Andrea Giornetti

IFRIC 12
Service concession arrangements and market disclosure quality

Investigation amongst European listed companies in the more extensive scenario of accounting standardisation

Accounting & Business Studies

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To my beloved children
Gabriele, Beatrice and Elisabetta

INTRODUCTION

A debate has been underway for some time now as to whether research is effectively able to guide and support problem-solving in relation to accounting rules (Barth 2006, 72). If it is impartial and strictly structured, and especially if based on economic theories, it can prove to be particularly useful in identifying problems[1], facilitating standard setters both in their correct conceptual framework of a specific issue and in providing evidence when dealing with it.

Over the last few decades, with the development of the financial markets, studies on accounting have increasingly been focused, indeed this has become a sort of "preferential path", on relations between accounting figures and information and the price of shares and returns (referred to as "value relevance"), firm in the belief that they can thus also contribute towards increasing the efficiency of the capital market. Various different opinions have been recorded in this respect. For example, it has been argued that the identification of a relationship in an efficient market, of book values and share prices or returns, does not, in itself, suffice to determine the need for a particular standard[2]: the latter, as it is considered an asset of public utility, is developed by standard setters after having duly

[1] A study of such accounting regulatory matters may not make a directly contribution towards understanding the problem, yet may in any case extend academic literature. Standard setters are committed to specifying which items need to be included in the financial statements and how they should be measured and presented. They strive to implement their conceptual framework in order to determine the form and contents of the financial statements, are involved in issues such as, for example, whether a potential inflow or outflow of economic benefits satisfies the definition of an item of the financial statements, whether or not a measurement of an element is sufficiently reliable and whether it should be booked or simply subject to disclosure.

[2] Standard setters consider a variety of factors. Their decisions are not based on the results of studies, as these are unable to cope with the considerable dimensions of accounting regulations (Gonedes and Dopuch, 1974).

evaluated a trade-off with respect to the social well-being[3]. The need for an accounting standard, therefore, requires a specification of social preferences (net benefits of certain operators with respect to net costs of others), which research does not generally consider.

Other scholars have claimed that in seeking to find measurement support in the use of an accounting standard, literature on value relevance may only make a marginal contribution on the problems of regulation, given that the lack of solid theoretical bases means that mere associations are reported (Holthausen and Watts 2001).

By contrast, it has been declared that research need not first define a complete theory of accounting and the related regulation. As both the objective of the financial reporting in accordance with the BIAS and the criteria to be applied in choosing between accounting alternatives have been explained in the conceptual framework[4], in order for studies on value relevance to be of help in examining the problems that are already all too clear (Barth, Beaver and Landsman, 2001), they need to adopt measurement models that, in outlining theoretical hypotheses, link concepts[5] with concrete accounting measurements.

In order to develop scientific routes that are therefore able at the same time to make a contribution to academic literature whilst also providing

[3] More specifically, whereas some companies may benefit from a given standard, others may incur costs. If this is the case, i.e. if the standard produces benefits or costs for individuals, simply focusing an analysis on the price of a company's shares cannot, alone, suffice.

[4] Upon completion of the joint project with the FASB – defined in order to converge, update and complete their respective frameworks – chapters 1 and 3 of the IASB's Conceptual Framework became final (BIAS 2013).

[5] Relevance and reliability of the accounting information are the first two qualitative characteristics presented in the Conceptual Framework. Accounting information is relevant if it is able to affect the economic decisions of the financial statement users. It can confirm or predict. Timeliness, i.e. making information available to decision-makers before they lose their capacity to influence decisions, is another aspect of relevance. Accounting information is reliable if it is a truthful representation. Faithful representation means that the information reports what it is intended to represent. Reliability can be considered in terms of verifiability, neutrality and completeness. Verifiability means that different observers basically obtain the same result; neutrality means that the information is free from prejudice that would lead to a predetermined result or bring about a specific type of conduct; completeness means that it includes all information necessary to ensure a faithful representation. Reliability does not imply certainty or precision. Two other qualitative characteristics of financial reporting are comparability and understandability (BIAS 2010). Comparability, which includes consistency, is the quality that enables users to identify similarities and differences between economic phenomena. Consistency refers to the use of the same accounting policies and methods over time, for a given reporting entity or in a single period across entities. Consistency increases comparability.

important points for consideration by accounting regulation, it is essential to identify a connection between the underlying questions – from which the research stems – and the issues it intends specifically to broach.

Studies on financial reporting may be based on an informative perspective, or one of measurement. In the first hypothesis, the key interest is focused on the role played by non-financial information on the decisions made by users and the interpretation of the financial statements. Research starting out from this perspective intends to verify whether or not the accounting information provides investors with new elements for evaluation.

From a measurement perspective, on the other hand, the focus is instead on the accounting values as measurements of the economic resources and related claims; the analysis is mainly based on the application of the qualitative characteristics of accounting information (as specified in the Conceptual Framework, and particularly relevance and reliability), in order to understand whether or not the accounting figure influences users' decision, what it intends to represent and whether or not it is neutral.

Under this scope, this research aims to verify if and how the implementation of the accounting interpretation IFRIC 12 "Service concession arrangements" has or has not increased the quality of market disclosures across Europe.

The work is a study on financial reporting that takes an informative perspective, reporting the results of empirical research aimed at ascertaining just how the application of IFRIC 12 has been achieved by listed groups in certain carefully-selected European countries.

This interpretation provides guidelines on how public and private service concession arrangements are reported and measured, with specific reference to the representation of revertible assets, the management of said assets and obligations to restore and maintain.

Published on 30 November 2006 and having come into force, in accordance with the rules of the BIAS, as from 1 January 2008, IFRIC 12 was endorsed by the European Union on 25 March 2009[6], with compulsory application as from 1 January 2010. This delay in itself shows just how the practical implications of its adoption meant that the interpretation effectively represented a key innovation with respect to the previous situation, also because it is a concrete translation of the principle of substance over form. It is, in fact, the principle of "substance over form"

[6] Commission Regulation (EC) No 254/2009 amending Regulation (EC) No 1126/2008, published in the Official Journal of the European Union.

that classifies which arrangements shall come under the scope of application of IFRIC 12, at the same time also affecting the accounting models to be used in order to represent the effects of the arrangement.

The research questions were therefore defined as follows:

RQ 1:

Is the quality of the disclosure, deriving from the application of IFRIC 12 homogeneous in the selected countries, thereby supporting the ideal objective of accounting harmonisation?

RQ 2:

If, by contrast, widespread heterogeneity is seen, are we looking at a phenomenon connected with the impact of IFRIC 12 on the original book values, or is this according to the structures chosen under the scope of corporate governance?

RQ 3:

Is the application of IFRIC 12 also reflected in the forecasts prepared by financial analysts for the market in their issuer outlook?

RQ 4:

Could the product market in which the ownership structure is mainly involved have in some way interacted with the results recorded in terms of IFRIC 12?

Having first analysed the interpretation in terms of its application, by analysing the consolidated financial statements of the chosen groups, the numerical effects obtained during the first time adoption (or "FTA") will be presented[7], quantifying, only for the items concerned, the timely changes made.

This will allow for the representation of the value trend determined upon implementing the new interpretation for each of the countries chosen,

[7] The consolidated financial statements for the year of first time adoption and those of the previous year, were mainly analysed. FY 2010 (and therefore 2009) were the main years considered. This was due to the widespread adoption of IFRIC 12 when it became compulsory (1 January 2010). For companies adopting the accounting interpretation earlier (as, for example, proved to be fairly common amongst the French companies chosen), clearly the study involved the financial statements relating to the year prior to the first time adoption.

by means of the aggregation of the specific financial statement item classes in relation to each group examined.

Having completed this preliminary verification, purely descriptive in quantitative terms and complementary to a more comprehensive analysis, the methods of application of IFRIC 12 in terms of the market disclosure, will then be examined. To this end, the opinion on each company will be accompanied by the results of a qualitative analysis of the informative content – achieved by applying an assessment method applied to four dimensions investigated with the use of four different parameters – summarised in a disclosure index (the "DScore Index).

In order to understand the qualitative dimension of the results of the research, for this same group of companies, corresponding research will also be carried out on their corporate governance structures, so as to identify which variables – of those duly chosen according to their explanatory capacity with respect to financial reporting – may be most significant. Here, we will also acknowledge any interaction between the results of the research and the breakdown of the ownership structure seen for each holding company for which data is available in terms of the ownership structure, and the main type of shareholder that can be identified for each group examined.

Lastly, the research also developed into identifying a relationship between the incorporation of the new interpretation and the outlook prepared by the specialist financial analysts for the issuers included in the sample. This will allow us to examine whether or not the increased understandability of the financial reports is effectively appreciated in their market position.

The research therefore seeks to supplement today's literature with a twofold objective: to note whether or not there are any significant differences between the corporate groups included in the sample in their effective application of IFRIC 12, in terms of the different graduation in the disclosure made; and, therefore, if any such differences are seen, to verify whether or not they can be significantly explained by different approaches to corporate governance or by the segment qualification as can be seen in terms of the ownership structure (i.e. greater or lesser concentration) and the main type of shareholder identifiable.

The publication is structured into four chapters, followed by some conclusive remarks. The first chapter considers the accounting context of reference in terms of financial reporting, in which the research develops into the IAS/IFRS, examining fair value as the measurement criterion increasingly prescribed in lieu of the cost criterion – by virtue of the

references made to this by IFRIC 12, before then moving onto considering the concept of the quality of information – also resulting from the standardised application of clearly high quality accounting standards – as this is the reference scope within which this research falls. The second chapter investigates the merits of IFRIC 12, first explaining the concept ("substance over form") underlying the regulation and secondly describing the main aspects introduced by the interpretation with respect to the main context. The third chapter, having acknowledged the approaches taken by literature, explains the method adopted with respect to the research structure defined, in order to answer the research questions. The last chapter reports on the results obtained from the research.

The conclusive remarks summarise the results of the research, outlining the answers and the ideal routes to be pursued.

I would like to thank Professor Enrico Laghi for his valuable suggestions provided throughout my research.

I would also like to thank the two reviewers for their useful considerations.

I am the sole party liable for the contents of this publication.

Andrea Giornetti

Rome, Sapienza University of Rome, 2013

1. INTERNATIONAL ACCOUNTING AND HARMONISATION

1. The harmonisation of accounting to improve the relationship between business and the environment

The globalisation of the markets, elimination of national boundaries, acceleration of the intensity of international trade, dissemination of global players and businesses and a growing integration of the world economies have driven the European Union to embark upon the adoption of a shared accounting "language" in preparing European Community corporate accounts.

Only standardised, comparable financial statements, achieved through the adoption of homogeneous rules, can satisfy the needs for information of those (businesses and individuals) who base their economic and financial decisions on the analysis, preparation and comparison of data given in corporate accounts.

The differences seen between the accounting criteria adopted in preparing corporate accounts in the various countries, has, in fact, meant that they are difficult to compare, thereby making it difficult for economic operators to decide how to invest, when the information with which they are presented is so diverse. The lack of homogeneity has ended up by hindering all analysis, save for a preventive, in-depth knowledge of the accounting policies used by the businesses. On the one hand, this acts as a deterrent to making international investments, and on the other, it makes it difficult to obtain capital beyond national confines.

In operative terms, the adoption of accounting terminology inspired by shared principles that are internationally comparable has required a preliminary choice to be made, between standardisation or harmonisation (Rossi 2007, 4-5)[1].

[1] Standardisation entails the adoption of a single *corpus* of accounting standards to be

The choice made in Europe was focused on pursuing the harmonisation of accounting standards. The complexity of this route was seen immediately, even in a relatively reduced geographic area as is Europe, where there are multiple differences, often irreconcilable, between accounting theories and rules. These are mainly due to several different factors:

- legal structure: in a non-codified system, such as the common law system, accounting legislation governing the preparation of financial statements is characterised by just a few provisions of law, meaning that the entity preparing the document has greater freedom in interpreting and choosing the criteria on which basis to prepare the financial statements, in respect of the single principle of providing a "true and fair view". A civil law system, on the other hand, pursues a stricter, more rigid observance of coded rules in a bid to thus present a true and fair view;
- financial structure: in some countries, business financing comes from the banking system, the State or directly from the entrepreneur's own equity; in other contexts, capital is collected on the financial markets. In this latter case, the importance of the financial statements as the first informative instrument available, is undisputed, despite the fact that, particularly in some common law countries, they are not always readily available. In a civil law system, the function assigned to the financial statements is not merely one of providing information, but is also organisational[2];

applied uniformly to businesses. This solution, which is more effective and stricter, is, however, difficult to implement in the medium-term, given the different institutional, economic and social basis adopted in the accounting systems of the different countries. Harmonisation reduces the variability of the accounting rules in the different countries, increasing their compatibility in respect of national accounting traditions. It is a procedure that has several alternatives, leaving the exact choice up to the individual country. Many authoritative studies have been conducted internationally on the matter of accounting harmonisation and standardisation and their reciprocal affinities and diversities, including by: Beaver, Eger, Ryan and Wolfson (1989); Belkaoui (1986; 1994); Di Pietra (2002; 2003); Eccher, Ramesh and Thiagarajan (1996); Epstein, Nach and Bragg (2007); Hoarau (1995); Hopwood (1994); Hulle (1993); Krishnan and Largay (1997); Mintchik (2006); Mironiuc (2007); Montrone (2008); Nobes (1988); Nobes (1996); Nobes and Parker (1995); Rees, Linck and Lopez (2007); Rivera (1989); Schön (2004); Tay and Parker (1990); Theunisse (1994); Van der Tas (1988); Wyatt (1991).

[2] "The income values shown in the financial statements are not used merely to inform stakeholders of the company's economic, equity and financial performance, but are also amounts according to which, for example, distributable wealth is defined, the decision is made as to whether or not a company needs to be recapitalised and a limit is defined for the purchase of treasury stock" (Laghi 2006, 87).

- tax regulations: there are contexts in which taxable income is determined by means of a non-accounting procedure performed after the preparation of the financial statements; in other situations, however, the financial statements are influenced by tax law in operations relating to the calculation of taxable income, meaning that the taxpayer is required to adjust figures and data given on the financial statements that is lacking in statutory justification.

Other factors (such as social-cultural aspects, accounting doctrine, dimension and complexity of the production structure, political system, etc.) also go towards determining the specificity of a country, enriching the harmonisation process (Onesti 1995; Campedelli 1990; Viganò 1990; Zambon 1996).

Harmonisation has thus provided a response to a context characterised by:

- a major acceleration to the globalisation process;
- a surprising implementation of IT and communications technologies that has reduced the distances to the circulation of capital and information between the various States;
- communication difficulties encountered by global players in the management and maintenance of a dual accounting system (separate, required to adhere to local provisions of law, and group, which must comply with the rules dictated by the parent company) (Mamoli 2002).

This has enabled increased comparability of the accounting standards and rules in force in each country, establishing limits to differences they may show.

2. The EU measures implemented to converge towards the IAS/IFRS

The primary legislative instruments adopted to harmonise national regulations on the financial statements of companies and groups, whilst preserving some differences (Azzali 2002, 3-4) come in the form of accounting directives (IV and VII, respectively of 1978 and 1983)[3].

[3] “Therefore, accounting harmonisation should tend to standardise not so much a rigid form of presentation of accounting information, imposed on a supranational level, but rather the quality, quantity and understandability of the information that can be surmised from a reading of the accounts. By contrast, standardisation would imply the preparation of a rigid set of rules that each State would need to replace *en bloc*, with no change to those currently in use, thereby achieving a unification of accounts in all States” (Rusconi 1999, 24).

The objective, moreover only partially achieved[4], soon showed the need to encourage a more widespread harmonisation of international accounting.

In 1995, the European Commission explained the strategy that had been outlined to this end[5], striving to approach the work carried out by the International Accounting Standard Committee (IASC)[6] since 1973[7].

This was followed by a second communication made by the European Commission to the Parliament[8], whereby a political-institutional convergence process began; in a short space of time, the IASC became the global accounting standard setter.

Although the path chosen by the BIAS[9] aimed to achieve harmonisation, albeit with some of the characteristics of standardisation intended as a solution towards global convergence, the EU adapted this solution to meet its specific requirements, opting for harmonisation first on a local level, amongst EU Member States. In this regard, the decision was made to adopt the BIAS standards only upon completion of a prior

Harmonisation is based on an act of creation able to achieve the greatest possible consent. By contrast, the logic of standardisation would appear to be based on the choice of a pre-existing solution that is believed to be the best (Di Pietra 2002, 8). Directives IV and VII sanction, with their adoption, a crucial stage in the accounting evolution of the European Community, considerably innovating the pre-existing situation in terms of the approach taken to the accounting information system, the role played by the information disclosed through the financial statements and the consolidation of financial statements of companies belonging to groups. The differentiation between the accounting systems of the various countries (legal, cultural, social and economic) end up generating a differentiation, by means of the multiple options permitted, between the different national contexts. The choice to use Directives in lieu of regulations represented the original price to be paid in order to initiate a harmonisation process that would otherwise have been impossible, even to conceive, given the differences in the accounting regulations of the different European Union Member States involved.

[4] This was following the massive quantity of options granted to the individual legislators for the transposition of the Directives; moreover, these also proved to be inadequate instruments as they were rigid in rapidly endorsing the continuous evolution of the methods by which economic business is conducted, the development of the financial markets and tools, the best ways of presenting accounts as identified by doctrine and the best accounting practices.

[5] Communication COM 95 (508) “Accounting harmonisation: a new strategy vis-a-vis international harmonisation”.

[6] On the origin and historical evolution of the IASC, see Zeff and Camfferman (2007).

[7] The declared objective concerned the possibility of allowing European global players who had sought multi-listing outside the European Union to present a single set of accounts (clearly, thereby, saving on costs) and, at the same time, to improve the comparability of consolidated accounts, thereby increasing competitiveness.

[8] COM 2000 (359) “EU Financial Reporting Strategy: the way forward”.

[9] The International Accounting Standards Board took over following the major reorganisation of the IASC, in the role of global standard setter.