

24 05 2005

Chairman IFRIC  
30 Cannon Street  
London EC4M 6XH  
UK

Dear Sir,

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.

#### The scope

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 arrangements in which the operator uses its own existing assets 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 than the IFRIC suggests.

Furthermore, it is not clear whether a concession arrangement in which the operator has partial control of the pricing policy is outside of the scope. We believe that if it is outside the scope this is not appropriate and we recommend the IFRIC to provide additional guidance on this type of arrangements that may occur frequently in practice. It is important that the interpretations deal with borderline cases in a clear manner.

#### Control versus risk and rewards

The IFRIC has identified two possible approaches to determine whether service concession infrastructure should be recognised as property, plant and equipment: the control approach and the risks and rewards approach. The IFRIC has chosen to adopt the first approach for the reasons explained in the Basis for Conclusion even though the IFRIC uses 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 that the risks and rewards approach leads to complexities and inconsistencies and would 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 is an indicator for control and can therefore be useful to assist in clarifying various aspects of control, which is how it is used in SIC 12. For that reason we do not believe it should be ruled out.

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 inconsistent with D4's test and 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 D12.5 would be the appropriate test to apply in other circumstances (i.e. 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. We think it probably would, and that the comments in the Basis of Conclusions about the relationship between the interpretation and IAS 18 are just one example of it. In our view the (draft) interpretations would benefit from having some additional material clarifying the position.

In our response to D12, question 1, we have elaborated on our concerns by questioning a number of premises that underpin the IFRIC control approach.

#### The two accounting models

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 in substance 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, even if the amount of the payments is determined by usage, 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. We believe that determining which accounting model to apply by looking only at who has the primary responsibility to pay, irrespective of who bears the risks and rewards, will often not result in an accounting treatment that reflects the substance of the arrangement. Such an outcome seems to be difficult to reconcile with the Framework language on the Qualitative Characteristics of Financial Statements, e.g. understandability and relevance. Therefore, we believe that reintegration of the demand risk feature into the (draft) interpretation is essential if the choice of model is to take into account the substance of the arrangement.

Another reason why we are concerned about where the line has been drawn between the financial asset model and the intangible asset model is because we are not convinced that it is appropriate to recognise a financial asset in all the circumstances the interpretations propose one should be recognised. (See our more detailed comment in our response to Question 2 of D12.)

Our serious concerns on this issue has lead us to question whether only one accounting model should be applied, as the choice of accounting model in situations that are in substance the same would be accounted for very differently under the IFRIC interpretations. We are not sure that applicable standards could be interpreted in a way that would result in only one accounting model. However, when the IASB is working on a standard on service concessions (see our comment below), this is an approach that should be seriously considered.

#### *The intangible asset model*

From the point of view of understandability and relevance, we question the outcome of some aspects of the intangible asset model, in particular the amount of revenue recognised under this model. As we have explained in our response to questions 1 and 2 in D 14, a case could be made favouring the draft interpretation's approach, i.e. recognising revenue on the exchange of construction and other services provided for the acquisition of an intangible asset. However, a case could also be made in favour of an approach under which the construction costs are treated as payments to acquire the intangible asset with such costs accumulated on the balance sheet in accordance with IAS 38. Under this approach the construction would not be viewed as a revenue earning activity. Both of these approaches seem to be in line with existing standards. The uncertainty on this point would reinforce the strong position with a number of TEG members that the IFRIC has not yet reached the required level of quality in the draft interpretations and that further work is needed.

#### *Transitional arrangements*

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 set of accounting interpretation for the European concession industry and regret that the whole process of developing of the draft interpretations has been

lengthy and time consuming. We stress the urgency of finalising the project, because in the absence of appropriate guidance by the end of 2005, European companies seeking to comply with IFRS would find it difficult to assess how to properly account for service concession arrangements.

Even if suitable interpretations are in place by the end of 2005, we believe that grandfathering existing practices within specified boundaries is necessary for 2005.

We have elaborated on this issue in our response to question 4 in D12.

#### Need for a standard

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 draft interpretations with a standard as soon as possible. The IFRIC has carried out substantial analyses of concession service arrangements. This work should be utilised in the development of a standard with a wider scope and with a robust accounting model developed taking into account the concerns that we have addressed in this letter.

#### The way forward

We have a number of concerns with the draft interpretations. As a result, we would like to avoid an outcome where final interpretations would be issued along the lines of the draft interpretations.

If the IFRIC so wishes, we would be happy to participate in a working session with the IFRIC to discuss the various alternatives that the IFRIC may consider in completion of its work with service concession arrangements.

Although the above concerns seriously 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 any of the points raised in this letter, I would be happy to discuss them with you further.

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?*

We agree that the key factor in determining which party has the infrastructure assets is control. However, we disagree with the particular control approach set out in paragraph 5. We question a number of premises that underpin the IFRIC control approach. Our main concerns are addressed below.

- *The IFRIC claims that the grantor retains control by its ability to control or regulate.*  
In a sense a government has the power to control and regulate a number of assets in a number of sectors. Thus this feature is not specific for a service concession arrangement. Furthermore, the draft approach seems to be too general and not to take into account the rights of each party that are laid down in the concession contract. The grantors' ability to control may be restricted and regulated by the concession contract.
- *The grantor retains control as the operator does not have the right of use.*  
In a number of cases the operator may have a greater right of use than the grantor, e.g. to sub-lease the infrastructure, whereas the grantor may not; and to make major modifications to the infrastructure, which the grantor may not be able to do. The approach also 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 the assets that are to be used.
- *The grantor retains control because the infrastructure is to be returned to the grantor at the end of the concession period.*  
Although the draft interpretation does not deal with the accounting of the grantor, this control approach is built on the premise that the accounting today has effects a long way into the future and in many cases beyond the existence of the grantor, e.g. a government granting the concession. This may have strange effects on the grantor's reporting and accountability.

Therefore, we are not convinced that it is appropriate to rely on a control test that largely disregards risks and rewards. The IFRIC criticises, in D12's Basis for Conclusions, the so-called risks and rewards approach, arguing that it is less durable and more complex than the control approach. However, we think the primary objective should be to appropriately portray the substance of the transaction, not to minimise the degree of complexity. We also note that the IFRIC 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). We believe that 'control' and 'risks and rewards' need not in fact be competing approaches; rather there is an interplay between the both approaches. For that reason we believe that the risks and rewards should not be ruled out, but reintegrated into the draft interpretations. We believe that a risks and rewards approach is useful to assist in clarifying various aspects of control. That is, for example, how the IFRIC has used it in SIC 12.

Furthermore, 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.

### ***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'.
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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 find it very concerning that one result of the interpretations is that accounting under the different models can be fundamentally different even though the substance of the arrangements is very similar. Therefore there is a danger that determining the accounting model by who has primary responsibility to pay puts too much emphasis on the form rather than on the substance of the arrangements.

In our view the distinction between the two models should be based on the difference of substance if any. In this context, we believe that not only the primary responsibility to pay but also risks and rewards approach should be applied to determining whether there is a financial asset.

Finally, we are not convinced that it is appropriate to recognise a financial asset in *all* the circumstances the interpretations propose a financial asset should be recognised. In some circumstances—such as for example when the grantor agrees to pay the operator on the basis of usage by third parties and no part of the payment is guaranteed—although the definition of a financial asset as set out in IAS 39 might be met, the type of asset involved will be unlike any other financial asset. In those circumstances the asset seems to be a financial asset more by accident than by design; it is unlikely that the IASB ever envisaged that items containing so much non-financial risk would fall within the scope of their requirements for non-derivative financial assets. We would ask therefore that the IFRIC re-examine its analysis in this area to see whether it is really the only possible conclusion.

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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 generally 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 expects preparers to strike the balance between

the messages of these two sentences and to evaluate the substance of the contractual arrangements.

Furthermore, in practice it is not uncommon to have borderline situations where there may be practical difficulties in applying the above test; for example where the operator is paid by both the grantor and the users.

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). However, this would introduce additional complexity and could be difficult for users to understand. Therefore, additional guidance is needed on how to deal with borderline cases and to what extent, if any, the draft interpretations would require bifurcation of contracts.

#### *Additional comments*

- It is not clear to what extent it would be required to switch between the two models when the substance of the contractual agreements changes as a result of, for example, a contract renegotiation. We believe that when the substance of the arrangements changes during the concession period, the operator will have to account for the change accordingly.

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#### 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. Unless the IASB issues the final interpretations well before the end of this year, companies will have insufficient time to prepare for any changes before the effective date. However, even if that is done, companies in the industry need guidance as to what they should do in their 2005 accounts (final and interim and for their 2004 comparatives).

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. Furthermore, the reality for many companies is that, because of the uncertainty about the implications of existing IFRS for service concession arrangements, pre-2005 accounting practices are still being applied and it is too late to change those practices for the 2005 interims and, in some cases, even for the 2005 annual accounts.

We therefore suggest that the final interpretations include, as part of transitional provisions, an explicit exemption from full compliance to IFRS, granted for service concession arrangements and applicable to first time adopters in 2005 only. This exemption should be granted within boundaries specified by the IFRIC, including for instance:



- A prohibition on recognising items in the balance sheet that do not meet the definition of assets and liabilities
- A prohibition on capitalising of borrowing costs after the construction phase was completed
- A prohibition on capitalising losses
- The requirement to test all assets recognised for impairment.

We also support a full retrospective application unless that is impracticable in which case the operator will 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. We would then recommend adding additional criteria to ensure that, if prospective application is adopted it would not result in the carrying forward of capitalised interest beyond what has been incurred in the construction phase or capitalised losses.

Draft Interpretation D13 – The Financial Asset Model
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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.

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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 generally support the line of thinking expressed in BC6 and BC7. However we ask IFRIC to explain in the Basis for Conclusion the reasoning that led it to conclude that an entity may report different profit margins on different activities even though the contract has not been segmented for the purposes of applying IAS 11.8.

Draft Interpretation D14 - Intangible Asset Model
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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?*

TEG members have different views on the exchange referred to above.

One view is that the proposal in the draft interpretations is correct, ie 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, others expressed the view that they were not convinced that there is an 'exchange transaction' where the entity exchanges 'construction services' for an intangible asset. Rather the construction cost are payments to acquire an intangible asset and the cost are accumulated on the balance sheet in accordance with IAS 38. Under this approach the construction would not be viewed as a revenue earning activity.

As mentioned earlier, one of the main concerns is that the application of the two different models will lead to differences in revenue recognition although the substance of the transactions is economically very similar.

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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.

As with our response to question 1 above, two views have been expressed by the TEG on this issue.

In the proposed 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 it is supported by those TEG members who believe that an intangible asset is received from the grantor in exchange for the construction

Others have the view that 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. Under this approach the construction would not be viewed as a revenue earning activity. Both of these approaches seem to be in line with existing standards. The uncertainty on this point would reinforce the strong position with a number of TEG members that the IFRIC has not yet reached the required level of quality in the draft interpretations and that further work is needed.

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 are designed to produce different accounting treatments, we agree with the interpretations 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.