

23 July 2008

The Chairman  
Australian Accounting Standards Board  
PO Box 204  
Collins Street West Vic 8007

Dear Chairman

***ITC 16: Request for Comment on IPSASB Consultation Paper Accounting and Financial Reporting for Service Concession Arrangements***

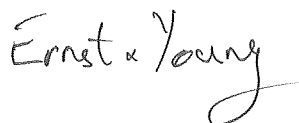
We are pleased to submit our comments on ITC 16: Request for Comment on IPSASB Consultation Paper- Accounting and Financial Reporting for Service Concession Arrangements.

Our comments on the specific matters outlined in the Invitation to Comment are addressed in Appendix A. Our comments in relation to matters not specifically requested are included as Appendix B.

As you are aware, service concession arrangements have been a significant feature in the provision of infrastructure in Australia for a number of years and as such, there has been considerable interest in Australia in the accounting by grantors for service concession arrangements. Subject to our comments below, we believe that ITC 16 is a positive step to addressing the accounting for service concession arrangements (SCAs) by the public sector.

We would be pleased to discuss our comments further with you. Please contact Georgina Dellaportas on (03) 9288 8621 if you wish to discuss any of the matters raised in this response.

Yours sincerely

A handwritten signature in cursive script that reads 'Ernst & Young'.

Ernst & Young

## Appendix A

### SPECIFIC MATTERS FOR COMMENT

#### (i) AASB questions

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?*

We agree that the AASB should use the IPSASB's work on service concession arrangements. At present there is considerable divergence in the accounting for SCAs due to the lack of specific guidance for the public sector grantor. As such, we believe that there is considerable need in Australia to address the accounting by grantors for service concession arrangements. Issuing in Australia an Exposure Draft based on any subsequent IPSASB exposure draft or standard would be a positive step forward in addressing this need.

In doing so however, we draw the AASB's attention to the current differences between the proposed scope under ITC 16 and IFRIC 12, that may result in infrastructure not being recognised either by the operator or the public sector grantor.

In particular, the IPSASB approach proposes to exclude generally legislated regulation from the assessment of control criteria leaving the reference to "regulation" in the first criterion essentially restricted to arrangements agreed upon by the grantor and the operator. On the contrary, Int 12 includes generally legislated regulation as part of the control assessment.

This difference in scope could lead to infrastructure assets being recognised by neither the operator nor the public sector grantor. Consider the following example:

Assume an arrangement is subject to generally legislated regulation (and that all other control criteria are met). The SCA would fall within the scope of Int 12 and hence require the operator not to recognise the infrastructure asset (operator would recognise a financial asset or intangible). However, as the IPSASB proposals exclude generally legislated regulation, the SCA would also fail the control criteria under the IPSASB proposals and hence the infrastructure asset would not be recognised by the public sector grantor. This would result in a situation where the infrastructure remains off balance sheet to the grantor and the operator.

In addition, there are differences in respect of the second criteria - control over the residual interest. Under Int 12, the grantor must control "any significant residual interest in the infrastructure" with the exception that whole of life arrangements fall within the scope of the Interpretation. On the other hand under the IPSASB proposals, the grantor must always control the residual interest for it to be within its scope.

Therefore where a grantor does not control the residual interest in the assets in a whole of life arrangement, the SCA would fall within the scope of Int 12 and the assets would not be recognised by the operator. The SCA would also fail the control criteria under the IPSASB proposals and hence the assets would not be required to be recognised by the public sector grantor.

The AASB will need to consider the effects of any differences between the ITC 16 proposals and IFRIC 12 to the extent that they may result in infrastructure assets which remain off balance sheet both from the perspective of the operator as well as the public sector grantor.

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

While we do not believe that there are any regulatory issues arising in the Australian environment that may affect the implementation of the IPSASB proposals, we do note that in discussing the notion of "control" and "expected flow of future economic benefits or service potential" of the infrastructure asset, the IPSASB proposals refer to the notion of "accountability" which is absent from the Australian framework which is designed for for-profit entities.

Nevertheless, the IPSASB paper concludes that if the grantor controls the use of the property, it can also be expected to benefit from its future service potential. The notion of "future service potential" is included in our Framework by virtue of Aus 49.1 and hence would permit the recognition of the asset.

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 financial statements that would be useful to users overall, as they would provide consistency in the application of accounting requirements for SCAs by the public sector and hence increase the comparability of financial statements.

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

Given Australia's sector neutral approach and the fact that the IPSASB proposals are not too dissimilar to the IFRIC 12 requirements, we believe that the IPSASB proposals are in the best interests of the Australian economy.

(ii) IPSASB questions

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?*

Subject to our comments below, we generally support the application of a "control" approach to be applied to determining who should recognise the assets under SCAs.

In relation to the first criterion, we support the IPSASB proposal to restrict the term "regulation" essentially to arrangements agreed upon by the grantor and the operator. This is on the basis that we believe that it is inappropriate to assess a grantor's control over the infrastructure based on whether a regulator has been established which has an overall regulatory role over the assets in question or the particular industry in which the entity operates.

This approach would also be consistent with our current accounting standard, AAS 31 par 9.7.1 (d) (and the revised AASB 127 following on from the removal of AAS 31) which states that a government does not have control merely because it "...has the power to regulate the behaviour of the entity by use of its legislative powers. The power of government to establish the regulatory environment within which entities operate and to impose conditions or sanctions on their operations does not of itself constitute control of the assets deployed by those entities. For example, governments regulate the operations of entities operating in the gaming industry, but those entities are not controlled by government unless the assets or residual assets of those entities can be deployed for the benefit of government..."

We believe however that the IPSASB must be very clear in defining the boundaries of what it considers "regulation" which would be restricted to arrangements agreed upon by the grantor and operator and therefore would fall within the criteria of ITC 16 as opposed to that which would be considered to be "generally legislated regulation".

In respect of the second criterion under the IPSASB proposals, the grantor must always control the residual interest for it to be within its scope. Hence to the extent that we have a whole of life arrangement or the grantor does not control the residual interest of an arrangement, the SCA would fall outside the scope of IPSASB proposals and thus be off balance sheet from the grantor's perspective. We do not agree with this proposal. In our view, in such situations, this criterion is irrelevant and the SCA should fall within scope based on meeting the first criterion.

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 do not agree with this proposed treatment for a number of reasons:

- (a) *Where scheduled payments made by the grantor can be separated into a construction element and a service element*

The IPSASB proposal to initially recognise the asset and the related liability (reflecting any obligation to provide compensation to the operator) at the fair value of the property or the present value of the scheduled construction payments if lower would be in conflict with the requirements in AASB 116 which require the asset to be recognised at its cost.

In addition, where the obligation to make payments to the operator rests with grantor, the liability represents a financial liability to be accounted for under AASB 139 as it reflects an obligation to deliver cash or another financial asset to the operator. Under AASB 139, such a financial liability is required to be recognised and initially measured at fair value and then at amortised cost unless designated at fair value through the profit and loss category. We do not believe the leasing standard as proposed by IPSASB, is appropriate.

We also do not agree with the IPSASB statement that "it would appear that the amount at which the liability associated with the SCA would initially be recognised is similar, that is the fair value of the property (or if lower, the present value of the of the scheduled payments)". In determining fair value for initial recognition, AASB 139 would only permit the recognition of the liability at fair value which may differ to the fair value of the property.

- (b) *To the extent that the service and construction elements of the payments cannot be separated, the IPSASB proposes that the underlying property and related liability be recognised at fair value.***

In addition to our comments noted above at (a) we also note that while fair value would be considered to be a good proxy for measuring the value of construction services in the early stages of construction, the closer to completion of construction that the asset gets, the margin between construction cost and fair value would significantly widen. Hence recognising the asset at its fair value could considerably overstate the cost at which the asset is recognised and understate the service cost component.

While it is rare that the service and construction elements of the payments cannot be reliably separated, where this is the case, we believe that it would be appropriate for the grantor to estimate the cost of the asset based on the cost of construction (inclusive of an appropriate construction margin), information of which would be obtainable from the operator.

- (c) *Arrangements involving reduced or eliminated grantor payments***

The IPSASB proposes that to the extent that the operator will receive no or reduced payments from the grantor because it will be collecting usage fees from the public, then the asset and associated liability would be recognised at fair value. While we agree that the asset should be recognised at fair value as this accords with the requirements in AAS 29 and 31 which require contributed assets to be recognised at fair value, the other side of the transaction would be required to be recognised in profit and loss.

In our view, neither the requirements in AASB 137 nor the requirements in AASB 139 are met for the recognition of a liability. The grantor has no legal or constructive obligation to make any payments or sacrifice any economic benefits. What the grantor has done is provide to the operator an intangible asset, being the right to toll - in exchange for the construction of an asset. However as the intangible was never recognised by the grantor, the recognition of the asset would result in the recognition of profit.

- 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 this proposed treatment.

## Appendix B

### OTHER COMMENTS ON ITC 16

#### 1. Extension of scope

The IPSASB paper has a much wider scope than that of Int 12. The Board will need to consider the implications of this extension when considering the impact of adopting the IPSASB's proposals.

The IPSASB paper specifically addresses the grantor's accounting when the control criteria are not satisfied in full as well as the situation where one or the other criterion are met, ie where the grantor controls the use of the property during the arrangement, but not the residual interest and where the grantor controls the residual interest, but not the use of the property during the arrangement.

On the other hand, Int 12 does not specify the accounting for such arrangements that fall outside its scope.

Preparers would need to look to UIG 4: *Determining whether an arrangement contains a lease* to determine whether the SCA contains a lease, before applying AASB 117: *Leases*.

To the extent that the AASB decides to adopt the IPSASB proposals, we believe that only those where the control criteria are met should be adopted, leaving the other scenarios to be dealt with by existing standards.

This comment also applies to the proposals relating to guarantees and other commitments which would be dealt with by existing standards.

IPSASB proposals also apply to public-public partnerships – the Board should give consideration to whether this extension in scope would cause any issues for the public sector, including a consideration of the costs/benefits of requiring such application, when such accounting will then be eliminated on consolidation.