# International Handbook on Public–Private Partnerships

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Cheltenham, UK • Northampton, MA, USA

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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010925942

MIX
Paper from
responsible sources
FSC® C018575
FSC
www.fsc.org

ISBN 978 1 84844 356 3 (cased)

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

# 11 Accounting for PPPs in a converging world[1]

*David Heald and George Georgiou*

## Why does PPP accounting matter?

Accounting academics often focus on the tension between setting accounting standards on the basis of 'principles' (high-level statements and aspirations) and 'rules' (prescriptions about how to do it). Principles are difficult to state in unambiguous language, whereas the precision of rules invites sophisticated ploys to circumvent their intention. The best way to grasp the essence of technical debates about PPP accounting is to recognize two key points:

- Mapping economic reality, whether in terms of the financial reporting of entities or the compilation of national accounts, requires the drawing of lines (i.e. distinctions), the location of which may substantially affect reported data.
- There is a gulf between the high-mindedness that officially surrounds the promulgation of accounting standards and the incentives of various actors to game the standards, at both the formulation and implementation stages.

Whereas few people know the detail of financial reporting or national accounts standards, far more understand the notions of seeking the best deal available and of gaming the rules. 'Arbitrage' in financial markets involves taking advantage of price differentials between markets, thus improving market efficiency and liquidity. In contrast, the 2008 global financial crisis has highlighted the effects of non-market forms of arbitrage:

> In the past, authorities around the world have tended to be tolerant of the proliferation of complex legal structures designed to maximise regulatory and tax arbitrage . . . Now we may have to demand clarity of legal structure. (Lord Adair Turner, Chairman of the UK Financial Services Authority, quoted by Giles et al. 2009)

'Venue shopping' is the term established by Mazey and Richardson (2006) in relation to multi-venued and multi-tiered regulation within the

European Union (EU). Those involved take the battle to that venue/jurisdiction (courts, regulatory system) where they have the best chance of winning. Arbitrage, when used in this broader sense, and venue shopping are almost synonyms, with wide applicability. For example, London has the reputation of being the divorce, bankruptcy and libel capital of the world, attracting litigants who have negligible connection with the UK.

PPP accounting is fundamentally important for a number of reasons:

- PPP accounting damages fiscal transparency when the assets that should have a counterpart in public debt are missing from the balance sheets of public sector clients. Various arguments are mounted in defence of such arrangements, ranging from denial that any public liability has been created to claims to be 'doing good by stealth' by securing assets for public service provision that would have been denied by 'irrational constraints'. Arguments about 'doing good by stealth', though tempting to those down the power chain, should always be regarded with suspicion as such devices erode accountability mechanisms.
- PPP accounting may generate hidden fiscal risks, as when the extent of government indebtedness is concealed. This would happen under cash accounting, as it would under accruals accounting whenever PPPs are artificially kept off the government's balance sheet. The IMF has frequently expressed concern about the fiscal risks associated with PPPs, particularly in relation to Eastern Europe and developing countries (Akitoby et al., 2007; Schwartz et al., 2008).
- PPP accounting can lead to distorted decision-making on public investment, at large resource cost, when the underlying criterion for project acceptance is balance-sheet treatment, not an assessment of best value for money (VfM). Not only might the project appraisal be manipulated, but also the project might be inefficiently designed so that a particular accounting treatment can be secured. Moreover, the widespread view that the accounting is manipulated will damage the credibility even of *bona fide* assessments of PPP versus the public sector comparator (PSC).[2]

Outside the scope of this chapter is whether PPPs offer better VfM than conventional procurement, a quite separate question from that of accounting treatment (Heald, 2003). These two issues are often run together, sometimes intentionally. It is important to emphasize that one can be critical of PPP accounting practice, yet be positive, neutral or negative on the VfM question.

The structure of this chapter is as follows. The second section notes that the term 'public–private partnerships' may be attached in different contexts and countries to substantively different economic relationships. The scope of this discussion is therefore specified. The third section considers the regulation of PPP accounting, both for purposes of financial reporting and for national accounts. It establishes that there has been inadequate enforcement of standards, in large part because of the availability of arbitrage opportunities. These have allowed the exercise of choice between accounting standards/guidance on the basis of which yielded the desired accounting treatment. This parallels venue shopping between the courts of different jurisdictions.

The fourth section discusses 'risks and rewards' as the criterion for determining the balance-sheet treatment, both for financial reporting and for national accounts. The accounting principles developed for lease accounting have been applied for financial reporting and for national accounts, though leading to markedly different treatments. Then the fifth section examines the adoption of the 'control' approach to PPP accounting, which has been propelled by the globalization of private sector financial reporting, with public sector financial reporting following. Although there is substantial convergence in financial reporting, both between public and private sectors and across countries, this introduces greater distance from national accounts, which will remain on the risks and rewards criterion. This creates new arbitrage opportunities, this time between financial reporting treatment and national accounts treatment; the latter is used for fiscal surveillance and for assessing country compliance with international obligations, such as those of EU countries under the Stability and Growth Pact.

Whereas the fourth and fifth sections focus on balance-sheet treatments, the sixth section examines the charges to the income statement in cases of both on- and off-balance-sheet treatment. Finally, the last section draws conclusions on PPP accounting, relevant to the concerns of public policy academics and PPP practitioners.

**Service concession arrangements**

Definitional matters are extremely important for two reasons. First, the terminology in which public policy initiatives are described can influence their reception. The emphasis can be placed on the 'public' (delivering public services), or on the 'private' (emphasizing the role of the private sector in public services which would not (yet) be privatized). 'Partnership' is an imprecise term, which in part accounts for its popularity. Second, the contracts that attract the label of PPP cover a wide range of commercial relationships. These include full privatization (i.e. complete transfer of the entity to the private sector), joint ventures and conventional subcontracting. Such arrangements are outside the scope of this chapter, which focuses on commercial arrangements involving fixed assets used by the private sector in the supply of public services.

Although a wide range of specific arrangements can be devised, the principal arrangements can be illustrated by examples:

1. A government entity leases a photocopier from a specialist supplier.
2. A government entity leases its headquarters building from a property company.

3a. A government entity grants a service concession to a private sector operator to design, build and operate a prison and, at the end of the concession period, transfer the prison to the government entity.

3b. As in 3a, except that, at the end of the concession period, the prison remains the property of the operator.

4a. A government grants a service concession to a private sector operator to design, build and operate a bridge over a major river crossing, with all costs being covered by user tolls, and, at the end of the concession period, the bridge reverts to the government.

4b. As in 4a, except that, at the end of the concession period, the bridge remains the property of the concessionee.

These illustrative cases highlight the key characteristics relevant to accounting treatment:

(a) Is the commercial arrangement necessarily between a public sector client and a private sector operator?

(b) Does it necessarily involve the provision of 'infrastructure' or of a 'public service'?

(c) Does it necessarily involve the supply of services to the public or can it involve intermediate outputs (e.g. administrative offices or computing systems) that are part of the production process of public services?

(d) Are other services (e.g. facilities management) bundled with the supply of the services from the fixed assets?

(e) Do the costs of provision fall on the public budget or are these met by the operator having the conditional right to charge service users?

(f) Do the fixed assets revert to the public sector client at the end of the concession period and, if so, does this occur at a zero or positive price?

An important question is whether the PPP is a service concession or a lease, although there is not necessarily a clear dividing line. Bundling of other services, the supply of infrastructure or public services, and a contract life considerably shorter than the asset life, often indicate that this may be a service concession rather than a lease.

**Regulation and enforcement of PPP accounting**

The problems that have arisen with PPP accounting are not essentially technical ones, but relate to (a) contested regulatory space, and (b) weak enforcement of relevant standards. Nevertheless, some of the detail is intricate and what follows is condensed as far as is practicable.[3] The objective in this section is to provide an accessible overview, before considering the more technical material in the fourth to sixth sections.

*Two systems of accounting*

There are two parallel systems of accounting that must accommodate PPP schemes: financial reporting and national accounting. The former is largely the preserve of accountants belonging to recognized accountancy institutes. The latter is the preserve of a different epistemic community, that of economic statisticians who mostly work in national statistical institutes or in international/supranational agencies such as Eurostat, the IMF and the OECD. There is limited career overlap between these two communities.

*Government financial reporting* Government financial reporting has traditionally been done on a cash basis, with detailed rules and procedures usually being the responsibility of finance ministries. Under cash accounting, government entities have no balance sheet, so that aspect of PPP treatment is irrelevant. The governance of financial reporting is likely to change when governments move from cash accounting to accruals, a conversion that may take many years to cover the whole of the public sector. Essentially, there are two options. The government could sign up to private sector standards, thereby giving leadership to the private sector accounting regulator. This has been the approach in Australia and New Zealand, where there has been strong commitment to sector-neutral accounting. The UK left primary responsibility with the Treasury, although the Financial Reporting Advisory Board (FRAB) has had an influential role and has been philosophically committed to minimizing adaptations from UK GAAP (Generally Accepted Accounting Practice) (2001–02 to 2008–09) and from IFRS (International Financial Reporting Standards) (2009–10 onwards). In contrast, the Government Accounting Standards Board (GASB) was established in 1984, with a remit restricted to US state and local governments. This has reinforced the separation of private sector accounting (Financial Accounting Standards Board

(FASB)) and public sector accounting (Federal Accounting Standards Advisory Board (FASAB) and GASB) in the USA.

The Accounting Standards Board (ASB), the UK private sector accounting regulator, and the Treasury clashed on how PPP schemes should be accounted for under UK GAAP (Broadbent and Laughlin, 2002; Hodges and Mellett, 2002). Heald and Georgiou (2009) demonstrated that there were huge variations across functional areas of UK government as to whether PPPs were on or off balance sheet under UK GAAP. They attributed this not to objective differences between PPPs but to the expenditure control and audit arrangements. Whereas the National Audit Office (the UK's supreme audit institution which audits central government) was insistent on implementation of ASB's (1998) FRS 5A, the appointed auditors of the Audit Commission (both direct employees and private subcontractors) were willing to accept recourse to Treasury Technical Note 1 (Revised) (TTN1R) (Treasury Taskforce, 1999a). This was supposedly an interpretation of FRS 5A but in practice acquired the influence of a competitor standard.

The exposition so far emphasizes the national jurisdiction. However, private sector accounting regulation has shifted dramatically to the global arena, with there now being only two first-tier regulators: the International Accounting Standards Board (IASB) and FASB. In principle there will be convergence on uniform global standards for the private sector, but that is a path strewn with difficulties outside the scope of this chapter. What is striking in terms of public sector accounting is the emerging influence of the International Public Sector Accounting Standards Board (IPSASB). Whereas at national level it is possible to conceptualize accounting regulation as a task delegated by the state to a private body, there is no world government to legitimize delegation at the global level.

The IPSASB was formerly the Public Sector Committee of the International Federation of Accountants, itself the international association of professional accountancy institutes that have increasingly been sidelined from accounting regulation in their own jurisdictions. The IPSASB has sought to derive legitimacy not only from due process in standards development but also from its engagement with the IMF and the World Bank. Its emergence creates potential difficulties for those countries that self-consciously see their own public sector accounting as being aligned to best private sector practice (now IFRS). Such countries may be uncomfortable with the intrusion of a separate standard-setter, which might develop standards diverging from best private sector practice, or whose adoption of IASB-derived standards lags adoption by the private sector. Moreover, government finances are always close to politics, and finance ministries may be reluctant to relinquish power to standard-setters of uncertain capacity, legitimacy and authority.

*National accounts* In terms of national accounts, the key issue is whether there is a calculation of imputed debt when PPPs are used rather than conventional procurement. In this way, published deficit and debt figures are affected by how the national accounting is done. The key source is the System of National Accounts (SNA) 93 (United Nations Statistical Division, 1993), which is interpreted for EU countries by the European System of Accounts (ESA) 95 (Eurostat, 1995).[4]

ESA 95 adopts the risks and rewards approach towards determining the national accounts treatment of both leases and PPPs. Further guidance on PPPs was provided in Eurostat (2004). A sequence of events analogous to what happened to UK government financial reporting can be observed. Eurostat (2004) purported to be an interpretation of ESA 95, but substantively changed it. For an asset to be off the balance sheet of the public sector client, the following two conditions must be met:

1. Construction risk has to be transferred to the private sector operator.
2. *Either* availability risk (covering volume and quality of output) *or* demand risk has to be transferred to the private sector operator.

Most UK PPPs aim to transfer construction risk. Moreover, availability risk (e.g. the hospital facilities are not fully operational on a particular date) can generally be assumed to be lower than demand risk (i.e. demand for the facilities is lower than available capacity). Accordingly, the Eurostat criterion simplifies to the transfer of both construction risk and availability risk. There is insufficient evidence in the public domain to determine whether this weak test was knowingly designed to allow off-balance-sheet treatment or was an unintentional outcome.

On this basis, it can be argued that most UK PPPs should not be on the public sector balance sheet for national accounts purposes. However, this immediately raises the issue that, unlike financial reporting where the accounts of the client and operator have no formal connection, the accounts of sectors in the national accounts must articulate. In the financial statements of the operator, whether prepared under UK GAAP (contract debtor accounting) or under IFRS (IFRIC 12) (Austin, 2009), the PPP will not be on the balance sheet as property, plant and equipment. Moreover, the Office for National Statistics (ONS) is unlikely to have the information necessary to make appropriate adjustments to the account of the non-financial corporations sector to offset any exclusion of PPP assets from the account of general government.[5] For the foreseeable future – and cycles of national accounts revisions are long – the national accounts test will remain one of risks and rewards.

*Lack of enforcement mechanisms*
Setting standards does not mean that they are applied. A fundamental element of effective accounting regulation is enforcement. There is no point in having pristine standards if there is no implementation or enforcement capacity. In some developing countries the problem might well be a lack of accounting capacity, but elsewhere it is a regulatory issue.

The problem in the UK has been the lack of enforcement mechanisms with regard to financial reporting. Over the period 2001–02 to 2007–08, during which FRS 5A and TTN1R both existed, there was regulatory arbitrage, using the weak standard (TTN1R) to undermine the strong standard (FRS 5A).[6] The arbitrage opportunity was to follow TTN1R rather than FRS 5A, thereby securing off-balance-sheet treatment in a context where public expenditure controls would have prevented an on-balance-sheet project. Provided that the relevant auditors did not qualify the accounts of public sector bodies on the grounds of PPP accounting, there was no enforcement mechanism. There was nowhere to complain about 'orphan' (off–off) assets. Whatever the original circumstances that created this arbitrage opportunity, the Treasury could – if it had so wished – have closed it down by withdrawing TTN1R. In contrast, with regard to UK private sector accounts, the Financial Reporting Review Panel has the right to call in company accounts, irrespective of the audit opinion, if it considers that there has been a breach of accounting standards. An order to rectify can be made where deemed appropriate.

Enforcement with regard to national accounts takes place within a different institutional context. Savage's (2005) analysis of the role of Eurostat in the run-up to the launch of the euro depicted the highly political context within which it operates. Given the laxness of Eurostat (2004), vigorous enforcement would, in the case of the UK, paradoxically lead to ONS putting fewer assets and associated debt on the UK government balance sheet.

**Risks and rewards as the criterion for PPP accounting**
Risks and rewards is the criterion governing the treatment of leases, both for financial reporting and national accounts. Standard-setters require capitalization as an asset by the entity that bears substantially all of the risks and rewards associated with ownership, as captured by the estimated variability in profits attributable to that asset. The risks and rewards approach was extended to service concessions in the 1990s.

This analysis proceeds on the assumption that the context is accruals accounting in relevant government entities. Whether a lease or a service concession, the central accounting issue is whether the cost to the government of a PPP arrangement should be treated on an annual basis as a government outgoing (as it definitely would be under cash accounting), or whether the long-term nature of this relationship with the private sector requires accounting recognition because government assets and liabilities have been created. These issues are important because commercial arrangements of this type can substitute for traditional procurement of photocopiers, headquarters buildings, prisons and toll bridges. In terms of the rationale of accounting treatment, whether the commercial arrangement is a lease or a service concession must be determined. However, the substantive accounting treatment will not necessarily differ.[7]

Lease accounting has been a highly unsatisfactory part of national GAAPs. The UK standard SSAP 21 (ASC, 1984) and IFRS's IAS 17 (IASB, 2003b) both provide for a distinction between an operating lease (the photocopier payments should be expensed annually as payment is made) and a finance lease (the office building should be capitalized as a fixed asset, subject to meeting certain tests regarding the allocation of risks and rewards, with an offsetting liability on the balance sheet). The UK standard, but not IAS 17, contains quantitative tests, which have long been known to be manipulated to justify treatment as an operating lease.[8] The IASB aims to develop a new leasing standard and to remove the operating lease option (IASB, 2010).

Given that the efficiency drivers behind PPPs are widely believed to be located in the transfer of risk from the public sector client to the private sector operator, there is logic in aligning the accounting treatment with the efficiency-enhancing mechanism. The economic case developed to justify PPPs emphasized the decomposition of total project risks, on the basis that the PPP should not transfer all risks to the operator but assign risks to the party best able to manage that risk. Managing risk should be understood to mean (a) reducing the absolute amount of risk, and (b) reducing the cost of bearing unavoidable risk.

In analyses of which party bears the majority of the risks and rewards of ownership from service concessions, the following decomposition of risk has often been used: construction risk, demand risk, third-party revenue risk, design risk, penalties for underperformance, penalties for non-availability, potential changes in relevant costs, obsolescence risk, and residual value risk. The intellectual and business climate of the late 1990s played a role, in conferring confidence in the benefits of financial innovation in general and in its specific application to the management of risk in PPPs.

The ASB's FRS 5A regarded the retention of demand risk (e.g. pupil numbers) and residual value risk (e.g. valuation of the school at the end of the concession period) by the public sector client as generally decisive. The Treasury's TTN1R was worded in such a way that it allowed for a

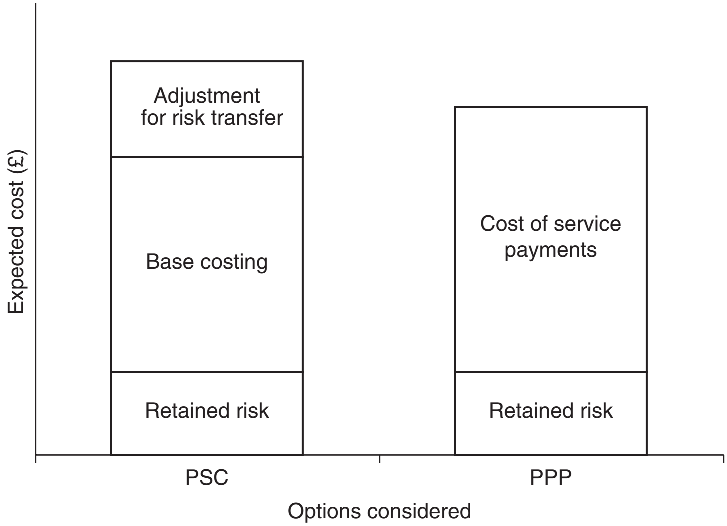



*Figure 11.1 Bid evaluation and cost components*

wider spectrum of risks to be brought into the assessment. This expansion made it easier to show that the majority of the risks and rewards were transferred to the private sector, and thus to justify off-balance-sheet treatment. Moreover, the PwC (PricewaterhouseCoopers) Method Statement (Treasury Taskforce, 1999b), supposedly an explanation of how to use TTN1R, encouraged quantification, including the use of Monte Carlo simulation methods (Heald, 2003). Quantification has the air of being more objective, although Power (2004) has highlighted the dangers inherent in the urge to quantify the unquantifiable. In the context of a physical asset with a life of perhaps 60 years, held in concession for 30 years, putting large weight on quantified analysis may generate too much confidence in the risk analysis.[9] It also enlarges the scope for consciously or subconsciously manipulating the quantitative analysis to support the desired decision.

Figure 11.1 illustrates how the quantified amount of risk assessed as transferred to the private sector operator will be decisive in terms of whether the project appraisal shows the PPP or the PSC as offering the best VfM. Irrespective of which is chosen, the cost of the risk retained by the public sector client is the same. The base costing of the PSC is shown as less than the PPP's service payments. However, the PPP transfers risks from the public sector client to the operator, and so the valuation placed on these risks is added to the PSC costing as the adjustment for risk transfer. In Figure 11.1, the PPP is shown as considerably cheaper than the PSC. There has been adverse comment with regard to UK PPPs that this adjustment for risk transfer has in many appraisals just been sufficient to make the PPP marginally better VfM than the hypothetical PSC for which public funding is not available.

**Control as the criterion for PPP accounting**

For those countries with a commitment to link public sector accounting directly to best private sector practice, the rapid adoption of IFRS by the non-US world had clear implications. Sooner or later there would have to be a change of anchor from national GAAP to IFRS.

Private sector accounting standard-setters attach little priority to the reporting needs of the public sector. One example is how the Joint FASB/IASB Conceptual Framework project relegated consideration of the government and not-for-profit sector until the end of its programme of work. IFRS does not contain a standard on accounting for PPPs. Rather than develop such a standard, IASB referred the topic of operator accounting alone to the International Financial Reporting Interpretations Committee (IFRIC), its own interpretations committee. The result was IFRIC 12 (IASB, 2006), dealing with a more substantive matter than would normally be left to an interpretation. Possible explanations for this route were the workload pressures confronting IASB, the expectation that the IFRIC route would be quicker, and concerns that a standard that addressed only operator accounting would be subjected to criticism.

Control is the criterion adopted in IFRIC 12 for dealing with the private sector operator side of service concessions. This substitution for risks and rewards is, in part, a consequence of how widespread abuse of lease accounting in the private sector (i.e. disguising finance leases as operating leases, and thereby avoiding capitalization) has persuaded IASB to move away from risks and rewards to control in the protracted process of developing a new leasing standard.

The control tests in IFRIC 12 will normally show that the private sector operator does not control the 'infrastructure' subjected to the service concession. Accordingly, the private sector operator will not account for the PPP as property, plant and equipment, but as either an intangible asset or as a financial asset.[10] Given that public policy interest in PPP accounting largely focuses on accounting by the public sector client, this exposition will concentrate on what has become known as the 'mirror-image of IFRIC 12' rather than on IFRIC 12 itself.

The mirror-image of IFRIC 12 fills the gap in IFRS regarding public sector client accounting. Using the argument that, if an IFRIC 12 analysis determines that the PPP should not be on the operator's balance sheet as property, plant and equipment, then symmetry requires that the public sector client should record the PPP assets as property, plant and equipment. This stretching of IFRIC 12 has been accompanied by an elastic definition of what constitutes 'infrastructure', designed to make PPPs fall within the scope of IFRIC 12.

There have been uncertainties about what IPSASB will require, so the exposition will start with the UK requirements that are operational from 2009–10 (Treasury, 2008). Then attention will turn to developments at IPSASB, which are proceeding along a similar path, albeit slowly and with some differences. Subsequently, there will be a brief examination of developments in other jurisdictions.

*Mirror-image of IFRIC 12 – the UK version*

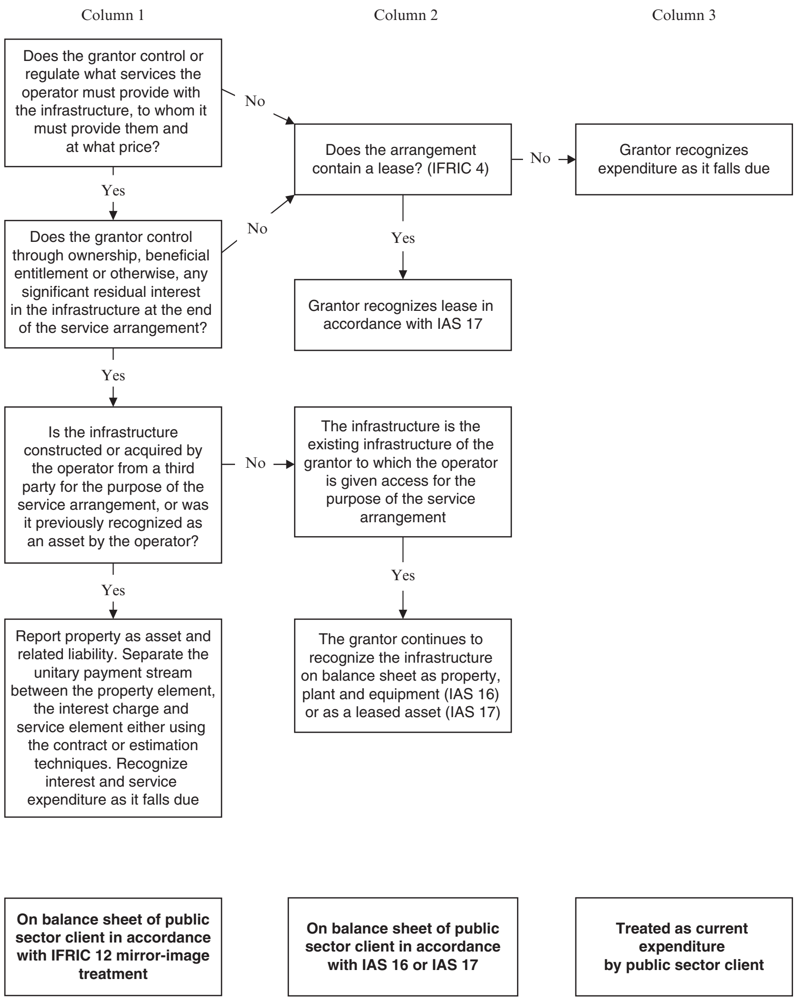
Figure 11.2 is a more pedagogic version of the flowchart developed by the UK Treasury to explain PPP accounting by UK departments and other public bodies that are subject to the IFRS version of its *Financial Reporting Manual* (Treasury, 2009c). It shows what should be put on the public sector client's balance sheet and what should be charged to its income statement, whether that is called an operating cost statement, an income and expenditure account or a profit and loss account. In the context of service concessions, the client is customarily called the 'grantor'.

The top two boxes of Column 1 contain the two principal questions that have to be answered:

(a) Does the grantor control or regulate what services the operator must provide with the infrastructure, to whom it must provide them, and at what price?
(b) Does the grantor control through ownership, beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the service arrangement?

If both these complex questions are answered in the affirmative, then this is a service concession within the scope of IFRIC 12.[11] The property will be reported by the grantor as an asset and related liability (IAS 16).

The dual test therefore depends on control of use and pricing and on control of significant residual interest. In (a), the verb 'control' is supplemented by the verb 'regulate', the implications of which will be discussed in the subsection on IPSASB. In (b), the adjective 'significant' qualifies the role that residual interest will play in the determination of accounting treatment. If residual interest is not significant, accounting treatment would depend on (a) alone.[12] The control approach uses the term 'residual interest' (e.g. who determines what happens to the asset at the end of the concession period), whereas the displaced risks and rewards approach considered 'residual value' (one of the categories of risks to be considered




*Source:* Adapted from Treasury (2008).

*Figure 11.2 UK Treasury flowchart for public sector PPP client under IFRIC 12*

when assessing which party enjoys the majority of risks and rewards of ownership).

Column 2 deals with those cases where the grantor does not control pricing or a significant residual interest (where such exists). This PPP is not a service concession. Using IFRIC 4, the arrangement must be tested to determine whether it contains a lease. If so, the asset will be accounted for in accordance with IASB's (2003b) leasing standard IAS 17. If the asset is the existing infrastructure of the grantor, to which the operator is given access for the purpose of the service arrangement, then it will continue to be recognized on the balance sheet of the grantor. Depending on the facts, this capitalization would either be as property, plant and equipment under IAS 16 or as leased assets under IAS 17. Therefore Column 2 can lead, albeit along a different channel of accounting logic, to a comparable treatment to Column 1.

Column 3 completes the analysis of Figure 11.2. If a PPP is not a service concession and moreover does not contain a lease, then the grantor recognizes the unitary payment as it falls due.[13] Therefore this will be treated as current public expenditure. The widely held belief in the UK is that IFRS will bring almost all PPPs on to the balance sheet of the public sector client, whether as a service concession or as a lease. In other words, Columns 1 and 2 will dominate and Column 3 will be rarely found in practice.

*Mirror-image of IFRIC 12 – the IPSASB version*

The IPSASB is moving along broadly the same track as the UK Treasury in terms of adopting the mirror-image of IFRIC 12 as the basis of public sector client accounting under IFRS. The February 2010 (IPSASB, 2010) Exposure Draft incorporates modifications to the March 2008 Consultation Paper (IPSASB, 2008), aligning its proposals more closely with IFRIC 12 and the UK Treasury's mirror-image, but not with GASB. Notwithstanding these changes of position, it is useful to examine key issues raised by the March 2008 Consultation Paper.

Given that there is an overlap of personnel closely involved in these matters, combined with the substantive considerations discussed above, alignment is unsurprising. However, the timetables have been substantially different, with the UK going live on IFRS-based PPP accounting in 2009–10 and IPSASB's February 2010 Exposure Draft scheduled to be followed at a later date by an IPSAS standard on service concessions.[14] Clearly the operating environment of IPSASB as a global accounting standard-setter is different from that facing the UK Treasury, in particular as FRAB was strongly supportive and opposition from some spending departments could therefore be brushed aside. It is difficult for those outside the IPSASB process, and that includes the present authors, to differentiate the effects of due process considerations, genuine technical difficulties and delaying tactics.

First, IPSASB's (2008) Consultation Paper on service concessions included flowcharts broadly consistent with Figure 11.2. The difference that attracted much criticism in the consultation responses was the dropping of 'significant' from 'significant residual interest' (the IFRIC 12 wording) in the second half of the dual test. If a residual interest controlled by the grantor exists but is not significant, then a PPP could be determined not to be a service concession on the basis of an irrelevant consideration.

Generally, the length of a concession is substantially less than the forecast economic life of an asset; figures such as 30 years and 60 years, respectively, are often used. Given the pace of change of modes of public service delivery, it is possible that the economic life of a facility (e.g. hospital, school or prison) might turn out to be substantially less than its physical life. Although this brings uncertainty as to residual value (risks and rewards), it does not directly affect control of residual interest. A possible loophole (i.e. structure the contract so that residual interest is not significant) has been closed by the Exposure Draft returning to the IFRIC 12 wording. Given the history of manipulation of PPP accounting under risks and rewards, allowing control of residual interest that is not significant to determine accounting treatment might have become a vulnerability of the control-based standard. A PPP judged, for this reason, not to be a service concession might then fail the leasing test – given the acknowledged weaknesses of the risks and rewards-based IAS 17 – and therefore be off the balance sheet of the public sector client.

Second, there are interconnected questions about the scope of service concessions:

(a) Is a service concession necessarily public-to-private, thereby requiring specification of which entities are public?
(b) Which economic activities are included within the definition of 'infrastructure' and 'public services', and does the definition of a service concession extend beyond tolled and untolled services to the public to include activities which support front-line service delivery?
(c) In the first part of the dual test, does 'regulate' function as a synonym for control or does it extend the coverage of the mirror-image of IFRIC 12?

Many of the practical difficulties arise because of the patchwork nature of accounting standard-setting for service concessions. If IASB had developed a standard for service concessions, it would have been less likely that only operator accounting would have been addressed. If IFRIC had simultaneously addressed both client and operator accounting, it seems likely that this would have been developed on a sector-neutral basis.

Logically there is no reason why service concessions are necessarily public-to-private.[15] If either path had been followed, then questions (a) and (b) would have been answered. The traditional notion of infrastructure, in relation to the physical networks that underpin the functioning of an economy, would not have been stretched to include almost any asset – office blocks and tanks included – that contributes to the production of a public service. Given the exclusively private sector priorities of IASB, those responsible for public sector accounting standard-setting have to respond in messy ways, working on the basis that service concessions are necessarily public-to-private and having to stretch the concept of infrastructure beyond its credible limits.

Third, in relation to question (c), does the insertion of 'regulate' extend 'control' and therefore the coverage of a standard based on the mirror-image of IFRIC 12? 'Control' is a concept that has caused great difficulties for private sector accounting standard-setters, both in terms of defining it and devising criteria for establishing its existence.[16] These difficulties are greatly magnified in the public sector, in which context 'control' has many ambiguities. Given the ultimate authority of government, with its monopoly of legitimate violence, almost no activity or entity within its jurisdiction is outside the potential scope of government action.

'Control' is straightforwardly present in core government, but more subtle in public entities that have been deliberately distanced from core government (e.g. various forms of agency) or are subject to their own forms of democratic legitimacy (e.g. state and local governments). If accounting depends on the application of specified control indicators, other mechanisms can be substituted. There is a vast political science literature on the complexities and ambiguities of control in the public sector, of which a seminal collection is Kaufmann et al. (1986). Around the edges of the public sector, there are many bodies with private sector status, regarding which there can be disputes about whether control according to IAS 27 (IASB, 2003c) does exist.

If 'control' is a difficult term to operationalize, then the introduction of 'regulate' greatly increases those difficulties. With its remit restricted to the operator side, IFRIC did not follow through the implications for the public sector client of the 'control or regulate' wording. This poses less of a problem in the context of national regulation of government accounting, in which context there are shared understandings of institutional arrangements, than it does for IPSASB. 'Regulate' introduces ambiguity, not least because governments regulate almost everything, not just 'inside government' (Hood et al., 1998), but they also regulate the private sector in ways that go beyond the general regulation of the market economy. For example, through various mechanisms governments across the world have long intervened in the pricing policies of public utilities, whatever their ownership status. In the Exposure Draft, IPSASB (2010, para. AG 8) narrows the meaning of 'regulate' by stipulating that this refers specifically to regulation by contract and not by statute. Nevertheless, this seems likely to be an area of future problems, not least because this narrowing is not in IFRIC 12, as applied by the operator.

*The GASB's proposed control-based standard*

The GASB has responsibility for US state and local government, but not federal, accounting standards. It published an Exposure Draft on PPP accounting in June 2009 (GASB, 2009) which was revised in June 2010 (GASB, 2010). Although based on control, this differed from IPSASB in certain important ways. First, it explicitly covers public-to-public as well as public-to-private arrangements, considering the public 'transferor' (in US terminology) and the public operator. This extension reflects the institutional reality of US state and local governments; inter-jurisdictional collaboration is extensive and there is not the assumption that the operator will be private. The fact that private-to-private arrangements receive no mention is attributable to GASB's remit for state and local governments. Neither FASB, whose responsibilities cover private operator accounting, nor the Federal Accounting Standards Advisory Board, responsible for US federal government accounting, have pronounced on service concessions.

Second, GASB's (2010, para. 4) conception of a service concession arrangement is narrower than that of IPSASB, relating only to arrangements in which the operator is remunerated by third-party payers (e.g. toll bridges or roads). Much of what would be regarded internationally as service concession PPPs is therefore excluded: for example, prisons, untolled roads and schools. The GASB labels PPPs without user charges as 'service and management arrangements' and believes that existing guidance – presumably a reference to leasing standards – is sufficient.

Third, GASB is explicit that, for a PPP to be a service concession arrangement and therefore within the scope of the proposed standard, the transferor must retain a significant residual interest in the asset. In the absence of significant residual interest, GASB (2009) regards the arrangement as a 'privatization, potentially with regulatory oversight'. Moreover, GASB's explanation of paragraph 4(c) of the Exposure Draft states that 'Assessment of whether the residual value is significant should be made based on the service utility of the facility at the end of the arrangement rather than on a fair value notion' (2010, para. 39). This formulation blurs the distinction between residual interest and residual value, seemingly using them interchangeably. Moreover, the rejection of fair value and insistence on service utility seems to make it more likely that a significant residual interest will be identified.

Fourth, the accounting treatment of up-front payments from the operator to the transferor figures prominently in the GASB Exposure Draft.

The GASB (2009, para. 10) originally proposed that the transferor should report the up-front payment or present value of instalment payments as a liability. The revised proposal treats these as a 'deferred inflow of resources' (GASB, 2010, para. 48), to be recognized as revenue in a systematic and rational manner over the term of the arrangement.

*Developments in other jurisdictions*
It is impossible within the space constraints to be comprehensive, but interesting points of comparison can be drawn with developments in Australia, South Africa and France.

Australia, like New Zealand, pioneered the application of accruals accounting in government. Unlike New Zealand, where PPPs have not been promoted because they were not regarded as good VfM, Australia has made extensive use of PPPs. These are mostly at the state government level, particularly in New South Wales and Victoria: tolled 'hard' infrastructure, such as roads and tunnels, are prominent. The Australian Accounting Standards Board (AASB) is a government body that sets standards for both private and public sectors, on the basis of sector neutrality. On public sector accounting issues, the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) plays a coordinating role, although formal responsibility and authority rests with the individual treasuries and accounts are audited by the respective auditors general. For example, the New South Wales Treasury (2006) published its version of HoTARAC guidance in June 2006. In the absence of AASB standards to cover all aspects of PPPs, this required compliance with the UK standard FRS 5A. It also provided guidance on topics not explicitly covered by FRS 5A, namely up-front contributions, the residual interest in the infrastructure, and associated leases of land.

Three points are worthy of note. The first is that the application of FRS 5A appears to have produced different results in Australia from those in the UK, though some of this may be attributable to the importance of tolled infrastructure in Australian PPPs. Because the majority of risks and rewards are assessed to fall on the operator, these schemes are generally not on the public sector balance sheet, which does, however, account for an 'emerging asset' (see next section). Second, the AASB has made IFRIC 12 optional for grantors, and the New South Wales Treasury has decided not to adopt ahead of a standard being published by IPSASB. Moreover, HoTARAC's (2008) response to the IPSASB consultation expressed a strong preference for continuing with risks and rewards. In contrast, writing about a prison PPP in Victoria, English and Walker (2004, p. 62) concluded that the 'experience suggests that it is inappropriate to choose accounting treatments on the basis of *ex ante* assessments of risk transfer and risk sharing'. Their criticism is directed at both FRS 5A and its Australian application, on the grounds of being too subjective and of risk profiles changing through the phases of a PPP. Third, it seems likely that Australia will adopt an IPSASB control-based standard when it comes into force, with the effect of bringing on balance sheet at least some of those tolled infrastructure PPPs that are currently off.

South Africa offers a contrast to Australia. In November 2008, the Accounting Standards Board of South Africa issued its guideline on PPP accounting: 'guidelines explain and expand on the principles in the Standards of [Generally Recognized Accounting Practice]. Guidelines do not, however, replace any of these principles' (ASBSA, 2008, p. 5), on the basis that PPPs are sufficiently covered by existing standards. Under the terms of the Public Finance Management Act 1999, these guidelines applied the mirror-image of IFRIC 12 to public sector clients. This move from risks and rewards under leasing standards has brought tolled concession roads on to the balance sheet of the National Roads Agency.

Another indication of the trend to international convergence is the use of IFRIC 12 in France, as required by EU-approved IFRS for listed companies that are concessionees. France has a long history of service concessions, in some cases public–public (as in the case of electricity before the partial privatization of Electricité de France) and in some cases public–private (as in the case of municipalities and privately owned water companies) (Heald, 1995). The development of concession accounting by the Concessions Commission of the Conseil National de la Compatabilité stalled in the mid-1990s, but the move of government accounting to accruals will highlight grantor accounting issues when the operator is using IFRIC 12.

**The charge to the income statement**

Earlier in the discussion, two key results of accounting treatment decisions were identified: treatment of the PPP in the public sector client's balance sheet (with implications for what is scored as borrowing and debt), and the amount and timing of the charge that goes through the public sector client's income statement (with implications for the time profile of the budget deficit). If the PPP is not a service concession and does not contain a lease, then the full amount of the unitary charge goes through the income statement in the year when that expenditure falls due.

Several complications arise when there is a service concession or a lease, although the discussion here will concentrate on the former. First, irrespective of whether the approach is risks and rewards or control, the unitary charge implicitly consists of (a) the property element, (b) the interest charge, and (c) service expenditure. An early issue in PPP accounting was the separability, or unbundling, of expenditure on non-property-related services that had been packaged into the PPP contract. The motivations for bundling included making the PPP contract more inviting to potential private sector bidders and making it easier to claim that there had been sufficient risk transfer to justify off-balance-sheet treatment for the property assets. Even when non-property services have been unbundled and accounted for separately on relevant standards, there will be property-related services falling in category (c).

Second, the public sector client does not necessarily know the actual capital cost of the property, as the 'special purpose vehicle' (SPV) may refuse to provide this information. Also, the construction member of the consortium may have incurred more or less cost than the price charged to the SPV. Accordingly, there may be estimation involved in the balance-sheet capital value and in the annual depreciation charge to the income statement.

Third, the decomposition of the unitary charge by the public sector client involves complications that can substantially affect the reported numbers. The interest rate to use in the computations is the rate implicit in the PPP contract, or as close to that as possible, because that represents the actual financing charge being paid out by the grantor. If the grantor does not know this rate, the estimated rate chosen should be as close as possible to the unknown implicit rate; otherwise, the financing costs that are disclosed would depart substantially from the unknown actual financing cost. If other rates, such as the grantor's cost of capital, are used, the reported decomposition of the unitary charge will be distorted. Moreover, the partitioning of the unitary charge is also sensitive to the indexation provisions in the contract, as these apply to the entire unitary charge, even though the construction costs have already been incurred and the financing costs will have been locked in at the beginning of the concession.

Fourth, part of the unitary charge is implicitly paying for the unexpired life of property, plant and equipment handed over, often without payment, to the public sector client at the end of the concession period. When the asset is off balance sheet to the client, the unitary charge should be abated in recognition of the building up of the reversionary interest ('emerging asset') as the life of the concession progresses. This involves estimating the residual value of the asset at the reversion date, and then building up this asset according to a predetermined time profile, while also testing for impairment.

**Conclusion**

This section concentrates on key issues that are important to academic and policy communities interested in PPPs. First, there is a quickening and irreversible shift in accounting regulation from the national to the global sphere. This brings issues of capacity, legitimacy and authority that are particularly difficult with regard to public sector accounting. There will be intensified competition for command of the regulatory space in which accounting standards are established and enforced. Unlike private sector accounting, where the tensions at the top tier are between the USA (FASB) and the rest of the world (IASB), the tensions in public sector accounting may be between IPSASB and national regulatory arrangements in some countries, and – more fundamentally – between financial reporting and national accounts. There will also be conflict between governments and accounting regulators because public finance numbers are always close to politics.

Second, regulatory arbitrage between financial reporting and national accounts may damage transparency about PPP assets and liabilities. In the national accounts, public sector net investment includes conventional procurement and those PPP projects that the national accounts treat as on balance sheet. The UK Treasury (2009a) announced in June 2009 that future spending plans and budgets will be prepared on a national accounts basis. This creates a divergence between spending plans and Estimates and Resource Accounts (both on IFRS and thus using the mirror-image of IFRIC 12), entirely at odds with the Treasury's (2009b) own Alignment project intended to improve comparability. This divergence exploits Eurostat's (2004) lax interpretation of risks and rewards, introducing a new form of arbitrage.[17]

With globalization and the growing importance of fiscal surveillance of countries by international organizations (for example, IMF, OECD and – for EU countries – the European Commission and the European Central Bank), there is emerging a greater interconnectedness between the technical substance of financial reporting and that of national accounting. Given the markedly different governance arrangements, and the hitherto limited contact between accountants and economic statisticians, the separate systems will generate different numbers. Ability to reconcile these different numbers will acquire more importance, especially in connection with sensitive topics such as PPP accounting.

Third, the issue is not just conceptual differences but also the mechanics of application of whichever criterion is in use. FRS 5A, TTN1R and Eurostat (2004) all use risks and rewards, yet generate dramatically different numbers. The lack of symmetry between operator and client accounting is disturbing in the context of financial reporting, even though there is not the formal articulation of sectors as in the national accounts. There is much to be said for the popular intuition that something is amiss when governments can make available new hospitals, prisons and schools without there being accounting recognition of either assets or associated debt. This intuition regarding PPP accounting aligns with the principle of 'substance over form': the accounting should penetrate behind the legal form to identify the economic substance of transactions. There is also a warning that, whereas accountants instinctively want to produce quantified 'objective' evidence, quantification in complex settings is vulnerable to back-working to generate desired answers.

Fourth, without a clearly specified and credible enforcement mechanism, the move to a control-based standard may not resolve the problem. A new generation of PPPs might be design-engineered around the control-based mirror-image of IFRIC 12: for example, writing contracts under which the assets do not revert to the public sector client even though they are integral to continuing public service delivery and the creation of alternative capacity is improbable. A harsh public spending environment in the aftermath of the global financial crisis makes this more likely. Unless these are genuine privatizations (e.g. roads, fully transferred to the private sector), there will be concerns about hidden fiscal risks, inferior VfM and inconsistencies in the national accounts.

Fifth, accounting for PPPs should attempt to convey the economic substance of transactions and relationships so that decisions about asset acquisition and procurement mechanisms are based as far as possible on the best available estimates of costs and benefits. VfM will be damaged if the project appraisal is manipulated to generate the desired accounting treatment, or if the asset is designed to secure a particular accounting treatment. Distorting the accounting so as to privilege off-balance-sheet procurement mechanisms breaches transparency and distorts consideration of intergenerational equity. Moreover, evidence of disreputable accounting practice will damage the image of PPPs and discourage even-handed assessments of their role as an instrument of public procurement.

## Notes

1. The views expressed in this chapter are solely those of the authors and should not be attributed to organizations with which they have connections.
2. The PSC is best thought of as the alternative conventionally procured asset against which the PPP project is tested at the appraisal stage. However, it should be stressed that this comparison is often made in the context of knowledge that conventional funding is unavailable, making the PSC hypothetical. The effective choice might reduce to a PPP or no investment (Heald, 2003).
3. The interested reader is referred to the specialist writings of the authors, particularly Heald (2003) and Heald and Georgiou (2009).

4. ESA 95 is the only 'regional' version of the United Nations System of National Accounts (SNA 93) (United Nations Statistical Division, 1993). A revised SNA 2008 (United Nations Statistical Division, 2009) has now been published but not yet implemented, to be followed by a new ESA. At the time of writing, Eurostat (2004) remains the authoritative guidance for EU countries.
5. 'General government' includes central government, subnational governments and social security funds. Public corporations are part of the public sector but outside general government.
6. This explanation simplifies a more complex chain (Heald and Georgiou, 2009).
7. Classifying a contractual arrangement as a service concession rather than a finance lease does not necessarily lead to different accounting treatment, although the accounting logic differs. Under IFRS, IAS 16 (IASB, 2003a) and IFRIC 12 (based on control) apply to service concessions while IAS 17 and IFRIC 4 (IASB, 2004) (based on risks and rewards) apply to leases. IAS 17 (IASB, 2003b, para. 31) requires, *inter alia*, that lessees disclose in the notes the net carrying amount in the balance sheet for each class of asset.
8. According to SSAP 21 (ASC, 1984, para. 16) a lease is treated as a finance lease if the present value of the minimum lease payments (including any initial payment) amounts to 90 per cent of the fair value of the leased asset.
9. The Chicago economist Frank Knight (1885–1972) strongly emphasized the distinction between risk (quantifiable and reducible to a probability distribution) and uncertainty (not quantifiable and reducible) (Phelps, 2009).
10. Under IFRS as opposed to UK GAAP, there is no fixed asset option for the private sector operator. Under UK GAAP, there was a decisive move around 2001–02 away from this to contract debtor accounting for taxation and ability to distribute profit considerations. Under IFRS the private operator may use a financial asset, intangible asset or composite model. The financial asset model, similar to contract debtor accounting, is likely to be adopted. Moreover, PPP projects are delivered through 'special purpose vehicles' (SPVs), which have so far been able to stay on national GAAP, even when the parent companies are listed and required to adopt IFRIC 12 in their IFRS financial statements. For consolidation purposes, SPVs must prepare shadow IFRS accounts but these do not reach the public domain (Austin, 2009).
11. The third box in Column 1 refers to whether an asset is being constructed by or for the operator, or whether the asset was previously recognized by the grantor. In the context of a PPP, this condition is likely to be satisfied if the first two conditions are.
12. This collapsing of the dual condition into condition (a) only is consistent with IFRIC 12: 'Infrastructure used in a public-to-private service concession arrangement for its entire useful life (whole-of-life assets) is within the scope of this Interpretation if the conditions in paragraph 5(a) are met' (IASB, 2006, para. 6).
13. See, however, the discussion of the income statement charge in the next section.
14. The due process of accounting standard-setters normally follows this sequence: Discussion Paper (when the issues are articulated, and alternatives are voiced); Exposure Draft (where what is proposed as a forthcoming standard is declared); and then Standard (the definitive statement).
15. IFRIC 12 (IASB, 2006, para. 5) explicitly restricts itself to 'public-to-private service concession arrangements'. However, this contractual relationship could exist between (a) a retail chain and a property management company, and (b) a municipality and a publicly owned water utility. These arrangements would be outside the scope of IFRIC 12.
16. The current IASB proposals define control of another entity as 'the power to direct the activities of that other entity to generate returns for the reporting entity' (IASB, 2008, para. 10).
17. Whereas IASB seems likely in the medium term to revise IAS 17 on a 'right of use' (i.e. control) basis, the fact that the new SNA 2008 remains on a risks and rewards basis for leases and concessions means that an equivalent change will not be made to the national

accounts. Revision intervals are extremely long: the previous SNAs were in 1978 and 1993.

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