The British Accounting Review 44 (2012) 235–247

Contents lists available at SciVerse ScienceDirect

The British Accounting Review

journal homepage: www.elsevier.com/locate/bar

The U.K. private finance initiative: An accounting retrospective

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ARTICLE INFO

Article history:
Received 12 April 2010
Received in revised form 30 November 2011
Accepted 12 December 2011

Keywords:
Accounting principles
Accounting rules
Financial reporting
Private finance initiative

ABSTRACT

The Private Finance Initiative (PFI) in the U.K. has been the subject of considerable interest in government, professional and academic literature. This reflects its importance as one of the classic forms of Public Private Partnership, its adoption in other jurisdictions, the scale of infrastructure investment under PFI legislation and the extent of controversy that has accompanied its development and application. The financial reporting of PFI schemes has been one element of this controversy in view of its potential to limit public sector financial accountability by off-balance sheet financing and the potential for alternative interpretations of its accounting treatment. It is now an appropriate time to review the turbulent history of accounting for the PFI as U.K. public sector accounting is now based upon International Financial Reporting Standards. This has resulted in the redundancy of previous accounting guidance issued by the UK ASB and the Treasury which, at the time of being abandoned, contained unresolved inconsistencies.

This paper uses a triangulation method of investigation linking the input to, and output from, the regulatory process to an analysis of public domain evidence of press coverage and letters submitted to the standard setter and interviews with key participants to the standard-setting process. This approach shows that hidden pressures were influential in the process of developing PFI accounting regulation. Different interpretations of the ASB's principles-based Application Note and the Treasury's more rules-based Technical Note created de-facto alternative accounting treatments. The pressure, from organisations such as the Financial Reporting Advisory Board, for reform of PFI accounting was only released by the government's decision to switch the U.K. public sector to IFRS-based accounting.

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1. Introduction

Accounting for the Private Finance Initiative (PFI) in the U.K. provides a strong illustration that accounting regulation, based upon underlying principles, may not be sustainable in the face of differing stakeholder interests. Audit firms may not be able to agree on its application within specific contractual arrangements, while other stakeholders in the accounting standard setting process contribute conflicting perspectives and interests. We see the story of accounting for PFI as illustrating the complexity of seeking to reconcile the interests of different stakeholders, while adhering to a set of overarching accounting principles. It demonstrates that the sustainability of a principles-based accounting standard may be undermined by differing interpretations in the presence of a powerful actor with an alternative view, in this case the U.K. Treasury.

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http://dx.doi.org/10.1016/j.bar.2012.09.005

The PFI has been controversial since its inception in 1992 and it continues to have a high political profile.[1] It has received the support of both Conservative and Labour governments in the UK and related capital outlays have been substantial; for example Treasury figures, at February 2010, indicated that 667 PFI projects had been signed with implied capital funding of over £56 billion and involving estimated commitments of £267 billion (Treasury, 2010). Such figures indicate the significance of the related accounting policy; in particular, the question of whether PFI obligations should be scored on or off balance sheet from the public sector viewpoint. The Office for Budget Responsibility (OBR) noted in its *Fiscal Sustainability Report* that Public Sector Net Debt at March 2010 'included about £5.1 billion (0.4 percent of GDP) in respect of PFI deals that were recorded as on balance sheet in the National Accounts' but that 'the total capital liability of on and off balance sheet PFI contracts was closer to £40 billion (2.9% of GDP)' (OBR, 2011, p.42).

Accounting for PFI is examined in this paper by considering how the Accounting Standards Board (ASB) adapted its regulatory proposals from an exposure draft (ASB, 1997) (ED) to the publication of an application note to FRS5 (ASB, 1998a) (FRS5A). All the changes made from the ED to FRS5A are triangulated with evidence from articles in the professional and financial press together with written submissions sent by respondents to the ASB. This evidence is used to identify those changes from the ED to FRS5A which are not explained by such public domain evidence and which reveal that other pressures must have been influential as the majority of recommendations proposed in the written submissions were not adopted by the ASB in FRS5A. The Treasury responded to FRS5A by revising its own Technical Note 1 *How to Account for PFI Transactions* (Treasury Taskforce, 1999) (TN), which was intended to guide the application of FRS5A in public sector financial statements. Interviews with key actors involved in the development of FRS5A and the TN are used to illuminate the process of developing the ED into FRS5A.

In practice, different interpretations of FRS5A and the TN created de-facto alternative accounting treatments. The result was that PFI assets and the related borrowing obligations could end up on both or neither of the balance sheets of the private and public sector partners to a PFI scheme (FRAB, 2006b). For example, Heald and Georgiou (2011) suggest that the Audit Commission was more likely to accept a TN-based view to support an off-balance sheet treatment than the National Audit Office. Similarly, private sector auditing firms took different views on the appropriate accounting treatment when tested with identical scenarios (FRAB, 2006c).

In its 2007 Budget (para. 6.59) the U.K. Government announced that the accounts of central government departments and the wider public sector would be produced using International Financial Reporting Standards (IFRS) from 2008. The implementation was subsequently deferred to 2009 in the 2008 Budget[2] (para. C.103). One of the effects of this move to IFRS was that the existing guidance on accounting for the PFI issued by both the ASB and the Treasury ceased to be applied to public sector financial reporting, being replaced with IFRS-based guidance (Treasury, 2011a, chap. 6, pp. 11–16).

The contribution of this paper lies in its detailed examination of the forces that attempted to influence the content of FRS5A and the subsequent effect of this on the practice of PFI accounting. Its originality stems from three features of the paper. First, it provides a detailed triangulation method, relating the input and output of the regulatory process to available public domain evidence to identify that unseen influences must have been present. The authors are not aware of any published work that has adopted this approach previously to analyse the development of accounting regulation. Second, the paper is able to review retrospectively the complete cycle from initial development to effective withdrawal of FRS5A and hence build on prior work that, necessarily, dealt with only the contemporaneous position. This paper covers the development of FRS5A, leading to the interpretation of its principles through the TN which culminated in considerable disquiet on the part of the Financial Reporting Advisory Board (FRAB). Third, the paper analyses the initial impact on PFI accounting of the move to IFRS-based reporting. The switch to international standards released the pressure towards a fundamental revision of PFI accounting under UK GAAP (FRAB, 2007) and has resulted in the increased recognition of PFI deals in the balance sheets of UK public sector entities (Treasury, 2011b).

2. Prior research

There appears to be broad consensus among regulators that accounting standards which place more reliance on the application of broad principles, and less on the construction of detailed rules, provide a solution to inadequate financial reporting (FASB, 2002; GAA, 2008; SEC, 2003). However, several studies have drawn out some of the difficulties and inconsistencies arising from reliance on principles-based standards. Dennis (2008) suggests that the concept of principles-based accounting regulation may be undermined by its vague and ambiguous nature. Benston, Bromwich, and Wagenhofer (2006) review the SEC (2003) proposals and suggest that there is an inconsistency between measurement concepts and principles-based standards as the former requires significant rules to guide managerial judgement. Schipper (2003) argues that U.S. standards are often based on principles and that accompanying rules can help to achieve consistency and comparability, while Nelson (2003) suggests that accounting rules help to increase the accuracy with which accounting standard setters communicate their requirements and reduce imprecision in financial reporting choices. Bennett, Bradbury, and Prangnell (2006) suggest that the rules-based versus principles-based distinction may not be meaningful, other than in relative terms. Their study of three standards on research and development costs concluded that all three

[1] For example, see the reports of Parliamentary inquiries into private finance and off balance sheet debt (House of Lords Economics Affairs Committee, 2010) and the future of PFI (House of Commons Treasury Committee, 2011).

[2] IFRS for local government in the U.K. was implemented from 2010.

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