



Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organizaçāo Internacional das Comissōes de Valore

7 June 2005

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

Re: IFRIC Draft Interpretations D12, D13 and D14

Dear IFRIC Members:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1 or SC1) thanks you for the opportunity to provide our thoughts regarding IFRIC 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*.

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement.¹ Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

Procedural Comments

Standing Committee No. 1 appreciates the substantial investment that IFRIC has made in developing the guidance contained in Draft Interpretations D12, D13, and D14. We agree that timely guidance regarding the operators' accounting for rights and obligations associated with a service concession arrangement is needed, particularly as many operators are changing from local GAAP to IFRS in 2005, and current accounting methods used in several jurisdictions do not meet the relevance and comparability criteria set forth in the Framework. Notwithstanding the need for timely guidance, we are concerned about the implications of the proposed Draft Interpretations D12, D13 and D14.

¹ See IOSCO website, www.iosco.org

In summary, we are concerned that the proposed guidance in D12, D13, and D14 sets forth new principles, such as looking to the identity of an obligor in order to determine the accounting model, while ignoring principles in existing IFRS for purposes of determining whether and when to recognize and de-recognize property, plant and equipment (“PP&E”). Because the proposed guidance is being characterized as interpretations of existing IFRS, we are concerned that they could have broad reaching consequences outside of the service concession arena. Although the guidance contained in the Draft Interpretations is intended for operators of service concession arrangements, analogies to this guidance will inevitably result from proper application of the hierarchy contained in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. We are concerned that individuals outside of the service concession arena may not have adequately focused on the broader ramification of what appears on the surface to be narrowly scoped interpretations.²

As a result of our broader concerns about the proposed guidance, we recommend that IFRIC (or possibly the Board itself, as the whole project is of such a magnitude and complexity that it resembles a new standard rather than an interpretation) take the necessary time to reconsider the conclusions reached in Draft Interpretations D12, D13 and D14. We realize that this reconsideration may prevent IFRIC from meeting its goal, and preparers’ expectations of having a comprehensive interpretation in place by 31 December 2005.

In order to prevent less favorable accounting practices from gaining momentum while IFRIC takes the time it needs to properly re-deliberate the contents of the Draft Interpretations, we suggest that IFRIC give consideration towards identifying in a future *IFRIC Update*, some of the more troubling accounting practices regarding service concession arrangements, with an accompanying explanation of why IFRIC believes such practices are not permitted under IFRS. This suggested interim action step would be similar to the manner in which the IFRIC Agenda Committee discusses its basis for not taking a potential agenda item on to its agenda.

As a result of our broader concerns about the overall approach of the Draft Interpretations, this letter does not provide responses to the individual questions posed by IFRIC in the draft interpretations. SC1 believes it is more beneficial to provide specific comments about our broader concerns and the merits of IFRIC’s approach.

Technical Comments

The remainder of this letter provides comments and concerns that the members of Standing Committee No. 1 had regarding the technical content of the Draft Interpretations. Our comments and specific concerns are focused on the Interpretation’s proposed scope, recognition of infrastructure and determining the accounting model.

Scope

SC1 believes that it would be advisable to define more precisely the concept of “public service obligation.” Understanding the definition of the term “public service obligation” is critical to determining which arrangements will fall within the scope of the Draft Interpretations.

² For example, the introduction of the control-based model in the proposed guidance has raised concerns about the implications to accounting for sale and leaseback transactions. .

Paragraphs 4 and 5 of D12 indicate that in order for an arrangement to be included in the scope of the Draft Interpretations, an arrangement must give rise to a public service obligation. Currently, the term “public service obligation” is defined in an attributes based manner in paragraph 2 of D12. The primary obligation associated with a “public service obligation” appears to be an obligation to provide services to the public. Although the attributes based definition in paragraph 2 of D12 is helpful, in the absence of such an actual definition, we could envision some preparers inadvertently concluding that common place private to private concession arrangements fall within the scope of the Draft Interpretations.

For example, assume that a private canteen or cafeteria operator is mandated by the grantor, another private organization, to make available to the public, a facility located in the grantor’s corporate office. Also assume that at the end of the concession arrangement, a significant residual interest in the canteen will revert back to the grantor. A preparer could reasonably conclude that this arrangement embodies a “public service obligation” and meets both of the conditions set forth in paragraph 5 of D12, thus scoping this arrangement into the Draft Interpretations.

We do not believe that this conclusion is consistent with IFRIC’s intention, as much of IFRIC’s discussion in the Draft Interpretations focuses on larger, infrastructure type arrangements, not commonplace arrangements between private enterprises. Nevertheless, we feel that this example illustrates the need for IFRIC to define the term public service obligation, if that term is going to be used to help determine the scope of the Draft Interpretations.

Recognition of Infrastructure

The proposal in Draft Interpretation D12 reflects IFRIC’s decision that whether an operator recognizes service concession infrastructure as its PP&E should depend on whether it controls the use of that infrastructure. Infrastructure assets not controlled by the grantor, in accordance with scope paragraph 5, are outside the scope of these proposed interpretations.

SC 1 does not believe that the Draft Interpretations represent an interpretation of existing IFRS because they appear to be introducing a new asset recognition model for PP&E. This model is not consistent with the current existing principles for PP&E asset recognition and de-recognition as provided in IAS 16 *Property, Plant and Equipment*, IAS 17 *Leases*, and IAS 18 *Revenue* as well as related interpretations. Our understanding is that IFRIC has concluded that the “risks and rewards” notion in existing IFRS is too difficult to apply. In BC11 of Draft Interpretation D12, the IFRIC states:

“... the economics and rewards approach as applied in IAS 17 leads to complexities and inconsistencies in lease classification and could be difficult to apply to service concession arrangements, especially those in which users pay for the concession services or large elements of the payments are contingent on usage.”

Although we agree that, in some instances, determining who bears the risks and rewards of ownership may be difficult; we do not believe that such difficulty is an appropriate basis for not applying existing IFRS. Implicitly, the IFRIC appears to be suggesting that it has a fundamental concern with the current risks and rewards-based lease accounting model in IFRS.

IFRIC is introducing a control-based PP&E recognition model that is based on a somewhat arbitrary interpretation of the meaning of “held for use” in the PP&E definition under IAS 16. IFRIC appears to have made quite an effort to avoid application of the existing asset recognition/de-recognition guidance in IFRS in IASs 16, 17, and 18.

Although we do not necessarily disagree with the notion of using a control-based asset recognition model, we believe that any such model should be appropriately characterized as a new one. Additionally, in light of the procedural concerns addressed earlier in this letter, if IFRIC was to pursue a controls based approach in the final interpretations, we recommend that IFRIC explicitly state that such control based PP&E recognition model should not be applied by analogy outside of the context of SCAs.

Determining the Accounting Model

In the draft interpretations, IFRIC has identified two accounting models that would be used to account for the rights and obligations of the operator in service concession arrangements. The financial asset model applies if the grantor (rather than users) has the primary responsibility to pay the operator for the concessions services. The intangible asset model would apply in all other cases.

Standing Committee No. 1 has an overriding concern that IFRIC has developed an approach that would generate significantly different accounting results for two arrangements with similar, if not identical, economics. As a result, the comparability of financial statements would be greatly impaired. Therefore, we believe that in order for a new accounting interpretation to become generally accepted, the interpretations should generate similar accounting results for similar transactions. We do not believe that the Draft Interpretations meet this requirement.

Consider two arrangements, both of which involve an operator constructing and operating a toll road for the grantor. In the first arrangement, the grantor pays the operator 5 Currency Units (CU) for each car that passes through a toll plaza. The second arrangement entails the vehicle's driver paying the operator 5 CU as he passes through the toll plaza. Both arrangements expose the operator to similar amounts of demand, operational and credit risk. As a result, both arrangements generate similar cash flows for the operator. Under the draft interpretations, the first arrangement results in the operator recording revenue equal to the total amount of cash collected, whereas the second arrangement, due to the mechanics of the intangible asset model,³ results in the operator recording revenue that exceeds the total amount of cash collected. In addition, as evidenced by the annual net income figures contained in the 50-year Service Concession – Website Example provided on the IFRIC Activities section of the IASB website, the timing of reported net income differs substantially between the two models.⁴ Under the financial asset model, the arrangement described appears to be consistently profitable throughout its life, whereas under the intangible asset model, the very same arrangement appears to be unprofitable for the first 17 years of the arrangement.⁵

³ Namely, the intangible asset model requires concession operators to recognize revenue equal to the fair value of the intangible asset received plus the amount of cash collected. Recognition and subsequent amortization of the intangible asset (both non-cash items) ultimately offsets the revenue associated with the intangible asset. Over the life of the service concession arrangement, the financial asset model does not have any revenue or expense recognition associated with non-cash items. Over the life of the service concession arrangement, net income (the excess of cash receipts over cash disbursements) is the same under both the intangible and financial asset models, as the revenue recognized upon recognition of the intangible asset is exactly offset by the amortization expense associated with the intangible asset over the life of the arrangement.

⁴ For purposes of illustration, we have included in Appendix A a chart plotting the differences between the net incomes reported for the Website Example under each of these models.

⁵ The intangible asset model appears unprofitable in earlier years because the intangible asset model requires that the intangible asset, recognition of which provides immediate revenue, but little profit, be amortized to expense on a straight-line basis over the life of the arrangements, whereas toll revenue is recognized as collected. In the example provided, it takes 17 years of toll revenue growth to overcome the expense associated with amortization of the intangible asset model. On the other hand, the financial asset model in essence requires that the operator record the present value of future tolls to be

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We believe an approach that provides such varied reporting for similar economics is not appropriate, as it fails to meet several of the qualitative characteristics of financial statements described in the Framework, including: Relevance, Reliability and Comparability. Such models also seem vulnerable to structuring opportunities. Thus, we are concerned that IFRIC would consider adding such a model to the IFRS hierarchy.

The problem appears to stem from whether IFRIC's distinction of "primary responsibility" is appropriate for determining which accounting model should be used to account for the concession arrangement. We do not believe that a binary model is appropriate for making this determination, as service concession arrangements rarely imbue the obligation to pay on a single party. With public service obligations, there is often a fine distinction between who has the primary responsibility for payment.

For example, consider an arrangements in which the payment obligation rests with a governmental body, but it is clear that the government is acting in the capacity of an agent for the public. In addition, there are cases where responsibility for payment is shared (e.g., 50% user and 50% grantor). Which model would be appropriate under these circumstances? IFRIC has chosen to rely on a binary model, but we believe such a model can not adequately reflect the economics of many service concession arrangements. At the same time, this model appears to be susceptible to structuring opportunities due to the fact that vastly different accounting can be achieved merely by restructuring the direction of cash flows in a service concession arrangement.

We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-551-5300.

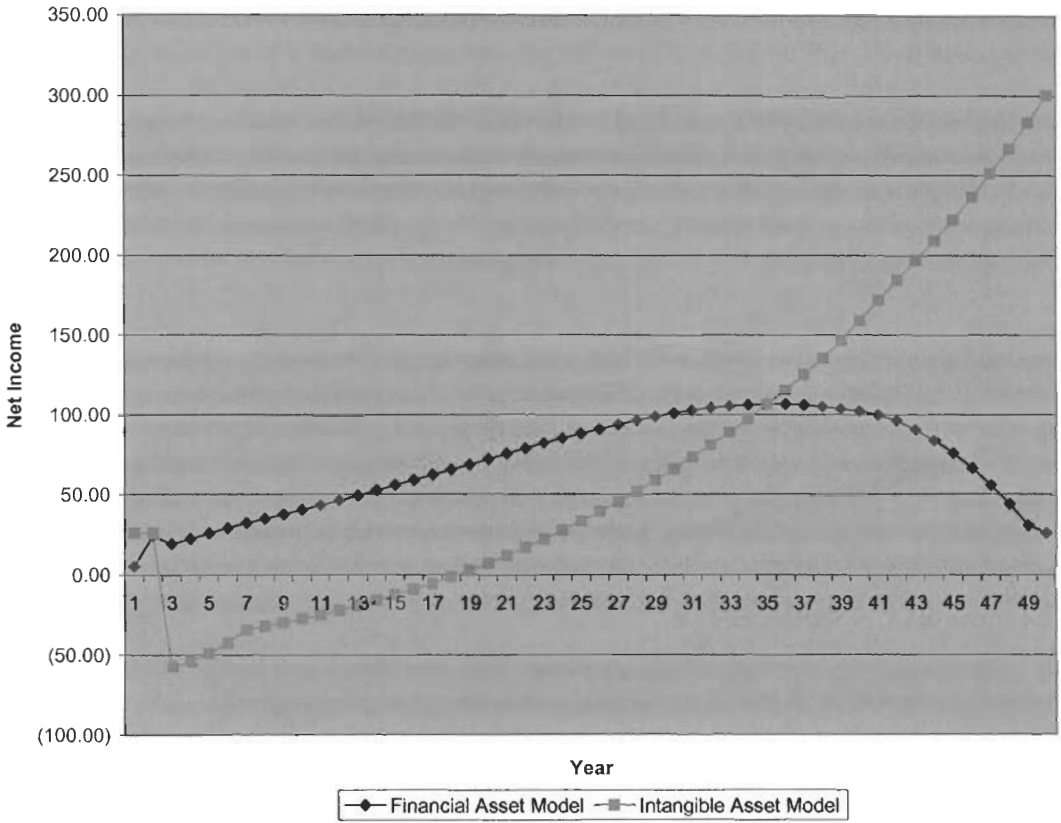
Sincerely,

A handwritten signature in black ink that reads "Scott A. Taub" followed by a date "6/28".

Scott A. Taub
Chairman, Standing Committee No. 1

collected as a financial asset. Interest is then accrued on the financial asset, while its principal balance is reduced by the amount of tolls collected. Interest revenue recorded in earlier years substantially exceeds the amount of toll revenue collected, thus resulting in negative amortization of the receivable balance (i.e. the receivable balance is increased with the offsetting recognition of interest income) for the first 31 years of the concession arrangement.

Income Statement Differences
Intangible Asset vs. Financial Asset Model



Source data: 50 Year Example provided at www.iasb.org/current/ifric.asp