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Endorsement of IFRIC 12 *Service Concession Arrangements*

Effect Study - Report

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1. EXECUTIVE SUMMARY

Introduction

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union. The Commission Services together with European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as an analysis of effects of using the new accounting rules in the EU.

The International Accounting Standards Board (IASB) issued the Interpretation 12 *Service Concession Arrangements* (IFRIC 12) prepared by the International Financial Reporting Interpretation Committee (IFRIC) on 30 November 2006 with an effective application date for annual periods beginning on or after 1 January 2008.

This effect study analyses potential effects of adopting IFRIC 12 in the European Union (EU). It focuses on key issues raised during the IASB and European Financial Reporting Advisory Group (EFRAG) consultations as well as the one recently carried out by the Commission Services.

Main findings from the Effect Study

There is an urgent need to provide guidance on the accounting treatment for service concession arrangements. In the long term, this accounting area should be the subject of a specific international standard. In the meantime, IFRIC 12 can usefully provide such guidance and increase the quality of financial statements for companies involved in the service concessions field.

IFRIC 12 provides guidance on the recognition of revenues and expenses which is consistent with existing IFRS already endorsed by the European Union. However, some respondents consider that timing mismatches between recognition of revenues and expenses in the intangible asset model do not reflect the economic substance of service concessions. The resulting accounting treatment appears very different from the financial asset model's one, although they think that the economic substance of both models is not so different. These views are thoughtfully considered in our report.

Nevertheless, the perceived timing mismatch between recognition of revenues and expenses is similar to the accounting treatment already applied in other situations where the operator is the owner of the infrastructure or in the start-up phase of a company. This accounting treatment does not seem to generate negative reactions from investors or analysts, assuming that companies provide adequate information in the notes of the financial statements. For these purposes, in addition to comply with SIC 29 *Service Concession Arrangements: Disclosures*, companies should be encouraged to develop additional disclosures if necessary, especially on expected future cash flows, that users require in order to better understand this kind of business.

Concerning the apparent similarity between the economic substance of the financial and intangible asset models, some respondents are not convinced that it would justify applying the same accounting treatment, as they considered that they could in reality be different in substance, even if the actual cash flows might be the same. Difference in substance may arise depending whether the operator is exposed to the demand risk or not. Enhance disclosures on such kind of risk exposure would also be helpful to users.

IFRIC 12 will help to increase clarity as to the accounting treatment to be applied, as well as enhanced comparability and distinction between different types of contract based on clear criteria. Companies already applying IFRIC 12 and external users of the related information note that IFRIC 12 assist both management and users to better assess the performance and risk exposures related to these service concession arrangements. Financial analysts will benefit from the harmonised accounting in this field assuming that adequate disclosures as abovementioned are provided in the financial statements.

Most stakeholders agree that IFRIC 12 should be limited to cover accounting by the entity that takes on a service concession agreement. This is in line with the general approach in the IAS Regulation. There does not seem to be any widespread demands for issuing guidance for accounting on the grantor's side.

The study concludes that for most service concession operators' implementation and application costs will not be significant. The implementation cost for preparers may depend on the number of service concession agreements to analyse. There seem to be very few companies with a really large number of contracts. Any additional costs to users are likely to be insignificant.

It has been argued that IFRIC 12 would make service concession activities economically less attractive and thereby make private sector financed infrastructure projects more difficult. During the analysis, Commission Services have found no evidence that IFRIC 12 would have such consequences. In those jurisdictions already using IFRIC 12 there has been no noticeable market effect on the companies applying it. On the contrary, external users of the related financial information – financial analysts, investors – have noted that effective application of IFRIC 12 helps them to better assess the nature, the performance and the related risk exposures of service concession arrangements. The companies already applying IFRIC 12 have diversified activities and types of service concession arrangements and have not experienced specific problems. This view may, however, need to be adapted if they apply to other companies much more specialised in service concessions arrangements qualifying for the intangible asset's approach. In such a perspective, an ex-post analysis of actual effects related to the implementation of IFRIC 12 should be done after a relatively short period of application, which the IASB committed to do after two years.

Conclusion and next steps

On the basis of the Effect Study, the Commission Services conclude that IFRIC 12 provides appropriate answers to the urgent need for clarification in the accounting treatment of service concession arrangements. IFRIC 12 will have positive cost-benefit effects and should therefore be endorsed in the EU.

The Commission Services are aware of diverging opinions in the EU concerning IFRIC 12. Some constituents express concerns about expected potential negative effects, whereas others, especially those that already apply IFRIC 12, are much more positive. The Commission Services believe that there is a need to closely follow the implementation of the interpretation in the EU, and that an ex-post analysis should be done after a period of use. The IASB has committed to do a review after two years of operation of the interpretation (i.e. in 2010).

2. BACKGROUND

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union. The Commission Services together with European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as an analysis of effects of using the new accounting rules in the EU. Effect studies are publicly available in the European Commission website[1]. On IFRIC 12, Commission Services have taken the lead on the preparation of the Effect Study and EFRAG has provided background technical support.

2.1. Explanation of the issue

In some countries, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of public services infrastructure, such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks. This infrastructure may already exist, or may be constructed during the period of the service arrangement.

The private sector entity (the operator) may construct, upgrade, operate and/or maintain the infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement, which is governed by a contract setting out performance standards, mechanisms for adjusting prices and/or revenues, as well as for arbitrating disputes. The operator is contractually obliged to provide services to the public on behalf of the (usually) public sector entity (the grantor), although it has some management responsibilities and does not merely act as an agent on behalf of the grantor. The operator is obliged to hand over the infrastructure to the grantor at the end of the period of the arrangement for little or no incremental consideration, irrespective of which party initially financed it.

The objective of IFRIC 12 is to clarify how certain aspects of the existing IASB literature are to be applied to these service concession arrangements.

2.2. How is the issue dealt with currently?

The European Accounting Directives do not provide any specific guidance on the accounting for service concession arrangements. In some Member States, the accounting treatment of service concession arrangements is specified by national law or GAAP. As many companies with service concession arrangements have to apply endorsed IFRS at least to their consolidated accounts, such national accounting treatments should be consistent with endorsed IFRS if used as guidance to elaborate such accounts.

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1 http://ec.europa.eu/internal_market/accounting/index_en.htm

In the US, SFAS 71 provides general guidance for the accounting of regulated industries without especially targeting the rules for the concession industry. SFAS 71 was intended to apply to the general purpose financial statements issued by enterprises which have regulated operations. It does not apply to any specific set of accounts provided to the regulatory authorities. The pronouncement recognises that regulatory agencies may require deviations from GAAP for the regulatory reporting they require, but it emphasises that these should not influence the general purpose financial statements.

Until IFRIC 12, there was no specific IFRS standard or interpretation dealing with service concession arrangements. Depending of the scope and contractual terms of the arrangement, the operator had to apply provisions of several standards or interpretations[2]. SIC-29 *Disclosure – Service Concession Arrangements* contains disclosure requirements in respect of service concession arrangements, but does not specify how they should be accounted for.

As IFRIC 12 is an interpretation that relates to IFRS and IAS already endorsed for use in the European Union (EU), some operators have decided to apply the interpretation voluntarily[3] , although IFRIC 12 has not yet been endorsed in the EU.

2.3. History of IFRIC 12

In 2003, the IASB asked a working group comprising representatives of national accounting standards-setters that had expressed concern[4] about the lack of guidance on service concession arrangements to carry out initial research on the subject. The working group recommended the IFRIC to clarify how certain aspects of existing accounting standards were to be applied.

On 3 March 2005, the IFRIC published three exposure drafts[5] for public comments and received 77 comment letters. In addition, the IASB staff met various interested parties, including preparers, auditors and regulators, in order to better understand the practical implementation issues. Although most respondents supported the idea to develop an interpretation, almost all of them expressed concerns with fundamental aspects of the proposals (for more details see 3.1.1):

- scope of the interpretation;

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2 Among others, IAS11 *Construction Contracts*, IAS 16 *Property, Plant and Equipment*, IAS 17 *Leases*, IAS 18 *Revenues*, IAS 20 *Government grants*, IAS 23 *Borrowing Costs*, IAS 38 *Intangible assets*, IAS 39 *Financial Instruments: Recognition and Measurement*, IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-29 *Disclosure – Service Concession Arrangements*

3 In an absence of a (endorsed) Standard or an interpretation, IAS 8 requires the management to use its judgment in developing and applying an accounting policy. When doing so, the management shall refer to sources provided by the IASB literature.

4 Australia, France, Spain, United Kingdom

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

- basis for recognition of property, plant and equipment;
- dividing lines between the two accounting models proposed – the financial and the intangible asset models;
- recognition of revenue under the intangible asset model.

Some of the respondents considered that the project should be passed on to the Board to develop a comprehensive standard. The IFRIC acknowledged that the project was a large undertaking, but concluded that it was at the time better placed than the Board to deal with the issues in a timely way, given the limited scope of the project.

As a response to criticisms, the IFRIC reconsidered the scope of the project, confirmed the basis for (non) recognition of property, plant and equipment, gave precision on distinction between the financial and intangible asset models as well as on the recognition of revenues in the intangible asset model, and amended the considerations on the amortisation of intangible assets. IFRIC also merged the three exposure drafts into a single Interpretation.

The final Interpretation was issued in November 2006 with effective application date on or after 1 January 2008.

2.4. How does the new interpretation suggest dealing with the issue?

IFRIC 12 explains the accounting treatment of service concession arrangements in the financial statements of the operator. It does not address the accounting treatment of such arrangements in the financial statements of the grantor.

IFRIC 12 clarifies how the infrastructure should be recognised in the financial statements of the operator:

- The infrastructure is ***within the scope of IFRIC 12*** when the grantor controls or regulates the services the operator must provide with the infrastructure, and when the grantor has right to the residual interest in the infrastructure at the end of the arrangement. In this case the infrastructure is not own property of the operator.
- If the arrangement is ***outside the scope of IFRIC 12***, the operator recognises the infrastructure as its own property or as a lease if the arrangement contains a lease according to interpretation IFRIC 4 *Determining whether an Arrangement contains a Lease*.
- The operator recognises a ***financial asset*** if it has an unconditional right to receive cash from the grantor, for example, through an explicit guarantee of the level of revenues to be received throughout the duration of the arrangement.
- The operator recognises an ***intangible asset*** when its revenues are contingent on the extent to which the public uses the service and pays the tolls the operator has been allowed to charge.

IFRIC 12 also deals with the different phases of the service concession arrangement. It distinguishes between the accounting treatment to be applied during the construction or upgrade phases from the one to be applied during the operation and maintaining phases.

It confirms that borrowing costs incurred by the operator can be capitalised in accordance with IAS 23 *Borrowing Costs* only during the construction or upgrade phase[6].

2.5. What would be the changes to currently applied accounting methods?

2.5.1. What are EU companies doing today?

The lack of guidance has led to a situation where company practice is highly diverging. In the study prepared by the Institute of Chartered Accountants in England and Wales (ICAEW) for the European Commission, companies stated that they used IFRS and IAS without giving clear specifications as to the accounting treatments. One company in the ICAEW sample stated that it had used IFRIC 12 voluntarily[7].

EFRAG's internal background analysis of financial statements from a sample of European companies involved in service concession activities highlighted that companies which have not yet implemented IFRIC 12 apply various accounting treatments to services concession arrangements. Some of them recognise the related infrastructure as their own property. Others apply accounting treatments similar to one of the approaches developed in IFRIC 12. Further description of this analysis is included in part 3.3.3 of the report.

2.5.2. What did companies who adopted IFRIC 12 already have to change?

Companies which have already applied IFRIC 12 have reclassified some of their tangible assets as either intangible or financial assets. The total value of these assets has not changed significantly. IFRIC 12 also had an impact on their income statements, but it seems that some changes to a certain extent did offset each other. Profit margins during the construction phase could be recognised more rapidly, whereas some cash flows previously considered as revenues were classified as reimbursement of financial assets – in the financial asset model - and no longer as income. In terms of expenses, amortisation of assets decreased as a result of the reclassification of some tangible assets as financial assets and revenues on financial assets increased.

The prohibition to capitalize interest expenses during the operation and maintaining phases – in the intangible asset model - may have had a negative impact on the net income when service concession arrangements were in their early years in comparison to current practices in some jurisdictions.

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6 IAS 23 has been recently revised and has introduced an amendment to IFRIC 12. In accordance with the revised IAS 23 borrowing costs shall be capitalised under certain circumstances. The option to recognise them as expense has been removed.

7 EU implementation of IFRS and the Fair Value Directive, Study prepared by ICAEW for the European Commission, 2007, available on the Commission website

3. OVERVIEW OF STAKEHOLDERS' CONSULTATIONS

3.1. Earlier consultations

3.1.1. General outcome of the IASB[8] consultation

In March 2005, the IFRIC issued the draft interpretations D12 *Service Concession Arrangements – Determining the Accounting Model*, D13 - *The Financial Asset Model* and D14 – *The Intangible Asset Model* for consultation.

IFRIC received 77 responses to the consultation with around two thirds (45) from EU countries. Most of the EU respondents came from the United Kingdom (38%) and France (27%). In view of their background, preparers of accounts represent the largest group (42%), followed by accountants and auditors (36%) and public authorities (20%). Only one user responded to the consultation.

A number of comment letters stressed the need for the IFRIC to finalise a solution even if that solution would only be interim in its nature. Many commentators argued that they preferred a standard rather than an interpretation on this particular issue. However, the IASB argued that in view of the urgency of providing guidance, the development of an IFRIC interpretation is the best way to finalise the project quickly.

Commentators criticised several aspects of the exposure drafts. The main areas of criticism were:

- the limited scope of the draft interpretations;
- the criteria for recognising property, plant, and equipment as assets of the grantor, which are outside of the scope of the draft interpretations, are not based on the risks and rewards of ownership;
- the dividing line between the intangible asset model and the financial asset model had been drawn in such a way that economically similar projects would be accounted for in vastly different manners, and
- the double recognition of revenue in the intangible asset model.

In general around half of European respondents were positive towards proceeding towards an interpretation, a quarter of the respondents was undecided and one fifth against.

8 Based on IASB document: http://www.iasb.org/NR/rdonlyres/A23BFAEA-A8E8-4F84-BBDD-A98E481F7AEB/0/Serviceconcessionsprojectsummary.pdf and Commission own analysis of responses

Following a public meeting organised in November 2006, the Board supported a staff proposal to remove a sentence in IAS 38.98 that could be interpreted as forbidding amortisation methods that result in lower amounts of accumulated amortisation than under the straight-line method. This made it clear that an increasing amortisation method reflecting the pattern of consumption of a toll licence recognised as an intangible asset under IFRIC 12 is allowed. It has also been clarified that the nature of the consideration including government guarantees must be determined by reference to the specific terms in the contract.

3.1.2. General outcome of the EFRAG[9] consultation

EFRAG followed the developments of IFRIC 12 very closely through a working group consisting of preparers, auditors and users. The group provided input to the IFRIC on various subjects during the development of the interpretation.

During the first quarter of 2007, EFRAG consulted on the draft endorsement advice for IFRIC 12. Feedback was provided by 58 constituents. The majority of responses came from Spain (33), France (5) and Italy (3). 69% of the responses came from industry (preparers), 14% from standard setters, 10% from industry federations and 7% from audit firms/accounting institutes. Users or user associations did not submit responses. However, EFRAG specifically consulted its User Panel on the issue (see 3.3.2).

A majority of respondents expressed reservations regarding the endorsement of IFRIC 12 (72%), whilst 21% expressed clear support for endorsement. 7% of the respondents did not explicitly state a view. Within the group of those expressing reservations against endorsement, the strongest opposition came from industry (preparers) (88%). Of those arguing in favour of endorsement 33% were audit firms/accounting institutes, 25% were industry federations, 25% standard setters and 17% industry (preparers). Submissions by constituents from France, the Netherlands, Sweden and the United Kingdom were generally supportive, whilst respondents from Austria, Germany, Greece, Ireland, Italy, Poland, Portugal and Spain were less supportive or against endorsement.

It was stressed that, following the technical proposals in IFRIC 12, substantially similar arrangements could be accounted for in a different manner: either as intangible assets or financial assets. Certain commentators argued that there was no difference in substance between acquiring a licence (an intangible asset) and a receivable (a financial asset), and therefore only actual risk involved should be considered in determining the accounting treatment.

The intangible asset model was criticised for resulting in large losses during the early years of the contract, even if the contract was profitable over the whole lifetime. Some respondents argued that the percentage of completion method should be allowed. It was also deemed inappropriate that operators recognise losses while at the same time investors, presenting their investments at fair values, would show profits.

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9 Based on EFRAG document: http://www.efrag.org/files/EFRAG%20public%20letters/IFRIC%20Service%20Concession%20Arrangements/EFRAGs%20endorsement%20advice%20%20letter%20on%20IFRIC%2012%20Final%202007-03-23.pdf and Commission own analysis of responses

EFRAG considered the various points raised by its constituents during its re-deliberation process. After having discussed the various issues in detail, EFRAG eventually concluded that IFRIC 12 meets the endorsement criteria set out in EC Regulation 1602/2002 and provided the European Commission with a positive endorsement advice. EFRAG explained its reasoning for its advice in the Basis for Conclusions accompanying the endorsement advice letter.

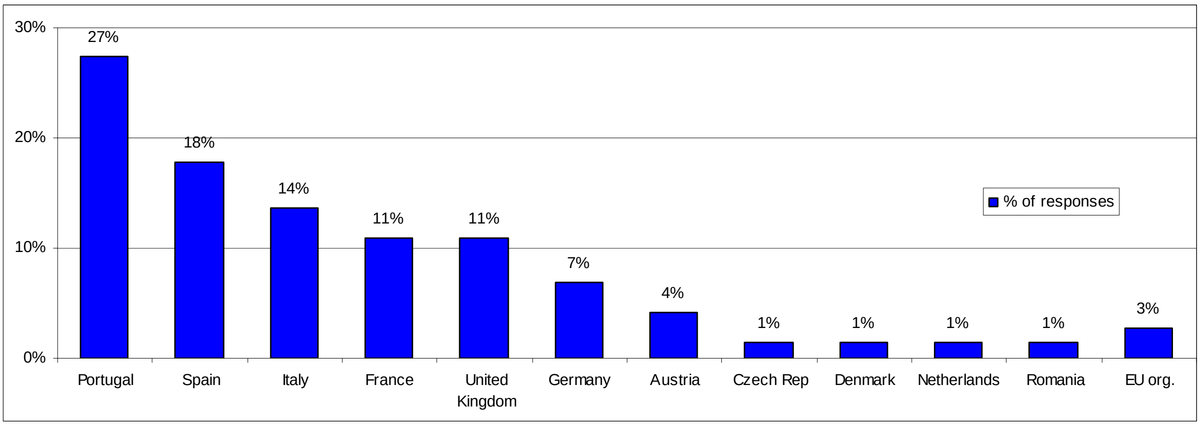
3.2. Overview and general outcome of the Commission Services' consultation

3.2.1. Organisation of the consultation and distribution of answers

On 7 December 2007, the Commission Services issued a questionnaire on the endorsement of IFRIC 12 for public consultation. This questionnaire included general questions as well as specific questions to preparers and to users. The deadline for comments was 25 January 2008.

The Commission Services received 73 answers[10] from 11 Member States. Almost half of responses came from Portugal (27%) and Spain (18%). Five countries (Portugal, Spain, Italy, France and the United Kingdom) represent 81% of the answers. The distribution of answers per Member States is presented in figure 1 below. Some of the answers represent the views of entities belonging to the same group, whereas others represent the views of several stakeholders.

Fig. 1. Responses per Member State



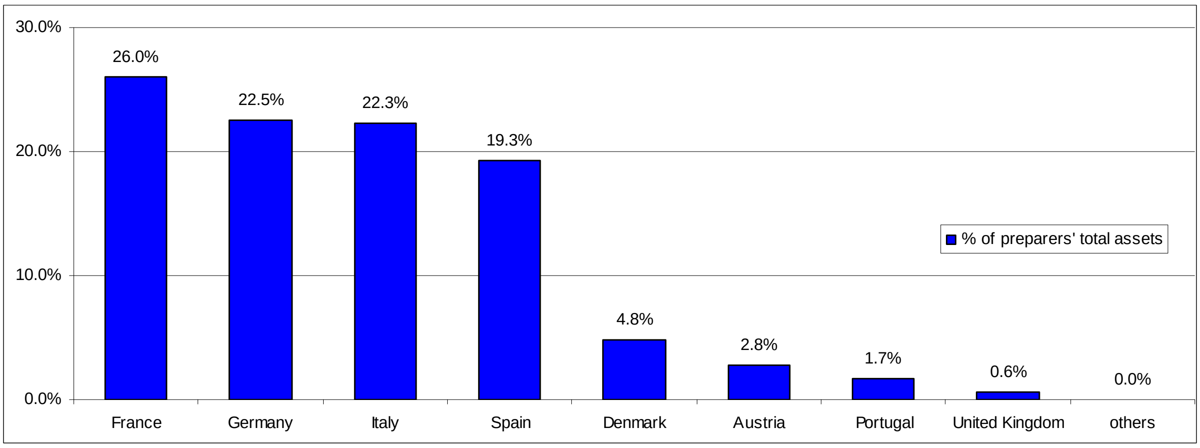
Source: Commission own analysis

Based on the value of total assets and the turnover figures shown in respondents' financial statements, four countries emerge as the key stakeholders in this area: France, Germany, Italy and Spain.

[10] See Annex 3

Preparers from these four countries accounted for 90% of total assets of all preparers who answered; lead by France and followed by Germany, Italy and Spain (see fig 2).

Fig. 2. Distribution of responses per Member State according to total assets of preparers

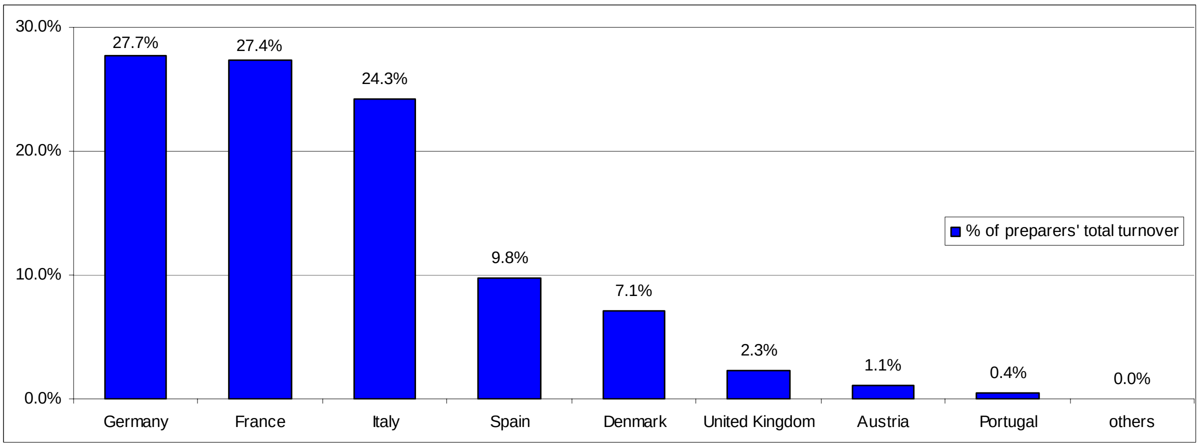


Note: 49 preparers (out of 52) provided data on total assets

Source: Commission own analysis

Preparers from these four countries accounted for 89% of total turnover of all preparers who answered; lead by Germany and followed by France, Italy and Spain (see fig. 3)

Fig. 3. Distribution of responses per Member State according to total turnover of preparers

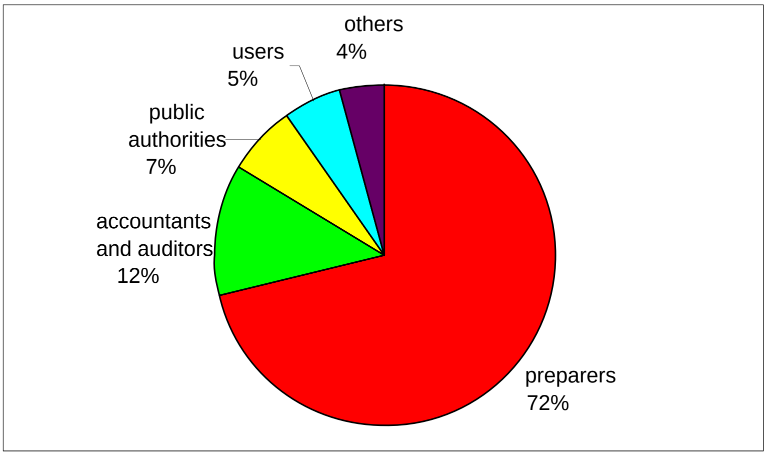


Note: 49 preparers (out of 52) provided data on turnover

Source: Commission own analysis

In terms of distribution by type of stakeholder, most answers came form preparers (72%) followed by accountants and auditors (12%), public authorities (7%) and users (5%). The distribution of answers per type of stakeholder is presented in figure 4 below.

Fig. 4. Responses by type of stakeholder



Source: Commission analysis

Of the 52 preparers responding to the questionnaire, 48 were listed companies. Among those that provided data on assets, revenues and employment, median total assets is €4billion (bn) with total around €1100bn and 36% above €10bn. Median revenues are €800m with total around €500bn and 18% above €25bn. Respondents employ 2500 employees in average with total around 2m and 24% more than 50000. Additional distribution figures are provided in figure 5 below.

Fig. 5. Various characteristics of the respondents

Listing	Europe	US	Other
	85%	10%	5%
Financial figures	Below €100m	Between €100m & €1bn	Above €1bn
Turnover Total assets	35% 20%	20% 14%	45% 66%
	Less than 100	Between 100 and 1000	More than 1000
Employment	24%	19%	57%

Note: Only those who answered included

Source: Commission own analysis

One third of the respondents participated also in consultations organised by IASB or EFRAG.

3.2.2. General outcome of the Commission Services' consultation

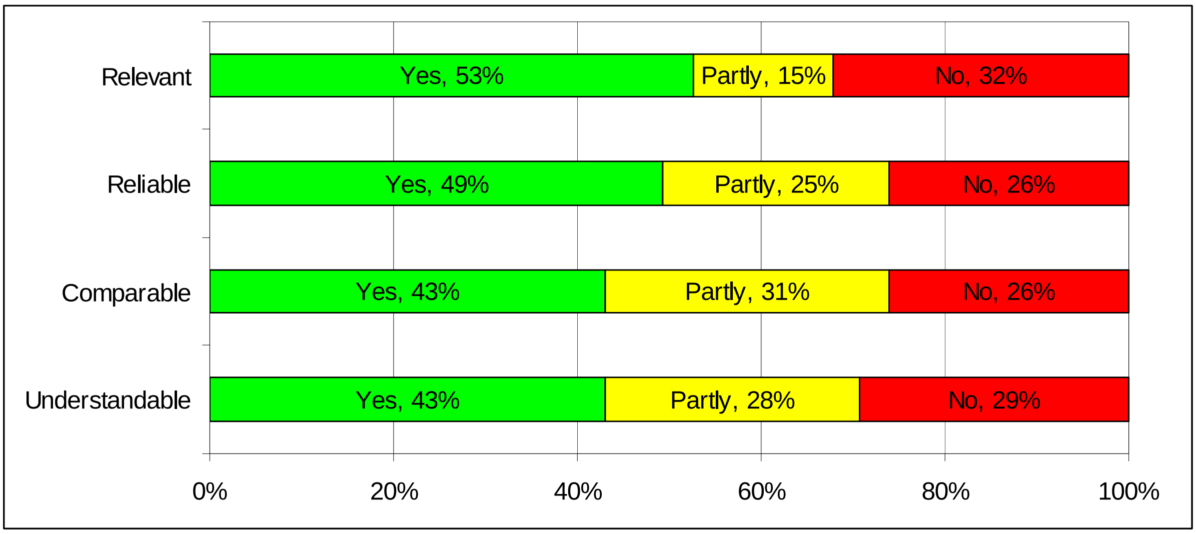
Necessity to clarify the accounting treatment

Most respondents (more than 80%) agree that it was necessary to clarify the accounting treatment to be applied to service concession arrangements under IFRS. This opinion is shared by all types of shareholders, as well as by all but one responding Member States.

Qualitative characteristics[11] of IFRIC 12

Out of the 89% of respondents who expressed an opinion on the qualitative characteristics of IFRIC 12, around 50 % considered that application of IFRIC 12 will result in relevant and reliable information. Around 43 % consider that the information provided would be comparable and understandable. Between 15% and 31% were of the opinion that these characteristics will be partly achieved, whereas the remaining respondents (around 30%) think that they will not be met.

Fig. 6. Responses to various characteristics of IFRIC 12



Note: Only those who answered included

Source: Commission own analysis

Accountants and auditors expressed very positive views concerning the qualitative characteristics of IFRIC 12 (especially on relevance and reliability). The majority of public authorities also consider that information provided by IFRIC 12 will be relevant and reliable, as well as at least partly comparable and understandable. Users generally consider that the qualitative characteristics will be at least partly achieved, except for understandability. A relative majority of preparers (between 44% and 50%) are of the opinion that these characteristics will be achieved, whereas between 16% and 24% think that they will be partly achieved. Between 28% and 34% of preparers consider that information provided will not meet these characteristics.

Appropriateness and usefulness of IFRIC 12, necessity of a specific standard on service concession arrangements

Opinions were split on the overall appropriateness of the accounting treatments provided by IFRIC 12. A small majority of those who answered this question thought that the IFRIC 12 accounting solutions are appropriate (48%) or at least useful (6%) until a specific standard for service concessions is issued. A large majority of accountants and auditors consider that IFRIC 12 is appropriate. The majority of public authorities share this view, whereas the majority of preparers and responding users disagree.

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[11] Relevance, reliability, comparability and understandability as referred to in article 3 of Regulation n°1606/2002

A strong majority of respondents (66% against 26%) would have preferred a standard to be issued, even some of those thinking that the accounting treatment provided by IFRIC 12 was appropriate. The greatest supporters are public authorities and preparers while views of accountants and auditors are split.

Main costs and benefits of IFRIC 12

Respondents, mostly preparers, have identified potential implementation costs: analysis needed in order to reclassify assets in different accounting categories, collection of necessary data and more generally changes in data processing systems, potential disruption of usual contractual, regulatory and tax practices.

The benefits most frequently identified were enhanced comparability, creation of clear guidance on the accounting treatment to be applied, relevant presentation of assets under a service concession arrangement, better understanding and strengthened compliance with IFRS.

It can be noted that preparers which have already implemented IFRIC 12 express more positive views than other preparers. They state that implementation costs and accounting changes were not so significant, whereas the benefits were considerable - also for internal management needs – as regards performance analysis and assessment of risk exposure.

Significance of IFRIC 12 for the respondents' business (preparers)

This question was answered by 74% of respondents, most of them preparers. A large majority of them (70%) considered that service concession arrangements are significant for their business. IFRIC 12 issues were significant for respondents from Italy, Portugal, Spain and France, but less important in Germany and UK.

Description of current accounting treatment applied (preparers)

The vast majority of those who described their current accounting treatment, if not IFRIC 12, recognised infrastructure under service concession arrangements as property, plants and equipment. In fewer cases infrastructure was recognised as intangible assets, and even more rarely as financial asset or lease. Amortization of these tangible assets was usually made on a straight-line basis. In some case amortization was done on a "usage basis" approach.

Usefulness of information provided by IFRIC 12 for internal purpose (preparers)

The majority of companies who answered the question did not see the usefulness of IFRIC 12 for internal purposes. However, all preparers currently applying IFRIC 12 considered that information and classification provided by IFRIC 12 was very helpful for internal purposes in order to assess risk exposure and performance of service concession arrangements.

Specific views from users

Few users answered to the questionnaire. It may be noted that most of the information they considered as useful for service concessions were not directly accounting data. Their needs were basically rather for economic (turnover, value added, investment), financial (cash flows, debt, ebitda) or non-financial information (activity level – such as traffic on motorways -, duration and contract details. Preparers should be encouraged to provide as much additional information as possible, in order to disclose to users the relevant information.

3.3. Other consultations, EFRAG survey and interviews

3.3.1. Discussions between European stakeholders and Commission Services

The Commission Services have held discussions with European companies who have already applied IFRIC 12 as guidance[12] or intend to apply it in 2008[13]. We have also discussed with companies that have expressed concerns about the use of the interpretation.

Companies who have already applied the interpretation

These companies noted that it was hard, but useful work to identify whether their contracts were in fact in the scope of IFRIC 12 or of another standard or interpretation. This helped the companies to clarify different kinds of risk exposure and assess the underlying performance of each type of contract. Companies agreed that IFRIC 12 therefore had positive effects for internal management purposes.

The main impact of applying IFRIC 12 consisted in reclassifying some tangible assets as either intangible or financial assets, without significant changes in their total value. Changes also had a limited impact on income statements (profit margins on construction phases, cash flows reclassified from revenues to reimbursement of financial assets, change in the amortisation pace of some assets, revenues recognised on financial assets).

One of these companies specifically presented the impact of IFRIC 12 implementation on its financial statements to analysts. The reactions from analysts were favourable as they considered that the new presentation provided put a clearer focus on cash flows and remuneration figures. In their opinion, this could lead to reduction in financing costs, and would facilitate analysis of risk exposures.

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12 Gaz de France, Suez, Veolia

13 Vinci, Eiffage, Sodexo, EDF

Companies opposing the interpretation

The Commission Services have also met with an organisation of companies which strongly oppose to IFRIC 12[14]. This organisation argued that IFRIC 12, although introducing some improvements, did not provide a true and fair view of the essence of the service concession business, especially when the infrastructure is recognised as an intangible asset. Its main criticism focused on the perceived timing mismatch between recognition of revenues and expenses in an intangible asset model. It considered that it would be inconsistent to force operators to recognise huge losses in the first years of the service concession arrangement, as well as huge profits in the last years, even if the contract considered as a whole would without doubt be highly profitable.

The organisation claimed that the accounting treatment should be adapted to the specificity to these contracts and the organisation has also provided several technical solutions (described in Annex 1) to reduce or eliminate the timing mismatch between recognition of revenues and expenses. As these technical solutions would generally require changes in existing IFRS, the organisation was of the opinion that accounting for service concession arrangements should have been addressed by a new or amended standard(s) rather than by an interpretation. It proposed that IFRIC 12 should not be endorsed and to authorise use of national GAAP as an interim solution until an appropriate new IFRS would address the issue.

The organisation also considered that implementing IFRIC 12 may weaken the attractiveness of service concession activities among investors and could harm the competitiveness of the European service concession industry internationally.

3.3.2. Discussions with the EFRAG User Panel

The EFRAG User Panel examined IFRIC 12 at its 11 December 2007 meeting. Representatives from the Commission Services attended the meeting.

Members of the User Panel pointed out that in their view it was reasonable to apply different accounting treatments to different service concession arrangements as the contractual provisions and economic substance may vary from one contract to another. In addition to accounting figures, they would like to see more specified disclosure of cash flows for each project, which however is not part of the IFRIC 12 guidance. Concerning the perceived timing mismatch in the recognition of revenues and expenses under the intangible asset model, they thought that this would not be different from the situation in other industries, for example telecom.

3.3.3. Analysis of financial statements by listed companies

EFRAG has undertaken a detailed internal background analysis of 2006 financial statements from European companies[15] involved in service concession activities in order to analyse the current accounting treatment for these activities. This analysis provides important insights in assessing the potential changes that the implementation of IFRIC 12 could imply.

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[14] The *Asociacion de Empresas Constructoras de Ámbito Nacional* (SEOPAN), representing Spanish companies involved in service concession activities.

[15] From France, Germany, Italy, Spain and UK

As noted in part 3.3.1, some companies already applied IFRIC 12 voluntarily. An analysis of their accounts confirms that the main impact is the reclassification of some tangible assets as intangible or financial assets. One company explained this by noting that the accounting treatment for intangible assets under IFRIC 12 is very similar to the previous one applied to tangible assets. These companies used both intangible and financial approaches in their accounts, depending of the characteristics of each concession contracts.

Companies that have not yet implemented IFRIC 12, apply various accounting treatments to recognise service concessions arrangements in their financial statements. Some companies recognise the related infrastructure as own property. Some apply an accounting treatment that seems to be close to the financial asset approach of IFRIC 12. Others use an accounting treatment similar to the intangible asset approach of IFRIC 12. Finally, some companies apply accounting treatments similar to both approaches depending of the characteristics of the contracts.

One company describes in the notes to the consolidated financial statements that it recognised deferred finance charges under local GAAP. IFRIC 12 may have a significant impact on its account.

3.4. Summary of reasons in favour or against the accounting treatments in IFRIC 12

Respondents to the consultations mentioned the following main reasons in favour of the accounting treatments and/or endorsement of IFRIC 12:

- It is necessary to urgently clarify the accounting treatment to be applied to service concession arrangements; uncertainty concerning the interpretation creates difficulties in application and legal risks; this clarification cannot wait until a permanent standard would be issued. It is also necessary to harmonise practices; the current lack of specific guidance results in diversity of practices, lack of comparability and distortion of competition.

- IFRIC 12 provides clarification in many areas: classification and recognition of related infrastructure; distinction between the construction/upgrade phase and the operating/maintaining phase; and recognition of related income and expense. Therefore, IFRIC 12 helps to better understand how to apply endorsed IFRS to service concession arrangements and strengthen consistency of practices with these standards.

- IFRIC 12 provides consistency between the accounting treatment of service concession arrangements and the accounting treatment of other types of contracts outside the scope of IFRIC 12, when the infrastructure is considered as own property of the operator.

- Effective application of IFRIC 12 helps the company management to better understand the nature, the performance and the related risk exposures of service concession arrangements.

- Overall IFRIC 12 leads to lower recurring accounting costs for companies.

- Effective application of IFRIC 12 also helps external users of financial information (investors, analysts) to better understand the nature, the performance and the related risk exposures of service concession arrangements; this may reduce the capital cost of such operation.

Respondents to the consultations mentioned the following main reasons against the accounting treatments and/or endorsement of IFRIC 12:

- A standard would have been preferable to address the complex issues related to service concession arrangements, especially as current provisions of endorsed IFRS may need to be changed to better reflect the substance of such operations.

- IFRIC 12 is not complete; it does not encompass all types of service concession arrangements and does not provide guidance for the accounting treatment by the grantor.

- The coexistence of two approaches (financial / intangible assets) with very different resulting accounting treatments brings confusion and creates lack of comparability between operations which are not so different from an economic point of view.

- The different accounting treatment to be applied by investment funds and industrial operators brings confusion, lack of comparability and distortion of competition.

- Recognition of the infrastructure related to a service concession arrangement as a financial or intangible asset instead of as the own property of the operator is questionable when in practice the operator is exposed to the main risks and rewards related to these kind of assets.

- The timing mismatch between recognition of revenues and expenses, especially when the infrastructure is recognised as an intangible asset does not reflect a true and fair view of the economic substance of the service concession.

4. EFFECT ANALYSIS

4.1. Methodology

The report aims at analysing the potential effects of introducing IFRIC 12 in the EU. The analysis of these potential effects was undertaken by the Commission Services using the following sources of input in preparing the report:

- Answers to the questionnaire[16] issued by the Commission Services for public consultation on 7 December 2007.

- Analysis of the outcome from consultations undertaken by EFRAG on the endorsement advice related to IFRIC 12, and by the IASB/IFRIC on their three exposure drafts.

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16 See Annex 2

- Analysis of argumentation and documentation received in the context of the additional discussions between the IASB and European stakeholders on IFRIC 12.

- Discussion between the Commission Services and European constituents, including Member States, ARC members, companies and business associations involved in service concession arrangements; in particular discussion and exchange of documentation with companies that already voluntarily apply IFRIC 12.

- Interviews and meetings with EFRAG staff and the EFRAG User Panel.

4.2. Discussion and analysis of main issues

On the basis of the consultations, the EFRAG survey and subsequent discussions with stakeholders, the Commission Services have identified a number of main IFRIC 12 related issues to be analysed further in this chapter.

4.2.1. Need for guidance on accounting for service concession arrangements

Issues: Is guidance on the accounting treatment for service concession arrangements needed? Should this be done through an interpretation or a standard? Is IFRIC 12 appropriate or useful in such a perspective?

Most respondents to the IASB, EFRAG and Commission consultations clearly believe that it is necessary to clarify the accounting treatment for service concession arrangements under IFRS. 81% of respondents who commented on the issue in the Commission questionnaire agreed that clarification would be needed. Many respondents highlighted that the current situation is not satisfactory. The lack of precision and guidance has led to significant technical difficulties and unsatisfactory results in applying existing IFRS to service concession arrangements. In practice, preparers and users noted a great diversity in application, which undermined comparability. Information provided is not easily understandable and may raise questions about consistency of current practices with endorsed IFRS.

Most respondents would have preferred a standard to address this issue. 72% of the respondents on the issue in the Commission questionnaire would have preferred a standard. Nevertheless, most stakeholders are aware that elaborating a standard would take several years.

34 respondents considered that IFRIC 12 provided an appropriate solution to the accounting for service concession arrangements and 4 further respondents found it useful to endorse IFRIC 12 in the meantime before a standard is issued. 32 respondents did not find IFRIC 12 appropriate or useful. Moreover, some of the respondents opposed to IFRIC 12 thought that that clarification could not wait until a standard is issued and would therefore favour an endorsement of an amended IFRIC 12.

Some respondents claimed that IFRIC 12 should not be endorsed before a new standard is issued and that companies should be authorized in the meantime to apply local GAAP. It should be highlighted that IFRIC 12 is an interpretation that give guidance on how to apply already existing and endorsed IFRS, which should in any case be applied by companies under the scope of the IAS Regulation. Local GAAP can only be used if in accordance with applicable IFRS.

Some respondents proposed to endorse IFRIC 12 for a limited period of time in order to address some application issues before a final standard is issued. This could also allow users to test in practice the usefulness and appropriateness of the information provided by IFRIC 12. In such a perspective, an ex-post analysis of actual effects related to the implementation of IFRIC 12 should be done after a relatively short period of application, which the IASB committed to do after two years.

The Commission Services believe that there is an urgent need to provide guidance on the accounting treatment for service concession arrangements. In the long term, this accounting area should be the subject of a specific international standard. In the meantime, IFRIC 12 can usefully provide such guidance and increase the quality of financial statements for companies involved in the service concessions field. An ex-post analysis of the effect of the IFRIC 12 implementation should be done after a relatively short period of application. The IASB has committed to undertake it after two years of IFRIC 12 application.

4.2.2. Accounting treatment by the grantor of a service concession

Issue: Should IFRIC 12 include guidance on the accounting treatment to be applied by the grantor of a service concession?

IFRIC 12 does not provide guidance for the accounting treatment to be applied by the grantor of a service concession. As IFRIC 12 focuses on public-to-private arrangements, this limitation is consistent with the general policy of the IASB not to elaborate IFRS with the view to have them be applied to public entities. The IASB generally elaborates standards and interpretations for the consolidated financial statements of listed companies.

Moreover, the IAS Regulation focuses on accounting rules for consolidated accounts of companies which securities are admitted to trading on regulated financial markets. The mandatory provisions of the IAS Regulation are limited to this scope.

Some stakeholders claim that service concession arrangements may be contracted between two private entities. Such cases are apparently rare and may be concentrated to some countries.

The Commission Services are of the opinion that IFRIC 12 should be limited to cover accounting by the entity that takes on a service concession agreement. This is in line with the general approach in the IAS Regulation. There does not seem to be any widespread demands for issuing guidance for accounting on the grantor's side. Organisations involved in elaborating public sector accounting standards may however want to look into this area.

4.2.3. Service concession arrangements in the scope of IFRIC 12

Issues: Should IFRIC 12 encompass all operations that may be perceived as service concession arrangements by stakeholders? Is the definition of service concession arrangements in IFRIC 12 appropriate?

IFRIC 12 includes in its scope "public-to-private service concession arrangements if:

- the grantor controls or regulates the services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

- the grantor controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement."

Some respondents considered that IFRIC 12 is not complete as it does not include all types of service concession arrangements. Some advocated a broader definition to encompass a larger set of similar contracts. This raises the question whether IFRIC 12 should provide guidance for all types of contracts that stakeholders would consider as service concession (or similar type of) arrangements.

Many respondents highlight the great variety of service concession arrangements. In this case, it may appear difficult that an interpretation could encompass all of them. Some respondents therefore considered that IFRIC 12 should not try to include all service concession arrangements in its scope. In fact, companies which already apply IFRIC 12 have not classified all their service concession contracts under IFRIC 12 and have maintained several as own property, plant and equipment or lease.

Some respondents questioned the conclusion in IFRIC 12 that infrastructure under the scope of a service concession arrangement should not be classified as property, plant and equipment. They argued that, due to the considerable length of the contracts, many unexpected events would be at the operator's risk and an application of a risks and rewards approach (similar to the one used for leases) would lead to considering the infrastructure as own property. However, many respondents – also some opposed IFRIC 12 for other reasons - considered that IFRIC 12 would provide welcome clarification of the classification of assets based on a control approach, resulting in clear distinction between tangible – when the operator controls the infrastructure - and financial/intangible assets. Some respondents also welcomed the distinction between the recognition of a financial asset or an intangible asset under a service concession arrangement within the scope of IFRIC 12 on the basis of the operator's exposure to the demand risk related to the infrastructure. This criterion may be seen as the application of a risks and rewards approach consistent with the one used for distinguishing financial from operational leases, with similar accounting consequences.

The Commission Services believe that it is not necessary that the scope of IFRIC 12 includes all arrangements that may be perceived by some stakeholders as service concession arrangements. Arrangements outside the scope of IFRIC 12 will be referred to other standards or interpretations, especially when the infrastructure may be considered as the own property of the operator or as a lease. This does not undermine the welcome clarifications in IFRIC 12 concerning the classification of assets related to many service concession service arrangements.

4.2.4. *Revenue and expense recognition in IFRIC 12 – True and fair representation of the nature of service concession arrangements*

Issues: Does the accounting treatments in IFRIC 12 lead to the correct recognition in time of revenues and expenses related to service concession arrangements? Does IFRIC 12 contain accounting solutions that provide a true and fair view of the economic substance of service concession arrangements?

The question when to recognise revenues and expenses for service concession arrangements in the scope of IFRIC 12 has created important debates between the IASB and some European stakeholders. A number of different accounting solutions have been presented by stakeholders and have been discussed in the IASB. An overview of such models can be found in Annex 1.

Many respondents have criticised how revenues and expenses are recognised in the intangible asset model in IFRIC 12. They consider that there is a timing mismatch between the recognition of accounting in- and outflows. On the one side, significant loans lead to interest expenses to be recognised in the first years of the contract – reflecting the huge investments necessary to build, upgrade or buy the infrastructure before operating it. On the contrary, revenues will be higher in the last years of the contract, as the use of the infrastructure by customers, as well as the price of the charged toll, are both expected to rise over the years. In such a context, the accounting treatment required by IFRIC 12 will result in the recognition of huge losses in the first years of the contract followed by huge profits being recognised during the last years. These respondents consider that this accounting treatment will not give a true and fair view of overall profitable contracts. They claim that the accounting treatment should reflect the economic rationale of service concession arrangements, which is based on expected revenues for the whole duration of the contract to cover all expenses, without the need of perfect matching of related cash flows on a yearly basis.

Other stakeholders as well as members of EFRAG's User Panel highlighted that this apparent timing mismatch between recognition of revenues and expenses is not specific to service concession arrangements. It is also the existing accounting treatment applied for a long time to activities that require huge initial investments and where the operator is considered as the owner of the infrastructure, such as telecommunication service companies or energy suppliers. This may also be the case for start-ups in high technology industries. In such situations, users are especially interested in companies providing information on expected future cash flows and on elaboration on management's assessment of the future profitability of the service concession agreement. Companies should be encouraged to provide such kind of information.

The IASB has taken into account some concerns expressed by European stakeholders related to the perceived timing mismatch between recognition of revenues and expenses. The Board has decided to amend provisions of IAS 38 *Intangible assets*[17] related to the amortisation pace of intangible assets in order to make it clear that the use of an amortisation method resulting in a lower amount of accumulated amortisation than under the straight-line method is permitted. This change will allow applying a progressive amortisation method to intangible assets in a service concession arrangement. Companies will be authorized to recognise a lower annual amortisation expense in the first years of the arrangements, reflecting the lower level of toll charges in these first years, which will reduce the perceived timing mismatch. Respondents to the questionnaire supported this amendment.

Many respondents also welcomed the clarification provided by IFRIC 12 concerning the distinction between the construction or upgrade phase (if any), and the operating and/or maintaining phase of a service concession arrangement. In particular, they were positive to the possibility to distinguishing different yield returns and to recognise the related profit margins at different times. Some respondents however noted that this may bring some technical difficulties in certain circumstances, but that it will provide additional useful information for both preparers and users.

The Commission Services have carefully considered the comments to the consultations as well as the outcome of several technical discussions with stakeholders on the recognition issues. The Services conclude that IFRIC 12 provides guidance on the recognition of revenues and expenses which is consistent with existing IFRS already endorsed by the European Union. They noted that some respondents consider that the timing mismatch between recognition of revenues and expenses does not reflect the economic substance of service concession arrangements. However, this perceived timing mismatch between recognition of revenues and expenses is similar to the accounting treatment already applied in other situations where the operator is the owner of the infrastructure or in the start-up phase of a company. This accounting treatment does not seem to generate negative reactions from investors or analysts, assuming that companies provide adequate information in the notes of the financial statements. In addition to comply with SIC 29 *Service Concession Arrangements: Disclosures*, companies should be encouraged to develop additional disclosures if necessary, especially on expected future cash flows, that users require in order to better understand this kind of business. IFRIC 12 also provides clarification on the distinction between the different phases of a service concession arrangement. Furthermore, the IASB has introduced an amendment in IAS 38 related to the amortisation pace of intangible assets, which has been welcomed by respondents.

4.2.5. Clarity and comparability of financial statements prepared on the basis of IFRIC 12 – Impact on financial and risk analysis

Issues: Does IFRIC 12 enhance the clarity, understanding and comparability of financial statements of companies involved in service concession business? Does it facilitate financial and risk analysis?

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[17] This amendment is included in the Annual Improvement to IFRS.

Many stakeholders, also some of those who oppose IFRIC 12, acknowledge the merits of the interpretation in identifying assets and liabilities related to service concession arrangements, as well as in clarifying the classification of the related assets and distinguishing construction phase from operating phase. Companies already voluntarily applying IFRIC 12 expressed the view that the application of the interpretation made them better assessing the nature, performance and risk exposures of their service concession contracts. Users who have analysed IFRIC 12 information considered that it brought increased clarity and understandability to service concession activities and that it facilitated the assessment of profitability and related risk exposures. At the EFRAG User Panel meeting it was noted that the interpretation may help to distinguish parts of the balance sheet that relate to service concession arrangements.

Some respondents questioned the distinction between two accounting treatments (a financial asset or an intangible asset) associated with very different approaches in recognising related revenues and expenses, for contracts they consider as quite similar from an economic viewpoint. On the contrary, other respondents, as well as members of the EFRAG's User Panel, considered it reasonable to apply different accounting treatments to contracts which are different in substance, even if the actual cash flows might be the same. Difference in substance may arise depending whether the operator is exposed to the demand risk or not. Operators of service concession arrangements should be encouraged to disclose exposure to this kind of risk which could help users to better understand their business.

Other stakeholders also questioned the difference in the accounting treatment to be applied to parties involved in a service concession arrangement depending of their status. They found it inconsistent that an investment fund could measure its investment in a service concession arrangement at its fair value – which they supposed to be reflecting the (high) expected profitability of the investment for the whole duration of the contract -, whereas the "industrial" operator would have to recognise huge losses in the first years of the arrangement if it is accounted for using the intangible asset model. They considered that a similar accounting treatment should be applied to both types of preparers of accounts, normally a convergence towards the method applied to investment funds. It may be noted that IFRS and other GAAPs usually apply a different accounting treatment to interests which are considered as financial investments - generally measuring them at fair value - from those which imply control of the decision making process and management of the activity. Unifying these accounting treatments would imply applying fair value accounting in the service concession field to a much larger extent than in other areas. Such a proposal obviously goes far beyond the scope of an interpretation.

The Commission Services are of the opinion that IFRIC 12 brings increased clarity as to the accounting treatment to be applied, as well as enhanced comparability and distinction between different types of contract based on clear criteria, although some of these different contracts may be perceived as very similar at first sight. Financial information prepared under IFRIC 12 will assist both the management of companies and users of financial statements to better assess the performance and risk exposures related to these service concession arrangements. Financial analysts will clearly benefit from the harmonised accounting in this field, as well as the improved disclosures.

4.2.6. Costs for preparers and users

Issues: What are the costs implications for preparers and users of using IFRIC 12?

Costs for preparers

Preparers have identified the following potential costs related to the application of IFRIC 12:

- understanding and getting familiar with the interpretation itself, considered as one of the main implementation cost, and, to a lesser extent, investors training costs,

- analysis of each service concession contract and reclassification of related assets in the different accounting categories,

- establishment of new internal procedures, collection of the necessary data and, to a lesser extent, changes in data processing systems in order to apply the new accounting treatment,

- legal costs that may be linked to possible disruption of usual contractual, regulatory and tax practices.

Most of the additional costs are linked to the implementation of the new accounting treatments, and will not be recurring to the same extent, except for new internal procedures. It may be noted that preparers which have already implemented IFRIC 12 are more optimistic than other preparers. They perceive implementation costs and accounting changes as less serious than forecasted, except for the case when a company has a very large number of service concession contracts to analyse.

Costs for users

Users will have to adjust their analysis models to adapt to the new financial information. Certain financial ratios currently used may need to be redefined. However, more relevant and comparative figures will significantly facilitate the work of the analysts. Additional costs are deemed insignificant.

The Commission Services conclude that for most service concession operators' implementation and application costs will not be significant. The implementation cost for preparers may depend on the number of service concession agreements to analyse. There seem to be very few companies with a really large number of contracts.

Any additional costs to users are deemed insignificant.

5. OVERALL COST-BENEFIT CONSIDERATIONS

The Commission Services have considered the overall costs and benefits of endorsing IFRIC 12. The Commission Services tentatively conclude that the benefits of endorsing the interpretation IFRIC 12 outweigh its costs.

The main benefits of endorsing IFRIC 12 will be the following:

- Clear guidance on the accounting treatment for service concession arrangements will enhance the general understanding of the financial statements of companies involved in this business. It will furthermore improve the consistency in application of IFRS rules for service concession arrangements. In the longer run, this would reduce uncertainty concerning the accounting treatment and strengthen the confidence in the financial information.

- It will facilitate the understanding and analysis of the nature of service concession contracts by users, as well as their performance and related risk exposure. It will also enhance comparability. This may reinforce the attractiveness of such operations among investors and may lessen their funding costs, provided adequate disclosures are given to users, especially on expected future cash flows.

- It will help company management to better assessing the performance and risk exposures of these operations for internal purposes, according to the experience of companies already applying IFRIC 12.

- It would make the European accounting framework consistent with the IASB framework in a field where European companies are in fact leading providers.

The main costs of endorsing IFRIC 12 will be the following:

- It will oblige European companies to analyse their - potentially numerous - existing service concession contracts in order to reclassify them in conformity with IFRIC 12's provisions and to adapt their related data collection systems.

- These companies will have to adapt their financial statement presentation and financial communication in order to explain the impact of the interpretation and provide the additional information required by users beyond regulatory disclosure requirements.

- It may induce changes in current business, contractual, regulatory and tax practices, which may be different from one jurisdiction to another.

- It will oblige users of financial statements to adapt their analysis procedures and practices.

Implementation costs are generally assessed to be minor to preparers as well as users.

In the discussion of IFRIC 12 it has sometimes been argued that the proposed changes would make service concession activities economically less attractive and thereby make private sector financed infrastructure projects more difficult. The Commission Services have not found any evidence that the accounting solutions in IFRIC 12 would have such consequences. In those jurisdictions already using IFRIC 12 there has been no noticeable market effect on the companies due to their application of the revenue and expense recognition provisions in the interpretation. Nevertheless, these observations may need to be adapted if they apply to other companies much more specialised in service concessions arrangements qualifying for the intangible asset's approach. In such a perspective, an ex-post analysis of actual effects related to the implementation of IFRIC 12 should be done after a relatively short period of application, which the IASB committed to do after two years.

6. COMMISSION SERVICES' CONCLUSIONS AND NEXT STEPS

The Commission Services believe that IFRIC 12 provides an appropriate answer to the urgent need for clarification of accounting for service concession arrangements. The interpretation will have positive cost-benefits effects and should therefore be endorsed in the EU.

The Commission Services are aware that there are diverging opinions in the EU concerning the application of IFRIC 12. Some constituents express concerns about expected potential negative effects, whereas others, especially those that already apply IFRIC 12, are much more positive in their comments. The Commission Services believe that there is a need to closely follow the implementation of the interpretation in the EU, and that an ex-post analysis should be done after a period of use. The IASB has committed to do a review after two years of operation of the interpretation (2011).

The Commission Services would like to express their appreciation to all stakeholders which provided valuable input to the report.

ABBREVIATIONS

ARC	Accounting Regulatory Committee
EFRAG	European Financial Reporting Advisory Group
EU	European Union
FAS/SFAS	Financial Accounting Standard/Statement of Financial Accounting Standard (issued by the FASB, the US standard setter)
FASB	Financial Accounting Standard Board
GAAP	Generally Accepted Accounting Principles (when referring to national sets of accounting rules)
IAS	International Accounting Standard
IAS Regulation	Regulation (EC)1606/2002 of the European Parliament and of the Council of 19.7.2002 regarding the introduction of IFRS in the EU
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IFRIC	International Financial Reporting Interpretations Committee and its interpretations
IFRS	International Financial Reporting Standard
SEOPAN	Asociación de Empresas Constructoras de Ámbito Nacional (Spanish construction firms' association)
SIC	Standard Interpretation Committee (predecessor of the IFRIC) and its interpretations)
UK	United Kingdom
US(A)	Unites States (of America)

ANNEX 1: DISCUSSION OF TECHNICAL ISSUES RAISED BY IFRIC 12

IFRIC 12 has been much debated as the interpretation may require accounting changes for some jurisdictions in comparison with current practice. In particular, the so-called intangible asset model has been questioned by some European constituents due to a perceived timing mismatch between recognition of revenues and expenses on service concession arrangements. The concern is that IFRIC 12 would result in large losses being recognised in the early years of the arrangements whereas huge profits would be recognised in the late years. Under the intangible asset model this may be the case as large interest costs recognised during the first years of the arrangement would not be offset by similarly large interest revenues as in the financial asset model.

Stakeholders, in particularly from Spain, have proposed alternative accounting approaches in order to reduce or even eliminate the perceived timing mismatch between recognition of revenue and expenses. These methods have been discussed by IFRIC and the EFRAG. Below we briefly describe these methods. The descriptions are principally based on material from European stakeholders, IASB, EFRAG and other public sources.

The purpose is to describe the methods that have been mentioned in the debate and should not be seen as Commission Services interpretations. The Commission Services do not interpret IAS/IFRS as this is made at international level by IFRIC.

Regulatory asset

The question is whether the service concession operator could recognise a regulatory asset representing the right to recover finance or other type of costs incurred during previous periods of a service concession arrangement through regulated tariffs charged to customers in future periods. The recognition of such a regulated asset would in fact consist in capitalising some expenses and amortise them at the same pace as recognition of future revenues resulting from tariffs specifically determined to recover these expenses. This would help reducing or eliminating the timing mismatch between recognition of revenues and expenses.

US GAAP allow recognition of certain expenses as regulatory assets subject to certain conditions under SFAS 71 *Accounting for the effects of certain types of regulation*. The Spanish "Sector Chart of Accounts" also allows deferral of financial expenses on highway financing whenever there is reasonable evidence that these expenses will be recovered in the tariffs of future business years. There is no specific provision related to regulatory assets in IFRSs.

Percentage of completion approach

Paragraph 22 of IAS 11 *Construction contracts* and paragraph 20 of IAS 18 *Revenue* state that revenue and costs associated with a construction contract, or revenue associated with a transaction involving the rendering of services, shall be recognised by reference to the stage (percentage) of completion of the contract activity, or the transaction, at the end of the reporting period, assuming that some conditions are fulfilled.

IFRIC 12 allows this approach to be used when recognising revenue on service concession arrangements during the construction phase.

In practice, this percentage of completion approach makes recognition of revenue match with recognition of costs incurred in reaching the stage of completion of the contract or transaction. Therefore, some European constituents would like to extent this percentage of completion approach to the recognition of revenue during the operating phase of a service concession arrangement when the operator has recognised an intangible asset. It may be noted that in such case, revenue is provided by users of the infrastructure who have not signed a contract with the operator.

Fair value measurement

IAS 40 *Investment property* allows certain tangible assets to be measured at their fair value. IAS 39 *Financial Instruments: recognition and measurement* allows financial assets to be measured at their fair value depending on their accounting classification. IAS 28 *Investments in associates* and IAS 31 *Interests in joint venture* allow as an exception interests held by venture capital organisations, mutual funds, unit trusts and similar entities, to be measured at fair value. Some European constituents would like fair value measurement to be allowed when operators' interests in service concession arrangements are concerned. Otherwise, they consider that accounting rules will create a competitive disadvantage for "industrial" operators compared to investment funds which are allowed to measure their investment in service concession arrangements at their fair value.

Other commentators do not see a problem in the different accounting treatment for venture capital organisations, mutual funds and unit trusts as existing IFRS has allowed them to measure their investments at fair value for a long time, regardless whether it was related to a service concession arrangement or other type of activity, without having raised particular concerns until now. Moreover, it is not clear how such an accounting treatment may solve the perceived timing mismatch between recognition of revenue and expenses on service concession arrangements under an intangible asset's approach. The current provisions of IAS 38 *Intangible Assets* allow measurement of these assets using a revaluation model when there is an active market. Even if it is assumed that such a market would exist for intangible assets related to service concession arrangements, increases in the intangible asset's value should be recognised in the other comprehensive income and accumulated in equity instead of being recognised in the income statement, except in specific cases. Going further would require changes in the standard.

Extension of the financial asset model

IFRIC 12 states that the operator of a service concession arrangement shall recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor. This unconditional right to receive cash or another financial asset is the condition required in IAS 32 *Financial instruments: presentation* to recognise a financial asset. IFRIC 12 states that this requirement is fulfilled if the grantor contractually guarantees the global level (specified or determinable amounts) of its future revenue to the operator.

The financial asset model under IFRIC 12 results in recognition of revenue and expenses which do not create a perceived timing mismatch. This accounting treatment has not appeared as controversial as the one related to the intangible asset model. Therefore, some European constituents would like to extend the financial asset model to service concession arrangements where the grantor has provided specific types of guarantees. These guarantees may take the form of a "right to a financial-economic equilibrium of the concession under certain circumstances", "the equity responsibility of the grantor for the concession assets", guarantees related to the tariffs, to the duration of the contract or with the traffic. The activation of these guarantees may be subject to various conditions or future contingent events. Other commentators have commentated that it is not clear if these guarantees could result in considering that the operator has obtained an unconditional right to receive cash or equivalent.

Amortisation of the intangible asset

Paragraph 98 of IAS 38 *Intangible assets* indicates that the amortisation method used to depreciate intangible assets should be selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset. But it adds that "there is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method".

Some European constituents claimed that this sentence is often interpreted as forbidding any amortisation pattern below the level of a straight-line method. Thus, a lower amortisation pattern of the intangible asset representing the licence authorising to charge tolls in a service concession arrangement is not accepted by many accountants, although the consumption pattern of the right to charge tolls could justify it. In order to avoid such an interpretation, the IASB tentatively decided at its December 2006 meeting to remove the abovementioned sentence[18]. This would be done in a forthcoming Annual Improvement process.

This change will help reducing the perceived timing mismatch between recognition of revenue and expenses in a service concession arrangement where an intangible asset has been recognised. Nevertheless, according to certain commentators it may not be sufficient to avoid recognition of losses in the first years of the concession's life. Some constituents proposed to go further in adjusting the amortisation pattern of intangible assets. They suggested other approaches, such as the "interest methods of depreciation".

Capitalisation or deferral of interest expenses

IAS 23 *Borrowing costs* states that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset and shall be capitalised. It adds that other borrowing costs are recognised as an expense.

[18] IASB Update December 2006

In conformity with IAS 23, IFRIC 12 allows borrowing costs related to the construction phase of an infrastructure related to a service concession arrangement to be capitalised. Some European constituents would like this possibility to capitalise borrowing costs to be extended to the operating phase, as this may contribute to eliminate or reduce the perceived timing mismatch between recognition of revenue and expenses. This is allowed in accounting GAAP of some jurisdictions. Other commentators have stated that it is not clear if such provisions are consistent with IAS 23 and other IFRS already endorsed and in force in the EU.

ANNEX 2: QUESTIONNAIRE

Questionnaire

EFFECT STUDY ON IFRIC 12 *SERVICE CONCESSION ARRANGEMENTS*

Please provide the following details together with your response:

□ Preparer □ User □ Other (please specify)_________

Name of your organization / company

Short description of the general activity of your organization/ company

Country where your organization/ company is located

Contact details incl. e-mail address

Please indicate whether you submitted comments to IASB and/or EFRAG during their consultations on exposure drafts, comment letters or endorsement advice related to IFRIC 12

□ Yes □ No

In case we need further details on the submitted information we will take the liberty to contact the relevant respondent.

Information from preparers

Markets where your company is listed:

□ European Union □ US □ Others (please specify)__________

Size on group level:

Total assets________ Revenues________ Employees_________

1. General questions on IFRIC 12

a) Do you think it is necessary to clarify the accounting treatment to be applied to service concessions arrangements under IFRS?

□ Yes □ No

Comments:

b) Do you think that IFRIC 12 will result in relevant, reliable, comparable and understandable information?

Relevant	□ Yes	□ No	□ Partly
Reliable	□ Yes	□ No	□ Partly
Comparable	□ Yes	□ No	□ Partly
Understandable	□ Yes	□ No	□ Partly

Comments:

c) Overall, do you think that IFRIC 12 provides an appropriate solution to the accounting for service concession arrangements?

□ Yes □ No

Comments:

d) Would you have preferred a standard to address this issue?

□ Yes □ No

Comments:

e) If you answered "yes" to question 1d, would you consider that endorsement of IFRIC 12 is necessary or useful in the meantime?

□ Necessary □ Useful □ Neither of them

Comments:

f) What do you consider are the main costs and benefits of IFRIC 12 and what importance would you assign to each of them?

2. Questions for preparers

a) Can you explain how significant service concession arrangements are for your business?

□ Significant □ Not significant

Additional information, if possible:

Turnover related to service concession arrangements (amount in millions Euros, % of the total turnover)

Comments:

b) Are you currently applying IFRIC 12 or expecting to apply it in the short term?

□ applying □ forecasting □ Neither of them

Comments:

c) If you are currently not applying IFRIC 12, could you describe current accounting treatment applied to service concession arrangements?

Comments:

d) Do you think that IFRIC provides/would provide useful information for internal purposes or other than issuing general purpose financial statements purposes?

□ Yes □ No

Comments:

3. Questions for users

a) Can you explain what kind of information you need to analyse companies with service concession arrangements?

b) Do you think that IFRIC 12 provides you with the kind of information you are looking for?

□ Yes □ No

Comments:

c) Do you think that IFRIC 12 will help you to better assess a company's management stewardship and relative performance compared to others?

□ Yes □ No

Comments:

4. Other Questions

a) Can you provide any information that has been generated by field studies, research work, internal analysis carried out in your organization, jurisdiction?

b) If you have any further comments on this consultation please provide them to us.

ANNEX 3: LIST OF COMMENTATORS

No	Organisation/name	Country	Field	Description
1	AFRAC	Austria	Accountants and auditors	accountants and auditors
2	KPMG (Austria)	Austria	Accountants and auditors	accountants and auditors
3	UNIQA	Austria	Preparers	insurance
4	Chamber of Auditors of the Czech Republic	Czech Republic	Accountants and auditors	accountants and auditors
5	Accounting Standards Committee of Germany	Germany	public authorities	standard setter
6	Bilfinger Berger	Germany	Preparers	construction
7	Hochtief	Germany	Preparers	construction
8	RWE	Germany	Preparers	energy
9	Siemens	Germany	Preparers	production
10	AP Moller-Maersk Group	Denmark	Preparers	shipping
11	Acciona	Spain	Preparers	construction
12	ACS	Spain	Preparers	construction
13	ASETA	Spain	Other	services
14	Cintra	Spain	Preparers	construction
15	CNC	Spain	Other	construction
16	FCC Group	Spain	Preparers	construction
17	Ferrovial	Spain	Preparers	construction
18	Grup Cassa	Spain	Preparers	utilities
19	ICAC	Spain	public authorities	standard setter
20	ICJCE - Instituto de Censores Jurados de Cuentas de Espana	Spain	accountants and auditors	accountants and auditors
21	Itinere Infraestructuras	Spain	Preparers	construction
22	Sacyr Vallehermoso	Spain	Preparers	construction
23	SEOPAN	Spain	Other	construction
24	FEE	EU	accountants and auditors	accountants and auditors
25	FIEC - EURopean Construction Industry Federation	EU	Preparers	construction
26	ACTEO, AFEP, MEDEF	France	Preparers	companies organisation
27	Compagnie des Alpes	France	Preparers	services
28	EIFFAGE	France	Preparers	construction
29	Gaz de France	France	Preparers	energy
30	MAZARS	France	accountants and auditors	accountants and auditors
31	Suez	France	Preparers	utilities
32	VEOLIA Environnement	France	Preparers	utilities
33	VINCI	France	Preparers	construction
34	ASTM	Italy	Preparers	road operator
35	ATIVA	Italy	Preparers	services
36	Atlantia	Italy	Preparers	construction
37	HPVdA	Italy	Preparers	road operator
38	SALT	Italy	Preparers	road operator
39	SIAS	Italy	Preparers	road operator
40	SITAF	Italy	Preparers	road operator
41	Terna	Italy	Preparers	energy
42	********	Italy	********	********
43	********	Italy	********	********
44	Dutch Accounting Standards Board (DASB)	Netherlands	public authorities	standard setter
45	AEA	Portugal	Preparers	road operator
46	Aenor	Portugal	Preparers	road operator
47	BRISA	Portugal	Preparers	road operator
48	CTT	Portugal	Preparers	road operator
49	INE	Portugal	Users	statistic office

No	Organisation/name	Country	Field	Description
50	Jose Rodrigues de Jesus	Portugal	Users	other
51	Lososcut Costa de Prata	Portugal	Preparers	road operator
52	Lososcut Grande Porto	Portugal	Preparers	road operator
53	Lusolisboa	Portugal	Preparers	road operator
54	Lusoponte	Portugal	Preparers	road operator
55	Lusoscut Beiras Alta	Portugal	Preparers	road operator
56	Operadora GL	Portugal	Preparers	road operator
57	Operadora Lusoscut	Portugal	Preparers	road operator
58	Operadora Lusoscut BLA	Portugal	Preparers	road operator
59	Operadora Lusoscut GP	Portugal	Preparers	road operator
60	Operanor	Portugal	Preparers	road operator
61	REN	Portugal	Preparers	Utilities
62	Sadoport	Portugal	Preparers	port operator
63	TCL	Portugal	Preparers	port operator
64	********	Portugal	********	********
65	Ministry of Economy and Finance (Romania)	Romania	public authorities	standard setter
66	ACCA	United Kingdom	accountants and auditors	accountants and auditors
67	Accounting Standard Board UK (ASB)	United Kingdom	public authorities	standard setter
68	Balfour Beatty	United Kingdom	Preparers	Construction
69	Bear Stearns	United Kingdom	Users	Broker
70	Kier Group	United Kingdom	Preparers	Construction
71	ICAEW	United Kingdom	accountants and auditors	accountants and auditors
72	LIBA - London Investment Banking Association	United Kingdom	Users	Bank
73	PriceWaterhouseCoopers (PWC)	United Kingdom	accountants and auditors	accountants and auditors

Note: ******** - respondents required anonymity