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Mr Simon Ash
Branch Manager - Ownership
Department of Finance and Administration
John Gorton Building
PARKES ACT 2600

26 July 2000

Re: Accounting Advice for Commonwealth IT Service Agreement Contracts

Dear Mr Ash

1.0 Introduction:

Thank you for your correspondence of 7 July 2000 in which you requested KPMG to provide the Department of Finance and Administration ('the Department') with accounting advice concerning the Commonwealth's IT Service Agreement contracts.

Specifically, you have requested us to advise you on:

- (1) *The appropriate accounting treatment of service agreements entered into by the Commonwealth for the provision of IT infrastructure services.*

And, pursuant to this request, our further advice that...

- (2) (a) *If they are found to be, or contain, leases, what assets are considered to be leased; and*
- (b) *Are those leases operating or financing leases?*

In providing us with background material for advising the Department in this matter, we note the following information provided to us:

- contract schedules and pricing information in relation to the Group (or Cluster) 5 IT Outsourcing agreement;
- general comments made in your briefing letter to us, which outlined the fundamental purposes of IT Outsourcing - as expressed in Government policy and as pursued in practice by the Office of Asset Sales and IT Outsourcing (OASITO), and
- draft legal advice provided to OASITO from Blake Dawson Waldron (BDW), which specifically dealt with the issue as to whether CASA's IT Outsourcing Services Agreement would constitute a 'borrowing' or not and thereby cause them to be in breach of their borrowing power prohibition as per their governing legislation.

2.0 *Summary of Accounting Advice:*

In response to your first question as to the *appropriate accounting treatment of service agreements entered into by the Commonwealth for the provision of IT infrastructure services*, we have concluded that:

- the IT Service Agreement contract is primarily a services contract,
- the nature of the services contract is such that it is executed (partially performed) throughout its term, and that consequently,
- the contract is best accounted for in such a way that the assets inherent or provided within it are not capitalised.

In response to your second set of questions *if they are found to be, or contain, leases, what assets are considered to be leased; and are those leases operating or financing leases*, we have concluded that:

- the contract does, in substance, contain leases of IT-related equipment although upon analysis we believe that the equipment and service components are not readily separable.

From an accounting perspective, after considering the essential economic substance of the arrangements attached to the different items of equipment, coupled with an assessment of the risks and indicators of ownership, we have reached the opinion that such assets are best represented as operating leases, ie they are not capitalised.

The overall effect of this advice suggests that these contracts are best viewed as single service contract arrangements. We further suggest that best accounting practice would require that the service contract's commitments / obligations in future years be reflected in the Primary Commitment Note to the financial statements of participating Agencies. In this way full accounting disclosure can be made without the requirement to pursue a detailed 'unpicking' arrangement that would seek to capitalise certain aspects of the overall arrangement. This would provide for a far cleaner presentation of the overall contractual arrangement as opposed to one which would break up the costs of the overall arrangement into capitalised and non-capitalised (commitment) components.

3.0 *Remaining Sections of Our Accounting Advice:*

The remaining sections of our advice are presented in accordance with the following structure:

- **Section 4** provides a brief listing of the key accounting standards and discussion papers that we have referenced in the construction of our advice to the Department.
- **Section 5** discusses the way in which we view the essential nature of these IT Service Agreement contracts.
- **Section 6** presents a perspective on the directions of lease accounting in general and highlights the difficulties encompassed when undertaking accounting assessments of service contracts. The section also outlines the assessment principles employed by the UK and Ireland Standards Board in the Financial Reporting Standard (FRS) 5 - 'Reporting the Substance of Transactions' (*Application Note F*) - and suggests that these principles are more useful and practical than solely relying on the simple distinctions of *finance lease* and *operating lease* as announced in AAS 17 – Leases.
- **Section 7** presents key detailed facts of the Group 5 IT Service Agreement contract and matches these facts to the tests provided in both FRS 5 and AAS 17 – Leases.
- **Section 8** presents our conclusions derived from the analysis provided in Section 7 and which, in our view, supports the accounting advice provided to the Department in Section 2.

4.0 *Relevant Background Accounting Standards and Discussion Papers:*

We have provided our advice to you after reflecting upon the principles and discussion contained in a number of Australian and Overseas accounting standards and/or position papers. These include:

- **AAS 17 – Leases,**
- **G4 + 1 Position Paper: *Leases: Implementation of a New Approach***
(February 2000)
A Discussion Paper produced by G4+1.
- **Amendment to FRS 5 ‘Reporting the substance of Transactions’
Private Finance Initiative and Similar Contracts**
(September 1998)
Issued by the Accounting Standards Board (UK, Ireland)

5.0 *The Essential Nature of the Commonwealth’s IT Outsourcing Contracts*

In providing the Department with accounting advice in this matter we believe it is initially necessary for us to determine the essential nature of the IT Outsourcing contracts entered into by the Commonwealth via the various clustering arrangements put in place.

We have assumed that these contractual arrangements, while embracing a degree of variability from cluster to cluster, are essentially similar in structure to the Group 5 contract provided to us.

It is apparent that the agreement entered into between the Commonwealth (Group 5 Agencies) and the Contractor is, as stated, an “*Agreement for IT&T services and industry development*”. We believe the essentially ‘service centric’ flavour of the contract is well evidenced throughout the body of the contract and its accompanying schedules. Some of these many evidences include:

- **Recital E** – The Contractor is a provider of a broad range of information technology and telecommunications services.
- **Recital G** – The Contractor represents that:
 - (a) It has the skills, qualification and experience necessary to perform and manage the information technology and telecommunications services required by the Group Members in an efficient, cost-effective and controlled manner consistent with the Group Members’ business needs;.....
- **Recital K** – This Agreement sets out:
 - (a) the terms on which the Contractor will provide the information technology infrastructure and telecommunications services to the Group Members;....
- **3 Scope of Agreement, paragraph 3.1 Contractor’s Role, sub-paragraph (c)** [The Contractor must:] (c) from the Handover Date, supply the information technology and telecommunications services that come within the description specified in clause 6 (Services) to the Group in accordance with the Performance Standards and otherwise in accordance with this Agreement;
- **3 Scope of Agreement, paragraph 3.2 Group’s Role, sub-paragraph (a)** [The Group’s role includes:] (a) paying the Contractor the Service Charges in accordance with clause 11 (Service Charges);

Moreover, when viewing the sets of services contained in this contract, it becomes apparent that these agreements should not be booked under Australian Accounting Standards – in their entirety – as leases.

For example, when reviewing the services being provided under contract it is notable that they are grouped into the following service sets:

- Desktop / Lan Services
- Data Network Services
- Voice Network Services
- Internet download Charges
- Moves Adds and Changes (MACS)
- Training
- Application Maintenance and Development Services
- Application Server Services

Characteristics of note in relation to the above is that:

- (a) A single contract exists, which includes a range of services to be provided - each with their own attendant schedule of rates / charges, and
- (b) Many of the above listed service sets bear no relationship or direct linkage (from an accounting perspective) with any 'leasable' assets eg Internet download charges, Training, MACS, Application maintenance and development services, etc

We also note (from advice received from the Department) that the majority of costs incurred in these arrangements relates specifically to service components and do not, in fact, relate to actual hardware.

In summary, on a *whole of contract* basis, we view these agreements as being service contracts. Consequently, if there are to be leases encompassed in these agreements then they are clearly in the nature of - *A service contract, which may / may not contain leases.*

6.0 *Determination of whether or not "A Service Contract" contains a Lease or Leases.*

AAS 17 states under Section 2 Scope, paragraph 2.1.1 that:

"This standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with their operation or maintenance. This standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other". [Emphasis added]

In relation to the highlighted sentence of AAS 17 para 2.1.1, it is apparent that service contracts, devoid of any transferring of the rights to use assets, are not covered by the Standard. Clearly, while the use of assets is undoubtedly implied in these agreements, the draft legal opinion of Blake Dawson Waldron (provided in relation to the CASA services agreement) is worthy of note. It states, inter alia:

"The Service Agreement contains no express exclusive or non-exclusive right to use any equipment of any kind. Although, as a matter of practice, CASA, will use equipment in the ordinary course, this implied right is ancillary to the leading object of the Services Agreement being the supply of services. In this regard there are a number of cases that provide that the existence of implied rights to use that are collateral to the leading object of an instrument that is an agreement for the provision of Services do not render the instrument a lease".

(Refer: Page 3 Draft legal opinion on CASA: Outsourcing Services Agreement provided to OASITO's Mr John Bridge and dated 3 February 2000).

The fact that these contracts do not express exclusive or non-exclusive rights to any equipment of any kind also further strengthens our view (expressed earlier) that these IT outsourcing contracts are principally, both in form and substance, service contracts.

While the legal status of the 'transfer of rights' is important in the overall accounting treatment to be afforded these arrangements it is not, in our view, sufficient to dismiss the need - from an accounting perspective - to consider the economic substance underlying the arrangements in respect of the assets that are being provided by the contractor and being used by the clustered Agencies.

We believe that for this to occur, it is necessary to outline key elements of the accounting framework (both in place and being developed) in the area of Leases.

6.1 *Background to the Accounting for Service Contracts that may contain Leases:*

As alluded to above, prior to exploring the existence or otherwise of leased equipment under these service contracts it is important, and we believe helpful, to briefly comment on the current matters being considered by relevant accounting bodies both in Australia and overseas.

G4+1 Position Paper:

It is notable, for example, that the Forward to the recent (February 2000) G4+1 position paper entitled "Leases: Implementation of a New Approach" stated:

"Accounting for leases is among the most controversial topics of financial reporting, and many view it as an area in which existing accounting guidance in many countries requires improvement".

The essential thrust of the G4+1 position paper is one which states that:

"The distinction between operating leases and finance leases is arbitrary and lease accounting standards whose guidance is based on that distinction do not provide for the recognition in the lessee's balance sheet of material assets and liabilities arising from operating leases".

Despite the all embracing nature of this G4+1 position paper (which includes the standard setting bodies of Australia), the Summary of the paper clearly notes:

"The proposals would, therefore, not apply to executory contracts, including take-or-pay contracts or service contracts". [Emphasis Added]

The importance of this G4+1 'exclusory' statement is that it underlines the difficulties of making lease determinations in respect to service contracts. In essence, not only is 'accounting for leases generally among the most controversial in financial reporting', the area of determining lease issues within service contracts can be even more so.

To further illustrate this point. Paragraph 2.45 of Chapter 2 of the position paper, when dealing specifically with the issue as to what accounting treatment is to be afforded service contracts that contain leases, states:

"The Group acknowledges that it can be difficult to identify when a contract stated to be for services in fact constitutes a lease contract".

Paragraph 2.46 continues on to state:

"Determining whether a contract is a service agreement, a lease, or both, depends on the circumstances and requires a rigorous analysis of the rights and obligations of the parties to the contract".

The paragraph continues on to outline three key tests to apply in the case of a contract for the supply of capacity on a telecommunications network. The tests outlined require an assessment of whether or not:

- (i) Capacity and service elements can be separately identified in the contract;
- (ii) The purchaser (ie the Group) has an exclusive right to the purchased capacity; and
- (iii) The purchaser (ie the Group) has the risk of obsolescence of the purchased capacity during the contract term.

If all of these three conditions are met, then it is the view of the G4+1 position paper that the purchased capacity should be accounted for as a lease.

Whilst the above example is useful for outlining some of the factors that need to be considered when analysing contracts of this type, we are of the opinion that the work done by the Accounting Standards Board of the UK and Ireland in recent years provides a more comprehensive framework for assessing these types of contracts.

FRS 5 – Application Note F:

In their amendment to Financial Reporting Standard (FRS) 5 - 'Reporting the Substance of Transactions', Private Finance Initiative and Similar Contracts (September 1998) – they have provided an additional Application Note F. This note particularly focuses on providing clarity in the area of 'separability' (of service and property elements in contracts) and identifies the *'variations in profits (or losses) which should be taken into account when determining who has an asset of the property in a PFI contract'*.

Under the Private Finance Initiative (PFI) the private sector in the UK was responsible for supplying services that traditionally were provided by the public sector. PFI service contracts covered a range of services, which included property items such as roads, bridges, offices etc. Of relevance, they also included information technology systems.

The amendment to FRS 5 provides an assessment regime in the following form:

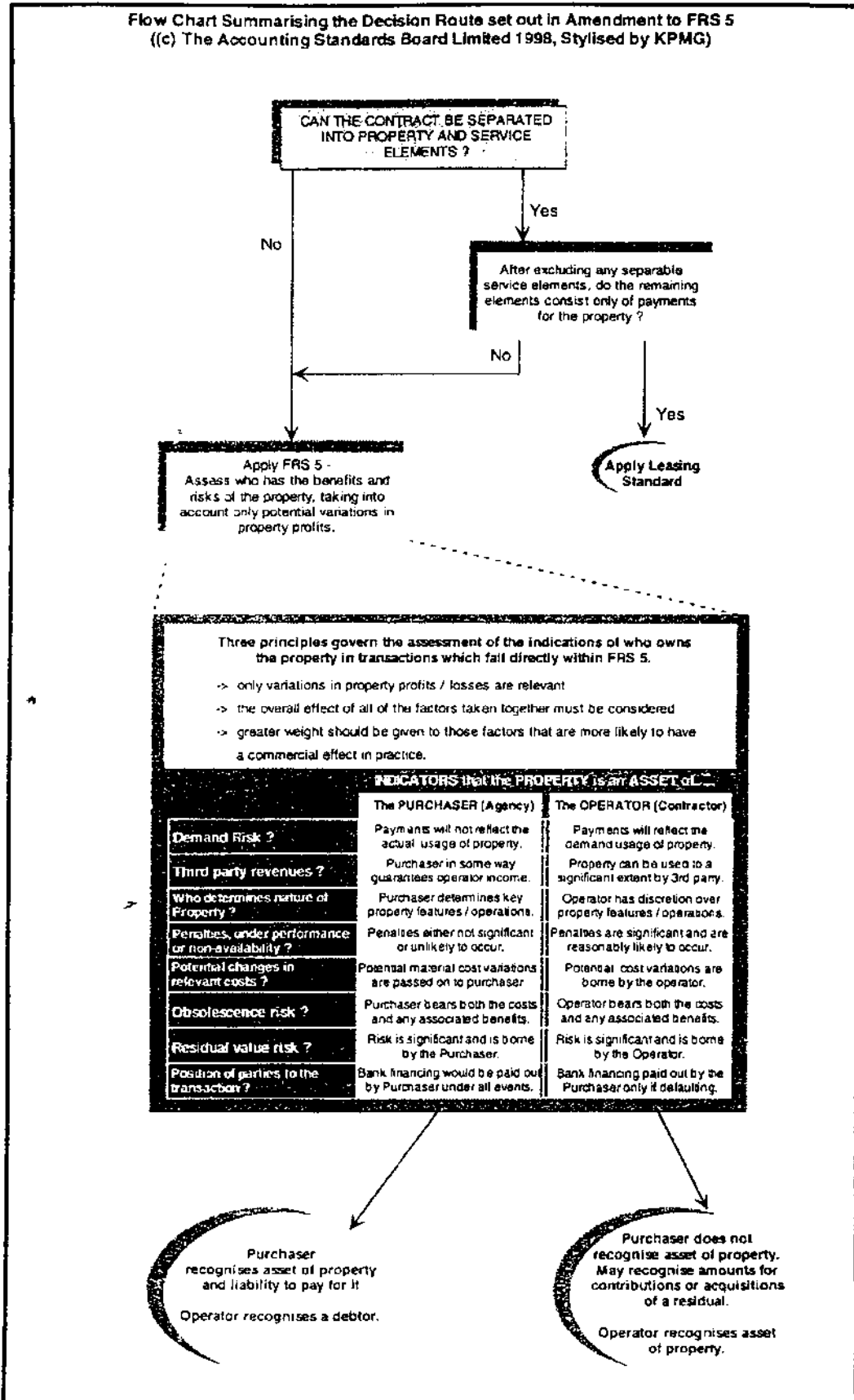
- (1) Determine whether or not the services contract can be separated into property and service elements; and
- (2) (Given that separation of elements is not readily achievable) assess who has the benefits and risks of the property according to the following eight indicators:
 - Who bears demand risk ?
 - Do any third party revenues exist (ie property used by a third party) ?
 - Who determines the nature of the property ?
 - Do penalties for under performance or non-availability exist ?
 - Who bears potential changes in relevant (property) costs ?
 - Who bears obsolescence risks, including the effect of changes in technology ?
 - Who bears residual risk at the end of the contract ?
 - What is the position of the parties in respect to the contract particularly in relation to bank financing payout upon termination ?

Three principles govern the application of these indicators, namely:

- Only variations in property profits / losses are relevant.
- The overall effect of all the factors taken together must be considered.
- Greater weight should be given to those factors that are more likely to have a commercial effect in practice.

While these indicators have been established for circumstances where UK leasing standards do not apply, they provide a comprehensive range of tests that can be utilised when considering whether property components of service contracts should be capitalised. For this reason the criteria presented above will be considered when determining an appropriate accounting treatment for the IT Service Agreement contract.

The operation of this assessment regime has been shown in the diagram appearing below.



AAS 17 – Leases:

While the discussions and insights gained from reviewing international standards and position papers is useful (and indeed will be utilised further in section 7), it is inevitable that the requirements of AAS 17, particularly in regards to lease classification, need to be considered.

AAS 17 defines a Finance Lease as *a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred.*

AAS 17 defines an Operating Lease as *a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset.*

In addition to the foregoing definitions, the two key paragraphs to consider in the classification of a lease are:

5.3.1 The classification of a lease depends upon its economic substance. Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor, the lease is an operating lease. Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease.

5.3.2 The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from the use of the asset and gains in realisable value.

While AAS 17 contains a number of other criteria for classifying leases (paragraphs 5.3.4 and following) it is important to note that paragraph 5.3.3 states: *'The following criteria are presented as guidelines to assist lessees and lessors in classifying leases. However, their application is not a substitute for applying the definitions of "finance lease" and "operating lease"'*

Finally, in the context of providing specific accounting advice to the Department in relation to IT Outsourcing contracts it is important to note that these contracts have been constructed such that Group IT assets have (by and large) been sold to the Contractor and are being rented or leased back. Under AAS 17 paragraph 5.3:

A lease resulting from a sale and leaseback transaction must be classified by the lessor either as a direct financing lease or an operating lease as at the inception of the lease and must not be classified as a sales-type lease.

Moreover, paragraph 10.1.1 of AAS 17 states:

A leaseback that involves a finance lease results in the lessor providing finance to the lessee with the asset as security.

The combining of these two paragraphs of AAS 17 would suggest that for a sale and leaseback transaction to be classified as a finance lease, then the construction of the contract should make some provision for the asset being held as security against the finances provided.

Interestingly, as discussed in more detail following, we do not see the construct or intent of these contracts in such a way, nor do they appear to contain sub-components within the contract that would indicate a 'financing' and 'asset as security' raison d'être.

7.0 *The Group 5 IT Outsourcing Contract*

This section summarises key aspects of the Group 5 IT Outsourcing contract and then proceeds to apply the regimes encompassed in FRS 5 and AAS 17 in order to determine whether the property components contained within this overall agreement should be booked as a financing or operating lease.

7.1 Overall Construction of the Group 5 Arrangement:

Our review of the Group 5 contractual arrangements and subsequent discussions with some Group 5 Agencies, Advantra and IBM Global Finance have revealed the following structure.

- IBM Global Finance (IBM-GF) have provided the equipment / finance pursuant to this overall arrangement such that they hold the view (and have accordingly booked) a finance lease arrangement with Advantra. While KPMG has not been able to assess or review the contractual arrangements in place between IBM-GF and Advantra, IBM-GF personnel responsible for this arrangement were quite clear in their view that the arrangements clearly resulted in IBM-GF having a finance lease.
- Advantra finance personnel responsible for the Group 5 contract have indicated that they have booked an operating lease in respect to the equipment provided to Group 5.

When discussing the overall structure of the Group 5 arrangement it is also important to restate the significance of maintaining a position that this overall contract is a service contract.

From an accounting perspective the fact that payments are only due upon the delivery of the service is significant in that existing accounting theory (Refer G4+1 position paper) in this area would suggest that service contracts are essentially executory throughout their term.

For example, the supplier must be able to continue to supply the goods or services over the life of the contract and, in return for the services delivered, the buyer must pay the supplier for the services rendered.

The only time when the continuous executory nature of the service contract is subject to challenge is in the circumstances that payment for asset components by the buyer are substantially paid in advance or when goods required throughout the contract term have been substantially provided. Moreover, in relation to the goods, which have been provided, we would suggest that it is also necessary to demonstrate that the purchaser has control of the goods – ie the *ability to use, pledge, sell or otherwise dispose of the good as it sees fit*. (Refer G4+1 paragraph 2.3 – *The Significance of Performance*).

When reflecting upon this view of service contracts in the light of the IT Outsourcing contract for Group 5 we would hold the view:

- The equipment proportions of the overall service contract are small in percentage terms (ie estimated by DOFA on the basis of individual Agency assessments as being in the order of 15% to 25% throughout the contract's life),
- The equipment to be used under these contracts is not fully provided at the beginning of the contract period – this is clearly evidenced by the provisions within the contract to refresh equipment during the contract period and if the Agencies call up the two year extension option, the contract could be in place for seven years during which a significant proportion of the equipment will be replaced by refreshment at least once, and twice in respect to PC/LAN equipment.

- When the above two attributes of the contract are combined, it becomes apparent that the percentage of equipment delivered at the beginning of the contract is even smaller than the 15% to 25% figures quoted above – ie at least half (7.5% to 12.5%). Moreover, when considering the genuine possibility that some Agencies within Group 5 could, in fact, receive two equipment refresh cycles then it is apparent that the equipment value delivered at the beginning of the contract period could represent a value which is even lower. Further more, in such a circumstance the value of the asset being delivered at the beginning of the contract is probably going to be something well below 30% of the ultimate value of the equipment to be delivered.

That is,

*Total contract proportion of equipment of 15-25% * 30% reflecting the proportion delivered up front*

Equals

The effective value of the contract proportionally delivered up front in the form of equipment.

We believe that this analysis of the contract reveals a situation, in both substance and form, whereby the contract is not substantially performed upon signing - and the assets pursuant to the contract period are also not substantially provided up front.

- Notwithstanding the foregoing analysis, when considering the 'control over asset' aspects of this transaction in the light of the agreements put in place by Advantra, we would hold the accounting view that the Group 5 contract does not provide a Group 5 Agency with the ability to do with the assets "as it sees fit".

For example, the Agencies under Group 5 who may wish to "purchase equipment that is primarily used to deliver the Services to the Group" at the end of the contract are, in fact, prohibited from doing so in the case of application servers. (Refer section 10 Disengagement Charges of Schedule 4 Price Schedule):

"...the Contractor will make available for purchase by the Group Members all such equipment that it owns, with the exception of application servers."

It would appear to us to be an unfair contrivance to construe that a finance lease could exist in the circumstances outlined above in relation to application servers, given that a contractual position expressly precludes the lessee ever holding title to or having residual ownership of an asset. Whilst the lessee may be in the position of wearing some economic risk in relation to the transaction it cannot be the economic risk of ownership. On balance, we believe an operating lease better represents the legal arrangements of the parties whilst still capturing the essential economic measurements required from an accounting perspective.

In regards to the above it is interesting to note the comments in G4+1 in Chapter 2 paragraph 2.33 when discussing the significance of performance:

"...whilst a focus on legal rights and obligations is helpful in suggesting when assets and liabilities come into existence and might be recognised, accounting has to go further and look at the consequences of such legal rights and obligations. Points must be identified when it is practicable to require recognition of assets and liabilities, in a manner that fairly reflects the economic and legal position of the parties, while acknowledging that a precise mirroring of legal rights and obligations is not always feasible." [Emphasis Added]

7.2 Separation of Service and Property Elements:

As noted previously in section 5, the Group 5 IT Service Agreement contract provides for Advantra to deliver a range of service sets to Group members:

- Desktop / Lan Services
- Data Network Services
- Voice Network Services
- Internet download Charges
- Moves Adds and Changes (MACS)
- Training
- Application Maintenance and Development Services
- Application Server Services

Upon initial inspection it would appear that these service sets may be readily separated into property and service elements. However, upon closer inspection of the service elements this is just not the case in many key areas – most notably it is not the case in respect to PCs and Printers.

For example, the pricing schedule in relation to a standard workstation and standard laptop (a component of Desktop / Lan Services) defines the components that make up the unit rate 'rental' charge in the following way:

The monthly rental charges for a Standard Workstation and Standard Laptop cover all services for the provision and maintenance of the workstation or laptop as described in Schedule 1 (Statement of Work) including:

- (A) the workstation or laptop itself;*
- (B) the workstation or laptop operating system;*
- (C) the cost of the initial installation of the workstation or laptop;*
- (D) the installation of peripheral equipment and options (if any) but only where this occurs contemporaneously with the initial installation of the workstation or laptop;*
- (E) the ongoing maintenance and repair of the equipment; and*
- (F) the removal of the equipment as part of the Contractor's equipment refresh or replacement obligations, or otherwise upon retirement.*

(Refer Schedule 4 – Price Schedule, 6 Monthly Charges (a) Desktop / LAN Services (i) Workstation and Laptop Equipment Rental Unit Rates)

A similar all encompassing charge exists for printers (Refer Schedule 4 – Price Schedule, 6 Monthly Charges (a) Desktop / LAN Services (iii) Unit Rates for Rental of Printers).

One instance where the fixed monthly charge for a service set contains a discrete property charge is in the area of Application Server Services. In this instance the equipment rental charges are separately identified in table 6.22 of the Price Schedule. However, in terms of the total costs involved in the contract re overall equipment charges, the amounts involved are not substantial.

In summary, given the general mixing of service costs with equipment charges in the key pricing schedule areas of PCs and Printers, it would be our view that it is more practicable to view the entire contractual arrangements as one which does not lend itself to a ready separation of property and service elements.

Such a conclusion does not imply that it would be impossible to obtain such costs, as clearly anything can ultimately be cost calculated. For us, however, the crucial test is whether or not the costing schedules attached to the contract readily present a separation of equipment costs.

7.3 Asset Management at Expiration of the Contract:

The following table summarises the essential actions and charges imposed at the expiration of the contract in relation to equipment provided under the IT Service Agreement contract. The two right hand columns also represent the procedures to be applied in the event that the Group determines that it has excess equipment beyond its need.

	OPTION to Keep Assets (Excludes Application Servers)		Equipment is Deemed to be Surplus either during or at the end of the contract period	
	PC Equipment is 3 years old (ie @ End of Lease)	All Other Equipment including PCs < 36 months.	PCs	All Other Equipment
Relevant Contractual Clauses	<i>Section 6(a)(viii) & Section 10 of Schedule 4 Price Schedule</i>	<i>Section 10 Disengagement Charges of Schedule 4 Price Schedule</i>	<i>Sections 8 & 6(a)(vi) Schedule 4 Price Schedule</i>	<i>Section 8 Schedule 4 Price Schedule</i>
Relevant Pricing Principles	<i>Residual wholesale fair market value or written down book value which ever is the less.</i>	<i>Written down book value</i>	<i>Group pays shortfall between total outstanding lease payments and wholesale fair market value</i>	<i>Group pays shortfall between written down book value and proceeds of sale</i>
Relevant Notes		<i>WDBV table 8.1 applies which uses a diminishing value method eg 60% pa for PCs.</i>	<i>Similar in principle to paying the difference between a lease and sub-lease arrangement.</i>	<i>WDBV table 8.1 applies which uses a diminishing value method eg 60% pa for PCs</i>
Commercial effect in practice	<i>More likely</i>	<i>More likely. WDBV would equate well to market value</i>	<i>Less likely but sufficiently probable to deem the lease cancellable.</i>	<i>Less likely but sufficiently probable to deem the lease cancellable.</i>

INDICATORS	Agency owns Assets	Contractor owns Assets	Notes
Demand Risk	✓	✓	Short term PC rentals available. Disk usage is variable charge on utilisation not deployment over baseline requirements. Annual resource baseline adjustments for PCs, printers etc done at levels of demand eg + or -20% - 0 discount / premium.
Third Party Revenue	✓	✗ ✓ (Refer Note 2)	(1) Equipment is dedicated to Group. (2) Upon consolidation of infrastructure equipment and from the perspective of an individual Agency it can be argued that there will be some '3 rd party' revenue.
Who determines the Nature of the Property	✓	✓	Attachment 3 Statement of Work cites baseline specs for PCs & Laptops. No specific make, model or manufacturer is required. Printers and mobile phones are specified by make and model.
Penalties of under performance or non-availability	✗	✓	Clearly the contract provides for the contractor to be penalised in circumstances of non-performance and non-availability.
Potential changes in relevant costs	✗	✓	Rates provided in advance and are only subject to proportions of CPI and Industry indexes. All other cost escalations will be borne by Contractor.
Obsolescence risk	N/A	N/A	Given the time frames of PC equipment refreshes etc the contract inherently manages this risk for both parties. If obsolescence did occur it would be a Contractor responsibility.
Residual value risk	The most likely scenario in practice is that equipment existing at the end of the contract period would be retained by the Agencies with a view to either renegotiating the contract with the same outsourcer or re-selling end of term acquired equipment back to a new outsourcer. In such circumstances WDBV would apply (refer table in previous Section 7.3), which given the depreciation method in place, would equate well to likely market values such that residual value risk would be low. Moreover, as per the entry into this existing Group 5 contract, the Agencies can simply transfer assets to an incoming outsourcer at zero cost and receive reduced rentals of equipment up until the time of the first refresh with the new outsourcer. Consequently, in practice, residual value risk is not likely to eventuate. Appropriately, the issue of application fileservers is interesting in that the Group is not allowed to purchase them and at the same time the Group would wish that the fileservers are not surplus to their needs.		
Position of parties to the transaction	✗	✓	Financial arrangements are clearly performed by Alcatel with IBM GF.

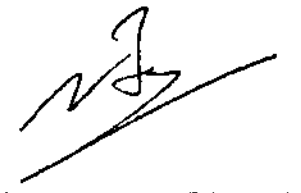
INDICATORS from AAS 17 para 5.3.2	Agency owns Assets	Contractor owns Assets	Notes
Risks of unsatisfactory performance	X	✓	Clearly the contract provides for the contractor to be penalised in circumstances of non-performance and non-availability.
Obsolescence risk	N/A	N/A	Given the time frames of PC equipment refreshes etc the contract inherently manages this risk for both parties.
Idle Capacity (Demand Risk)	X (✓)	✓	Short term PC rentals available (3, 6 and 12 months). Disk usage is variable charge on utilisation not deployment over baseline requirements. Annual resource baseline adjustments for PCs, printers etc done at levels of demand (Eg -20% to +20% variation = 0 discount / premium). Surplus equipment can be returned with savings being return to the group albeit that a premium for early cancellation is incurred (not unreasonably).
Losses in realisable value (Residual value risk)	<p>The most likely scenario in practice is that equipment existing at the end of the contract period would be retained by the Agencies with a view to either renegotiating the contract with the same outsourcer or re-selling 'end of term' acquired equipment back to a new outsourcer. In such circumstances WDBV would apply (refer table in previous Section 7.3), which given the depreciation method in place, would equate well to likely market values such that residual value risk would be low. Moreover, as per the entry into this existing Group 5 contract, the Agencies can simply transfer assets to an incoming outsourcer at zero cost and receive reduced rentals of equipment up until the time of the first refresh with the new outsourcer. Consequently, in practice, residual value risk isn't likely to eventuate. Appreciably, the issue of application fileservers is interesting in that the Group is not allowed to purchase them and at the same time the Group would hold out that the fileservers are not surplus to their needs. Finally, it is also important to remember that for all old equipment that is refreshed during the term of the contract, the contractor wears all the risks and benefits of disposal.</p>		
Uninsured damage	X	✓	Contractor required to take all risk of loss or damage except malicious / negligent act by Group member (Group 5 Agreement - paragraph 27.3).
Condemnation of Asset	X	✓	Not likely to occur but if it possibly did occur then it is our view that it would be the contractor's responsibility to continue to provide the services contracted.

8.0 Conclusions

Based upon our review of relevant Australian and overseas accounting standards and position papers and the information provided to us in relation to the Group 5 IT Outsourcing arrangements - we have reached the following conclusions.

- The contract between Group 5 Agencies and Advantra is a services contract.
- The nature of the services contract is such that it is executed (partial performed) throughout its term.
- The contract does, in substance, contain leases of IT-related equipment although upon analysis we believe that the equipment and service components are not readily separable.
- The essential economic substance of the arrangements attached to the different items of equipment, coupled with an assessment of the risks and indicators of ownership, are such that we are of the opinion that they are best represented from an accounting perspective as operating leases.

Yours sincerely



N J Baker
Partner KPMG



J H Richardson
Partner KPMG

Disclaimer:

This advice has been prepared on the basis of the information provided to us by the Federal Department of Finance and Administration ('the Department') as outlined on page one of this advice. This information contained facts and circumstances regarding the matter upon which we have provided advice. Should actual facts and circumstances differ from those conveyed to us then our conclusions reached in this advice may not be valid.

We believe that the statements made in this letter of advice are accurate, but no warranty of accuracy or reliability is given. Accordingly, neither KPMG, nor any member or employee of KPMG undertakes responsibility arising in any way whatsoever to any persons other than the Department in respect of this letter, for any errors or omissions herein, arising through negligence or otherwise, however caused.

This letter is for the sole use of the Management of the Department. We also stress that the ultimate responsibility for the accounting treatment of any transaction must rest with the Management of the Department.

This letter advice should not be used for any other purpose than those specified herein, nor may extracts or quotations be made without our express written approval.

C

Mr Simon Ash
Branch Manager – Ownership
Department of Finance and Administration
John Gorton Building
PARKES ACT 2600

4 August 2000

Re: Follow On Accounting Advice for Commonwealth IT Service Agreement Contracts

Dear Mr Ash

1.0 Introduction:

I refer to our correspondence to you of 26 July 2000 in relation to the above mentioned matter and your subsequent correspondence of 2 August 2000 whereby you requested that we review the IT Service Agreement contract from clusters 3 and 5 as well as the ATO contract with a view of establishing whether or not our accounting advice would differ in relation to these three contracts.

2.0 Summary of Previous Accounting Advice:

Our previous advice to you in relation to the Group 5 contract concluded that:

- the IT Service Agreement contract is primarily a services contract,
- the nature of the services contract is such that it is executed (partially performed) throughout its term, and that consequently,
- the contract is best accounted for in such a way that the assets inherent or provided within it are not capitalised.

We further concluded:

- The contract does, in substance, contain leases of IT-related equipment although upon analysis we believe that the equipment and service components are not readily separable – a problem not uncommon in transactions of this type. *(You will also recall our discussion on the difficult nature of classifying service agreements by reference to a broader spectrum of accounting thinking as it is emerging on the international scene. Particularly, we made reference to both the G4+1 position paper and the relatively recent amendment to the UK FRS 5 "Reporting the substance of Transactions").*

- When analysing the risks and benefits incidental to ownership, we believed the leases contained within the group 5 services contract more reflected a Contractor ownership posture rather than an Agency ownership posture. *(In supporting our view in this area we provided summary tables (Pages 13-15 of the 26 July advice refers) which presented our view as to where the risks and benefits of ownership reside).*

In summarising our position in section 2 of our advice of 26 July we stated that:

"From an accounting perspective, after considering the essential economic substance of the arrangements attached to the different items of equipment, coupled with an assessment of the risks and indicators of ownership, we have reached the opinion that such assets are best represented as operating leases, ie they are not capitalised".

The overall effect of our advice was to suggest:

"...that these contracts are best viewed as single service contract arrangements and that best accounting practice would require that the service contract's commitments / obligations in future years be reflected in the Primary Commitment Note to the financial statements of participating Agencies. In this way full accounting disclosure can be made without the requirement to pursue a detailed 'unpicking' arrangement that would seek to capitalise certain aspects of the overall arrangement. We believed that this would provide for a far cleaner presentation of the overall contractual arrangement as opposed to one which would break up the costs of the overall arrangement into capitalised and non-capitalised (commitment) components".

3.0 Information Provided to Us:

As your accounting advisors on this matter we note the information provided to us which has included:

- the Group 3 IT Service Agreement contract,
- the Group 8 IT Service Agreement contract,
- the ATO IT Service Agreement contract, and
- Lease Classification advice from Duesburys concluding that the ATO / EDS IT Service Agreement contains operating leases.

4.0 Relevant Facts pertaining to this Matter:

In view of our previous advice to you, we have provided a summary of the three additional IT Service Agreement contracts in accordance with the lease classification criteria provided by AAS 17 (Refer table provided at Attachment A). This table essentially applies the facts, as we view them, to the relevant tests in AAS 17. (Refer section 5 following).

5.0 Relevant Accounting Standards pertaining to this Matter:

Under AAS 17, a Finance Lease is defined as *a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incidental to ownership of the leased asset and where legal ownership may or may not eventually be transferred.*

AAS 17 defines an Operating Lease as *a lease under which the lessor effectively retains substantially all the risks and benefits incidental to ownership of the leased asset.*

The two key paragraphs to consider in the classification of a lease are:

- 5.3.1 *The classification of a lease depends upon its economic substance. Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor, the lease is an operating lease. Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease.*
- 5.3.2 *The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from the use of the asset and gains in realisable value.*

While AAS 17 contains a number of other criteria for classifying leases (paragraphs 5.3.4 and following) it is important to note that paragraph 5.3.3 states: *'The following criteria are presented as guidelines to assist lessees and lessors in classifying leases. However, their application is not a substitute for applying the definitions of "finance lease" and "operating lease"'*

Notwithstanding this, we believe it is also important to highlight the reasons why we do not believe that paragraph 5.3.4 is met. Under paragraph 5.3.4 the standard states:

- 5.3.4 *The effective passing of substantially all of the risks and benefits incident to ownership from a lessor to a lessee is normally presumed where both of the following criteria are satisfied:*
- (a) *the lease is a non-cancellable lease*
 - (b) *either one or both of the following tests is met:*
 - (i) *the lease term is for 75 per cent or more of the remaining economic life of the leased asset*
 - (ii) *the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 per cent of the fair value of the leased asset at the inception of the lease.*

When defining what constitutes a non-cancellable lease the standard provides the following guidelines:

Non-cancellable lease means a lease which:

- (a) *can be cancelled only with the permission of the lessor or upon the occurrence of some remote contingency; or*
- (b) *the lessee, upon cancellation, is committed to enter into a further lease for the same or equivalent asset with the same lessor or a third party related to the lessor; or*
- (c) *provides that the lessee, upon cancellation, incurs a penalty of a magnitude that is expected to discourage cancellation in normal circumstances.*

It is our view, in light of the contracts we have reviewed, that the leases contained in these service agreements are, in fact, cancellable. We hold this view for the following reasons:

- The fact that either the Group or Agency may wish to reduce the amount of equipment being used (eg workstations) would appear to be clearly considered and planned for in contract. As such, we would deem the reduction of such equipment as being in the ordinary course of business. Its mere presence in the contract is substantial proof that such an event or contingency has been anticipated by both parties as being both probable and likely.
- The fact that a reduction from the full lease payment otherwise due for the life of the asset is provided for in the contracts implies that an Agency is financially better off to rid itself of surplus equipment because in doing so they will invoke some reduction of future costs. The fact that this 'penalty' is incurred by an Agency in such circumstances (ie resource usage below stated or nominated baselines) is not sufficient in our view to be of such a magnitude as *'to discourage cancellation'*. On the contrary, Agencies would have a clear fiduciary duty to realise savings for the Commonwealth as far as possible.

In conclusion, we hold the view that these contracts are cancellable, and as such the guideline principles of paragraph 5.3.4 do not apply. Consequently, we have provided (in Attachment) only our view of the risks and benefits of ownership as contained within these three contracts.

In doing so, we do not mean to detract in any way from our original view that the entire service posture of these agreements needs to be 'ever in scope' in order to ensure they are accounted for in a consistent and fair manner which recognises both *legal intent* and *accounting substance*.

6.0 Summary of our Accounting Advice on Additional IT Service Contracts:

In reviewing the additional contracts provided to us for:

- Group / cluster 3,
- Group / cluster 8, and
- The ATO

nothing has come to our attention that would suggest that our accounting advice to you on 26 July 2000 would be any different in respect to these contracts. Whilst we noted that the contracts do contain differences, both in comparison to each other and the group 5 contract, those differences do not, in our view, alter the substantial directions and conclusions contained in our previous advice.

Yours sincerely



N J Baker

Partner KPMG

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Applying the Tests of AAS 17:

INDICATORS from AAS 17 para 5.3.2

INDICATOR Description	AGENCY OWNS ASSETS			Contractor owns Assets	Notes
	Group 3	Group 5	ATO		
Risks of unsatisfactory performance	x	x	x	✓	Clearly the contract provides for the contractor to be penalised in circumstances of non-performance and non-availability. (Group 3 - para 8.1-8.6) (Group 8 - para 9.1-9.7) (ATO - para 9.1-9.7)
Obsolescence risk	N/A (x)	N/A (x)	N/A (x)	N/A (✓)	Given the time frames of PC equipment refreshes etc the contracts inherently manages this risk for both parties. However, to the extent to which obsolescent equipment was not able to deliver the services contracted then it would be the contractor's risk to rectify the service.
Idle Capacity	x	x	x	✓	Some contracts contain short term PC rentals. Mainframe charges in some contracts are based purely on usage rates, hence charges vary with demand. Disk usage is variable charge on utilisation not deployment over baseline requirements. Annual resource baseline adjustments for PCs, printers etc done at levels of demand in some contracts. Surplus equipment can be returned with savings being return to the group albeit that a premium for early cancellation is incurred (not unreasonable)

INDICATORS from AAS 17 para 5.3.2 (Continued)

INDICATOR Description	AGENCY OWNS ASSETS			Contractor owns Assets	Notes
Losses in realisable value	x	x	x	✓	<p>It is important to appreciate that for all old equipment that is refreshed during the term of the contract, the contractor wears all the risks and benefits of disposal. Given the extension periods provided in some of these contracts, this means that most of the assets provided during the full contract period will be dealt with in this fashion. Assets remaining at the end of the contract are usually available for purchase as an 'option' using WDBV. Surplus equipment is usually paid out by Agencies at the rate of (Outstanding lease payments - realisable value) - not unreasonable in the case of 'surplus' equipment.</p>
	(Some ✓)	(Some ✓)	(Some ✓)		
Uninsured damage	x	x	x	✓	<p>Contractor required to take all risk of loss or damage except malicious / negligent act by Group member. (Group 3 - para 27.3) (Group 8 - para 28.4) (ATO - para 28.4)</p>
Condemnation of Asset	x	x	x	✓	<p>Not likely to occur but if it possibly did occur then it is our view that it would be the contractor's responsibility to continue to provide the services contracted.</p>