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Fourth Report of Session 2009–10

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(The first three are figures taken straight from supplementary table 2.8, while the rest are calculated using the "new" methodology—PSNB + Primary Balance + interest and dividends received).

Supplementary written evidence submitted by Professor David Heald

THE ACCOUNTING TREATMENT OF PRIVATE FINANCE INITIATIVE PROJECTS

1. Table B13 of the 2009 Pre-Budget Report (Treasury 2009a, p. 189) shows public sector gross investment reducing from £68.7 billion (2009–10 estimate) to £47 billion (2014–15 projection). The fall in public sector net investment is more pronounced, the corresponding figures being £49.5 billion and £23 billion. In paragraph B.7 (p. 164), this is euphemistically expressed: "public sector net investment is projected to move to 1.25 per cent of GDP in 2013–14".

2. My memorandum (Heald 2009) raised the possibility that restrictions on public sector net investment might lead to more recourse to Private Finance Initiative (PFI) schemes that are off-balance sheet in the national accounts, even when on-balance sheet in the Estimates and Resource Accounts. The purpose of this supplementary note is to expand on why that is my expectation.

3. There are two different types of accounting that are relevant to assessing public expenditure plans and performance:

- the accounting used to prepare the accounts of government departments and other public bodies:
  - up to and including 2000–01, UK central government accounted on a cash basis
  - from 2001–02 it followed private sector accounting as embodied in UK Generally Accepted Accounting Practice (UK GAAP), with limited modifications to accommodate public sector differences
  - from 2009–10 it follows International Financial Reporting Standards (IFRS), with limited modifications to accommodate public sector differences
- the accounting used for the national accounts, on which basis the main public expenditure aggregates (Total Managed Expenditure, Departmental Expenditure Limits and Annually Managed Expenditure) are expressed. This accounting is governed by the European System of Accounts (ESA 95) (Eurostat 1995), which is the Eurostat version of the United Nations System of National Accounts.

4. From 2001–02 to 2008–09, when central government accounting was on an accruals basis linked to UK GAAP, many PFI projects were kept off the balance sheet of the public sector client. This occurred because there was the opportunity for regulatory arbitrage (ie choose the accounting rule which gave the desired result) by the public sector client, between the Accounting Standard's Board's FRS 5A (ASB 1998) and the Treasury's Technical Note 1 (Revised) (Treasury Taskforce 1999). Although Treasury Technical Note 1 (Revised) was supposed to be guidance on how to implement the risks and rewards tests of FRS 5A, it came to be treated as an alternative standard. Whether the Treasury intended this to happen is open to dispute. However, what is clear is that the Treasury did not stop the arbitrage which developed between them.[11] The results in terms of balance sheet treatment were anomalous, and not related to objective differences between PFI projects in different parts of UK government. Prisons and roads were generally on the balance sheet of the public sector client, whereas hospitals and schools were almost entirely off. These differences stemmed from differences in expenditure control frameworks and in the approach taken by the auditors (Heald 2008). Moreover, there were many 'orphan assets', on neither the balance sheet of the public sector nor on that of the private sector operator.

5. The Financial Reporting Advisory Board (FRAB),[12] established by the Treasury to advise on adaptations and interpretations of UK GAAP for the public sector, repeatedly expressed concerns about PFI accounting, with no effect for many years. One possibility would have been the withdrawal by the Treasury of Technical Note 1 (Revised), leaving the field to FRS 5A. There was evidence that variations in auditor judgements about PFI accounting by the public sector client would largely disappear if only FRS 5A were to be considered. Although the Treasury consistently argued that the criterion for PFI was Value-for-Money, this was disputed by many observers and participants in the PFI process: many public sector organisations felt that PFI was "the only show in town".

6. UK central government accounting has moved to International Financial Reporting Standards (IFRS) in 2009–10. There is no guidance within IFRS on how a public sector client should account for PFI assets: IFRIC 12 (IASB 2006), an interpretation issued by the International Accounting Standards Board,

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[11] How this arbitrage occurred, when both FRS 5A and Treasury Technical Note 1 (Revised) used the risks and rewards approach, is explained by Heald and Georgiou (2009).

[12] I was a member of FRAB from 1 August 2004 to 31 July 2009, having been nominated as an independent economist by the Head of the Government Economic Service. The views expressed in this supplementary note are entirely my own.

applies only to the private sector operator. However, the Treasury, with the approval of FRAB, has adopted what is known as the 'mirror image of IFRIC 12 treatment'. IFRIC 12 is based on the principle of control, not of risks and rewards. If the application of IFRIC 12 indicates that the private sector does not control the infrastructure, on certain tests, then the implication is that the public sector client does. The expectation is that almost all PFI assets will go on the balance sheet of public sector clients from 2009–10. In terms of the first type of accounting (ie financial reporting), this seems to be a belated resolution of a long-standing problem.

7. However, in June 2009, the Treasury reissued its 2009–10 Consolidated Budgeting Guidance (Treasury 2009c, pp. 117-20), announcing that the budgeting treatment of PFI would be on a national accounts basis, not on an IFRS basis. This opens up a new opportunity for arbitrage, this time between financial reporting and national accounts rather than between different "standards" for financial reporting.

8. The second type of accounting (ie for national accounts) is important in this context because the fiscal aggregates are defined on a national accounts basis. The approach taken by ESA 95 is to adopt a risks and rewards approach to deciding on whose balance sheet a particular asset should be placed. Of great importance is that the national accounts are a fully articulated set of accounts, in which it is an error to have an asset either on the balance sheet of both client and operator or—much more likely because of the incentives facing decision-makers—on neither.[13] The sheer scale of PFI in the United Kingdom, in relation to the modest resources available to the Office for National Statistics (ONS), has meant that ONS followed the financial reporting treatment, even though it was known that this was unsatisfactory. Chesson and Maitland-Smith (2006) report a major review by ONS, which led to more PFI assets being placed on the public sector balance sheet, but the problem of limited resources in relation to the task remained unresolved. If challenged by Eurostat, ONS could reasonably respond that the UK treatment was placing more PFI assets on balance sheet, and therefore contributing to higher general government gross debt, than would occur under a strict application of Eurostat (2004) guidance.

9. Whereas IFRS adoption involves the switch to a control approach, the national accounts remain on a risks and rewards approach. It is not obvious how much practical difference is made by the choice of approach, as the two criteria have much in common: for example, who bears the risks and rewards of an asset may give an indication as to who controls that asset. The fundamental problem is that the Eurostat (2004) guidance is so lax. For the asset to be off-balance sheet to the public sector client, Eurostat (2004) requires that construction risk, together with either availability risk or demand risk, are transferred to the private partner. Normally, availability risk will be lower than demand risk, so the condition reduces to the transfer of construction risk and availability risk.[14] Such conditions are not difficult to meet, and would normally be met by UK PFI projects. There has been international concern, most notably on the part of the International Monetary Fund, that the Eurostat (2004) criteria will lead to increases in fiscal risks because they make off-balance sheet PFI so easy to achieve. There is a parallel with what happened in terms of UK financial reporting: supplementary guidance effectively changes the standards being "clarified".

10. The Treasury's (2009c) decision to treat PFI within the Spending Review/budgeting system on a national accounts basis, rather than on an IFRS basis, is wholly unsatisfactory and should be reversed before the next Spending Review announcement:

— This treatment involves arbitraging between IFRS and national accounts in an analogous way to the earlier arbitrage between FRS 5A and Treasury Technical Note 1 (Revised). This conflicts with the commitment to fiscal transparency made in the Code for Fiscal Stability (Treasury 1998)

— It compromises one of the achievements of the United Kingdom's move to accruals accounting and reporting, which was that budgeting and accounting were done on the same basis. This was an important objective of the Resource Accounting and Budgeting project, brought to fruition in Spending Review 2002

— The United Kingdom has complete discretion as to how its budgeting figures are presented to Parliament, as evidenced by the UK focus on the public sector whereas the European Union focus is on general government. Moreover, given the attention that UK practice on PFI receives internationally, the United Kingdom should be a beacon of best practice. Whereas the Treasury and ONS must be able to generate fiscal data on prescribed international bases, the information used in domestic debates should be transparent and logically defensible

[13] In contrast, the financial reports reflect the independent judgements of the management of the reporting entities and of their auditors. There might be cases where different views are taken by the client and operator about where the majority of risks and rewards actually lies. This might therefore lead to some cases of On:On and Off:Off, but certainly not to the observed pattern of extensive Off:Off and of variations across the functional areas of government.

[14] FRS 5A (ASB 1998) attached great importance to which party carries demand risk and residual value risk (concession lives are generally much shorter than asset lives), meaning that an asset would be on the balance sheet of the public sector client if the majority of these fell to the public sector client.

— Combined with the drastic planned reductions in public sector net investment, it is likely to lead to the adoption of PFI as a procurement route for reasons of accounting treatment (this time national accounts rather than financial reporting), with the likely effect of leading to manipulations in project appraisals and possibly also distorting the physical or contractual design of PFI schemes

— The June 2009 revision of Consolidated Budgeting Guidance (Treasury 2009c) illustrates the temptation to seize arbitrage opportunities, without thinking through their wider implications. The Government wishes Parliament to accept changes to Estimates in order to establish a "Clearer Line of Sight" (Treasury 2009b) from Spending Plans to Estimates to Accounts. There are potential benefits to Parliament from such alignment, but only if the Treasury recognises that alignment places new responsibilities upon itself. The treatment of PFI in spending plans indicates that this message has not registered

— Trust in government and in government statistics is at an extremely low level. The move to IFRS created a window within which financial reporting for PFI could be put on a proper basis. The exclusion of off-national accounts PFI from the Spending Review numbers will encourage more cynicism, at a time when the impact of the global financial crisis on UK public finances means that the amounts involved in PFI are comparatively small

16 December 2009

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Supplementary written evidence submitted by John Whiting, Low Incomes Tax Reform Group

Notional Entitlement

Under the tax credit rules as they stand, if couples separate, or one member of a couple dies, or two single people get together to form a couple, this must be reported to HMRC within one month. The reason is that tax credits payable to a person in one capacity (eg a member of a couple) cease as soon as they can no longer claim in that capacity. They may then be able to claim in their new capacity (eg as a single person), but they must make a separate claim for that.

This means that if they are late reporting their change of status, and hence in claiming in their new capacity, they incur a recoverable overpayment even if the amount to which they would have been entitled in their new capacity is equal to, or greater than, the amount they have been receiving hitherto.

We were therefore extremely pleased with by the announcement that where people who receive tax credits start to live together, or separate, but are late reporting the change to HMRC, the resulting tax credit overpayment will be reduced by the amount that the claimant would have been entitled to receive had they reported the change promptly.