International
Public Sector
Accounting
Standards Board

**Consultation Paper**
March 2008
Comments are requested by August 1, 2008

# Accounting and Financial Reporting for Service Concession Arrangements

International Federation
of Accountants

## REQUEST FOR COMMENTS

**The IPSASB welcomes comments on the proposals in this Consultation Paper**. Please submit your comments, preferably by email, so that they will be received by **August 1, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

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ISBN: 978-1-934779-33-0

## Executive Summary

A public-private partnership (PPP) can be described as an arrangement between a public sector entity and a private sector entity to deliver a public sector asset (normally infrastructure or a public facility) and/or service. The use of PPP arrangements by the public sector as a vehicle to build and improve infrastructure and other public facilities, and provide the services associated with these structures, has continued to grow worldwide over recent years. This growth is reflected in both the number of countries in which PPP arrangements have been executed or studied and the types of infrastructure and public facilities that are associated with these arrangements. PPP arrangements can take a number of different forms that are often distinguished by the extent of private sector involvement in the underlying project. A specific subset of PPP arrangements is commonly referred to as service concession arrangements (SCAs).

SCAs differ from other types of PPP arrangements in that the risks and benefits associated with constructing, owning and operating the underlying property, along with the control over the property, are shared to a greater degree by the public sector entity and private sector entity involved in the arrangement. The sharing of these aspects of the property, as well as the general complexity of these transactions, often has made the financial reporting of the property for the public and private sector entities unclear.

This lack of clarity is partly because, until recently, there was little in the way of accounting and financial reporting guidance specific to SCAs. The UK Accounting Standards Board issued an amendment to its Financial Reporting Standard (FRS) 5, *Reporting the Substance of Transactions*, which addressed SCAs. This amendment also forms the basis for recommended guidance in Australia and New Zealand. Additionally, the European Commission issued guidance on accounting for SCAs for statistical reporting purposes. However, many jurisdictions continue to only apply their existing authoritative accounting and financial reporting guidance, such as their general accounting framework and leasing standards, to account for the property associated with SCAs.

This lack of specific guidance for SCAs has caused divergence in how the property in these arrangements is reported, even occasionally resulting in the property not being reported as property, plant and equipment by either the public sector entity or the private sector entity. This has also provided public sector entities the opportunity to use SCAs as a means to fulfill their infrastructure needs while not recognizing the property and related financing in their financial statements, thereby potentially enabling the meeting of fiscal targets.

In November 2006, the International Accounting Standards Board's (IASB) International Financial Reporting Interpretations Committee (IFRIC) issued Interpretation 12, *Service Concession Arrangements* (IFRIC 12). This interpretation provides guidance on reporting the property associated with SCAs that meet specified criteria related to control over the property. However, the guidance in this interpretation only specifically applies to private sector entities, generally the operator in such arrangements.

Because of this focus on the operator alone in IFRIC 12, the IPSASB initiated its own project on SCAs, approving the project brief in November 2006. This Consultation Paper is the product of the first stage of the IPSASB's project. The objective of this Consultation Paper is to explore the accounting and financial reporting issues related to SCAs. The Consultation Paper identifies issues and provides proposals to be considered by the IPSASB in the development of any

authoritative international public sector requirements for accounting and financial reporting of SCAs. Obtaining feedback from constituents is a key desired outcome of the Consultation Paper.

Because the public sector entity is generally the grantor in these arrangements, the project has been focused on the accounting and financial reporting issues of these arrangements from the perspective of the public sector entity, the grantor. Only limited consideration has been given in the Consultation Paper to operators to these arrangements. This is primarily because operators (whether a private sector entity or a government business enterprise) generally would consider IFRIC 12, and the IASB's Standing Interpretations Committee (SIC) Interpretation 29, *Service Concession Arrangements: Disclosures*, to determine their accounting and financial reporting for service concession arrangements.

The Consultation Paper first provides an overview of the various types of arrangements that are considered PPPs, of which SCAs are a subset, as stated previously. Included in this is an analysis of existing authoritative guidance to assess whether it is sufficient to address the accounting and reporting implications for these arrangements. The Consultation Paper concludes that additional guidance is needed to address SCAs.

From there, much of the Consultation Paper focuses on the financial reporting of the underlying property to SCAs. The Consultation Paper discusses the determination of whether the public sector entity should report the underlying property as an asset in its financial statements and the circumstances involved in making this determination. The Consultation Paper also discusses reporting issues resulting from the public sector entity reporting the underlying property as an asset. These issues largely relate to the timing of the recognition and the measurement of the underlying property, as well as any associated liabilities.

In addition, the Consultation Paper addresses other accounting and financial reporting issues for public sector entities that may result from the execution of SCAs, including the recognition of revenue from inflows of resources related to an SCA. These inflows most often occur when the private sector entity receives fees for services directly from third-party users of the underlying property. The public sector entity may receive inflows from revenue-sharing provisions established as part of the contractual terms of the SCA, or through an upfront payment, or predetermined series of payments, made by the private sector entity to enter into the arrangement.

Guarantees and commitments made by the public sector entity as part of an SCA are also considered. These guarantees and commitments can be made to the private sector entity, or to third parties on the behalf of the private sector entity. For example, the public sector entity as part of an SCA may guarantee to repay the debt of the private sector entity in the event of default. The public sector entity generally also has a commitment to its constituents to continue the service being provided under the arrangement if the private sector entity becomes unable to perform or otherwise defaults on the arrangement.

Further addressed is the potential for the private sector entity to be considered controlled by the public sector entity for purposes of consolidation, particularly when the private sector entity is a special purpose entity or a government business enterprise. In cases where the public sector entity holds an ownership or equity interest in the private sector entity, existing IPSASB

guidance related to investments in associates or joint ventures may also need to be considered. Existing IPSASB guidance is also considered in relation to a number of other areas and issues.

Finally, the Consultation Paper sets out proposed financial statement note disclosures related to SCAs that would provide information useful for decision-making and demonstrate the accountability of the public sector entity for the resources entrusted to it.

The balance of the cost and benefit of providing such information is considered in the proposals outlined in the Consultation Paper.

## Request for Comments

The IPSASB welcomes comments on all of the proposals in this Consultation Paper. Comments are most useful when they include the reasons for agreeing or disagreeing. If you disagree, please provide alternative proposals.

The IPSASB has identified the following Specific Matters for Comment that it is particularly interested in:

1. It is proposed that a grantor report the property underlying an SCA as an asset in its financial statements if it is considered to control the property. Criteria for determining control are proposed in the Consultation Paper. Do you agree with this approach and the control criteria identified? (See Paragraphs 28-104)

2. It is proposed that the underlying property reported by the grantor as an asset and the related liability (reflecting any obligation to provide compensation to the operator) is initially measured based on the fair value of the property other than in cases where scheduled payments made by the grantor can be separated into a construction element and a service element. In such cases, the present value of the scheduled construction payments should be used if lower than the fair value of the property. Do you agree? (See Paragraphs 105-140)

3. It is proposed that contractually determined inflows of resources to be received by a grantor from an operator as part of an SCA should be recognized as revenue by the grantor as they are earned over the life of the SCA beginning at the commencement of the concession term, that is, when the underlying property is fully operational. These inflows generally should be considered earned as the grantor provides the operator access to the underlying property, and amounts received in advance of providing a commensurate level of access to the property should be reported as a liability. Do you agree? (See Paragraphs 191-196)

**ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS**

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# Introduction

## What Are Public-Private Partnerships?

1. More than ever before, governments are confronted with the challenges of (a) building new infrastructure and public facilities to keep up with population growth, and (b) refurbishing existing infrastructure and public facilities that have deteriorated from years of deferred maintenance. They also face the challenge of providing their constituents with services that are associated with infrastructure and public facilities in an efficient and cost-effective manner. Increasingly, governments have found a common way to approach these challenges through public-private partnership arrangements.

2. No single, widely accepted definition for the term "public-private partnership" (PPP) exists. However, most descriptions characterize a PPP as an arrangement between a public sector entity and a private sector entity to deliver a public sector asset (normally infrastructure or a public facility) and/or service[1]. In this way, PPP arrangements offer an alternative to traditional public sector procurement methods used to accomplish a public duty or responsibility.

3. Traditional procurement methods place most of the risks associated with the underlying project with the public sector entity, although fixed price contracts may transfer some of the construction risk to the private sector entity. In a PPP arrangement, project risks are generally allocated between the public sector entity and the private sector entity. These risks commonly include the following:

   - *Construction risk.* This encompasses the many issues that may be encountered during the construction phase of a project, such as cost overruns, building material defects, construction delays, planning regulation, structural integrity issues with existing infrastructure, technical deficiencies, health risks, and worksite accidents.
   - *Availability risk.* This is the risk that the infrastructure or public facility will not provide sufficient services, for example, because of insufficient management or not meeting the required quality standards.
   - *Demand risk.* This risk relates to variability in the amount of service required or consumed by users of the infrastructure or public facility. Users can be the public sector entity itself, third-party users such as citizens, or both.
   - *Operational and maintenance risk.* This risk encompasses a broad range of risks that exist after the infrastructure or public facility becomes operational. Examples include price increases or shortages of materials, increases in labor costs, damage as a result of natural disasters, costs related to deferring maintenance, and obsolescence. Demand and availability risk may also be considered specific components of operational and maintenance risk.

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[1] In the context of this Consultation Paper, the term "PPP arrangements" does not include arrangements that solely involve a public sector entity holding an ownership interest in another entity, for example, as in a joint venture. These arrangements may be subject to the guidance in IPSAS 7, *Accounting for Investments in Associates* or IPSAS 8, *Interests in Joint Ventures*.

- *Residual value risk.* This risk relates to the possible difference between the market price of the infrastructure or public facility at the end of the PPP arrangement and the original market price expectation.
- *Financing risk.* This describes the risk that the full funding required for the project will not be obtained, or will be obtained at interest rates that would prevent the project from achieving its expected benefits. This might be due to the circumstances of the specific parties to the arrangement (for example, their credit status or debt limitations), or investor perceptions of the risks of a project.

4. Public sector entities undertake PPP arrangements for various reasons. The common, underlying reason is to leverage benefits created from partnering with a private sector entity that may not otherwise exist if the public sector entity were solely responsible for construction of the infrastructure or public facility and/or the delivery of the associated service. A common phrase used to refer to this leveraging objective is "achieving improved value for money." Often, the potential "value" sought by a public sector entity under a PPP arrangement is monetary in nature, for example, through attempting to control or reduce costs, or receiving an upfront inflow of resources. In other instances, the potential "value" may include an improved ability to deliver new or renovated infrastructure or public facilities, improved quality of construction and maintenance, or improved efficiency of the resulting public service. Conceptually, public sector entities "achieve improved value for money" by optimally allocating project risks (many of which are listed above) between the public and private sector entities, based on their respective abilities to use their resources and capabilities to manage such risks.

5. Some public sector entities see financial benefits to entering into PPP arrangements through the opportunity to share in certain tax benefits available to the private sector entity. For example, in jurisdictions where governments are typically not income tax payers, they do not benefit from asset deductions. If, however, a taxable private sector entity provides services utilizing an asset, that entity may be able to claim asset-based tax deductions and reflect the resulting tax benefit in a lower overall charge to the public sector entity.

6. Aside from "achieving improved value for money", some public sector entities are motivated to enter into PPP arrangements to meet fiscal targets. Some public sector entities see PPP arrangements as a vehicle for meeting needs for new or renovated infrastructure or public facilities, while at the same time excluding the infrastructure and public facilities and any associated financing from the budgetary process and financial reports of the public sector entity. This motivation appears to have been particularly prevalent in early PPP arrangements.

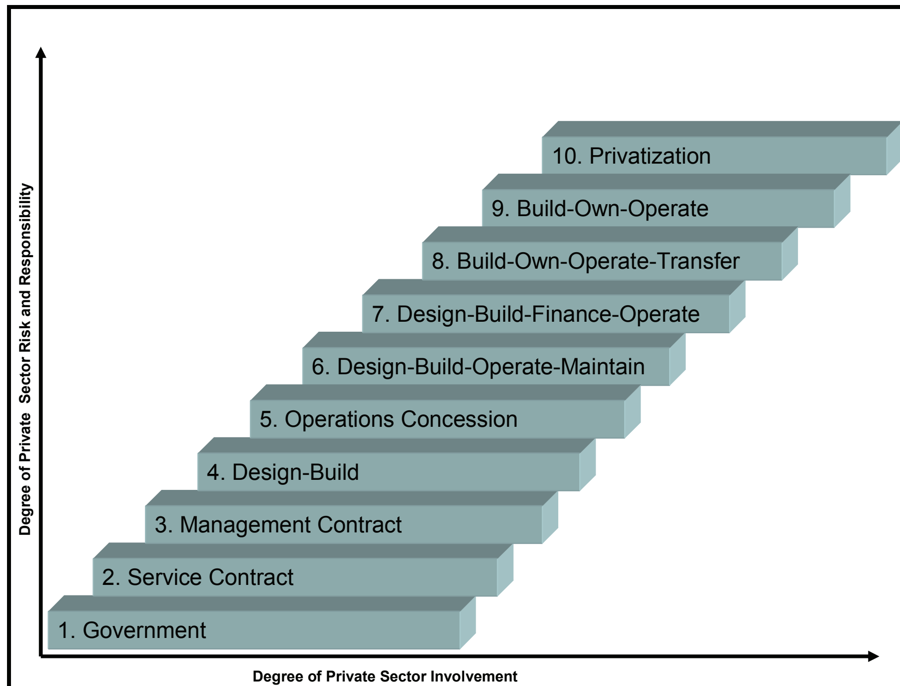
7. Generally, the private sector entity benefits from a PPP arrangement from compensation for its participation. Compensation provisions of PPP arrangements can vary (a) in their basis for payment (for example, contractually fixed payments, or variable payments based on level of availability or use of the infrastructure or public facility), and (b) in the source of the funding (third-party users, the public sector entity itself, or both). The timing of the payments may also vary. For example, to lessen the financing the private sector entity requires, the public sector entity may make a substantial payment at the beginning of the arrangement, followed by a reduced stream of periodic payments.

8. The level of proliferation of PPP arrangements in individual countries around the world varies greatly. Some countries, such as the United Kingdom and Australia, have used PPP arrangements to assist in meeting their infrastructure and public facilities needs for a number of years. In other countries, public sector entities have either only begun to enter into PPP arrangements or are still exploring them. The interest in PPP arrangements and the actual number of arrangements entered into is, however, growing steadily around the world. Additionally, although these arrangements originally were only commonly used in particular sectors, such as transportation and utilities, now they extend to many diverse types of infrastructure and public facilities and associated services. For example, PPP arrangements are now being used in sectors of public service such as education, corrections, healthcare, airports, defense, housing, ports, recreation, and arts and leisure.

## Types of Public-Private Partnerships

9. Just as the use of PPP arrangements has grown and become more diverse over recent years, so have their types. The types of PPP arrangements are often distinguished by the extent of private sector involvement in the major phases of the project. As private sector involvement increases, so generally does its assumption of project risk and responsibility. This is depicted in Chart A below, which plots the various types of PPP arrangements by the degree of risk and responsibility allocated to the private sector entity[2].

**Chart A**




[2] Chart A and the descriptions of the types of PPP arrangements that follow it present a generalized view of the types of PPP arrangements that are commonly used as of the issuance of this paper. In practice, the nature of an individual PPP arrangement or an associated project may differ from the concepts expressed in this chart and the descriptions, particularly as the utilization of PPP arrangements continues to evolve.

*Service and Management Contracts*

10. In a service contract, the public sector entity contracts out to the private sector entity services it would otherwise have performed. For example, a public sector entity may enter into a service contract with a private sector entity for the performance of waste collection services. These services generally are performed by the private sector entity in accordance with requirements set by the public sector entity. A management contract builds on a service contract by placing management responsibilities for the service with the private sector entity. Using the previous example, in contrast to a service contract, a management contract would make the private sector entity responsible not only for actual waste collection, but also for management functions associated with the operation of the service, such as hiring employees, interacting with other vendors, and preparing budgetary information related to the operation of the service. In both cases, the relationship between the public sector entity and the private sector entity is similar to that of a purchaser and vendor, and the arrangements are generally short-term, renewable only on certain conditions. Risk and responsibility for delivery of the service largely remains with the public sector entity. These arrangements can be similar to those referred to as "outsourcing" or "contracting-out." These arrangements may or may not involve the use of infrastructure or public facilities.

*Design-Build Arrangements*

11. In design-build[3] arrangements, the private sector entity is responsible for designing and building the infrastructure or public facility in accordance with the public sector entity's requirements. In these arrangements, the private sector entity usually assumes the construction risk. After construction is completed, the public sector entity is responsible for operating and maintaining the infrastructure, leaving the private sector entity with little or no further project risk.

*Operations Concession Arrangements*

12. In an operations concession arrangement, the public sector entity conveys to the private sector entity the right to provide services directly or indirectly to the public through the use of an existing infrastructure asset or public facility. The private sector entity in turn assumes an obligation to provide such services, normally in accordance with the public sector entity's performance requirements. This form of arrangement, which allocates certain economic risks and benefits of delivering services to a private sector entity, is commonly used with existing infrastructure or public facilities that do not require significant construction. In many of these arrangements, the public sector entity will receive an upfront inflow of resources (or a series of such inflows) from the private sector entity in exchange for the right to access the existing infrastructure or public facility and collect fees from third parties for its use. In other arrangements, the public sector entity will make payments to the private sector entity, generally as performance criteria are met. In contrast with service or management contracts, operations concession arrangements are

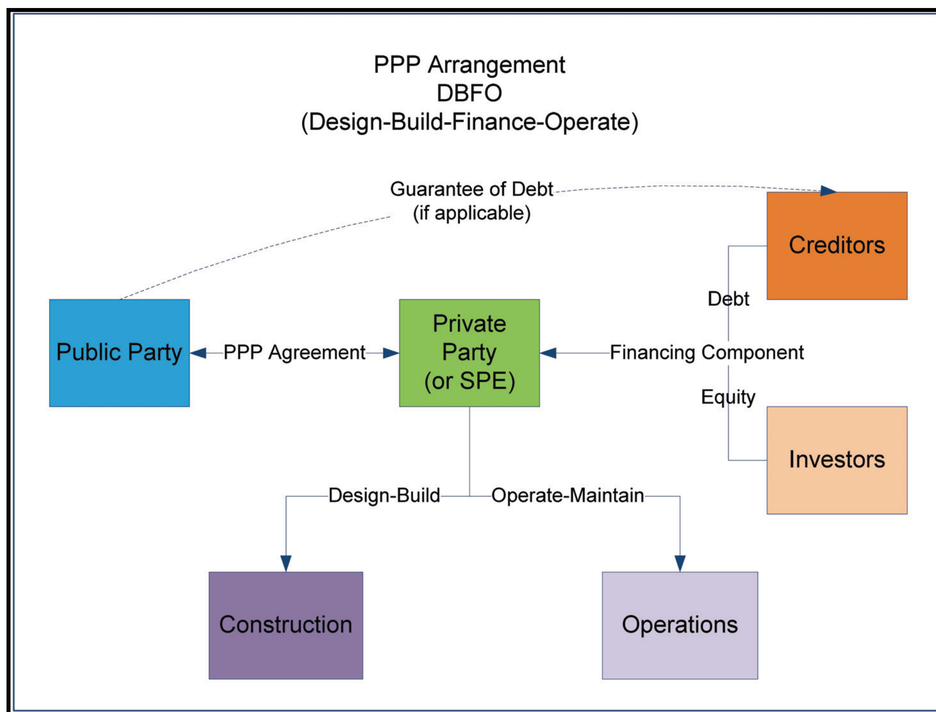
[3] In the context of this section, the term "build" refers to new construction of infrastructure and public facilities or renovation of existing infrastructure and public facilities.

generally longer in term, often to allow the private sector entity an opportunity to earn an acceptable rate of return on its investment.

*Design-Build-Operate-Maintain & Design-Build-Finance-Operate Arrangements*

13. In a design-build-operate-maintain (DBOM) arrangement, the aspects of design-build arrangements are combined with those of operations concession arrangements. The private sector entity is allocated the risks of constructing the infrastructure or public facility, along with the risks of its operation and maintenance. In a design-build-finance-operate (DBFO) arrangement, the private sector entity designs and builds the infrastructure or public facility, finances its construction costs, and provides the associated services, typically returning the infrastructure or public facility to the public sector entity at the end of the arrangement. In the latter type of arrangement, financing risk is added to the risks allocated to the private sector entity in a DBOM arrangement. The DBFO scheme is viewed by many as the traditional PPP model to use when the project involves the construction or significant renovation of the infrastructure or public facility. Chart B below illustrates the various parties to a DBFO arrangement:

**Chart B**




Note: SPE refers to “special purpose entities”, also known as “special purpose vehicles”.

*Build-Own-Operate-Transfer & Build-Own-Operate Arrangements*

14. In a build-own-operate-transfer (BOOT) arrangement, the private sector entity owns the constructed infrastructure or public facility until the end of the arrangement, then transfers that ownership to the public sector entity. Thus, risks and responsibilities related to property ownership are allocated to the private sector entity during the arrangement that

extend beyond those allocated under a DBFO scheme. A build-own-operate (BOO) arrangement differs from a BOOT arrangement in that the private sector entity does not transfer ownership of the constructed infrastructure or public facility to the public sector entity. Thus, under the BOO scheme, continued assumption of the risk of ownership beyond the term of the arrangement places an even greater degree of risk and responsibility with the private sector entity.

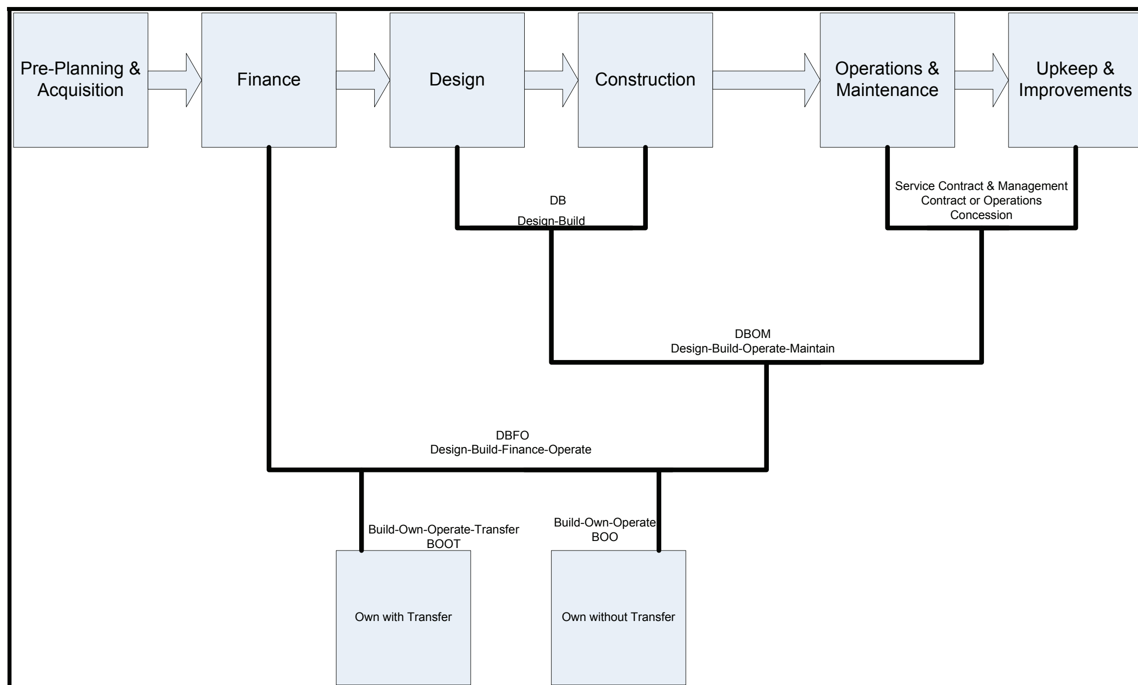
*Privatization*

15. In the context of Chart A, privatization occurs through a transfer of the infrastructure or public facility to a private sector entity, generally through sale. The public sector entity divests itself of responsibility for the property and the related delivery of services (other than possible regulatory authority), resulting in maximum risk and responsibility for the private sector entity.

*Summary of Types of PPPs*

16. To summarize the above descriptions of the various types of PPPs, Chart C below depicts the major phases of an infrastructure or public facility project and common types of PPP arrangements that may be used to carry them out.

**Chart C**[4]




4 Adapted from AECOM Consult, Inc. 2007 "Case Studies of Transportation Public-Private Partnerships around the World" p. 2.7 (prepared for the U.S. Department of Transportation Federal Highway Administration Office of Policy and Governmental Affairs). Arlington, VA.

### Public-Public Partnerships

17. The preceding paragraphs assume arrangements between one or more public sector entities[5], (grantor) and a private sector entity (operator). In some cases, however, both parties to the arrangement can be public sector entities. Generally, the operator in these arrangements is a government business enterprise (GBE). For example, in North America, a DBFO arrangement for the construction of a new toll road involves a state/provincial government as the grantor and a local tollway authority as the operator[6]. By definition, these arrangements would not be considered PPP arrangements; however, despite the difference in the nature of the operator party, these "public-public arrangements" generally take on the same forms and are carried out similarly to the PPP arrangements described above. Therefore, in the balance of this Consultation Paper, "PPP arrangements" will be understood to include both public-private partnerships and public-public partnerships, and the terms "grantor" and "operator" will apply to both types.

## Scope of the Consultation Paper

18. The accounting and financial reporting implications for the grantor of the various types of PPP arrangements discussed in the Introduction appear straightforward for some types of arrangements. For example, service and management contracts would be reported similarly to other vendor service contracts, with related outlays reported as an expense by the grantor as services are provided by the operator. Likewise, design-build arrangements would be accounted for similarly to other types of construction-related contracts, with property, plant and equipment reported (as appropriate) based on the guidance in IPSAS 17, *Property, Plant and Equipment*. In these cases, ownership of the infrastructure or public facility remains with the grantor, as do the majority of the risks, responsibilities, benefits, and control of the infrastructure or public facility, and the associated services.

19. A single arrangement could combine the aspects both of a design-build arrangement and a service or management contract (as opposed to an operations concession arrangement). For example, a grantor may contract with an operator to design and build a bridge and provide maintenance and toll collection services for a period after completion of construction. In such a case, each portion of the arrangement—the design-build portion and the service contract portion—would be accounted for as discussed in the previous paragraph. In some of these arrangements, the amount of the payments related to the construction and service aspects of the arrangement can be discretely identified in the contract. If they cannot, estimates may be required to allocate the payments.

20. Privatization through an asset sale would generally be reported similarly to any other asset sale. In this case, ownership of the infrastructure or public facility passes to the operator along with the majority of the risks, responsibilities, benefits, and control of the infrastructure or public facility, and the associated services.

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[5] When multiple public sector entities constitute the grantor, those entities may be subject to IPSAS 7, *Accounting for Investments in Associates,* or IPSAS 8, *Interests in Joint Ventures*.

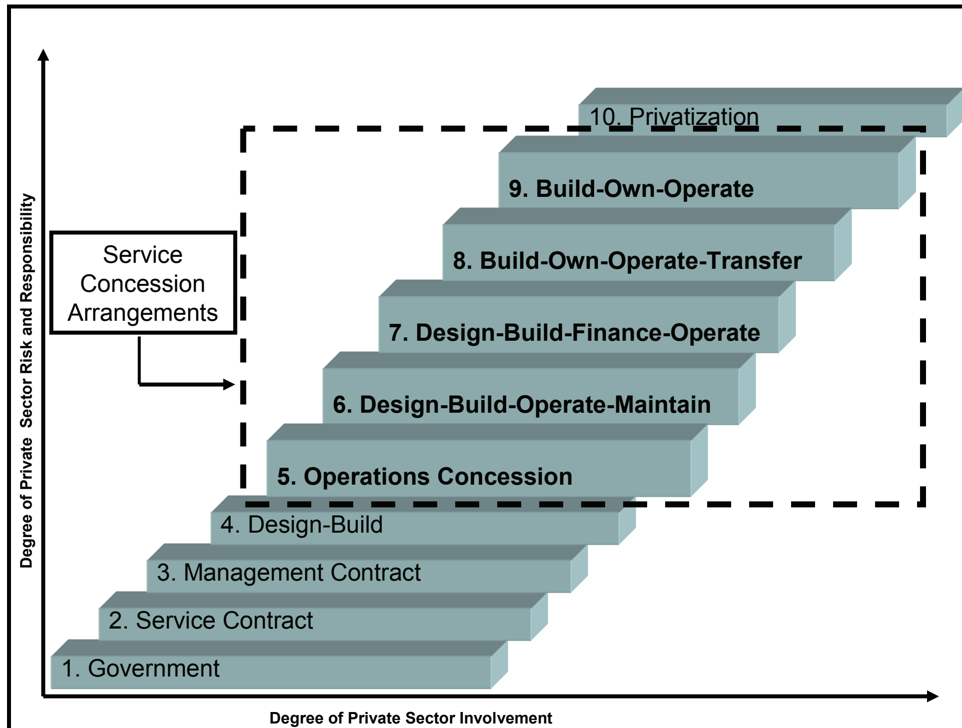
[6] Richard Williamson, "NTTA Approves up to $3.75 Billion of BANs for SH-121 Toll Project," *The Bond Buyer,* November 9, 2007.

21. Unlike the arrangements discussed above, the accounting treatment for operations concession arrangements is not as clear and is often contentious. This is also the case for those types of PPP arrangements described in the Introduction that combine a construction element with an operations concession element, such as a DBFO arrangement. The difficulty in accounting for these arrangements results from a more even *sharing* between the grantor and the operator of the risks, responsibilities, benefits, and control of the underlying infrastructure or public facility, and the delivery of the associated services. This raises the question—which party to the arrangement should report the underlying infrastructure or public facility as an asset in their financial statements. The formal legal owner of the infrastructure or public facility may not be the same party that, in substance, both benefits from the property and related service delivery and bears its risks.

22. Based on the above discussion, the Consultation Paper primarily focuses on the accounting and financial reporting issues related to (a) operations concession arrangements, and (b) other PPP arrangements that combine a construction element with an operations concession element. These arrangements are more commonly referred to collectively as *service concession arrangements* (SCAs), a term used in the balance of this Consultation Paper.

23. Examples of the types of PPP arrangements included in Chart A in the Introduction that would be considered SCAs are highlighted in Chart D below:

**Chart D**




24. Originally, the term "service concession arrangement" generally was used narrowly to describe arrangements funded by the operator receiving a concession that would enable it to directly charge the public for use of the underlying property. More recently, however,

the International Accounting Standards Board's (IASB) International Financial Reporting Interpretations Committee (IFRIC) Interpretation 12, *Service Concession Arrangements*, (IFRIC 12) has defined SCAs more broadly. In IFRIC 12, the term includes both arrangements where the private sector entity directly charges the public (as third-party users), as well as those where the grantor makes payments to the operator. The grantor may make these payments either on behalf of the public as third-party users, or because it directly uses the underlying property. In this Consultation Paper, "service concession arrangement" is used in this broader context. Also, SCAs can involve both new and existing infrastructure or public facilities.

25. The Board believes the discussion in this Consultation Paper should also be applied to public-public partnerships that meet the above description of an SCA, because the public sector nature of the operator party should not impact the accounting and financial reporting implications of the arrangement.

26. The discussion in this Consultation Paper will focus on the accounting and financial reporting implications of SCAs for the grantor. Operators in SCAs are generally private sector entities or GBEs for which International Financial Reporting Standards (IFRSs) issued by the IASB would be considered. These operators should review IFRIC 12 and Standing Interpretations Committee (SIC) Interpretation 29, *Service Concession Arrangements: Disclosures*, (SIC-29) in determining the appropriate accounting and financial reporting for SCAs[7]. This Consultation Paper does not consider guidance for public sector entities other than GBEs that serve as operators in an SCA, because the Board believes that this circumstance seldom occurs.

27. The key accounting and financial reporting issue related to SCAs addressed in this Consultation Paper is the reporting of the associated infrastructure or public facility by the grantor (including potential derecognition of existing assets), along with the reporting of any related liabilities reflecting the obligation of the grantor to compensate the operator for the property. Other SCA-related areas of accounting and financial reporting addressed in this Consultation Paper include (a) guarantees and other commitments made by the grantor as part of SCAs, (b) the recognition by the grantor of revenues generated through these arrangements, (c) the potential consolidation of the operator into the grantor's economic entity, and (d) financial statement disclosures for these arrangements.

## Financial Reporting of Infrastructure and Public Facilities

### Summary of Potential Approaches

28. The central accounting and financial reporting issue for grantors related to SCAs is the reporting of the infrastructure or public facility (property) associated with these arrangements, along with any related liability reflecting the obligation to compensate the operator for the property. As noted previously, because the risks, responsibilities, benefits, and control of the property in SCAs are shared in varying degrees between the grantor and the operator, basing financial reporting of the property solely on legal ownership may not

[7] The guidance in the Consultation Paper could be applied to GBEs that are grantors in SCAs, because IFRSs currently do not provide accounting and financial reporting guidance for grantors.

result in the most faithful representation of the effects of the arrangement. Both the relationship among the parties to the SCA and the underlying property must be analyzed to determine the financial reporting that most faithfully represents ownership of the property on a "substance over form" basis.

29. Many jurisdictions currently apply their existing authoritative accounting and financial reporting guidance, such as their general accounting frameworks and leasing standards, to account for property associated with SCAs. However, some standard-setting bodies have either issued or proposed guidance specifically addressing the unique nature of SCAs (or, more broadly, PPP arrangements). These standard-setting bodies include the following:

- UK Accounting Standards Board
- European Commission (Eurostat)
- IASB's IFRIC; and
- Accounting Standards Board of South Africa

30. The existing and proposed guidance of these standard-setting bodies on SCAs (or PPP arrangements, as applicable) take different approaches to determining the appropriate reporting of the property associated with the arrangement. This section of the Consultation Paper summarizes the different approaches of these standard-setting bodies. Other alternative approaches to reporting the property associated with an SCA are also discussed below.

*UK Accounting Standards Board*

31. In the UK Accounting Standards Board's 1998 Amendment to Financial Reporting Standard (FRS) 5, *Reporting the Substance of Transactions*, entitled *Private Finance Initiative and Similar Contracts Application Note F* (Application Note F), economic risks and rewards are the basis for determining the accounting for the property associated with a private finance initiative[8] (PFI) arrangement. (FRS 5 and Application Note F also are the basis for the recommended public sector accounting and financial reporting guidance related to PPP arrangements in Australia[9] and New Zealand, although application of the guidance has varied among jurisdictions.) Application Note F works from the premise that most PFI arrangements call for the operator to design, build, finance, and operate the associated property, thereby creating an SCA, as previously described. Application Note F sets forth the following basic principle for determining the reporting of the property associated with a PFI contract:

> *Under the general principles of the FRS, a party will have an asset of the property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits. If that party is the purchaser [grantor], it will have a corresponding liability to pay the operator for the*

[8] 'Private finance initiative' is the term used in the UK for a type of SCA or PPP arrangement.

[9] *Additional Guidance on the Application of FRS 5—Methods to Determine Control of Infrastructure Assets Used in the Australian Public Sector and Recognition of Emerging Assets, Up-Front Contributions and Leased Land, June 2005,* prepared and endorsed by the Heads of Treasuries Accounting and Reporting Advisory Committee.

*property where the commercial effect of the PFI contract is to require the purchaser to pay amounts to the operator that cover the cost of the property. [Paragraph F5]*

32. To determine which party should report the associated property as an asset, Application Note F states that service elements of the contract should be separated from required payments for the property, to the extent they operate independently of each other. Service elements may relate to ancillary services associated with the property provided by the private sector entity, such as cleaning or catering. Separable service elements should be excluded from consideration because such elements are not relevant to determining which party should report the property as an asset. Separable service elements would be accounted for similarly to any other service contract. After separable service elements have been excluded, PFI arrangements are classified into one of the following two categories:

    1. Those where the only remaining elements are payments for the property. Application Note F states that these contracts would be similar to a lease and should be accounted for under the guidance in UK SSAP 21, *Accounting for leases and hire purchase contracts*, as interpreted under Application Note F.

    2. Those where the remaining elements include some services. These contracts would fall under the guidance provided in Application Note F.

    It should be noted that many, if not most, of these PFI arrangements are constructed so as to fall into the second category.

33. Under Application Note F, a party's access to the benefits of the property and exposure to the associated risks is reflected in how the potential variations in property profits or losses are shared by the parties. Potential variations in costs and revenues that flow from features of the property should be distinguished from those that do not. Only those potential variations that flow from features of the property are relevant to determining which party should report the property as an asset.

34. Application Note F describes the factors that may be relevant to assessing which party bears the potential variations in property profits and losses as follows:

    - *Demand Risk.* Demand risk is the risk that demand for the property will be greater or less than predicted or expected. Application Note F states that demand risk, where significant, will *normally* give the clearest evidence of how the associated property should be reported, and that the bearer of demand risk should report the asset.

    - *The Presence, if any, of Third-party Revenues.* Some PFI arrangements involve the expectation that the property will be used by parties other than the grantor. The operator's reliance on revenues from these third-parties to cover its property costs is evidence that the property is an asset of the operator. Third-party use that is minimal or solely a future possibility is evidence that the property is an asset of the grantor.

    - *Who Determines the Nature of the Property.* This factor relates to who determines how the PFI arrangement is to be carried out and, in particular, what kind of property is to be built. If the grantor, having determined the key features of the property and how it is to be operated, bears the cost implications of any operational changes, this is

evidence that the property is the asset of the grantor. If, on the other hand, the operator has significant and ongoing discretion over how to carry out the PFI arrangement, and makes the key decisions on what property is built and how it is operated, thus bearing the consequent costs and risks, this indicates that the property is the asset of the operator.

- *Penalties for Underperformance or Non-availability.* Some PFI arrangements provide for penalties in the form of cash payments or reductions in revenue if the property is below a specified standard or is unavailable because of operator fault. In determining which party should report the property as an asset, these penalties should relate strictly to the property—not the provision of services. If the penalties are unlikely to occur or their impact is insignificant, this is evidence that the property is an asset of the grantor. If the potential penalties could cause the operator's profits associated with the property to be genuinely subject to significant potential variation, then this would be evidence that the property is an asset of the operator.
- *Potential Changes in Relevant Costs.* Potential changes in property costs may be dealt with in different ways in a PFI arrangement. If significant future cost increases can be passed on to the grantor, this would be evidence that the property is an asset of the grantor. If the operator's costs are both significant and highly uncertain, and no provisions pass on cost variations to the grantor, this is evidence that the property is an asset of the operator.
- *Obsolescence, Including the Effects of Changes in Technology.* Whether obsolescence or changes in technology are relevant will depend on the nature of the contract. Where this factor is relevant, the bearing of costs and any associated benefits by a party provides evidence that the property is its asset.
- *The Arrangements at the End of the Contract and Residual Value Risk.* Residual value risk is the risk that the actual residual value of the property at the end of the arrangement will be different from expected value. Application Note F states that for arrangements where residual *value* risk is significant, identification of the party that bears that risk will normally provide clear evidence of which party should report the property as an asset. The grantor will bear residual risk where:

    1. It will purchase the property for a substantially fixed or nominal amount at the end of the arrangement;
    2. The property will be transferred to a new operator selected by the grantor for a substantially fixed or nominal amount; or
    3. Payments over the term of the PFI arrangement are sufficiently large for the operator not to rely on an uncertain residual value for its return.

    The operator will bear residual value risk where:

    1. It will retain the property at the end of the PFI arrangement; or
    2. The property will be transferred to the grantor or another operator at the prevailing market price.

35. Application Note F goes on to state that in determining which party reports the property as an asset, the combined effect of all of the relevant factors should be considered for a range of reasonably possible scenarios, with greater weight being given to more likely outcomes.

36. It is worthwhile to note that construction risk is not included in the above list of factors. Construction risk is referred to in Application Note F in the discussion on "who determines the nature of the property". Construction risk was specifically excluded from Application Note F because the risk occurs before the service concession period starts. The UK Accounting Standards Board took the view that construction risk generally is not relevant to determining which party has an asset of the property after construction is completed, because such risk normally has no impact during the property's operational life. However, Application Note F does state that construction risk may be relevant where it calls into question the other evidence, particularly in a case where the grantor bears construction risk, but based on the other factors, the property is otherwise claimed to be the asset of the operator.

*European Commission (Eurostat)*

37. In 2004, Eurostat published an additional chapter to its *ESA95 Manual on Government Deficit and Debt*, entitled *Long term contracts between government units and non-government partners (Public-private-partnerships)* (the Chapter). In the Chapter, Eurostat provides guidance on accounting for property associated with PPP arrangements for statistical reporting purposes. The general focus of the guidance is the bearing of economic risks in a manner similar to the UK guidance discussed above. However, in an effort to simplify the risk analysis, Eurostat limited the risks to be considered to those perceived to be the most significant. The guidance in the Chapter also distinguishes between (a) arrangements where the grantor is the primary purchaser of the services provided by the operator, either on the grantor's own behalf or on behalf of third-party users, and (b) arrangements where third-party users are the primary purchasers of the services. The Chapter refers to the former as a *PPP arrangement* and the latter as *a concession agreement.*

38. The general principle the Chapter puts forth for contracts it refers to as *PPP arrangements* is that the associated property is only reported as an asset of the operator if there is strong evidence that the operator is bearing the majority of the economic risks attached to the contract. For purposes of applying this general principle, the Chapter states that the property should be reported as an asset of the operator only if both of the following conditions are met:

    1. The operator bears construction risk; and
    2. The operator bears at least one of either availability or demand risk.

39. These risks are described in the Chapter as follows:

    - *Construction Risk.* This risk covers events related to the initial state of the associated property. In practice, it relates to events such as late delivery, non-respect of specified standards, significant additional costs, technical deficiency, and external negative

effects (including environmental risk) that trigger compensation payments to third parties.

- *Availability Risk.* This risk covers cases where, during the operation of the asset, the operator assumes responsibility because of insufficient management, resulting in a volume of services lower than was contractually agreed upon, or in services that do not meet the quality standards specified in the contract.
- *Demand Risk.* This risk covers the variability of demand (higher or lower than expected when the contract was signed), irrespective of the performance of the operator. In other words, a shift of demand cannot be directly linked to the level of quality of the services the operator provided. Instead, the shift results from other factors, such as the business cycle, new market trends, a change in final users' preferences, or technological obsolescence.

40. In many acquisitions (including those considered traditional procurement), there would normally be some attempt to transfer construction risk to the builder, for example by use of a fixed-price contract. Therefore, it has been argued that, in substance, the operator often only needs to accept either availability or demand risk to report the property as an asset in its financial statements. However, the Chapter also states that the contractual provisions related to the disposition of the property at the end of the PPP arrangement can supplement the above criteria for determining overall risk transfer, particularly when assessment of these risks does not result in a clear conclusion. The guidance in the Chapter as to whether the provisions related to the disposition of the property provide evidence of risk transfer to the grantor or the operator is similar to the guidance of the UK Accounting Standards Board described above. The Chapter also states that the grantor's participation in the upfront financing of the project, either directly by issuing debt or indirectly by guaranteeing the debt of the operator, could influence the risk transfer assessment as a component of construction risk.

41. Although not specifically stated, certain guidance in the Chapter implies that the associated property in concession arrangements should be reported as an asset of the operator.

*IASB's IFRIC*

42. In November 2006, IFRIC 12 was issued to provide accounting and financial reporting guidance on service concession arrangements, specifically for operators of such arrangements—guidance for grantors is not provided. The provisions of IFRIC 12 cover public-private service concession arrangements in which:

    1. The grantor controls or regulates what services the operator must provide with the associated property, to whom it must provide them, and at what price; and
    2. The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the property at the end of the arrangement.

    Arrangements are also considered to fall within the scope of IFRIC 12 if the underlying property is used for its entire useful life under the arrangement and the first criterion above is met.

43. IFRIC 12 states that its provisions apply both to (a) property the operator constructs or acquires from a third party for the purpose of the SCA, and (b) existing property to which the grantor gives the operator access for the purpose of the arrangement.

44. Paragraph 11 of IFRIC 12 addresses whether the operator should report the property associated with the SCA as an asset as follows:

> *Infrastructure within the scope of this Interpretation shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.*

45. The IASB's *Framework for the Preparation and Presentation of Financial Statements* (*Framework*) is cited as the basis for IFRIC 12's conclusions with respect to this focus on control over the use of the underlying property, specifically as follows:

    - An asset is defined by the *Framework* as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'
    - The *Framework* notes that many assets are associated with legal rights, including the right of ownership. It goes on to clarify that the right of ownership is not essential.
    - Rights are often unbundled. For example, they may be divided proportionately (undivided interests in land) or by specified cash flows (principal and interest on a bond), or over time (a lease).

46. Therefore, regardless of which party holds legal title to the property during the arrangement, IFRIC 12 states that the operator should not report the property as its asset in the case of SCAs within its scope, because the operator does not control its use, and the definition of an asset is not met.

47. Respondents to the draft interpretation on SCAs issued by the IFRIC in March 2005, *D12 Service Concession Arrangements—Determining the Accounting Model* (D12)*,* questioned how its control-centric approach could be reconciled with the approach in International Accounting Standard (IAS) 17, *Leases,* (which is similar to the approach in IPSAS 13, *Leases*) in which the leased asset is recognized by the party that bears substantially all the risks and rewards incidental to ownership. IFRIC 12 cites IFRIC 4, *Determining whether an Arrangement contains a Lease,* as justification for not considering the allocation of risk and rewards in its approach to reporting the property underlying an SCAs. IFRIC 4 states that an arrangement is a lease if it conveys the right to control the use of the underlying asset. Because the operator is deemed not to have control over the use of the property in SCAs that meet the scope of IFRIC 12, the arrangement would not be a considered a lease, and the operator could not report the property as a leased asset[10].

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[10] As illustrated in Information Note 2 of IFRIC 12, it is generally assumed that the grantor owns the underlying property for SCAs that meet the scope of IFRIC 12.

48. IFRIC 12 thereby concludes that the operator's right to the property in an SCA is different than the rights of a lessee in a lease arrangement. Because the grantor controls the use of the asset, the operator does not have the same right of use of the property as a lessee. Instead, the operator is more like a service provider to the grantor, only having *access* to the property to provide the public service on behalf of the grantor in accordance with contractually specified terms.

49. IFRIC 12 states that the asset the operator should recognize is the consideration it receives for its services, as opposed to the property that it constructs, upgrades, or accesses as part of the arrangement. IFRIC 12 requires the operator either to:

    - Report a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor; or

    - Report an intangible asset to the extent that it receives a right to charge users of the public service, that is, there is no unconditional right to receive a financial asset because the amounts are contingent on the extent that the public uses the service.

50. As noted above, IFRIC 12 only provides guidance for operators. However, practically speaking, it can be inferred from the operator guidance provided under IFRIC 12 that the grantor should report the underlying property as an asset.

*Accounting Standards Board of South Africa*

51. In September 2005, the Accounting Standards Board of South Africa issued a proposed accounting guideline entitled, *Guideline on Accounting for Public-Private Partnerships* (the Proposed Guideline). The Proposed Guideline distinguished two different types of PPP arrangements: (a) one involving the performance by an operator of an "institutional function," and (b) the other involving some form of "use of state property" by the operator for its own commercial purposes. The Proposed Guideline provides somewhat different guidance on accounting for the associated property for each type of PPP arrangement. However, for both types, the main factor used to determine the financial reporting for the associated property is possession of the property at the end of the arrangement. It should be noted that the provisions of the Proposed Guideline would only apply to the grantor—guidance for the operator is not provided.

52. Similar to the guidance of the UK Accounting Standards Board, the Proposed Guideline would require that, for accounting and financial reporting purposes, the payments made by the grantor to the operator be divided into an asset element and a service element. The Proposed Guideline describes how to account for the asset element, that is, how to report the property associated with the PPP arrangement.

53. The Proposed Guideline describes an "institutional function" PPP as an arrangement under which the operator will perform part of the grantor's service delivery or administrative functions, and assume the associated risks. The arrangement involves a substantial transfer of some form of project life cycle risk to the operator. The grantor retains a significant role in the project, however, either as the main purchaser of the services or as the main enabler of the project.

54. For property associated with this type of arrangement, the Proposed Guideline uses the provisions of the South African Standard of Generally Recognised Accounting Practice on leases as the basis for determining whether the property should be reported as an asset of the grantor. In all PPP arrangements that require the development or construction of immovable property, ownership of the immovable assets will revert to the grantor at the end of the arrangement. This is so because South African legislation generally does not permit the transfer of any government property to a private party unless the applicable legislative requirements with regard to the disposal of government assets are met. Therefore, payments toward the development or construction of immovable property fall within the definition of a finance lease, resulting in the grantor reporting the property as its asset. Ownership of movable property can either remain with the operator or revert to the grantor when the PPP arrangement expires. Therefore, it must be determined whether the payments made by the grantor toward the development or construction of the movable property meet the definition of a financing lease or an operating lease, to determine whether the grantor would report the movable property as an asset in its financial statements.

55. The Proposed Guideline describes the "use of state property" PPP as an arrangement under which the grantor will transfer the right of use of immovable or movable property to an operator for its own commercial use. The Proposed Guideline states that pre-existing immovable or movable assets under this type of arrangement would continue to be reported by the grantor, because (a) control and ownership of these assets will remain with the grantor for the duration of the arrangement, and (b) use will revert to the grantor at the end of the arrangement. The grantor will report as its asset immovable or movable property constructed or developed at the commencement of the PPP arrangement that will revert to it at the end of the agreement. Movable property that will remain with the operator at the end of the agreement would not be reported as assets of the grantor.

*Other Approaches*

Lease Approach

56. It can be argued that, for purposes of reporting the underlying property, an SCA can be viewed similarly to a lease—an agreement that conveys the right to control the use of an asset for an agreed-upon period of time. Therefore, the criteria used to determine whether a lease is a finance lease or an operating lease could be used to determine which party to the SCA should report the underlying property as an asset in its financial statements. These criteria are designed to determine whether the risks and rewards incident to ownership of the property substantially lie with the lessor or lessee (and therefore, arguably, which party ultimately controls the property). Risks include the possibilities of losses from idle capacity, technological obsolescence, or changes in value due to changing economic conditions. Rewards may be represented by the expectation of (a) service potential or profitable operation over the property's economic life, or (b) gain from appreciation in value or realization of a residual value.

57. A lease is classified as a finance lease if it transfers to the lessee substantially all the risks and rewards incident to ownership. IPSAS 13 provides the following examples of

situations that would normally result in a finance lease and reporting of the asset by the lessee:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, so that at the inception of the lease it is reasonably certain that the option will be exercised;

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;

(e) The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made; and

(f) The leased assets cannot easily be replaced by another asset.

Any lease not classified as a finance lease is considered an operating lease, meaning that the lessor continues to report the property as its asset.

Unbundling/Components (Rights and Obligations) Approach

58. One common aspect of all of the above approaches to reporting infrastructure and public facilities associated with SCAs is that only one of the parties should report the underlying property as a property, plant and equipment asset in its financial statements. Under an alternative approach, the grantor could report a portion of the underlying assets and liabilities of an SCA based on allocation of project risks and benefits. An unbundling/components approach is suggested in the paper, *Public-Private Partnerships, Government Guarantees, and Fiscal Risk*, prepared by a staff team from the International Monetary Fund led by Richard Hemming[11]:

> *More important, however, is the question of whether [a] binary approach, under which PPP assets are classified either as government assets or private assets, is an appropriate way of accounting for risk transfer. The specific concern is that such an approach is insensitive to the fact that PPPs are intended to share risk according to which party can best manage it. The fact is that government exposure to PPP risk will vary widely across projects, and the accounting profession ideally should be seeking to develop a workable approach to identifying and quantifying the risk to which the government is exposed under PPPs and for assessing and disclosing the fiscal consequences of such risk.*

59. Although that paper acknowledges the difficulty of developing this type of approach, it goes on to warn that a binary approach creates the risk that PPPs in which the grantor bears

[11] International Monetary Fund Staff Team led by Richard Hemming, 2006, *Public-Private Partnerships, Government Guarantees, and Fiscal Risk,* p. 27-28.

the larger share of project risk might be discouraged. This is because, in that case, the grantor would be required to report the property as an asset along with a related liability to the operator. In some circumstances, the grantor could view this as an undesirable accounting result. This could result in tailoring arrangements so that the operator bears more risk, resulting in higher project costs that could negatively impact the operational efficiency of the arrangement.

60. An approach under which both the grantor and the operator would report assets and liabilities would also honor the concept that property ownership is essentially ownership of a “bundle of rights” that in some cases can be separated and individually transferred. For example, the right to benefit from the use of property through collecting rents could be transferred separately from the other rights of ownership. IFRIC 12 could be interpreted to consider this possibility by requiring the operator to report as an intangible asset the right to charge users of the service provided through the underlying property, when the operator does not have an unconditional contractual right to receive cash or another financial asset from, or at the direction of, the grantor.

61. An unbundling/components approach may also be similar to a ‘rights and obligations’ approach proposed in accounting journals and other literature. Rights and obligations are also being considered by the IASB and the US Financial Accounting Standards Board (FASB) as a potential basis for a new accounting standard on leases. Under that joint project, the rights and obligations of a lessee and lessor will be identified and analyzed to see to whether they meet the definition of financial statement assets and liabilities. The IASB and the FASB are expected to issue a discussion paper expressing their preliminary views in 2008.

**Analysis**

62. The existing or proposed guidance on reporting the underlying property in an SCA (or PPP arrangement), discussed above, each has a different focus that can result in different reporting results even under the same set of circumstances. As an example, under IFRIC 12, the operator would not report the underlying property for any SCA that is within its scope. However, of the 53.4 billion (UK) capital values of PFI arrangements declared by the UK Treasury (which are required to be accounted for by grantors using Application Note F as implemented currently by HM Treasury Technical Note 1 (revised) ‘How to account for PFI Transactions’ based on Chapter 5 of the UK Government Financial Reporting Manual), approximately 29.1 billion (UK) is currently off-balance sheet for the grantor[12]. This implies that the property underlying these capital values is reported as property, plant and equipment either by the operator, or by neither party, a fact that is cited in a 2004 report of the UK Financial Reporting Advisory Board. That report notes a number of cases where underlying property of a PFI was not reported as a property, plant and equipment asset on the balance sheet of either the grantor or the operator[13].

[12] Paul Gosling, “End of the Line for PFI?,” *www.publicfinance.co.uk,* July 27, 2007 (www.publicfinance.co.uk/features_details.cfm?News_id=31025).

[13] (7th) Report for the period April 2003 to March 2004 of the UK Financial Reporting Advisory Board to the House of Commons, section 2.3.

63. Even in the case of the UK and Eurostat approaches, both of which emphasize economic risk, the difference in the specific risks considered, particularly construction risk, can result in different reporting. This potential for different reporting illustrates the need for a harmonized approach to reporting the property associated with these arrangements.

64. Despite the differences in the current guidance, proposed guidance, and other approaches, two broad focuses in addressing this reporting issue can be identified—a control focus, and a risks and rewards focus. Although the concepts of control and risks and rewards are not mutually exclusive, the current guidance, proposed guidance, and other approaches emphasize one concept or the other in determining the reporting of the underlying property of an SCA. Each focus applies a different aspect of the definition of an asset in IPSAS 1, *Presentation of Financial Statements*. That IPSAS defines assets as "resources controlled by an entity as a result of past events and from which future economic benefits[14] or service potential are expected to flow to the entity." The notion of control over resources is clearly laid out in the definition. Risks and rewards are connected to the expected flow of future economic benefits or service potential because generally it is sufficiently certain that future economic benefits or service potential will flow to an entity when it (a) will be assured of receiving the rewards attaching to the asset, and (b) will undertake the associated risks.

65. Based on the definition of an asset in IPSAS 1, both control and future economic benefit or service potential would need to be achieved for the grantor to report the property associated with an SCA as an asset. Therefore, both the concepts of control and risks and rewards discussed above should be considered in developing an approach to determine how grantors should report this property.

*Control*

66. Control over the use of the underlying property is the key principle found in the conclusion reached in IFRIC 12, that is, that the operator should not report that property as an asset in an SCA that meets its scope. IFRIC 12 focuses on control over the operational aspects of the property—the services that must be provided with it, those receiving the services, and the rate to be charged for them—as well as control over any significant residual interest in the property at the end of the arrangement. Although based on leasing principles, the proposed South African guidance also indirectly focuses on control over the property. In that case, control over the property at the end of the term of the arrangement dictates the reporting of the property. Because this aspect of control over property is a subset of the IFRIC 12 criteria for control, previously mentioned, the rest of this section will focus on the guidance in IFRIC 12.

67. A basic question to be answered is how to determine control over the property for financial reporting purposes. To answer this question, IFRIC 12 cites guidance in IFRIC 4 that discusses control over the use of an asset when determining whether an arrangement contains a lease. IFRIC 4 states that the right to control the use of the underlying asset to an arrangement is conveyed if any of the following conditions are met:

[14] As used in this section, the term 'future economic benefits' specifically refers to the direct generation of net cash inflows, which is consistent with how such term is used in the definition of an asset in IPSAS 1.

- The purchaser (lessee) has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
- The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
- Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

68. IFRIC 12 concludes that, for SCAs that meet its scope criteria, the operator would not control the use of the property based on the above IFRIC 4 criteria. This implies, therefore, that the grantor would control use of the property for financial reporting purposes. It then draws the conclusion that without control over the use of the property, the operator cannot report it as an asset based on the definition of an asset in the IASB *Framework*.

69. Despite the existence of the circumstances laid out in the scope of IFRIC 12, it can be argued that the operator still has some control over use of the asset. The operator has the ability to manage how the property is used within the standards established in the arrangement. For example, the terms of the arrangement in an SCA for a roadway may specify certain physical conditions that the operator must maintain. Generally, however, the contract will not specify how to meet such conditions, leaving this to the discretion of the operator. In this way, the question to be answered in determining the financial reporting of the property, having assessed the relative position of the parties, is which party has *ultimate control* over the property.

70. The Board believes that the nature of the criteria incorporated into the scope of IFRIC 12 generally is appropriate to determine whether the grantor has control over the underlying property of an SCA for financial reporting purposes. These criteria, considered together, indicate that (a) the grantor would have a continuing right to require the property to be operated to meet its public service objectives throughout the life of the arrangement and beyond, and (b) the operator's practical ability to sell or pledge the property (potentially resulting in a different use) is restricted. Despite the operator's control over delivery of certain aspects of services generated by the property, the overall use of the property is still limited to the objective of the grantor set forth in the arrangement. Moreover, the grantor controls key operational aspects of the property, such as the rates to be charged for its use. The Board therefore concurs that the operator is operating the property on behalf of the grantor, and that the grantor has ultimate control over the property, if criteria similar to those in IFRIC 12 are met.

71. Alternatively, it can be argued that the nature of the grantor's control over property associated with an SCA that meets criteria similar to those in IFRIC 12 is no different from the control that a government often exercises in regulating certain industries. This

argument can particularly be made when the industry provides services that formerly had been provided by the government. Paragraph 32 of IPSAS 23, *Revenue From Non-Exchange Transactions (Taxes and Transfers)* addresses whether control derived solely from a government's regulatory role can result in control over assets for purposes of meeting the definition of an asset for financial reporting purposes as follows:

> *The ability to exclude or regulate the access of others to the benefits of an asset is an essential element of control that distinguishes an entity's assets from those public goods that all entities have access to and benefit from. In the public sector, governments exercise a regulatory role over certain activities, for example financial institutions or pension funds. This regulatory role does not necessarily mean that such regulated items meet the definition of an asset of the government, or satisfy the criteria for recognition as an asset in the general purpose financial statements of the government that regulates those assets.*

72. Furthermore, paragraph 37 of IPSAS 6, *Consolidated and Separate Financial Statements*, states that regulatory powers do not constitute control for the purposes of financial reporting. Such paragraph states that the meaning of control for the purposes of IPSAS 6 does not extend to:

> …the power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed by these entities.

73. Based on this guidance in IPSAS 23 and IPSAS 6, it could be argued that if the grantor's control over the underlying property in the SCA agreement is akin to regulatory control, such control alone is not sufficient to meet the control aspect of the definition of an asset for purposes of the grantor's financial reporting.

74. The Board believes that there is a distinction in these two scenarios, in that criteria similar to those in IFRIC 12 would require the grantor to maintain control over the residual interest in the property at the end of the arrangement. This is not normally the case when the government, in its regulatory role, establishes rules or restrictions on use of property. The private sector owner in this case can normally transfer its property or even choose to use it for another purpose. Additionally, the grantor's control over the underlying property in an SCA is based on a contract willingly entered into by the operator. It is not established through legislation, as contemplated in the guidance in IPSAS 23 and IPSAS 6.

75. Another argument can be made that restrictions on the use of the property present in criteria similar to those in IFRIC 12 can be analogized to stipulations on non-exchange transactions. For example, a national government may transfer a parcel of land to a public university stipulating that the land is to be used to build a campus. Under IPSAS 23, despite such a stipulation, the public university in this example (the "user" of the property) would still be considered to control the land and would recognize the land as an asset in its financial statements. The university also would report a liability if the stipulation were considered a condition, reflecting that it would have to return the land to the donor if it was

not used for its intended purpose. The financial reporting results in this example could be seen to conflict with the guidance discussed above related to control over property in SCAs where the party imposing the restrictions on the use of the asset (the grantor), and not the user of the asset (the operator), would be considered to control the property for financial reporting purposes.

76. The key distinction between the university transfer example in the preceding paragraph and an SCA that meets criteria similar to those in IFRIC 12 is again the grantor's maintaining of control of the residual interest in the underlying property at the end of the SCA. In arrangements typical of those considered in the preceding paragraph, the transferred assets will not revert to the transferor at the end of a specified period (in some cases of property, plant and equipment, the transferor holds a residual interest in the salvage value of the property; however, that interest is often expected to be insignificant). Even where the stipulation is a condition, the asset only reverts to the transferor on breach of the condition. So long as the condition is met, the asset remains with the transferee.

77. Questions also can be posed regarding the nature of the residual interest in the property that must be controlled by the grantor for it to be considered in control of the property for financial reporting purposes—specifically, (a) whether that residual interest must be significant, and (b) whether circumstances exist where the grantor would not have to control the residual interest to be considered in control of the property for financial reporting purposes.

78. In the exposure process that led to the issuance of IFRIC 12 (IFRIC's draft interpretation D12), it was proposed that for the arrangement to meet the scope criteria (a) the grantor must control the residual interest in the infrastructure at the end of the concession arrangement, and that (b) the residual interest must be significant. Respondents to D12 commented that this requirement would result in the exclusion of SCAs in which the entire economic life of the underlying property is expected to be used during the term of the arrangement (whole-of-life arrangements), thereby limiting the draft interpretation's potential usefulness.

79. To address these comments, the IFRIC modified the residual interest criterion in the final version of IFRIC 12 to state that the grantor must control "*any* significant residual interest in the infrastructure" (italics added), and added an exception for whole-of-life arrangements that states that only the control over use criterion need be met for this type of arrangement to fall within the scope of IFRIC 12. This exception essentially eliminates the requirement for the grantor to have any control over the residual interest in the underlying property at the end of a whole-of-life arrangement to be considered to have control over the property for financial reporting purposes under IFRIC 12. A rationale for this position is that by the end of the arrangement the property will have been controlled by the grantor for the entire useful life of the property—therefore, no significant residual interest in the property is left to control after the end of the arrangement.

80. The Board believes that, in most cases, a significant residual interest in the underlying property will exist at the end of an SCA. This is mainly because of the long-lived nature of the underlying property, and the frequent inclusion of a contractual requirement for the operator to return the property in a state of good condition at the end of the arrangement.

Even where the contract does not require this return, fulfillment by the operator of often imposed maintenance requirements throughout the term of the arrangement helps ensure that the property is in operational condition at the end of the SCA. Given the core nature of the public services provided through the property, it would seem that such property, if in operational condition at the end of the SCA, would provide future service potential or future economic benefit, and therefore, have a significant residual interest.

81. However, the Board does acknowledge that certain SCAs may be whole-of-life arrangements, resulting in a less than significant residual interest in the underlying property. This may occur, for example, when (a) an SCA involves property used to deliver a service that is not expected to continue after the end of the arrangement; or when (b) an SCA requires the operator to demolish the property at the end of the arrangement and return the underlying land in clean condition. Therefore, the above questions related to the residual interest control criterion must still be addressed.

82. The Board believes that some aspect of control over the residual interest in the underlying property at the end of the SCA is important to establish control over the property for financial reporting purposes, even in a whole-of-life arrangement. As discussed above, grantor control over the residual interest in the property at the end of the arrangement gives the grantor a continuing right to use the property by limiting the operator's practical ability to (a) sell or pledge the property during the SCA, or (b) terminate the agreement before its scheduled completion and use the property for another purpose. In this way, control over the residual interest in the property helps to preserve the use of the property for the public sector objective intended by the SCA. Control over the residual interest in the property is also a key factor in distinguishing the control of a grantor over the property underlying an SCA from the control a public sector entity may have over property through its role as a regulator. Therefore, the Board believes that the grantor must control the residual interest in the property to be considered to control it for financial reporting purposes, even if it is expected that its entire economic useful life will be used up during the arrangement.

83. In considering this notion of control over the residual interest, it must be determined whether the residual interest itself must also be significant to establish control over the property for financial reporting purposes. It can be argued that if the residual interest is insignificant, then whether or not the grantor controls the residual interest is (virtually by definition) inconsequential, and should have no bearing on who controls the property for financial reporting purposes. Therefore, if control over residual interest must be present to establish control for financial reporting purposes, it can be argued that the residual interest also should be significant for this test to be meaningful.

84. The above argument would be persuasive if the residual interest control criterion was established solely to preserve the public sector use of the property after the term of the arrangement. However, as discussed previously, controlling the residual interest in the property serves to preserve the grantor's continuous use of the property *during* the arrangement as well. This does not appear to depend on the significance of the residual interest at the end of the arrangement—the fact that the grantor controls the residual interest in the property would appear to preserve this right of continuous use.

*Expected Flow of Future Economic Benefits or Service Potential*

85. Even though the grantor in an SCA may control the use of the underlying property, to meet the definition of an asset in IPSAS 1, as noted above, the property should produce an expected flow of future economic benefits or service potential for the grantor. Because IFRIC 12 concluded that the use of the underlying property of SCAs that meet its scope is not controlled by the operator (thereby precluding it from meeting the definition of an asset for the operator), and IFRIC 12 only covers operator accounting, it does not address the flow of benefits to the grantor from the property.

86. As noted above, an expected flow of future economic benefits or service potential can be evidenced by the receipt of rewards related to the asset and the assumption of risks associated with it. Allocation of risks and rewards is the basis of the approaches used by the UK Accounting Standards Board and Eurostat to account for the underlying property of SCAs. It is also the basis for the guidance on reporting leases in IPSAS 13.

87. In the UK guidance, access to the benefits of the property and exposure to the associated risks is reflected in the extent to which each party bears the potential variations in property profits or losses. Determining who bears the risks described in the Eurostat guidance is also affected by their economic impact, as the guidance refers to potential additional payments (by either party) and impact on operator profit as indicators of the party that bears risk. This focus on the economic risks and rewards of the underlying property may help determine whether future economic benefits will flow to an entity from an asset. However, it ignores the service potential aspect of the future benefits that may flow to an entity from an asset.

88. The service potential aspect of the future benefits that may flow from an asset is the key difference between the definition of an asset in IPSAS 1 and that in the IASB *Framework*, which focuses only on future economic benefits. Paragraph 11 of IPSAS 1 further explains this "service potential" aspect of the definition of an asset as follows:

> *Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity's objectives but which do not directly generate net cash inflows are often described as embodying "service potential."*

For example, a toll-free roadway is considered an asset of a government because it delivers services used to meet a government's transportation objectives, although it generates no future economic benefit[15] for the government.

89. Generally, governments enter into SCAs to meet service delivery objectives through the construction, renovation, or improved operation of the underlying property. In this way, the underlying property is intended to provide the grantor rewards related to service potential even if the property will not provide any future economic benefit. Even if the grantor's motivation for entering into the SCA is economic benefit, for example, to receive an upfront inflow of resources in exchange for the right to operate a roadway, the underlying

[15] As used in this section, the term 'future economic benefits' specifically refers to the direct generation of net cash inflows, which is consistent with how such term is used in the definition of an asset in IPSAS 1.

property would still be used to meet the government's objectives—it would just be operated by the operator—and therefore, also would be providing service potential rewards to the grantor.

90. Service potential rewards the grantor may obtain through the property underlying an SCA are accompanied by risks associated with the property that the grantor assumes. This is because the grantor generally is still ultimately accountable for the delivery of the service provided through the property. The grantor is therefore accountable for the operation of the property, even though its operation is being undertaken by the operator. Because of this, and because of the general public perception that the service being provided in an SCA is a public one, political risk associated with the delivery of services through the underlying property remains with the grantor, though some service delivery risk may fall to the operator.

91. The effects of political risk can be impacted by the effects of the economic risks discussed above, even when they are borne by the operator. For example, both (a) events considered in construction risk that cause delays in the delivery of the property, and (b) events that limit the availability of the underlying property to users, can impact the grantor's political risk associated with service delivery. Further, if the negative effect on the operator of these economic risks reaches the point where service quality declines, the grantor's political risk will be heightened. In extreme cases, if the operator cannot continue to operate the property, the grantor will have to step in to provide the public service. Thus, it can be viewed that ultimately the grantor is always subject to these economic risks.

92. The notion of accountability for the services provided through the property underlying an SCA is a key concept. It can be argued that if the grantor remains accountable for those services, it will be (a) entitled to the rewards related to the service potential of the property, and (b) subject to the risks that may impact that service potential (along with any economic risks and rewards that may be allocated to it). It can further be argued that a grantor's accountability for the services provided by the underlying property can be evidenced by its control over the use of the asset. The grantor retains control over aspects of the property, such as operating conditions and user charges, because it remains accountable for the provision of the services provided through the property to the public, regardless of whether the operator actually provides the services day-to-day.

93. The grantor's ability to control the underlying property, as discussed above, also ensures its ability to benefit from the service potential of the property for the life of the arrangement, and potentially beyond. The ability of the grantor to control how and for whom the property must be used ensures that the property will be operated for public use during the term of the arrangement. The grantor's control over the residual interest in the property at the end of the arrangement ensures its continuous use during the arrangement, and the opportunity to make the property available for public use after the arrangement ends.

94. Therefore, if the grantor retains control over the property underlying an SCA (as determined using the criteria discussed above), it can be argued that it is accountable for that property and the services provided through its use. This accountability would subject the grantor to the risks associated with the property related to service delivery, and allow it to obtain rewards related to achievement of its service objectives. This therefore indicates

that future service potential benefits from the property will flow to the grantor. Based on this argument, it can be concluded that if the grantor controls the use of the property, it also can be expected to benefit from its future service potential. Thus, the property underlying an SCA would meet the definition of an asset in IPSAS 1 if the grantor controls the use of the property.

95. Given the service potential aspect of the definition of an asset in IPSAS 1, this argument appears appropriate. Consider a toll-free roadway that is reported as an asset by a grantor based on its service potential. That roadway becomes the subject of an SCA where the operator is granted the right to charge tolls to users of the roadway, in exchange for taking responsibility for making repairs and renovations and operating the roadway to the grantor's specifications. If the grantor has control over that roadway under the terms of the agreement, the roadway would appear to provide the grantor with the same service potential benefits that it did before execution of the SCA. This is in spite of the fact that the grantor has largely transferred the economic risks and rewards of the roadway to the operator. Therefore, it appears that the roadway should continue to be reported as an asset of the grantor, because the basis for reporting it as an asset in the first instance has not changed, that is, it is an asset of the grantor based on its service potential.

96. The UK and Eurostat approaches that focus on economic risks and rewards do not specifically refer to control over the property. It can be presumed that under those approaches, the party with the greater share of risks and rewards is conceptually considered to control the property. This type of approach is effective when the assessment of risks and rewards can be measured using a singular basis—which in the case of the UK and Eurostat approaches is expected net cash flows. However, the service delivery objectives of the grantor entering into an SCA, and the service potential aspect of the definition of an asset unique to guidance for public sector entities, add a second dimension of potential risks and rewards that would need to be considered in an approach that focuses on risks and rewards. Combining service potential risks and rewards with risks and rewards related to expected net cash flows into a single approach would, however, be complex both to develop and to apply. Additionally, such an approach could be biased toward the conclusion that the grantor controls the property, because the operator would generally not bear any of the risks and rewards associated with service delivery. Therefore, the Board prefers a more fundamental approach to determining control over the property, as detailed in the previous section.

97. The guidance in IPSAS 13 on reporting property subject to leases arguably also starts with a determination of whether control over the use of the underlying property has been conveyed. Having established that control has been conveyed, the reporting of the asset depends on whether substantially all of the risks and rewards related to ownership have been transferred to the lessee. If such transfer occurs, the lessee reports the property as an asset; if not, the lessor continues to report the property as its asset. Several of the circumstances provided in IPSAS 13 that indicate a transfer of risks and rewards has occurred are associated with how long the lessee will control the use of the property during the overall economic life of the property, including:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;

- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, so that at the inception of the lease it is reasonably certain that the option will be exercised; and
- The lease term is for the major part of the economic life of the asset even if title is not transferred.

98. The control criteria discussed in the previous section incorporate a similar concept into the residual interest criterion. In addition to securing the continuous use of the property by the grantor during the arrangement, the residual interest criterion also ensures that the grantor will continue to be able to control its use after the SCA ends. In this way, the control approach proposed above can be viewed to ultimately incorporate the concept of risks and rewards (similarly to the leasing guidance), with a focus on service potential risks and rewards.

99. An argument can be made, however, that this focus on service potential risks and rewards ignores the economic risks and rewards the operator may assume under the SCA. This omission could be viewed as a flaw in the proposed approach, in the same way as the omission of service potential risks and rewards from the UK and Eurostat approaches could be considered a flaw. In considering this argument, the nature of a public sector entity and the purpose of the types of property associated with an SCA must be considered. The general mission of public sector entities is to provide services to the public, as opposed to generating income. Income generated by a public sector entity generally is used to provide additional services to the public. The general purpose of the types of property associated with SCAs is also to provide services to the public. Cash inflows to a public sector entity generated by such a property are often used to offset the costs of its operation. Given the service delivery focus of public sector grantors and the types of property associated with SCAs, the Board believes that the focus on service potential risks and rewards in the proposed approach is appropriate, much like an economic risk and rewards approach would be appropriate for private entities whose primary mission is to generate income.

100. Further, it can be argued that when the grantor controls the property, the operator essentially operates the property for the grantor, and thus is a service provider to the grantor. The economic risks and rewards assumed by the operator through the SCA, therefore, can be analogized to those assumed by a vendor in a service contract. These would be different from the risks and rewards associated with ownership of the property. The economic risks and rewards, however, could be associated with an asset reported by the operator relating to its *access* to the property. For example, the operator may report an intangible asset under IFRIC 12 when it has no unconditional right to receive a financial asset from the grantor, because payments are contingent on the public's use of the service.

*Unbundling/Components (Rights and Obligations) Approach*

101. The Board also considered an unbundling/components approach to this issue. Although such an approach could have conceptual merit, the Board believes that it would represent a paradigm shift in the accounting and financial reporting of assets and liabilities for public sector entities that could have implications beyond SCAs. Discussions of this type of

approach to reporting assets and liabilities would therefore be more appropriately explored as part of a more broadly scoped project. The Board also believes that the complexity of quantifying the risk and rewards or rights and obligations assumed by each party to determine the value of assets and liabilities would make an unbundling/components approach difficult to apply. Such an approach would also require the application of significant judgment in establishing such quantification, which could result in inconsistencies in application. For these reasons, the Board chose not to further pursue an unbundling/components approach as part of this project. However, the development of this kind of approach as part of the IASB/FASB project on leases will continue to be monitored.

**Proposal**

102. The Board proposes that a grantor should report the property underlying an SCA as an asset in its financial statements if it is considered to control the property for financial reporting purposes. The proposed criteria for determining grantor control are as follows:

    1. The grantor controls or regulates[16] what services the operator must provide with the underlying property, to whom it must provide them, and the price ranges or rates that can be charged for services; and

    2. The grantor controls—through ownership, beneficial entitlement or otherwise—the residual interest in the property at the end of the arrangement.

103. The Board believes that the grantor's control over the property underlying the SCA evidences that it remains accountable for the services provided either directly or indirectly to the public through the property. This accountability subjects the grantor to risks and rewards related to service delivery that are associated with the property. Retaining those risks and rewards indicates that the grantor can expect future service potential to flow from the underlying property. This expectation, combined with the grantor's control over the property, indicate that the property should be considered an asset of the grantor based on the definition of an asset in IPSAS 1. The next section of this Consultation Paper covers the accounting and financial reporting for the underlying property of SCAs where the proposed control criteria are not met.

104. As noted previously, this proposal is largely based on the current definition of an asset in IPSAS 1. Defining elements of financial statements is a component of the IPSASB's current project to develop a public sector conceptual framework that would apply to the preparation and presentation of general purpose financial statements. The conceptual conclusions regarding the definition of elements of financial statements drawn as part of that project may impact the proposal, mentioned above, that relates to the reporting of property underlying an SCA.

[16] The concept of regulation in this criterion is restricted to arrangements agreed upon by the grantor and the operator, and to which both parties are bound. It excludes generally legislated regulation that does not establish control for the purposes of financial reporting as concluded in IPSAS 6 and IPSAS 23.

## Ancillary Accounting Issues Associated With Property

### Grantor Financial Reporting When the Proposed Control Criteria Are Met

105. If it is determined that the grantor should report the property underlying an SCA as an asset in its financial statements based on the proposed control criteria, two reporting issues associated with the property and the related liability reflecting the obligation of the grantor to compensate the operator[17] must be addressed: (a) the timing of their recognition, and (b) the measurement of their carrying value, both upon recognition and in subsequent periods. These issues largely arise when the SCA involves the construction of the underlying property.

*Timing of Recognition*

106. The first step for a grantor reporting the property associated with an SCA that involves construction is determining when to recognize the property as an asset—either while it is under construction, or when it becomes in place and operational. Of the current or proposed SCA guidance discussed above, only the guidance of the UK Accounting Standards Board directly addresses this issue. Such guidance provides that the grantor should report the asset when it comes into use, unless the grantor bears significant construction risk, in which case the property would be reported as an asset as constructed.

107. Guidance on when to recognize property, plant, and equipment is provided in IPSAS 17. Specifically, that statement requires that an item of property, plant and equipment be recognized as an asset when:

    (a) It is probable that future economic benefits or service potential associated with the asset will flow to the entity; and

    (b) The cost or fair value of the asset to the entity can be measured reliably. [Paragraph 14]

108. Determining the timing of initial recognition of the construction in an SCA as an asset using this guidance should focus on criterion (a) above. Determining whether this criterion is met requires an assessment of the degree of certainty of the flow of future economic resources or service potential, based on the available evidence. Existence of sufficient certainty that future economic benefits or service potential will flow to an entity typically requires an assurance that the entity will receive the rewards attaching to the asset and will undertake the associated risks. This assurance is usually only available when the risks and rewards have passed to the entity. Before this occurs, the transaction to acquire the asset can usually be canceled without significant penalty, which would preclude the passing of associated risks and rewards.

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[17] The liability addressed in this section of the paper is only that related to the obligation of the grantor to provide compensation (either with cash or non-cash consideration, such as access to the underlying property) to the operator for the property underlying an SCA. A grantor may also report financial statement liabilities related to guarantees and other commitments made, both explicitly and implicitly, to or on behalf of the operator as part of an SCA. These guarantees and other commitments are addressed in the next section of the paper.

109. The guidance in IPSAS 17 for determining when property, plant and equipment should be recognized, and the practical application of such guidance described in the preceding paragraph, would also appear to be appropriate for determining when the grantor should recognize the property underlying an SCA. When the grantor bears construction risk (for example, under arrangements that involve geological or environmental factors that result in a level of construction risk greater than the operator is willing to accept), it seems clear that application of this guidance would result in the grantor recognizing the property as an asset as it is being constructed. This is because the risks associated with the property have been assumed by the grantor before completion of construction.

110. The timing of recognition for the grantor is not as clear for SCAs under which the operator bears construction risk. As construction risk remains with the operator and the asset is not yet in use, the risks and rewards associated with the property have arguably not yet passed to the grantor. As noted above, this passing is usually considered necessary before future economic benefits or service potential will be considered probable to flow to the grantor. However, the terms of an SCA contract often will prohibit either party from canceling the transaction without significant penalty. Thus, the execution of the SCA contract itself may provide evidence of sufficient certainty that future economic benefits or service potential associated with the property will flow to the grantor before the passage of risks and rewards (that is, while the property is under construction). This determination would, however, ultimately be a matter of professional judgment.

111. Although determining when to recognize the construction in an SCA as an asset should focus on the probability of future economic benefits or service potential flowing to the entity, the ability to reliably measure the asset (criterion (b) in paragraph 107) must also be considered. For some SCAs, the grantor may be unable to estimate a percentage of construction completion that would allow it to reliably measure the value of the construction-in-progress as of the reporting date. In this case, under IPSAS 17, the grantor should not report the construction-in-progress as a property, plant and equipment asset until a reliable measurement can be made. In some instances, this may not be possible until construction is completed.

112. Upon the recognition of the property as an asset, either during construction or when it becomes operational, the related liability reflecting the obligation of the grantor to provide compensation (either cash or non-cash) to the operator for the property should also be recognized.

*Measurement of the Property and Related Liability*

113. Having determined the timing of recognition by the grantor, the initial measurement of the value of the asset reflecting the property, and the related liability reflecting the obligation to provide compensation to the operator for constructing such property, must then be determined. Measurement of the asset and liability subsequent to initial recognition must also be addressed. The circumstances of the SCA may influence these measurements, as discussed below.

Separable Payments

114. In some SCAs, the grantor makes regularly scheduled payments over the life of the arrangement, and the portions of those payments related to the construction (or acquisition) of the property can be separated from those related to the service element of the SCA (based on the terms of the contract or other information). In those cases, measurement of the asset and related liability can be determined similarly to the guidance for finance leases in IPSAS 13. That is, the asset and related liability could be recognized at amounts equal to the fair value of the property, or, if lower, at the present value of the scheduled construction payments[18]. After the asset is measured upon recognition, the asset would be subject to the guidance in IPSAS 17 for subsequent measurements (for example, depreciation, impairment, and subsequent measurement using the cost model or adjusted fair value using the revaluation model). The construction element of the scheduled payments would be allocated between the imputed finance charge and the reduction of the outstanding liability to the operator. The service element of the scheduled payments would be expensed as incurred, that is, as the economic benefits of the service are rendered.

115. Although reporting the property in a manner similar to a finance lease in IPSAS 13 may readily appear appropriate, a potential alternative approach may be suggested for reporting the liability to the operator. This liability would appear to meet the definition of a financial liability in IPSAS 15, *Financial Instruments: Presentation and Disclosure,* because it is a contractual obligation to deliver cash or another financial asset to another entity. IPSAS 15, however, only addresses presentation and disclosure related to financial liabilities. On the other hand, IAS 39, *Financial Instruments: Recognition and Measurement,* provides guidance on the recognition and measurement of these financial liabilities.

116. IAS 39 requires that, upon initial recognition, financial liabilities should be measured at their fair value. After initial recognition, IAS 39 requires financial liabilities to be measured at amortized cost using the effective interest method, except for (a) financial liabilities at fair value through profit or loss (as defined in IAS 39), which are generally measured at fair value, and (b) financial guarantee contracts and commitments to provide a loan with a below-market interest rate. These are generally measured at the higher of the initially measured amount and the amount that would be reported under the provisions of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Applying the guidance in IAS 39 for measuring the grantor's liability to the operator associated with SCAs could perhaps result in a different treatment than applying the guidance in IPSAS 13 for liabilities related to finance leases.

117. In comparing the guidance in IAS 39 for financial liabilities, and that in IPSAS 13 for liabilities related to finance leases, it would appear that the amount at which the liability associated with an SCA would initially be recognized is similar, that is, the fair value of the property (or, if lower, the present value of the scheduled payments.) This is because this amount could be viewed as the "price" of the transaction, which would be the basis for the fair value of the liability when the SCA was entered into. The general requirement in IAS

[18] If the scheduled construction payments are based on contingencies, for example, minimum fixed payments with increases based on availability of the property, the calculation of the present value of scheduled construction payments should consider the expected level of payments.

39 to make subsequent measurements of financial liabilities at amortized cost using the effective interest method would also appear to result in a treatment similar to IPSAS 13.

118. A difference in treatment between IAS 39 and IPSAS 13 could result if the financial liability met one of the exceptions (discussed above) to the requirement to measure the liability at amortized cost after initial recognition. However, the liability related to future cash payments to be made for property acquired through an SCA would clearly not be considered a financial guarantee contract or a commitment to provide a loan at a below-market interest rate. These liabilities also would generally not meet the conditions in paragraph 9 of IAS 39 to be considered a financial liability at fair value through profit or loss present in paragraph 9 of IAS 39. Therefore, these liabilities generally would be measured subsequent to initial recognition at amortized cost under IAS 39. The Board believes this would result in essentially the same treatment as under IPSAS 13 for liabilities related to finance leases. The Board does believe that these liabilities meet the definition of a financial liability, and therefore, would be subject to the disclosure requirements of IPSAS 15.

Inseparable Payments

119. Unlike the scenario described in Paragraph 114, under many SCAs the construction and service elements of the scheduled payments are not readily separable. In this case, those elements will need to be estimated. One method of estimation is based on the fair value of the property. This method is used in the PPP guidance issued by the UK Accounting Standards Board, which states that the initial amount recorded for the asset and related liability should be the fair value of the property. When scheduled payments are made in subsequent years, (a) a portion of the payment would be attributed to repaying the liability, (b) another portion would be reported as an imputed finance charge on the property, and (c) the remainder of the payment would be reported as an operating cost reflecting the service element. This method is similar to that prescribed in IFRIC 4 for separating payments under a lease from other payments related to the arrangement.

120. The guidance on PPPs proposed by the Accounting Standards Board of South Africa is also similar in this area, with the exception that it does not recognize an imputed financing charge. That proposed guidance provides an example in which an entity enters into a 10-year PPP agreement under which the operator will construct a building from which a service will be delivered. The grantor makes an annual payment of 1.5 million currency units to the operator covering both the construction and service elements, and the fair value of the building at the inception of the arrangement is 12 million currency units. The grantor will own the property at the end of the arrangement. Under the South African proposal, the asset and related liability would be valued at 12 million currency units. Based on this fair value of the asset, the example goes on to illustrate that the portion of the annual payment related to the construction element is 1.2 million currency units (12 million units divided by the 10 year term), with the remaining 0.3 currency units considered the service portion of the annual payment, and therefore, expensed as incurred.

121. The Board believes that using the fair value of the property as the initial measurement of the asset and related liability is the best approach where the construction element of the

scheduled future payments cannot be separated from the service element. This is consistent with the guidance prescribed in IPSAS 17 for another circumstance when there is no discernable "historical cost" to use for the initial measurement of property, plant and equipment—the acquisition of property, plant and equipment at no cost, or for a nominal cost. It is also analogous to the guidance for reporting assets and liabilities associated with finance leases in IPSAS 13.

122. The Board also concurs with the approach in the UK guidance on PPPs that allocates the scheduled payments between (a) amounts that reduce the liability associated with the asset, (b) imputed finance charges, and (c) charges for services provided by the operator as the remainder of the payment. The Board believes that it is important to reflect the financing aspect of these transactions in the financial statements through the imputed finance charge. This raises the question, however, of what rate to use to impute the finance charge. The UK guidance states that a rate that reflects the operator's expected return on the property (a "property-specific" rate) should be used. In contrast, IPSAS 13 states that the incremental borrowing rate of the lessee (which in this context is similar to that of the grantor) should be used to discount minimum lease payments if the interest rate implicit in the lease cannot be determined. The Board believes that by transferring financing risk to the operator, the grantor has subjected itself to the operator's cost of raising capital through borrowings or equity contributions. It is this cost of capital that will be considered when arriving at the payments to be made by the grantor as part of the arrangement. Therefore, the Board believes that an estimate of the operator's cost of capital specific to the SCA should be used to determine the imputed finance charges.

123. Measurement and reporting of the property subsequent to initial recognition should follow the guidance in IPSAS 17, similar to arrangements in which the payments to the operator are separable, as described above.

Arrangements Involving Reduced or Eliminated Grantor Payments

124. Measurement of the underlying property and related liability is also an issue with SCAs involving the construction of property under which the operator will collect usage fees directly from third parties. Often these fees are expected to cover all or at least most of the operator's costs of construction, financing and service, as well as its expected rate of return. In these cases, the grantor's obligation to make payments to the operator are often greatly reduced or eliminated; in some cases the grantor may even *receive* payments from the operator. (Refer to the section on Inflows of Resources from a Service Concession Arrangement for discussion of accounting for contractually determined inflows received by the grantor from the operator.)

125. Determining how to report the underlying property and related liability in these instances requires an examination of the exchange between grantor and operator embodied in the transaction. The grantor receives the construction of the underlying property from the operator. In exchange, the operator receives access to the underlying property, after it becomes operational, to provide services to fee-paying users. Either party may also potentially provide cash. In measuring the property for financial reporting, this exchange

can be viewed similarly to an exchange of non-monetary assets covered in IPSAS 17, which states:

> *One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognize the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up. [Paragraph 38]*

126. The Board therefore believes that the grantor should report the property at its fair value. A related liability of that amount, increased for cash received by the grantor or decreased for cash paid by the grantor (or to be paid in future, which could be reported as a separate liability), would also be reported. This liability would reflect consideration received in advance of performance, because the grantor is receiving an inflow of resources in the form of the property (adjusted for cash received, paid or to be paid) without having delivered on its portion of the exchange—the provision of access to the property[19]. The grantor would generally amortize this liability, and recognize revenue, over the life of the SCA as access to the property is provided[20].

127. Measurement of the property subsequent to initial recognition should follow the guidance in IPSAS 17, similar to arrangements in which the grantor makes payments directly to the operator, as described above.

128. The exchange for the service element of an SCA in which the operator collects usage fees directly from third-party users is between the operator and the third-party users. The grantor would therefore not report this aspect of the arrangement in its financial statements. However, the grantor would report revenue when providing the operator with access to the property, as discussed in Paragraph 126.

129. In some instances, the future cash payments to be made by the grantor to the operator as part of an SCA also may be reduced or eliminated by the provision of non-cash compensation to the operator. This non-cash compensation is most often provided through granting the operator use of grantor-owned land (often adjacent to the property underlying the SCA) for a nominal amount. The operator typically develops such land for its own profit, for example, through constructing retail space.

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[19] Refer to the section on Arrangements Involving Existing Property of the Grantor below for a discussion as to whether the granting of this access should result in a reduction in the carrying value of the property in the financial statements.

[20] Refer to the section on Inflows of Resources from a Service Concession Arrangement for more detail on amortizing inflows of resources received by the grantor in advance of performance.

130. The reporting of the property underlying the SCA and related liability in these circumstances would be similar to the reporting described above for SCAs in which the operator is compensated through the direct collection of third-party usage fees. The liability in this case would, however, be amortized, and revenue would be recognized by the grantor, over the period that the operator pays the nominal rent, as opposed to the life of the SCA. This revenue would reflect rental revenue for the rights to the additional land.

131. An alternative to the approach detailed above where grantor payments are reduced or eliminated would be to omit both the property and the obligation to provide access to the property from the grantor's financial statements. This would result in reporting the SCA on the face of the financial statements only to the extent that cash is or will be exchanged between the grantor and the operator. It can be argued that reporting the property and obligation to provide access to the property serves only to inflate the statement of financial position of the grantor, by including an asset and liability that essentially emanate from each other, and that will not be settled in cash. It also creates revenue for the grantor that does not result in amounts that are available for spending, which could be seen as misleading to users of the financial statements. The reporting of the property under this approach would be similar to that required by Eurostat for what it considers concession agreements (arrangements for which third-party users are the primary purchasers of services).

132. The Board does not believe that the alternative approach described in the preceding paragraph most faithfully represents the SCA in the financial statements. Omitting the property from the financial statements of the grantor understates both the assets used to provide services to the public, and the assets for which the grantor is accountable. The cost of providing services also would potentially be understated because the grantor would not report depreciation of the property. Lastly, it must be considered that the asset (the property) and the liability (the obligation to provide access to the property) would not necessarily offset each other in the grantor's financial statements. This may be because of an exchange of cash, which would result in the grantor reporting an offsetting asset or liability, depending on whether it was paying or receiving the cash. Also, the useful life of the property may exceed the length of the grantor's obligation to provide access to the property. Omitting the property and the related obligation to provide access from the financial statements when the arrangement is entered into would raise the question of whether the property should be reported as an asset after the obligation ceases, and if so, how to handle the reporting.

*Arrangements Involving Existing Property of the Grantor*

133. Generally, for SCAs involving existing property that the grantor has already reported as an asset, no additional accounting associated with the property would be required when the SCA is entered into. Financial reporting considerations for other aspects of these types of arrangements, including guarantees and the receipt of contractually determined inflows, are discussed later in this Consultation Paper.

134. It can be argued, however, that the grantor has relinquished an aspect of its rights of ownership in the existing property to the operator through the SCA (that is, the right to

charge for use of the property). Therefore, the carrying value of the property could be reduced to reflect this fact (assuming the property is reported at historical cost as opposed to fair value under the revaluation approach in IPSAS 17). Although the ability of the grantor to charge third parties for use may be limited by the SCA, thereby impacting potential future cash flows from the property, the Board believes that this limitation does not impact the service potential of the property. In IPSAS 21, *Impairment of Non-Cash-Generating Assets*, the present value of the remaining service potential of the asset (value in use) is one of the key measurements used to determine whether a non-cash-generating asset is impaired, resulting in a reduction in the carrying value of the asset (the property associated with an SCA would generally be considered a non-cash-generating asset as that term is defined in IPSAS 21). Under IPSAS 21, if the value in use of the asset exceeds its carrying value, then no reduction in the carrying value should be recorded. An SCA is not an impairment circumstance. The Board believes, however, that this principle can be applied to conclude that the value of the property in the financial statements should not be reduced, because there is no reduction in service potential of the property through granting the operator the right to collect fees from users of the property.

**Proposals**

135. For SCAs meeting the proposed control criteria, the Board proposes that the criteria in IPSAS 17 for recognizing property, plant and equipment should be used to determine when to recognize the underlying property as an asset (for example, during construction, or when it is in place and operational), along with a liability reflecting the grantor's obligation to provide compensation (either cash or non-cash) to the operator for that property. The Board expects that the recognition criteria will often be met during construction if the value of the construction-in-progress can be reliably measured. This is either because the grantor bears construction risk, or if not, because the terms of the arrangement prohibit either party from canceling it without significant penalty. If neither of these scenarios is the case, the recognition criteria are unlikely to be met until construction is complete.

136. The Board also proposes that for SCAs where the construction and service elements of scheduled payments by the grantor can be separated, the property and related liability reflecting the grantor's obligation to compensate the operator for that property should be reported at the fair value of the property, or if lower, the present value of the payments related to construction. Subsequent to initial recognition, the property should be measured following the guidance in IPSAS 17 (for example, depreciation, impairment, and subsequent measurement using the cost or adjusted fair value using the revaluation model). The liability should be measured similarly to a liability resulting from a finance lease subsequent to initial recognition, and should be considered a financial liability for reporting purposes. The service element of these payments should be expensed as incurred.

137. If the payment elements are not separable, the Board proposes that the property be reported at its fair value, along with the related liability. The scheduled payments under the SCA should be allocated between (a) repayment of the liability, (b) an imputed finance charge (based on the cost of capital of the operator specific to the SCA), and (c) operating costs to reflect the service element of the SCA. Measurement and reporting of the property

subsequent to initial recognition should be similar to that for arrangements in which the payments are separable, as described above.

138. As mentioned above, in some SCAs cash payments made by the grantor to the operator for construction of the property are reduced or eliminated because the operator is directly collecting third-party usage fees or receiving other non-cash compensation from the grantor (typically through granting the operator use of additional grantor-owned land for a nominal amount). In that case, the Board proposes that the underlying property should be reported by the grantor at its fair value. A related liability reflecting the receipt of consideration in advance of performance (which in this case is the provision of access to the property) also should be initially reported at the same amount, adjusted for cash received or paid (or to be paid) by the grantor. This liability should be amortized and revenue should be recognized generally over the life of the SCA, as more fully described in the section on Inflows of Resources from a Service Concession Arrangement later in the Consultation Paper. Measurement and reporting of the property subsequent to initial recognition should be similar to that for arrangements in which the grantor makes payments to the operator, as described above.

139. For SCAs involving existing property that the grantor has already reported as an asset, no additional accounting associated with the property generally should be required when the SCA is entered into. An impairment of the value of the property in the grantor's financial statements should not be recorded as a result of granting the right to access the property to the operator through the SCA assuming that the property is considered by the grantor to be a non-cash-generating asset as defined in IPSAS 21.

140. For aspects of reporting the property underlying an SCA beyond recognition and measurement, including reporting subsequent expenditures related to the property and financial statement note disclosures, the guidance in IPSAS 17 should be applied, as appropriate.

### Grantor Financial Reporting When the Proposed Control Criteria Are Not Met

141. If an SCA does not meet the proposed control criteria, then the accounting and financial reporting of the underlying property will depend on the facts and circumstances of the arrangement. A number of factors may impact the reporting, including:

- Which, if any, of the proposed control criteria are met;
- Whether the underlying property exists and is reported by the grantor before the arrangement is entered into, or whether the property will be newly constructed; and
- Which party legally owns the property during the arrangement.

A number of scenarios where SCAs do not meet the proposed control criteria are analyzed below. A decision tree illustrating these scenarios and the related Board proposals is included in Flowchart 2 of Appendix A.

*Arrangements for Which Neither of the Control Criteria is Met*

142. If neither of the proposed control criteria is met in an SCA arrangement, it would appear clear that the grantor should not report the underlying property as an asset. Instead, the grantor would expense any SCA-related outlays as incurred (that is, as the economic benefits of the arrangement are provided), similar to a service contract. If the underlying property exists and is reported by the grantor at the time the SCA is entered into, it would appear that the asset reflecting such property should be derecognized. This circumstance would be similar to a disposal of the property, which is one of the instances identified in IPSAS 17 that would result in derecognition of property, plant and equipment.

*Arrangements for Which Only the Control Over Use Criterion is Met*

143. The Board believes that most SCAs in which the grantor controls the use of the underlying property during the arrangement, but does not control the residual interest in the property at the end of the arrangement, are structured as a BOO arrangement—the operator builds, owns and operates the underlying property without transferring it to the grantor at the end of the arrangement. This type of arrangement does not meet the proposed control criteria that would result in the grantor reporting the underlying property as an asset. However, an argument can be made that the arrangement could still meet the criteria for a finance lease. In this circumstance, the grantor would recognize the property as an asset under IPSAS 13, as set out below.

144. As detailed previously, IPSAS 13 provides a number of examples of circumstances which would normally lead to classifying a lease as a finance lease. It is possible for the terms of an SCA to meet certain of those circumstances. However, a fundamental question that must first be addressed is whether an SCA should be considered a lease, or be subject to leasing guidance, for financial reporting purposes.

145. IPSAS 13 defines a lease as "an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time." Common examples are the leasing of office space in a building or the leasing of a piece of equipment. The lessor owns the building or equipment, and provides the right to use such property to the lessee in exchange for a payment or series of payments. Also, although not formally adopted through an IPSAS, IFRIC 4 further describes the right to use property in the context of the right to control its use, and provides criteria for determining whether such right has been conveyed (the specific criteria are listed in the Analysis of the Financial Reporting of Infrastructure and Public Facilities section of this Consultation Paper).

146. The Board believes that BOO arrangements in which the grantor controls the use of the underlying property would often meet the definition of a lease, with the grantor being considered the lessee and the operator considered the lessor. The operator's ownership of the property and the grantor's control over its use indicates that the arrangement involves the conveyance of the right to use an asset, as described in IFRIC 4, for an agreed period of time. These arrangements will also often involve payments by the grantor to the operator for the right to use the underlying property. If the BOO arrangement does meet the

definition of a lease, then the guidance on determining whether it is a finance lease or an operating lease should be followed to determine the reporting of the underlying property.

147. An SCA involving existing property reported by the grantor as an asset, in which the grantor transfers ownership of the property to the operator but retains control over its use, is similar to a BOO arrangement described above. In this case, however, the operator, instead of building the asset, is "buying" it from the grantor. This type of arrangement would appear to be similar to a sale-leaseback arrangement, assuming the "leaseback" portion of the arrangement meets the definition of a lease in Paragraph 145. If this is the case, the grantor should follow the guidance in IPSAS 13 for sale-leaseback transactions and for determining whether a lease is a finance lease or an operating lease.

148. Some SCAs may involve property over which the grantor retains ownership and control over use during the arrangement, but the operator controls the residual interest in the property at the end of the arrangement. The definition of a lease would not appear to be met in these cases, because there is no conveyance of the right to use an asset—the grantor both owns and controls the use of the asset. In this case, it would appear that the grantor should report the property during the life of the arrangement. If the SCA involves newly constructed property, the property and a related liability would be measured as described in the previous section on grantor financial reporting when the control criteria are met. As described in that section, measurement may depend on whether the construction and service elements of the payments to the operator are separable or inseparable, or whether the payments are eliminated altogether because the operator is to receive payments from third-party users of the property. At the end of the arrangement, any remaining carrying value of the property would be derecognized, reflecting the transfer of the property to the operator. If the SCA does not meet the definition of a lease and the grantor does *not* own the property, then the grantor should not report the property as an asset. Instead, the grantor should expense any outlays related to the SCA as incurred.

*Arrangements for Which Only the Control Over Residual Interest Criterion is Met*

149. The central financial reporting issue for SCAs in which only the control over residual interest criterion is met is when and how the underlying (residual) property should be recognized in the grantor's financial statements. This issue arises because the amount the grantor is required to pay (including zero) upon the reversion of the property at the end of the arrangement will often not equal the expectation, at inception, of the fair value of the property at the end of the arrangement. Determining the appropriate reporting treatment in this case may also depend on whether the underlying property is being newly constructed, or whether it already exists and was reported by the grantor as an asset before the arrangement.

150. The Board believes that SCAs in circumstances where the underlying property is being newly constructed will most often be structured as a BOOT arrangement—the operator will build, own and operate the property, and then transfer ownership of the property to the grantor at the end of the arrangement. One approach to reporting the reversion of the property in such an arrangement is to consider a portion of the payments made by the grantor to the operator during the SCA to represent the difference between the expected fair

value of the underlying property at the end of the arrangement and the specified amount to be paid by the grantor upon reversion. This portion of the payments would be accumulated in the financial statements as an asset (assuming the expected fair value of the property at the end of the arrangement exceeds the amount the grantor is required to pay for reversion), similar to a prepaid item, so that when combined with the actual final payment, the amount reflects the fair value of the property. For example, if the fair value of the associated property was expected to be 20 currency units at the end of a 20-year arrangement, and the grantor was not required to pay for the property at the end of the arrangement, the 20 currency units would be accumulated as an asset, spread over the life of the arrangement.

151. Such an approach is consistent with the guidance of Application Note F of the UK Accounting Standards Board. Specifically, Application Note F states the following:

> *Where the contract specifies the amount (including zero) at which the property will be transferred to the purchaser [grantor] at the end of the contract, the specified amount will not necessarily correspond with the expected fair value of the residual estimated at the start of the contract. Any difference must be built up over the life of the contract in order to ensure a proper allocation of payments made between the cost of services under the contract and the acquisition of the residual. At the end of the contract, the accumulated balance (whether positive or negative), together with any final payment, should exactly match the originally estimated fair value of the residual. [Paragraph F56]*

152. Another potential approach is to record the present value of the difference between (a) the amount to be paid by the grantor to acquire the asset, and (b) the expected fair value of the underlying property at termination, as an asset at the beginning of the arrangement. Contribution revenue would be reported along with the asset. The fair value of this asset would be adjusted to reflect the passage of time (interest) and any change to the expectation of fair value. This approach can also be altered to have the contribution revenue reported at the end of the arrangement, when the underlying property reverts to the grantor.

153. A final approach to this issue would be to report the property at the actual amount paid at the end of the arrangement instead of reporting it at its fair value. This could be seen as consistent with the provisions of IPSAS 17, which require initial measurement of property, plant and equipment at historical cost. However, in this instance, the amount paid, which might be zero, may not represent a fair price in an arms-length transaction.

154. The Board believes that building the excess of the expected fair value of the underlying property at the termination of the SCA over the amount to be paid by the grantor upon reversion to it as an asset, over the life of the arrangement, most faithfully represents the economics of the transaction. The Board believes that the operator would normally intend to receive fair value for the property at the end of the arrangement. If the grantor is not expected to pay the fair value at the end of the arrangement, it is likely that any difference has been incorporated into the payments made during the arrangement. Thus, such payments reflect both a service element and an element representing the "purchase" of the property. The Board therefore believes that the grantor is "prepaying" the property and

should be reporting such prepayment as an asset. Also, as suggested by Application Note F, such an approach would result in the appropriate allocation of service expense associated with the arrangement.

155. An arrangement in which the grantor does not control the use of the asset during the arrangement, but receives the asset at the end of the arrangement, is made more complicated when the underlying property exists and is reported by the grantor as an asset before the SCA is entered into. The Board believes that in most of these situations the grantor would retain ownership of the property during the arrangement, but control over its use would fall to the operator under the terms of the arrangement. In most cases, the operator would provide services to third parties, either paid for directly by the third parties or by the grantor on their behalf. In these cases, treatment of the asset reported by the grantor upon execution of the arrangement must be determined—in other words, whether or not the asset should be derecognized—along with treatment of the residual interest at reversion.

156. Paragraph 82 of IPSAS 17 states that the carrying amount of an item of property, plant and equipment shall be derecognized (a) on disposal, or (b) when no future economic benefits or service potential is expected from its use or disposal. It can be argued that the grantor has disposed of the property because it no longer controls its use, and situation (a) will have been met. Following this argument, it would then need to be determined whether to derecognize the entire asset, and how to report any derecognition in the financial statements.

157. It might initially be clear that if a derecognition approach is applied to the above scenario, the entire carrying value of the property should be removed from the financial statements when the arrangement is entered into. However, this leaves the reporting of the reversion of the asset in question. It may be appropriate to preserve some value in the financial statements that reflects the future return of the property. This could be reported at the expected fair value of the property at the end of the arrangement. The obligation of the operator to return the property would exist when the arrangement was entered into, and the grantor would generally not be required to fulfill any obligation to be entitled to reversion. Therefore, it appears this right to reversion would be a recognizable asset when the arrangement is entered into. The resulting net amount of assets to be derecognized would then be the difference between the carrying value of the property when the SCA was entered into and the expected fair value of the property at reversion. Because the transaction would be considered the disposal of an asset, this net derecognition amount, adjusted for any cash paid or to be paid by the operator, would be reported as a gain or loss when the arrangement was entered into.

158. Another approach to this scenario is to apply the leasing guidance in IPSAS 13. In contrast with the above discussion of an SCA that meets the definition of a lease, in this case the grantor would be considered to be conveying the right to use the property to the operator. Therefore, the grantor would be considered the lessor and the operator would be considered the lessee. Under many of these types of arrangements, the operator will make a payment(s) to the grantor for the right to use the asset. Any such payments would be for the consumption of services, either for itself or on behalf of third parties, and would not impact

the reporting of the property. If the leasing guidance were followed, the key determination to be made related to derecognition is whether the arrangement would be considered a finance or an operating lease. If considered a finance lease, the grantor would no longer report the property as an asset. Instead, it would report its gross investment in the lease as a receivable, which would include the expected residual value of the property upon reversion. If considered an operating lease, the grantor would continue to report the property without any derecognition.

**Proposals**

159. The Board proposes that for SCAs in which neither of the proposed control criteria discussed in the previous section is met, the grantor should not report the underlying property as an asset. Consequently, any outlays related to the SCA are for a service, not for property, and therefore, should be expensed as incurred, that is, as the economic benefits of the service are rendered. If the underlying property exists and is reported by the grantor as an asset at the time the SCA is entered into, the property should be derecognized as in a disposal under IPSAS 17.

160. The Board proposes that the guidance in IPSAS 13 for lessees should be followed for SCAs in which the grantor only controls the use of the property during the arrangement (such as in certain BOO arrangements), if the arrangement meets the definition of a lease.

161. If the grantor only controls the use of the property during the SCA, and the SCA does *not* meet the definition of a lease because the grantor maintains ownership of the underlying property during the arrangement, the Board further proposes that the grantor should report the property as an asset. If the SCA in this case involves newly constructed property, the property and a related liability would be reported and measured as described in the previous section on grantor financial reporting when the control criteria are met. At the end of the arrangement, the remaining carrying value of the property would be derecognized, reflecting the transfer of the property to the operator. If the SCA does not meet the definition of a lease and the grantor does *not* own the property, then the grantor should not report the property as an asset. Instead, the grantor should expense any outlays related to the SCA as incurred.

162. For SCAs involving *newly constructed* property in which the grantor does not control use of the property during the arrangement, but instead controls the residual interest in the property at the end of the arrangement (such as in certain BOOT arrangements), the Board proposes that the grantor report as an asset the excess of the expected fair value of the property at the end of the arrangement over the amount the grantor will be required to pay the operator upon reversion. This asset should be built up from payments made by the grantor to the operator over the life of the SCA.

163. For SCAs involving *existing* property in which the grantor does not control use of the property during the arrangement, but instead controls the residual interest in the property at the end of the arrangement, the Board proposes that the guidance for lessors in IPSAS 13 should be followed if the arrangement meets the definition of a lease. If the arrangement does not meet that definition, the grantor should derecognize the property as an asset, and recognize as an asset the operator’s obligation to return the property at the end of the

arrangement. This asset should be recognized at the expected fair value of the property at the end of the SCA. The net derecognition amount should be reported as a gain or loss in the period in which the SCA was entered into.

## Guarantees and Other Commitments

164. In addition to the financial statement liabilities reported by a grantor related to the property underlying an SCA discussed in the previous section, a grantor may also report liabilities resulting from guarantees and other commitments it makes as part of an SCA. These guarantees and commitments generally are made to the operator, or to third parties on its behalf. A common example of a guarantee made by a grantor as part of an SCA is a commitment to repay the debt of the operator in the event of default. In many countries, debt issued by public sector entities has a lower cost than debt issued by private sector entities. However, for a variety of reasons, some grantors may have an incentive to require the operator to secure the financing for the underlying project in an SCA. In this case, the grantor may guarantee the debt of the operator to lower the cost of borrowing. This in turn would lower the grantor's project cost. Also, in some circumstances, lenders may require the grantor to guarantee the financing to the operator. For example, an Asian government had to provide a debt guarantee as part of its first "mega" public-private partnership, which involved the construction and operation of a high speed rail system, because the lenders would not finance the project without a full government debt guarantee[21].

165. In some circumstances, the grantor may take on the responsibility of repaying operator debt in the event of default even in the absence of a contractual requirement. For example, where the operator provides a key public service that the grantor could not readily step in and provide, the grantor may be willing to voluntarily repay operator debt in the event of default so that the operator can remain solvent, thereby avoiding an interruption in service.

166. A second type of guarantee commonly made under SCAs is a guarantee of minimum revenue for the operator. This guarantee is often made in arrangements in which the payments to the operator are based on third-party use of the underlying property. For example, as part of an SCA for a highway in a Middle Eastern country, the grantor is required to pay the operator 80 percent of any shortfall in actual revenues from projected revenues[22]. This type of guarantee can also be made when the grantor is the primary user of the services provided by the operator. For example, as part of an SCA for an Australian waste treatment facility, the grantor is obligated to provide a minimum amount of municipal solid waste to the operator for processing[23]. Also, similar to the discussion in the previous paragraph, in some circumstances a grantor may choose to make payments to the

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[21] S. Ping Ho. Book chapter for *Government Policy on PPP Financial Issues: Bid Compensation and Financial Negotiation*. Book to be published, chapter available at: http://crgp.stanford.edu/publications/working_papers/S_Ping_Ho_PPP_Policy.pdf.

[22] AECOM Consult, Inc. 2007 Case Studies Report 4-18. "Case Studies of Transportation Public-Private Partnerships around the World" p. 2.7 (prepared for the U.S. Department of Transportation Federal Highway Administration Office of Policy and Governmental Affairs). Arlington, VA.

[23] New South Wales Eastern Creek UR-3R Facility; http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0020/3098/awt_cont.pdf.

operator in the event of revenue shortfalls, even if not contractually required to do so, to prevent decreases in service quality or service interruptions.

167. Also incorporated into many SCAs is the right of the grantor to assume the responsibility to provide the services in the event of operator default stemming from circumstances such as financial insolvency or violation of performance standards. For instance, in an SCA for the operation of a toll road in a North American country, the grantor may declare a "concessionaire default" and terminate the arrangement for cause. Cause may include failure to comply with, perform, or observe a contractual operating standard if such failure materially threatens the safety of the operations of the toll road, or materially impairs the toll road or its continued use for transportation purposes[24]. Even if this right is not explicitly stated in the terms of the arrangement, the grantor will generally have a moral responsibility to take over the provision of services if the operator fails to perform, given the public nature of the service. This responsibility of the grantor is often referred to as "step-in" responsibility—a responsibility to users of the service provided through the SCA or to others impacted by the service, rather than to the operator.

**Analysis**

168. IAS 39 provides guidance on the measurement of financial liabilities associated with the issuance of financial guarantee contracts, which are defined in that statement as "contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument." Certain guarantees made by a grantor as part of an SCA, for example, a contractual guarantee of repayment of the operator's debt in the event of default, may meet this definition of a financial guarantee contract. In this case, the provisions of IAS 39 should be used to measure and recognize a financial liability related to the guarantee in the grantor's financial statements.

169. Guarantees and commitments that do not meet the definition of a financial guarantee contract in IAS 39 generally would fall under the scope of IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*. Paragraph 22 of IPSAS 19 states that a provision should be recognized as a liability in the financial statements if all of the following criteria are met:

   1. An entity has a present obligation (legal or constructive) as a result of a past event;

   2. It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and

   3. A reliable estimate can be made of the amount of the obligation.

170. A past event that leads to a present obligation is referred to as an obligating event in IPSAS 19. For an event to be an obligating event, the entity must have no realistic alternative to settling the obligation created by the event. In the case of contractual guarantees and

[24] Indiana Toll Road Concession and Lease Agreement, 2006; http://www.in.gov/ifa/files/4-12-06-Concession-Lease-Agreement.pdf

commitments made by the grantor under an SCA, it would be fairly clear that the giving of the guarantee is an obligating event—because settlement of the obligation (the guarantee) can be enforced by law.

171. Determining whether an obligating event has occurred is less clear when the guarantee or commitment is constructive, that is, when it is not a contractual requirement. In this case, IPSAS 19 states that an obligating event has occurred only if the event creates valid expectations in other parties that the entity will discharge the obligation. The event may be an action of the entity, such as an established pattern of past practice, published policies or a sufficiently specific currently made statement. Whether execution of an SCA results in a present constructive obligation(s) for the grantor depends largely on professional judgment, given the facts and circumstances of the specific situation.

172. Professional judgment would also be required in determining whether it is probable that the present obligation created by the guarantee or commitment will result in an outflow of resources. Paragraph 31 of IPSAS 19 states that an outflow of resources is considered probable if there is a greater percentage that the outflow will occur, than that it will not. If such outflow is not probable (or the amount of the obligation cannot be reliably measured), then the present obligation is considered a contingent liability. Contingent liabilities are not recognized in the financial statements; instead they are disclosed in the notes to the financial statements, unless the possibility of an outflow of resources is remote, in which case no disclosure is required.

173. Based on the guidance in IPSAS 19, in many cases a provision would not be recognized in the financial statements of the grantor for guarantees or commitments associated with SCAs until the contingent event that is the subject of the guarantee occurs or does not occur—for example, the operator does not achieve a minimum revenue threshold. An argument can be made that this treatment does not provide an optimum level of transparency in the financial statements for the additional risk being assumed by the grantor through these guarantees and commitments. This raises the question whether a liability should be recognized in the grantor's financial statements upon the giving of these guarantees or commitments, regardless of the probability of an outflow of resources. This type of approach has been proposed by the IASB in its Exposure Draft, Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* (the Exposure Draft) issued in June 2005 (the provisions of IAS 37 served as the basis for those in IPSAS 19).

174. Under the proposals in that Exposure Draft, the concept of contingent liabilities would be eliminated. 'Contingency' would only be used to refer to uncertainty about the amount required to settle a liability, not uncertainty about whether a recognizable liability exists. A present obligation arising from a past event for which the settlement amount is contingent on one or more uncertain future events would be recognized independently of the probability of occurrence of the uncertain future event(s). In other words, the probability of an outflow of resources would not be a factor in determining whether a present obligation should be recognized as a liability in the financial statements. Instead, such probability would only factor into the measurement of the liability to be recognized.

175. The Exposure Draft proposes that where the amount required to settle a present obligation is contingent on the occurrence or non-occurrence of an uncertain future event, the entity has incurred two obligations—an unconditional obligation and a conditional obligation. For example, under the Exposure Draft, if a grantor guarantees the debt of an operator, it would have an unconditional obligation to stand ready to guarantee the debt of the operator and a conditional obligation to repay the debt if the operator actually defaults. The grantor would recognize its liability arising from its unconditional obligation to guarantee the debt of the operator. Uncertainty about whether the operator will default would be reflected in the measurement of the liability. This approach, as compared to that of IPSAS 19, would likely result in the recognition of a greater number of guarantees and commitments made by grantors as part of SCAs as liabilities in their financial statements.

176. The Exposure Draft proposes that these liabilities should be measured at the amount the entity would rationally pay to settle the present obligation (or to transfer it to a third party) at the balance sheet date. This measurement can be approached in several ways. Contractual or other market evidence could be used, although market evidence often will not exist, given the nature of the liability. If the amount must be estimated, an expected discounted cash flow approach would be an appropriate method of determining the amount to recognize as a liability on the balance sheet. As stated above, the measurement should reflect the risks and uncertainties associated with the contingent future events.

177. The comment period for the Exposure Draft closed in October 2005, and deliberations on the project continue. The IASB expects to issue a final Standard in the first half of 2009.

**Proposals**

178. The Board proposes that for guarantees and commitments made by a grantor as part of an SCA that meet the IAS 39 definition of a financial guarantee contract, the provisions of that statement should be used to measure and recognize a financial liability related to the guarantee in the grantor's financial statements.

179. The Board further proposes that the guidance in IPSAS 19 generally should be applied to determine the accounting and financial reporting for guarantees and commitments made by grantors that do not meet the IAS 39 definition of a financial guarantee contract. The Board believes that the existence of these guarantees and commitments under an SCA would not necessitate accounting treatment different than that for similar guarantees and commitments made in another context. Potential amendments to IPSAS 19 based on any amendments the IASB makes to IAS 37 may be considered by the IPSASB as part of a broader project on provisions, contingent liabilities and contingent assets, in accordance with its policy to converge public sector accounting standards with private sector standards to the extent appropriate. Proposals for disclosures related to guarantees and commitments are discussed later in the Consultation Paper.

## Inflows of Resources From a Service Concession Arrangement

180. A grantor has two main opportunities to receive inflows of resources from an operator through an SCA. Both of these occur most often when the operator receives fees for services directly from third-party users of the property underlying the SCA. One means of

receiving inflows of resources is through a revenue-sharing provision in the SCA contract. The other is through receipt of inflows of resources established by other contractual provisions. The latter inflows typically include an upfront payment from the operator to enter into the SCA, but may take the form of payments in several installments over all or a portion of the life of the concession. The following paragraphs discuss revenue recognition for the grantor in both of these circumstances.

**Revenue-Sharing Provisions**

181. For SCAs under which the operator will collect fees directly from third-party users of the underlying property, the grantor will often negotiate to include a revenue-sharing provision in the contract with the operator. This way, if the use of the underlying property exceeds projections, the revenue-sharing provision will allow the grantor to share in the financial success of the project. This type of provision also protects the grantor from the political risk and public criticism of entering into an agreement that is excessively profitable for the operator.

182. Revenue-sharing as part of an SCA is generally based on all revenue earned by the operator, or on revenue above a certain threshold, or on revenue more than the operator needs to achieve a specified rate of return. For example, as part of a BOOT arrangement for construction of an indoor arena in a Pacific Island country, the grantor receives a fixed royalty on every ticket sold to an arena event The grantor uses this royalty to fund community events[25]. Also, in an SCA involving a toll road in a North American country, the grantor is entitled to receive 40 percent of gross toll revenues after the real net cash flow of the arrangement yields the operator a 6.5 percent pre-tax internal rate of return on total invested projected funds. The grantor’s share increases to 80 percent of gross toll revenues after the arrangement yields the operator an 8 percent internal rate of return[26].

183. Revenue-sharing provisions often are incorporated into the terms of an SCA along with a minimum revenue guarantee for the operator. For example, the SCA for a highway in a Middle Eastern country noted in the Guarantees and Other Commitments section of the Consultation Paper contains a revenue-sharing provision. That provision requires the operator to pay the grantor 57 percent of the excess of actual over projected revenue. That provision is accompanied by a provision requiring the grantor to pay the operator 80 percent of any shortfall between actual and projected revenues[27]. In this way, the grantor offsets the demand risk it assumed by giving the operator a minimum revenue guarantee with the potential for an increased reward if revenues exceed projections.

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[25] Controller and Auditor General, New Zealand; Performance Audit Report, *Achieving Public Sector Outcomes with Private Sector Partners,* Appendix 1 (2006)

[26] Obtained from memorandum of understanding between Virginia Department of Transportation and a consortium consisting of Transurban, Inc. and DEPFA Bank plc. http://www.virginiadot.org/news/resources/PocaPkwyAssocPubPrivPart.pdf

[27] S. Ping Ho. Book chapter for *Government Policy on PPP Financial Issues: Bid Compensation and Financial Negotiation*. Book to be published, chapter available at: http://crgp.stanford.edu/publications/working_papers/S_Ping_Ho_PPP_Policy.pdf .

**Analysis**

184. To determine the appropriate method of recognizing revenues for inflows that the grantor can potentially receive through a revenue-sharing provision, these inflows can be analogized to royalties (a type of revenue arising from the use of an entity's assets by others) that are addressed in IPSAS 9, *Revenue From Exchange Transactions*. IPSAS 9 states that royalties should be recognized as they are earned in accordance with the substance of the relevant agreement when it is probable that (a) economic benefits or service potential associated with the transaction will flow to the entity, and (b) the amount of the revenue can be reliably measured. For arrangements in which the grantor shares in all of the subject revenue earned by the operator, without contingency, it seems clear that these criteria are met, and the grantor should recognize its share of the revenue as the revenue is earned by the operator. When to recognize that share is less clear, however, when a contingent event must occur before the grantor can share in the revenue earned by the operator. The key issue to resolve in this case is when it is considered probable that economic benefits will flow to the grantor under the revenue-sharing provision.

185. One approach is to consider that the flow of economic benefits to the entity is probable when sufficient evidence exists that the contingent event will probably occur. Conceptually, this point could be at any time during the measurement period specified in the revenue-sharing provision. For example, consider a revenue-sharing provision in a tollroad SCA that states that the grantor will receive 20 percent of all toll revenue earned in excess of 10 million currency units in a year. In recent history, the tollroad has earned between 15 and 20 million currency units annually. Based on this historical data, it could be argued that it is probable that the grantor will receive economic benefits from the revenue-sharing provisions at the very beginning of the measurement period. The grantor should, therefore, recognize revenue and a receivable from the time the operator first earns the subject revenue. The amounts recognized by the grantor would be based on a projection of the total revenue to be received for the measurement period. The reliability of such projection should of course be considered before recognizing the revenue.

186. An alternative approach would be to consider the flow of economic benefits to the grantor to be probable only after the contingent event occurs. This approach is consistent with guidance related to recognition of royalties provided in item 25 of the Appendix to IPSAS 9, which states the following:

> *In some cases, whether or not a license fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognized only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.*

187. Using the facts and circumstances of the above example, under this approach the grantor would not recognize revenue until the tollroad generates 10 million currency units. At that point, the grantor would recognize its portion of the toll revenue (along with a related receivable) as it is earned by the operator. This approach limits the subjectivity in determining the probability of the flow of economic resources to the grantor, thereby presumably resulting in a more consistent recognition of the revenue. It also limits the potential for recognizing revenue that will ultimately not be realized because the contingent

event does not occur. Given these factors, and the consistency with the guidance in IPSAS 9, the Board believes this to be the preferred approach.

188. Another issue related to accounting for a revenue-sharing provision is whether the grantor should recognize its right to share in the revenues of the operator as an asset. This asset would be separate from the physical property associated with the arrangement (if reported as an asset by the grantor), and from any receivables from the operator associated with the recognition of revenue discussed above. As discussed earlier in this Consultation Paper, IPSAS 1 defines assets as resources controlled by an entity as a result of past events, and from which future economic benefits or service potential are expected to flow to the entity. It can be argued that this revenue-sharing right meets this definition—(a) the grantor usually has control over this right (even if it does not have control over the property underlying the SCA), (b) the past event would be the execution of the SCA contract, and (c) the cash flows to be received through this right represent the future economic benefits.

189. The Board does not believe that the execution of the SCA contract is a past event that results in the creation of an asset related to a revenue-sharing provision. The Board instead believes that the only past events that would result in recognition of an asset related to revenue-sharing provisions are the third-party use of the services provided by the operator and, if applicable, the meeting of any prescribed thresholds upon which the sharing of revenue with the grantor is contingent. The Board does not believe that, before such events occur, future economic benefits or service potential can be expected to flow to the grantor from revenue-sharing provisions. Therefore, the Board does not believe that the grantor should report as an asset the right to share in the revenues of the operator.

### Proposal

190. The Board proposes that grantors should recognize revenue (and related receivables) generated from revenue-sharing provisions in SCAs as it is earned, in accordance with the substance of the relevant agreement, after any contingent event (such as the achievement of a revenue threshold) is deemed to have occurred.

### Contractually Determined Inflows[28]

191. The other potential source of inflows of resources for the grantor in an SCA is a contractually determined payment(s) whose value is effectively predetermined. A common example is an upfront payment made by the operator in exchange for concession rights associated with the SCA, but other patterns of receipt, such as annual installments over the life of the SCA, or predetermined sums for predetermined years, also occur in practice. These contractually determined inflows most often occur when the SCA involves existing infrastructure or public facilities. For example, in an SCA for a North American toll road[29], the operator received the right to operate an existing toll road, subject to maintenance and

[28] This guidance applies for SCAs in which the grantor reports the underlying property. Refer to the previous section, Grantor Reporting the Property When the Proposed Control Criteria Are Not Met, for SCAs in which the grantor does not report the underlying property.

[29] Indiana Toll Road Concession and Lease Agreement, 2006; http://www.in.gov/ifa/files/4-12-06-Concession-Lease-Agreement.pdf

renovation responsibilities, in exchange for an upfront payment of $3.85 billion to the grantor. However, these inflows may also occur in SCAs involving construction of new property. For example, in an SCA for another North American toll road, an operator paid $3.3 billion for the right to design, build, finance, and operate the toll road[30].

**Analysis**

192. Contractually determined inflows raise the accounting issue of the timing of revenue recognition. There are two basic approaches to this issue. One approach is for the grantor to recognize the entire value of the consideration (including any other amounts owed by the operator) as revenue at the execution of the contract. This approach is based on the premise that the entirety of the exchange occurs upon the execution of the contract—in essence, the grantor has already fulfilled its contractual responsibilities to the operator at execution. The other approach is to recognize the value of the consideration as revenue over the life of the agreement. This approach is based on the premise that the grantor has an obligation to perform throughout the SCA—in other words, the grantor has not fulfilled its contractual responsibilities at execution. Therefore, the recognition of revenue should occur as it is earned by the grantor through performing the contract. Any consideration received from the operator in advance of performance should be reported by the grantor as a liability until it is earned.

193. Generally, in SCAs featuring contractually determined inflows from the operator, the consideration provided by the grantor in exchange is the right to operate the property underlying the SCA. Given this exchange, it would appear that the grantor would continue to have some obligation to perform throughout the life of the agreement, even if that performance is nothing more than allowing the operator access to the property. Therefore, the contractually determined inflows should be recognized as revenue as the grantor provides access to the property.

194. In this regard, the method of revenue recognition for the contractually determined inflows can be analogized to that for the rendering of services found in IPSAS 9. Paragraph 19 of IPSAS 9 states that revenue recognition in a transaction involving the rendering of services should reflect the extent of completion of the transaction at the reporting date, presuming the extent of completion can be estimated reliably. Paragraph 24 of IPSAS 9 further clarifies by stating that when services are performed by an indeterminate number of acts over a specified time frame, revenue is recognized on a straight-line basis over that period. This would appear to be the circumstance in many SCA agreements. Therefore, it would appear that the contractually determined inflows received by a grantor as part of those SCAs could be recognized as revenue in a similar manner. The Appendix to IPSAS 9 also includes an illustration of a concession fee and reaches a similar conclusion, stating that fees charged for the use of continuing rights granted by the agreement are recognized as revenue as the rights are used.

195. However, given the varying nature of the types of property associated with SCAs, and the length of many of their terms, there may be more appropriate alternative methods for

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30 Richard Williamson, "NTTA Approves up to $3.75 Billion of BANs for SH-121 Toll Project," *The Bond Buyer,* November 9, 2007.

recognizing revenue associated with contractually determined inflows, methods that better reflect the operator's economic consumption of their access to the underlying property and/or the time value of money. For example, an annuity method that applies a compounding interest factor that more evenly recognizes revenue on a discounted basis, as opposed to on a nominal basis, may be more appropriate for an SCA with a term extending over several decades.

### Proposal

196. The Board proposes that contractually determined inflows to be received by a grantor from an operator as part of an SCA should be recognized as revenue by the grantor as they are earned over the life of the SCA, beginning at the commencement of the concession term, that is, when the property is fully operational and the operator has the ability to use the property to generate third-party usage fees. The Board believes that before this point the grantor cannot begin to deliver on its side of the exchange—generally, providing access to the property to the operator. After the property becomes fully operational, the grantor should recognize the contractually determined inflows as revenue, using the straight-line method, or a method that better reflects the operator's economic consumption of its access to the underlying property and/or the time value of money, given the facts and circumstances of the SCA. As noted earlier, any consideration received from the operator in advance of performance should be reported by the grantor as a liability until it is earned.

## Consolidation

197. In addition to determining whether the grantor controls the property underlying an SCA for purposes of financial reporting, an issue that also needs to be addressed is whether the operator should be considered a controlled entity of the grantor for financial reporting purposes under the authoritative guidance in IPSAS 6. In this case, the financial accounts of the operator would be included in the grantor's consolidated financial statements. Addressing this area may be particularly relevant when the operator in the SCA is a GBE. In these cases, the GBE operator is often closely related to the grantor, or the GBE may even be created by the grantor or another governmental entity for the purpose of serving as the operator.

198. Addressing this area may also be relevant when the operator in an SCA is a special purpose entity (SPE), referred to in some jurisdictions as a special purpose vehicle. An SPE will often be created by a project consortium to serve as the "legal" operator in an SCA. The consortium may include a number of participants, such as construction entities, operations entities, and equity investors. The sole purpose of the SPE is to carry out the operator's responsibilities under the SCA. The SPE can also securitize the claims to future project revenues and sell these securities to investors. An SPE that issues these securities limits the risks associated with the project for the individual participants. The potential for consolidation of an SPE serving as the operator under an SCA into the financial statements of the grantor may not be apparent. However, certain terms included in SCA contracts may be viewed as indicators of control, as identified in IPSAS 6.

**Analysis**

199. IPSAS 6 includes guidance for determining whether for financial reporting purposes one entity (a controlling entity) controls another entity (the controlled entity). In the context of an SCA, generally the grantor would be the potential controlling entity and the operator would be the potential controlled entity. Control, as defined by IPSAS 6, is the power to govern the financial and operating policies of another entity so as to benefit from its activities. For one entity to control another, two separate elements must be present in the relationship between the two entities: power and benefit.

200. *Power* relates to the power to govern the financial and operating policies of another entity. The existence of power in the context of IPSAS 6 does not necessarily require a majority shareholding or any kind of equity interest in the potential controlled entity. The power to control must be presently exercisable, but its existence does not depend upon whether the power has been exercised. That is, the mere existence of the power to control is sufficient to establish power under IPSAS 6. Similarly, the potential controlling entity is not required to be involved in the day-to-day operations of the potential controlled entity to establish the power to control, only to have the ability to be involved. In many cases, this power may only be invoked by a breach or violation of a contractual agreement.

201. *Benefit* relates to the ability of the potential controlling entity to benefit from the activities of the potential controlled entity. These benefits may be financial, such as the distribution of a dividend; non-*financial*, such as the achievement of policy objectives; or a combination of both. Although IPSAS 6 focuses on how the relationship with the potential controlled entity benefits the potential controlling entity, the concept of benefit also considers circumstances where the relationship between the two entities creates a financial burden for the potential controlling entity.

202. Paragraph 39 of IPSAS 6 states that in examining the relationship between two entities, control is presumed to exist *when* at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity:

*Power Conditions*

(a) The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.

(b) The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the board of directors or equivalent governing body and control of the other entity is by that board or by the body.

(c) The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.

(d) The entity has the power to cast the majority of votes at the meeting of the board of directors or equivalent governing body and control of the other entity is by that board or by that body.

*Benefit Conditions*

(a) The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example, the benefit condition may be met if an entity had responsibility for the residual liabilities of another entity.

(b) The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

203. When at least one of the above circumstances under each category does not exist, paragraph 40 of IPSAS 6 identifies the following factors that are likely, either individually or collectively, to indicate the existence of control:

*Power Indicators*

(a) The entity has the ability to veto operating and capital budgets of the other entity.

(b) The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.

(c) The entity has the ability to approve the hiring, reassignment, and removal of key personnel of the other entity.

(d) The mandate of the other entity is established and limited by legislation.

(e) The entity holds a "golden share"[31] (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

*Benefit Indicators*

(a) The entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these.

(b) The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation or in a distribution other than liquidation.

(c) The entity is able to direct the other entity to co-operate with it in achieving its objectives.

(d) The entity is exposed to the residual liabilities of the other entity.

*Government Business Enterprises*

204. Where the operator is a GBE, the Board believes that certain of the indicators of control discussed in paragraphs 39 and 40 of IPSAS 6 will often exist between the grantor and the GBE, particularly if the GBE was specifically created to serve as the operator under the

[31] "Golden share" refers to a class of share that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder's ownership interest or representation on the governing body.

SCA. It generally would be appropriate to consolidate the GBE operator into the financial statements of the grantor in these circumstances, as provided for under IPSAS 6.

*Special Purpose Entities*

205. Where the operator is an SPE, the indicators of control described in paragraph 39 of IPSAS 6 would generally not be present in the relationship between the grantor and the operator. However, the contractual terms of the SCA may result in the presence of certain of the control indicators in paragraph 40 of IPSAS 6, or analogous ones. For example, in an SPE for an African toll road[32], the following contract provisions may be indicators of the grantor's power to control the operator:

- The operator is only permitted to issue debt as specified in the contract, and the grantor must pre-approve any additional indebtedness.
- All toll rates are subject to approval by the national Minister of Transport (on recommendation from the grantor), and the grantor may amend the toll rates.
- The grantor may require the operator to remove any employee the grantor believes is incompetent or guilty of misconduct.

206. Provisions of the SCA in this example that may indicate the grantor's ability to benefit from the activities of the operator are as follows:

- The operator is required to ensure that the highway is open to traffic at all times, and that the traffic flow satisfies certain predetermined standards that meet the grantor's objectives related to transport (thus indicating the grantor's ability to direct the operator to co-operate with it in achieving the grantor's objectives).
- The operator is required to make payments to the grantor if the return on the project exceeds a certain threshold.

207. Another provision somewhat common to SCAs that could be viewed as a benefit indicator is a guarantee by the grantor of the debt of the operator. This could expose the grantor to residual liabilities of the operator, as described in paragraph 40 of IPSAS 6.

208. Given the limited operations of an SPE, the presence of these or similar indicators could lead to the conclusion, based on the guidance in IPSAS 6, that the grantor can "control" the operator. However, as described in paragraph 39 of IPSAS 6, whether there is clear evidence that an entity other than the grantor holds control over the operator should be considered. In most cases involving an SPE as an operator, the Board expects that such evidence will exist. The Board believes that the sponsors or shareholders of the SPE generally will exhibit a greater degree of control than the grantor over the SPE through voting rights or ownership stakes in the SPE. The indicators of control for the grantor will generally be based on the binding nature of the contract terms, as opposed to control over the entity itself. The Board therefore expects that in most cases where the operator is an SPE, such operator would not be determined to be a controlled entity of the grantor.

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[32] Report to National Treasury—PPP Unit November 27 2006.

209. The Board believes that this expectation is also consistent with the guidance in the IASB's SIC Interpretation 12, *Consolidation – Special Purpose Entities* (SIC-12). SIC-12 describes the circumstances to consider when determining whether an SPE is controlled by another entity. These circumstances, which are in addition to those provided in paragraph 13 of IAS 27, *Consolidated and Separate Financial Statements*, (which are similar to the power conditions in paragraph 39 of IPSAS 6), include the following:

    (a) In substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation;

    (b) In substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the entity has delegated these powers;

    (c) In substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or

    (d) In substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

210. The Board believes that in the context of an SCA, the grantor generally would not meet any of these criteria before one of the participants of the SPE would. This is particularly the case when the criteria are considered in the context of the establishment of the SPE in the first instance, and when it is considered that the risks and benefits referred to in the criteria relate to the generation of future economic benefits.

211. If the grantor does have an ownership or equity interest in the operator, in addition to assessing the reporting impact of the relationship between grantor and operator under IPSAS 6, the relationship should also be assessed under IPSAS 7, *Accounting for Investments in Associates,* and IPSAS 8, *Interests in Joint Ventures,* for purposes of consolidation.

212. IPSAS 7 provides accounting and financial reporting guidance for ownership interests in which the investor has significant influence over the investee. IPSAS 7 defines significant influence as the power to participate in the financial and operating policy decisions of the investee, but not control or joint control over those policies. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

    (a) representation on the board of directors or equivalent governing body of the investee;

    (b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

    (c) material transactions between the investor and the investee;

    (d) interchange of managerial personnel; or

    (e) provision of essential technical information.

213. If the investor's ownership interest is in the form of shares and it holds, directly or indirectly, 20 percent or more of voting power of the investee, significant influence is

presumed; an investor holding less than 20 percent is presumed not to have significant influence. If the grantor has an ownership interest in the operator and the criteria for significant influence are met, then the appropriate guidance in IPSAS 7 should be followed.

214. When the grantor has an equity interest in the operator, the operator could be considered a jointly controlled entity, which is a form of joint venture under IPSAS 8. More specifically, as defined by IPSAS 8, a jointly controlled entity is a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. IPSAS 8 requires that to establish a joint venture requires a binding arrangement that establishes joint control. The participants in the jointly controlled entity typically transfer assets and liabilities to the separate jointly controlled entity to carry out an activity. In some cases, the operator under an SCA could be an entity jointly controlled by the grantor and another entity (either a public or private sector entity). If the criteria established by IPSAS 8 are met for a jointly controlled entity, then appropriate guidance should be followed.

215. The ownership structure of the operator or the specific terms of the SCA may change during the term of the arrangement. In this case, the financial reporting conclusions resulting from application of the above standards should be reassessed to ensure their continued validity. Any changes to those conclusions should be appropriately reflected in the grantor's financial report.

### Proposals

216. The Board proposes that the relationship between the grantor and the operator in an SCA should be evaluated using the guidance in IPSAS 6 to determine whether the grantor controls the operator for financial reporting purposes. The characteristics of the reporting entity is a component of the Board's current project to develop a public sector conceptual framework that would apply to the preparation and presentation of general purpose financial reports of public sector entities. The conceptual conclusions regarding the reporting entity drawn as part of that project may therefore impact determinations reached related to consolidation in the context of SCAs. The Board also proposes that the guidance in IPSAS 7 and IPSAS 8 should also be considered if the grantor has an ownership or equity interest in the operator.

## Financial Statement Note Disclosures

217. Given the general complexity of SCAs and the potential magnitude of their impact on the financial statements of the grantor, note disclosures related to SCAs need to be considered for the benefit of financial statement users. When considering the types of information that should be included in financial statement note disclosures, the objectives of general purpose financial reporting in the public sector must be taken into account.

218. Overall, according to IPSAS 1, those objectives should be to provide information useful for decision-making, and to demonstrate the accountability of the entity for the resources entrusted to it by:

   (a) Providing information about the sources, allocation, and uses of financial resources;

(b) Providing information about how the entity financed its activities and met its cash requirements;

(c) Providing information that is useful in evaluating the entity's ability to finance its activities and to meet its liabilities and commitments;

(d) Providing information about the financial condition of the entity and any changes in it; and

(e) Providing aggregate information useful in evaluating the entity's performance in terms of service costs, efficiency, and accomplishments.

219. Paragraph 16 of IPSAS 1 also states that general purpose financial statements can have a predictive or prospective role, providing information useful in predicting (a) the level of resources required for continued operations, (b) the resources that may be generated by continued operations, and (c) the associated risks and uncertainties.

220. Furthermore, IPSAS 1 states that note disclosures should provide information that is not presented on the face of the financial statements, but that is relevant to understanding them. Aspects of SCAs may appear on the face of the financial statements of the grantor, such as the cash flow statement for the receipt of an upfront payment from the operator, or the statement of financial position by the addition of a building that has been constructed through the SCA. Further information is, however, essential for users to understand the transactions that have taken place.

221. The IASB's SIC-29 includes financial statement disclosure requirements related to SCAs for both the grantor and the operator. Paragraph 6 of SIC-29 details the requirements:

> *All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. An operator and a grantor shall disclose the following in each period:*
>
> *(a) a description of the arrangement;*
>
> *(b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (e.g., the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);*
>
> *(c) the nature and extent (e.g. quantity, time period or amount as appropriate) of:*
>
> *i. rights to use specified assets;*
>
> *ii. obligations to provide or rights to expect provision of services;*
>
> *iii. obligations to acquire or build items of property, plant and equipment;*
>
> *iv. obligations to deliver or rights to receive specified assets at the end of the concession period*
>
> *v. renewal and terminations options*

*vi. other rights and obligations (e.g., major overhauls); and*

*(d) changes in the arrangement occurring during the period;*

*(e) how the service arrangement has been classified.*

222. Additionally, in *Public-Private Partnerships, Government Guarantees, and Fiscal Risk*, prepared by a staff team from the International Monetary Fund led by Richard Hemming, the following disclosures related to SCAs (or, more broadly, PPPs) are also suggested for financial reports[33]:

- An outline of the objectives of current or planned PPP programs and a summary description of projects that have been contracted or are at an advanced stage in the contracting process.
- Future service payments and receipts (such as concession and operating lease fees) by government specified in PPP contracts for the following 20-30 years.
- Details of contract provisions that give rise to contingent payments or receipts (for example, guarantees, shadow tolls, profit-sharing arrangements, events triggering contract renegotiation), with the latter valued to the extent feasible.
- Amount and terms of financing and other support for PPPs provided through government on-lending or via public financial institutions and other entities (such as SPVs) owned or controlled by government.
- How the project affects the reported fiscal balance and public debt, and whether PPP assets are recognized as assets on the government balance sheet. It should be noted whether PPP assets are recognized as assets on the balance sheet of any SPV or the private sector partner.

**Analysis**

223. The financial statement note disclosures required by SIC-29 are consistent with the objectives of IPSAS 1. Indeed, the IASB's *Framework* and IAS 1, *Presentation of Financial Statements* (which was the basis for IPSAS 1), is referenced in the basis for conclusions of SIC-29 as justification for financial statements to provide information that is not on the face of the statements, but that is relevant to the needs of their users.

224. The suggested disclosures described in *Public-Private Partnerships, Government Guarantees, and Fiscal Risk*, are also consistent with the objectives of IPSAS 1, as well as with the requirements of SIC-29. The disclosures suggested by Hemming, however, are more specific than those in SIC-29. For example, "future service payments and receipts (such as concession and operating lease fees) by government specified in PPP contracts for the following 20-30 years" can be interpreted to be encompassed in the SIC-29 requirement to disclose "significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows".

[33] International Monetary Fund Staff Team led by Richard Hemming, 2006, *Public-Private Partnerships, Government Guarantees, and Fiscal Risk,* p. 28-29.

225. In addition to the information to be included in these disclosures, other types of information related to an SCA warrant consideration for disclosure in the grantor's financial statements. For example, information related to aspects of an SCA that could impact the delivery of services to the constituents of the grantor could be considered for disclosure. Property operation and maintenance requirements may be an example of such an aspect. Also, because service delivery could be negatively impacted if the operator is unable to fulfill its obligations under the SCA, it may be relevant to users' understanding of the financial statements of the grantor to have information about the operator's financial condition. In the same vein, the provisions related to a default on the part of the operator, and the grantor's contractual ability to step in and re-assume service provision in the event of poor performance by the operator, may also be information related to service delivery that could be disclosed.

226. The accountability of the grantor for the resources involved in an SCA, most notably the underlying property, should also be considered for disclosure. Examples of specific disclosures related to accountability may include disclosure of (a) management's assessment of how the SCA achieves improved value for money, and (b) the nature of the risks transferred to the operator. For SCAs that allow the operator to collect fees from third-party users of the underlying property, another potential disclosure related to accountability is the estimated net future revenues to be earned by the operator from third-party use of the underlying property, along with a comparison of that amount with the value of consideration received from the operator.

227. In determining what types of information should be included in financial statement note disclosures, it must be considered that although certain information may be of interest to some constituents of the grantor, it may not be relevant to users' understanding of the financial statements. Accordingly, in this case, certain types of information may be more appropriately included in other financial reports and documents of the grantor, as opposed to in the financial statements.

**Proposal**

228. The Board proposes that the following types of information should be included in disclosures related to SCAs in the financial statements of grantors:

- A general description of the SCAs in effect during the reporting period, including management's objectives for entering into them;
- The nature and extent of rights acquired under SCAs, which may include rights to expect the provision of services and revenue-sharing;
- The nature and extent of obligations, guarantees, and other commitments assumed under SCAs, which may include guarantees of operator debt and guarantees of minimum revenue amounts for the operator;
- Aspects of SCAs that may impact service delivery to constituents, which may include property operation and maintenance requirements, events of operator default and their potential effect on service delivery, and information on the financial condition of the operator;

- The nature and amount of assets and liabilities related to SCAs that are recognized in the statement of financial position; and
- Future cash inflows and outflows associated with SCAs, and any significant conditions or contingencies that may affect the amount, timing, and certainty of those future cash flows.

229. The Board acknowledges that some grantors may have several SCAs in effect at one time, which could make developing detailed disclosure information costly and burdensome. To balance the cost and benefit of providing SCA information in the financial statement note disclosures, the Board believes that aggregation of information should be considered, as appropriate.

230. In addition to the types of information proposed above to be included in disclosures specifically addressing SCA contracts, the disclosure requirements of other authoritative guidance that may apply to aspects of the SCA should also be followed, as appropriate. These may include, for example, the disclosure requirements related to:

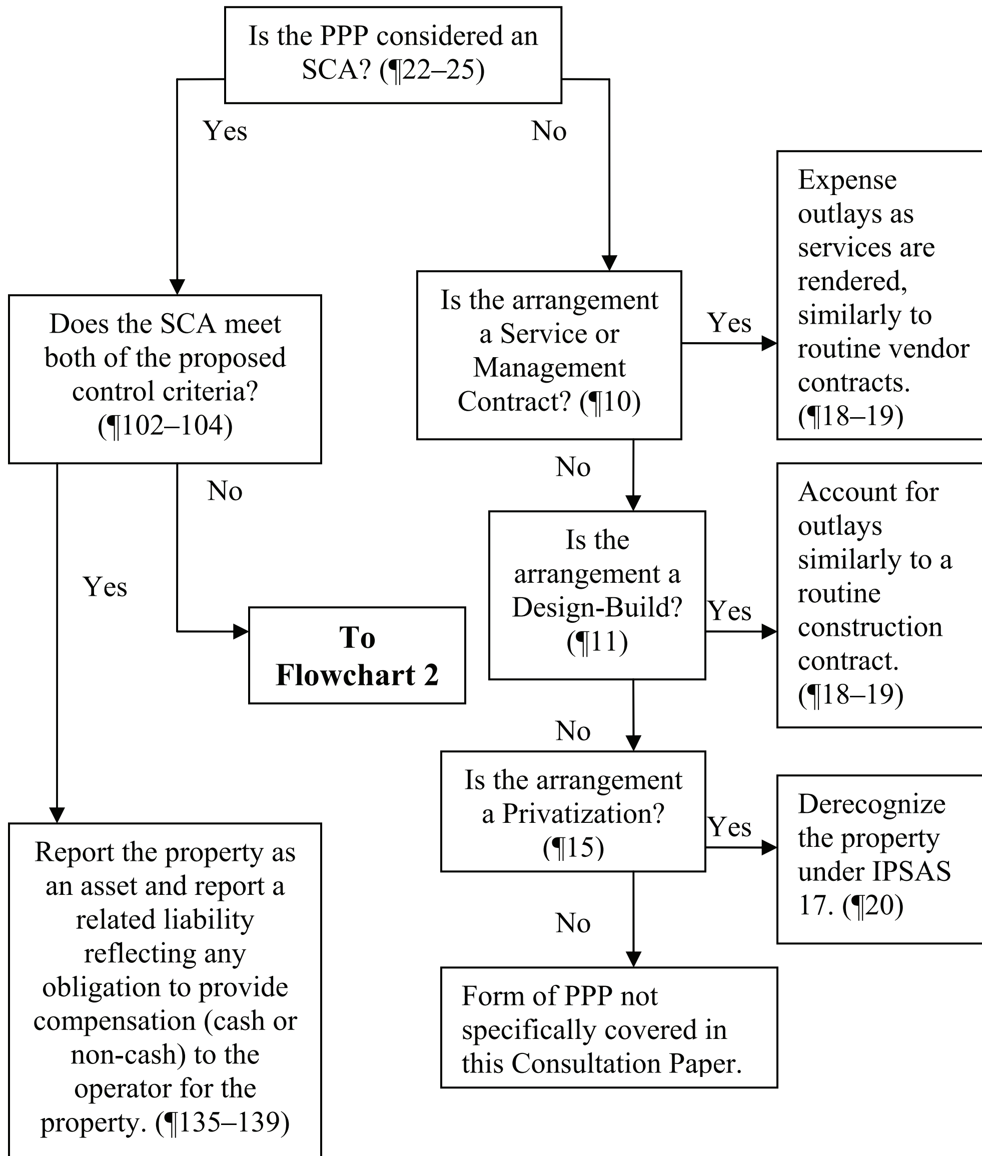
- Property, plant, and equipment present in IPSAS 17;
- Financial liabilities (including financial guarantees) present in IPSAS 15[34]; and
- Contingent liabilities present in IPSAS 19.

[34] The IPSASB is currently considering revisions to IPSAS 15. The proposals are still in the preliminary stages but are focused on whether to align the standards for disclosure and presentation more closely with IFRS 7, *Financial Instruments: Disclosures* and IAS 32, *Financial Instruments: Presentation*.

# Appendix—Illustrative Flowcharts

The flowcharts below illustrate the proposed guidance for the various types of PPPs discussed in the Consultation Paper. Flowchart 1 depicts the proposals for PPPs that are not considered SCAs and for PPPs that are considered SCAs and meet both of the proposed control criteria. Flowchart 2 depicts the proposals for PPPs that are considered SCAs but do not meet both of the proposed control criteria. The flowcharts include references to specific paragraphs in the Consultative Paper that provide a detailed explanation of the particular topic.

### Flowchart 1—Accounting and Financial Reporting of PPPs by Grantors



## Flowchart 2—SCAs That Do Not Meet Both of the Proposed Control Criteria

**From Flowchart 1**

Does the SCA meet either of the proposed control criteria? (¶102)

Yes

No

Does the SCA only meet the proposed control over use criterion? (¶143–148)

Is the property new or an existing asset of the grantor? (¶142)

New

Yes

Existing

No

Do not report the property and expense any outlays related to the SCA as incurred. (¶159)

Derecognize the property under IPSAS 17 and expense any outlays related to the SCA as incurred. (¶159)

Does the SCA meet the definition of a lease in IPSAS 13 (grantor as lessee)? (¶145–147)

Yes

No

Does the SCA only meet the proposed control over residual interest criterion? (¶149–158)

Follow IPSAS 13 guidance for lessees, including sale-leasebacks, if applicable. (¶160)

Does the grantor own the property during the SCA? (¶148)

No

Do not report the property and expense any outlays related to the SCA as incurred. (¶ 161)

Yes

No

Is the property new or an existing asset of the grantor?

SCA does not meet either of the proposed control criteria.

Yes

New

Existing

Report the property as an asset during the SCA. Derecognize property under IPSAS 17 upon disposal at end of SCA. (¶ 161)

Does the SCA meet the definition of a lease in IPSAS 13 (grantor as lessor)? (¶158)

Yes

No

Report the excess of the expected fair value of the property at the end of the arrangement over the amount the grantor will be required to pay the operator upon reversion as an asset. This asset should be built up from payments made by the grantor to the operator over the life of the SCA. (¶162)

Follow guidance in IPSAS 13 for lessors. (¶163)

Derecognize the property under IPSAS 17 and report an asset representing the operator's obligation to return the property. (¶163)

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