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European Commission
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1049 Brussels

23 March 2007

Dear Mr Holmquist

Adoption of IFRIC 12 *Service Concession Arrangements*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRIC 12 *Service Concession Arrangements* (IFRIC 12), which was published on 30 November 2006. It was issued in draft as D12-14 and EFRAG commented on those drafts.

IFRIC 12 gives guidance on the accounting by operators for public-to-private service concession arrangements. The Interpretation applies to public-to-private service concession arrangements if:

- (a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
- (b) the grantor controls—through ownership, beneficial entitlement or otherwise - any significant residual interest in the infrastructure at the end of the term of the arrangement,

except that infrastructure used in a public-to-private service concession arrangement for its entire useful life needs to meet only condition (a) to be within the Interpretation's scope.

The Interpretation applies to both infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement and existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement. It does not however specify the accounting for infrastructure that was held and recognised as property, plant and equipment by the operator before entering the service arrangement, referring to the derecognition requirements of IFRSs.

IFRIC 12 becomes effective for annual periods beginning on or after 1 January 2008, with earlier application permitted.

EFRAG has carried out an evaluation of IFRIC 12. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the

content of this letter, it took the comments received in response into account. EFRAG's discussions of technical matters are open to the public.

EFRAG supports IFRIC 12 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

- (a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 12 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix 1—Basis for Conclusions'.

A minority of EFRAG members (three) has concerns about IFRIC 12 that cause those members to believe that EFRAG should not recommend the Interpretation for endorsement. The reasoning of those members is explained in the attached 'Appendix 1—Dissenting Views'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1

Basis for Conclusions

Set out below is the basis for the conclusions reached and the recommendation made by EFRAG in respect of IFRIC 12 Service Concession Arrangements.

- 1 When evaluating IFRIC 12, EFRAG asked itself four questions:
 - (a) Is there an issue that needs to be addressed?
 - (b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?
 - (c) Is IFRIC 12 a correct interpretation of existing IFRS?
 - (d) Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?

IS THERE AN ISSUE THAT NEEDS TO BE ADDRESSED?

- 2 It is clear from the discussions that EFRAG has had during its meetings, from the comment letters that it has received, feedback obtained from the service concession industry and from the experiences of its own members that there are indeed different views amongst stakeholders as to how existing IFRS should be applied when accounting for service concession arrangements. Further, there is evidence that this uncertainty is leading to differences in practice and that those differences in practice can be significant. For those reasons all members of EFRAG agree that accounting for service concessions is an issue that needs to be addressed.

IS AN INTERPRETATION AN APPROPRIATE WAY OF ADDRESSING THIS ISSUE?

- 3 As explained in the previous section, there is uncertainty amongst stakeholders as to how existing IFRS should be applied when accounting for service concession arrangements. IFRIC Interpretations are often the most appropriate way of dispelling such uncertainty. However, that is not always the case.
 - (a) If the uncertainty arises from inconsistencies between standards, it might not be possible to eliminate the uncertainty by issuing an Interpretation.
 - (b) If it is impossible to interpret existing IFRS in a way that meets all the endorsement criteria—to achieve that, new or amended IFRSs are needed—an Interpretation is not appropriate regardless of the diversity it will eliminate. It might be that optimal accounting cannot be achieved without issuing new or amended IFRSs, but significant improvements can be achieved by issuing an Interpretation. Where that is the case, issuing an Interpretation can be considered appropriate—even though optimal accounting will not result—as long as the Interpretation meets all the endorsement criteria.
- 4 Against this background, EFRAG considered whether an Interpretation is an appropriate way of addressing the issues that exist in applying IFRS to service

concession arrangements. All the members of EFRAG agree, for the following reasons, that it is.

- (a) One of the biggest concerns that exist currently is that, because of the uncertainty as to how IFRS should be applied to service concession arrangements, there is a wide diversity of practice. An IFRIC Interpretation that addresses the right issues in sufficient depth will eliminate that uncertainty (and therefore result in converged practice).
- (b) Whatever their concerns about the content of IFRIC 12, all the members of EFRAG agree is that it is possible to develop an Interpretation on service concession arrangements that would both reduce diversity of practice and result in financial statements that provide a true and fair view. Had the IASB chosen to issue a new or amended IFRS, it might have been possible to deal with a number of arrangements that are not dealt with in IFRIC 12 and it might have been possible to take a fresh look at some IFRSs that some commentators believe stand in the way of achieving optimal accounting for service concession arrangements. However, assessing whether optimal accounting is reached or whether a different accounting would have been a valid alternative is not a criterion for endorsement. EFRAG is of the opinion that an Interpretation on service concession arrangements could improve consistency and comparability and result in financial statements that provide a true and fair view. In fact, as will be pointed out below, nearly all EFRAG members, besides their concerns on the drafting, believe that IFRIC 12 results in an appropriate accounting solution for service concession arrangements.

- 5 Some commentators have argued that using an Interpretation to deal with accounting issues that arise in the context of service concession arrangements is not appropriate because it suggests that service concession arrangements are not important. EFRAG does not agree with this argument. IFRIC Interpretations and IFRSs have the same status as each other and the fact that the IASB has chosen to issue an Interpretation rather than an IFRS says nothing about the importance the IASB attaches to the subject.
- 6 Further, EFRAG believes that, if an appropriate interpretation of existing IFRS literature and underlying principles results in financial statements that provide a true and fair view, increase comparability and consistency, an Interpretation would be an appropriate response to at least some of the issues and could meet the criteria for endorsement even though a different result could have been achieved by issuing a new standard and / or amending IFRS principles.

IS IFRIC 12 A CORRECT INTERPRETATION OF EXISTING IFRS?

- 7 IFRIC 12 is by far the longest and most complex Interpretation that IFRIC has issued, and service concession arrangements is a complex subject anyway. EFRAG's analysis of IFRIC 12 has been complex because some EFRAG members believe it is in places not well drafted and contains other weaknesses.
- 8 As has been explained in Appendix 2, three EFRAG members think there are so many weaknesses and consequential issues and those weaknesses and issues are, as a whole, so important that endorsement of the Interpretation is not appropriate. Other EFRAG members agree with some of the weaknesses and issues identified by

those EFRAG members or have other concerns, but do not attach the same importance to them collectively and therefore believe that they should not prevent endorsement. They believe in particular that it is important to put those weaknesses and concerns in their proper context. That context can be summarised by considering the four principles on which the fundamental accounting model set out in IFRIC 12 is based.

- (a) The operator will not recognise any of the infrastructure that falls within the scope of IFRIC 12. As explained more fully in paragraph 13 below, only one EFRAG member disagrees with this principle.
- (b) To the extent that the contract involves construction, upgrade and operations phases, the construction and upgrade phases should be accounted for together but separately from the operations phase. Again, only one EFRAG member disagrees with this principle (for the reasons set out in paragraphs 17 and 20 below).
- (c) If and to the extent that the operator provides construction or upgrade services, it will recognise either (and in some cases both) a financial asset (ie a receivable) or an intangible asset (ie a right to charge for usage). Only two EFRAG members disagree with this principle (for the reasons set out in paragraph 21(a) below).
- (d) Whether (and the extent to which) the operator has a financial asset or an intangible asset will depend on whether (and the extent to which) the operator's income from providing services under the contract is exposed to demand risk. Only two EFRAG members disagree with this principle (for the reasons set out in paragraph 23 below and consequential of their disagreement with (c) above). However, although all other EFRAG members agree with that it is the right principle on which to base accounting for service concessions arrangements—and many of them believe the principle is based on a correct, or at least reasonable, interpretation of the existing literature—some believe it has been possible for IFRIC to enunciate that principle only by 'stretching' certain definitions and criteria set out in existing IFRS inappropriately (as explained in paragraph 25(a) below).

All the other weaknesses and concerns raised do not involve disagreement with the fundamental model; rather, they are about the details.

Which existing standards need to be interpreted?

- 9 As the references at the beginning of the Interpretation make clear, IFRIC 12 is an interpretation that had to consider 14 standards, two interpretations, and the Framework. One EFRAG member thinks this is wrong; as explained in appendix 2, in his view, service concession arrangements have the characteristics of leases and as a result the Interpretation should have been largely an Interpretation of IAS 17. EFRAG disagrees with this conclusion. In its view, leases and service concession arrangements are just two examples of a relatively new type of transaction in which some or all of the rights and obligations that usually attach themselves to ownership of physical items are separated from ownership and each other and shared amongst different parties. Leases are in many ways the simplest of these new type of transactions. As a result, treating service concession arrangements as largely akin to

leases would have meant ignoring that parts of the arrangements are also like licences (ie intangible assets), construction service contracts, etc.

The scope of IFRIC 12

- 10 EFRAG started its detailed analysis of IFRIC 12 by considering whether the Interpretation's scope was sufficiently clear. For example, some EFRAG members are concerned about the meaning of the word 'infrastructure'—whether the scope paragraphs should be applied to an arrangement's infrastructure as a whole or each infrastructure item separately—and how the scope paragraphs are to be applied to whole of life assets, especially those that are replaced during the life of the arrangement. Other issues that have been mentioned include the meaning of the term 'service concession arrangements'; whether the notion XXX of controlling or regulating what services are provided to whom and at what price is clear (see IFRIC 12.5(a)); and what control of a residual interest actually entails (see IFRIC 12.5(b)). A concern is that such uncertainties could result in inconsistencies in practice, which could have an effect on the comparability and understandability of the information provided.
- 11 EFRAG considered all these various issues. Ideally, every scope section in every IFRS and every IFRIC Interpretation should be crystal clear. However, in a principles-based set of financial reporting requirements that will rarely be the case. Instead, those applying IFRS are expected to use their judgement and those judgements will often play a fundamental role in the accounting process. EFRAG believes the scope section of IFRIC 12 is no different in that respect and therefore did not share the concerns raised.

Is it correct that, under existing IFRS, none of the infrastructure falling within the scope of IFRIC 12 should be recognised on the operator's balance sheet?

- 12 According to IFRIC 12, the operator shall not recognise on its balance sheet as property, plant and equipment any of the infrastructure items that falls within the scope of the Interpretation. That is because for an item of property to be an asset of an entity, that entity must control the right to use the item—and the operator will not control any of the infrastructure items falling within the scope of IFRIC 12. EFRAG considered whether this use of a test based on controlling the right of use is consistent with existing IFRS.
- 13 One EFRAG member thinks it is not consistent with existing IFRS to use the notion of 'a right of use' in isolation from a 'risks and rewards' test. In its view the 'risks and rewards' test is necessary to clarify aspects of the 'control' notion and help ensure that assets are recognised only by those who control them. That member believes that, without the test, IFRIC 12 will not necessarily correctly reflect the economic substance of the underlying service concession arrangement because an operator could be exposed to all the demand risk—usually the biggest risk—and still not recognise the infrastructure. This made this EFRAG member believe that the endorsement criterion of true and fair view is not met and that he could therefore not support endorsement.
- 14 However, EFRAG thinks the use of 'a right of use' test in isolation *is* consistent with existing IFRS.

- (a) EFRAG notes that existing IFRS is inconsistent on this issue. For example, although IAS 17 gives a fundamental role to the 'substantially all the risks and rewards' test, IAS 16 does not even mention it and the derecognition requirements in IAS 39 is somewhat undecided. EFRAG thinks that, in such circumstances, what is important is whether the Interpretation is reasonable.
- (b) EFRAG believes that it would be unusual for the operator to have retained substantially all the risks and rewards incidental to ownership of the infrastructure under the circumstances in which the grantor has placed severe constraints on the operator's ability to access the rewards normally associated therewith and, in addition, has any significant residual value risk. EFRAG concluded that even if the operator is exposed to the demand risk, it is unlikely to be substantial (because it would be extremely unusual for a private sector entity to be willing to take on a risk it cannot manage—which would be the case with any demand risk the operator might be exposed to—unless that risk is not substantial). Therefore, the absence of a risks and rewards test is unlikely to have any effect on the accounting in the vast majority of cases.

15 The second issue EFRAG considered was whether in the circumstances described in the Interpretation it is a correct interpretation of existing IFRS to conclude that the operator does not control the right to use the infrastructure items. EFRAG believes that in the circumstances described in IFRIC 12 the Interpretation has correctly interpreted existing IFRS on this issue.

Are IFRIC 12's disaggregation requirements consistent with existing IFRS?

16 EFRAG next considered whether the disaggregation of the service concession contract required by IFRIC 12 is consistent with the principle in IAS 18 that, where necessary, contracts should be disaggregated into separately identifiable components to ensure that the substance of the transaction is accounted for correctly.

17 One EFRAG member believes that the disaggregation that IFRIC 12 requires results in the use of unreliable revenue numbers, because it will be necessary either to allocate the total contract consideration amount between the separately identified elements of the contract on the basis of extremely difficult-to-estimate relative fair values or to estimate the fair value of the intangible asset received. This EFRAG member therefore believed that understandability, reliability and comparability would be impaired. For that reason, that member believes the contract should not generally be disaggregated. However, no other EFRAG member shares those particular concerns, at least not to the same extent. Accounting involves making certain estimates, and some of those estimates are made in conditions of great uncertainty. However, in all cases, IFRS requires these estimates to be reliable and relevant to be appropriate. EFRAG thus concluded that these uncertainties are no different from other cases.

18 A number of EFRAG members have concerns about the disaggregation that IFRIC 12 requires of maintenance and repairs services provided by the operator.

- (a) There are in theory two ways to account for maintenance and repairs services provided under a service concession arrangement.

- (i) They can be viewed as separately identifiable components of the service concession arrangement. Under this view, revenue is allocated to the activity and, as it is undertaken and the costs are incurred, revenue is recognised. As a result, no provision is made in advance for the costs expected to be incurred.
- (ii) They can be viewed as not involving separately identifiable components of the service concession arrangement. Under this view, they would not be a revenue generating activity. Instead, a provision is made in advance for the costs expected to be incurred in accordance with IAS 37.

Some EFRAG members believe that it is not clear which approach IFRIC 12 requires to be applied.

- (b) Some further believe that, if IFRIC's intention is that maintenance and repairs services provided when the Financial Asset model¹ is being applied should be accounted for differently from exactly the same services provided when the Intangible Asset model is being applied, that would be an incorrect application of the principle in IAS 18 (which seems to require all maintenance and repairs services that are in substance the same to be treated in the same way).
- (c) However, other EFRAG members do not share these concerns, believing that IFRIC 12 is sufficiently clear and consistent with the principles in IAS 18. Although IAS 18 does not give much detailed guidance on how to disaggregate, IAS 18 is clear in requiring disaggregation whenever different goods or services are being provided in a single contract.

19 Those issues apart, all EFRAG members agreed that IFRIC 12's disaggregation requirements—which require service concession arrangements to be disaggregated into a construction/upgrade component and an operations component but no further—are consistent with existing IFRS. They note that, although there would usually be a single contract, the two components identified are completely different economically. Indeed, this is often reflected in the way the financing is arranged, with the whole contract being refinanced at significantly lower interest rates at the end of the construction/upgrade phase.

20 Existing IFRS does not set out how revenue should be allocated between the separately identifiable elements of a contract. As explained in paragraph 17, one EFRAG member believes that the approach required by IFRIC 12—allocating revenue on the basis of the relative fair values of each of the components—would result in unreliable and highly subjective allocated revenue numbers. However, the other EFRAG members believe IFRIC 12's approach is reasonable. It will mean that there is more estimation than would otherwise be the case, but they believe that that estimation is inevitable if the contract is to be disaggregated and disaggregation is necessary if the accounting is to reflect the substance of the transaction. EFRAG believes that this is in line with the general need to apply judgment in a principle based accounting framework.

¹ EFRAG is aware that IFRIC 12 does not refer to 'models'. However, for simplification during discussion, it continues to refer to models.

Is it correct that, under existing IFRS, the operator has either (or both) a financial asset or an intangible asset representing the consideration received or receivable?

- 21 Having concluded that the infrastructure items falling within the scope of the Interpretation are not assets of the operator, IFRIC considered what if any assets should be recognised by the operator. It concluded that, during any initial building phase, the operator would receive consideration for the construction services provided in the form of either a financial asset (a right to cash payment) or an intangible asset (ie a right to charge users).
- (a) Two EFRAG members do not believe that to be a correct interpretation of existing IFRS; one believes that the asset the operator has is part of the cost of the infrastructure assets that the operator should be recognising and the other thinks it is a lease prepayment. However, both those members believe that a different accounting model to the one applied in IFRIC 12 is appropriate (see paragraph 9 above and paragraph 3 of appendix 2) and they base their view of the asset arising on that different accounting model.
- (b) In the view of EFRAG, having accepted that the infrastructure items should not be recognised by the operator as assets and that the lease accounting model is not the model to be applied, it is not controversial that under existing IFRS sometimes the operator will have an intangible asset, sometimes a financial asset, and sometimes both.

Is the line between when to recognise a financial asset and when to recognise an intangible asset drawn in the right place?

- 22 According to IFRIC 12, whether (and the extent to which) the operator should recognise a financial asset and/or an intangible asset will depend on whether the operator has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor. If and to the extent that it has such a right, a financial asset will be recognised. Otherwise, an intangible asset will be recognised. IFRIC 12.16 goes on to explain that the operator has such a right if, for example, “the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between the amounts received from users of the public service and specified or determinable amounts...” EFRAG considered whether this is a correct interpretation of the existing IFRS literature.
- 23 Some EFRAG members do not think that it is a correct interpretation of existing IFRS. In their view, if the grantor provides a guarantee of the type described in IFRIC 12.16, what the operator has is:
- (a) an equally unperformed executory contract with users to provide a service and in return be paid, plus
- (b) a right to receive payments from the grantor that is contingent on the payments from users falling below the minimum specified (in other words, a guarantee).

The guarantee is a contingent asset and, under existing IFRS, contingent assets are not recognised in the balance sheet until they cease to be contingent. In other words, they believe that IFRIC 12 is varying the recognition criteria that would usually apply

to guarantees of this kind; which is not an appropriate thing to do without formally amending those criteria.

These concerns resulted in three EFRAG members believing that such a variation in recognition criteria, has a negative impact on the understandability, reliability and comparability of the financial information.

- 24 However, EFRAG believes the guidance given by IFRIC 12 in this area is consistent with existing IFRS, for the following reason. It is a fundamental principle of accounting that one must look at the substance of an arrangement and not just its form. When the operator has a right to receive payment based on usage that is underwritten by a guarantee from another party that, if the usage payment falls short of a specified amount, the guarantor will make up the difference, what the operator has in substance is an unconditional right to receive the guaranteed amount plus a right to receive additional amounts if usage exceeds the specified amount. (In effect, the grantor owes the operator an amount and has put in place arrangements that mean that any payments by users will be offset against that obligation.) Thus, the operator has a financial asset. In other words, those EFRAG members believe that all IFRIC has done is take the substance of the arrangements into account in applying the financial asset definition.

The accounting to be adopted when the financial asset is to be recognised

- 25 EFRAG considered the accounting that IFRIC 12 requires to be adopted when a financial asset is recognised to determine whether that accounting is consistent with existing IFRS. In EFRAG's view the only potentially controversial issue not already discussed above concerns the asset that the operator recognises during the construction/upgrade phase. This asset, which is often referred to somewhat vaguely as a 'due from customer' balance, is treated by IFRIC 12 as a financial asset.

- (a) A number of EFRAG members are not convinced that this asset meets IAS 32's definition of a 'financial asset'. That is because under IAS 32's definition a financial asset does not exist unless and until the operator has an unconditional contractual right to a financial asset. In the view of these EFRAG members, the operator will typically not have an unconditional contractual right until the operator has met specific criteria (such as—but not limited to—finalisation of the construction of the infrastructure and making it ready for use) under the contract. They therefore believe IFRIC 12 changes (or 'stretches') IAS 32's definition of 'financial asset', even though IAS 32 has not been formally amended. In their view, it is not appropriate, as a matter of principle, to stretch an established definition in this way; if a definition is wrong, it should be formally amended.

These concerns resulted in three EFRAG members believing that such a change in definition has a negative impact on the understandability, reliability and comparability required of the financial information.

- (b) However, other EFRAG members have one or both of the following views:
- (i) Existing IFRS is silent on whether the due from customer balance is an unconditional right (and therefore a financial asset), and there clearly exist different views on the subject. In those circumstances it is reasonable—

and within IFRIC's remit—for it to clarify the position. Furthermore, it is reasonable—and within IFRIC's remit—for it to clarify the definition in a way that gives new or adjusted meaning to the definition *as long as that new or adjusted meaning is not inconsistent with the wording in existing IFRS*. In the view of some EFRAG members, the new or adjusted meaning *is* consistent with the wording of existing IFRS.

- (ii) Even if that were not the case, giving an existing definition new or adjusted meaning would only be a significant issue for EFRAG's endorsement decision were it to result in significantly different accounting than would otherwise be the case. In the view of some EFRAG members, that is not the position in this case.

Therefore, EFRAG did not share the concerns raised by the three EFRAG members.

The accounting to be adopted when an intangible asset is to be recognised

- 26 EFRAG then considered the accounting that IFRIC 12 requires to be adopted when an intangible asset is to be recognised in order to determine whether it is consistent with existing IFRS. Several issues were considered in particular.
- 27 The first issue was whether it is right under existing IFRS that, when the Intangible Asset model is applied, the operator will recognise as revenue an amount that can be much higher than the cash received under the contract. Some EFRAG members thought it was not correct; the total revenue earned on the contract should equal the total cash received. However, the other EFRAG members disagreed, arguing that there are in effect two transactions: in the first transaction the operator barter construction/upgrade services with the grantor for an intangible asset (the licence to charge); and in the second transaction the operator uses that intangible asset to charge users. It is appropriate to recognise revenue on the first transaction and the amount of that revenue is the amount of consideration the operator receives in return for the services provided (ie the value of the intangible asset). Recognising revenue in certain barter transaction is a requirement of existing IFRS. Therefore, revenue can be recognised in the absence of receipt of cash or only a partial receipt of cash.
- 28 All EFRAG members recognise that the value of that intangible asset can sometimes be difficult to estimate and, in the light of that, EFRAG considered whether the revenue recognition model that IFRIC 12 requires to be applied during the construction/upgrade phase is consistent with existing IFRS. Some EFRAG members are concerned that IFRIC 12 expects IAS 11's percentage-of-completion accounting to be applied in circumstances in which they believe IAS 11's criteria for applying percentage-of-completion accounting will not be met (because of the degree of uncertainty involved). However, the other EFRAG members note that IFRIC 12 itself states merely that IAS 11 shall be applied (IFRIC 12.14); it does not require percentage-of-completion accounting to be applied. Whether IAS 11's criteria for applying percentage-of-completion accounting can be met when the Intangible Assets model is being applied is a matter of judgement, taking into account the circumstances in each particular case. For example, it did not necessarily follow that, just because the consideration will be received in a non-cash form that could vary in value, IAS 11's criteria for applying percentage-of-completion accounting could not be met.

- 29 Finally, EFRAG considered what IFRIC 12 says about the capitalisation of borrowing costs in case of the intangible asset model to determine whether it is consistent with existing IFRS. Most EFRAG members found this part of the Interpretation poorly drafted and, as a result, capable of being understood to require a treatment of borrowing costs that is not consistent with existing IFRS. Indeed, several EFRAG members remain convinced that that is so. However, other EFRAG members concluded that IFRIC 12's requirements in this respect were consistent with existing IFRS.

DOES IFRIC 12 MEET THE CRITERIA FOR EU ENDORSEMENT?

- 30 Finally, EFRAG asked itself whether it believed that the information resulting from the application of IFRIC 12 would result in information that meets the criteria for EU endorsement; in other words, that:
- (a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
 - (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Interpretation.

- 31 All EFRAG members agree that IFRIC 12 will ensure much greater consistency in accounting for service concession arrangements. Where the Interpretation is unclear, some inconsistency might remain, but overall the increase in consistency will be significant.
- 32 EFRAG also considered whether the accounting that results from IFRIC 12 is appropriate. Some members did not believe it was appropriate, because they do not—as already explained—believe that the fundamental accounting model set out in IFRIC 12 is the right one. However, all other EFRAG members believe that, even though some question whether aspects of the model are based on a correct interpretation of existing IFRS, the appropriate principles have been identified for service concession arrangements. Furthermore, even though some EFRAG members have concerns about some of IFRIC 12's detailed requirements, all but two consider the resulting accounting treatment for service concession arrangements is acceptable.
- 33 In reaching these conclusions, EFRAG considered some issues not so far discussed in this appendix. For example, IFRIC 12 interprets existing IFRS as requiring that sometimes the operator will have an intangible asset, sometimes a financial asset, and sometimes both. Is it appropriate for there to be two models; does it reflect the economic substance involved? And does IFRIC 12 draw the dividing line between the two models in a place that represents a difference of substance? Some commentators, for example, argue that the effect of IFRIC 12 is to require two service concession arrangements that are in substance the same to be accounted for very differently. Two EFRAG members believe that there should not be two models, primarily because—as already explained—they believe that IFRIC 12 does not adopt the appropriate fundamental accounting model. However, EFRAG believes having

two models and drawing the dividing line where IFRIC 12 draws it, does reflect the economic substance of the arrangements involved. Service concession arrangements can differ in many ways, but a key difference is whether the operator acquires a licence (a right to charge users), a receivable or sometimes both. When there is a difference of substance, it is generally the case that the accounting will differ too.

- 34 Some commentators argue that the difference between acquiring a licence (an intangible asset) and acquiring a receivable (a financial asset) is not a difference of substance. In their view, one needs to consider the level of risk involved in order to ascertain the substance and economic reality of the arrangement. However, EFRAG notes that this was an issue that IFRIC considered during its deliberations (see, for example, IFRIC 12.BC50-BC52). EFRAG agrees with the conclusions IFRIC reached. EFRAG further believe that in many cases the bifurcation guidance included in IFRIC 12 will ensure appropriate mitigation of these concerns.
- 35 Secondly, EFRAG has considered whether IFRIC 12 has taken into account all the relevant aspects of service concession arrangements that are commonly seen. Some EFRAG members are concerned that IFRIC 12 might not have taken sufficiently into account mechanisms such as renewal and extension options and rights, profit or return on capital floors and caps, and similar revenue management mechanisms. These mechanisms are widely used in some jurisdictions to allocate risk between the parties and to alter the rights and obligations that they would otherwise have and without them many of the transactions would not take place. They are, as a result, often fundamental to the contract. However, other EFRAG members either do not share these concerns or do not share them to the same degree. In their view mechanisms that have the effect of guaranteeing that a minimum amount is received from operating the licence are taken fully into account. The Interpretation states merely that the other types of mechanism should not be taken into account in determining which model to apply, and therefore does not prohibit them from being recognised on the balance sheet should the necessary definition and recognition criteria be met.
- 36 Thirdly, EFRAG is aware that some commentators believe that IFRIC 12 does not result in service concessions being faithfully represented because it will result, under the Intangible Asset model, in large losses being recognised in the early years of an arrangement that is highly likely to be profitable overall. EFRAG has worked hard to ensure that it understands fully these concerns and, for example, EFRAG representatives have met with some of the commentators involved on a number of occasions.
- (a) In EFRAG's view the concerns relate to existing IFRS, rather than to IFRIC 12's interpretation of existing IFRS. For example:
- (i) some commentators have argued that it ought to be possible to apply percentage of completion method during the operating phase under the Intangible Asset model. However, EFRAG agrees that this would not be consistent with existing IFRS. That is because when the Intangible Asset applies the operator's customers during the operating phase are the users on the infrastructure assets, so the operator is delivering a service only as each user uses the infrastructure. The service is completely delivered at that point of time.

Additionally, EFRAG members noted that, even if the percentage of completion method would be appropriate, existing IFRS would not permit interest costs arising during the operating phase to be treated as part of the contract costs. Existing IFRS treats those costs as relating to the financing of construction of the infrastructure and not to the operating of the underlying infrastructure.

- (ii) Some commentators believe it is inappropriate that the operators will often recognise losses under the Intangible Asset model whilst investors in the contracts will recognise profits. However, EFRAG notes that under existing IFRS the accounting treatment of an interest varies depending on whether one controls, has significant influence or is 'just' an investor. That is the case regardless of whether it is a service concession arrangement or some other type of contract involved.
 - (b) EFRAG also does not share the view that IFRIC 12 (and therefore existing IFRS) will not result in a fair presentation of some service concession arrangements. The 'fair presentation' notion reflects, amongst other things, what it is that accounting is expected to achieve. Currently, existing practices envisages that, even though an activity is expected to be profitable overall, losses may be suffered on the activity in any individual accounting period. Similarly, existing accounting practice generally treats interest costs that are not incurred in the construction of an asset as costs of the period. It is against these expectations that the accounting resulting from IFRIC 12 should be judged.
 - (c) As a result, having considered the concerns in detail and at length, all EFRAG members have concluded that they do not share the concerns expressed.
- 37 All EFRAG members have some concerns about IFRIC 12. The issue that EFRAG members have therefore had to consider is whether those concerns are significant enough either in isolation or when taken together to lead the member to conclude that the criteria for endorsement are not met.
- (a) Three EFRAG members believe they are, primarily because in their view IFRIC 12 has stretched various aspects of existing IFRS in ways that, though resulting in acceptable accounting for service concession arrangements, might not result in acceptable accounting for analogous transactions; thus creating reliability, comparability and understandability issues.
 - (b) On the other hand, some other EFRAG members do not believe that existing IFRS has been stretched in the way indicated and therefore do not believe that IFRIC 12 could result in analogous transactions being accounted for inappropriately;
 - (c) some believe that even though parts of existing IFRS have been stretched, it will not result in analogous transactions being accounted for inappropriately; and
 - (d) some pointed out that any inappropriate accounting that might result is not sufficient to justify non-endorsement of the Interpretation.

38 As a result, having weighed the different arguments brought forward in the discussion, EFRAG as a whole concluded that it should recommend endorsement of IFRIC 12.

Appendix 2 Dissenting Views

The views of the three EFRAG members who voted against recommending endorsement of IFRIC 12 are explained in this appendix.

- 1 Three EFRAG members (Mr Roberto Monachino, Mr Michael Starkie and Mr Carsten Zielke) believe that IFRIC 12 should not be endorsed for use in the European Union and therefore dissent from EFRAG's decision to recommend its endorsement.
- 2 Mr Monachino and Mr Zielke have a number of concerns about the content of IFRIC 12. Those concerns are, they believe, satisfactorily explained in Appendix 1, although they would draw different conclusions from those concerns than EFRAG as a whole: in their view:
 - (a) although none of the concerns, when considered separately from each other, is so significant in itself that it causes them to conclude that the Interpretation does not meet the criteria for endorsement.
 - (b) those concerns are so numerous and sufficiently important that, when considered together, they cause them to conclude that IFRIC 12 does not meet the endorsement criteria.
- 3 Mr Starkie believes that service concessions have the characteristics of leases and that as a result the Interpretation should have been largely an interpretation of IAS 17 *Leases*. For example, in his view:
 - (a) In a service concession arrangement, the grantor retains substantially all the risks and rewards incidental to ownership of the infrastructure. Under IAS 17, that would result in the grantor treating the infrastructure as being leased to the operator under an operating lease. Thus the operator would not recognise the infrastructure on its balance sheet. IFRIC 12 reaches the same conclusion.
 - (b) The operator may incur costs to build or upgrade the infrastructure but this is done for the sole purpose of earning revenue. An asset would therefore be recognised and, under IAS 17, it would be viewed as a prepayment for a lease, as the amounts would be incurred to earn revenue at a future date. Ultimately, this asset would be amortised over the life of the arrangement as the revenue is earned. An asset would also be recognised under IFRIC 12, although it would be a financial asset or intangible asset rather than a lease prepayment.
- 4 Mr Starkie therefore disagrees with IFRIC 12's fundamental accounting model. He also shares many of the concerns that are referred to in appendix 1 and draws the conclusion that Mr Monachino and Mr Zielke have drawn from them, i.e. not to support endorsement.