by 'Purchased' lifecycle replacement and 'free' lifecycle replacement?

205. In PFI schemes, the operator generally bears the risk and reward that the actual lifecycle replacement may be greater or less than it anticipates.
206. Where the operator has to undertake additional lifecycle replacement that it has not planned for, then it bears this cost rather than the NHS body. For the NHS body, therefore the replacement asset is 'free'.
207. Distinguishing between lifecycle that is funded through the unitary charge i.e. 'purchased' lifecycle, and the unplanned 'free' lifecycle is important because the NHS body will account for these in different ways.

#### How do we tell if the actual lifecycle is paid for through the unitary payment, or it is free?

208. In some cases, the operator may need to replace capital items earlier or later than it originally planned. Where this happens, the NHS body needs first to identify whether in practice it is paying for this replacement through the unitary payment. This distinction is illustrated through the examples below:

## Section 3.5: Treatment of lifecycle replacement

### Examples

In a 30-year hospital PFI scheme, the operator has assumed that it will replace the lifts once during the contract. This is expected to occur in year 18. The cost of this replacement is included in the operator's project financial model and therefore is reflected in the unitary payment charged to the NHS body.

#### Scenario 1

During the contract, the operator discovers that the lifts are suffering wear and tear at a faster rate than it expected and that it therefore needs to replace the lifts two years earlier in year 16 of the contract. It does not expect to have to replace them a second time before the end of the contract.

The replacement of the lifts in year 16 is being paid for by the NHS body through the unitary payment in year 18 and therefore the cost incurred by the operator in that year reflects a timing difference only. The NHS body accounts for it in the manner described further below.

#### Scenario 2

As above, but in year 27 the operator discovers that it has to replace the lifts a second time.

The NHS body is only paying for one lift replacement through the unitary payment, and therefore the operator has to bear the cost of this second replacement itself. The NHS body therefore recognises this second replacement as a 'free asset' as described later in this section.

#### Scenario 3

The operator discovers that it needs to replace the lifts in year 14 instead of year 18. It also expects to have to replace the lifts a second time before the end of the contract.

Again, the NHS body is only paying for one lift replacement during the

contract and therefore one of the replacements is 'free'. The NHS body will need to decide, on the particular facts, which of the replacements it treats as 'purchased' and which as a free asset. Factors which it should take into account include:

- Whether one of the replacements is clearly a timing difference the other appears to be unexpected; and
- The likelihood of the later replacement actually being required, particularly if it is due close to the end of the contract.

In scenario 3, the NHS body would probably recognise the first replacement as 'purchased' earlier than planned since its timing is close to the planned replacement, and treat the second replacement as the 'free'.

209. In order to make these judgements, the NHS body will need to understand the exact nature of the planned lifecycle replacement together with details of the actual lifecycle expenditure incurred by the operator during the contract.

#### *How do we treat lifecycle replacement that is 'free'?*

210. When the replacement asset is installed by the operator and made available for the NHS body's use, the NHS body should recognise the capital asset as an item of Property, Plant and Equipment. The balancing credit entry should be to create a deferred income account.

#### Example

Using the example earlier (scenario 2), the operator replaces the lifts again in year 27. The capital cost of the replacement is £1.5m. The NHS body recognises this as:

Dr	Property, Plant and Equipment: Plant and Machinery	£1,500,000
Cr	Deferred Income                      PFI asset	£1,500,000

## Section 3.5: Treatment of lifecycle replacement

211. Subsequently, the NHS body should depreciate the asset over its useful economic life, which may extend beyond the remaining contract period, for the reasons given in section 3.3 above i.e. the whole PFI asset reverts to the NHS body at the end of the contract.
212. The deferred income balance is released to operating income over a period that is the shorter of the useful economic life of the new component or the period to the end of the contract.

### Example (cont.)

Continuing the example above, the NHS body depreciates the asset over its expected useful life, which it determines to be 13 years. The annual depreciation charge (ignoring future revaluations for the purposes of this example) will be:

Dr	Operating Expenditure – Depreciation	£115,000
Cr	Property, Plant and Equipment: Plant and Machinery	£115,000

The deferred income balance is released to operating income over the remaining 3 year period of the contract, because this is shorter than the remaining life of the asset.

Dr	Deferred Income – PFI assets	£500,000
Cr	Operating income – release of deferred income on PFI assets	£500,000

**Subsequent accounting where ‘purchased’ lifecycle items are replaced earlier than planned**

**NHS Finance, Performance & Operations**  
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### How do we account for ‘purchased’ lifecycle replacement that is incurred earlier than the operator planned?

213. Where the operator incurs lifecycle expenditure earlier than it has planned and the NHS body determines that the lifecycle in question is ultimately being funded through the unitary payment i.e. it is not ‘free’, then it should account for it as follows.
214. The new items provided by the operator should be recognised as capital assets. They are being paid for through the unitary charge, but in a later year. Therefore, the balancing credit entry should not be to cash but instead should be to create a temporary finance lease liability.
215. Subsequently, when the year in which the asset was planned to be replaced is reached, the relevant amount from that year’s unitary charge is used to discharge the liability.

### Example

From the Scenario 1 example above, the lift is due for replacement in year 18 but is actually replaced in year 16. The estimated cost of the asset in the operator’s financial model is £1.2m. The actual cost incurred in year 16 is also £1.2m.

In year 16, the following entries are made:

Dr	Property, Plant and Equipment: Plant and Machinery	£1,200,000
Cr	Lifecycle liability	£1,200,000

Subsequently in year 18, part of the unitary charge payment is used to

## Section 3.5: Treatment of lifecycle replacement

discharge the obligation, as follows:

Dr	Lifecycle liability	£1,200,000
Cr	Cash (part of unitary charge)	£1,200,000

**If we recognise a finance lease liability, do we not need also to recognise a finance cost each year on the outstanding liability until it is discharged?**

216. In principle, a finance cost should be recognised each year on the outstanding liability in accordance with the requirements of IAS 17. Where the operator incurs lifecycle expenditure earlier than planned, it will incur additional finance costs, but it cannot pass this on to the NHS body because the contract price, in the form of the unitary charge, is pre-agreed. The contractor thus suffers this finance cost but the NHS body does not.
217. As a result, the finance rate and the finance cost of this liability can both be considered to be zero from the perspective of the NHS. The NHS body therefore does not need to recognise any finance cost for this short-term lease liability (although it would need to explain this treatment in its accounting policies).

### Purchased lifecycle which is replaced later than planned

**How do we account for 'purchased' lifecycle replacement that is incurred later than the operator planned?**

218. Where purchased lifecycle is incurred later than planned, then the NHS body should recognise a prepayment in the year in which the planned purchase was scheduled to be due. Subsequently, when the lifecycle is actually received the new item is capitalised as PPE and the prepayment is discharged.

### Example

In a hospital PFI scheme, the main heating boilers are due to be replaced in year 21 of the contract for a value of £2m. The boilers last longer than expected and do not need to be replaced until year 23 at a cost of £2m. The accounting entries are as follows:

In year 21 of the contract, when £2m of the unitary charge is identified for the lifecycle replacement, the NHS body recognises this as a prepayment:

Dr	Prepayment of lifecycle capital replacement	£2,000,000
Cr	Cash (part of unitary charge)	£2,000,000

In year 23 of the contract, when the lifecycle is actually replaced, the entries are:

Dr	Property, Plant and Equipment – Plant and Machinery	£2,000,000
Cr	Prepayment of lifecycle capital replacement	£2,000,000

### Where the actual cost of purchased lifecycle is different to the planned cost

219. The fixed-price nature of the contract means that where the lifecycle replacement costs less than planned, the operator receives the benefit.

## Section 3.5: Treatment of lifecycle replacement

**How do we account for the lifecycle where it costs the operator less than it has planned?**

220. Where the actual lifecycle cost is less than the amount of nominal lifecycle costs planned in the operator's financial model, for that year the NHS body will be paying an excess amount relative to the value added to the asset. This excess represents a charge that needs to be recognised in operating expenses in the period in which the asset is recognised. This is illustrated in the examples below.

**EXAMPLE – cost of lifecycle is LOWER than anticipated in the operator's financial model**

In a hospital PFI scheme, the operator plans to replace the heating boilers in year 21 for a cost of £2m.

**Scenario A - the operator replaces the boilers in year 21 for a cost of £1,800,000**

In year 21, the NHS body records the following transactions:

Dr	Property, Plant and Equipment – Plant and Machinery	£1,800,000
Dr	Operating expenses – PFI cost	£200,000
Cr	Cash (part of unitary charge)	£2,000,000

**Scenario B - the operator replaces the boilers in year 19 for a cost of £1,800,000**

In year 19, the NHS body records the asset and a short-term finance lease liability.

Dr	Property, Plant and Equipment – Plant and Machinery	£1,800,000
Cr	Lifecycle liability	£2,000,000
Dr	Operating expenses – PFI cost	£200,000

In year 21, the NHS body pays for the asset through the unitary charge and records the following accounting entries:

Dr	Lifecycle liability	£2,000,000
Cr	Cash (part of unitary charge)	£2,000,000

**Scenario C - the operator replaces the boilers in year 23 for a cost of £1,800,000**

In year 21, the NHS body records the prepayment asset. At this stage, it is unlikely that the actual cost will be known, and therefore the prepayment is recognised for the full amount.

Dr	Prepayment of lifecycle capital replacement	£2,000,000
Cr	Cash (part of unitary charge)	£2,000,000

Subsequently, in year 23, the NHS body records the following transactions:

Dr	Property, Plant and Equipment – Plant and Machinery	£1,800,000
Dr	Operating expenses – PFI cost	£200,000
Cr	Prepayment of lifecycle capital replacement	£2,000,000

## Section 3.5: Treatment of lifecycle replacement

**How do we account for the lifecycle where it costs the operator more than it has planned?**

221. Where the actual lifecycle cost is greater than the amount of nominal lifecycle planned in the operator's financial model, the NHS body will receive a benefit. This excess amount is treated in the same manner as 'free' lifecycle replacement. Again, this is illustrated in the examples below.

**EXAMPLE – cost of lifecycle is *GREATER* than anticipated in the operator's financial model**

In a hospital PFI scheme, the operator plans to replace the heating boilers in year 21 for a cost of £2m.

***Scenario A - the operator replaces the boilers in year 21 for a cost of £2,200,000***

In year 21, the NHS body records the following transactions:

Dr	Property, Plant and Equipment – Plant and Machinery	£2,200,000
Cr	Deferred Income – PFI assets	£200,000
Cr	Cash (part of unitary charge)	£2,000,000

In subsequent years, the asset is depreciated over its useful economic life and the deferred Income is released to operating income over the same period and in a similar pattern.

***Scenario B - the operator replaces the boilers in year 19 for a cost of £2,200,000***

In year 19, the NHS body records the asset, a short-term finance lease liability and establishes a deferred income account.

Dr	Property, Plant and Equipment – Plant and Machinery	£2,200,000
Cr	Lifecycle liability	£2,000,000
Cr	Deferred Income – PFI assets	£200,000

Subsequently, the asset is depreciated over its useful economic life and the deferred income is released to operating income over the same period and in a similar pattern.

Then, in year 21, the NHS body pays for the asset through the unitary charge and records the following accounting entries:

Dr	Lifecycle liability	£2,000,000
Cr	Cash (part of unitary charge)	£2,000,000

***Scenario C - the operator replaces the boilers in year 23 for a cost of £2,200,000***

In year 21, the NHS body records the prepayment asset. At this stage, it is unlikely that the actual cost will be known, and therefore the prepayment is recognised for the full amount of the planned cost.

Dr	Prepayment of lifecycle capital replacement	£2,000,000
Cr	Cash (part of unitary charge)	£2,000,000

Subsequently, in year 23, the NHS body records the following transactions:

Dr	Property, Plant and Equipment – Plant and Machinery	£2,200,000
Cr	Deferred Income – PFI assets	£200,000

## Section 3.5: Treatment of lifecycle replacement

Cr	Prepayment of lifecycle capital replacement	£2,000,000
In subsequent years, the asset is depreciated over its useful economic life and the deferred income is released to operating income over the same period and in a similar pattern.		

### 'Purchased' lifecycle replacement which ultimately is not needed

222. In some circumstances, lifecycle replacement planned by the operator may not actually be needed, for example because the asset component does not wear out as quickly as expected.
223. These circumstances are perhaps more likely to occur towards the end of the contract, where the operator takes the view that it is more economic to spend money maintaining the existing asset than to replace it (assuming that it can do this while maintaining the asset to the agreed condition for the rest of the contract and meeting any requirements on the asset's condition at the end of the contract).
224. The situation is likely to become evident initially through the operator delaying some planned lifecycle replacement. The NHS body will therefore initially recognise a prepayment of lifecycle replacement, which it will carry forward in its accounts. As the contract progresses, this prepayment may build up further where each year, some lifecycle is delayed.
225. This prepayment represents an asset and therefore its continued recognition requires the NHS body to be able to demonstrate that it will receive future economic benefit in the form of future lifecycle replacement. To the extent that the operator revises its plans and replaces components for a smaller cost than anticipated, the NHS body should address this through the guidance above on 'The replacement costs less than planned'. Any remaining prepayment after this adjustment will thus represent the excess of lifecycle

replacement funded through the unitary payment over that which the operator now expects to incur.

226. If it becomes apparent that the amount of future lifecycle which the operator plans to deliver is less than the carrying amount of the prepayment, the NHS body will need to impair the prepayment asset, taking the write-down to operating expenses:

Cr Prepayment of lifecycle capital maintenance

Dr Operating expenses

227. The NHS body will therefore need to keep any prepayment asset under review, particularly towards the end of the contract and maintain a dialogue with its operator to determine the extent to which future lifecycle will be received.

### Lifecycle replacement - accounting for the replaced asset

#### Do we need to recognise any accounting entries for the existing asset that is being replaced?

228. IAS 16 requires that where a component of an asset is replaced, an amount equivalent to the remaining net book value of the replaced asset is written-out of Property, Plant and Equipment to operating expenses.

#### What accounting is required when component depreciation is being applied to the existing asset?

229. If the item being replaced has previously been recognised as a separate component of the PFI asset, and accounted for separately, then one would expect this component's useful economic life to reflect the planned replacement date. Where the lifecycle replacement occurs on schedule then the existing asset should be fully depreciated by that time and therefore no write-out is required (although the gross replacement cost and matching

## Section 3.5: Treatment of lifecycle replacement

accumulated depreciation may need to be written-out of the capital asset register and general ledger).

230. Where replacement of the component occurs earlier or later than expected then this maybe evident some time in advance to permit the economic life to be adjusted accordingly. If, for any reason, there is a net book value remaining for the asset when it is replaced then this will need to be written-out to operating expenses.

### ***What accounting is required when component depreciation is not being applied to the existing asset?***

231. Where component depreciation is not being applied to the existing asset, then by definition its net book value is included within that of either the main asset or one of its components.
232. In this situation, the NHS body will need to make an estimate of this asset's net book value. If the original cost is not known, then the replacement cost could be used as a sufficiently close estimate because the larger asset is subject to periodic revaluations. One possible approach to estimating the net book value is shown in the example below:

#### **Example – estimating the net book value of the existing asset**

An item of plant and equipment is replaced in year 17 of the PFI contract, The cost of the replacement is £200,000, and the replacement has equivalent specification to the item being replaced.

The existing asset has not been separately recognised as a component and is included within the carrying value of the main building. The building is being depreciated over its useful economic life of 60 years.

By definition, the item of plant and machinery is also being depreciated over 60 years, and therefore when it is replaced in year 17, its net book value is 43/60ths of its gross replacement cost (GRC)

The gross replacement cost is unknown, but the cost of the new component can be used as a suitable estimate because it is similar in specification.

The estimate of the net book value of the existing item is therefore:

$$43 / 60 \times £200,000 = £143,000$$

This net book value is then written out of property, plant and equipment as follows:

Cr	Property, Plant and Equipment – Buildings	£143,000
Dr	Operating expenses	£143,000

### **Agreed variations to the contract**

233. It is not uncommon for an NHS body to agree with its operator a variation to the contract, for example to increase the specification of a particular part of the asset or to have new assets built under the contract.
234. Where the variation is solely related to services, this will normally be reflected in a change to the annual unitary payment. This change should be recorded as an increase, or where appropriate a decrease, to the Services element of the unitary payment.
235. Where the variation is for additional capital expenditure, this can be funded as a one-off payment by the NHS body and/or through an increase in the annual unitary payment.
236. Where the variation is funded through a one-off payment, this should be treated as capital expenditure by the NHS body when it occurs.

## Section 3.5: Treatment of lifecycle replacement

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237. Where the variation is funded through an increase in the unitary payment, this increase should be treated separately as an additional finance lease.

### **How do we account for additional lifecycle services arising from a variation to the contract?**

238. Where the increase also includes additional services, then these will need to be expensed as incurred.
239. However, where these additional services include lifecycle replacement for the additional assets, then these should be accounted for as follows:
- Where the asset is funded through unitary payment, then the additional finance lease and lifecycle replacement costs should be treated like an additional mini-PFI and the unitary payment (after deduction of revenue services) allocated between the finance lease, lifecycle and contingent rental in the manner described in section 3.4 and earlier in this section.
  - Where the asset has been funded through a one-off payment to the operator, the NHS body will need to allocate the unitary payment (after deduction of revenue services) to a lifecycle prepayment. When actual lifecycle expenditure is incurred, it is capitalised, with the credit taken to the prepayment. Adjustments will need to be made where the cost is greater or less than planned, using the principles described above.

The accounting in this situation will be essentially the same as that described above for short-term lifecycle prepayments but in this situation, a prepayment is likely to exist for most of the contract.

## Section 3.6: Accounting for payment deductions

Service concessions frequently contain incentive mechanisms that can result in deductions to the annual payment for poor service performance by the operator or where the asset is unavailable.

### Key Points:

- Identifying the types of deduction regimes that typically are found in service concessions.
- How to account for deductions for poor service performance.
- Accounting for deductions for unavailability of the property.

### How do we tell which deductions are for poor services and which for unavailability?

240. Most schemes operate two separate deduction mechanisms. It should therefore be clear as to the reason for a deduction. These schemes normally operate on either a monthly or a quarterly basis, with deductions being applied in the following period.
241. Generally, service performance deductions are capped at the notional amount of the unitary payment that represents the fair value of the services. Deductions for unavailability are usually uncapped and can thus theoretically result in the entire unitary payment being abated if the asset is entirely unavailable.

### Example:

A form of unitary payment is as follows (ignoring indexation):

$$\text{Unitary Payment} = A + (S - PD) - AD$$

Where:

'A' is the payment for the Availability of the property.

'S' is the payment for the services

'PD' are the deductions for poor service performance

'AD' are the deductions for unavailability of the property.

'S - PD' can never be negative so the deductions for poor service performance are capped at the amount of the UP which represents payments for the services.

'AD' is capped only at the amount of the total Unitary Payment, so unavailability of part or all of the property can result in deductions to both the availability element and the services payment (also reflecting the fact that the services for that part of the asset are not being received in full).

242. In practice, it is unlikely that these deduction caps will ever be reached, because the contract default triggers are usually set much higher. Repeated poor performance will therefore normally put the contract into default before the full deduction is ever reached.

### How do we treat deductions for poor service performance?

243. This is straightforward. The deductions for poor service performance are accounted for as a reduction in the cost of the affected service(s) for the period.

## Section 3.6: Accounting for payment deductions

***Should the deduction be accounted for in the period to which it relates or the period in which it is applied to the contract i.e. on an accruals or a cash basis?***

244. This should reflect how the contract describes them and whether it sees them as deductions for the prior or present period. A good indicator may be how the contract deals with deductions in the last period of the contract.
245. However, in practice, the difference may very well not be material. Where the incentive regime operates monthly or quarterly then most of the deduction will be on an accruals basis and the difference is limited to one month's or one quarter's deductions. Furthermore, the presence of contract default triggers means that the ongoing deductions are likely to be relatively low.

**How do we treat deductions for unavailability of the property?**

246. Deductions for unavailability will normally be in respect of a specific part of the property, and will reflect two aspects, that:
- that part of the property is not available for use; and
  - the services are not being provided to that part of the property.
247. Where a deduction occurs, the NHS body should split it between these two elements. This could be done pro-rata to the split between the Availability and Service elements in the overall unitary payment unless this is not typical for that part which is unavailable in which case the NHS body will need to estimate the split in another way.
248. The element estimated as relating to services should be accounted for in the same way as performance deductions described above.
249. The element estimated as being property-related should be applied as a reduction in the 'finance lease rental' part of the Unitary Payment in the following order:

- Reduction in the 'contingent rent' element of the finance cost; then
- reduction in the finance lease element.

250. The contingent rent element is likely to absorb all or much of any deduction, particularly in the later years of the contract.
251. If the contingent rental element in any year is insufficient to absorb all of the deduction, the remaining amount reflects a genuine reduction in the minimum lease payments of the finance lease element.
252. There is no clear approach to applying these additional deductions and IAS 17 does not address this issue. On the face of it, the simplest approach is to apply the deduction to the finance cost element of the lease, However, this would conflict with IAS 17 because the standard requires the finance cost for the year to be calculated as the finance rate applied to the opening liability.
253. The alternative is to apply it to the finance lease repayment element, which will reduce the amount by which the liability is repaid in-year. In turn, this means that in subsequent years, the liability will be higher than planned and the finance cost will similarly be higher than planned. This will lead to an overstatement in subsequent years' finance cost and a remaining unpaid liability at the end of the contract.
254. For simplicity, NHS bodies may therefore wish to consider applying the deduction to the finance cost element in-year. However, where this would lead to a material misstatement of the finance cost, then NHS bodies should discuss the issue with their auditors to reach an appropriate accounting treatment. In practice, as noted earlier the contract default triggers, coupled with the significant 'cushion' of the contingent rentals after the first few years of the contract mean that this situation may occur rarely.

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## Section 4: Other features

## Section 4.1: Schemes with no unitary payment

In some PFI schemes, such as accommodation for NHS staff, the operator receives all, or most, of its income from individual users rather than in the form of a unitary payment from the NHS body. When recognising the asset in the NHS body's Statement of Financial Position this creates accounting difficulties such as 'Where does the credit go?'.

### Key Points:

- Identify the types of schemes where the NHS body does not fund the asset through a unitary payment.
- Whether the arrangement should be accounted for as a service concession within the scope of IFRIC 12.
- How to recognise the credit entry when such assets are brought onto the NHS body's Statement of Financial Position.
- Recognition of the gain arising from this credit entry.
- Dealing with assets contributed by the NHS body to such schemes.

### Introduction

255. Some service concessions involve the operator obtaining a significant proportion of its revenue from third parties rather than from the NHS body. Examples may include:
- Staff accommodation schemes, where the operator (or a third party) charges the individuals for rental of the accommodation. Where the charges are less than the market rent this may reflect some form of subsidy provided by the NHS body to the

operator in the form of assets contributed. If the charges are controlled or regulated by another party involved in the scheme e.g. a Registered Social Landlord (RSL), then this of itself would not constitute control of the price by the NHS body unless the RSL is considered to be a related party of the NHS body.

- Car parks on hospital sites, where the operator's income derives from charges to users of the car park. These too may be subsidised in some way by the contribution of assets from the NHS body.

256. For a scheme such as one of these, if the operator determines that it should be accounted for under IFRIC 12, it would recognise an intangible asset reflecting its contractual right to generate income from the physical assets. Where an annual payment is also received from the NHS body e.g. where the NHS body is using part of the asset itself, then a financial asset would be recognised in respect of this annual payment. Conceptually, the financial asset and the intangible should sum to the fair value of the asset.
257. Where third party income e.g. from retail outlets in a PFI hospital, is incidental to the overall scheme and does not represent a significant proportion of the operator's revenue, it should be treated in the manner described in section 3.2
258. If the nature of the scheme is that the NHS body itself manages the facility, collects the income, and pays a unitary charge to the operator to cover the asset and services provided, then this should be treated as a normal PFI scheme.

### Do these schemes fall within the scope of IFRIC 12?

259. NHS bodies should apply the principles in section 2 of this guidance to determine whether or not the scheme falls within the scope of service concessions.

## Section 4.1: Schemes with no unitary payment

260. Generally, if the price which the operator (or third party) charges is based on market prices and is not controlled or regulated in any way by the NHS body, then the scheme would not fall within the scope of IFRIC 12. If, however, the price is not market-based because, for example, the NHS body has provided the operator (or third party) with a subsidy in the form of contributed assets, then the scheme may fall within the scope of IFRIC 12, depending on the other contract features.
261. The rest of this section provides accounting guidance for schemes that do fall within the scope of IFRIC 12.

### What is the accounting issue for the NHS body?

262. Under IFRIC 12, the problem for the NHS body is when recognising the physical asset as an item of PPE in its Statement of Financial Position at its fair value, where should the balancing credit entry go? In the absence of any payment for the asset, there is no finance lease obligation to recognise. Where there is a small annual payment, then a finance lease liability can be recognised for this element, but this will not match the fair value of the entire asset and there is still a balancing credit entry to recognise.

### How should we account for it?

263. In these circumstances, the NHS body should recognise the credit as a deferred income balance, which is then released to revenue over the life of the concession. The deferred income credit should be recognised at the same time as the asset is recognised. It should be recognised at the same amount as the asset's fair value unless the NHS body has contributed assets, in which case further guidance is provided below.

### How can we justify realising income when we are not getting the asset or any benefit from it until the end of the contract?

264. In some schemes, the NHS body does not receive any income or other economic benefit from the operator during the life of the scheme. The economic benefit obtained is solely the acquisition of the asset at the end of the contract. The NHS body does, of course receive other benefits during the concession – principally the provision of serviced facilities that it might otherwise have to provide itself.
265. The deferred income credit recognised together with the asset is not a reflection of *economic* benefits received but of the asset's service potential received.
266. NHS bodies usually hold property, plant and equipment for their future service potential and not to generate economic benefits. Normally the value inherent in both the service potential and the economic benefits lie with the NHS body.
267. In the case of service concessions with third party income, the economic benefits lie with the operator. However, IFRIC 12's approach focuses on control of the asset and not on the economic benefits. Thus, the IFRIC recognises that the asset contributes to the service objectives of the NHS body, which then recognises the asset as its own.
268. The NHS body is therefore receiving benefits in the form of 'service potential' over the life of the concession and recognises this in the form of the release of the deferred income balance. In practice, this compensates for the depreciation and capital charges suffered on the asset.

## Section 4.1: Schemes with no unitary payment

### How do we deal with contributed assets?

269. Assets contributed by the NHS body which the operator will use to provide the PFI services, should be accounted for in the manner described in section 3.4.
270. Contributions of cash and surplus assets, which the operator will not use to provide the PFI services, represent a payment by the NHS body for the PFI asset. The example below illustrates the required accounting treatment.

#### Example:

A Trust enters into a contract with a private sector entity for the design, build finance and operation of a new accommodation building for medical staff on land owned by the Trust. At the start of the contract, the Trust will contribute:

- the land on which the asset will be built, for nil rental;
- an initial cash lump sum of £200,000; and
- a separate site which is surplus to the Trust's requirements and which will not be used by the operator in providing the PFI services. The fair value of this surplus site is £700,000, which is also the value attributed to it in the contract.

The Trust will also make an annual payment of £8,000 representing payment for the provision of an 'on-call suite' for doctors within the building. The fair value of the new building is determined to be £5,000,000. The contract is to run for 25 years, with a 2-year construction period. At the end of the contract, the building will transfer to the Trust for nil consideration.

The finance lease liability has been determined in accordance with the principles for a normal on-balance sheet service concession and has been calculated to be £70,000.

#### Accounting entries:

##### Year 1

#### ***Contributed land on which the PFI building is to be constructed***

The lease of this land is classified as an operating lease in accordance with IAS 17. The land will therefore will remain as an item of PPE on the Trust's Statement of Financial Position.

#### ***Initial payment of cash contribution:***

Dr	Prepayment	200,000	
	Cr	Cash	200,000

#### ***Initial contribution of surplus site:***

#### ***De-recognition of the contributed surplus asset:***

Dr	Profit/(Loss) on disposal of PPE	700,000	
	Cr	Property, Plant and Equipment	700,000

#### ***Recognition of prepayment, and disposal proceeds:***

Dr	Prepayment	700,000	
	Cr	Profit/(Loss) on sale of PPE	700,000

## Section 4.1: Schemes with no unitary payment

### Year 3

#### **Recognition of PFI asset:**

Stage 1: Recognition of finance lease liability:

Dr Property, Plant and Equipment 70,000

Cr Finance lease liability 70,000

Stage 2: Application of cash prepayment:

Dr Property, Plant and Equipment 200,000

Cr Prepayment 200,000

Stage 3: Application of contribution of land

Dr Property, Plant and Equipment 700,000

Cr Prepayment 700,000

Stage 4: Recognition of deferred income balance

Dr Property, Plant and Equipment 4,030,000

Cr Deferred Income 4,030,000

This leaves the Trust's Statement of Financial Position as follows:

Property, Plant and Equipment 5,000,000

Deferred Income 4,030,000

The deferred income balance thus reflects the fair value of the asset less the sums of the contributions made by the Trust (200,000 cash and 700,000 surplus site) and the finance lease liability of 70,000.

#### **Annual accounting entries:**

The asset is accounted for as normal, through depreciation, revaluation and impairments if necessary.

The deferred income balance is released to operating income over the life of the concession.

## Section 4.2: 'Sub-leasing' arrangements between NHS bodies

It is not uncommon for more than one NHS body to be involved in a PFI scheme. This section describes the accounting principles, which NHS bodies should apply to such schemes.

### Key Points:

- Identifying the ways in which two or more NHS bodies can be party to a service concession and how this affects the accounting.
- The accounting principles to follow for such schemes.

### Introduction

271. It is not uncommon for neighbouring NHS bodies to link up with one another when entering into a service concession. The nature of the arrangement will generally take one of two forms.

### How do we account where each of the NHS bodies is a party to the contract?

272. In this situation, each NHS body has its own assets, services and unitary payment with the operator. Each body therefore applies the requirements of this manual independently.

### What accounting is required where one NHS body contracts with the operator, and then 'sub-leases' part of the asset on to the second NHS body?

273. These arrangements usually involve one NHS body (the 'intermediate') contracting with the operator for the entirety of the scheme. This intermediate NHS body then enters into an arrangement with the second NHS body to 'sub-lease' a part of the asset. The terms of this 'sub-lease' are normally identical to the

main service concession, and involve a unitary payment with equivalent indexation, service standards, performance and unavailability deductions etc.

### How should we account for this type of arrangement?

274. Although IFRIC 12 is intended to be for public-to-private service concessions rather than public-to-public, it is nevertheless the most appropriate accounting for this type of arrangement and therefore NHS bodies involved apply the guidance in this manual.
275. The intermediate NHS body will need to recognise the transactions on a gross basis, i.e.:
- Recognise the entire asset and finance lease liability; and
  - account for the entire unitary payment as service cost, lifecycle and finance lease.
276. Whether the transaction between the intermediate and second NHS body is also seen as a service concession is likely to depend on which of the parties controls the residual interest in the asset. If the second NHS body does not have the option to acquire the asset from the intermediate at the end, then the 'sub-lease' arrangement will not be within the scope of service concessions and will not automatically be 'on-balance sheet' for the second NHS body. However, the sub-lease arrangement will have to be examined under IFRIC 4 and therefore may still need to be accounted for as a finance lease.
277. If the 'sub-lease' is a service concession, then:
- the second NHS body will have to follow the on-balance sheet treatment set out in this manual.
  - The intermediate NHS body will need to:

## Section 4.2: 'Sub-leasing' arrangements between NHS bodies

- a) derecognise the relevant PPE asset and recognise instead a finance lease receivable;
- b) in the unitary payment which it pays to the operator, it will need to separate out the lifecycle element for the sub-leased assets and record that as a revenue expense in its own accounts; and
- c) account for the unitary payment it receives from the second NHS body as: (a) operating income (the service and lifecycle elements), (b) finance income (the finance lease interest charge) and (c) reduction in the finance lease receivable.

**We are an 'Intermediate' NHS Trust in a 'sub-leasing' PFI scheme that is on-balance sheet for the second NHS trust. Do we have to recognise the finance lease asset and liability 'gross' or can we treat them like an agency arrangement and exclude them from our accounts?**

278. Whether you need to recognise a finance lease receivable from the sub-leasing Trust and include the full finance lease payable to the operator will depend on the terms of the contract.
279. The relevant accounting guidance is set out in IAS 39 Financial Instruments: Recognition and Measurement. Although IAS 39 excludes from its scope most aspects of lease accounting, there are a couple which do fall within its scope. One of these is de-recognition of finance lease assets and liabilities (the other is embedded derivatives that is discussed in section 4.4).
280. The relevant part of the standard is the section that deals with de-recognition of financial assets, and specifically the circumstances in which a financial asset may be considered as transferred to another entity and can therefore be de-recognised.

281. Under the standard, in order for the intermediate NHS body to de-recognise the finance lease asset, all of the following must be satisfied:

- The NHS body has no obligation to pay amounts to the operator unless it collects equivalent amounts from the 'sub-leasing' trust.
- The NHS body is prohibited from selling or pledging the finance lease receivable other than as security to the operator for the obligation to pay them cash flows.
- The NHS body must remit any cash flows it collects on behalf of the operator without material delay. In addition, it is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7) during the short settlement period from the collection date to the date of required remittance to the operator, and interest earned on such investments is passed to the operator.

282. In practice, the first of these criteria is likely to be the most relevant. If the intermediate NHS body is still liable to pay the total unitary payment to the operator regardless of whether they have received the relevant sums from the 'sub-leasing' NHS body, then it cannot de-recognise the finance lease receivable from its accounts and must account for the transactions on the 'gross' basis.

## Section 4.3: Financial instruments and service concessions

This section describes how the financial instruments standards affect the accounting for service concessions.

### Key Points:

- Identifying the ways in which the financial instruments accounting standards affect service concessions.
- Considering de-recognition of finance lease payables and receivables.
- Identifying the scope for embedded derivatives to be present in service concessions by reference to typical contract features.

### Introduction

283. The financial instruments standards under IFRS are:
- IAS 32 Financial Instruments: Presentation
  - IAS 39 Financial Instruments: Recognition and measurement; and
  - IFRS 7 Financial Instruments: Disclosure
284. The definition of financial instruments is quite wide and can encompass items from other standards. For example, finance lease liabilities and finance lease receivables are, respectively financial liabilities and financial assets within the scope of the financial instruments standards.

### What impact does IAS 32 have for service concessions?

285. It has very little impact in practice. The standard deals with the definition of financial assets and financial liabilities and specifies where in the Statement of Financial Position they should be

recorded. Although finance lease payables and receivables are within the scope of the standard, its impact is limited to requiring them to be recognised in the Statement of Financial Position as liabilities and assets respectively, which is already required by IAS 17.

### What impact does IFRS 7 have?

286. The standard deals solely with disclosures in relation to financial instruments. NHS bodies need to include amounts recognised as finance lease payables and receivables and their in-year transactions within the financial instruments disclosures in their annual accounts. These disclosures are additional to the disclosures required by other standards such as IAS 17 and SIC 29: Service Concession Arrangements: Disclosures.

### What impact does IAS 39 have?

287. This standard deals with recognition and measurement of financial instruments and is very long and very complicated. The good news for NHS bodies is that it specifically excludes from its scope most aspects of finance leases because their recognition and measurement is already covered by the more specific standard of IAS 17.
288. There are, however, two aspects of finance leases which are within the scope of IAS 39: These are:
- De-recognition of finance lease payables; and
  - embedded derivatives in leases.
289. In addition, where a 'sub-lease' arrangement exists in a service concession, the intermediate NHS body will need to recognise a financial asset for the amounts due from the other NHS body. The asset will need to be measured at its fair value, and the NHS body will need to determine the appropriate category for subsequent

## Section 4.3: Financial instruments and service concessions

measurement. The most appropriate category is likely to be 'loans and receivables' whereby the asset would be measured at amortised cost. The asset will also be subject to the impairment requirements of the standard.

### De-recognition of finance lease payables

290. Under IAS 39 the finance lease obligation recognised by the NHS body is only de-recognised where it has been extinguished i.e. it has been paid, or it has been cancelled or written-off. In most cases, this principle will be straightforward to apply.
291. In a service concession where a part of the asset is sub-leased from one NHS body to another, the intermediate NHS body can only de-recognise that part of its finance lease obligation to the operator if it is extinguished i.e. if it is not liable for payment in the event that the other NHS body fails to pay the operator.

### Embedded derivatives

#### What are embedded derivatives?

292. Embedded derivatives can be found in any type of contract, not just leases. IAS 39 provides a definition of embedded derivatives that is rather long and not easily understood.
293. In essence, the standard assumes that for any contract into which an NHS body enters, the future cashflows under the contract are fixed and known from the outset. If, however, the contract contains any element that means that the cashflows will vary in a way that cannot be predicted, then it is likely that the contract contains an embedded derivative.
294. A service concession is an excellent example of a contract containing an embedded derivative, because it will normally contain an indexation factor in the payment mechanism. Thus if the annual unitary payment increases by RPI each year, then the

future cashflows cannot be known for certain at the outset because the actual future movement in the RPI index cannot be predicted. The RPI uplift mechanism is therefore an embedded derivative.

#### So any aspect of a service concession that creates variation in the contract cashflows is an embedded derivative?

295. Such aspects causing variation in the cashflows are likely to be embedded derivatives, but not necessarily in all cases. The IAS 39 definition notes that an embedded derivative causes the contract cashflows to be changed according to:
- “a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.”**
296. An increase in the unitary payment based on RPI is an embedded derivative because it is modified according to a specified “index of prices” in the definition above.
297. In contrast, deductions due to poor service performance or unavailability of the property are not embedded derivatives even though they modify the cashflows. This is because they are a change arising from a “non-financial variable” i.e. the operator’s poor performance. This non-financial variable is specific to a party to the contract because it arises from the operator’s actions. Thus, it is not an embedded derivative because it is a non-financial variable that *is* specific to a party to the contract and therefore falls outside the definition above. This is confirmed by paragraph BC62 of IFRIC 12.
298. As noted in section 3.2, PFI contracts sometimes contain volume-related payments for certain services e.g. laundry. Variations in the contract payments due to volume adjustments would not be embedded derivatives because they are caused by non-financial

## Section 4.3: Financial instruments and service concessions

variables (i.e. the volume of activity) which are specific to a party to the contract (i.e. the volume is requested by the NHS body).

299. Similarly, energy costs are sometimes present in PFI contracts on a pass-through basis to the NHS body. The payment will therefore vary in relation to the volume of energy consumed by the NHS body that therefore is not an embedded derivative. To the extent that the unit price of the energy can vary, this will not be an embedded derivative to the extent that it follows market prices. This will need to be assessed on an individual basis. If the unit price varies in relation to an index or some other financial factor then it may represent an embedded derivative and will need to be assessed further, as described below.

### What do we do about these embedded derivatives?

300. NHS bodies need to determine whether any embedded derivatives in a contract are 'closely-related' to the contract itself. If they are determined to be closely-related then no further action is required. If however, they are not closely-related then they will need to be separated from the contract and accounted for differently.

### What does closely-related mean?

301. Rather unhelpfully, IAS 39 does not provide a definition. Instead, it provides a series of examples of embedded derivatives that are closely-related and of ones which are not closely related. These can be found in paragraphs AG33 and AG30 respectively of the standard.
302. The example which is most relevant to service concessions is found in AG33:
- “(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is

- (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment),
- (ii) contingent rentals based on related sales or
- (iii) contingent rentals based on variable interest rates.”

303. In example (f)(i), where lease payments are inflated by a general inflation index relevant to the economic environment of the entity, the embedded derivative is considered to be closely-related to the host contract, unless it is 'leveraged'. The term 'leveraged' is not defined in the standard, but is generally taken to mean that the multiplier is greater than one. Thus in a lease where the payments increase by two times RPI, the embedded derivative would be considered not to be closely-related.

304. The standard does not provide examples of embedded derivatives in service contracts, but by general consensus the principles for leases are extended to service contracts. Therefore, where a UK service concession has a price adjustment feature set at RPI, this would be considered to be 'closely-related'. Similarly, an adjustment using a proportion of RPI e.g. 0.7x RPI would also generally be considered to be closely related as it is arguably tracking the underlying costs more closely by reflecting the variable/fixed nature of the service/debt costs.

### Where, in the case of an on-balance sheet PFI, the service concession is split into component parts i.e. services, lease and lifecycle replacement, can a non-closely-related embedded derivative arise if the RPI uplift is not applied uniformly across the components?

305. An argument could perhaps be made that a non-uniform allocation of RPI e.g. the lease component increasing by 1.1 x RPI represents a non-closely-related embedded derivative for that component.

## Section 4.3: Financial instruments and service concessions

306. However, there are a number of interpretations involved in doing so:
- The extension of the embedded derivative principles to service contracts is a consensus among practitioners rather than one that is formally required by IAS 39.
  - At the service concession level, provided that the RPI increase is not greater than 1, the inflation adjustment will be closely-related to the contract.
  - The finance lease within a service concession is not legally a lease but is being accounted for as one based on the substance of the contract.
  - The allocation of the cashflows between particular components is based upon the relative fair values but still incorporates a degree of subjectivity and judgement.
  - The substance of the price adjustment feature in the contract is to reflect the underlying variability in the price of the service components and in some cases also reflect the financing profile of the underlying debt.
307. Therefore reaching a judgement that individual components contain non-closely-related embedded derivatives would involve looking at the contract in a manner that seems to contradict the substance of the arrangement. It therefore does not appear to be reasonable that an apparent minor leveraging of the indexation of a component should lead to a conclusion of the presence of a non-closely-related embedded derivative.

**The items in AG30 and AG33 include options. Is an option to purchase a leased asset at the end of the lease, or to extend the lease for a secondary period, an embedded derivative?**

308. No, it is not. The reason is that options in leases to purchase or extend the lease term are already taken into account when determining the lease classification and the minimum lease payments.
309. An option to purchase at less than fair value is an indicator of a finance lease. The presumption is that it will be exercised and therefore it is included in the minimum lease payments. The same principles apply to secondary rental periods at less than a market rental.
310. Options to purchase at fair value or to extend a lease at market rental are not embedded derivatives. This is because a standalone option to be exercised at fair value is not a derivative and therefore a fair value option in a contract cannot be an embedded derivative.

## Section 4.4: Treatment of refinancing gains

**This section sets out the approach to accounting for gains received by NHS bodies as a result of the operator refinancing its project debt.**

### Key Points:

- Considering the ways in which refinancing gains may be received by the NHS body.
- Identifying the relevant accounting requirements for each of these.

### Introduction

311. A refinancing takes place where the operator amends the terms of the main project finance (the 'senior debt') so as to benefit from a lower overall cost of project finance. Refinancing usually occurs after the PFI asset has been constructed.
312. Extant PFI guidance requires the public sector body to ensure that the PFI contract anticipates the possibility of refinancing so as to ensure that an element of the operator's cost saving (i.e. the refinancing gain) is shared with the public sector body.

### Why does refinancing occur?

313. In health PFI schemes, the senior debt is usually fixed initially for the term of the contract. The main risk in the project is generally the construction risk and the initial senior debt terms of early PFI schemes, in particular, usually included a significant premium for this risk. Once the construction phase was completed, this main risk disappeared and this, coupled with falling interest margins and improving debt terms in the late 1990s and early 2000s, made refinancing of the senior debt attractive for operators.

314. Over time, as financiers have become more comfortable with PFI schemes, the risk premium for the construction phase has generally reduced. This, together with, until recently, more stable interest rates has made post-construction senior debt refinancing less attractive.
315. It is common practice in health PFI schemes for the operator to fix its underlying interest rates through the use of either bonds or swaps. The effect of these financial instruments is to prevent the operator from benefiting from any reductions in market rates (and to protect it from increases). However, it also limits its ability to benefit from refinancing the senior debt because of the penalty it will incur in buying itself out of the interest rate swap. As such, the benefits of refinancing typically accrue from improvements not in underlying base rates but in other terms of the debt package such as lower margins and/or additional debt capacity.

### How does the sharing of the refinancing gain with the NHS body happen?

316. Where the operator shares the refinancing gain with the NHS body, it may take the form of:
- A recurring reduction in the annual unitary payment; or
  - A cash lump sum; or
  - A mixture of the two.
317. In practice, it is more likely that the gain will take the form of a reduction in the annual unitary payment. This is because providing a cash lump sum will usually mean the operator having to borrow additional debt to finance it. This in turn will lead to an increase in the project costs. Thus, taking the gain as a reduction in the annual unitary payment over time will usually represent the better value for money option for the NHS body. Consequently, DH policy is to take the public sector share of gains over time through unitary

## Section 4.4: Treatment of refinancing gains

payment reductions. HM Treasury requires a value for money analysis to be undertaken should the cash lump sum option instead be requested.

### How do we account for the gain where there is a reduction in the annual unitary payment?

318. The reduction in the unitary payment arises from changes to the project financing rather than any adjustment to other aspects such as the services or lifecycle replacement. The fair value of services will therefore remain unaffected and consequently the accounting change should be applied to the asset elements of the payment stream i.e. lease payments for the assets.
319. There is no accounting guidance in IFRS on how this change should be applied. Renegotiations of leases under IAS 17 only result in significant changes where this alters the actual classification of a lease – which is not the case here, as the finance lease treatment remains driven by IFRIC 12.
320. Where a renegotiation results in a change to the lease payments, IAS 17 assumes that this will be to increase the payments and then simply requires that these are treated as contingent rentals and expensed in the periods in which they are incurred. However, IAS 17 is silent on how to account for reductions in the minimum lease payments – such as arise here.
321. The substance of the reduction is a lower cost of project capital and therefore NHS bodies should account for the reduction by recalculating the finance rate for the lease, and then applying this lower finance rate prospectively over the remaining life of the lease.

### How do we account for a cash lump sum received?

322. In some circumstances, all or part of the refinancing gain may be received in the form of a cash lump sum. The accounting treatment

will depend on whether or not the cash lump sum is paid to the NHS body with conditions attached.

### *What is meant by a conditional lump sum payment and how do we account for one?*

323. The cash lump sum may be paid by the operator with explicit conditions attached, for example that the NHS body continues with the contract for its full term. Such conditions may be present in the project agreement or in a separate agreement between the parties as part of the refinancing.
324. Alternatively, the lump sum may be effectively conditional as a result of other aspects of the contract. For example, the compensation payments due to the operator should the NHS body wish to terminate the contract voluntarily before the full term may change, as explained below.
325. There are standard compensation terms for NHS PFI contracts, although these have changed over the years and depend upon the termination scenario in question. In summary, there are two general approaches which have been used for compensation for voluntary termination by the NHS body:
- The compensation payment is linked to the level of the operator's outstanding project debt (senior and/or junior, as relevant) at the date of termination; or
  - The compensation payment is linked to the market value of the contract at the date of termination.
326. The payment is usually adjusted for additional costs which the operator may incur (including finance breakage costs) and is designed so that the operator is effectively compensated for its remaining project finance and any profit it might have expected to make had the contract run to its full term.

## Section 4.4: Treatment of refinancing gains

327. As noted earlier, where a cash lump sum is paid, the operator will normally borrow additional debt as part of the refinancing in order to pay the NHS body. Where the voluntary termination compensation is based on the outstanding project debt, this means that in substance, the NHS body must continue with the contract in order to avoid having to pay the unamortised portion of the lump sum back through the compensation payment.

328. Similarly, where the compensation is based on the market value of the contract at the date of termination, this will reflect the future cashflows receivable from the NHS body<sup>13</sup> that will fund the additional borrowing. As such, if the NHS body terminates the contract it will in, substance, have to repay the lump sum to the operator through the compensation payment.

329. In both cases therefore, any cash lump sum may be seen as conditional on the NHS body continuing the contract. The NHS body will therefore recognise the refinancing gain as deferred income:

Dr	Cash	£x
Cr	Deferred Income	£x

330. This deferred income is then released to the Statement of Comprehensive Income (or for PCTs the OCS) as finance income over the remaining life of the contract in the manner described below.

331. The release of deferred income should reflect the extent to which the NHS body does not have to repay the sum. As noted above, this will in turn reflect the level of outstanding project debt at any point in the contract. The deferred income balance therefore needs to reduce in a similar manner to the outstanding project debt.

<sup>13</sup> Which are higher than they would be in a case where the gain is taken over time, given that the unitary payment is not reduced by the amount of the gain share (as it is when the gain is taken over time).

332. The NHS body therefore needs to calculate the initial sum required so that it reduces at an increasing pace using the post-refinancing project weighted cost of capital i.e. such that:

$$N + Nx(1+WCC) + Nx(1+WCC)^2 \dots + Nx(1+WCC)^Y = \text{Refinancing Gain}$$

Where:

N is the amount released to income in the first year following refinancing,

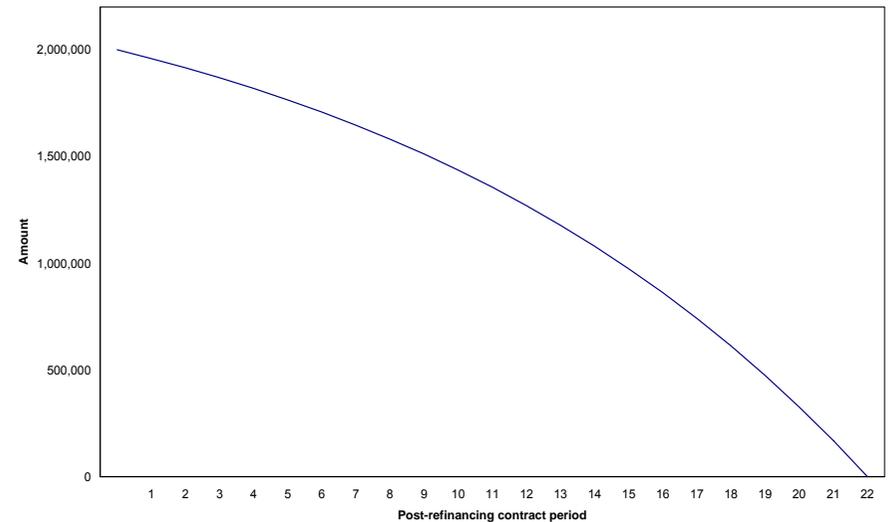
WCC is the operator's post-refinancing (after-tax) weighted project cost of capital

Y+1 is the number of years remaining in the contract

## Section 4.4: Treatment of refinancing gains

<b>Example</b>				
An NHS body receives a refinancing gain in the form of a cash lump sum of £2,000,000. The remaining contract period is 22 years. The operator's project weighted cost of capital (after tax) after the refinancing is 7%:				
Post - refinancing contract year	WCC: 7%	Annual Release to Finance Income	Opening Deferred Income Balance	Closing Deferred Income Balance
				2,000,000
1		40,812	2,000,000	1,959,188
2	x1.07 =	43,668	1,959,188	1,915,520
3	x1.07 =	46,725	1,915,520	1,868,795
4	x1.07 =	49,996	1,868,795	1,818,799
5	x1.07 =	53,496	1,818,799	1,765,303
6	x1.07 =	57,240	1,765,303	1,708,063
7	x1.07 =	61,247	1,708,063	1,646,816
8	x1.07 =	65,534	1,646,816	1,581,282
9	x1.07 =	70,122	1,581,282	1,511,160
10	x1.07 =	75,030	1,511,160	1,436,129
11	x1.07 =	80,282	1,436,129	1,355,847
12	x1.07 =	85,902	1,355,847	1,269,945
13	x1.07 =	91,915	1,269,945	1,178,029
14	x1.07 =	98,350	1,178,029	1,079,680
15	x1.07 =	105,234	1,079,680	974,446
16	x1.07 =	112,600	974,446	861,845
17	x1.07 =	120,482	861,845	741,363
18	x1.07 =	128,916	741,363	612,447
19	x1.07 =	137,940	612,447	474,507
20	x1.07 =	147,596	474,507	326,911
21	x1.07 =	157,928	326,911	168,983
22	x1.07 =	168,983	168,983	0
		2,000,000		

**Figure 9 – Profile of deferred income balance write-down**



**How do we account for an unconditional lump sum payment?**

333. It seems likely that an unconditional cash lump sum will be received only on rare occasions, However, should this occur, the NHS body should recognise it as an immediate gain within 'finance income' in the Statement of Comprehensive Income. The accounting entries being simply:

Dr Cash	x
Cr Finance Income	x

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## **Section 5 – Changing the existing accounting treatment**

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

This section sets out the principles of bringing an existing 'off-balance sheet' arrangement on to the NHS body's Statement of Financial Position and provides a worked example.

### Key Points:

- Approaches to determining the PFI asset value and liability when they were originally brought into use;
- Adjusting the opening 1 April 2008 assets, liabilities and reserves to the cumulative amounts which would have been recorded had an 'on-balance sheet' treatment always been followed.
- removal of residual interests previously recognised in the PFI asset;
- changes to the treatment of assets contributed to the operator; and
- illustration of the required changes through a worked example.

### Introduction

334. Where an NHS body has an existing PFI scheme that it has accounted for under UK GAAP – probably with an 'off-balance sheet' treatment – it needs to reassess the scheme under IFRS in accordance with this manual. This will probably lead to a change in accounting treatment to 'on-balance sheet'. As with most accounting adjustments on the transition to IFRS, a change to an 'on-balance sheet' treatment is applied as a change in accounting policy. This requires that all past transactions for the service concessions are reviewed and where necessary replaced with the entries which would have been made had the scheme always been 'on-balance sheet'.
335. NHS bodies will need to follow the guidance set out in sections 3 and 4 to determine the appropriate amounts and accounting

entries for an 'on-balance sheet' treatment for their scheme. The rest of this appendix summarises the mechanics of reversing-out the previous UK GAAP accounting entries and replacing them with the new IFRS accounting entries.

### How do we recognise the initial asset and liability?

336. The initial fair value of the service concession asset needs to be determined as at the inception of the lease, as described in section 3.3. This value is necessary because it determines the initial amount of the finance lease obligation.
337. The equal and opposite asset and liability are therefore recognised at the date when the asset is made available to the NHS body. The accounting entries simply being:
- Dr Property Plant and Equipment
  - Cr Finance lease obligation.
338. Depreciation and revaluations then need to be applied to the asset as if it had always been treated 'on-balance sheet'. The cumulative depreciation and revaluations up to 1 April 2008 are taken to the I&E reserve and revaluation reserve as appropriate. Up to and including 2007/08, annual indexation was applied to NHS tangible fixed assets. Indexation could thus be applied retrospectively to the asset values as a complete or partial estimate of price changes that would have been applied during the period had the asset been on-balance sheet. The indexation factors for each year are shown in the following table:

### NHS Fixed Asset Indexation factors

	Land	Buildings	Equipment
1995/96	102	128	115
1996/97	104	133	118
1997/98	108	137	120
1998/99	131	147	123
1999/2000	100*	158	126

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

2000/01	100	160	129
2001/02	115	161	132
2002/03	140	184	136
2003/04	148	202	139
2004/05	100*	218	142
2005/06	105	222	145
2006/07	111	240	149
2007/08	117	260	153

\*in these years, the index was rebased to 100.

339. Full NHS estate revaluations were undertaken as at 1 April 2000 and 1 April 2005, and it is unlikely that any off-balance sheet PFI assets were revalued on those occasions. NHS bodies should discuss with their auditors and valuers a suitable approach to determining the impact that such revaluations may have had. One approach might be to consider the average proportionate movement to asset carrying values which occurred as a result of those valuations to assets held by the NHS body that are similar to the PFI assets.
340. The finance lease obligation needs to be written-down as described below so that the appropriate carrying amount is reached as at 1 April 2008. Consequently as at that date, the values for the asset and the liability are likely to be very different.

### Do we need to make any changes in respect of the past unitary payment for interim services?

341. Payments for services received during the interim period prior to the main asset being made available by the operator do not normally include any payment for the property, and are purely for services received. The payments will have been expensed to operating expenses when the services were received. This accounting treatment does not change as a result of the scheme being brought into the NHS body's Statement of Financial Position.

### What cumulative adjustments do we need to make in respect of the unitary payment during the operational period to date?

## NHS Finance, Performance & Operations

### Accounting for PFI under IFRS – October 2009

342. Under the off balance sheet treatment, the full unitary payment (less any capitalisation of residual interests) in the PFI asset has been expensed to operating expenses.
343. In switching to an on-balance sheet treatment, the following adjustments need to be made:
- The cumulative element of the unitary payment attributable to the finance lease for the PFI asset needs to be removed from operating expenses and allocated to a finance charge and repayment of the finance lease principal using a finance rate calculated for that purpose:
 

Dr	I&E: finance charge
Dr	I&E: finance charge – contingent rent
Dr	PFI Finance lease obligation
Cr	I&E: operating expenses
  - The cumulative element of the unitary payment attributable to lifecycle needs to be removed from operating expenses. These amounts then need to be compared to the actual lifecycle components received to 1 April 2008 and recognised as one or more of the following:
    - a) Items of PPE, where the lifecycle was received;
    - b) A prepayment where the lifecycle was not received at 1 April 2008 but was still expected to be received after that date;
    - c) An operating expense to the extent that:
      - o the lifecycle was received but its value was less than that paid for through the unitary payment; or
      - o the lifecycle will not be received.
  - The cumulative amount of unitary payment deducted for the capitalisation of the residual interest in the PFI asset needs to be reinstated in operating expenses, as described below.

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

**We currently recognise a residual interest in respect of the PFI assets to be received at the end of the concession, what do we do with this?**

344. As noted above, where the NHS body receives the asset at the end of the concession, it will normally capitalise part of the unitary payment during the life of the concession. This capitalisation is designed to occur at a rate that ensures that by the end of the contract the residual value accrued represents the amount by which the anticipated fair value of the asset at the end of the contract exceeds any final amount to be paid. In most cases, the final payment is nil and therefore the amount capitalised is the anticipated fair value of the asset. The residual value is recognised as an asset within Property, Plant and Equipment.
345. Where a scheme is brought into the NHS body's Statement of Financial Position, recognition of the residual interest is no longer required as the entire asset is recognised instead. Thus the residual value accrued needs to be written-out of Property, Plant and Equipment and the amount capitalised transferred to the Income and Expenditure reserve as if that part of the unitary payment had always been expensed. The residual value asset may also have been revalued or indexed since its initial recognition and therefore this element of the asset's value need to be written-out against the revaluation reserve. The accounting entries required are:
- Cr Property, Plant and Equipment                      a + b
  - Dr Income and Expenditure reserve                      a
  - Dr Revaluation Reserve                                      b

**We previously contributed assets for use by the operator in the service concession and are recognising these as prepayments. Do we need to treat these instead as property plant and equipment?**

346. Where the NHS body has contributed assets, e.g. buildings or equipment to the operator for use in the service concession, the treatment under UK GAAP generally follows that of the PFI asset

itself i.e. if the scheme is 'off-balance sheet' then the contributed asset usually was as well.

347. Where the asset is currently 'off-' then the NHS body will normally also recognise a prepayment. This represents the reduction in the unitary payment that the NHS body receives because the operator has not had to source an asset elsewhere. This prepayment is amortised to operating expenses over the period of the benefit received. In practice, this amortisation is normally straight-line over the life of the concession.
348. In older schemes, the initial value of the prepayment was normally the carrying value of the asset in the NHS body's Statement of Financial Position immediately prior to transfer. This occurred usually because the reduction in the unitary payment was not readily known, but inferred. In later schemes, the contract and the operator's financial model may have identified explicitly the annual cash reduction in the unitary payment. The prepayment was then established at the present value of that reduction, and any difference between this and the carrying value of the asset would have been recorded as a profit or loss on disposal of the asset.
349. Where the asset reverts to the NHS body at the end of the scheme, a small reversionary interest may have continued to be recognised in the NHS body's accounts. This reversionary interest represents the present value of the contributed asset's expected fair value on reversion at the end of the concession. This reversionary interest may have been subject to indexation and revaluations. In an on-balance sheet treatment, this value is subsumed within the contributed asset's value.

## Section 5.1: Changing from ‘off-’ to ‘on-balance sheet’ - an example

350. In an on-balance sheet scenario, the contributed assets need to be re-recognised in the NHS body’s accounts as if they had never been de-recognised in the first place. This involves the following.

- Dr Prepayment a
- Cr I&E reserve a

To reverse the amortisation of the prepayment

- Cr Prepayment b
- Dr Property, Plant and Equipment b

To remove the prepayment and reinstate the asset

- Cr Property, Plant and Equipment c
- Dr I&E Reserve c

To reflect depreciation on the asset which would have been charged

- Dr Property, Plant and Equipment d
- Cr Revaluation reserve d

To reflect any revaluations or indexation which would have been applied to the asset

351. In the event that any profit or loss was originally recognised when the prepayment was established, this will also need to be reversed.

352. Land contributed by the NHS body and used by the operator in the course of the service concession by the operator should currently be recognised in the NHS body’s balance sheet. This is the required treatment under UK GAAP where the asset reverts to the NHS body at the end of the concession. In such cases, it should be accounted for in the same way as buildings contributed and used.

**We also originally contributed some surplus assets to the operator and made an up-front cash payment. We are showing these as prepayments at the moment, do we need to make any changes to this treatment?**

353. In an off-balance sheet treatment, where an NHS body contributes cash or another surplus asset to the operator, the normal practice is to treat the contribution as a prepayment. This prepayment is then amortised to operating expenses over the life of the concession.

354. In an on-balance sheet treatment, as noted in section 3.4, such contributed assets are treated initially as prepayment during the construction period and then as an immediate payment against the initial finance lease liability when the asset is made available to the NHS body.

355. It is therefore necessary to:

- reverse the cumulative amortisation to I&E of such prepayments to reinstate their original values; and
- treat the full contributions as an initial payment against the finance lease obligation.

356. The accounting entries are therefore:

- Dr Prepayment- contributed assets x
- Cr I&E reserve x
  
- Cr Prepayment – contributed assets y
- Dr Finance lease obligation y

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

### Restatement as at 1 April 2008 – worked example

#### Description of Scheme:

Financial close	1 April 1999			
Construction period	2 years			
Operational period commenced	1 April 2001			
Contract Period	27 years (25 years operational)			
PFI asset	Initial Fair Value	£30,000,000	Estimated useful economic life	50 years
Assets contributed by the NHS Body	Cash		£1,000,000	
	Surplus land		£3,000,000	
	Existing buildings for use in the PFI scheme		£5,000,000 value transferred, £100,000 Reversionary Interest retained	50 years remaining useful economic life
Unitary Payment	£6,000,000 for interim services in year 1, uplift by RPI for year 2 £10,000,000 from year 3, uplifted by RPI			

RPI assumed to have been 2.5% for each year since start of contract

#### Off-Balance Sheet Treatment:

- Unitary Payment expensed less capitalisation of residual Interest in PFI asset
- Residual interest capitalised on straight-line basis of £15m (estimated RI) over 25 years = £600k p.a. (Straight-line basis assumed here for simplicity. In practice the capitalisation of the RI should have been calculated in accordance with methodology set out in Annex 2 to 'Land and Buildings in PFI (Version 2)' issued by DH in January 2003)
- Residual Interest subject to annual indexation

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

- Contributed cash and surplus land amortised over 25 years, straight line
- Contributed existing building for use in PFI scheme – transferred value amortised over 25 years, Reversionary Interest of £100k, subject to annual indexation.

### On-Balance Sheet Treatment

- Capital value of asset recognised at £30,000,000 as at 1 April 2001. Subject to annual depreciation and indexation to 1 April 2008 (and thereafter).
- Finance lease obligation recognised at £30,000,000 as at 1 April 2001. Subsequently reduced through application of annual finance lease rental.
- Operational period Unitary Payment components determined to be:
  - Services £7,500,000 in Year 3, increasing by RPI
  - Lifecycle replacement As set out in the table below
  - Finance lease rental (principal and interest) As calculated in the table below
  - Contingent Finance cost £0, thereafter, comprising RPI increase of Finance lease rental
- Contributed cash and surplus land £4,000,000 treated initially as a prepayment, then set against finance lease obligation at 1 April 2001.
- Finance lease rental – finance rate determined through calculation to be 7.6%
- Existing building – removal of reversionary interest (including revaluation reserve balance) and reinstatement of full building. Subsequently revalued and depreciated over its useful economic life of 50 years.

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 10 – Analysis and calculations to derive finance lease components

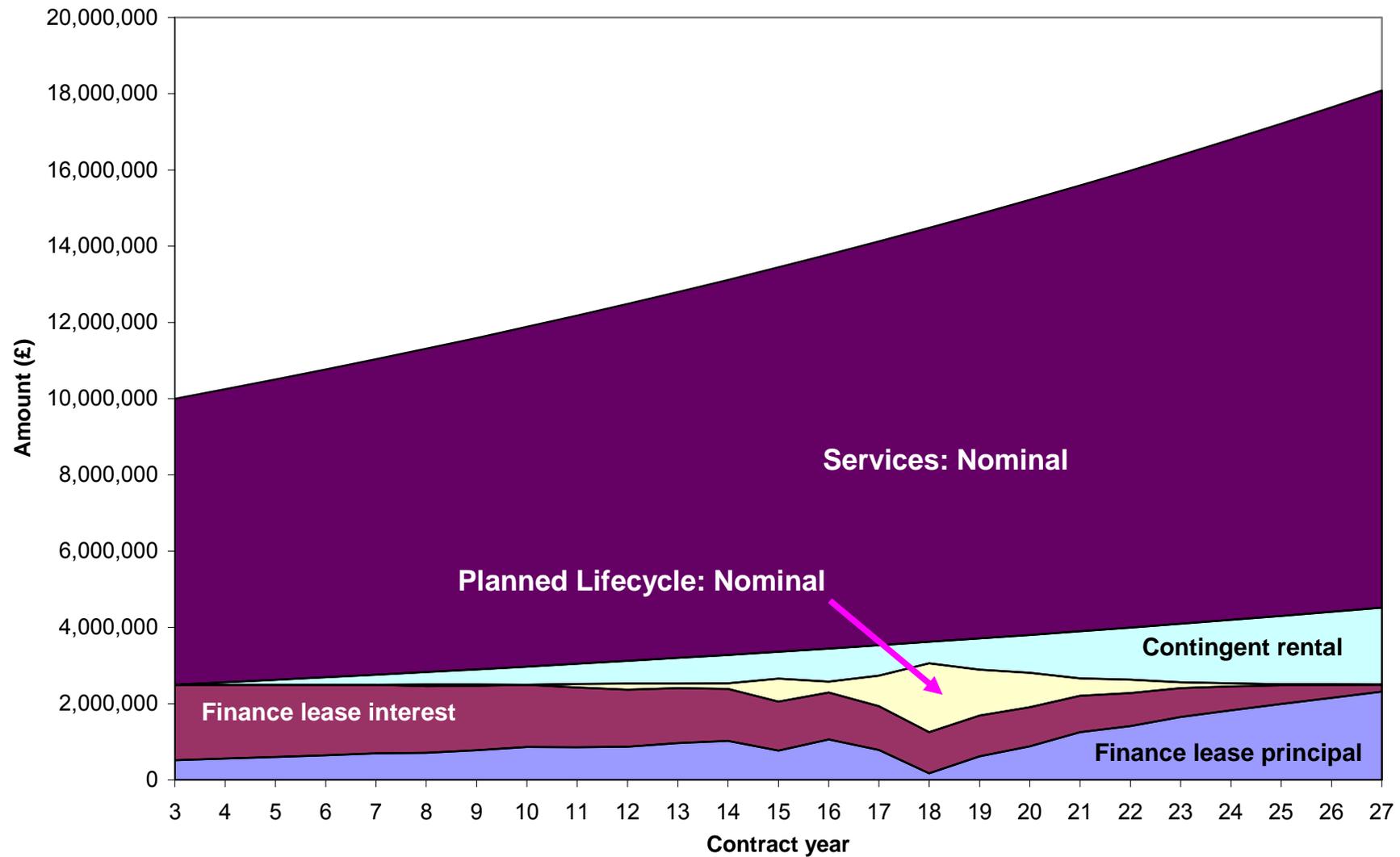
Contract Year	Financial Year	Real Amounts:				Finance Lease Calculations:				
		Unitary Payment: Real	Services: Real	Planned Lifecycle: Real	Lease Rental: Real	Opening Liability	Finance Cost	Lease Rental - Real	IRR= Closing Liability	7.6% Finance lease principal repaid
		A	B	C	D = A-B-C	E	F = E x IRR	D	H = E+F-D	I = D-F
3	2001/02	10,000,000	7,500,000	0	2,500,000	26,000,000	1,978,594	2,500,000	25,478,594	521,406
4	2002/03	10,000,000	7,500,000	0	2,500,000	25,478,594	1,938,916	2,500,000	24,917,510	561,084
5	2003/04	10,000,000	7,500,000	0	2,500,000	24,917,510	1,896,217	2,500,000	24,313,727	603,783
6	2004/05	10,000,000	7,500,000	0	2,500,000	24,313,727	1,850,269	2,500,000	23,663,996	649,731
7	2005/06	10,000,000	7,500,000	0	2,500,000	23,663,996	1,800,825	2,500,000	22,964,821	699,175
8	2006/07	10,000,000	7,500,000	44,193	2,455,807	22,964,821	1,747,618	2,455,807	22,256,632	708,189
9	2007/08	10,000,000	7,500,000	25,869	2,474,131	22,256,632	1,693,725	2,474,131	21,476,226	780,406
10	2008/09	10,000,000	7,500,000	0	2,500,000	21,476,226	1,634,336	2,500,000	20,610,562	865,664
11	2009/10	10,000,000	7,500,000	73,867	2,426,133	20,610,562	1,568,459	2,426,133	19,752,889	857,673
12	2010/11	10,000,000	7,500,000	128,117	2,371,883	19,752,889	1,503,191	2,371,883	18,884,196	868,693
13	2011/12	10,000,000	7,500,000	93,744	2,406,256	18,884,196	1,437,083	2,406,256	17,915,023	969,173
14	2012/13	10,000,000	7,500,000	114,322	2,385,678	17,915,023	1,363,329	2,385,678	16,892,674	1,022,349
15	2013/14	10,000,000	7,500,000	446,134	2,053,866	16,892,674	1,285,529	2,053,866	16,124,336	768,338
16	2014/15	10,000,000	7,500,000	210,372	2,289,628	16,124,336	1,227,058	2,289,628	15,061,766	1,062,570
17	2015/16	10,000,000	7,500,000	566,182	1,933,818	15,061,766	1,146,197	1,933,818	14,274,145	787,621
18	2016/17	10,000,000	7,500,000	1,242,838	1,257,162	14,274,145	1,086,259	1,257,162	14,103,243	170,903
19	2017/18	10,000,000	7,500,000	808,350	1,691,650	14,103,243	1,073,254	1,691,650	13,484,846	618,396
20	2018/19	10,000,000	7,500,000	591,476	1,908,524	13,484,846	1,026,194	1,908,524	12,602,516	882,331
21	2019/20	10,000,000	7,500,000	288,525	2,211,475	12,602,516	959,049	2,211,475	11,350,089	1,252,427
22	2020/21	10,000,000	7,500,000	218,935	2,281,065	11,350,089	863,739	2,281,065	9,932,763	1,417,326
23	2021/22	10,000,000	7,500,000	91,541	2,408,459	9,932,763	755,881	2,408,459	8,280,185	1,652,578
24	2022/23	10,000,000	7,500,000	47,631	2,452,369	8,280,185	630,120	2,452,369	6,457,936	1,822,249
25	2023/24	10,000,000	7,500,000	17,426	2,482,574	6,457,936	491,448	2,482,574	4,466,810	1,991,127
26	2024/25	10,000,000	7,500,000	11,334	2,488,666	4,466,810	339,923	2,488,666	2,318,067	2,148,743
27	2025/26	10,000,000	7,500,000	5,529	2,494,471	2,318,067	176,404	2,494,471	0	2,318,067
<b>Total</b>		250,000,000	187,500,000	5,026,381	57,473,619		31,473,619	57,473,619		26,000,000

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Contract Year	Financial Year	Nominal Amounts:			
		Unitary Payment: Nominal	Services: nominal	Planned Lifecycle: Nominal	Contingent rental
		J	K	L	M = J-K-L-D
3	2001/02	10,000,000	7,500,000	0	0
4	2002/03	10,250,000	7,687,500	0	62,500
5	2003/04	10,506,250	7,879,688	0	126,563
6	2004/05	10,768,906	8,076,680	0	192,227
7	2005/06	11,038,129	8,278,597	0	259,532
8	2006/07	11,314,082	8,485,562	50,000	322,713
9	2007/08	11,596,934	8,697,701	30,000	395,102
10	2008/09	11,886,858	8,915,143	0	471,714
11	2009/10	12,184,029	9,138,022	90,000	529,874
12	2010/11	12,488,630	9,366,472	160,000	590,274
13	2011/12	12,800,845	9,600,634	120,000	673,955
14	2012/13	13,120,867	9,840,650	150,000	744,538
15	2013/14	13,448,888	10,086,666	600,000	708,356
16	2014/15	13,785,110	10,338,833	290,000	866,650
17	2015/16	14,129,738	10,597,304	800,000	798,616
18	2016/17	14,482,982	10,862,236	1,800,000	563,583
19	2017/18	14,845,056	11,133,792	1,200,000	819,614
20	2018/19	15,216,183	11,412,137	900,000	995,521
21	2019/20	15,596,587	11,697,440	450,000	1,237,671
22	2020/21	15,986,502	11,989,876	350,000	1,365,560
23	2021/22	16,386,164	12,289,623	150,000	1,538,082
24	2022/23	16,795,819	12,596,864	80,000	1,666,586
25	2023/24	17,215,714	12,911,785	30,000	1,791,354
26	2024/25	17,646,107	13,234,580	20,000	1,902,861
27	2025/26	18,087,259	13,565,445	10,000	2,017,344
<b>Total</b>		341,577,639	256,183,229	7,280,000	20,640,791

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 11 – Unitary payment components



## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 12 – Existing Off-Balance Sheet transactions

	Year Ended 31 March:									Cumulative as at 01/04/2008
	2000	2001	2002	2003	2004	2005	2006	2007	2008	
<b>INCOME AND EXPENDITURE ACCOUNT</b>										
<b>Operating Expenses:</b>										
<i>Gross Unitary Payment</i>	6,000,000	6,150,000	10,000,000	10,250,000	10,506,250	10,768,906	11,038,129	11,314,082	11,596,934	87,624,301
<i>Less capitalisation of residual interest</i>	0	0	-600,000	-600,000	-600,000	-600,000	-600,000	-600,000	-600,000	-4,200,000
Net Unitary Payment	6,000,000	6,150,000	9,400,000	9,650,000	9,906,250	10,168,906	10,438,129	10,714,082	10,996,934	83,424,301
<b>Amortisation of Deferred Assets over 25 years:</b>										
Cash	0	0	40,000	40,000	40,000	40,000	40,000	40,000	40,000	280,000
Surplus Land	0	0	120,000	120,000	120,000	120,000	120,000	120,000	120,000	840,000
Buildings used in concession	0	0	200,000	200,000	200,000	200,000	200,000	200,000	200,000	1,400,000
<b>Total Operating Expenditure</b>	6,000,000	6,150,000	9,760,000	10,010,000	10,266,250	10,528,906	10,798,129	11,074,082	11,356,934	85,944,301

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

### Year Ended 31 March:

2000      2001      2002      2003      2004      2005      2006      2007      2008

<b>BALANCE SHEET - EXTRACT</b>									
<b>Tangible Fixed Assets</b>									
Residual Interest in new buildings	0	0	600,000	1,285,714	2,011,490	2,770,816	3,421,657	4,299,089	<b>5,257,346</b>
Reversionary Interest in existing buildings	100,000	101,266	101,899	116,456	127,848	137,975	140,507	151,899	<b>164,557</b>
<b>Deferred Assets</b>									
Cash	1,000,000	1,000,000	960,000	920,000	880,000	840,000	800,000	760,000	<b>720,000</b>
Surplus land	3,000,000	3,000,000	2,880,000	2,760,000	2,640,000	2,520,000	2,400,000	2,280,000	<b>2,160,000</b>
Buildings used in concession	5,000,000	5,000,000	4,800,000	4,600,000	4,400,000	4,200,000	4,000,000	3,800,000	<b>3,600,000</b>
	9,000,000	9,000,000	8,640,000	8,280,000	7,920,000	7,560,000	7,200,000	6,840,000	6,480,000
<b>Revaluation Reserve</b>									
Residual interest in new buildings	0	0	0	85,714	211,490	370,816	421,657	699,089	<b>1,057,346</b>
Reversionary interest in contributed buildings	0	1,266	1,899	16,456	27,848	37,975	40,507	51,899	<b>64,557</b>

<b>Statement of Total Recognised Gains and Losses:</b>									
Revaluation of Residual Interest in new buildings	0	0	0	85,714	125,776	159,326	50,841	277,432	358,257
Revaluation of reversionary interest in existing buildings	0	1,266	633	14,557	11,392	10,127	2,532	11,392	12,658

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 12 – New On-Balance Sheet transactions to be recognised

	Year Ended 31 March:									Cumulative as at 01/04/2008
	2000	2001	2002	2003	2004	2005	2006	2007	2008	
<b>STATEMENT OF COMPREHENSIVE INCOME</b>										
<b>Operating Expenses:</b>										
Gross Unitary Payment	6,000,000	6,150,000	10,000,000	10,250,000	10,506,250	10,768,906	11,038,129	11,314,082	11,596,934	<b>87,624,301</b>
<i>Less: Finance lease rental</i>	0	0	-2,500,000	-2,562,500	-2,626,563	-2,692,227	-2,759,532	-2,778,521	-2,869,234	<b>-18,788,575</b>
<i>Lifecycle replacement</i>	0	0	0	0	0	0	0	-50,000	-30,000	<b>-80,000</b>
Services Charge	6,000,000	6,150,000	7,500,000	7,687,500	7,879,688	8,076,680	8,278,597	8,485,562	8,697,701	<b>68,755,726</b>
<b>Depreciation</b>										
PFI Asset	0	0	600,000	685,714	752,795	812,422	827,329	894,410	970,175	<b>5,542,846</b>
Existing Building	0	0	103,291	103,950	119,109	131,009	141,612	144,268	156,231	<b>899,470</b>
<b>Finance Costs</b>										
PFI asset lease liability finance charge	0	0	1,978,594	1,938,916	1,896,217	1,850,269	1,800,825	1,747,618	1,693,725	<b>12,906,164</b>
PFI asset contingent rent finance charge	0	0	0	62,500	126,563	192,227	259,532	322,713	395,102	<b>1,358,637</b>
<b>Total expenses</b>	<b>6,000,000</b>	<b>6,150,000</b>	<b>10,181,886</b>	<b>10,478,580</b>	<b>10,774,371</b>	<b>11,062,607</b>	<b>11,307,895</b>	<b>11,594,571</b>	<b>11,912,934</b>	<b>89,462,843</b>
<b>Other Comprehensive Income:</b>										
Revaluation of PFI asset	0	0	0	4,200,000	3,219,876	2,802,484	685,714	3,018,633	3,283,670	<b>17,210,377</b>
Revaluation of existing buildings	0	64,557	32,278	727,649	559,296	487,717	119,525	526,383	572,847	<b>3,090,252</b>

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Year Ended 31 March:

	2000	2001	As at 01/04/2001	2002	2003	2004	2005	2006	2007	2008
<b>STATEMENT OF FINANCIAL POSITION</b>										
<b>Assets:</b>										
<b>Property, Plant and Equipment</b>										
PFI asset - original	0	0	30,000,000	29,400,000	32,914,286	35,381,367	37,371,428	37,229,813	39,354,036	<b>41,717,531</b>
Additions - Lifecycle Replacement				0	0	0	0	0	50,000	30,000
<b>Total - PFI Asset</b>	<b>0</b>	<b>0</b>	<b>30,000,000</b>	<b>29,400,000</b>	<b>32,914,286</b>	<b>35,381,367</b>	<b>37,371,428</b>	<b>37,229,813</b>	<b>39,404,036</b>	<b>41,747,531</b>
Existing buildings	5,100,000	5,164,557	5,164,557	5,093,544	5,717,243	6,157,430	6,514,138	6,492,051	6,874,166	<b>7,290,782</b>
<b>Prepayments</b>										
Contributed Cash	1,000,000	1,000,000	0	0	0	0	0	0	0	0
Contributed surplus land	3,000,000	3,000,000	0	0	0	0	0	0	0	0
<b>Liabilities:</b>										
PFI Finance lease liability			<b>-26,000,000</b>	<b>-25,478,594</b>	<b>-24,917,510</b>	<b>-24,313,727</b>	<b>-23,663,996</b>	<b>-22,964,821</b>	<b>-22,256,632</b>	<b>-21,476,226</b>
<b>Revaluation Reserve</b>										
PFI asset	0	0	0	0	4,200,000	7,419,876	10,222,360	10,908,074	13,926,707	<b>17,210,377</b>
Existing Building	0	64,557	64,557	96,835	824,484	1,383,780	1,871,497	1,991,022	2,517,405	<b>3,090,252</b>

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 13 - Restatement journals as at 1 April 2008

Recognition of the asset and liability	Debit	Credit
<b>Removal of existing off-balance sheet entries:</b>		
Retained earnings:		
<i>Removal of cumulative finance lease rental element of Unitary Payment</i>		-18,788,575
<i>Removal of cumulative lifecycle replacement which has been capitalised</i>		-80,000
<i>Removal of cumulative amortisation of Cash &amp; Surplus Land prepayments to 31/3/08</i>		-1,120,000
		<u>-19,988,575</u>
<i>Prepayments: removal of amortised Cash and Surplus Land prepayments as at 31/3/2008</i>		-2,880,000
<b>New on-balance sheet entries:</b>		
<i>PPE: PFI Asset - fair value (including cumulative lifecycle replacement additions)</i>	41,747,531	
<i>Finance lease liability: written down as at 1 April 2008</i>		-21,476,226
<i>Revaluation Reserve: cumulative amount for PFI asset as if it had always been on-balance sheet</i>		-17,210,377
Retained earnings:		
<i>Cumulative depreciation on PFI asset</i>	5,542,846	
<i>Cumulative finance cost (lease)</i>	12,906,164	
<i>Cumulative finance cost (contingent rent)</i>	1,358,637	
	<u>19,807,575</u>	
<b>Total</b>	<u>61,555,178</u>	<u>-61,555,178</u>

Removal of existing Residual Interest	Debit	Credit
<i>Property, Plant and Equipment: removal of residual interest</i>		-5,257,346
<i>Revaluation Reserve: removal of balance attributable to residual interest</i>	1,057,346	
<i>Retained earnings: to reinstate amounts previously deducted from annual unitary payment and capitalised</i>	4,200,000	
<b>Total</b>	<u>5,257,346</u>	<u>-5,257,346</u>

Reinstatement of existing building	Debit	Credit
<b>Removal of existing off-balance sheet entries:</b>		
<i>Property, Plant and Equipment : removal of reversionary interest in existing buildings</i>		-164,557
<i>Revaluation reserve: removal of balance attributable to reversionary interest</i>	64,557	
<i>Prepayment: removal of existing building</i>		-3,600,000
<i>Retained earnings: removal of cumulative amortisation of prepayment</i>		-1,400,000
<b>New on-balance sheet entries:</b>		
<i>Property, Plant and Equipment: existing building</i>	7,290,782	
<i>Retained earnings: cumulative depreciation</i>	899,470	
<i>Revaluation reserve: reinstate full asset at current value at 1 April 2008</i>		-3,090,252
<b>Total</b>	<u>8,254,809</u>	<u>-8,254,809</u>

## Section 5.1: Changing from 'off-' to 'on-balance sheet' - an example

Figure 14 – Summary of adjustments to balances as at 1 April 2008

Summary of Movements	Debit	Credit
<b><i>Property, Plant and Equipment</i></b>		
Recognition of PFI Asset	41,747,531	
Removal of Residual Interest in PFI asset		-5,257,346
Removal of Reversionary Interest in existing building	7,290,782	
Reinstatement of existing building		-164,557
<b><i>Prepayments</i></b>		
Removal of Cash contribution		-720,000
Removal of surplus land contribution		-2,160,000
Removal of existing building contribution		-3,600,000
<b><i>Liabilities</i></b>		
Recognition of PFI Finance lease liability		-21,476,226
<b><i>Capital and Reserves</i></b>		
Revaluation Reserve		-19,178,726
Retained earnings	3,518,542	
Total	52,556,855	-52,556,855

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# Appendices

## Appendix 1: Useful Sources of Further Relevant Guidance

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This appendix provides details of some useful sources of additional valuable guidance.

1. HM Treasury Financial Reporting Manual 2009/10.  
[http://www.financial-reporting.gov.uk/IFRS\\_Based\\_FReM.htm](http://www.financial-reporting.gov.uk/IFRS_Based_FReM.htm)
2. NHS Financial Management website  
<http://www.info.doh.gov.uk/doh/finman.nsf>
3. DH: 'Land and Buildings in PFI version 2' (January 2003):  
<http://www.dh.gov.uk/en/Procurementandproposals/Publicprivatepartnership/Privatefinanceinitiative/LandandbuildingsinPFIschemes/index.htm>

***NB this last item has been superseded by this guidance manual, but NHS bodies with existing PFI schemes may find it of assistance in identifying the accounting entries made previously under UK GAAP.***

## Appendix 2: Discounting cashflows – a refresher

Any attempt to determine the accounting entries for an 'on-balance' sheet PFI will very quickly involve having to interrogate a dauntingly complex financial model provided by the operator and will also require some knowledge of how to discount real and nominal cashflows.

Furthermore, this guidance manual makes reference in places to discounting of cashflows and we have therefore included this appendix as a refresher for practitioners on the principles and practices.

First, a couple of definitions:

**Real cashflows** are amounts that are not adjusted for inflation. The 'smoothed' nature of most PFI Unitary Payment streams means that they are constant in real terms over the life of the contract.

**Nominal cashflows** are the real cashflows as adjusted for the effects of inflation. Thus in a PFI scheme where the Unitary Payment is subject to an annual increase for inflation e.g. RPI, the nominal cashflows represent the actual cash which is paid out each year by the NHS body and recorded in its accounts.

### Example:

The PFI Operator's Model includes an annual unitary payment in year 1 of £2,000,000, which is subject to annual increases in line with RPI. The model contains an assumption that RPI will be 2.5% for the life of the scheme. The real and nominal cashflows are as follows:

	<b>Real Cashflow (£)</b>	<b>RPI Increase</b>	<b>Nominal Cashflow (£)</b>
<b>Year 1</b>	2,000,000	--	2,000,000
<b>Year 2</b>	2,000,000	2.5%	2,050,000
<b>Year 3</b>	2,000,000	2.5%	2,101,250
<b>Year 4</b>	2,000,000	2.5%	2,153,781
<b>Year 5</b>	2,000,000	2.5%	2,207,626
<b>Year 6</b>	2,000,000	2.5%	2,262,816
<b>Year 7</b>	2,000,000	2.5%	2,319,387
<b>Year 8</b>	2,000,000	2.5%	2,377,372
<b>Year 9</b>	2,000,000	2.5%	2,436,806
<b>Year 10</b>	2,000,000	2.5%	2,497,726
<b>Total</b>	20,000,000		22,406,764

## Appendix 2: Discounting cashflows – a refresher

### Discounting the cashflows

When discounting the cashflows, it is important to ensure that the correct type of discount rate is used. A Real Discount Rate is one that is unadjusted for inflation whereas a Nominal Discount Rate is the real discount rate adjusted for inflation.

The nominal discount rate is calculated from the real discount rate as follows:

$$1 + \text{Nominal Discount Rate} = (1 + \text{Real Discount Rate}) \times (1 + \text{Inflation Rate})$$

When discounting real cashflows, a real discount rate must be used. Similarly, when discounting nominal cashflows, a nominal discount rate should be used. A consistent discounting rate should be used for both cashflows. When this is the case, the NPV of real and nominal flows will be identical.

Everything else being equal, discounting a set of real cashflows using a real discount rate should yield the same Net Present Value as discounting the corresponding nominal cashflows using the appropriate nominal discount rate. In other words, it should not matter which set of cashflows are used provided that the relevant discount rate is used. However, care should be taken to avoid mixing of real and nominal cash flows in discounted cash flow calculations.

### Example:

Extending the example above, with the following assumptions: The real discount rate is 4.8% and the RPI inflation assumption is 2.5%.

The discount factor for each year is found by the following formula:

$$\frac{1}{(1 + \text{the Discount Rate})^n}$$

Where n is the year in question and the discount rate is expressed as a decimal

e.g. the real discount factor in year 3 =  $\frac{1}{(1.048)^3} = 0.910$

The discount factor is then multiplied by the cashflow for that year to arrive at the present value of that cashflow.

	Real Cashflow (£) A	Formula for Discount Factor	Discount Factor B	Present Value A*B
<b>Year 1</b>	2,000,000	1.00	1.000	2,000,000
<b>Year 2</b>	2,000,000	$1 / (1.048^2)$	0.954	1,908,397
<b>Year 3</b>	2,000,000	$1 / (1.048^3)$	0.910	1,820,989
<b>Year 4</b>	2,000,000	$1 / (1.048^4)$	0.869	1,737,585
<b>Year 5</b>	2,000,000	$1 / (1.048^5)$	0.829	1,658,001
<b>Year 6</b>	2,000,000	$1 / (1.048^6)$	0.791	1,582,062
<b>Year 7</b>	2,000,000	$1 / (1.048^7)$	0.755	1,509,601
<b>Year 8</b>	2,000,000	$1 / (1.048^8)$	0.720	1,440,459
<b>Year 9</b>	2,000,000	$1 / (1.048^9)$	0.687	1,374,484
<b>Year 10</b>	2,000,000	$1 / (1.048^{10})$	0.656	1,311,531
<b>Total</b>	20,000,000		<b>Total NPV</b> =	16,343,111

## Appendix 2: Discounting cashflows – a refresher

### Example (cont.)

The nominal discount rate is calculated using the formula given earlier as:

$$\text{NDR} = (1 + 0.048) * (1 + 0.025) = 1.0742, \text{ or } 7.42\%$$

	Nominal Cashflow (£) A	Formula for Discount Factor	Discount Factor B	Present Value A*B
Year 1	2,000,000	1.00	1.000	2,000,000
Year 2	2,050,000	$1 / (1.0742^2)$	0.931	1,908,397
Year 3	2,101,250	$1 / (1.0742^3)$	0.867	1,820,989
Year 4	2,153,781	$1 / (1.0742^4)$	0.807	1,737,585
Year 5	2,207,626	$1 / (1.0742^5)$	0.751	1,658,001
Year 6	2,262,816	$1 / (1.0742^6)$	0.699	1,582,062
Year 7	2,319,387	$1 / (1.0742^7)$	0.651	1,509,601
Year 8	2,377,372	$1 / (1.0742^8)$	0.606	1,440,459
Year 9	2,436,806	$1 / (1.0742^9)$	0.564	1,374,484
Year 10	2,497,726	$1 / (1.0742^{10})$	0.525	1,311,531
<b>Total</b>	22,406,76		<b>Total NPV</b>	
	4		=	16,343,111

As can be seen, provided that the correct discount rate is employed, the result should be the same regardless of which set of cashflows are used for the calculation.

The above example assumes that the cashflows occur at the beginning of each year and therefore the year 1 amounts are not inflated in the Operator's model nor discounted in the NPV calculation. Where the

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cashflows occur at the end of the period, then the first period's cashflows should be discounted.

Many PFI financial models use semi-annual amounts i.e. every 6 months, rather than annual amounts. When discounting, a semi-annual discount rate must similarly be used which can be approximated as the annual rate divided by two (in the example above the semi-annual real and nominal rates would be 2.4% and 3.71% respectively). However, the true semi annual rate is that which, when compounded, gives the annual rate.

### Using Microsoft Excel to do the calculations

In Microsoft Excel, the NPV function can be used to perform the NPV calculations quickly. The formula is:

$$=\text{NPV}(\text{'Discount Rate'}, \text{'First Period Amount'} : \text{'Last Period Amount'})$$

The Discount Rate can be entered either as a percentage or as a cell reference. The Period amounts are cell references and should form a continuous range of cells i.e. uninterrupted.

The NPV function does not identify whether the amounts and discount rate are real or nominal and hence users need to ensure they are using the appropriate rate themselves based on the cashflows to be used (and may need to calculate the nominal discount rate separately). The NPV function also does not identify how long each period lasts - instead each period for which amounts are entered is assumed to be of the same duration and the rate is that applying for that duration. The NPV function assumes that cashflows occur at the end of the period and therefore the first period's cashflows are discounted. (Microsoft Excel also has a XNPV function that assigns numbers to dates whilst applying an annual rate). This is useful when dealing with irregular periods as well as multiple sign changes in the cashflows.

### Glossary of terms

			equipment.
Contingent rent	Under IAS 17, any amounts payable under a lease that are not certain to be paid as they depend on future events are considered to be contingent rentals. Examples include inflation-linked rentals.	IAS 17	The international accounting standard for Leases.
		IAS 39	The international accounting standard which covers recognition and measurement of financial instruments
	They are excluded from the minimum lease payments determined under the lease.	IASB	International Accounting Standards Board. The body that issue International Financial Reporting Standards.
Finance lease	A lease where substantially all of the risks and rewards of ownership lie with the lessee. The lessor will normally achieve its return on investment solely from the lease payments. For the lessee, a finance lease is accounted for as if it had purchased an asset and taken out a loan to fund the purchase.	I-FReM	HM Treasury's IFRS-based Financial Reporting Manual for central government bodies for 2009/10. The requirements in the 2009/10 NHS Manuals for Accounts are derived from the I-FReM.
Finance rate	In accordance with paragraph 25 of IAS 17, the annual lease rentals are split between finance cost and repayment of principal so as to generate a constant rate of finance over the lease term. This is referred to in this guidance as the 'finance rate'. This will usually be a different rate to the implicit interest rate in the lease.	IFRIC	International Financial Reporting Interpretations Committee. A body that considers specific topics on which consensus is sought and which need to be resolved quickly. It serves a similar function to the ASB's Urgent Issues Task Force in the UK. IFRIC issues Interpretations which form part of IFRS
Grantor	The term used by IFRIC 12 to denote the party procuring the services under a service concession. The grantor is usually a public sector body.	IFRIC 4	An Interpretation that considers contracts which in substance contain a lease.
		IFRIC 12	An Interpretation covering service concessions.
IAS 16	The international accounting standard covering most aspects of accounting for property, plant and	IFRS	International Financial Reporting Standards – they include IASs, IFRS, IFRIC and SIC Interpretations

## Appendix 3: Glossary

Implicit Interest Rate	In a finance lease, the implicit rate is the one that, at the inception of the lease, discounts the minimum lease payments and any unguaranteed residual value in the asset to the fair value of the asset. Where the asset and liability are recognised initially at the present value of the minimum lease payments, this is derived using the implicit interest rate.	Operator's Financial Model	PFI schemes are usually transparent insofar as the operator's cash inflows and outflows and overall return are visible. This information is set out in the operator's financial model which is usually a spreadsheet.  An on-balance sheet treatment for the project requires the NHS body to disaggregate the unitary payment into its key components. The operator's financial model provides much of the information that is needed to do to this disaggregation.
Junior Debt	The smaller element of project finance after senior debt. The junior debt is normally provided by the parent companies that sit behind the operator and represents a tax-efficient form of equity injection to the operator by these companies.	PFI	Private Finance Initiative.
Lifecycle replacement	The replacement of a component of an asset that has reached the end of its useful economic life.	Project finance	This normally refers to the amount of borrowing which the operator has secured to finance the construction of the asset and its initial reserves and working capital. Project Capital usually comprises 'Senior Debt', Junior Debt and Equity contributions.
Minimum lease payments	Under IAS 17, these are the contractual minimum payments that the lessee must make to the lessor. They exclude contingent rents.	Refinancing	The renegotiation by the operator of its project debt in order to lower the overall cost of the project finance. Construction of the PFI asset represents the riskiest phase of the contract, and therefore refinancing may occur after construction has been completed to take advantage of better credit terms that may then be available.
Operating lease	A lease other than a finance lease. The lessor retains significant risks in the asset.	SIC	Standing Interpretations Committee. The predecessor body to IFRIC. Many of its Interpretations are still extant in IFRS.
Operator	The party providing the services to the grantor in a service concession. The operator is normally a private sector company, and is usually established specifically for the project. Parent companies usually sit behind the operator and provide an element of project finance (junior debt and equity). The operator normally subcontracts its contractual obligations to these companies.	Senior Debt	The main element of project finance, typically

between 85% and 95% of the total. Senior Debt is obtained from external financiers – usually banks – and the debt is normally secured e.g. on the PFI asset.

On some occasions, bond finance may be used instead of senior debt.

Statement of Comprehensive Income

The statement of annual performance under IFRS. It comprises income and expenditure amounts e.g. operating income, operating expenses, finance costs, together with other unrealised income and expenses e.g. revaluations gains and losses on property, plant and equipment.

Statement of Financial Position

The IFRS terminology for the Balance Sheet.

Unitary Payment

The payment that the NHS body makes to the operator in each year of the PFI contract.

The payment reflects all amounts due in respect of services, lifecycle replacement and payments for the asset (lease rentals).