



# Accounting Standards Board

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Dear Sir

## **Consultation Paper Accounting and Financial Reporting for Service Concession Arrangements**

- 1 The UK Accounting Standards Board (ASB) welcomes the opportunity to comment on the International Public Sector Accounting Standards Board's proposals for the Accounting and Financial Reporting of Service Concession Arrangements ('SCAs'). This addresses a very significant financial reporting issue. It is also an issue of particular significance to the UK where the public sector has for a number of years used service concession arrangements called Public Private Partnerships (PPP) as a means delivering public services and of improving the infrastructure used to provide these services.
- 2 As the consultation paper acknowledges, accounting for SCAs was addressed by the ASB in 1998 when it issued an amendment to its Financial Reporting Standard 5 'Reporting the substance of transactions', and, following that, by the UK Treasury which issued its own Technical Note on 'How to Account for PFI transactions'. In advance of central government moving to preparing IFRS based accounts, the UK Treasury has now issued final text for central government bodies on the accounting treatment of PPP arrangements, including Private Finance Initiative schemes, under IFRS and these requirements are based on the IFRIC 12 controls approach.
- 3 We believe the IPSASB consultation paper is very helpful. In particular, it provides a clear and comprehensive overview of all aspects of the accounting and financial reporting requirements for SCAs. We agree with most of the proposals that are made.

### *Consistency with IFRIC 12*

- 4 The IPSASB proposals are particularly welcome because IFRIC 12 'Service Concession Arrangements' provides guidance only for the operator (generally the private sector entity). Corresponding guidance at the international level for the grantor is therefore required.
- 5 In our view, it is important the requirements for accounting by the grantor follow closely the requirements of IFRIC 12, unless there are convincing reasons for a departure.

### *The whole asset approach*

- 6 The consultation paper notes that most existing approaches assume that one party to an SCA should report the underlying infrastructure as property, plant and equipment in its financial statements (a "whole asset approach"), but also refers to an alternative approach (an "unbundling approach") under which each party would report its rights and obligations (paragraphs 58-61 and 101).
- 7 Although we believe the whole asset approach has limitations, we agree that it is the only practicable way to develop workable proposals for SCAs at this time, especially as IFRIC 12 broadly adopts a whole asset approach. But the limitations of this approach need to be carefully considered, and it may be that departures from a strict whole of asset approach may be necessary in some circumstances. The Paper itself, for example, adopts what we would see as an unbundling approach in the case of newly constructed property where the grantor controls only the residual interest.
- 8 The whole asset approach as noted in the consultation paper is consistent with existing standards on lease accounting. For this reason, a wholesale move away from this approach should await further progress with the IASB/FASB project on leases. We therefore agree with the IPSASB proposal not to pursue further an unbundling approach as part of this project but to review this position in the light of developments in the IASB/FASB project.

### *The focus on control*

- 9 The amendment to FRS 5 and the Treasury Technical Note both use the "risk and rewards" approach to determine the required accounting for the public sector grantor. However, the ASB supports the IPSASB proposal to use a "control" focus for reporting the underlying property in an SCA; an approach that is also required by the UK Treasury for central government bodies that are to prepare IFRS accounts from 2009-10. We believe this approach is clearer and can generally be applied more consistently than the risk and rewards approach but does not lead to fundamentally different reporting. It is

however important that the exposure draft gives sufficient guidance on the application of control, for example by addressing circumstances in which the grantor may have the ability or obligation to 'step-in' to assume control from a delinquent or insolvent operator. Adopting the controls approach also achieves the desired consistency with IFRIC 12.

- 10 We do not support the proposed departure from IFRIC 12 in respect of the residual interest control criterion. We would be concerned if the effect of the proposal were that property would not be reported by the grantor simply because there is an insignificant residual interest which the grantor does not retain. Further detail on this matter is provided in the Appendix to this letter (paragraphs A1.1-A1.7).
- 11 The Appendix also comments on the other Specific Matters for Comment raised in the consultation paper as well as a number of the ancillary issues. In particular, we would highlight the following points:
  - (i) It seems further analysis is required of the proposal that a liability should be reported by the grantor in arrangements where the grantor makes no payments to the operator because the SCA involves the operator collecting fees such as tolls directly from users. It is not clear that, in this situation, the grantor has a liability to the operator or what the nature of that liability is. We would suggest that consideration is given to the extent that an asset is recognised in such circumstances.
  - (ii) Regarding the proposals for reporting contractually determined inflows of resources, we consider there is a case for the grantor to report a financial asset at the start of the concession term where it has unconditional rights to future inflows of resources either through revenue sharing provisions in the SCA or as a result of another contractual provision.
  - (iii) We disagree with the proposal that the grantor should use an estimate of the operator's cost of capital specific to the SCA to determine the imputed finance charges. We would suggest that the grantor's borrowing rate provides a more relevant and appropriate interest rate.
  - (iv) We agree with IPSASB that, where the grantor bears all significant construction risk, the grantor should recognise the property as it is being constructed. We would, however, suggest IPSASB consider whether, in some circumstances, a grantor should recognise an asset (and perhaps a liability) during the course of construction, even if the operator bears some of the construction risk.
- 12 We would also suggest that as part of the exposure draft IPSASB should include some illustrative examples. It would be helpful if these are based on the three examples that are included in IFRIC 12.

- 13 We are pleased to continue supporting IPSASB as it takes this project forward, both in terms of providing ASB resource to support the work of the project team as well as commenting on consultation papers.
- 14 If you would like any further information on our comments, please contact Alan O'Connor (+44 (0)20 7492 2421; [a.oconnor@frc-asb.org.uk](mailto:a.oconnor@frc-asb.org.uk)) or myself.

Yours faithfully



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## Specific matters for comment

### *The criteria for determining control (question 1)*

A1.1 We agree with the proposal that the grantor should report the property underlying the SCA as an asset where it is considered to control the property. We also agree with the first of the two criteria for determining control, ie that the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price.

A1.2 We do however have concerns about the second control criteria, which reflects the view that control over the residual interest is important in preserving the continuous public sector use of the property *regardless of whether the residual interest is significant*. The consultation paper's reasons are that control over the residual interest gives the grantor additional control over the property, but it is difficult to see why this would not be achieved by the first criterion for control.

A1.3 It may be that the proposals aim to cater for the position where a grantor assumes control of an asset at the end of an SCA, for example, to ensure continued delivery of a service and where the residual interest may appear to have little market value. We would suggest that, in these circumstances, the residual interest would be significant and the requirement for a significant residual interest in the second control criteria, as required by IFRIC 12, would be met.

A1.4 We do not support the proposed departure from the wording of IFRIC 12 in respect of the second control criterion. In particular, we are concerned that it could be open to mis-interpretation: it is not clear whether the grantor needs to control "all" of the residual interest (even if the residual interest is insignificant) or "any" of the residual interest (which may be an insignificant amount) for the second control criterion to be met.

- Our interpretation, as reflected in paragraph 10 of the covering letter, is that the grantor will need to control "all" of the residual interest; hence there may be circumstances where the property is not reported by the grantor simply because there is an insignificant residual interest which the grantor does not retain.
- The alternative interpretation is that the grantor needs to control only part of the residual interest, even an insignificant part, for the second control criterion to be met and that, where this is the case, the property would be reported as the property of the grantor (provided of course that the first control criterion is also met). Under this interpretation more assets would be reported by the grantor.

A1.5 We do not see any adequate justification for the proposed departure from IFRIC 12 and therefore suggest that IPSASB align the wording of the second control

criterion with that used in IFRIC 12. If IPSASB decides to retain the proposed departure, we suggest that it seeks to clarify how the second control criterion should be interpreted.

A1.6 We also find the discussion of the situation where only the first criterion for control is met in paragraphs 143-148 of the consultation paper confusing but it seems to accept that there will be cases where a property is reported even where the residual interest criterion as drafted is not met. We are also concerned this suggests that, in some, circumstances, the accounting treatment will vary depending merely on the identity of the party which has legal title to the asset.

### *Reporting the liability (question 2)*

A2.1 We agree with IPSASB's proposal that, where the control criteria are met, the grantor should report the property underlying the SCA as an asset in its balance sheet. We also agree that the grantor should report a liability, in respect of the obligation to provide compensation to the operator and with the proposed accounting where the construction and service elements are not separable.

A2.2 We do however have concerns about the proposed accounting where the arrangements involve the operator collecting usage fees directly from third parties rather than the grantor. Where this happens, IPSASB's view is that there remains a liability for the grantor to report despite the fact that it makes no payments to the operator.

A2.3 IPSASB's argument is that a liability arises because the grantor is obliged to make the asset available to the operator for the period of the concession and the proposal is that this liability should be amortised and revenue should be recognised over the life of the SCA. We do not believe this represents an obligation to transfer economic resources; hence we do not think the grantor has a liability.

A2.4 There remains a need to account for the asset which might be recognised at inception of the arrangement at its fair value. However, this would seem to overstate the value of the asset and, since the grantor does not have outright ownership of the asset, it would not be representationally faithful to present it as such in its balance sheet. A preferable approach which, in our view, most closely reflects the economic reality of the arrangement, would be for the grantor to instead report its "right to receive the asset" at the end of the contract. This would initially be reported at a discounted amount and built up over the life of the contract. It may be noted that the operator, if applying paragraph 17 of IFRIC 12, will report an asset (as an intangible) which broadly represents the difference between the value of the whole asset and the residual interest reported by the grantor.

If an asset is to be recognised that exceeds the value of any previously recognised asset, then a gain would be reported. Where the asset is not previously recognised, a gain representing the contribution of the asset would be reported in full.

A2.5 We would also emphasise that the accounting should reflect the economic reality of the party that benefits from the charges paid by users rather than the arrangements put in place for the collection of these charges.

### ***Reporting contractually determined inflows of resources (question 3)***

A3.1 We agree with the proposal that contractually determined inflows of resources to be received by a grantor from an operator as part of an SCA should be recognised as revenue by the grantor as they are earned over the life of the SCA.

A3.2 However, we note that where the grantor has an unconditional right to receive amounts and the operator has little, if any, right to avoid payment, there is a case for the grantor recognising a financial asset at the outset of the arrangement. If within its scope, this would be required by IAS 39 and might be seen as similar to an operator's unconditional right to receive cash which is addressed in IFRIC 12, paragraph 16. If this were required, it would be necessary to consider how the value of the property should be adjusted to reflect the portion that has been 'sold' to the operator so as to avoid double counting.

### **Ancillary issues**

#### ***When should the property be recognised?***

A4.1 We note the IPSASB proposal that the control criteria can be met during the construction phase of an SCA and that, where this is the case, an asset should be recognised during the course of construction. The ASB agrees that, at least where the grantor bears all significant construction risk, the grantor should recognise the property as an asset as it is being constructed.

A4.2 This is consistent with the current UK approach under Application Note F to FRS 5 which requires an assessment of "risks and rewards", including design and construction risk, although the Application Note does emphasise that construction risk is not generally relevant to determining which party has an asset of the property once construction is completed. It should also be noted that in the UK contracts are often negotiated so that construction risk rests with the operator with the result that the underlying property will not be recognised by the grantor as an asset until the start of the concession term when the property is fully operational.

A4.3 We would encourage IPSASB to consider, however, whether there may be cases where a grantor should recognise an asset (and perhaps a liability) during the course of construction even if the operator bears some element of construction risk.

#### ***Arrangements involving the existing property of the grantor***

A5.1 The consultation paper suggests that there should be no impairment review for arrangements involving the existing property of the grantor. This is because, where an SCA involves existing property of the grantor and this property is already reported as a fixed asset, the carrying value should be unaffected. We agree that, in most cases, and despite the grantor relinquishing some aspects of its right of

ownership, there will be no reduction in the service potential of the asset; hence no additional accounting should be required when the SCA is entered into.

A.5.2 However, in our view, because an SCA is likely to be a major transaction for a public sector entity, that it would be reasonable for the exposure draft to require a review of the carrying value of the asset. It may also be the case that negotiating the SCA provides evidence that the public sector was either holding an over-specified asset or was not holding the asset at the correct value.

### *What interest rate should be used?*

A6.1 We agree with the IPSASB proposal that where scheduled payments are not readily separable, there is a need to estimate the construction and service elements of the arrangement. We do however disagree with the IPSASB proposal that the interest rate used to impute the finance charge should be the operator's cost of capital specific to the SCA. In our view, the grantor's borrowing rate will provide a more relevant measure. This is because the financial statements should portray the financial position of the grantor, and the costs incurred by the operator are not directly relevant.

Whilst it may on occasions be necessary to calculate a cost of capital specific to the project, we would suggest the government's borrowing rate will, in most instances, provide a rate that is appropriate for financial reporting purposes.

### *What if one or other of the control criteria isn't met?*

A.7.1 We consider this to be an important issue, particularly in terms of the IPSASB proposal that the residual interest control criteria should not require the residual interest to be significant. We therefore support the proposal to set out the accounting requirements when one or other of the control criteria isn't met.

### *Guarantees and other commitments*

A8.1 We agree with IPSASB that there are a number of examples of guarantees and commitments that can arise under SCAs and that any standard should make clear that these should be reported either as financial guarantee contracts under IAS 39 or, for those guarantees and commitments made by grantors that fall outside the scope of IAS 39, then IAS 19 'Provisions, Contingent liabilities and Provisions' should apply.

### *Consolidation*

A9.1 We also agree that, when considering consolidation, the relationship between the grantor and the operator should be evaluated using the guidance in IPSAS 6 'Consolidated and Separate Financial Statements' and that where the grantor has an ownership or equity interest in the operator that IPSAS 7 'Accounting for Investments in Associates' and IPSAS 8 'Interests in Joint Ventures' should also be assessed.

## *Disclosures*

A10.1 We agree that, given the general complexity of SCAs and the potential magnitude of their significance on the financial statements, there is a need to provide guidance on the required disclosures. We also agree with the proposal to draw upon the disclosure requirements as set out in the IASB's SIC-29 'Service Concession Arrangements' which, unlike IFRIC 12, cover both the grantor and the operator.

A10.2 As many public sector entities may have several SCAs, it would seem appropriate for IPSASB to allow disclosure in aggregate as long as this does not obscure individual arrangements that might be significant. We therefore support the proposal in paragraph 229 of the consultation paper to allow the aggregation of information.

A10.3 To ensure the proposed disclosures are not onerous and provide information that is useful and relevant to a user's understanding of the arrangements entered into, we support the reference in paragraph 227 of the consultation paper that certain information may be more appropriately included in other financial reports and documents of the grantor. We are, however, concerned that the fourth indent of paragraph 228 may be onerous and result in excessive information being presented in the notes to the financial statements. In particular, we have doubts about the proposal to include information on the financial condition of the operator.