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Our ref KPMG submission - ITC 16final

Mr David Boymal  
Chair  
Australian Accounting Standards Board  
PO Box 204  
Collins St West VIC 8007

4 July 2008

Dear David

**Submission - ITC 16 - IPSASB Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements***

We are pleased to have the opportunity to comment on ITC 16 – IPSASB Consultation Paper *Accounting and Financial Reporting for Service Concession Arrangements* (consultation paper).

**Executive summary**

The key issues discussed in this submission are as follows:

- We support providing guidance to grantors in accounting for Service Concession Arrangements (SCAs) and ensuring that its application provides consistency in accounting treatment of SCAs between grantors.
- We do not have any significant concerns regarding the proposed control criteria. However we have noted some points for clarification regarding consistency with the criteria set out by IFRIC 12.
- We do not have any significant concerns regarding the proposed recognition and measurement criteria for SCAs by the grantor. However we have noted some minor points for clarification.
- We believe further consideration is required of the accounting treatment applied by the grantor when the grantor controls only the residual interest in the property underlying the SCA.
- We consider that the term “ownership” is not required when setting out the proposed accounting for SCAs by the grantor where the control criteria over use only is met and the property underlying the SCA are existing assets.

Yours sincerely

Kim Heng  
Partner

## **General comments**

We acknowledge that the current situation in Australia, being no specific Australian Accounting Standard for the accounting of SCAs by the grantor can and has led to inconsistent treatments in practice between the grantor and operator of SCAs and between grantors of SCAs. We therefore welcome the AASB's move to clarify the accounting treatment in relation to grantor accounting for SCAs.

## **Specific comments**

Our comments on the specific matters raised for comment by the IPSASB are set out below.

- 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?***

We agree that a grantor should report the property underlying a SCA as an asset in its financial statements if it is considered to control the property. Furthermore we agree in principal with the control criteria set out in the proposal and the fact they are based fundamentally on the definition of an asset set out in the AASB Framework in paragraph 49(a). However, we have the following comments with respect to the control criteria proposed in the consultation paper:

- We note that the proposed control criteria relating to residual interest specifically the exclusion of "any significant" from the control criteria differ from those set out in IFRIC 12 but no significant discussion was included in the consultation paper as to the justification for this change and the intended impact. We note that if applied in its proposed form the control criteria may result in different accounting for whole of life arrangements based on whether or not the grantor controls the residual interest, even though in economic substance these transactions are the same. Under the IFRIC 12 criteria this issue was resolved through the inclusion of a scope exemption for whole of life arrangements from applying the residual interest criteria.

Paragraph 80 of the consultation paper states that in most cases, a significant residual interest in the underlying property will exist at the end of the SCA. It has been our experience where the property underlying a SCA is a building or piece of equipment the SCA has generally been for a significant period of the underlying property's life such that the residual interest at the end of the arrangement is insignificant. Therefore we believe given the importance of any proposed control criteria to the application of the proposal further commentary and explanation is required with regard to the differences from IFRIC 12.

- The footnote to the control criteria regarding the restriction to the definition of "regulates" to exclude any generally legislated regulation is at odds with the scope of IFRIC 12 which includes operators who are regulated by legislation to perform a service. We understand why the consultation paper proposes to limit "regulates" to exclude any generally legislated regulation, we are aware that users of IFRIC 12 have difficulties with the application of the term "regulates" and that practice regarding how it is applied varies due to the broadness of the definition. However we are concerned that the drafting as proposed in the consultation

- paper may lead to differences in accounting between grantors and/or operators based on the form rather than the substance of the arrangement; as grantors may be able to achieve a certain accounting outcome by ensuring that the control of use terms underpinning the SCA are contained in legislation rather than in the contractual arrangement between the grantor and the operator.

An example of the limitation that the proposed control criteria may have is with respect to an infrastructure project in a newly emerging industry. As this is an emerging industry there is no government regulation regarding how services and pricing should be determined. The first SCA that is undertaken in this industry has all the terms and conditions of the arrangement documented in the SCA agreement; application of the proposed control criteria particularly the first leg of the criteria regarding control over use results in the property underlying this SCA being recognised by the grantor. As the industry becomes more established there is more government regulation regarding how services and pricing should be determined such that the agreement between the grantor and operator no longer contains these terms. Under the control criteria proposed in the consultation paper, these later SCA will not be recognised as assets of the grantor despite the substance of the arrangement being exactly the same as that of the first SCA.

Given the potential differences regarding how the control criteria in respect of this issue could be applied the consultation paper should provide more explanation as to why this footnote has been worded as such and include further comment on the intended application of the term.

- 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?*

We agree with the treatment proposed in the consultation paper. However we would like to make a comment with regard to the measurement requirements where the capital and service payments under the SCA are separable. The proposal sets out that the asset should be measured at the lower of the fair value of the property or present value of the payments for construction of the property. In our opinion in an arm's length transaction the fair value of the property underlying the SCA will always equal the present value of the SCA payments related to the construction of the property. Consequently we do not consider it necessary for the measurement guidance to stipulate that in situations where the payments are separable the asset should be measured at the lower of the fair value of the property or present value of the payments for construction. Whether the construction element of the payment is capable of being separated from the service payment or not, the asset should be measured at the fair value of the underlying property.

Furthermore given the detailed financial modelling performed by both the grantor and the operator as part of developing the tender for the SCAs, we believe it would be rare for a grantor to claim they cannot separate payments for the construction of the underlying property from the service payments.

- 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?*

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 beginning with the commencement of the concession term.

In addition to the specific matters raised for comment by the IPSASB we have additional comments we would like to make as follows:

***Recognition of an asset over the concession period where control in the residual only is held by the grantor***

While we agree with the practical nature of the proposed accounting we struggle with the technical justification for this treatment as we are not able to reconcile this treatment to any currently applicable accounting concepts. We consider that an alternative is that an asset should be recognised upfront at the fair value of the residual interest in the property with a corresponding liability recognised; as a result of entering into the SCA the grantor receives an intangible asset representing a right to receive the residual interest at the end of the concession arrangement but has not “paid” for that asset. When the SCA requires the grantor to make payments to the operator, this liability will be reduced as payments are made to the operator. When the SCA does not require the grantor to make payments to the operator, the question arises as to when this liability should be recognised as revenue; should revenue be recognised upfront or over the life of the arrangement? We believe this will depend on the terms and conditions of the arrangement. If in return for receiving the residual interest, the grantor provides the operator with a non-monetary asset (e.g. an operating lease over the land on which the property underlying the SCA is constructed) then revenue might be recognised over the period of the arrangement representing the operating lease that the grantor provided to the operator. However if under the terms of the SCA, the grantor receives the residual interest as a result of entering into the SCA and is not required to make payments to the operator nor provide the operator with a non-monetary asset in return, then revenue might appropriately be recognised upfront. We believe further consideration or comment should be given in the next consultative document as to how the treatment proposed in the consultation paper is supported by the current accounting framework and why the alternative we propose is not appropriate.

***Accounting for an existing asset where control of use only are met***

With regard to the proposal where the grantor controls use of the property during the SCA but not the residual interest and the SCA does not meet the definition of a lease because the grantor maintains ownership of the underlying property during the arrangement, while we agree that the grantor should report the property as an asset we question whether the consultation paper necessarily needs to refer to “ownership”. The term ownership can have many meanings and as accounting standards place less reliance on “title” to property relative to the substance of the

arrangement; in the context of this proposed control model we do not believe the term is required.

**Consideration of the potential impact of IFRIC 15 *Agreements for the construction of real estate***

While we recognise that IFRIC 15 is related to when an entity who signs agreements for the construction of real estate should recognise revenue in relation to an agreement for the construction of real estate we believe some of the thinking in IFRIC 15 regarding why the entity entering into the construction agreement should recognise revenue on a percentage of completion basis should be included the next consultative document when assessing whether an asset should be recognised by the grantor during the construction period.

Our comments on the specific matters raised for comment by the AASB are set out below.

**1) *Should the AASB use the IPSASB's work on service concession arrangements, such as issuing in Australia an Exposure Draft based on a subsequent IPSASB Exposure Draft or Standard?***

As noted above under our general comments, the lack of a specific Australian Accounting Standard for the accounting of SCAs by the grantor can and has led to inconsistent treatments in practice between the grantor and operator of SCAs and between grantors of SCAs. We therefore welcome the AASB's move to consider an accounting standard specifically in relation to grantor accounting for SCAs and we agree that using the IPSASB's work on service concession arrangements is appropriate as we believe consistency in the accounting by grantors of SCAs internationally is an appropriate goal.

**2) *Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the IPSASB proposals?***

We are currently not aware of any regulatory or other issues arising in the Australian environment that may affect the implementation of the IPSASB proposals.

**3) *Would the IPSASB proposals result in financial statements that would be useful to users overall?***

We believe that the IPSASB proposals would result in useful financial statements, as it will provide consistency in the accounting treatment of SCAs by operators and grantors, and allow users to compare financial statements.

**4) *Are the IPSASB proposals in the best interests of the Australian economy?***

For all the reasons noted above, we agree that the IPSASB proposals are in the best interests of the Australian economy.