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Contact Mary Tokar

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Dear Ms. Fox

We appreciate the opportunity to respond to the International Public Sector Accounting Standards Board's (IPSASB or the Board) Exposure Draft 43 *Service Concession Arrangements: Grantor* (the ED). This letter expresses the views of KPMG International and its member firms.

We support the IPSASB's issuance of an International Public Sector Accounting Standard (IPSAS) addressing accounting and financial reporting for service concession arrangements by public sector grantors. We believe that the proposed IPSAS will enhance the consistency of reporting about these arrangements among public sector entities around the world, and between public sector grantors and private sector operators. However, we do have a number of comments on the proposals in the ED. These comments address the specific matter for comment identified in the ED, as well as certain other aspects of the ED. Our comments are provided below.

Specific Matter for Comment

This Exposure Draft addresses service concession arrangements from the grantor's perspective. It mirrors the principles set out in IFRIC 12 for accounting by the operator.

Do you agree with this approach?

Given the IPSASB's "rules of the road" for developing its standards, we agree with the basic approach for the proposals of the ED to mirror the principles set out in IFRIC 12 for accounting by the operator. We do not believe that the public sector environment necessitates differences in the approach to the financial reporting of service concession arrangements from private sector standards. Further, we expect that mirrored approaches will result in consistency in the financial reporting of the public sector grantor and private sector operator to an individual service concession arrangement, particularly the recognition of the infrastructure assets underlying the arrangement. Currently, the lack of consistency in financial reporting between these parties has resulted in infrastructure assets going unrecognized by either the public sector grantor or the private sector operator in a number of arrangements.

Other Comments

Our comments on various other aspects of the ED are provided below. These comments are organized by major section of the ED.

Scope

It is unclear whether service concession arrangements for which both the grantor and operator are public sector entities ("public-to-public arrangements") are within the scope of the proposed IPSAS. We believe that these arrangements should be within the scope of the final standard. It appears, however, that potentially unique aspects of public-to-public arrangements, through which the provision of services remains with a government entity, were not expressly considered as part of the ED. If public-to-public arrangements are to be within the scope of the final standard, then we suggest that the Board specifically deliberate these arrangements and consider the possibility of circumstances unique to them that may require additional or modified accounting and financial reporting guidance. If public-to-public arrangements are excluded from the scope of the final standard, such a fact should be stated explicitly.

Recognition and Measurement of a Service Concession Asset

- We agree with the concept of the control-based criteria detailed in paragraphs 10 and 11 of the ED. We do suggest clarification of certain of the terms in the criteria. As one of the control-based criteria for recognizing the infrastructure underlying a service concession arrangement as an asset, paragraph 10(a) of the ED states the following:

  > *The grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price…*

  Paragraphs AG6 through AG8 of the ED provide guidance as to the application of the terms "control" and "regulate." Both paragraphs AG6 and AG7 indicate that the criterion indicated above is met if the control over the specified aspects of the infrastructure and its use is possessed by "a third party regulator that regulates other entities that operate in the same industry or sector as the grantor." Similar guidance is provided for in IFRIC 12. While we believe this guidance is appropriate from the perspective of the private sector operator, we believe that it is problematic as far as determining recognition of the infrastructure as an asset by the grantor. From the perspective of the private sector operator, in either the case in which control of the specific aspects of the infrastructure and its use is possessed by the grantor or another third-party regulator, the operator does not control the asset and, therefore, it is appropriate that the operator not recognize the infrastructure as an asset as provided for in IFRIC 12. However, from the perspective of the grantor, if control over the specific aspects of the infrastructure and its use is possessed by another public sector entity, there may be insufficient evidence of control of the infrastructure supporting the recognition of the asset by the grantor. Requiring a grantor to recognize assets on the basis of control exercised by a third party could have wide-ranging implications in other aspects of public sector accounting and financial reporting. We believe that the Board should explore this further in the Application Guidance section and consider limiting the scope of the ED to service concession arrangements for which the aspects of the infrastructure and its use detailed in paragraph 10(a) are controlled exclusively by the grantor or by the grantor and other public sector entities within the same reporting entity as the grantor.

Further, the notion of a "third-party regulator" possessing control of the specific aspects of the infrastructure and its use resulting in the control criterion in paragraph 10(a) of the ED being met appears to be in conflict with the application guidance in paragraph AG8 which states that the terms "control" and "regulate" are "intended to be applied in the context of the specific terms of the service concession arrangement" instead of the broad regulatory powers of government entities. The "third-party regulators" referred to in paragraphs AG6 and AG7 are often not a party to the service concession arrangement and, therefore, by definition, their "control" or ability to "regulate" the infrastructure often would not be in the context of the service concession arrangement. We believe that the Board should resolve this apparent conflict in the Application Guidance section or provide clarification in paragraphs AG6 and AG7 of the role of the "third-party regulator" and how such a regulator would impact the assessment of the criterion in paragraph 10(a).

- Paragraph 12 of the ED states the following:

  > *Where an existing asset of the grantor specified in paragraph 8(d) meets the conditions specified in paragraph 10 (or paragraph 11 for a whole-of-life asset), the grantor <u>shall not recognize the asset as a service concession asset in accordance with this Standard.</u> The grantor shall reclassify the existing asset as a service concession asset for reporting purposes and disclose the reclassification in accordance with paragraph 27. (Emphasis added)*

  Because in the circumstances described in paragraph 8(d), the grantor already should report the underlying infrastructure as an asset, we found the emphasized phrase in the citation above confusing. We believe one could infer from this phrase that the infrastructure asset previously reported by the grantor should be *derecognized*. We suggest that this phrase be deleted from the final standard or language similar to that in paragraph AG15 be incorporated into paragraph 12.

- The above citation from paragraph 12 and other paragraphs in the ED refer to the classification (or reclassification) of the infrastructure underlying a service concession arrangement as a "service concession asset." We are unclear as to the benefit of such a classification separate from property, plant and equipment, or intangible assets, as applicable, particularly as these "service concession assets" are to be accounted for in accordance with IPSAS 17, *Property, Plant and Equipment,* or IPSAS 31, *Intangible Assets*, as appropriate. Although subject to a service concession arrangement, the underlying character of the infrastructure asset remains consistent with other property, plant and equipment or intangible assets. We believe that the disclosures proposed in the ED are sufficient to indicate the assets involved in service concession arrangements to users of financial statements without separate classification. Reporting the infrastructure asset based on its nature is consistent with the guidance in IPSAS 13, *Leases*, for lessors of operating leases.

- We believe that the guidance in paragraph 15 of the ED should be amended as follows to address measurement of both new and existing assets subject to a service concession arrangement:

  *The grantor shall initially measure ~~the original~~ **a new** service concession asset at its fair value.* ***Existing service concession assets as described in paragraph 8(d) should continue to be measured based on the guidance in IPSAS 17.***

  If the final standard retains the apparent requirement to remeasure existing service concession assets at fair value, then we believe that additional guidance is required on the presentation of the remeasurement gain or loss.

- We believe that the guidance at the end of paragraph 16 of the ED should be amended as follows to reflect more accurately the appropriate fair value of the service concession asset when payments from the grantor are separable and to be consistent with the guidance in AG24:

  Where the grantor compensates the operator for the ***new*** *service concession asset by making payments, and the asset and service portions of the payments by the grantor to the operator are separable, the ~~fair~~ value ~~in paragraph 15~~* ***of the asset*** *is the ~~fair~~* ***present*** *value of the asset portion of the payments;* ***however, if the present value of the asset portion of the payments is greater than fair value, then the service concession asset initially is measured at fair value.***

- We believe that the guidance in paragraph 17 of the ED should be amended as follows to address the measurement of assets subject to a service concession arrangement for which the grantor compensates the operator by means other than cash payments:

  Where the asset and service portions of payments by the grantor to the operator are not separable, ***or the operator is compensated by means other than cash payments,*** *the fair value* ***of the service concession asset*** *is determined using estimation techniques.*

- Paragraph AG26 of the ED notes that service concession arrangements for which the grantor compensates the operator by means other than cash payments (described in paragraph 14(b)) are non-monetary exchange transactions and refers to guidance on non-monetary transactions in IPSAS 17 and IPSAS 31. However, service concession arrangements with these circumstances are not necessarily non-monetary transactions because the *operator* may make cash payments to the *grantor* for the right to use the service concession asset. Further, the guidance in IPSAS 17 and IPSAS 31 on non-monetary transactions relates to the measurement of the involved assets, which would appear to be addressed specifically in the final standard for service concession assets. Accordingly, we suggest the deletion of paragraph AG26.

  We do believe, however, that commentary would be useful identifying the arrangements referred to in paragraph 14(b) as exchange transactions and explaining the nature of the components of the exchange. We suggest that this be provided immediately following paragraph 14 or as part of a new paragraph AG 26.

- Paragraph AG27 states that the forms of non-cash compensation from the grantor to the operator described in paragraph 14(b) of the ED are intended to compensate the operator both for the cost of the facility and for operating the facility during the term of the service concession arrangement. We believe, however, that in this case, the non-cash compensation provided by the grantor is only to compensate the operator for the provision of the service concession asset. The fees collected from third-party users of the asset (or from the government if they are paying on behalf of third-party users) are the operator's compensation for the operation of the asset. If the right to access the service concession asset was compensation for both the provision and the operation of the asset, it would appear that the performance obligation would exceed the value of the asset or there would be an imputed cost of service in future periods for the operation component. We also believe that the term "facility" used in this paragraph should be replaced with "service concession asset" to be consistent with the rest of the ED.

Recognition and Measurement of Liabilities

- While we do not disagree with the premise in paragraph 19 of the ED that the grantor shall recognize a liability when it recognizes a new service concession asset, such liability representing compensation due to the operator for such asset, we believe that the Board should explain in the basis for conclusions why it considers that the "performance obligation" referred to in paragraph 19 meets the definition of a liability in IPSAS 1, *Presentation of Financial Statements*. In particular, the Board should explain why it concluded that providing future access to the service concession asset to the operator represents an outflow of resources embodying economic benefits or service potential, such that the obligation to provide future access meets the definition of a liability, notwithstanding that the obligation will not be settled, either directly or indirectly, by the payment of cash or delivery of another asset. We do agree that the liability reported by the grantor initially should be measured at the same amount as the value reported for the service concession asset.

- We believe the guidance related to the classification of the liability reported by the grantor when it recognizes a new service concession asset as a financial liability as considered in IPSAS 28, *Financial Instruments: Presentation,* IPSAS 29, *Financial Instruments: Recognition and Measurement,* and IPSAS 30, *Financial Instruments: Disclosures*, or a performance obligation requires additional clarification.

  In the ED, the decisive factor in the classification of the grantor's liability for compensation due to the operator for the service concession asset is the identity of the party making cash payments to the operator. For example, paragraph 21 of the ED states that when the grantor compensates the operator for the service concession asset by making payments, the liability shall be classified as a financial liability; paragraph 22 of the ED states that when the operator receives the right to collect fees from third-party users of the service concession asset, the grantor's liability is classified as a performance obligation. This approach is similar to that proposed by the IFRIC to determine the nature of the asset to be recognized by the operator in draft interpretations that preceded IFRIC 12. However, the IFRIC ultimately rejected this approach in its redeliberations as respondents argued that this approach "would result in an accounting treatment that did not reflect the economic substance of the arrangement." (IFRIC 12, BC 38)

  We believe that a more appropriate basis for classification of the grantor's liability is the bearing of demand risk. This basis results in reporting that is more consistent with the definition of a financial liability in IPSAS 28. A grantor only has a contractual obligation to deliver cash or another financial asset to the operator for the acquisition of the service concession asset if the payments to be made to the operator are contractually predetermined or if the grantor contractually guarantees to pay the shortfall, if any, between amounts received from third-party users and contractually determinable minimum amounts. In both of these cases, demand risk lies with the grantor, even though some of the actual payments to the operator may come from third-party users.

  In the case in which the operator bears demand risk, meaning its compensation is determined based on the volume of usage of the service concession asset, the grantor's liability to the operator is solely to provide exclusive access to the service concession asset so that the operator can earn revenue from the service provided to third parties. Even in the case of a shadow toll in which the grantor will pay the operator for the usage of the service concession asset by third parties, such payment is compensation in exchange for the usage of the service concession asset, not for the acquisition of the service concession asset. Further, the grantor is obligated to make payments to the operator only to the extent of the usage of the service concession asset.

  We also believe that basing the classification of the grantor's liability to the operator for the acquisition of the service concession asset on demand risk better mirrors the final guidance on classification of the operator's asset as provided in IFRIC 12. Paragraphs 16 and 17 of IFRIC 12 provide the following guidance regarding classification of the operator's asset as a financial asset or intangible asset:

> 16. *The operator shall recognise 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 for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.*
>
> 17. *The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.*

This is further described in paragraph BC40 of IFRIC 12 in terms of the operator's cash flows being guaranteed by the grantor or being conditional on usage of the service concession asset:

> *The IFRIC noted that the operator's cash flows are guaranteed when (a) the grantor agrees to pay the operator specified or determinable amounts whether or not the public service is used (sometimes known as take-or-pay arrangements) or (b) the grantor grants a right to the operator to charge users of the public service and the grantor guarantees the operator's cash flows by way of a shortfall guarantee described in paragraph 16. The operator's cash flows are conditional on usage when it has no such guarantee but must obtain its revenue either directly from users of the public service or from the grantor in proportion to public usage of the service (road tolls or shadow tolls for example).*

- Paragraph 23 of the ED further discusses the classification of the grantor's liability for providing the operator the right to use the service concession asset as consideration for the operator providing the service concession asset and/or the operator making payments to the grantor. We do not believe paragraph 23 needs to address the grantor's liability for the operator's provision of the service concession asset as that is the subject of paragraphs 19 through 22 of the ED. Further, we believe that any payments made by the operator to the grantor for the right to use the service concession asset impacts the measurement of the grantor's liability to the operator, not its classification. Therefore, we believe that guidance on such payments from the operator to the grantor should be incorporated into the guidance in paragraph 19 of the ED.

- Paragraph AG33 of the ED states that when allocating predetermined payments made by the grantor to the operator as part of the service concession arrangement between a reduction in the reported liability to the operator, the finance charge on such liability and the expense associated with the service portion of the arrangement, the operator's cost of capital specific to the service concession arrangement should be used to determine the finance charge. We believe that the rate used to determine the finance charge should be the rate implicit in the arrangement specific to the service concession asset, if determinable, or instead, the grantor's incremental borrowing rate. We believe that using either of these rates is more reflective of the economic substance of the finance charge implicit in the payment arrangement, which is that the operator has provided services or goods to the grantor on deferred payment terms, and, as a practical matter, either rate is likely to be more readily determinable than the operator's cost of capital.

- Paragraph AG38 of the ED states the following in the context of recording the satisfaction of the grantor's performance obligation to the operator when the operator's compensation for the provision of the service concession asset is the right to collect revenue from third-party users of the asset:

  > *If the operator's collection of third-party revenues significantly reduces or eliminates the grantor's predetermined series of payments to the operator, another basis may be more appropriate for reducing the liability (e.g. the term over which the grantor's future predetermined series of payments are reduced or eliminated).*

  Because the grantor's liability in this case is the obligation to provide the operator access to the property, it is unclear how such liability would be reduced over any period shorter than the life of the arrangement. We acknowledge that depending on the nature of the asset and the length of the arrangement, the most appropriate reduction of the liability may take a pattern other than a straight-line basis. However, we believe that a portion of the grantor's liability should exist over the entire period during which the operator has access to the service concession asset We also believe that the guidance in the citation above is inconsistent with the guidance on revenue recognition in paragraphs AG42 through AG51 of the ED which states that revenue should be recognized and the grantor's liability reduced as revenue is earned, which is presumably as access to the service concession asset is provided to the operator, resulting in straight-line recognition in most cases.

Recognition and Measurement of Revenues

- We believe that an explicit statement regarding the approach to recognizing revenue in cases in which the grantor reports a performance obligation as part of the service concession arrangement would clarify the guidance in the Application Guidance section for revenue recognition. Such a statement should indicate that when the grantor recognizes a performance obligation, it should recognize revenue as the performance obligation is discharged, normally on a straight-line basis, over the life of the arrangement. This explicit guidance, in lieu of solely referring to IPSAS 9, would clarify the Application Guidance section related to revenue recognition and place the remainder of the paragraphs in the section in better context.

- It is unclear what "revenue" is being referred to in the first sentence of paragraph AG48. We do not believe that it should refer to the grantor's revenue under the circumstances described because the grantor would not earn revenue as the operator provides services to third-party users. However, the reference to the reduction of the grantor's liability implies that the revenue being referred to is that of the grantor.

- We do not agree with the guidance provided in paragraph AG50. We do not believe that the reduction in future predetermined payments to be made by the grantor is non-cash compensation for the grantor. The compensation for the grantor in this case is the value of the service concession asset provided by the operator in exchange for the provision of the right to access the asset provided to the operator. We also do not agree with the guidance in paragraph AG51. While the rent being paid by the operator is less than market value, the rental transaction is a component of the broader service concession arrangement which is an exchange transaction. Therefore, we do not believe the guidance in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* should be applied.

- We believe that the requirements in the Application Guidance section of the ED related to revenue recognition go beyond a routine application of IPSAS 9, *Revenue from Exchange Transactions.* The guidance in this section addresses conventions that are unique to service concession arrangements, such as revenue-sharing arrangements. We believe that certain salient aspects of revenue recognition addressed solely in the Application Guidance section should be moved forward to the body of the final IPSAS.

Transition

We believe that providing different transition guidance regarding retroactive application of the standard for governments that previously have recognized service concession assets and related liabilities, revenues, and expenses and those that have not creates unnecessary inconsistency. The impact of this inconsistency on users of the financial statements is exacerbated by the fact that these service concession arrangements often involve significant infrastructure assets, both from a financial reporting and service delivery perspective, as well as significant cash payments between the grantor and the operator. We believe that retroactive application of the final standard should be required for all entities following the accrual basis of accounting. Should there be practical concerns as to determining the value of the service concession asset or other related assets or liabilities, guidance regarding the use of estimated values could be provided, similar to the transition relief included in IFRIC 12.

KPMG appreciates the opportunity to respond to this Exposure Draft. Please contact John Hummel at +1 202 533-3008, Archie Johnston at +1 604 527-3757, Greg Driscoll at +1 212 909-5421, or Mary Tokar at +44 207 694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely,

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