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Kevin Brady

Dear Stephanie

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

Thank you for the opportunity to comment on the International Public Sector Accounting Standards Board's (the "Board's") Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements* (the "consultation paper").

We are pleased the Board has developed the consultation paper because there is currently diverse accounting practice internationally. We look forward to an IPSAS on Service Concession Arrangements (SCAs) in due course.

We agree that grantors should recognise property underlying a SCA when they control the property.

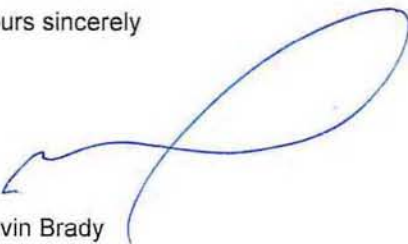
We also generally agree with the proposals covering the recognition of property, liabilities, revenues, and expenses associated with SCAs.

Due to the complex accounting for SCAs, we recommend the inclusion, where appropriate, of guidance and illustrative examples in the exposure draft to demonstrate the practical application of the proposed accounting requirements.

Our responses to the specific matters for comment on the consultation paper are set out in the attachment to this letter.

If you have any questions or would like clarification about any of our comments, please contact Greg Schollum on +64 4 917 1603 (email: [greg.schollum@oag.govt.nz](mailto:greg.schollum@oag.govt.nz)) or Todd Beardsworth on +64 4 917 1590 (email: [todd.beardsworth@oag.govt.nz](mailto:todd.beardsworth@oag.govt.nz)).

Yours sincerely



Kevin Brady

## Specific matters for comment

1. **It is proposed that a grantor report the property underlying a 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?**

We agree with the proposed control approach for determining whether a grantor report property associated with a SCA. That approach is consistent with the current definition of an asset in IPSAS 1 *Presentation of Financial Statements*.

Also, we agree that for many arrangements the grantor will be accountable for services from the property underlying a SCA. We therefore believe there should be a link between the accountability for services and the reporting of service accomplishments, that is, non-financial reporting of performance. The grantor normally remains accountable for the services under SCAs and accordingly, should be reporting on its service accomplishments. We appreciate that the Board has yet to consider the whole area of non-financial performance reporting. However, we don't think that this precludes increasing the prominence of the link with non financial performance information.

The control approach provides an objective framework for determining whether a grantor should recognise property underlying a SCA when compared to other approaches, such as the risks and rewards approach. The subjectivity of the risks and rewards approach for public finance initiatives has been evidenced, in some jurisdictions, by the non-recognition of property by both the grantor and operator.

We note the wording addressing control of the residual value of the SCA property is different to the IASB's IFRIC 12. If the IPSASB's position continues to differ (as reflected ultimately in an IPSAS), we recommend the Board bring the wording to the attention of the IASB.

We generally agree with the control criteria identified, however, we have suggested below some improvements that could be made to the proposals:

- The first aspect of the control criteria uses the term *regulates*. The consultation paper provides a footnote explaining that the concept of regulate is restricted to arrangements agreed upon by the grantor and operator and excludes generally legislated regulation. For clarity, *regulates* could be replaced with *contractually determines* to give the same intended effect. If the Board decides to continue with the existing wording of the proposal, we recommend the exposure draft include a definition of *regulates* to clarify the Board's intended meaning of that term.
- We note that the consultation paper has not addressed the circumstances under which the grantor is considered to control or regulate (contractually determine) the price ranges or rates that can be charged by the operator. For example, consider the scenario where the operator has the freedom to set prices, but any excess profits are returned to the grantor so

in effect the operator's return is capped. Based on the substance of this scenario, does the grantor indirectly have control over the price ranges or rates that can be charged for services? Additional commentary, similar to that found in IFRIC 12 paragraph AG3, requiring an assessment of the substance of the arrangement will aid in the interpretation of the pricing component of the control criteria.

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 the 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?**

We agree that the recognition criteria of IPSAS 17 *Property, Plant and Equipment* should be applied to the property underlying a SCA. However, in addition to the indicators provided in paragraph 135 of the consultation paper, we consider the transfer of legal ownership of the underlying property to the grantor as construction progresses is an indicator of the timing of recognition (referred to as continuous transfer). For example, in certain jurisdictions (such as New Zealand) the legal ownership of improvements attached to land transfer to the land owner, unless agreed otherwise. This provides an indicator that the risks and rewards associated with the construction of the asset attached to the land transfer to the land owner as construction progresses.

We agree with the proposed basis for initial recognition of property associated with SCAs. However, we found the consultation paper did not clearly set out the reasons for there being a different approach for determining the imputed finance charge for separable and inseparable payments. For inseparable payments, it appears that 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. We feel this rationale equally applies to separable payments.

The Board's preferred approach for inseparable payments, whilst consistent with current UK guidance on private-public-partnerships, is not consistent with IFRIC 4 *Determining Whether an Arrangement Contains a Lease* (IFRIC 4) paragraph 15. For inseparable payments, IFRIC 4 requires the finance charge to be based on the lessee's incremental borrowing rate of interest. In our opinion, the Board should base the imputed finance charge on existing IPSASB standards (in this case, IPSAS 13 *Leases*) rather than UK guidance, unless there is a clear rationale for departing from a relevant existing IPSAS.

3. **It is proposed that contractually determined inflows of resources to be received by a grantor from an operator as part of a SCA should be recognised 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?**

We agree with the Board's proposal, however, provide specific comments below.

In our opinion, the term *fully* operational is ambiguous and may lead to different interpretations for when revenue recognition should commence. For example, is property *fully* operational when it is in a condition that it is *ready* to be used by the operator or when it is *actually* being used by the operator?

We suggest revenue recognition be described as commencing when property subject to the SCA is *available to be used* by the operator. Revenue recognition from that point in time is consistent with the requirement of IPSAS 17 paragraph 71 that depreciation of the underlying asset commence when it is available for use.

Paragraph 195 of the consultation paper outlines that the time value of money notion may be appropriate for a SCA with a term extending over several decades. The time value of money notion is an issue, particularly where a grantor receives concession payments from the operator at the commencement of a SCA that has a term spanning several decades.

In New Zealand, we have a SCA where the grantor received a significant concession payment at the commencement of the SCA that spans 50 years. The grantor of this SCA recognises a finance cost based on the outstanding amount of the unearned revenue liability and an associated amount of revenue so as to recognise an equal amount of revenue over each period of the arrangement. Particular issues we have had to consider with this SCA included an assessment of whether the finance cost and concession revenue be reported gross or net in the statement of financial performance and the basis for determining the discount rate given the long-term nature of the liability.

We note that the discounting of revenue received in advance of it being earned is not common in practice and is not specifically considered by the IPSAS or IFRS standards. IPSAS 9 *Revenue from Exchange Transactions* paragraph 16 provides guidance for the measurement of revenue where payment is deferred, but does not require the same approach for payments received in advance.

At a conceptual level, we accept the argument for discounting revenue received in advance of it being earned. However, we are concerned about how this concept is applied in practice and how it is reported in the financial statements of grantors. We believe that further guidance is needed if the Board proposes to apply the notion of the time value of money to payments received in advance (see comments below on guidance and illustrative example), including clarity about when it shall be applied.

#### 4. Other comments

##### *Borrowing costs*

It appears that the consultation paper has not addressed how IPSAS 5 *Borrowing Costs* (IPSAS 5) should be interpreted and applied in the case of an entity (that is party to a SCA) that capitalises borrowing costs. There are a number of questions that need to be considered:

- Is the finance charge on the outstanding liability to provide the operator compensation a borrowing cost eligible for capitalisation?
- When there is a finance charge, does it matter whether the liability to provide the operator compensation reflects the grantor's obligation to provide compensation in the form of cash, the right for the operator to charge third-party users, or a combination of both?
- How should borrowing costs be reflected in the measurement of the underlying asset?

In our view, the Board needs to consider how IPSAS 5 and an IPSAS on accounting for SCAs will interact with each other when developing a SCA exposure draft.

*Examples*

Due to the complex accounting for SCAs, it would be beneficial to include illustrative examples in an IPSAS to demonstrate the practical application of the proposed accounting requirements.