GASB Proposes Updated Guidance on P3s

Potential Impact on Public Colleges and Universities

Perspectives | August 2019

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The Governmental Accounting Standards Board (GASB) issued an exposure draft on public-private and public-public partnerships and availability payments dated June 6, 2019 (the Statement).[1] Comments are due on September 13, 2019. GASB proposes that the requirements of the Statement become effective for the fiscal year beginning after June 15, 2021, with earlier implementation encouraged.

The requirements of the proposed Statement are intended to increase transparency and improve consistency in the financial reporting of public-private partnerships (P3s) and availability payment arrangements (APAs). As discussed later in this paper, part of the proposed guidance in the Statement would require institutions to account for certain P3s that had previously been considered off-balance sheet. The Statement is intended to complement Statement 87 on Leases, and will supersede Statement 60 related to service concession agreements (SCAs).[2] The Statement is intended to provide guidance for certain arrangements that do not meet the definition of an SCA or a lease under Statement 87.

The purpose of the following commentary is to provide a high-level overview of the Statement, and the potential applicability for public institutions of higher education. This commentary is not intended to address all of the details included in the Statement, and does not focus on certain provisions that are less common in the higher education industry, such as public-public partnerships.

Public-Private Partnerships (P3)

GASB defines P3s as "an arrangement in which a government (the Transferor) contracts with an operator (a governmental or nongovernmental entity) to provide public services by conveying control of the right to operate or use an infrastructure or other nonfinancial asset (the underlying P3 asset) for a period of time in an exchange or exchange-like transaction."[3]

The term P3 is used broadly in the higher education industry to describe a wide variety of projects. The GASB definition of a P3 would apply only to agreements where a private party provides a public service through the use and operation of an underlying asset, and the private party is compensated by third party fees. These agreements are demand risk projects, commonly utilized in higher education for assets such as privatized student housing and parking.

There are a number of other legal and finance structures that have been utilized in the higher education industry that are commonly referred to as P3s that would not meet GASB's proposed definition. Agreements where the private party is compensated by the institution would either fit the definition of a lease or an

1 "GASB Exposure Draft—Public-Private and Public-Public Partnerships and Availability Payment Arrangements," GASB, last modified June 6, 2019, accessed July 25, 2019, https://www.gasb.org/cs/Satellite?c=Document_C&cid=1176172835654&pagename=GASB%2FDocument_C%2FDocumentPage.

2 "GASB Statement No. 87 - Leases," GASB, last modified June 2017,"accessed August 5, 2019, https://www.gasb.org/cs/ContentServer?c=Pronouncement_C&cid=1176169177502&d=&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage.

3 Ibid.

Availability Payment.

This would be applicable for agreements that pertain to non-revenue generating assets (such as academic, research or office buildings), or revenue generating assets where the institution assumes the financial risk of the asset and makes payments to a third party operator based on their ability to design, build, operate and maintain the asset in the future.

There is a multi-step process for determining the accounting treatment of a P3, as outlined below.[4]

- P3s that meet the definition of a lease, and do not meet the definition of an SCA, will be accounted for under the provisions provided in Statement 87.
    - GASB 87 establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset.
    - The statement requires the recognition of certain lease assets and liabilities for leases that previously were classified as operating leases.
    - GASB 87 is to become effective for the reporting period following December 15, 2019.
- P3s that meet the definition of an SCA will be accounted for in a manner consistent with the current practice under GASB 60. The definition of an SCA pertains to arrangements in which all of the following criteria are met:
    - The Transferor conveys to the operator the right and related obligation to provide public services through the use and operation of an underlying P3 asset in exchange for significant consideration, such as an up-front payment, installment payments, a new facility, or improvements to an existing facility;
    - The operator collects and is compensated by fees from third parties;
    - The Transferor determines or has the ability to modify or approve which services the operator is required to provide, to whom the operator is required to provide the services and the prices or rates that can be charged for the services; and
    - The Transferor is entitled to significant residual interest in the service utility of the underlying P3 asset at the end of the arrangement.
- P3s that do not meet the definition of a lease under Statement 87 or the definition of an SCA will be accounted for as a P3. GASB notes in Appendix B of the Statement that this is intended to provide guidance for other P3s, and provides the specific example of a transaction for "an operator building and owning a new capital asset to provide additional governmental services, such as a college dormitory. In exchange for transferring ownership of the capital asset to the Transferor at the end of the arrangement, the operator is allowed to set the price or rate that will be charged to users of the capital asset during the arrangement." The fact that the Transferor does not control the rates being charged for the project differentiates this arrangement from an SCA.

4 See disclosure for important information.

Accounting Treatment of an SCA

There are multiple examples of higher education institutions that account for SCAs under GASB 60 for arrangements that include certain privatized student housing projects, book store contracts and dining contracts. Student housing SCAs include projects that have been financed with non-recourse third party project level debt (example: Wayne State University[5]) or 100% developer equity (example: University of Kentucky[6]).

Under an SCA, the Transferor should recognize:

- **Capital Assets**
  - If the underlying P3 is an existing asset of the Transferor, the Transferor should continue to report the underlying P3 asset;
  - If an underlying P3 asset is a new asset purchased or constructed by the operator, or an existing asset of the Transferor that has been improved by the operator, the Transferor should recognize:
    - The new asset measured at acquisition value when it is placed into operation; and
    - The asset improvements made by the operator at acquisition value when the improvements are placed into operations.
  - If the P3 arrangement requires the operator to return the underlying P3 asset in its original or enhanced condition, the Transferor should not depreciate the asset during the P3 term, otherwise the Transferor should apply depreciation and impairment.
- **Installment Payments**
  - If the Transferor is to receive installment payments as a result of the P3, it should recognize them in the following manner:
    - Fixed payments and variable payments that depend on an index or a rate or are fixed in substance: receivable at the present value of the payments expected to be received during the P3 term, reduced by any provision for estimated uncollectible amounts; and
    - Variable payments based on future performance of the operator or usage of the underlying P3, or amounts to be received under residual value guarantees that are not fixed in substance: inflows of resources in the period to which those payments relate.
- **Deferred Inflow of Resources**
  - At the commencement of the P3 term, the Transferor should initially recognize a deferred inflow of resources as a sum of the following:
    - The amount of the initial measurement of the receivable for installment payments;
    - P3 payments received from the operator at or before the commencement of the P3 term that relate to future periods;
    - The underlying P3 asset or improvements to the underlying P3 asset; and
    - The receivable for the underlying P3 asset.
  - In subsequent years, the Transferor should recognize the deferred inflow of resources as revenue in a systematic and rational manner over the P3 term.

5 Wayne State University Financial Report 2018, Year Ended September 30, 2018
6 University of Kentucky 2018 Financial Statements

- **Notes to Financial Statements**
    - A Transferor should include a description of its P3 activities in the notes to its financial statements, which is outlined in the Statement. These notes should include provisions for guarantees and commitments the Transferor may have made as part of the P3.
- **Outflow of Resources (Expense)**
    - Any initial direct costs incurred by the Transferor should be reported as outflows of resources for the period.

Accounting Treatment of P3s not Defined as a Lease or an SCA

The accounting treatment for P3s that do not fit the definition of an SCA is similar to an SCA, with the exception of the recognition of a capital asset as described above. Instead of a capital asset, the Transferor should recognize:

Receivables

- A receivable for the underlying P3 asset purchased or constructed to be received from the operator.
    - The receivable for the underlying P3 asset should be recognized and measured based on the operator's estimated carrying value of the underlying P3 asset as of the future date of the transfer in ownership from the operator.

Potential Impact of Statement

The proposed guidance included in the Statement is consistent with GASB 60, and will not likely have a material impact for projects that meet the definition of an SCA. However, the guidance will impact the accounting treatment for arrangements that do not meet the definition of a lease or an SCA. For example, privatized student housing projects that have previously been structured as "off-balance sheet" will be reflected on an institution's balance sheet.

The rating agencies have stated that they currently take these "off-balance sheet" P3 arrangements into consideration when evaluating the credit of the host institution. If the rating agencies determine that the P3 is essential to the institution, or if the institution provides significant support for the project (financial or

Privatized Student Housing Consideration

Higher education institutions have commonly financed student housing assets as P3s in the past. As of May 8, 2019 Moody's Investors Service ("Moody's") provided a public rating on 46 privatized student housing projects,[1] and Standard & Poor's ("S&P") provided public debt ratings on 62 projects.[2] The rated projects by Moody's and S&P do not include projects rated by other rating services, non-rated projects, or projects that have been funded by developer equity.

Some of the rated projects are already included on the host institution's financial statements through meeting the definition of an SCA, or as a result of a direct support organization (affiliated foundation) serving as the project company. However, there are a number of other projects that are not currently accounted for on a public institution's financial statements.

1 Moody's Investors Service, Privatized student housing – US, "Medians – Number of stressed P3 projects increases, though sector is solid overall," May 8, 2019

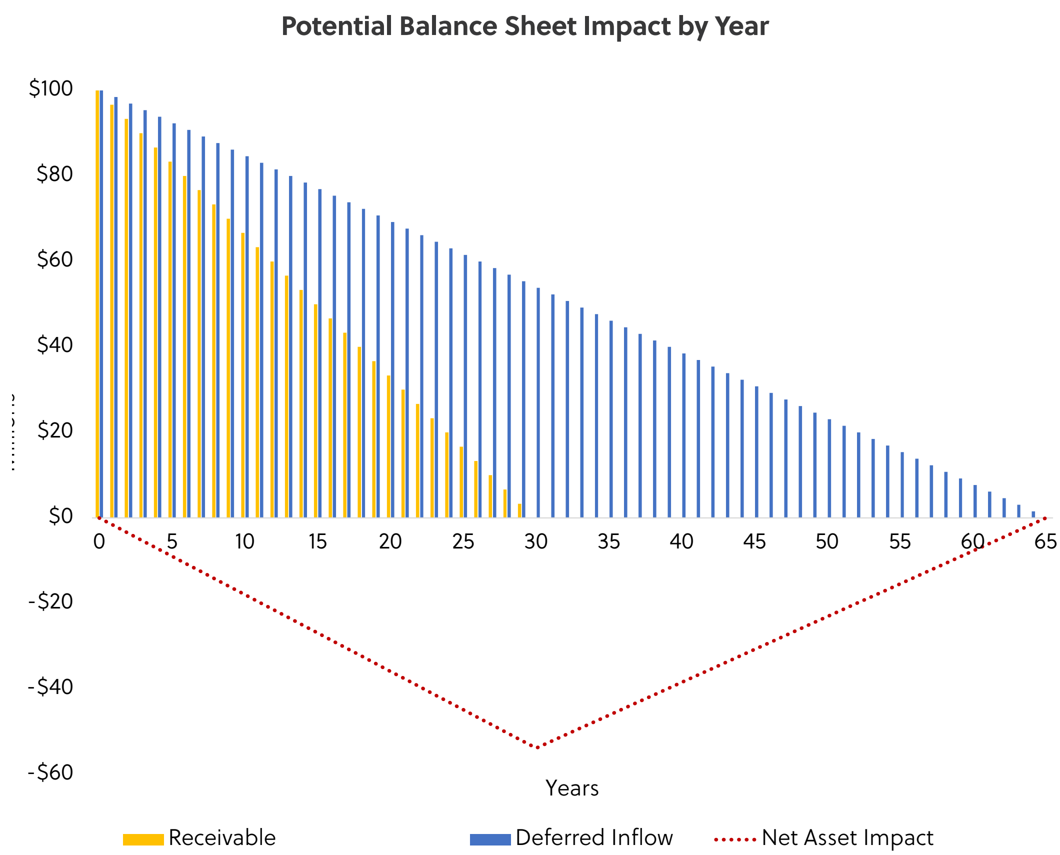
2 S&P Global Ratings, "Opportunities and Risks Continue to Emerge in Privatized Student Housing", May 8, 2019

otherwise), the rating agencies have demonstrated that they will include the Project as direct debt of the institution, regardless of the accounting treatment. In PFM's view, the increased accounting transparency for these projects may make it more likely that a rating agency will adjust its rating criteria in the future to evaluate these P3s in a more quantitative manner.

The proposed guidance provides an institution with the ability to initially account for a P3 project with off-setting assets and liabilities, with the liability accounted for as a deferred inflow, as opposed to long-term debt, of an institution. This should limit the change in accounting treatment's impact on an institution's financial covenants.

However, PFM believes that the change in accounting rules could potentially have an impact on an institution's net position (and related credit ratios) over time in certain circumstances. As one illustration, an institution enters into a 65-year ground lease with a private developer for a student housing project. The financing for the project is secured by student housing fees, the funding is provided by developer equity and the developer maintains a certain level of control over the operations of the asset and the future setting of fees. While the developer is financially incented to maintain the asset over time, it is not contractually obligated to return the asset to the institution in its original or enhanced condition at the end of the term of the ground lease.

The proposed guidance would treat this arrangement as a P3, with a receivable and an offsetting deferred inflow (as well as installment payments for ground rent, if applicable). An auditor could depreciate the receivable based on the accounting useful life of the underlying asset (for example, a 30-year straight line basis), while reducing the deferred inflow over the 65-year term of the agreement.



As illustrated in the chart above, we believe this could potentially impact an institution's net position, as the term of the P3 agreement is significantly longer than the accounting useful life of the underlying asset.

This is intended to be a conservative example, and actual accounting treatment for an institution will be subject to their auditor's interpretation of the Statement.

Availability Payment Arrangements

GASB defines APAs as "an arrangement in which a government compensates an operator for services that may include designing, constructing, financing, maintaining, or operating an underlying infrastructure or other nonfinancial asset for a period of time in an exchange or exchange-like transaction." The payments by the government are based entirely on the asset's availability for use, which may be based on specified criteria such as the physical condition of the asset, construction milestones, or the achievement of certain performance measures.

The proposed Statement includes two accounting approaches for APAs:

1. **Financed Purchase:** An APA that is related to designing, constructing, and financing an infrastructure or other nonfinancial asset in which ownership of the asset transfers by the end of the contract to be accounted for by a government as a financed purchase of the underlying infrastructure or other nonfinancial asset.

2. **Operating Agreement:** An APA that is related to operating or maintaining an infrastructure or other nonfinancial asset would be required to be reported by a government as an outflow of resources (expense) in the period in which payments relate.

The Statement recognizes that an APA may contain multiple components, each of which should be recognized as a separate arrangement. For example, an APA may include an arrangement where a government agrees to make fixed payments designed to compensate an operator for the design, construction, financing, operation and maintenance of an asset, and variable payments based on certain performance measures.

Although less common than demand risk projects that are defined as P3s by GASB, there are a number of examples of higher education institutions entering into APAs in recent years. Examples include the University of California's Merced 2020 Project, The Ohio State University's Comprehensive Energy Management Project and Purdue University's West Lafayette campus student housing project.[7] In these examples, the portion of the APA that is considered a financed purchase is, or will be, considered a long-term liability of the institution and taken into consideration by the rating agencies.

Conclusion

Comments to the proposed guidance are due on September 13, and GASB intends for the guidance to be effective for the fiscal year beginning after June 15, 2021. While the guidance that is ultimately implemented may change as a result of the comment period, PFM believes that the initial guidance included in the Exposure Draft could accomplish GASB's goals to increase transparency and improve consistency in the accounting treatment of various financial arrangements.

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7 The Ohio State University Financial Statements as of and for the years ended June 30, 2018 and 2017; University of California Annual Financial Report 2017 and 2018; and Purdue University and the Trustees of Purdue University, Annual Financial Information and Operating Data for the year ended June 30, 2018.

Within the higher education industry, the term P3 has been used to describe a wide variety of projects. We are hopeful that the proposed guidance will provide more consistency in how projects that utilize the private sector are considered. The private sector can provide value to institutions in various types of legal and financial arrangements, through the design and delivery, maintenance and operations or financing of capital assets. The increased transparency that will result from the proposed guidance should enable institutions to better understand the value proposition and financial impact of these arrangements.

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