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1 August 2008

Dear Stephanie,

CONSULTATION PAPER ON *ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS*

In response to your request for comment on the Consultation Paper on *Accounting and Financial Reporting for Service Concession Arrangements*, issued by the International Public Sector Accounting Standards Board (IPSASB), we enclose our comment letter.

We would like to thank you for the opportunity to provide comment on this document. In addition to our response to the specific questions and proposals raised in the consultation paper, we have also included general comment and comment on other aspects not specifically dealt with in the specific questions and proposals.

Please do not hesitate to contact me should you wish to discuss or require any clarification on our comment provided.

Yours sincerely

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Erna Swart

Chief Executive Officer

GENERAL MATTERS

1. The explanatory guidance in this consultation paper that explains the relationship between the proposed control criteria, the risks and rewards approach in IPSAS 13, and how the grantor's control over the property will result in expected future economic benefits and service potential, is extremely useful. We would encourage the inclusion of such explanatory guidance in any future guidance that the IPSASB intends to develop on the accounting and financial reporting for SCA.

2. The consultation paper considered the application of the control approach to "whole-of-life" arrangements. It was concluded in paragraph .84 that controlling the residual interest in the underlying property to the SCA serves to preserve the grantor's continuing use of the property during the arrangement, and it does not appear to depend on the significance of the residual interest at the end of the arrangement. Based on this conclusion, of the term "significant" was excluded from the proposed control criteria in the consultation paper when compared to the criteria applied by the operator under IFRIC 12. The reason for excluding the term "significant" from the control criteria to be applied by grantors is therefore critical in understanding the difference between the two approaches to be applied by grantors and operators. We therefore recommend that the exclusion of the term "significant" from the control criteria to be applied by grantors, should be explained in any future guidance that the IPSASB intends to develop on the accounting and financial reporting for SCA.

3. Even though this consultation paper provides guidance on the accounting treatment for SCA by grantors, we recommend that, when future guidance is developed by the IPSASB on the accounting and financial reporting for SCA, consideration be given to the contra entries of the operator to ensure that any property, liability and/or rights granted to the parties in terms of the SCA are treated symmetrically, i.e. that both parties come to the same conclusion when the applicable principles are applied. Certain inconsistencies may arise as a result of the application of the proposed approach in the consultation paper. This consultation paper propose a control approach, which is in line with IFRIC 12, but in addition, also provides guidance on assessing the risks and rewards which is not addressed in IFRIC 12. If the IPSASB is of the view that additional guidance should be provided by the IASB, we encourage the IPSASB to address the matter with the appropriate parties.

SPECIFIC MATTERS FOR COMMENT

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)*

   We support the proposed criteria for determining whether the grantor controls the underlying property in the SCA as set out in paragraph .102.

   We do recommend that, when further guidance is developed by the IPSASB on the accounting and financial reporting for SCA, such guidance should explain what is meant with the principle "services provided to the public", i.e. does it constitute only those services that fall within the scope, mandate or service delivery objective of the grantor as determined by legislation or otherwise, and/or does it includes services other than those to be provided in terms of the grantor's scope or mandate. For example, when a SCA involves the development of hotel accommodation, of which control will revert to the grantor at the end of the SCA in terms of the proposed control criteria, will the provision of such accommodation fall within the definition of "services provided to the public"? Another example would be a SCA where the services will be rendered to a public sector entity and not directly to the public.

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)*

   We support the proposals on the initial measurement of separable and inseparable scheduled payments.

   In addition, we recommend that, when further guidance is developed by the IPSASB on the accounting and financial reporting for SCA, such guidance should require an entity to also determine the fair value of the services to be provided under the SCA that will constitute the service element of the unitary payment. The entity then needs to determine whether any additional amount is payable to the operator as part of the unitary payment. This should be done by deducting the fair value of the construction and service element from the unitary payment. If an additional amount is payable to the operator, it may constitute an onerous payment that needs to be accounted for in terms of IPSAS 19. If, however, the fair values of the construction and service elements are more than the unitary payment, the entity should recognise the difference as an asset if, and only if, the definition of an asset is met. Reference should be made to the applicable IPSAS for guidance on the recognition and measurement of such an asset. If the definition of an asset is not met, the difference should be recognised in the statement of financial performance.

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)*

   We support this proposal.

PROPOSALS

Proposals in paragraphs 102 to 104

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:

a. The grantor controls or regulates 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

b. 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.

We support the proposed criteria for determining whether the grantor controls the underlying assets in the SCA as set out in paragraph .102. We do however recommend clarification on "services provided to the public" as explained in our response to specific matter no. 1.

Proposals in paragraphs 135 to 140

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.

We support this proposal.

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.*

We support the proposal on recognition of the liability at fair value. However, the argument for recognising the liability is based on the principles in IPSAS 13 on *Leases.* We recommend that, when further guidance is developed by the IPSASB on the accounting and financial reporting for SCA, such guidance should set the principle for recognising and measuring the liability rather than making reference to IPSAS 13, as IPSAS 13 deals with lease accounting only and when applying the proposed control criteria, lease accounting may not be applicable to that SCA.

Furthermore, we recommend that more guidance should be provided on the subsequent measurement of the liability where the proposed control criteria are met. Any further guidance to be developed by the IPSASB on the accounting and financial reporting for SCA should clarify whether the liability falls within the scope of a financial liability, and if not, what IPSAS should be applied for the subsequent measurement of such a liability.

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.

We support this proposal, but in addition recommend the development of further guidance as explained in our response to specific matter no. 2.

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.

We support this proposal, but recommend that, when the IPSASB develops further guidance on the accounting and financial reporting for SCA, such guidance should include principles on the initial and subsequent measurement of the liability, i.e. does it fall within the scope of IPSAS 9.

Furthermore, any future guidance should explain the timing of the initial recognition of the underlying property.

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.

Even though the grantor will not account for any additional property associated with this type of SCA, the grantor can still have an obligation towards the operator. We therefore recommend that , when the IPSASB develops further guidance on the accounting and financial reporting for SCA, such guidance should include principles on the initial and subsequent measurement of liabilities, where applicable, that can be incurred by the grantor under such SCA, and explain what IPSAS should be applied for the subsequent measurement of such a liability.

In addition, we recommend that, even though 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, the grantor should still assess whether an indicator for an impairment of the asset was triggered by applying the principles 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.*

We support this proposal.

<u>Proposals in paragraphs 159 to 163</u>

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.*

We are of the view that, if either one of both of the proposed control criteria has been met, that the grantor should first determine whether the SCA constitutes a lease, as defined in IPSAS 13. Only if the SCA does not constitute a lease should the grantor expense any payments to the operator as proposed in paragraph 159.

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.*

In terms of the proposed control criteria, both criteria need to be met before the property and associated liability is recognised by the grantor. Therefore, if either one of both of the proposed control criteria has been met, the grantor's next step will be to determine whether the SCA constitutes a lease as defined in IPSAS 13. Whether the lease should be classified as a finance or operating lease will depend on risks and rewards incidental to the ownership of the property. Only if the SCA does not constitute a lease should the grantor expense any payments to the operator as proposed in paragraph 159.

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.*

In terms of the proposed control criteria, both criteria needs to be met before the property, and associated liability, is recognised by the grantor. If the grantor only controls the use of the property during the SCA, whether existing or newly constructed property, the grantor's should determine whether the SCA constitutes a lease as defined in IPSAS 13, if either one of both of the proposed control criteria has been met. Only if the SCA does not constitute a lease should the grantor expense any payments to the operator as proposed in paragraph 159.

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.

Even though we support this proposal, we are of the view that the operator may account for the property under this SCA in a different manner when applying IFRIC 12, IFRIC 4 and IAS 17.The grantor would account for the transaction in terms of IPSAS 13 as the proposed control criteria were not met. The property would in all probability be recognised as a leasehold improvement and the land as an operating lease. It is unclear how the grantor would account for the residual value that needs to be returned to the operator. We therefore recommend that consideration be given to the accounting by the operator to ensure that both parties come to the same conclusion when applying the approach applicable to them. Also refer to our comment raised under general matters.

Furthermore, guidance should be given on how to determine the expected fair value of the property at the end of the arrangement, for example, is the residual value representative of the residual value as defined in IPSAS 16?

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.

As stated in our response to the proposal in paragraph 162, even though we support this proposal, we are of the view that the operator may account for the property under this SCA in a different manner when applying IFRIC 12, IFRIC 4 and IAS 17. The grantor would account for the transaction in terms of IPSAS 13 as the proposed control criteria were not met. The property would in all probability be recognised as a leasehold improvement and the land as an operating lease. It is unclear how the grantor would account for the residual value that needs to be returned to the operator. We therefore recommend that consideration be given to the accounting by the operator to ensure that both parties come to the same conclusion when applying the approach applicable to them. Also refer to our comment raised under general matters.

Furthermore, guidance should be given on how to determine the expected fair value of the property at the end of the arrangement, for example, is the residual value representative of the residual value as defined in IPSAS 16?

<u>Proposals in paragraphs 178 and 179</u>

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.

We support this proposal.

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.*

We support this proposal.

Proposal in paragraphs .190

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.

We support this proposal, but in addition recommend that, when the IPSASB develops further guidance on the accounting and financial reporting for SCA, such guidance should include principles on the initial and subsequent measurement of the revenue in terms of the applicable IPSAS.

Furthermore, we recommend that the relationship between contingent assets and revenue generated from revenue-sharing provisions should be expanded and clarified in the future guidance.

Proposal in paragraph .196

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.

We support this proposal.

Proposal in paragraph .216

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.

We support this proposal.

Proposals in paragraph 228 to 230

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.*

We support the disclosure requirements.

In addition, we recommend that grantors should also be required to disclose any assumptions made by management in determining the fair values of the property and/or liabilities that were recognised in the financial statements as a result of entering into the SCA.

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.

We support this proposal, but in additional recommend that the future guidance to be developed by the IPSASB should clarify that the aggregation of such information should be based on management's discretion.

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; and*
- *Contingent liabilities present in IPSAS 19.*

We support this proposal, but recommend that contingent assets should also be included in this list.

OTHER MATTERS

1. The inclusion of a flow chart or diagram that will illustrate the approach to be adopted in determining ownership of an asset, and illustrating the recognition of the associated liability, where applicable, will be very useful to assist preparers in understanding the approach to be adopted in recognising SCA. We recommend that such a flow chart or diagram should be included in future guidance to be developed by the IPSAS on the accounting and financial reporting for SCA.
2. The application of the proposed principles in the consultation paper to a SCA that involves the development or acquisition of movable property during the SCA should be considered. For example, when a grantor enters into a 10 year SCA that requires the acquisition of computer hardware to be used by the operator in meeting the provisions of the SCA, and such hardware are to be replaced by the operator every three years, will the proposed control criteria apply to the acquired property that are replaced during the SCA period?
3. When the IPSASB develops future guidance on the accounting and financial reporting for SCA, the inclusion of practical examples and illustrations will assist in understanding the principles to be applied in accounting for SCA. We therefore recommend the inclusion of such examples and illustrations.