



European Financial Reporting Advisory Group ■

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Kevin Stevenson
Chairman IFRIC
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER
PLEASE SEND YOUR COMMENTS TO
BART.DE.LEEUW@EFRAG.ORG BY NO LATER
THAN 29 APRIL 2005.

Dear Kevin,

Re: IFRIC Draft interpretations on Service Concessions Arrangements

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC draft interpretations D12 - Service Concessions Arrangements - *Determining the Accounting Model*, D13 – Service Concessions Arrangements - *The Financial Asset Model* and D14 – Service Concessions Arrangements - *The Intangible Asset Model*. This letter is submitted in EFRAG's capacity of contributing to IASB's and IFRIC's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the final interpretation.

On 18 November 2004 we provided you with a letter with our preliminary comments on the then available drafts. We expressed the view that we found the analyses of the various structures of concession arrangements and the illustrative examples performed by the IFRIC helpful as a basis for evaluation on how to account for certain concession arrangements. We are pleased to find that some of our earlier concerns have led to amendments incorporated in the draft interpretations. However we remain uncomfortable with important aspects of the issues dealt with in the drafts. Below we list our main concerns.

- While we can understand the reasons for limiting the scope of the interpretations, we are concerned that the scope is too narrow to provide a significant number of service concession operators with the necessary accounting guidance.

Many service concession arrangements will fall outside the scope of the interpretations and, although the paragraphs D12.BC17-D12.BC23 provide some explanation of how those arrangements should be accounted for, there are a number of important issues that are not addressed in those paragraphs. For example, we believe existing assets of the operator should have been dealt with in the interpretations so that guidance could have been provided on the circumstances in which the conditions of IAS 18 are not met, since we

believe this type of infrastructure occurs more often in reality than the IFRIC suggests.

- The IFRIC has identified two possible approaches to determine whether an operator should recognise service concession infrastructure as its property plant and equipment: the control approach and the risks and rewards approach. The IFRIC has chosen to adopt the first approach for reasons explained in the basis for conclusion even though the IFRIC uses also parts of the risks and rewards approach in defining the control criteria in SIC-12 *Consolidation—Special Purpose Entities*. In the Basis for Conclusions, the IFRIC justifies the focus on control by arguing that the control approach is more durable and the risks and rewards approach leads to complexities and inconsistencies and be difficult to apply to service concession arrangements. We do not find this justification to be convincing. We believe that the risks and rewards approach as an indicator for control, should not be ruled out. A risks and rewards approach may be useful to assist in clarifying various aspects of control, similar to the SIC 12 approach, where the transfer of risks and rewards is used for this purpose. We recognise that the IFRIC is seeking to apply a similar notion of control to the one that underpins IFRIC 4 *Determining whether an Arrangement contains a Lease*—an entity that controls the output of an asset controls the asset—but, in our view, the control test in paragraph D12.5 is flawed, as explained in more detail below in our answer to D12’s question 1.

We also question whether the control test in paragraph D5.12 would be the appropriate test to apply in other circumstances (ie more generally) and, if it is not, whether applying a special control test to transactions falling within the scope of the interpretations will result in inconsistencies in the application of the control concept. In our view the (draft) interpretations would benefit from having some additional material clarifying the position.

- If the control approach set out in paragraph D12.5 is met, the IFRIC has concluded that the infrastructure assets should be recognised on the balance sheet of the grantor and that the operator should recognise either a financial asset or an intangible asset, depending on whether it is the grantor or someone else who has the primary responsibility to pay the operator. Although we recognise the simplicity of such an approach, we are concerned that the result will sometimes be that transactions that are economically identical will be accounted for differently. For example, a service concession contract will be accounted for under the financial asset model when the operator receives payments from the grantor and under the intangible asset model when the operator receives the payments directly from the users. It follows from this that a shadow toll scheme will result in the operator recognising a financial asset, while a toll scheme will result in an intangible asset being recognised. We question this outcome because we believe the economic substance of the contracts could essentially be the same. Furthermore, we believe that determining the accounting model by looking only at who has the primary responsibility to pay, irrespective of who bears the

demand risk, will often not result in an accounting treatment that reflects the substance of the arrangement. Therefore, we believe that reintegration of the demand risk feature into the (draft) interpretation would be essential in order to provide a clear choice for the relevant model.

- Further we are dissatisfied with aspects of the intangible asset model; in particular the amount of revenue recognised under the model. We understand the reasons for the outcome, but would prefer a method of accounting under which total revenues are limited to the total cash inflows.
- Finally, we appreciate the efforts that the IFRIC has put into the work on the concession project. We again emphasise the importance and urgency of having a workable accounting interpretation for the European concession industry and regret that the whole process has been lengthy and time consuming. We stress the urgency of finalising the project, because in the absence of a final IFRIC interpretation by the end of 2005, European companies seeking to comply with IFRS will lack sufficient guidance how to properly account for service concession arrangements. However, we agree with the view first expressed in the IASB Research Group on Service Concession Arrangements that what is really needed if service concessions are to be accounted for appropriately is a comprehensive Standard dealing with recognition, measurement and disclosure, rather than a series of interpretations of existing standards. We hope therefore that the IASB will add this project to its work programme with the aim of replacing the interpretations with a standard as soon as possible.

Although the above concerns call into question whether the draft interpretations adequately address the problems relating to the accounting for service concession arrangements in an acceptable manner, we respond below within the framework of these interpretations to the detailed questions raised by the IFRIC.

If you would like further clarification of the points raised in this letter, I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX 1:

In this appendix we answer the questions of the drafts D12, D13 and D14.

Draft Interpretation D12: Determining the accounting model

Question 1:

The proposal in paragraph 5 of the draft Interpretation reflects the IFRIC's decision that whether an operator recognises service concession infrastructure as its property, plant and equipment should depend on whether it controls the use of that infrastructure. The IFRIC selected this approach instead of one based on the extent to which the risks and rewards of ownership lie with the operator. The rationale for selecting this approach is explained in paragraphs BC9-BC11 of the Basis for Conclusions. Do you support the approach selected?

In our letter of 18 November 2004 we expressed the view that in practice it would often be correct for the service concession infrastructure to be treated as an asset of the operator. For that reason it is important that the (draft) interpretations deal with borderline issues in a clear manner.

We question the appropriateness of the control approach set out in paragraph 5. The control approach proposed is based on the notion that an entity that controls the output of an asset also controls the asset itself. However, the way this notion has been reflected in paragraph 5 is flawed, because it ignores the possibility that the grantor has stipulated the services to be provided, the persons to whom the services should be provided, and the price at which the services should be provided—but not which assets are to be used. We are also concerned that the tests set out in paragraph 5(a) have the potential to be very form-based, and as a result may not be robust enough. Finally, we are not yet convinced that it is appropriate to disregard demand risk. The IFRIC criticises, in D12's basis for conclusions, the so-called risks and rewards approach, arguing that it is less durable. Yet, at the same time it includes a residual value risk test in paragraph 5(b) of D12 and adopts a risks and rewards based approach in some of its other work (SIC 12 for example). EFRAG believes that 'control' and 'risks and rewards' need not in fact be competing approaches; there is an interplay between the both approaches. For that reason we believe that the risks and rewards approach should not be ruled out. A risks and rewards approach may be useful to assist in clarifying various aspects of control, similar to the SIC 12 approach, where the transfer of risks and rewards is used for this purpose. Therefore, we believe that reintegration of the demand risk feature into

the (draft) interpretation is essential in order to be able to correctly determine the accounting model and determine who will recognise the asset on its balance sheet.

Do constituents support the view that there is a need for insertion of the demand risk feature into the interpretation? If they are, do they believe it should be inserted at the point of the existing control test (ie paragraph D12.5) or in the 'who has primary responsibility to pay' test (ie paragraph D12.11-12)?

The IFRIC has pointed out in D12's basis for conclusions that the control approach in D12 conflicts with the derecognition criteria set out in IAS 18.

On the one hand the draft explains that an asset should be recognised by the grantor since he controls its use (BC12), and on the other hand BC21 clarifies that an asset should be recognised by the operator unless and until the IAS 18 derecognition rules are met, even if the grantor controls the asset. This apparent difference might cause a practical conflict between the control concept and the derecognition rules of IAS 18 (transfer of risks and rewards), which is not properly dealt with in the draft interpretations. Similarly there seems to be a conflict between the draft interpretation and IFRIC 4. Both are based on the notion that an entity that controls the output of an asset controls the asset. However, D12.5's control test can be met without the grantor knowing precisely which assets are being used by the operator to provide the services; IFRIC 4, on the other hand, requires the fulfilment of the arrangement to be dependent on the use of a specific asset or assets.

We also note that the draft (BC 21) mentions that it is unusual for the operator to use its existing infrastructure assets in a new service concession arrangement as a whole. This statement surprises us because our understanding is different.

Furthermore, it appears that the application of AG C3, which explains that a capping mechanism is sufficient for the price to be regulated by the grantor, might lead to scoping out cases that are common in practice. For example, it is not clear whether a concession arrangement in which the operator has (partly) control of the pricing policy, depending on the substance of the arrangements, is outside of the scope. We believe that if so this is not appropriate and we recommend the IFRIC to provide additional guidance on this type of arrangements that may occur frequently in practice.

Additional comments

- We suggest a rewording of BC11. The paragraph states that the risks and rewards approach as applied in IAS 17, would necessarily lead to more complexities and inconsistencies, but we believe more substantive and more appropriate arguments should be put forward as a basis for conclusion
- We have an editorial comment on the last sentence of BC16. It would be more logical to change 'in principle' to 'under the conditions stated above'.

Question 2:

Paragraph 11 of the draft Interpretation proposes that the operator should apply the financial asset model only if the grantor has primary responsibility to pay for the concession services. The rationale is explained in paragraphs BC24-BC43 of the Basis for Conclusions. Do you agree with this proposal? If not, what criteria would you use to determine whether the financial asset model should apply? How would you reconcile those criteria to the definition of a financial asset set out in IAS 32 Financial Instruments: Disclosure and Presentation?

We believe that the determination of the accounting model as formulated in the current drafts simplifies the choice of model. On that basis we could be supportive of how to draw the line between the both models.

However we are concerned that drawing the line by who has the primary responsibility to pay, puts too much emphasis on the form rather than on the substance of the arrangements. We understand that the IFRIC believes that who has the primary responsibility to pay is significant because it determines whether a financial asset exists: if the grantor has the primary responsibility there is a financial asset and if the grantor does not have primary responsibility there is no financial asset. We believe that not only the primary responsibility to pay but also the demand risk should be applied to determining whether there is a financial asset. Our reasoning is as follows. According to IAS 32.AG 8, the ability to exercise a contractual right may be contingent on the occurrence of a future event. Following that logic and the similarities in certain concession arrangements between a guarantee of the grantor to pay and a financial guarantee, we think the borderline between a financial asset and an intangible asset should be drawn in a different place from that described in paragraph 11 and in the Basis for Conclusions, BC 40 through BC 44 because we think there might be a contractual right to receive cash—and thus a financial asset—to be recognised by the operator as a result of past transactions, even though the operator's ability to exercise his right is contingent on a future event the use of the guarantee.

Question 3:

As explained in paragraph BC44 of the Basis for Conclusions, paragraph 13 of the draft Interpretation proposes that the identity of the party or parties with primary responsibility to pay for the concession services should be determined by reference to the substance of the contractual arrangements (which would not be affected by, for example, changing the parties through whom payment is routed). Do you agree with this proposal?

We agree with this proposal.

We note that paragraph D12.BC44 explains that: *“Whether the financial asset model applies therefore depends on the operator’s contractual rights. However, the IFRIC did not wish to overemphasise the importance of legal form”*.

We are not, however, sure how these sentences should be understood. We understand that professional judgement should be exercised, but we would welcome

an explanation as to how the IFRIC would strike the balance between the messages of these two sentences and how the IFRIC would evaluate the substance of the contractual arrangements.

In practice it is not uncommon to have borderline situations where there may be practical difficulties in applying the test; for example where the operator is partly paid by both the grantor and the users. By applying the substance over form, a possible solution could be bifurcating the contract into two components, a receivable component (the part paid by the grantor) and an intangible component (the remainder part paid by the users). We would however welcome additional guidance on how to deal with borderline cases and to what extent, if any, the draft interpretations would require bifurcation of contracts.

Additional comments

- We wonder to what extent it would be required to switch between the two models when the substance of the contractual agreements changes. We believe that when the substance changes during the concession period, then the operator will have to account for the change accordingly.

Question 4:

The IFRIC aims to issue this and the two other proposed Interpretations on service concessions (D13 and D14) in final form before the end of 2005. It proposes that, subject to it achieving this aim, the three Interpretations should be applied for annual periods beginning on or after 1 January 2006. Do you agree with this proposal?

We have previously expressed our concern on the transitional issue.

The delayed issuance of the Interpretations creates practical problems for 2005. We think it is very important that the IASB issues the final drafts well before the end of this year so that companies have at least some time to prepare for any changes.

Companies in the industry are seeking guidance as to what they should do for the 2004 comparatives, in their 2005 interims, and until the final interpretations are issued.

The fact that no final interpretations are available at the beginning of 2005 creates a problem for those companies reporting to the capital markets on an interim basis. There is an understandable concern within the industry that they may have to change accounting policies more than once (first to comply with existing IFRS as required by the IAS 8 hierarchy and then to adopt the guidance provided in the interpretation) and that the resulting lack of consistency is not helpful to users of financial statements.

Finally we support a full retrospective application unless impracticable in which case the operator will have to recognise the financial or intangible assets that existed at the start of the earliest period presented and consequently use the previous carrying amounts of those assets as their carrying amounts as at that date performing an impairment test when necessary. It will be important however to ensure that such

prospective application would not result in the carrying forward of capitalised losses or capitalised interest.

Draft Interpretation D13 – The Financial Asset Model

Question 1:

As discussed in paragraphs BC3-BC5, the proposals in the draft Interpretation are based on a conclusion by the IFRIC that the discharge of each contractual obligation (including obligations to repair and maintain the infrastructure) gives rise to revenue for the operator. Do you agree with this conclusion? (Question 3 in the Invitation to Comment on draft Interpretation D14 Service Concession Arrangements—the Intangible Asset Model poses a similar question in relation to the intangible asset model.)

We agree with the conclusion, but think it would be helpful if the IFRIC could provide a fuller explanation of how it should be applied in practice.

Question 2:

As explained in paragraphs BC6 and BC7, the IFRIC has concluded that, applying IAS 11 Construction Contracts, operators might recognise different profit margins on different activities undertaken within a single service concession contract. Do you agree with this conclusion?

We support the line of thinking expressed in BC6 and BC7. Some TEG members believe that it would be useful from a user perspective to add a disclosure requirement, asking entities to disclose various profit margins used on different activities undertaken within a single service concession contract.

Do the constituents support this view?

Draft Interpretation D14 - Intangible Asset Model

Question 1:

In the intangible asset model on which this draft Interpretation is based, the service concession operator is regarded as receiving an intangible asset from the grantor in exchange for the construction or other services it provides to the grantor. Paragraph 7 of the draft Interpretation proposes that the operator should recognise revenue and profit or loss on that exchange. The rationale for this proposal and for an alternative view—ie that no revenue or profit should be recognised on the exchange—is set out in paragraphs BC7-BC14 of the Basis for Conclusions. Do you agree with the proposal? If not, how would you reconcile non-recognition of revenue and profit to the requirements of existing IFRSs?

Within the framework of the current drafts, we agree with the proposal because we believe it is correct to follow the line of thinking in paragraph 12 of IAS 18 which states that when goods or services are rendered in exchange for dissimilar goods or services, the exchange should be regarded as a transaction that generates revenue. However as mentioned already, one of the main concerns is that the application of the two different models will lead to different revenue recognition although the substance of the transactions is economically very similar.

Question 2:

As explained in paragraph BC6 of the Basis for Conclusions, the draft Interpretation does not specify the timing of recognition of the intangible asset. The IFRIC identified three possible approaches. Do you agree that the proposed Interpretation should remain silent on this matter? If not, which of the three approaches do you think should be specified and in what circumstances?

We believe the interpretation should be more specific with respect to the timing of recognition of the intangible asset. It should also explain the basis for the approach chosen.

In our view, the first alternative (a), which recognises the intangible asset at the outset of the contract, would result in the recognition of an executory contract on a 'gross' basis, which is not how executory contracts are currently accounted for. Therefore this alternative is in our opinion not a valid option unless service concession arrangements are to be treated as an exception to the usual approach adopted for executory contracts.

Alternative (b) proposes that the cost of the construction services should be built up as the construction progresses, measured by reference to the stage of completion, and that an intangible asset is received once construction is complete. Until then, a receivable is recognised

In alternative (c) the operator will receive an intangible asset only after it has completed and finalised the construction phase. Until then, it is argued, there is no intangible asset to recognise. This alternative is illustrated in the example attached to the interpretation and we support it.

Do constituents also prefer alternative (c)? If not, which do they prefer and why?

Question 3:

As explained in paragraph BC16 of the Basis for Conclusions, the proposed requirements for maintenance and repair obligations in this draft Interpretation are different from those in D13 Service Concession Arrangements—The Financial Asset Model. Do you agree that the IFRIC has interpreted existing IFRSs correctly in respect of these proposals?

Assuming that the two accounting models would be designed to produce different accounting treatments (a solution which we do not favour), we agree with the interpretation and the resulting difference in treatment between them. Under the intangible asset model, a repair obligation is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

It is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the usage of the asset by that date and (normally) increases on a periodical basis (yearly). The operator discounts the provision to its present value in accordance with IAS 37.

Under the financial asset model, all contractual obligations are obligations in respect of which revenue is recognised, which means that they are measured on the basis of the amount of revenue received as correctly interpreted by the IFRIC.