Hong Kong Institute of
Certified Public Accountants
香港會計師公會

14 July 2005

By E-Mail and by Post

Our Ref.: C/FRSC

The International Financial Reporting Interpretations Committee,
International Accounting Standards Board,
30 Cannon Street,
London EC4M 6XH,
United Kingdom.

Dear Sirs,

IFRIC Draft Interpretations D12, D13 and D14 on Service Concession Arrangements

The Hong Kong Institute of Certified Public Accountants welcomes the opportunity to provide you with our comments on the captioned Draft Interpretations. Our responses to the questions raised in your Invitations to Comment are set out in the appendix for your consideration.

In general, we welcome the issue of these Interpretations to give guidance on the accounting by operators for public-to-private infrastructure service concessions. However, since these Interpretations draw a fine line between the use of the financial asset model and the use of intangible asset model and using either one model would result in very different results being reported on the financial statements as compared to using the other model, we have some concerns that the guidance in these Interpretations on determining which model should be applied is not sufficient and robust enough so as to avoid any abuse or selective treatment.

We trust that our comments are of assistance to you. If you require any clarification on our comments, please contact the undersigned at schan@hkicpa.org.hk.

Yours faithfully,

Stephen Chan
Executive Director

SSLC/EC/al

Encl.

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APPENDIX

Hong Kong Institute of CPAs

Responses to the questions raised
in the respective IFRIC Draft Interpretations

D12 *Service Concession Arrangements – Determining the Accounting Model*

Q1 *The proposal in paragraph 5 of the draft Interpretation reflects the IFRIC's decision that whether an operator recognises service concession infrastructure as its property, plant and equipment should depend on whether it controls the use of that infrastructure. The IFRIC selected this approach instead of one based on the extent to which the risks and rewards of ownership lie with the operator. The rationale for selecting this approach is explained in paragraphs BC9-BC11 of the Basis for Conclusions. Do you support the approach selected?*

Given that the "control" approach and the "risks and rewards of ownership" approach are both used in International Financial Reporting Standards and consistent with the Framework, we believe that the IFRIC should give due consideration as to the control approach and the risks and rewards of ownership approach in determining whether service concession infrastructure should be recognised by an operator as property, plant and equipment. However, we do not consider that BC9-BC11 have provided an adequate explanation as to why the IFRIC considered using the control approach is preferable than using the risks and rewards of ownership approach in accounting for service concession arrangements. In particular, there is no convincing justification to support that the control approach is likely to be more durable than the risks and rewards of ownership approach. Accordingly, we would like to suggest the IFRIC to provide more appropriate and substantive arguments in the Basis for Conclusion.

Q2 *Paragraph 11 of the draft Interpretation proposes that the operator should apply the financial asset model only if the grantor has primary responsibility to pay for the concession services. The rationale is explained in paragraphs BC24-BC43 of the Basis for Conclusions. Do you agree with this proposal? If not, what criteria would you use to determine whether the financial asset model should apply? How would you reconcile those criteria to the definition of a financial asset set out in IAS 32 Financial Instruments: Disclosure and Presentation.*

We do not consider that the financial asset model should apply only when the grantor has primary responsibility to pay for the concession services as it places too much emphasis over the legal form rather than on the substance of the transaction. We do not agree that the accounting model that the operator applies is based solely on who has the nominal responsibility to pay the operator, as it would result in different accounting treatment for economically similar transactions. An example of this is toll and shadow toll arrangements. In a toll arrangement, the operator collects the tolls from users. There is no contractual right and the operator will adopt the intangible asset model.

For a shadow toll arrangement, the operator has contractual right to receive cash and will apply the financial asset model. However, assuming that the cash flows under the above arrangements are the same, it is difficult to provide a reasonable justification for using different accounting models to account for economically similar transactions. It would create inconsistencies and would be misleading to users of financial statements. Also, it may lead to structuring of arrangement to fit in an accounting model seen to be more favourable to the operator.

In light of the above, we consider that it is more appropriate that the financial asset model should be applied when the grantor provides assurances that have the effect of ensuing the operator receives sufficient cash to recover its investment in the service concession arrangement, regardless of whether the cash is from the grantor or the users.

Q3 *As explained in paragraph BC44 of the Basis for Conclusions, paragraph 13 of the draft Interpretation proposes that the identity of the party or parties with primary responsibility to pay for the concession services should be determined by reference to the substance of the contractual arrangements (which would not be affected by, for example, changing the parties through whom payment is routed). Do you agree with this proposal?*

We agree with the proposal in principle. However, we do not believe that the form of payment arrangement dictates the accounting model applied. We also recommend the IFRIC to provide some examples of situations where the substance of the contractual arrangements overrides the legal form of the contract to help users to exercise their judgement in applying the principle in practice.

Q4 *The IFRIC aims to issue this and the two other proposed Interpretations on service concessions (D13 and D14) in final form before the end of 2005. It proposes that, subject to it achieving this aim, the three Interpretations should be applied for annual periods beginning on or after 1 January 2006. Do you agree with this proposal?*

We agree with this proposal. However, given that the Interpretations may need further amendments or clarification, the IFRIC should provide sufficient time to allow preparers of financial statements to adopt the changes to their accounting policies before their effective dates.

D13 *Service Concession Arrangements – The Financial Asset Model*

Q1 *As discussed in paragraphs BC3-BC5, the proposals in the draft Interpretation are based on a conclusion by the IFRIC that the discharge of each contractual obligation (including obligations to repair and maintain the infrastructure) gives rise to revenue for the operator. Do you agree with this conclusion? (Question 3 in the Invitation to Comment on draft Interpretation D14 Service Concession Arrangements—the Intangible Asset Model poses a similar question in relation to the intangible asset model.)*

We agree with this conclusion.

Q2 *As explained in paragraphs BC6 and BC7, the IFRIC has concluded that, applying IAS 11 Construction Contracts, operators might recognise different profit margins on different activities undertaken within a single service concession contract. Do you agree with this conclusion?*

We are not sure how it applies in practical situations. We foresee practical difficulties in the segmentation of contracts and the determination of the fair values of different components within a single contract.

D14 *Service Concession Arrangements – The Intangible Asset Model*

Q1 *In the intangible asset model on which this draft Interpretation is based, the service concession operator is regarded as receiving an intangible asset from the grantor in exchange for the construction or other services it provides to the grantor. Paragraph 7 of the draft Interpretation proposes that the operator should recognise revenue and profit or loss on that exchange. The rationale for this proposal and for an alternative view—ie that no revenue or profit should be recognised on the exchange—is setout in paragraphs BC7-BC14 of the Basis for Conclusions. Do you agree with the proposal? If not, how would you reconcile non-recognition of revenue and profit to the requirements of existing IFRSs?*

We disagree with this proposal and support the alternative view that no revenue or profit should be recognised on the exchange. We believe that the substance of the arrangement is that the construction cost paid by the operator is payment-in-kind for the intangible asset. Assuming that the construction services and the related intangible asset are unique in nature, as would be most of the cases, it is unlikely that fair values can be reliably measurable. The intangible asset should be recognised based on the construction costs and neither revenue nor profit should be recognised by the operator.

Q2 *As explained in paragraph BC6 of the Basis for Conclusions, the draft Interpretation does not specify the timing of recognition of the intangible asset. The IFRIC identified three possible approaches. Do you agree that the proposed Interpretation should remain silent on this matter? If not, which of the three approaches do you think should be specified and in what circumstances?*

We consider that the Interpretation should give guidance on the timing of first recognition of the intangible asset as otherwise would lead to inconsistency in practice.

We are of the view that the operator should only be regarded as receiving its right to charge users once the construction is complete and therefore support alternative (c).

Q3 *As explained in paragraph BC16 of the Basis for Conclusions, the proposed requirements for maintenance and repair obligations in this draft Interpretation are different from those in D13 Service Concession Arrangements—The Financial Asset Model. Do you agree that the IFRIC has interpreted existing IFRSs correctly in respect of these proposals?*

We agree that the IFRIC has interpreted existing IFRSs correctly in respect of these proposals. However, we express concerns about the inconsistencies between the two accounting models.