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Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
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1 August 2008

Dear Sir,

Consultation Paper: Accounting and Financial Reporting for Service Concession Arrangements

1. I am Professor of Accountancy at the University of Aberdeen where my research specialisms are in public sector accounting, auditing and expenditure management. Information about that work, which includes accounting for service concessions (Private Finance Initiative in UK terminology), can be found at www.davidheald.com. I am a member of the United Kingdom's Financial Reporting Advisory Board (which has submitted comments on this Consultation Paper) and a specialist adviser to the Treasury Committee of the UK House of Commons. The views expressed in this comment letter are mine alone and should not be attributed to any of the above-mentioned organisations.

2. I welcome the publication of this wide-ranging Consultation Paper and the opportunity to comment. I have found the comprehensive analysis most helpful in clarifying my own views on these complex and important matters. Given where public sector client accounting now is - as opposed to where it might have been - I support IPSASB's decision to adopt what might be described as 'the mirror image of IFRIC 12 treatment'. Given that IFRS provides no direct guidance on service concession accounting for public sector clients, this approach has also been adopted by the UK Treasury and the Financial Reporting Advisory Board so that the United Kingdom can move the anchor of its government accounting from UK GAAP to IFRS in 2009-10. This involves a change from 'risks and rewards' to 'control' as the criterion as to whether a service concession asset will be on the balance sheet of the public sector client.

3. I appreciate the difficulties that regulatory bodies face in the drafting of documents that go into the public domain, but there are dangers that avoiding certain issues or having recourse to coded language may damage public understanding of important accounting issues. The following statements relate specifically to the UK experience[1] but my understanding is that they may resonate in some other countries:

   - The unsatisfactory nature of service concession accounting is not primarily a technical accounting problem but attributable to governments wishing to keep privately

[1] See D. Heald and G. Georgiou, "The Regulation and Substance of PPP Accounting', mimeo, 2008, attached to this comment letter.

financed assets off public sector balance sheets and/or outside fiscal rules. This leads to the design of concession arrangements around the accounting rules (sacrificing some potential Value-for-Money gains) and/or manipulation of accounting treatment (facilitated in the United Kingdom by the existence of the Treasury Technical Note 1 (Revised) (1999) in addition to the Accounting Standards Board's (1998) FRS 5A). Arbitrage between these two pronouncements, with the former being more permissive of Off-balance sheet treatment by the public sector client, has contributed to the extensive occurrence of Off-Off treatment.[2]

- The pattern of On-treatment by public sector clients appears to owe more to the control framework under which they operate than to objective differences between the distribution of risks and rewards on particular concessions. This factor has interacted with differences of approach between the National Audit Office (which has insisted on On-balance sheet treatment for most prisons and roads) and the appointed auditors of the Audit Commission (a mixture of private firms and Audit Commission employees who exercise independent judgement); almost all schools and hospitals in England are Off-balance sheet. An extensive business has developed whereby the potential grantor's auditors and/or audit firms acting as consultants give views on accounting treatments in advance of funding/consents being approved; often funding/consents would not be available were there to be On-balance sheet treatment.

- The growing importance of fiscal rules and fiscal surveillance, especially for those countries within the European Union, draws attention to the significance of national accounts treatment. Whilst following financial reporting in using the risks and rewards criterion, Eurostat's guidance restricts the risks considered to construction risk and availability risk, thus making Off-balance sheet more likely than under either the UK's Treasury Technical Note 1 (Revised) or FRS 5A. This was the politically desired outcome, and has contributed to IMF concerns about the fiscal risks attached to service concession arrangements.

I would not expect IPSASB to be explicit about such regulatory arbitrage, or the motivations for it, but the context is fundamentally important and affects how the implications for new proposals based on 'control' are thought through.

4. I was disappointed not to find in the Consultation Paper an extended discussion of how, in the context of service concession arrangements, 'control' differs from 'risks and rewards'. Paragraph 21 states:

> … The difficulty in accounting for these [service concession] arrangements results from a more even *sharing* between the grantor and the operator of the risks, responsibilities, benefits, and control of the underlying infrastructure or public facility, and the delivery of the associated services. This raises the question - which party to the arrangement should report the underlying infrastructure or public facility as an asset in their financial statements.

This statement defines service concession arrangements in terms of both 'risks and rewards' (though the term 'benefit' is used) and of 'control' (with the term 'responsibilities' also being used). In the United Kingdom it is widely expected that the 2009-10 move to IFRS will bring On-balance sheet to the public sector client most service concession

[2] Page 3 of the Consultation Paper refers to 'even *occasionally* resulting in the property not being reported as property, plant and equipment by either the public sector entity or the private sector entity' (emphasis added). In my view, this understates the extent of this practice.

assets that are currently Off. My view is that this is not inherently a result of control replacing risk and reward but a consequence of previously bad accounting being eliminated. It is more difficult to think of service concessions that would have been properly Off under FRS 5A but On under the IFRIC 12 mirror-image treatment. Given that national accounts treatment will continue to be on a risks and rewards criterion, and that revisions to Eurostat rules follow totally different processes and timescales to those for financial reporting standards, this matter has practical importance for public sector clients that will follow IFRS for their financial statements but may also be required to provide information on a national accounts basis.

5. I can understand why the Board sees appeal in having two control criteria, one over use and the other over residual interest, as these represent two well-understood dimensions of service concession arrangements. However, given the prior history to which I refer above, I fear that having two control criteria may make it easier to design projects around the accounting standards to achieve Off-balance sheet treatment for the grantor. As mentioned above, this may involve sacrificing some potential Value-for-Money gains by sub-optimal contract design or by finding some artificial means to arbitrage the accounting standards. If there are two control criteria, it is imperative that IFRIC 12's wording of 'significant residual interest' be used; residual interest that is not significant should not influence the accounting decision. I commend the clarity of the flowchart developed by the UK Treasury to explain mirror-image treatment under IFRIC 12.

6. The transfer of construction risk to the private sector consortium, and in particular to its construction partner, is one of the mechanisms through which the public sector client can potentially achieve Value-for-Money gains from service concession arrangements. Accordingly, unless there is clear evidence in a particular case that construction risk remains with the grantor, my view is that the timing of recognition should be when the property first comes into use. Accordingly, I disagree with the view in paragraphs 106-112 and support the existing guidance provided by the UK Accounting Standards Board in FRS 5A.

7. The reputation of service concession arrangements has been damaged by manipulated accounting and inadequate transparency which have together clouded debates about whether they generate Value for Money. There should be a disclosure requirement on public sector grantors so that their annual report and accounts disclose the name, address and tax domicile of the private sector operator of each service concession arrangement, its duration and purpose, and - in all cases where the property is not on the balance sheet of the grantor - whether it is on the balance sheet of the private sector operator (usually a Special Purpose Vehicle) and of ultimate parents. These disclosures will enhance transparency and provide safeguards against new forms of accounting manipulation.

Yours sincerely

Professor David Heald

Attachment: "The Regulation and Substance of PPP Accounting", mimeo, 2008.