Deloitte.

Deloitte Touche Tohmatsu
Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

6 May 2005

Chairman - IFRIC
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sir/Madam

IFRIC Drafts D12, D13 & D14 – Accounting for Service Concession Arrangements

Deloitte Touche Tohmatsu is pleased to comment on the International Financial Reporting Interpretations Committee's (the IFRIC's) Draft Interpretations:

- D12 *Service Concession Arrangements – Determining the Accounting Model*;
- D13 *Service Concession Arrangements – The Financial Asset Model*; and
- D14 *Service Concession Arrangements – The Intangible Asset Model*,

(referred to as D12, D13, D14 or the draft Interpretations(s)). Our responses to the questions raised by the IFRIC in the draft Interpretations and other technical comments are set out in the Appendix to this letter.

We commend the IFRIC on the self-evident time and effort that has been devoted to this project. With the benefit of hindsight, we believe that if this project were started from the beginning, it might be better suited to a Board project to develop an accounting standard, rather than an interpretation of existing requirements. However, given the advanced stage of the project , and the desperate need in the market place for these interpretations we believe the IFRIC should complete this project with all due haste. When agenda time permits the IASB should determine whether it is possible to develop a superior model in the form of an accounting standard. We believe that if the IASB were to take this onto the agenda in the future, they should consider the appropriateness of a model that takes into account operating risk – the absence or limitation of which is a common feature of service concession arrangements in many jurisdictions.

We do have a number of pervasive concerns, which we believe are fundamental flaws in the accounting models proposed by the IFRIC. These concerns are explained in more detail in the Appendix to this letter, however, stated briefly they are as follows:

Whilst we believe the two accounting models for service concession arrangements are a consequence of current IFRS, we believe the IFRIC:

- Has drawn an inappropriate line between the intangible asset model and the financial asset model, such that arrangements for which the cash flows, and risks attached thereto, are essentially the same, would be accounted for in vastly different ways; and

- Should seek to mandate the timing of recognition of the intangible asset in the intangible asset model, and that the timing mandated should be the same as is illustrated in D14.

Our specific comments on those matters on which IFRIC requested comments and other technical issues are contained in the Appendix to this letter.

However, we believe it is imperative that companies operating in service concessions type industries have a clear indication of the accounting methodology that is appropriate under IFRS as soon as possible. Accordingly, we would support the IFRIC proceeding with the principles contained in the draft interpretations in order to provide clarity and guidance to those endeavouring to apply IFRS to service concession arrangements in the financial year ending 31 December 2005.

If you have any questions concerning our comments, please contact the undersigned in London at (020) 7007 0907.

Sincerely,

Ken Wild

Global IFRS Leader

D12: Service Concession Arrangements – Determining the Accounting Model

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 accept this approach as a pragmatic interim solution on which to base the service concessions project. However, we do not believe that the explanation provided in paragraphs BC9 – BC 11 is robust, or adequately explains the IFRIC's rationale for using the control approach.

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 do not believe that the financial asset model should apply only where the grantor has 'primary responsibility' to pay for the concession services. We note that this results in an accounting treatment which is the same for contracts for which the risks and cash flows are vastly different. For example, where the entity carries all of the demand risk but the government pays (a shadow toll); and alternatively where the government carries all the demand risk and the government pays (a guaranteed minimum shadow toll); both of these would be accounted for as a financial asset. In fact, one is the right to receive tolls if people drive down the road, the other is a right to receive cash. We believe that it is appropriate that both of these be accounted for as financial assets, but we do not see how it is then possible to distinguish between the latter case and the case where the user pays but the government meets a minimum guarantee. It does not seem appropriate to us that where the first two scenarios are vastly different in possible financial outcomes, they are both accounted for in the same way, but the third example, which is identical to the second in possible financial outcome, must be accounted for differently.

We believe that in a public sector service concession the right of the operator to claim cash should generally be treated as a financial asset. This is because to allow anything else would simply encourage structuring of new deals to achieve this accounting outcome (see our specific concerns on the intangible asset model below, which, together with industry feed back leads us to believe that financial asset model is preferred by most) and would, in financial reporting terms, disadvantage those who are in the midst of concession contracts. The creation of such a disadvantage would continue to impact the financial reports of many entities for upward of 25 years. When an entity enters into a service concession arrangement, it does so on the basis that someone will pay for it – where a user pays this is effectively a hypothecated tax – that is, the user could equally well pay additional tax to the government for the services received, possibly in the form of a government levied toll, and the government pay the concession operator. For whatever reason the deals are structured such that cash flows directly from the user to the operator. It does not seem appropriate to us that the structuring of methodology of cash flows should have such a significant effect on the financial reporting outcomes.

It seems to us that a concession arrangement is, in many cases, a contract which entitles the operator to receive cash from users, and the contract is signed on behalf of the users by the government. We believe a more appropriate criterion would be that the financial asset model should be applied when the grantor provides assurances that have the effect of ensuring the operator receives sufficient cash to recover their investment in the service concession arrangement. In this way, arrangements for which the operator has a right to receive cash, but is not aware at inception where this cash will come from (users, grantor or a combination of the two) could be treated as a financial asset. We believe this would be consistent with IAS 32 because at the date of inception the operator does have a right to receive cash from the grantor, albeit that some of that right may be eliminated by the receipt of cash directly from users in the future.

We also note that the phrase 'primary responsibility' is not particularly helpful, in that it could be interpreted as meaning 'first in order' (so in a toll road scenario, the user), or most significant (possibly the government). We are concerned that this phrase may not translate readily.

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?

Whilst we agree with this proposal, we are unsure as to how it can be made operational. As discussed under point 2 above, the IFRIC appears to be drawing a very fine line between the use of the financial asset and the use of the intangible asset models. That line is, in itself, dependent on the form of the agreement, as in the first and third examples discussed, the substance of the arrangement is the same – it is the re-routing of the payment which changes the accounting treatment. If the IFRIC chooses to proceed with the distinction as currently drafted we do not think BC44 will be in anyway helpful, as the very nature of the documents suggest that the form of the arrangement will dictate the accounting model applied.

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 agree with the proposed effective date, and urge the IFRIC to proceed with this project as quickly as possible, as we understand many entities will seek to adopt the requirements of the IFRIC Interpretations early in completing their first IFRS accounts. We note that, in the absence of an exemption from the IAS 8 hierarchy of sources of accounting policy, companies will be forced to determine their own accounting policies which they believe to be IFRS compliant, which could lead to divergence in practice until the effective date of the draft interpretations.

Other Comments on D12

<u>Scope</u>

We question the appropriateness of paragraph 2 of the draft interpretation which discusses the provision of services to the public. We consider there are a number of examples of items which we believe are service concession arrangements which do not involve the provision of services to the public, e.g., private sector entities providing information technology equipment and services to the public sector. In such a scenario a member of the public has no access to the IT service provided. Similarly defence contracts do not result in the provision of services to the public, although they are of course a public service. It could also be considered doubtful whether a prison fits within the description in paragraph 2, as in fact prison services are not made available to the public generally. We believe the interpretations are intended to capture services provided to the benefit of the public, rather than necessarily to the public. We believe that paragraph 2 should be re-drafted to reflect better the wide range of activities we believe were intended to be captured by these interpretations.

We note that the cross reference to paragraph 2 contained in paragraph 5 is un-necessary and potentially misleading. The cross reference can be read to imply that all arrangements as described in paragraph 2 are within the scope, when in fact the IFRIC intends to limit the application to only those arrangements specifically described in paragraph 5.

We also question whether the interpretations as currently drafted capture service concession agreements with an indefinite useful life. In some arrangements the infrastructure asset will revert back to the grantor based on a trigger (such as profitability or usage) for which it is unable, at the inception of the contract, to determine whether the residual value of the asset will be significant at the time of the reversion. Therefore it is difficult to determine whether such arrangements should be captured within the draft interpretations. Similarly, it is difficult to tell whether when an operator must maintain and return an equivalent piece of infrastructure, rather than the infrastructure granted at inception, the arrangement is considered to be within the draft interpretations.

<u>Choice of accounting model</u>

It is unclear to us from the draft interpretations whether or not the determination of accounting model in respect of an arrangement is a one-off election made at the inception of the arrangement, or is a matter for reassessment. A number of service concession arrangements have changes in contractual terms part way through the arrangement (often caused by private sector entities seeking rectification of losses caused by lower than forecasted demand) that are so significant as to alter the accounting model under which the arrangement would be accounted for if it were reassessed. If reassessments are expected the interpretation should specify under what circumstance a reassessment is made and how any resulting changes in accounting model should be accounted for.

We are also unsure as to how priority is assigned when an arrangement contains elements which would fall within both the financial asset model and the intangible asset model, priority is assigned. The draft interpretations are not clear in indicating whether or not bifurcation of the arrangement into its component parts is required. We are aware of examples where on initial examination, the amounts to be received directly from the government and the amounts to be received from users appear to be substantially equal – we do not know in such a case which accounting model should be applied in preference to the other.

<u>Sundry payments from the grantor</u>

In many service concession arrangements, the grantor pays subsidies or grants to the operator that are related to the service concession arrangement, but are not directly linked to the provision of services to the public. Although we find the draft interpretation unclear, we assume that such payments should be accounted for within the service concessions model rather than as government grants within the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government* Assistance. It would seem to us that if the value of such grants was expected to be so significant as to ensure the recovery of the carrying amount of the asset, that asset could rightfully be called a financial asset. We believe it would be helpful for the interpretations to clarify this point.

Other issues

In BC20, the IFRIC says that "without the IAS 18 conditions for a sale having been met, there cannot be a sale and leaseback". We believe that this inclusion in the basis for conclusions is inappropriate and unnecessary. The IFRIC appears to be standard setting in its basis for conclusions by suggesting that the sale and leaseback guidance in IAS 17 could, in fact, never be used as such a situation is conceptually impossible. The sale and lease back guidance in IAS 17 is regularly applied in practice and we can see no good purpose for the inclusion of the IFRIC's conclusion on this matter within the Basis for Conclusions of the Draft Interpretation. We believe the final interpretations should remain silent on this matter which we trust will be resolved in the course of the Board's leasing project.

In BC21, the IFRIC says that "there will be circumstances when the conditions of IAS 18 are not met, and therefore the assets should continue to be recognised by the operator (with no sale), even if the grantor controls the assets". We are unsure what situations the IFRIC is endeavouring to cover by this paragraph and to us this does not add to the interpretation.

D13: Service Concession Arrangements – The Financial Asset Model

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; however we are deeply concerned by the inconsistency that arises between the two models as a result of this conclusion. However, like the IFRIC, we find the logic technically sound – if the financial asset model as it stands is accepted, then this is the correct way of accounting for revenue on the discharge of each obligation.

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?

While we find this line of thought to be conceptually robust, we are unsure as to how it ought to be applied in practice. Determining the fair value of the resurfacing of the road for example, is unlikely to be a straight-forward exercise.

Other Comments on D13

Other issues: Transitional Provisions

The transitional provisions should also consider those cases where liabilities have been recognised related to the concessions assets and only the net of those two elements shall be recognised either as an intangible asset or a financial asset. For example, in some jurisdictions where assets were given by the grantor, recognised as PP&E whilst at the same time a liability is recognised since the assets will be returned at the end of the concessions. The net of these two elements is nil, which would be appropriate under the intangible and financial asset model. Similarly, in some jurisdictions, the physical asset has been recognised as property, plan & equipment with a corresponding liability for the return of that asset to the grantor. When derecognising the physical asset in accordance with the transitional provisions, it would also be necessary to derecognise the hand-back obligation. However, it seems that there is grandfathering only of the asset side (i.e. in the first case the entity would reclassify the asset but would not be allowed to deduct their liability from it, and in the second could derecognise the asset but not the liability), which may result in inappropriate accounting outcomes.

Recognition of Revenue

Paragraphs 8(a) and 16 of the draft interpretation are very unclear. Broadly, we understand that they are intended to mean that IAS 18 should be applied in determining the timing of revenue recognition. However, this is not clear from the words, nor is it adequately explained in the basis for conclusions.

Use of Available-for-Sale Model

We accept the principle articulated in D13.10, that financial assets with a risk of non-recovery that arises other than from the credit deterioration of the counter-party cannot be classified as a loan or receivable. However we are concerned that the available-for-sale model is not necessarily appropriate to service concession arrangements with long terms. The reliability of fair value measurements in respect of future expected cash flows over periods of up to, and in some cases greater than, 25 years, is questionable. We believe it is possible to resolve this issue by extending the application of paragraph 46(c) of IAS 39. We believe that these financial instruments are akin to unlisted equity instruments – they are effectively investments in the government's activities over a long period of time for which there is no active market. Accordingly, where fair value cannot be reliably measured, we believe that measurement at cost is appropriate, and that incorporating this into the interpretations is consistent with IAS 39, as well as eliminating a significant difficulty in the application of the proposals. We note that many constituents are keen to measure items at fair value in order to achieve some degree of matching between the asset and the liabilities financing the asset, therefore we are not concerned that this might result in abuse – rather we believe it will ensure that insufficiently reliable numbers are not used in the accounting.

Embedded derivatives

We note that BC11 states that amounts linked to demand or quality would not be considered an embedded derivative. The amendment to the definition of a derivative that excludes non-financial variables that are specific to a party to the contract was introduced following the introduction of IFRS 4 *Insurance Contracts* to ensure an appropriate scope out of payments linked to the condition of the specific non-financial item which would fall into the insurance standard (as described in IAS 39.AG12A). We have considerable concerns that the amendment to the definition of a derivative, which this IFRIC also interprets, is being interpreted far more widely that its original intention. We note that linkage to variables such as sales/EBITDA of one of the parties to the contract could be argued to fail the definition of a derivative because they are specific to a party to the contract, even though the variable may have no specific linkage with the quality or delivery of the service under the contract. We believe that this wider interpretation of the definition of a derivative is not appropriate as this understates the number of embedded derivatives in contracts where the economic characteristics and risks are not closely related with the host contract.

Considering IAS 39.IG.B8 refers to sales volume as being an underlying, and IAS 39.AG33(f) refers to contingents rentals based on related sales being an embedded derivative, we therefore urge the Board to reconsider the wording of the definition of a derivative, as this has considerable impact not only for service concessions, but for many contractual arrangements.

D14: Service Concession Arrangements – The Intangible Asset Model

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—i.e. 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?

We concur with the IFRIC that, if the intangible asset model is accepted, there does not appear to be any methodology within current IFRS that would allow the non-recognition of revenue and profit on the exchange transaction. We note that many parties, particularly user groups such as analysts, are concerned about the divergence this creates between accounting revenue and cash flows, and we share this concern. We believe this accounting obfuscates the actual economic nature of the arrangement. We therefore respectfully request that the IFRIC reconsider the application of this accounting model.

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 specify the timing of the recognition of the intangible. It seems inappropriate to us for the IFRIC to identify and articulate an issue within its own accounting model without providing a solution. Given that the accounting model being proposed is vastly different from what has been applied in practice, entities will need as much guidance as possible on how this is to be applied. Accordingly, by illustrating only one method, and not providing substantive guidance on the application of the alternatives, IFRIC have, in fact, effectively encouraged most entities to apply the model in this manner.

We believe the use of alternative (c) to be technically correct. Alternative (a) appears to us to be tantamount to recognising an executory contract at inception, which we believe to be inappropriate. Alternative (b) does not appear to us to be valid – in the case of a road for example, the operator has no right to obtain tolls from that road until the road is completed, and therefore is not constructing an intangible asset – they are completing construction services in respect of a road. This is further supported by brief consideration of the accounting in the books of the grantor – until a road is complete, it is unlikely they would recognise anything; yet there is obviously a physical asset being constructed which should appropriated be recognised somewhere – in our view it is appropriately recognised as construction services asset by the operator. Accordingly we support alternative (c). We believe that if the IFRIC does choose to mandate which alternative a robust explanation should be provided in the basis for conclusions. If it does not elect to mandate this then an explanation of the effect of using the alternative treatments should be given in the introduction to the illustrative example.

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?*

We agree with the conclusion; however we are deeply concerned by the inconsistency that arises between the two models as a result of this conclusion. However, like the IFRIC, we find the logic of this conclusion technically sound – if the intangible asset model as it stands is accepted, then this is the technically correct way of accounting for repairs and maintenance obligations.