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Dear Ms Fox

COMMENTS REGARDING ITC 16 SERVICE CONCESSION ARRANGEMENTS

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to respond to the IPSASB's Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements.*

Many government agencies in Australian jurisdictions are grantors under such service concession arrangements, some of which have been in place for 15 years.

In the absence of authoritative accounting pronouncements on SCAs, HoTARAC developed and issued its own guidance for Australian grantors in 2004 and 2005. This was based on Application Note F *Private Finance Initiative and Similar Contracts* contained in the United Kingdom Accounting Standards Board's Financial Reporting Standard FRS 5 *Reporting the Substance of Transactions.* The guidance determines which party should recognise the SCA property based on which party has the greater risks and benefits associated with the property. Where the grantor has those risks and benefits, it recognises the property as its asset, together with an associated liability, if necessary. Where the grantor only has a residual interest in the property at the end of the concession period, it may recognise this as an asset and revenue, built up over the concession term and allocated on either a straight line or an annuity basis (if reliably measurable).

HoTARAC supports the work of the International Public Sector Accounting Standards Board in reviewing grantor accounting for SCAs.

HoTARAC's major comments in response to ITC 16 are set out below and supplemented with reasons and detailed comments in the Attachment.

1. Control

HoTARAC agrees that the party controlling SCA property and expecting an inflow of future economic benefits or service potential should recognise (ie report) it as an asset. The definition of asset embodies the concept of control.

2. Tests of control

HoTARAC is not convinced that the Consultation Paper conceptually justifies its proposal for using a modified IFRIC 12 model for testing which party has control. The Consultation Paper would benefit from a more rigorous articulation of the various models contained in existing accounting pronouncements and a clearer analysis of the reasons for accepting or rejecting them. HoTARAC is happy to examine alternative ways for grantors to account for SCAs. Although, from the grantor's viewpoint, the modified IFRIC 12 proposal is better than the original IFRIC 12 approach, HoTARAC has enduring concerns that the proposed tests of control are too limited, are applied inconsistently, are not principles-based, and may be inconsistent with existing standards on leases (IPSAS 13, IAS 17, AASB 117), revenue (IPSASB 23) and intangible assets (IAS 38, AASB 138). HoTARAC considers that the proposal should more clearly assess the allocation of risks and rewards associated with SCA property and, where relevant, consider the expected inflow of economic benefits from the property. HoTARAC urges the IPSASB to review its proposal and articulate why the IFRIC 12 model is considered superior to the other alternatives. HoTARAC has found a risks and rewards model to be robust and practical in Australia. It appears to give outcomes that are conceptually sound and that reflect the economic substance of the arrangements.

3. Grantor's regulatory capacity

HoTARAC considers that a grantor's regulatory capacity, as embodied in the IFRIC 12 model, is an inappropriate indicator of a grantor's control of SCA property. While the Consultation Paper proposes to restrict the meaning of "regulates", HoTARAC considers that the proposed grantor control tests should avoid using the term altogether. To the extent that a grantor's regulatory capacity is relevant, it is already incorporated into existing authoritative standards dealing with control of an asset. Under such standards, control of an asset arises when an entity can, inter alia, exclude or otherwise regulate (or restrict) the access of other parties to the benefits embodied in the asset.

4. Definition and scope

HoTARAC also considers that the expression ***service concession arrangement*** should be explicitly defined as its meaning is fundamental to the proposal. A SCA should only include arrangements where the operator is the primary provider of services with the SCA property and where it serves the public directly (rather than providing services to a government agency). HoTARAC also considers that asset purchases and leases should be scoped out of the proposals.

5. Property received for zero cash consideration

In HoTARAC's experience, SCA grantors often grant a service concession in exchange for the right to receive the SCA property in good condition at the end of the concession period. The operator is permitted to charge the public directly for the services provided with the SCA property. In such cases, the grantor and operator do not exchange any cash. A significant issue for Australian grantors under such arrangements is how and when to account for their residual interest in the infrastructure for which there is zero cash consideration. The existing HoTARAC guidance allows the residual interest to be recognised as an asset and revenue, built up over the concession term and allocated on either a straight line or an annuity basis. While the proposals in the Consultation Paper may permit this approach, they are not explicit about the treatment for zero cash consideration arrangements where the grantor does not control the use of the SCA property during the concession period. HoTARAC recommends that this be clarified.

6. Impact of proposals

Applying the Consultation Paper's proposals to a sample of 20 existing Australian SCAs produces a similar accounting outcome to the present Australian guidance based on risks and benefits. For example, many Australian SCAs fail the proposed tests of grantor control because the grantor does

not control or (contractually) regulate to whom the services are provided or the rates to be charged. Although this confirmation of present accounting is reassuring, HoTARAC notes that the proposed tests are rule-based rather than principles-based and could therefore be vulnerable to manipulation. The tests are sometimes open to interpretation.

In response to the specific questions raised in the Consultation Paper, HoTARAC:

- supports the concept of control being used to determine which party recognises SCA property as its asset, but does not support the proposed model for testing which party has that control as the model is not conceptually justified or rigorous;
- supports the proposed basis for initially measuring a grantor-controlled SCA asset and its associated liability, but requests some additional guidance; and
- agrees that contractually-determined inflows should be allocated over the entire concession period as they are received in exchange for granting the concession.

If you have any queries regarding HoTARAC's comments, please contact either Robert Williams on +61 2 9228 3019 or David Laidley on +61 2 9228 4759 at NSW Treasury.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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Encl

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Comments on IPSASB Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements*

HoTARAC offers specific comments on the following matters:

A. SCOPING THE PROPOSALS

Definition of service concession arrangement

Paragraph 22 notes that an SCA is, or includes, an operations concession arrangement. Paragraph 12, in describing the latter, effectively defines an SCA as an arrangement under which a grantor conveys to an operator "the right to provide services directly or indirectly to the public through the use of an existing infrastructure asset or public facility."

HoTARAC recommends that "service concession arrangement" be explicitly defined, as the term is fundamental to the proposals in the Consultation Paper.

Based on those proposals and subject to HoTARAC's other comments below, a possible definition could be:

> "A service concession arrangement is, or includes, an agreement under which a public sector entity (the grantor) conveys to a private sector entity (the operator) the right to provide services directly to the public through the use of an infrastructure asset or public facility."

Serving the public "indirectly"

Paragraph 12, uses the term "indirectly" when describing the nature of a operations concession arrangement and hence an SCA, whereby:

> "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."

Paragraph 103 also uses the term "indirectly".

Using this word broadens the definition considerably. An SCA could consequently include any arrangement obligating a private sector entity to use an item of plant to supply services to a public sector entity rather than directly to the public.

For example:

(a) A steel manufacturer using dedicated plant to fulfil a contract to supply rails to a railway authority could be viewed as indirectly providing services to the public because supplying rails supports the authority in providing railway services to the public.

(b) A contractor using dedicated plant to fulfil a contract to provide filtered water to a water authority could be viewed as indirectly providing services to the public because supplying treated water supports the authority in providing water reticulation services to the public.

(c) A contractor that operates a government-owned prison could be viewed as indirectly providing services to the public because the contractor supports the government in protecting the public.

HoTARAC considers that SCA should only refer to an arrangement where the operator provides services directly to the public, regardless of whether the operator is paid by the public or by a government agency on their behalf. The SCA operator obtains a concession to provide services to the public that the government might otherwise have provided through a public sector agency. However, HoTARAC notes that the services provided by the public sector are likely to change over time as an economy matures or as government functions are privatised.

In any case, examples clarifying the meaning of SCA in general, or operations concession arrangements in particular, would be helpful.

Arrangements where the public sector agency is the primary operator

A related issue is whether a service concession arrangement, as described in the Consultation Paper, could include an arrangement where the public sector remains as the primary service provider and the private sector party merely has a secondary or supportive role.

For example:

(a) A public sector agency arranges for a private contractor to design, finance and build a new school. The agency then provides the teaching staff and operates the new school while the private contractor maintains the buildings and grounds under a long-term contract.

(b) A public sector agency arranges for a private contractor to design, finance, supply on a daily basis, and maintain a fleet of trains. The agency then provides the drivers and operates the trains while the contractor maintains them (as lessor) under a long-term leasing contract.

Although the public sector agency ostensibly acquires an asset and then operates it, such arrangements could be viewed as the agency conveying to the private contractor “the right to provide services indirectly to the public through the use of an existing infrastructure asset or public facility.”

HoTARAC considers that arrangements where the public sector is the primary operator of infrastructure or a public facility and a private contractor merely provides secondary or support services should be explicitly excluded from the scope of the term “service concession arrangement”.

Purchases and leases

The Consultation Paper uses the term SCA so broadly that it could include long term purchase or finance lease arrangements that are not, in substance, service concession arrangements. It could include an arrangement under which a public sector agency acquires an asset, pays for it over an extended period, and requires the supplier to manage and/or maintain it during that period, even where the supplier does not have a service concession.

Although paragraphs 160 and 161 contemplate that SCA property could be accounted for as a leased or purchased asset, the proposals do not specifically discuss purchase or lease arrangements or conceptually distinguish them from other types of SCA.

HoTARAC also notes that paragraphs BC27 and BC28 of the Basis for Conclusions on IFRIC 12 assert that SCAs are not leases.

HoTARAC considers it would help users if, at the outset, the proposals excluded arrangements that are clearly purchase or lease transactions. Such arrangements appear to be adequately dealt with by existing accounting standards on property, plant and equipment or leases.

B. DETERMINING WHICH PARTY CONTROLS THE SCA PROPERTY

Control concept supported

HoTARAC agrees with paragraph 65 that, for a property to be reported as an asset it would need to satisfy the definition of an asset in IPSAS 1 *Presentation of Financial Statements*. The reporting entity would therefore need to both (a) control the SCA property and (b) expect an inflow of either future economic benefits or service potential from it.

HoTARAC also agrees that:

- future economic benefits or service potential will flow to the entity having the risks and rewards attaching to the asset (paragraph 64);
- control and risks and rewards are not mutually exclusive concepts (paragraph 64); and
- control of an asset gives an entity the associated risks and rewards and indicates the entity's expectation of an inflow of some form of benefit (paragraph 103).

Therefore, control effectively becomes the sole determinant of which party to an SCA should report the underlying property as its asset, (paragraph 102).

HoTARAC considers the reconciliation of the, sometimes competing, concepts of control and risks and rewards is a useful contribution to the literature. Also, that control determines which party should report SCA property.

HoTARAC's additional comments on the tests of control are below.

How to determine which party has control

- Analysis is unclear

Paragraphs 62 to 104 analyse how to determine which party controls SCA property. This is arguably the most important part of the Paper.

As a general comment, HoTARAC finds the analysis unclear and often difficult to follow. It is sometimes difficult to ascertain the line of argument, the conceptual basis being used and whether any conclusions are being drawn.

The analysis would be better presented if it set out the concepts and propositions more clearly and then explicitly drew conclusions from them.

- Possible models

HoTARAC agrees with paragraph 67, that a fundamental issue in accounting for SCAs is how to identify the party that controls the underlying property.

Having agreed, on the principle, that control is the primary determinant of which party reports SCA property, HoTARAC agrees that it is necessary to give guidance on how such control is to be ascertained. However, HoTARAC questions the approach taken in the Consultation Paper.

Authoritative accounting pronouncements give at least three models for determining which party controls an asset. Put simply, these models may be described as:

(a) benefit and access, as used in IPSAS 23, IAS 38 and AASB 138;
(b) risks and rewards, as used in IPSAS 13, IAS 17 and AASB 117; and
(c) use and residual interest, as used in IFRIC 12, and the Consultation Paper.

These models and their sources are briefly described in Appendix 1.

HoTARAC assumes that the three models are intended to give similar accounting outcomes.

The Consultation Paper does not discuss the theoretical basis for the three models for determining control. It does, however, cite the United Kingdom's experience that the use and residual interest model used by operators, applying IFRIC 12, and the risks and rewards model used by grantors, applying FRS 5-F, can produce inconsistent outcomes. Sometimes neither party recognises the SCA property. This outcome may arise from the application of the model rather than the model itself. As shown below, the proposed grantor-control tests are also open to manipulation.

Although the Consultation Paper reviews various jurisdictions' present approaches to accounting for SCAs and notes the use of the risks and rewards model and the use and residual interest model, it does not appear to have considered the possible applicability of the benefit and access model. If the IPSASB did consider the benefit and access model, no reasons are given for its rejection.

Paragraph 102 proposes a modified form of the use and residual interest model used in IFRIC 12. However, it gives no clear theoretical argument for favouring that model over the alternatives. In fact, the reasons given in paragraph 70 to illustrate why a grantor controls SCA property under this model might equally be used to demonstrate that a grantor still controls a fully privatised asset or industry.

HoTARAC is concerned that the Consultation Paper may have adopted the use and residual interest model without due consideration of the alternatives. HoTARAC notes that the benefit and access model, and the risks and rewards model, are both established approaches embodied in accounting standards including IPSAS. The use and residual interest model arises from an, arguably less authoritative and less well-established, IFRIC Interpretation for which there is no equivalent IPSAS guidance.

HoTARAC notes also that the Exposure Drafts leading to IFRIC 12 were controversial and did not consider the grantor's perspective. A majority of commentators, representing both grantors and operators, criticised the proposed control tests and the absence of a grantor perspective, ultimately unsuccessfully.

HoTARAC also notes that paragraph 101 considers, and dismisses, another possible approach, the rights and obligations model. Unlike the other models, which allocate control to a single party, this one recognises a sharing of control and allocates the unbundled rights and obligations associated with a property accordingly.

SCA grantors and operators arguably have a degree of joint control over the SCA property. The proposals in paragraphs 161-163 envisage situations where a grantor controls either the use of, or the residual interest in, SCA property, but not both. This implies some sharing of the control over the SCA property. Therefore, a rights and obligations model may be relevant.

A rights and obligations model is used in IFRIC 12, which "sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements" (paragraph 10). IFRIC 12 separates the right of SCA property use and access, and allocates them to different parties (BC28). IAS 39 and AASB 139 *Financial Instruments - Recognition and Measurement,* also uses rights and obligations model for derecognising of certain financial assets (paragraph 16). The IASB's projects on leases and joint arrangements are also considering a rights and obligations model. HoTARAC urges the IPSASB not to be too quick to dismiss this model, as it seems to be gaining support.

Proposed modified Interpretation 12 model

To determine whether an SCA grantor (as opposed to operator) controls the SCA property, the Consultation Paper proposes a use and residual interest model based on the approach taken in IFRIC 12. This entails four specific tests, three relating to whether the grantor controls or regulates the use of the SCA property and one relating to whether the grantor controls the residual interest in the property.

However, paragraph 102 modifies the application of those tests by proposing that:

- "regulates" means contractually agreed rather than generally legislated;
- the grantor must have a residual interest in the SCA property; and
- the grantor's residual interest need not be significant.

HoTARAC has several concerns with the proposed modified IFRIC 12 model for determining grantor control and with the associated analysis:

- analysis of IFRIC 12 is superficial and unsatisfactory;
- appropriateness of the proposed tests is not demonstrated;
- political risk does not necessarily indicate control;
- the model fails to consider risks and rewards;
- grantor's regulatory capacity does not necessarily indicate control;
- the residual interest test is unnecessary;
- the grantor may have an intangible asset;
- mutual agreement does not necessarily indicate control;
- economic benefits are also relevant; and
- purported distinction between economic and ownership risks and rewards.

These are discussed below.

- Analysis of Interpretation 12 is superficial and unsatisfactory

Paragraph 70 endorses the criteria incorporated into the scope of IFRIC 12 as generally being appropriate for determining grantor control of SCA property. This endorsement seems to be based solely on the analysis in paragraphs 67 to 69.

HoTARAC considers the analysis to be superficial and unsatisfactory.

Firstly, and most importantly, the Consultation Paper contains no analysis of the specific control tests set out in IFRIC 12. HoTARAC considers that a rigorous analysis is necessary to justify any proposed control tests. This is elaborated on under the next heading.

Secondly, the Consultation Paper does not specify the IFRIC 12 scope criteria that it is endorsing. The scope paragraphs of IFRIC 12 deal with a range of matters. Although the Consultation Paper is probably intending to endorse the criteria in paragraphs 5 and 6 of IFRIC 12, this is not clear. HoTARAC recommends that the Consultation Paper quote the paragraphs of IFRIC 12 that it is referring to, as this is fundamental to an understanding of the proposals.

Thirdly, most of the analysis preceding its endorsement of the IFRIC 12 scope criteria deals with IFRIC (and AASB) Interpretation 4 *Determining whether an Arrangement contains a Lease* (IFRIC 4). Paragraph 68 asserts that IFRIC 12 conclusions were based on IFRIC 4. However, IFRIC 12 placed little explicit reliance on IFRIC 4. The only substantive reference to it was in paragraph BC22 of the basis for conclusions accompanying IFRIC 12, which noted that under IFRIC 4 an arrangement is a lease if it conveys the right to control the use of the underlying asset. IFRIC 12 also amended IFRIC 4 to ensure that their scopes did not overlap. The Consultation Paper appears to have endorsed the IFRIC 12 scope criteria solely on the basis of one minor reference in the basis for conclusions, which is not even integral to the Interpretation.

Fourthly, paragraph 68 notes that IFRIC 12 concludes that an operator would not control the use of SCA property and that this implies the grantor would control the property. However, IFRIC 12 explicitly asserts in paragraph AG6, BC27 and BC28, that the grantor controls SCA property. This is much stronger than the mere implication noted in the Consultation Paper.

- Appropriateness of the proposed tests is not demonstrated

Paragraph 102 proposes tests to determine whether a grantor controls SCA property. These are based on the tests in IFRIC 12 and are intended to assess, in relation to the SCA property, the grantor's ability to control the services provided, customers served, prices charged and residual interest.

Paragraph 70 asserts that these tests are appropriate, but the Consultation Paper does not indicate how the tests point to compliance with existing definitions of asset, in IPSAS 1 and control of an asset in IPSAS 23. Paragraph BC28 of the Basis for Conclusions in IFRIC 12 at least suggests that the tests indicate the grantor's control over the use of the property.

While the proposed tests might arguably determine which party regulates access to the property, they do not appear to explicitly test which party uses or otherwise benefits from it, in accordance with the definition of "control of an asset" in paragraph 7 of IPSAS 23. Similarly, regarding future economic benefits in accordance with the definition of asset in IPSAS 1 and paragraph 13 of AASB and IAS 138. Nor does there appear to be any indication of how the tests demonstrate which party has exposure to the risks and rewards of ownership of the SCA property, despite paragraph 65 asserting that such risks and rewards should be considered.

Moreover, the Consultation Paper applies its grantor-control tests inconsistently. The tests require the grantor to control both (i) the use of the SCA property and (ii) the residual interest therein. However, the grantor control tests are sometimes applied selectively. In some cases, paragraphs 135-139 and 161-163 permit a grantor to recognise SCA property as an asset if it controls (i) only the use of the SCA property or (ii) only the residual interest therein. Therefore, neither test seems to be essential for determining control. This inconsistent application of the tests suggests that they are neither robust nor based on sound principles.

HoTARAC does not consider that the Consultation Paper conceptually or practically demonstrates how the use and residual interest model, as used in IFRIC 12 or in its proposed modified form, test that the grantor controls SCA property in accordance with existing accounting frameworks and standards.

HoTARAC considers that any tests of control need to be explicitly justified by demonstrating how they indicate that the controlling entity has benefit and access, or risks and rewards, or the expectation of service potential in relation to the SCA property.

IFRIC 12 does not specify the accounting by SCA grantors and it was developed without considering the grantor's perspective.

HoTARAC suggests that the approach used in IFRIC 12 is deficient because it:

- only considers SCAs from the operator's perspective;
- captures more arrangements than intended;
- adopts a regulatory control test that is unduly broad in its scope;
- incorrectly assumes that a grantor and an independent regulator have similar interests;
- fails to take account of the complexity of SCAs;
- fails to acknowledge the operator's rights of use are often greater than the grantor's;
- fails to acknowledge the operator's wide discretion in design, construction and operation;
- assigns grantor control on the basis of asset reversion (which is far into the future);
- breaks the nexus between control and responsibility for risk;
- is inconsistent with the Framework, especially in relation to substance over form;
- fails to articulate why risks and rewards are not considered; and
- fails to indicate why benefits and access are not considered.

Many of these deficiencies are carried forward into the proposed modified IFRIC 12 approach.

- Political risk does not necessarily indicate control

Paragraphs 90 to 94 argue that a grantor would control SCA property if it is ultimately accountable for the services provided with it. A grantor could have the service potential risks (eg political risk) and rewards (eg achievement of its social objectives) associated with the SCA property, despite the operator having some, if not all, service delivery risks and rewards.

HoTARAC is not convinced that political risk is a factor to be taken into account in determining which party controls SCA property.

A Government bears political risk for many things in its jurisdiction, especially those things affecting large numbers of citizens. This is the nature of government.

However, the existence of political risk does not necessarily indicate that the SCA grantor controls the property associated with the politically risky activity. Furthermore, political risks arising from services can be distinguished from political risks arising from the property used to provide those services.

Users of SCA property typically look to, or prosecute, the operator in the first instance if something goes wrong. A primary objective of many SCAs is to transfer risk and responsibility to the operator.

Although a grantor may have step-in rights in relation to SCA property, it usually has to compensate the operator fairly if those rights are exercised. A grantor therefore has to acquire control (by purchasing the SCA property). This strongly indicates that, in this situation, grantor control does not exist until the step-in rights are exercised and compensation is paid, regardless of any political risk the grantor may have.

- The model fails to consider risks and rewards

Paragraphs 64 and 65 note that the concepts of control and risks and rewards are not mutually exclusive and that both should be considered in determining which party should recognise SCA property as its asset. Paragraphs 85 to 100 analyse some of the risks and rewards relevant to SCAs and relate them to service potential and ultimately asset control.

However, there is no clear articulation of how the proposed modified IFRIC 12 model embodies an assessment of the risks and rewards associated with SCA property. It appears that the use and residual interest model contained in the proposal is an alternative to the risks and rewards model and takes little or no account of the risks and rewards embodied in the SCA property.

The modified IFRIC 12 approach differs from the risks and rewards model, based on FRS 5-F, used by Australian grantors. The present Australian approach determines control based on which party has certain risks and rewards, especially the demand and residual value risks.

HoTARAC considers that an assessment of the SCA property risks and rewards attributable to each party is relevant to the determination of which party controls it and therefore recognises an asset.

HoTARAC therefore recommends that the analysis sets out how the proposed tests determine which party has the majority of the risks and rewards of the SCA property.

- Grantor's regulatory capacity does not necessarily indicate control

Paragraph 5 of IFRIC 12 asserts that a grantor controls SCA property if, among other things, it regulates certain matters relating to the use of the property. Paragraph AG2 explains that, for the purpose of interpreting the word regulates, a grantor is considered to include related parties, the public sector as a whole, and any regulators acting in the public interest.

Paragraph 102 of the Consultation Paper proposes similar tests to those in IFRIC 12 for determining grantor control but also proposes in footnote 16 to restrict the meaning of regulates to a specific agreement between grantor and operator, rather than general legislation.

HoTARAC is troubled by the word regulates as used in the grantor control tests in IFRIC 12 because it:

- inappropriately broadens the concept of control;
- blurs the distinction between entities by including rights and responsibilities of related parties;
- incorrectly assumes the interests of a grantor and an independent regulator would be the same;
- is based upon form rather than substance; and
- misinterprets the nature of a government's regulatory role.

IFRIC 12 did not explain the reason for using this term.

"Regulates" has several possible interpretations. For example, it could mean legislates or restricts or, simply, controls.

Authoritative pronouncements on the meaning of control of an asset identify the controlling entity's ability to (i) benefit from the asset and (ii) regulate or restrict others' access to that benefit. Paragraph 7 of IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* states that:

> "control of an asset arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives and can exclude or otherwise regulate the access of others to that benefit."

Paragraph 13 of IAS 138 and AASB 138 *Intangible Assets* discusses control of an asset in equivalent terms but uses the expression "restrict the access of others*"* rather than "regulate the access of others*"*.

Accordingly, HoTARAC considers that, in the context of determining control of an asset, the term “regulates” should be interpreted to mean “restricts” rather than “legislates”.

Moreover, as the concept of an entity’s ability to regulate or restrict access is already embodied in authoritative pronouncements on asset control, HoTARAC considers it superfluous to state it separately in the proposed tests, thereby implying it differs from control.

The test should be “controls” rather than “controls or regulates”.

HoTARAC recommends that the term “regulates” be deleted from the proposed grantor control tests.

However, if the IPSASB wishes to retain the term, HoTARAC agrees with the Consultation Paper that, as a minimum, “regulates” needs to be interpreted more narrowly than the way it has been used in IFRIC 12. HoTARAC notes that paragraph 37 of IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* indicates, in relation to controlled entities, that a Government’s regulatory power does not constitute control for the purposes of financial reporting.

HoTARAC notes that unity of purpose between a grantor and an operator is insufficient to establish control. For the grantor to control the operator and its assets, the grantor must have a presently exercisable capacity to exert power over the operator. Such control does not usually exist in SCAs, as an operator is free to engage in other activities during the concession period. Where a grantor is permitted to intervene, this is usually an action of last resort and requires the grantor to pay compensation to the operator.

In addition, HoTARAC considers that the substance of a grantor’s ability to control or regulate SCA property is more important than its form. A grantor’s capacity to regulate is more likely to give rise to control if, in substance, the regulation is specific to the SCA rather than of general applicability, regardless of whether it is contractual or legislative.

The Consultation Paper’s narrower interpretation of “regulates” has a potentially significant impact, at least in theory. For example, in our assessment, in one Australian jurisdiction alone, 11 SCAs that would be grantor-controlled under IFRIC 12 would fail the grantor control tests in the Consultation Paper, solely as a result of the narrower interpretation of “regulates”. However, in practice there is no impact as the grantors, not being subject to IFRIC 12, do not presently recognise such property; and this non-recognition would continue under the proposed tests in the Consultation Paper.

HoTARAC also considers that, due to its potentially significant impact, the Consultation Paper should be more explicit about the narrow interpretation of “regulates”. It should be presented as part of the grantor control tests in paragraph 102. It warrants greater prominence than a mere footnote.

- The residual interest test is unnecessary

Paragraphs 74, 82 and 102 propose that, in order to recognise SCA property as its asset, a grantor would, among other things, need to control the residual interest in the property at the end of the arrangement.

Under IFRIC 12, a grantor only needs to control a "significant" residual interest (or no residual interest in the case of a whole-of-life asset). However, the Consultation Paper proposals would require the grantor to control the residual interest in all cases, even if the interest is insignificant. This is a major difference from IFRIC 12, unnecessarily expanding the scope and intent of the residual interest test.

HoTARAC is not convinced that a grantor needs to control the residual interest in the SCA property in order to demonstrate control and therefore recognise the property as an asset during the concession period. HoTARAC believes this proposed requirement would conflict with guidance in existing accounting standards. For example, under IPSAS 13/IAS 17/AASB 117 *Leases*, a finance lessee is required to recognise leased property as its asset without necessarily controlling any residual interest therein.

HoTARAC also notes that a leasehold improvement that reverts to a lessor at the end of a lease would normally be recognised as the lessee's asset in the interim, despite the lessee's lack of control over the residual interest therein.

Moreover, IFRIC 12, on which the proposal is based, only requires the grantor to control the residual interest in certain, not all, circumstances.

The proposal also ignores the possibility that the operator's control of the SCA property during the concession may be far more significant than either party's control of the residual interest.

HoTARAC finds the arguments in paragraphs 74 and 82 unconvincing.

- Grantor may have an intangible asset

The grantor control tests in paragraph 102 aim to determine whether a grantor controls the physical SCA property. The Consultation Paper does not contemplate that the grantor may have a recognisable intangible asset. For example, a grantor's residual interest in SCA property may represent a right received in exchange for granting the service concession. It may be appropriate to recognise such right as being progressively earned over the concession period, just as the operator progressively uses the concession over the same period. This treatment would be similar to that proposed in paragraph 162.

HoTARAC recommends that the Consultation Paper should consider whether, in some cases, the grantor might control an intangible rather than a physical asset in relation to the SCA property and whether the control tests would be equally appropriate for determining the presence of such control.

- Mutual agreement does not necessarily indicate control

Paragraph 74 states that the grantor's control over SCA property is based on a contract willingly entered into by the operator, rather than through legislation.

HoTARAC notes that willing agreement between contracting parties does not necessarily indicate control of SCA property by either party. Such a contract could give control to the grantor, the operator or both, jointly. Control of SCA property could vary from case to case and would most likely depend on the terms of the contract. Such contracts usually allocate risks and benefits to each party by mutual agreement. A freely negotiated SCA with a fair exchange of economic benefits does not of itself give any evidence of one party's control of the SCA property.

In addition, some SCAs are the subject of specific legislation that, like a contract, could give control to either party.

- Economic benefits are also relevant

IPSAS 1 and the AASB Framework define assets as resources "… from which future economic benefits or service potential are expected to flow to the entity".

Paragraph 99 of the Consultation Paper asserts that focusing on service potential risks and rewards and ignoring economic risks and rewards is appropriate given the types of SCA property being considered.

HoTARAC agrees that, for not-for-profit entities, service potential may be more relevant than economic benefits, however, it notes that some for-profit GBEs engage in SCAs. Footnote 7 to paragraph 26 acknowledges that the guidance in the Consultation Paper could be applied to GBEs that are grantors.

Also, the commercial nature of SCAs gives rise to economic benefits for at least one of the SCA parties, regardless of any party's not-for-profit status. Thus, for grantors under such arrangements, economic benefits may be more relevant than service potential.

HoTARAC therefore suggests that economic benefits need to be considered, where relevant, as they are an integral part of the asset definition and integral to the economic substance of many SCAs.

- Purported distinction between economic and ownership risks and rewards

Paragraph 100 asserts that when a grantor controls the SCA property, the operator, like a vendor in a service contract, only has economic, rather than ownership, risks and rewards.

HoTARAC disagrees with this assertion and would argue instead that the risks and rewards of ownership are economic in nature. This view is supported by

paragraph 12 of IPSAS 13, or paragraph 7 of AASB 117 or IAS 17, *Leases*. In determining which party controls an asset, any alleged distinction between economic and ownership risks and rewards is imaginary.

Furthermore, an operator's obligation to deliver SCA property to the grantor in an agreed condition is, arguably, a risk of ownership during the concession period. Otherwise, the operator might only maintain the property to the extent necessary to obtain economic benefits up to the end of that period, and not beyond.

Impact of proposals

Paragraph 102 states the proposed tests for determining whether a grantor controls SCA property. These tests appear to result in a similar outcome to the existing accounting approach adopted in practice by public sector grantors in Australia.

From HoTARAC's assessment, applying the proposed control tests to a sample of 20 Build-Operate-Transfer, Build-Own-Operate-Transfer or Build-Own-Operate arrangements in one Australian jurisdiction results in exactly the same outcome as applying the control tests under HoTARAC's existing guidance for Australian grantors, based on FRS 5-F. None of the SCA properties was assessed as grantor-controlled under either approach.

In each case in the sample, the SCA property fails at least one of the grantor control tests under the proposed model. In most cases, the grantor does not control to whom the operator must provide the services. In some cases, the grantor does not control the price ranges or rates that the operator can charge. In some cases, particularly in BOO arrangements, the grantor does not control the residual interest in the SCA property.

HoTARAC considers the similarity of the outcomes of both approaches to be purely coincidental, given its reservations with the robustness and conceptual justification for the proposals.

HoTARAC also notes that the impact of the proposed grantor control tests could vary among jurisdictions due to differences in applying the tests, as discussed in the next section.

Rules can be manipulated

The accounting outcome is very sensitive to failing any one of the proposed grantor control tests.

The four proposed control tests in paragraph 102 are in the nature of rules and their rigidity could expose them to manipulation or different interpretations. Three tests relate to the use of the SCA property (services, recipients and pricing) and the other relates to the residual interest therein.

The omission of one of those tested matters from an SCA contract would be sufficient for the grantor to fail the control tests. However, the addition of an innocuous clause dealing with that matter could confer grantor control even if, in substance, nothing else changed.

For example, in HoTARAC's experience, SCA contracts rarely specify the clients to whom services are to be provided. Market forces usually determine this. However, if the recitals to a contract were to indicate that the services are to be provided to the citizens of a particular region, this could be sufficient to satisfy one of the grantor-control tests even though the use of the SCA property, and the relationship between the contracting parties, is substantively unchanged.

HoTARAC suggests that tests based on principles rather than rules would be more robust and less liable to manipulation or disputation with auditors.

A unilateral approach may give biased results

Paragraph 62 notes that the existing or proposed guidance on accounting for SCAs can result in different reporting results even under the same set of circumstances. To overcome this, paragraph 63 suggests there is a need for a harmonised approach to reporting.

IFRIC 12 gives guidance for operators but does not consider the grantor's perspective. The Consultation Paper proposes guidance for grantors but does not consider the operator's perspective. Such unilateral approaches, only considering one party's point of view, may produce a biased accounting treatment that does not reflect the substance of the transaction consistently for both parties. Consequently, SCA property might be recognised by both parties, or neither party. HoTARAC observes several instances of the latter in Australia.

Although two parties to a transaction may have asymmetrical accounting treatments, this usually arises where they are applying consistent rules and concepts but where their individual circumstances are different. HoTARAC considers it undesirable, however, if SCA property goes unreported because each party is applying inconsistent rules and concepts.

IFRIC 12 and the proposals in the Consultation Paper are not equally applicable to both SCA parties. Nor are their control tests based on explicit, generally applicable concepts for determining control of an asset. HoTARAC considers that any accounting guidance for SCAs should be conceptually based and equally applicable to both parties to the arrangement. IFRIC 12 only applies to operator accounting for SCAs under which the SCA property is grantor controlled. Arguably, its broad control tests were framed to demonstrate such grantor control. Similarly, in the Consultation Paper, the control tests based on those in IFRIC 12, and the accompanying discussion seem to be premised on grantor control of SCA property.

HoTARAC suggests that a more conceptually balanced approach would be to consider the arrangement in its totality and test which SCA party controls the SCA property, without prejudging which party that will be.

C. RECOGNISING THE GRANTOR'S OBLIGATION TO PROVIDE ACCESS

Paragraphs 135 and 138 propose that a grantor would recognise an asset and a liability in respect of grantor-controlled SCA property constructed by the operator as part of the arrangement. The grantor's liability would represent its obligation to pay the operator for the construction of the property or, if there is no payment obligation, to provide access to the SCA property.

HoTARAC considers the explanation of the nature of the liability to be flawed. In such SCAs, the grantor would always have an obligation to provide the operator with access to the SCA property. If a grantor is to recognise a liability for its obligation to provide access, it is inconsistent to suggest it should only do so where it has no payment obligation.

HoTARAC does not consider that a grantor should recognise its obligation to provide access. This would be a departure from current accounting practice in relation to agreements equally proportionately unperformed, with wide-ranging ramifications. Any change in this area would need to be the subject of a detailed investigation on a range of affected transactions.

HoTARAC considers that where a grantor controls the SCA property and has no obligation to pay for it, the operator has given the property to the grantor in exchange for receiving the service concession. It is effectively an up-front service concession fee akin to a royalty. The grantor should therefore defer it and amortise it to revenue over the term of the SCA.

While the grantor's access obligation would exist under all SCAs involving grantor-controlled property, an up-front service concession fee (in kind) would only arise in those cases where it was negotiated as part of the arrangement. Deferral and amortisation of the up-front fee would achieve the same accounting outcome as the proposal to recognise an access obligation where the grantor has no payment obligation.

D. MEASURING THE GRANTOR'S ASSET AND LIABILITY

Paragraphs 135-138 propose that where a grantor recognises an asset and associated liability for grantor-controlled SCA property, they should initially be measured based on the lower of (i) the fair value of the property and (ii) the present value of any separable scheduled construction payments. Question 2 of the Consultation Paper specifically seeks comment on this.

HoTARAC agrees with this proposal, provided that all relevant commissioning costs are included. HoTARAC also requests that the Consultation Paper be expanded to include specific guidance on the subsequent measurement, including revaluation of the grantor's asset, given that it may have a long life and be managed by the operator.

Paragraphs 134 and 139 note that, despite a grantor relinquishing its right to charge for the use of SCA property, such property would not be impaired under IPSAS 21 *Impairment of Non-Cash-Generating Assets*. While this is true under IPSASs, it does not necessarily hold in jurisdictions, like Australia, where national or IASB standards prevail. Under IAS 36 and AASB 136 *Impairment of Assets*, grantor-controlled SCA property is likely to be substantially impaired in cases where the grantor is a for-profit entity (eg a GBE) and the SCA permits the operator to enjoy the cash inflows from the property during the concession period.

E. ACCOUNTING FOR GRANTOR'S RESIDUAL INTEREST IN SCA PROPERTY

Residual interest received for zero payment

Paragraphs 150 and 162 deal with how a grantor should account for an arrangement, involving newly-constructed SCA property, where it only controls the residual interest therein at the end of the concession term but not the use thereof during the term. Those paragraphs propose that the grantor recognise its interest as an asset, built up over the concession term, and measured as the excess of the expected fair value of the property at the end of the term over the amount payable by the grantor on reversion.

While HoTARAC agrees with the need to build up the asset over the concession term, the proposal does not specifically consider the case of a grantor receiving such a residual interest without having to pay for it. The grantor in such arrangements grants the service concession solely in exchange for its right to receive the infrastructure (in good condition) at the end of the arrangement. The grantor pays nothing for the property it receives. Such arrangements are common in Australia and often involve toll roads.

HoTARAC considers that the guidance in the proposals, and also in FRS 5-F, applies equally to such zero-payment cases. The grantor would recognise an asset, built up over the concession term and measured as the expected fair value of the property at the end of the term.

HoTARAC strongly recommends that the proposals be expanded to explicitly cover the case of an SCA where the grantor receives a residual interest in the property for zero payment.

Revenue recognition for contributed SCA property

Paragraph 196 proposes that contractually determined inflows to be received by a grantor from the operator as part of an SCA should be recognised as revenue by the grantor as they are earned over the concession term, using an appropriate allocation method. Question three of the Consultation Paper specifically seeks comment on this.

HoTARAC agrees with this proposal and it favours allocating such revenue on an annuity basis because of the longevity of SCAs.

Sometimes, as in a Build-Own-Operate-Transfer arrangement, the contractually determined inflow will be the residual interest in the SCA property, which the grantor receives for zero payment. HoTARAC considers that the proposal applies equally to such cases. Where a grantor receives a residual interest in the SCA property at the end of the term for zero payment, the grantor should recognise an asset and revenue, built up over the concession term.

HoTARAC recommends that the proposals be expanded to explicitly indicate that, not only the asset, but also the revenue, is to be reported over the concession term, in the case of an SCA where the grantor receives a residual interest in the property for zero (or payment that is less than fair value).

HoTARAC also notes that the residual interest in the SCA property, given in exchange for the service concession, can be likened to a royalty. Paragraph 25 in the Appendix to IPSAS 9 *Revenue from Exchange Transactions* (and Appendix paragraph 20 of AASB 118 or IAS 18 *Revenue*) requires royalty payments to be allocated on a straight line or other justifiable basis in accordance with the substance of the agreement. This also supports HoTARAC's recommendation.

F. SHARING THE AASB PROJECT REPORT ON ACCOUNTING FOR SCAs

In December 2006, the AASB resolved to appoint an Interpretation Advisory Panel to consider accounting by public sector grantors for SCAs. A panel of experts was duly appointed and the Board considered its report in December 2007. On the basis of the Report, the AASB took the view that AASB Interpretation 12 did not determine the general accounting by public sector grantors for SCAs within the scope of the Interpretation. Although the Panel's Report was not published, it is likely to be quite relevant to the IPSASB's current project, given the grantor perspective, expertise of the Panel members and time spent considering the matter.

HoTARAC notes that the AASB's view differs from the IPSASB's view expressed in paragraph 50 that it can be inferred from IFRIC 12 that the grantor should report the SCA property as an asset. HoTARAC urges the AASB and IPSASB to confer with a view to sharing the Panel's Report.

Existing models for determining control of an asset

Existing accounting pronouncements contain various models for testing whether an entity controls an asset.

Benefit and access model

IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* states that:

> Control of an asset *arises when the entity can use or otherwise benefit from an asset in pursuit of its objectives and can exclude or otherwise regulate the access of others to that benefit* [para 7]

IAS 138 and AASB 138 *Intangible Assets* also give similar guidance:

> *An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits* [para 13].

The asset control tests in these pronouncements are based upon whether the entity can (a) use or otherwise benefit from, and (b) restrict the access of others to, the asset.

Risks and rewards model

IPSAS 13, IAS 17 and AASB 117 *Leases* require a lessor to recognise operating-leased property, and a lessee to recognise finance leased property, as its asset. They distinguish finance and operating leases as follows:

> *A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership* [IPSAS 13: para 13, IAS 17 and AASB 17: para 8].

IPSAS 9 *Revenue from Exchange Transactions* and IAS 18 and AASB 118 *Revenue* only permit an entity to recognise revenue from the sale of goods after it transfers the significant risks and rewards of ownership and loses effective control thereof [IPSAS 9: para 28, IAS 18 and AASB 118: para 14].

IAS 39 and AASB 139 *Financial Instruments: Recognition and Measurement* require a financial asset to be derecognised only after an entity transfers substantially all the risks and rewards of ownership or (if it has neither transferred nor retained the risks and rewards) loses control thereof [para 20]. (There is no equivalent IPSAS.)

The asset control tests in these pronouncements are based upon whether the entity has the risks and rewards incidental to ownership of the asset.

Use and residual interest model

IFRIC and AASB Interpretation 12 *Service Concession Arrangements* state that:

> *This Interpretation applies to public-to-private service concession arrangements if:*
>
> *(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and*
>
> *(b) the grantor controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement* [para 5]
>
> *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.* … [para 11]

The asset control tests in these pronouncements are based upon the entity's control of (a) the use of the asset during the concession period and (b) the residual interest in the asset at the end of that period.