AICPA

October 7, 2009

Mr. David R. Bean
Director of Research and Technical Activities
Project No. 30
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Accounting and Financial Reporting for Service Concession Arrangements,* and is pleased to offer its comments. Overall, we support the GASB's efforts to improve financial reporting by establishing recognition, measurement, and disclosure requirements for service concession arrangements (SCAs). We also believe that the issuance of a standard addressing SCAs will improve the comparability of governmental financial statements. However, as further described in this letter and its Appendix, we differ with some of the Board's conclusions on reporting for SCAs and believe there is a need for additional clarification, particularly as it relates to the scope of the standard and the guidance in paragraph 11 of the ED, to ensure consistent application by financial statement preparers.

The remainder of this letter provides our responses to the issues that the Board raised in the ED and several other observations on residual interest. The Appendix to this letter contains our other comments and recommendations on the ED.

<u>RESPONSE TO ISSUES</u>

Issue 1: How should up-front or installment payments be reported when a transferor does not control the facilities subject to an SCA? Please state why you support this position.

The Board poses this issue and issue #2 as contingent upon the control of the facility by the transferor. We do not agree that the question of control is the sole key to addressing the appropriate accounting for up-front or installment payments. In our view, the existence or absence of residual interest in a transaction should also dictate the reporting of the up-front or installment payments and rights to residual interest in a facility because of the effect on the exchange transaction for the transferor. We also believe up-front or installment payments and rights to residual interest in a facility comprise elements of one exchange transaction and thus, must be considered together to determine the proper reporting.

Our recommended reporting for situations where there is no residual interest versus when there is a residual interest is described in more detail below. Our recommendations also distinguish whether or not a facility already exists as we believe such factors impact the appropriate accounting.

Existing Facility With No Residual Interest. With regard to an SCA involving an existing facility, we believe that when a transferor does not retain residual interest in the facility at the end of an SCA, the transferor has permanently given up control of the facility and related service—effectively a privatization. This scenario is analogous to a capital asset sale (i.e., exchanging an asset for cash). Further, there is no sacrifice of resources by the transferor in future periods in this scenario. Instead, the sacrifice takes place at the time of the transaction. Therefore, we concur with the Board's position that the transferor should derecognize the existing facility, record the receipt of up-front or installment payments, and report a gain or loss upon commencement of the arrangement to reflect the transfer of the facility to the operator.

Newly Constructed or Acquired Facility With No Residual Interest. We believe that when a transferor does not retain residual interest in a newly constructed or acquired facility at the end of an SCA, the reporting would be similar to that for an existing facility with no residual interest except that there would be no facility to derecognize. Thus, the transferor would record the receipt of up-front or installment payments and recognize the gain immediately. This is consistent with what the ED proposes.

Existing Facility With Residual Interest. For an SCA where a transferor retains residual interest in an existing facility at the end of an SCA, we believe that the transaction is different than when there is no residual interest because the transferor has only temporarily given up control of the facility. Therefore, the transferor will be sacrificing its own use of the facility throughout the SCA. If we correctly understand the ED proposal, it would have the transferor (assuming it does not meet the control criteria in the ED) record a residual interest in the existing facility and any up-front or installment payments and derecognize the capital asset. Any difference would be recognized as an immediate gain or loss upon the commencement of the SCA. Given that the transferor has only temporarily given up control of the facility and that the transferor has a continued sacrifice throughout the SCA, we believe it is not appropriate to immediately recognize the gain or loss in the manner proposed. Instead, we believe this scenario is more analogous to a type of capital lease (i.e., exchanging the right to control the use of the facility for the duration of the SCA for up-front or installment payments and the return of the asset in a particular stated condition). Therefore, we recommend that the transferor record a residual interest in the existing facility and any up-front or installment payments and derecognize the existing capital asset. Any difference would be recorded as unearned revenue that would be amortized in a systematic and rational manner over the term of the SCA (i.e., the period that the transferor is earning the value of the residual interest and up-front or installment payments).

Our rationale for recording unearned revenue is based on the definition of a liability in paragraph 17 of GASB Concepts Statement No. 4, *Elements of Financial Statements*, and the following:

- The receipt of up-front or installment payments and residual interest represent a present obligation by the transferor to sacrifice the economic benefit related to the facility over the term of the SCA; and

- The transferor has an obligation to the operator to provide access and use of that facility to the operator over the term of the SCA and has little or no discretion to avoid.

Further, we disagree with recognizing revenue immediately or applying it to future periods through reporting as a deferred inflow of resources because the transferor will be sacrificing its own use of the facility throughout the SCA. Therefore, we believe that an acquisition of net assets has not occurred at the time of execution even to the extent that up-front or installment payments and the value of the residual interest exceed any carrying value of the underlying facility reported by the transferor.

Newly Constructed or Acquired Facility With Residual Interest. With regard to an SCA involving a facility that is either newly constructed or acquired when the transferor retains residual interest in the facility, the ED would record the up-front or installment payments offset by an immediate gain and would also record a residual interest asset offset by a deferred inflow of resources. Using the same logic as in the previous comment, we disagree with this approach and would instead recommend that the up-front or installment payments and residual interest in the new facility be recorded and offset by unearned revenue.

Paragraph 11 Needs Clarification. Paragraph 11 of the ED discusses numerous topics and various arrangements. Many of the members that assisted us with developing this letter struggled to understand all of the concepts included in paragraph 11. We are concerned that without further clarification others may misunderstand the Board's intent for the appropriate accounting. Therefore, we recommend that in developing the final standard, the Board divide the various concepts covered in paragraph 11into separate paragraphs. We also recommend that the Board develop an additional Appendix, perhaps in the form of a matrix, illustrating the appropriate accounting for when control criteria are met, when control criteria are not met, when the asset is existing, and when the asset is newly constructed or acquired. Such an Appendix would help ensure that users of the final standard understand the appropriate accounting in the various scenarios.

Valuation Guidance for Allowances for Installment Payments. The Board should also consider developing guidance for purposes of determining the valuation of an appropriate allowance for installment payments.

Issue 2: How should a transferor's residual interest in a facility subject to an SCA be reported when the transferor does not control the facility? Please state why you support this position.

Our response to issue #1 addresses our views on the initial reporting of residual interest in various scenarios. We had difficulty understanding the reason for the ED's difference in treatment of the residual interest for SCAs involving an existing facility (i.e., report an immediate recognition of the gain/loss in the change statement) versus those involving a newly constructed or acquired facility (i.e., report as a deferred inflow of resources until the transferor resumes control of the facility). We believe the nature of the arrangement is the same in both cases in that the transferor is sacrificing both control and the economic benefit of the facility in exchange for up-front or installment payments and the rights to the residual interest in the facility at the end of an SCA. We also believe the nature of the residual interest asset is the same in both scenarios.

OTHER RESIDUAL INTEREST ISSUES

The ED is unclear whether a residual interest asset would be classified as a capital asset, intangible asset, or receivable. This classification could impact the treatment of the residual interest asset over the life of the SCA, for example, whether or not the asset should be amortized. Preparers could also be confused about the correct reporting within financial statements following the current financial resources measurement basis in the absence of any authoritative guidance on classification of residual interest. Thus, we recommend that the Board clarify its intent as to the classification of residual interest in the final standard to promote consistency in application.

Further, we were unclear on how a transferor's residual interest asset would be measured. Paragraph 11 of the ED states that fair value for the residual interest should be used for SCAs involving a newly constructed or built facility, but limits the value of the residual interest asset to the proportionate historical cost of the asset at the beginning of the SCA when the SCA involves an existing facility reported as a capital asset by the transferor. These limitations may be problematic in that they do not allow for consideration of increases in the service capacity of the facility created through improvements made by the operator during the SCA (e.g., the addition of two traffic lanes to an existing four lane tollway). Further, it appears there is an underlying assumption that the facility will be in a deteriorated condition at the end of the SCA which may not always be the case since many SCAs have "state of good condition" clauses. We recommend that the Board consider developing measurement guidance that would equate the value of the residual interest as the difference in service capacity expected at the end of the SCA to the service capacity at the beginning of the SCA, in proportion to the carrying value of the facility at the beginning of the SCA.

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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and was reviewed by representatives of the Accounting Standards Executive Committee (AcSEC) who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,

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Chair
AICPA State and Local Government
Expert Panel

Mary M. Foelster
Director
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cc: State and Local Government Expert Panel
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APPENDIX COMMENTS AND RECOMMENDATIONS

Definition of SCAs is Unclear or May be Misunderstood. There are many varieties of public-private partnership (PPP) arrangements. In various presentations made by Board members or staff it has been implied that the scope of the final standard is intended to be relatively narrow. However, after reviewing the ED, some of our members were unclear about whether certain types of arrangements were intended to be included in the scope of the final standard. For example, we were unclear whether the Board intended to include common partnerships (e.g., food service arrangements) in the scope of the project. If it were to apply to such arrangements, the broad definition of scope in paragraph 4 combined with the control criteria in paragraph 7 may result in a significant change in accounting for many governments with common partnerships, particularly with regard to the derecognition of assets. While the flowchart in Appendix C of the ED assists in illustrating the scope of the standard, we recommend that the Board further clarify its intent. Additional examples and discussion would assist in ensuring a common understanding of what arrangements are within the scope of the standard and a more consistent implementation.

Another area that the Board should consider more fully addressing is service management arrangements (SMAs). These arrangements often meet the criteria in paragraph 7 but fall outside of the scope elements in paragraph 4. We are concerned that some financial statement preparers will be confused about whether SMAs are within the scope of the standard. We recommend that for clarity purposes the Board define how an SMA differs from an SCA, beyond the flowchart illustration in Appendix C, and include a few examples of traditional SMAs and SCAs.

Finally, we question whether arrangements in which a government and a private entity enter into a joint venture with respect to the use and operation of a facility were intended to be included in the scope of the standard. In this example, both entities jointly own the facility, but the private entity is responsible for the operation and management of the facility. Further, ownership of the facility would revert to the government upon the termination of the operational agreement. We recommend that the Board provide clarifying guidance regarding the effect of a joint venture on the scope of the standard.

SCAs Involving Intangible Assets. It appears that the scope of the ED would exclude SCAs in which the subject of the arrangement is an intangible asset. We are unclear why such arrangements would be excluded. Paragraph 4 of the scope and applicability section discusses transfers of a facility which is further defined by a footnote which describes a facility as being tangible property. We believe that SCAs that transfer intangible assets should also be within the scope of this final standard. For example, state lotteries have often been discussed as potential targets of an SCA in which the right to use intangible assets such as trademarks, licenses, or slogans would be transferred. We encourage the Board to revise the scope of the standard to include SCAs that involve intangible asset transfers. If the Board does not accept this recommendation, it should more clearly address in the Basis for Conclusions the reasoning for excluding such arrangements.

Operator Improvements Need to be More Clearly Defined. We have concerns related to the guidance on existing facilities that are improved by the operator. Paragraph 9 of the ED states that when the control criteria are met, the transferor should report the fair value of new facilities or improvements to existing facilities. We believe that the reference to improvements is too broad. For example, roadway project improvements may range from adding lanes to roadway paving. Based on

Paragraph 9, it appears that all such improvements would be capitalized. Some members that participated in drafting this letter expressed concerns that requiring transferors to record all capitalizable improvements may be problematic because of the difficulty in obtaining knowledge of operator improvements. Thus, we encourage to Board to reach out to governments that have arrangements like this to determine the practicality of recording operator improvements and to consider whether the Board should limit the scope of what improvements a transferor should record (e.g., improvements specifically identified in the SCA).

Treatment for Improvements Made During the Term of SCA Need More Clarity. The ED appears to assume that all improvements to an existing facility would be made at the beginning of the SCA. Given the lengthy terms of many SCAs, it is likely that improvements would be made by the operator over the term of the SCA, rather than just at the inception, and could be made to both existing and new facilities. We suggest that the Board discuss how improvements related to new facilities and existing facilities that occur over the term of the SCA should be treated. Further, we suggest that such guidance address the difference in reporting, if any, under the various scenarios of an SCA (e.g., control maintained, residual interest retained, etc.). Finally, the final standard should address the treatment of improvements in the body of the Statement versus the Basis for Conclusions.

Operator Reporting. The proposed guidance only contemplates the operator reporting an intangible asset for the right to access the facility and collect third-party fees. We question whether the operator should report a tangible capital asset in cases where the transferor does not maintain residual interest in the facility (as discussed in paragraph 13 of the ED). In addition, we recommend that the Board consider providing guidance as to whether the operator should increase the carrying value of its asset when improvements to a facility are made, analogous to a leasehold improvement.

Clarification of the Term "Regulator." Paragraph 7(a) of the ED uses the term 'regulates' for purposes of defining control criteria. We are concerned that some may be confused by this since a government could be interpreted to regulate the items in 7(a)1-3 solely based on its overarching role as a regulator. We recommend that the Board clarify that for purposes of the standard that the term is intended more narrowly as provided for in an SCA.

Clarification of the Term "Significant" and Limitations on Scope. We also think that the term 'significant' needs clarification in terms of the significant residual interest discussed in paragraph 7(b). Significance could be interpreted in terms of the financial statements, the original service capacity of the facility, or the remainder of the transferor's capital assets. This should be clarified. Paragraph 47 states that assessment of whether the residual value is significant should be made based on the service utility of the facility at the end of the arrangement rather than using a fair value notion. This is an important concept that the Board should address in the body of the Statement. Further, the flowchart in Appendix C indicates that the transferor must retain significant residual interest in the facility for the SCA to be within the scope of this Statement (i.e., see the final diamond in the flowchart). This concept is not addressed in paragraph 4 of the ED (the scope section of the proposed standard) and is mentioned for the first time in paragraph 7 which describes the control criteria. This is an inconsistency that should be addressed by the Board in the final standard and in Appendix C. We would support the retention of a significant residual interest as a determining factor in the appropriate accounting for an SCA rather than as a scope factor.

Liability when Control Criteria are Met. Paragraphs 9 and 10 of the ED discuss the accounting for a facility when the control criteria discussed in paragraph 7 are met. We believe that this discussion of the accounting should provide more detail and context regarding the nature of the liability as it is not obvious from reading the paragraphs. We recommend that the Board include in the body of the Statement, rather than solely the Basis for Conclusions, clarification regarding the liability and the amortization of the liability. We believe this would be particularly helpful in the circumstances described in paragraph 9 in which recognition of the liability does not result from the receipt of up-front or installment payments, but rather solely from the receipt of the new facility.

Timing of Recognition of Revenue Sharing Arrangements. Paragraphs 15 and 16 of the ED cover the accounting for revenue sharing arrangements. We recommend that the Board expand this guidance to provide a discussion of the timing of revenue recognition for the transferor when there is revenue sharing considered in the SCA. This guidance would be especially important for situations when revenue sharing is contingent upon achieving benchmarks such as specific gross revenue levels or operator rate of returns.

***Transferor Reporting of Gross/Net Revenue and Expense*.** Paragraph 16 of the ED discusses the effects of operational risk on the accounting for revenue sharing arrangements. Given the narrowing of the scope of the ED to include only SCAs in which the operator collects third-party use fees (as opposed to a broader array of PPP arrangements, including SMAs), we believe the economic operational risk will reside with the operator acting on their own behalf and not as the agent of the transferor in all arrangements within the scope of the standard. Thus, we question the need for the guidance in paragraph 16. Further, retention by the operator of a fixed dollar amount per customer transaction or a stated percentage of the amounts charged to customers may not always indicate that the operator is acting as an agent for the transferor as suggested in paragraph 16. Consider a situation in which a transferor government receives 3% of gross user fees while the operator retains the remainder of the fees (i.e., a fixed 97% of gross user fees) and responsibility for the costs of operation. In this case, it would appear that the operator is not acting as an agent of the transferor, but instead, the revenue-sharing arrangement may be another mechanism used by the operator to compensate the transferor for the right to operate the facility. We believe it would not be appropriate for the transferor to report the gross revenues and expenses of the operation of the facility in this case due to its receipt of, and the operator's retention of, a fixed percentage of gross user fees.