

Financial Reporting Advisory Board

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From the Chairman

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Dear Sir,

Consultation Paper: Accounting and Financial Reporting for Service Concession Arrangements

1. The Financial Reporting Advisory Board (the Board) welcomes the opportunity to comment on the proposals set out in the International Public Sector Accounting Standards Board's (IPSASB) Consultation Paper on the Accounting and Financial Reporting for Service Concession Arrangements (SCAs).

Background to the Board

2. The Board acts as an independent element in the process of setting accounting standards for government. The Treasury is required by the Government Resources and Accounts Act 2000 to consult the Board on financial reporting principles and standards. The Board exists to promote the highest possible standards in financial reporting by government and to ensure that any adaptations of, or departures from, generally accepted accounting practice are justified and properly explained. The Board reports annually to Parliament about its activities and highlights areas of concern. More details on the work of the Board can be found on its website at www.frab.gov.uk.

The Board's interest in Service Concession Arrangements

3. The Consultation Paper addresses what is a very significant issue for public sector entities in the United Kingdom (UK). Within the UK the public sector has over many years used public private partnership arrangements as a means of delivering public services. These partnership arrangements have resulted in the development or improvement of the infrastructure required in the delivery of services to the public. In the context of such partnering arrangements, the achievement of better

consistency in the public sector accounting for contracts under the Private Finance Initiative (PFI) remains a particular concern of the Board, as expressed in its annual reports to Parliament.

The Board's response

4. The Board welcomes the IPSASB proposals that aim to provide guidance for public sector grantor parties to service concession arrangements, that was outside the scope of IFRIC 12 'Service Concession Arrangements'. The Consultation paper provides a very comprehensive overview of the accounting and financial reporting requirements for SCAs that is very helpful in the consideration of the development of international guidance for grantors. The Board agrees with many of the proposals put forward in the Consultation Paper.

The focus on control

5. The Board agrees the proposal to use a 'control' focus for reporting the underlying property in a SCA, which is also generally but not wholly consistent with IFRIC 12, in that the latter requires that the grantor controls a 'significant residual interest' in the property, rather than in the IPSASB proposal 'a residual interest' that may be insignificant.

6. The Board views that the control approach is not too fundamentally different from the existing UK risks and rewards approach, and importantly from the Board's perspective, is considered likely to result in a more consistent application by public sector parties in accounting for PPP/PFI projects than prevailing guidance.

Reporting the whole underlying property by one party only

7. The Consultation Paper discusses the common aspect of all the existing approaches to reporting property associated with SCAs, in that only one of the parties should report the property in its financial statements. The paper further raises the prospect of an alternative approach, an unbundling or components (or rights and obligations) approach.

8. The Board agrees with the IPSASB that although the unbundling approach may have conceptual merit, in practice it would represent such a fundamental shift in the accounting and financial reporting of assets and liabilities for public sector entities that it could have implications beyond SCAs. The Board also views that this approach would have distinct disadvantages in that the complexities involved may make the approach difficult to apply in practice, and such an approach would inevitably rely on the exercise of judgement, that can more readily lead to inconsistencies in application. The Board therefore agrees that IPSASB should not pursue the development of this approach as part of its service concession project.

9. I attach at Annex A, the Board's response to the specific matters for comment as raised in the Consultation Paper, as well as on several ancillary accounting issues. I hope you find the comments useful.

Yours faithfully,

Larry Pinkney

p.p. ELWYN EILLEDGE

Approved by the Board and signed in the Chairman's absence.

IPSASB Consultation Paper: Accounting and Financial Reporting for Service Concession Arrangements - Response of the Financial Reporting Advisory Board

Specific Matters for Comment:

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? (See Paragraphs 28-104).

The Board agrees with the proposal that the grantor should report the property underlying an SCA as an asset when it is considered to control the property. The Board also agrees the first of the two criteria, i.e. 'The grantor controls or regulates what services the operator must provide with the underlying property, to whom it must provide them, and the price ranges or rates that can be charged for services'.

However, the Board has reservations about the second of the control criteria that 'The grantor controls – through ownership, beneficial entitlement or otherwise – the residual interest in the property at the end of the arrangement'. The IPSASB's reasons for this is that controlling the residual (rather than significant residual) interest in the property serves to preserve the grantor's continuous use of the property during the arrangement as well as at the end of the arrangement, and does not depend on its significance.

The Board is of the view that this control of continuous use is satisfied by the first of the criteria and if the residual interest is insignificant, then whether the grantor controls the residual interest is inconsequential, and should have no bearing on which party controls the property for financial reporting purposes. The Board believes that for this second test to be meaningful the residual interest should be significant and supports the wording in IFRIC 12.

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? (See Paragraphs 105-140).

The Board agrees the proposal.

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 recognised as revenue by the grantor as they 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? (See Paragraphs 191-196).

The Board agrees the proposal.

Comments on Ancillary Accounting Issues:

Timing of Recognition

For SCAs meeting the proposed control criteria, the IPSASB expects that the recognition criteria will often be met during construction if the value of the construction-in-progress can be reliably measured.

The Board agrees this approach in that where the grantor bears the construction risk it should recognise an asset and a liability as the asset is being constructed.

You will wish to note that within UK PPP/PFI contracts construction risk is generally passed to the operator and therefore if the property were determined to be on the grantor's balance sheet, recognition in the financial statements would be as the property becomes operational, i.e. when it comes into use.

Not meeting the proposed control criteria

The Board views that it is important to clearly set out the accounting requirements in the event that one or all of the control criteria are not met.

Guarantees and commitments made by a grantor

The Board agrees that for guarantees and commitments made by a grantor as part of an SCA that meet the IAS 39 definition of a financial guarantee contract, the provisions of that Standard should be used to measure and recognise a financial liability related to the guarantee in the grantor's financial statements. The Board also agrees the further proposal that the guidance in IPSAS 19 should generally apply to determining the accounting and financial reporting for guarantees and commitments made by grantors that do not meet the IAS 39 definition of a financial guarantee contract.

Financial Statement Note Disclosures

Given the general complexity of SCAs and their potential material impact on the financial statements of grantors, the Board agrees that there is a requirement to provide guidance on the required disclosures, taking into account the objectives of general purpose financial reporting in the public sector. The IASB's SIC-29 provides an appropriate basis for the drawing up of the necessary disclosures for both grantors and operators.