



Australian Government

**Australian Accounting
Standards Board**

Level 4, 530 Collins Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03) 9617 7608

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Chairman – IFRIC
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir,

IFRIC Draft Interpretations

D12 Service Concession Arrangements – Determining the Accounting Model

D13 Service Concession Arrangements – The Financial Asset Model

D14 Service Concession Arrangements – The Intangible Asset Model

The Urgent Issues Group (UIG) has considered the proposals in Draft Interpretations D12, D13 and D14, prepared by the International Financial Reporting Interpretations Committee (IFRIC). The UIG is pleased to provide its principal views in respect of the proposals for consideration by the IFRIC.

Australian grantors and operators have embraced service concession arrangements as an innovative way to provide infrastructure and deliver infrastructure-related services. Operators construct, manage and control all the major risks and benefits for 30 to 50 years associated with billions of dollars of investments in tollroads, airports, ports and railways. It is within this context that the UIG has considerable reservations with the IFRIC proposals. Our main concerns with the Draft Interpretations follow.

1. Comprehensive Standard on Service Concession Arrangements

The UIG notes that the IASB Research Group that undertook a preliminary examination of service concession arrangements recommended a Phase 1 and Phase 2 approach that:

- (i) in recognition of the IASB's busy agenda, Phase 1 should be a matter for IFRIC, and that a final Interpretation should be published in the first quarter 2004 and be mandatory for 2005; and
- (ii) Phase 2 be a comprehensive project on accounting for all types of service concession arrangements undertaken by the IASB when resources allow.

The IASB Research Group noted that "... due to the limited time the group has had available, the discussions to date have tended to focus on public-private concessions and

the accounting adopted by the concession operator. Further work would therefore be necessary to confirm that the proposals in this paper can be applied more widely.”¹

The UIG acknowledges the work of the IFRIC. However, we consider that the delay in finalising that work is evidence that service concession arrangements are best dealt with as a standard-setting issue, rather than an interpretative issue. At the same time, we consider that the drafting of an Interpretation within the accounting framework and existing accounting standards is more problematic than was envisaged by the IASB Research Group. Accordingly, we suggest that Phase 1 be terminated, and in its place the IASB commence Phase 2 as a matter of urgency.

2. The Control Approach

The UIG does not think of the control approach and the risks and rewards approach as mutually exclusive. The UIG notes that some of the accounting literature acknowledges the place of risks when determining control, for example “Control of an asset is the ability to obtain the future economic benefits that flow from the asset. Thus the concept is linked to access to economic benefits, and associated exposure to risks.”² It is the view of the UIG that this interpretation of control acknowledges risk as a primary attribute of control – an interpretation different from that proposed in the Draft Interpretations. The UIG supports the use of a control approach that incorporates an indicator that refers to the grantor’s exposure to risk.

3. Lease Accounting

The UIG considers there may be occasions when the future economic benefits embodied in the assets that are the service concession arrangement can be unbundled and the operator and the grantor recognise as assets their interest in the unbundled future economic benefits. The UIG suggests an approach that is consistent with an unbundling approach is worthy of further exploration. This exploration may lead to a fundamental rethink of not only the Draft Interpretations but also of the current leasing standard.

4. Scope

The Draft Interpretations prescribe the accounting by the operator, but do not specify the accounting by the counterparty – a decision that the UIG considers is unprecedented. Standard setters typically deal with both sides of a transaction. Should the IFRIC continue with the development of the Draft Interpretations, the UIG considers that the IFRIC should specify the accounting by the grantor, rather than rely on IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to do this. Further, the UIG notes that the accounting required of the grantor when using the intangible asset model is not clear. The UIG suggests that the IASB undertake this work co-operatively with the International Public Sector Accounting Standards Board of the International Federation of Accountants.

Further, the proposed scope of the Draft Interpretations excludes:

- public-to-private service concession arrangements that do not meet the conditions articulated by paragraph 5 of Draft Interpretation D12;
- private-to-private service concession arrangements, notwithstanding that paragraph BC6 of Draft Interpretation D12 comments that the IFRIC “decided to define the scope in terms of the nature of the arrangements themselves rather than the status of the parties to the arrangements”; and

¹ Report to the Joint Meeting of Standard-Setters, London, April 2003.

² The IASB’s Project Summary “Consolidation (including special purpose entities)”, revised 23 November 2004

- the accounting for infrastructure that the operator held and recognised as its property, plant and equipment before entering the concession arrangement.

The UIG considers that given the very limited scope of the Draft Interpretations, the Draft Interpretations will be less helpful than they could be in resolving the issues arising in accounting for service concession arrangements.

5. The Financial Asset Model and the Intangible Asset Model

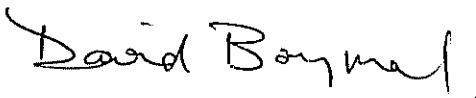
The Draft Interpretations specify that the operator's right is dependent on the identity of the payer. The UIG considers that credit risk is the only risk that varies depending on the payer's identity. The UIG is concerned that determining the accounting model by the identity of the payer can result in similar economic transactions being accounted for in very different ways and dissimilar economic transactions being accounted for in an identical manner – an outcome that is not consistent with the magnitude of the variance in the risk profiles of the two payers.

Compared with the credit risk, demand risk has a more profound weighting on the determination of the economic substance of transactions and on the estimation of the fair value of the service concession asset. Most service concession arrangements are demand based, and the credit risk introduced under the Financial Asset Model is merely a difference in the features of the arrangements, yet the Draft Interpretations give rise to different accounting consequences. This divergent accounting treatment lacks a conceptual basis, and has a long-term effect on the accounting of individual operators, through recognising gains/losses on some financial assets (when the fair value option is applied), and recognising gains/losses on intangible assets directly in equity reserves.

Responses to the specific questions raised in the Draft Interpretations are attached to this submission, together with other concerns of the UIG.

Please contact us if further information or clarification is required.

Yours faithfully,



David Boymal
Chairman, AASB and UIG

Attachment

IFRIC Draft Interpretation D12

Questions

- 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?

Paragraph BC11 of Draft Interpretation D12 concludes that a control approach is superior to a risks and rewards approach. The UIG agrees that this conclusion is accurate when the two approaches are treated as mutually exclusive. However, the UIG suggests that this approach is not consistent with other interpretations of the *Framework* or IFRSs. We note that some of the accounting literature acknowledges the place of risks when determining control, for example:

- the IASB's Project Summary "Consolidation (including special purpose entities)" revised 23 November 2004 comments that "Control of an asset is the ability to obtain the future economic benefits that flow from the asset. Thus the concept is linked to access to economic benefits, and associated exposure to risks." It is the view of the UIG that this interpretation of control acknowledges risk as an important factor in determining control – an interpretation different from that proposed in the Draft Interpretations;
- IAS 18 *Revenue* paragraph 16 comments that an entity that retains significant risks of ownership does not satisfy one of the conditions of a sale – hence, no revenue is recognised. The UIG considers that IAS 18 appears to rely on the location of risk as a determinant of the passage of control; and
- paragraph 5(b) of the Draft Interpretation D12 includes within the scope of the Draft Interpretations those service concessions where there is a significant residual interest for the grantor to control. The UIG considers that the inclusion of this condition in Draft Interpretation D12 imports the notion of access to economic benefits and associated exposure to risks into the Draft Interpretations – an approach that is not consistent with treating the control approach and the risks and rewards approach as mutually exclusive.

The UIG supports the use of a control approach that incorporates an indicator that refers to the grantor's exposure to risk. The UIG suggests that paragraph 5 of Draft Interpretation D12 be reworded to refer to:

- (a) the grantor controls or regulates ~~what the~~ services that 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 – the residual interest in the infrastructure at the end of the concession, and the residual interest is significant; ~~and~~
- (c) the grantor controls the infrastructure – through the grantor's exposure to the risks associated with accessing the future economic benefits that flow from the asset.

Although the price for the core services provided by the operator may be subject to regulation by related parties of the grantor performing their legislative function, such regulation may be no different from that which applies to other services provided wholly by monopolistic private sector operators, for example electricity generation provided by a private sector entity. The UIG understands that a principal purpose of price regulation in a monopolistic market is as a surrogate measure of the price present under competitive conditions. It is therefore not sufficient to merely assert that the grantor controls an asset by regulating it. But that is in effect what Draft Interpretation D12 paragraph 5 does, in conjunction with paragraph BC13, by linking ‘control or regulates’ and not arguing the case for control separately. The Basis for Conclusions to Draft Interpretation D12 would need to present a rational and supportable argument to explain why the grantor and any independent regulator should be considered together.

The UIG notes that the contractual arrangements underpinning most service concessions constrain the grantor from disposing of the property, plant and equipment asset without renegotiating the contract with the operator. The UIG suggests that the Basis for Conclusions to Draft Interpretation D12 explain why this and other factors are not relevant to determining who has control of the property, plant and equipment asset.

Put more strongly, the reasons given at paragraph BC13 to assert that the operator does not have a right to use the asset are poorly argued. If the grantor controls the asset (proposed paragraph (c) above), the operator cannot also control it. However, Paragraph BC13 merely asserts this by the phrase “controlling or regulating what services the operator must provide ...” Regulation alone does not constitute control, yet the sentence reverts to an assertion that regulation equates with control.

- 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*.

See response to Question 3.

- 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?

No. The UIG is concerned that determining the accounting model by the identity of the payer can result in similar economic transactions being accounted for in very different ways – an outcome that is not consistent with the magnitude of the variance in the risk profiles of the two payers.

Paragraph BC44 of Draft Interpretation D12 indicates that the operator’s right is dependent on the identity of the payer – the right is a financial asset when the payer is the grantor (as with a shadow toll road) and an intangible asset when the payer is not the

grantor (as with a toll road). Credit risk is the only risk to vary when the payer is not the grantor – a risk that the service concession arrangement contracts can mitigate by the inclusion of statutory penalties for non-payment.

In addition, a grantor may change its policy in terms of who pays. For example, a grantor may, during the term of the service concession arrangement, decide to eliminate road tolls on users and become directly responsible for paying a shadow toll in their place. The required change in the accounting model to be applied suggests that the approach to determining the accounting model at the inception of the service concession arrangement is not appropriate.

- 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?

No. Given the issues raised by our response, the UIG suggests that, not only should the application of the Draft Interpretation be deferred, but IFRIC's work on the Interpretations should be terminated, in its place the ISAB commence work on a comprehensive project as a matter of urgency. Should the IFRIC continue with the development of the Draft Interpretations, the Draft Interpretations should grandfather the continued use of each jurisdiction's current practice.

IFRIC Draft Interpretation D13

Questions

- 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.)

Yes.

- 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?

Yes.

IFRIC Draft Interpretation D14

Questions

- 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?

Yes, we agree with the proposal and that is consistent with the existing IFRSs.

- 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?

The Interpretation should address this matter. Paragraph BC6 of Draft Interpretation D14 comments that IFRIC decided not to specify when the operator should first recognise an intangible asset. The IFRIC has noted in its considerations “that an operator could be regarded as receiving its right to charge users at three different points in time”. The UIG is concerned that the choice of timing of recognition of the intangible asset can result in similar economic transactions being accounted for in very different ways.

The UIG supports recognition of an intangible asset as the construction services are provided. We suggest this should be the basis for the Illustrative Example to Draft Interpretation D14. We disagree with the view in paragraph IE6 of Draft Interpretation D14 that an operator recognises a receivable for its construction services until construction is complete and the operator receives the intangible asset. We do not think a financial asset is present – given that the operator is providing construction services for the grantor in exchange for an intangible asset.

- 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?

Yes, we agree that this proposal is consistent with existing IFRSs.

Other Comments

- Definition of public service obligations

The UIG considers that the activities that constitute a public service obligation may change over time, and may vary across jurisdictions, with the result that the application of the Draft Interpretations might result in inconsistent financial reporting of the same transaction. For example, in some jurisdictions health services may be provided solely by government and be regarded as a public service obligation, whilst in other jurisdictions health services are provided in a competitive market.

- Right of use and right of access

Paragraph BC13 of Draft Interpretation D12 comments that “Unlike a lessee, the operator does not have a right of use: it has only access to the infrastructure to provide the specified services on the specified terms.” Paragraph BC16 of Draft Interpretation D12 comments “In principle, the operator should recognise neither the infrastructure nor a lease of the infrastructure.” The UIG contemplates that one reason for the IFRIC proposition that the operator has only a right of access might be to preclude the operator from applying lease accounting – whereby the entity might have the option to elect to apply IAS 40 *Investment Property* to a property interest that is held under an operating lease. The UIG considers that in some service concession arrangements the grantor may not have the right to make major modifications to the infrastructure assets without re-negotiating the service concession contract, whereas the operator could, subject to it being able to meet its contractual obligation to deliver services – we consider this might evidence the operator’s right of use. As presently drafted, we do not consider that the Basis for Conclusions to Draft Interpretation D12 adequately explains why the operator has only a right of access and not a right of use.

- Assets used for unregulated purposes

Paragraph C5 of Appendix C to Draft Interpretation D12 comments that “any infrastructure that is physically separable and capable of being operated independently shall be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.” The UIG considers that the guidance in paragraph C5 introduces a degree of arbitrariness into the process of separating assets that may not be consistent with the *Framework*, in that the accounting does not faithfully represent the underlying transaction.

- Lease accounting

Paragraph C6 of Appendix C to Draft Interpretation D12 comments that there may be a lease from the grantor to the operator that shall be accounted for in accordance with IAS 17 *Leases*. The UIG suggests that the flowchart of the accounting framework for service concession arrangements in Appendix B to Draft Interpretation D12 should specifically refer to when IAS 17 would apply.

- Initial measurement of the financial assets

Paragraph 8(b) of Draft Interpretation D13 comments that the amounts due shall be measured on initial recognition at fair value. IAS 39 *Financial Instruments: Recognition and Measurement* paragraph 43 requires that, on initial measurement, a financial asset is measured at fair value (plus transaction costs when not a financial asset at fair value through profit or loss). The UIG suggests that paragraph 8(b) reflect that requirement.
