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International Accounting Standards Board

IFRIC Project Updates are provided for the information and convenience of constituents who wish to follow the IFRIC's deliberations. All conclusions reported are tentative and may be changed at future IFRIC or IASB meetings. Decisions become final only after formal approval by the IASB to issue an International Financial Reporting Interpretation.

Latest revision: 2006/09/28

Highlights

1. At the September 2006 IFRIC meeting, staff was directed to present the revised draft text of an Interpretation on service concession arrangements to the Board with a request that it be issued as an Interpretation.

2. The revised draft text reflects the decisions taken by the IFRIC during its post-exposure deliberations. The proposals (D12-14) were issued in three separate draft Interpretations, D12 *Service Concession Arrangements—Determining the Accounting Model,* D13 *Service Concession Arrangements—The Financial Asset Model* and D14 *Service Concession Arrangements—The Intangible Asset Model*. In finalising IFRIC X, the IFRIC combined the three draft Interpretations. **Click here for IFRIC Update (September 2006).**

3. The draft text clarifies how concession operators should apply existing International Financial Reporting Standards (IFRSs) to account for the obligations they undertake and rights they receive in service concession arrangements. The draft Interpretation interprets the requirements of a number of relevant IFRSs, including those addressing accounting for construction contracts, service contract revenue, borrowing costs, financial assets and intangible assets.

4. On 3 March 2005, the IFRIC published for comment three draft Interpretations on service concessions:

   - D12 *Service Concession Arrangements - Determining the Accounting Model*

- D13 *Service Concession Arrangements - the Financial Asset Model*
- D14 *Service Concession Arrangements - the Intangible Asset Model*

5. Comments were requested by 3 May 2005, subsequently extended to 31 May 2005.

6. Some of the conclusions on which the proposals are based would apply not only to service concession arrangements but also to other transactions within the scope of the relevant IFRS. For example, the draft Interpretations are based on a conclusion that the assets arising from the application of IAS 11 *Construction Contracts* are financial assets within the scope of IAS 39 *Financial Instruments*: *Recognition and Measurement*. The complete texts of the draft Interpretations and worked examples are available here.

- **Project Objective and Background**
- **Latest IFRIC Update (September 2006)**
- **Summary of the IFRIC's Post Exposure Deliberations.** Comment letters are available here.
- **Summary of the IFRIC's deliberations (leading to the publication of the draft Interpretations)**
    - Which party recognises the infrastructure as property, plant and equipment
    - Scope of the Interpretations
    - Application of IAS 11 *Construction Contracts* and IAS 18 *Revenue*
    - Treatment of the Infrastructure in the books of the operator. Financial asset model vs intangible asset model. The main differences between the two models are illustrated by graphs
    - Treatment of borrowing costs
    - Application of the control conditions

OBJECTIVE AND BACKGROUND

OBJECTIVE

7. The objective of this project of the International Financial Reporting Interpretations Committee is to clarify how certain aspects of existing IASB literature are to be applied to service concession arrangements.

8. Service concession arrangements are arrangements whereby a government or other body grants contracts for the supply of public services—such as roads, energy distribution, prisons or hospitals—to private operators.

BACKGROUND

9. SIC-29 *Disclosure – Service Concession Arrangements* contains disclosure requirements in respect of service concession arrangements, but concern has been expressed about the lack of specific guidance on how service concession arrangements should be accounted for. In response to these concerns, the Board asked a group comprising representatives of the standard-setters of Australia, France, Spain and the UK (four of the countries that had expressed such concerns) to carry out some initial research on the subject. The working group recommended that the IFRIC should seek to clarify how certain aspects of existing IASB literature are to be applied to service concession arrangements.

SUMMARY OF THE IFRIC'S POST EXPOSURE DELIBERATIONS

10. One theme in the comments was that the Board should have taken responsibility for the project from the start. The IFRIC considered this point but decided that, with its limited scope project, it was probably by now better placed than the Board to reach a timely conclusion on the most pressing issues.

Key concerns raised by respondents

11. Most commentators expressed reservations about one or other important aspect of the draft Interpretations. The major concerns raised were:

- the narrow scope of the Interpretations;
- the basis for recognition of property plant and equipment (pp&e);
- the dividing line between the financial and intangible asset models, i.e. the determination of the appropriate accounting model being dependent on whether the grantor or a third party has primary responsibility to pay; and
- the recognition of revenue under the intangible asset model.

Scope

12. Several commentators believed the proposals were complex and that they failed to deal with significant areas of the topic. In their view the scope exclusions limited the usefulness of the guidance.

13. At its September 2005 meeting, the IFRIC agreed that the scope criteria did need to be reconsidered, particularly with respect to the significant residual interest criterion, as it

seemed anomalous that a concession for the whole period of an asset's physical life should be excluded from the scope of the Interpretations.

14. The IFRIC reconfirmed that the Interpretations would be drafted so as to provide guidance on the accounting from the perspective of the operator only. In many cases the grantor is a government body, and providing accounting interpretations for government bodies is not the primary focus of the IFRIC. For that reason, D12 dealt only with the operator's accounting.

15. In the light of the comments, the IFRIC agreed that the scope of the Interpretations should be better explained.

16. The scope of the proposals was reconsidered at the January 2006 meeting.

Basis for recognition of property plant and equipment

17. Commentators questioned the approach taken in D12, believing that the criteria should take into account the risks and rewards relating to the asset, rather than a purely control based approach. Many respondents believed that the nature of the grantor's and operator's assets should have been analysed under lease accounting or a risk and rewards model. They claimed that under IFRIC 4 *Determining whether an Arrangement Contains a Lease* the operator would be deemed to have 'right of use' of the infrastructure and therefore a lease. Others argued that the assets should be analysed under property plant and equipment accounting. Some accused the IFRIC of introducing a new asset recognition model for PP&E that was not recognised under the *Framework*.

18. At its August 2005 meeting, the IFRIC reconsidered the issues giving rise to these comments. While agreeing to research these aspects further, IFRIC members were not persuaded that the proposals should be changed. Their view remained that, for service concession arrangements within the scope of the draft Interpretations, the grantor's ability to control the use of the infrastructure throughout the concession and its control of the residual infrastructure at the end were such an overpowering indicator of control that the infrastructure should not be recognised as property, plant and equipment of the operator.

19. At its March 2006 meeting, the IFRIC considered the distinction between IFRIC 4 and D12 and whether the 'significant residual interest' criterion was a necessary part of the scope requirements in D12. The IFRIC agreed a consequential amendment to the scope of IFRIC 4 to specifically exclude arrangements falling within the scope of D12. In addition, it was agreed that the Basis for Conclusions of IFRIC 4 should be amended to explain why the scope exclusion was required.

20. Paragraph 5b of D12 sets a criterion for a concession arrangement to fall within the scope of D12-14 that the residual interest in the infrastructure should revert to the grantor at the end of the concession and that the residual interest should be significant. The IFRIC agreed that paragraph 5b of D12 should be amended. The condition that the residual interest should revert to the grantor would apply only if the residual interest is significant. The amendment results in 'whole of life' assets, (ie where an asset is used in a service concession arrangement for the whole of its useful life) falling within the scope of D12-14, rather than IFRIC 4.

Dividing line between the financial and the intangible asset models

21. Commentators argued that the accounting treatment does not reflect the economic substance of service concession arrangements and as a result similar arrangements would be accounted for very differently. Determining which accounting model to apply by looking only at who has the primary responsibility to pay, irrespective of who bears the risks of the cash flows, would often not result in an accounting treatment that reflects the economic substance of the arrangement.

22. At its March 2006 meeting, the IFRIC reconsidered the dividing line between the two models. In the light of comments received the staff proposed amending the criterion contained in paragraphs 10-13 of D12 to better reflect the definition of a financial asset in IAS 32: ie a financial asset exists when the operator has a contractual right to receive cash or other financial asset. With this change, the proposed amendment would better reflect the economic reality of concession arrangements: to the extent that the operator is remunerated for its construction services by obtaining a contractual right to receive cash from, or at the direction of, the grantor, the operator would recognise a financial asset and, to the extent that the operator receives a licence to charge users, it would recognise an intangible asset. The IFRIC clarified that the grantor does not have to pay cash to the operator directly. The IFRIC agreed that bifurcation of the operator's right to cash flows into a financial and an intangible asset may be necessary in certain circumstances and that the Interpretations should reflect this.

23. At its May 2006 meeting, the IFRIC decided to proceed with the revised draft of D12 that staff presented. The revised draft requires that an entity should recognise a financial asset to the extent that the operator has a contractual right to receive cash from or at the direction of the grantor. A right other than a contractual right to receive cash does not meet the definition of a financial asset and is within the scope of IAS 38 *Intangible Assets*. The revised draft also makes it clear that some service concession arrangements will need to be bifurcated.

Recognition of revenue in the intangible asset model

24. Some respondents were disturbed by the effect of the draft requirement in D14 that, over the course of the contract, the revenue recognised by the operator should exceed, by a large margin, the total cash flows from the contract. However, many others, in particular operators, supported the proposed approach. They argued that it reflects the economic reality of the concession contracts. In both models the delivery of the constructed infrastructure to the grantor is exchanged either against cash payments in the financial asset model or the right to charge users in the intangible asset model.

25. At its January 2006 meeting, the IFRIC redeliberated this matter noting that one aspect of D14 that caused concern amongst respondents was the revenue recognition profile under the intangible asset model. Over the course of the contract, the revenue recognised by the operator would exceed the total amount of cash flows from the contract. In the light of the comments received the IFRIC had directed staff to research the matter further. The IFRIC noted that, at some point, the construction activity gives rise to an intangible asset in the books of the operator. IFRIC decided to proceed with the revenue recognition profile as

proposed in D14. Revenue and, when applicable, profit should be recognised on the construction phase of the arrangement, when the requirements of IAS 11 are met.

Other tentative decisions reached

Amortisation of an intangible asset

26. The IFRIC noted that the Basis for Conclusions as currently drafted could result in creating the false impression that the IFRIC was prohibiting the use of unit-of-production amortisation for intangible assets recognised under D14. The IFRIC decided to amend the Basis for Conclusions to clarify that amortisation methods specified in IAS 38 would be acceptable for intangible assets recognised under D14, provided that the method used reflected the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The IFRIC confirmed its earlier decision that use of interest methods of amortisation is prohibited under D14. .

Single Interpretation

27. The IFRIC decided to combine in a single Interpretation the material covered in the three draft Interpretations (D12, D13 Service Concession Arrangements – the Financial Asset Model and D14 Service Concession Arrangements – the Intangible Asset Model).

SUMMARY OF THE IFRIC's DELIBERATIONS (leading to the publication of the draft Interpretations)

28. The IFRIC began its consideration of the issues in October 2003. Its views evolved over subsequent meetings, the more significant decisions are summarised below

Which party recognises the infrastructure as its property, plant and equipment

29. The IFRIC first identified the criteria for determining which party should recognise the infrastructure as its property, plant and equipment. It decided that:

- previously-existing infrastructure assets of either the operator or the grantor should continue to be recognised by that party unless the conditions for derecognition in IAS 16 *Property, Plant and Equipment* are met.
- existing accounting standards contain little guidance on which party should recognise infrastructure constructed or acquired for the purpose of the concession as its own. The IFRIC agreed that the determination should be based on who controls the infrastructure, and that control may be separated from ownership.

30. The IFRIC concluded that the grantor should be considered to control a property, if the grantor (including parties related to it) both:

a. controls or regulates what services the operator must provide using the property, to whom it must provide them, and at what price; and

b. will control, through ownership, beneficial entitlement or otherwise, the residual interest in the property at the end of the concession, and the residual interest is significant.

31. The IFRIC noted that the feature described in condition (b) is generally present in service concessions, but not in regulated industries, which properly recognise infrastructure assets as their own.

32. Regarding the derecognition of previously-existing infrastructure assets of the operator the IFRIC noted that the de-recognition requirements of IFRSs apply to these assets.

Scope

33. In September 2004, the IFRIC agreed to restrict the scope to circumstances where:

- the control conditions set out in paragraph 30 above are met; and
- infrastructure assets are either newly built or acquired, or contributed by the grantor for the duration of the concession.

34. As a result the only two models that could apply to arrangements within the scope of the draft Interpretations were the financial asset model and the intangible asset model.

35. The IFRIC also agreed that the Interpretations should deal only with the accounting by the operator, and should be restricted to service concession arrangements in which there is an obligation to keep the services available to the public.

Application of IAS 11 *Construction Contracts* and IAS 18 *Revenue*

36. The IFRIC discussed how the principles of contract accounting might be applied to a road concession contract in which the operator would build, operate and maintain the road, and at the end of the concession refurbish the road and transfer it in “as new” condition to the grantor, depending on how the contract and the operator’s resulting assets were characterised.

37. The IFRIC agreed that, if it were correct for the operator to recognise the physical asset of the road as its own asset, the operator could not have provided construction services to the grantor, and so the operator could not recognise revenue on the construction of the road. Contract accounting would not apply in this case. Conversely, if it were correct for the operator not to recognise the physical asset of the road as its own asset, this would mean that the operator must have provided construction services to the grantor.

Treatment of the infrastructure in the books of the Operator (when the infrastructure is not recognised as property, plant and equipment of the operator)

38. The next step was to decide which accounting model should apply when the infrastructure is not recognised as property plant and equipment of the operator – ie, how the operator's asset resulting from the provision of initial construction or other services should be characterised.

Financial asset model vs intangible asset model

39. The IFRIC noted that, for service concessions within the proposed scope of the Interpretations, the operator's rights could be regarded as giving rise to either a financial or an intangible asset.

40. It considered the definitions of financial assets (in IAS 32) and intangible assets (in IAS 38 *Intangible Assets*). It decided that the draft Interpretation should propose that:

    a. the operator would have a financial asset only if the grantor had primary responsibility for paying for the services provided by the operator; and

    b. the operator would have an intangible asset if the users paid for the services provided by the operator.

41. The IFRIC agreed that in the intangible asset model, the supply of construction services in exchange for an intangible asset is an exchange of dissimilar items, on which revenue and profit must be recognised under IAS 18.

42. Some members were unhappy with the recognition of construction revenue for various reasons. Some disliked the fact that total revenues would not equal total cash flows. Others felt that it was inappropriate to recognise construction revenue and profit on what could be seen as a purchasing activity – the acquisition of the intangible asset. The IFRIC requested staff to explain the rationales for both the consensus agreed by the IFRIC and the alternative views in the Basis for Conclusions in the draft Interpretations.

43. The IFRIC also discussed which contract obligations should be included in the cost of the intangible asset. The IFRIC agreed that the operator should treat obligations to construct new assets, or to enhance either new or existing assets to a condition better than at the start of the concession, as a cost of the intangible. However, all other obligations should be treated as giving rise to operating costs. This includes obligations to maintain, refurbish or replace assets (except for any enhancement element), all of which compensate the owner of the physical asset for the using up of its service potential of the asset over time.

Operating lease model – IAS 17 *Leases*

44. The operating lease model would apply if the operator had an operating lease of the infrastructure from the grantor. This would require the operator to have the right of use of the infrastructure.

Treatment of Borrowing Costs

45. Service concession arrangements involving the construction of major infrastructure assets are often funded largely by debt, which is repaid over the life of the concession. The burden

of finance costs is high in the early years, which creates large losses if they are recognised as expenses in the period in which they occur. Both concession operators and some national standard-setters have argued that recognising such losses on a concession that is expected to be profitable does not give a faithful representation and that (at least in some circumstances) the costs should be related to the concession as a whole.

46. The IFRIC noted that under the intangible asset model if the operator adopts the allowed alternative treatment in IAS 23 *Borrowing Costs*, it should capitalise borrowing costs attributable to contract activity, provided that the costs are reliably estimated to be recoverable. Capitalisation should cease when required by IAS 23, which is once revenue is recognised in relation to the relevant expenditure. In addition the draft Interpretations would clarify that, when the intangible asset is ready for use, borrowing costs should cease being capitalised.

Application of the control conditions

47. In September 2004, the IFRIC discussed the extent to which the control conditions should be applied in a "holistic" way, to the infrastructure as a whole, or separately to each item of infrastructure.

48. The IFRIC noted that the replacement of significant items of newly constructed infrastructure over the life of a concession would probably not be common. More often, the replacement of significant infrastructure items would occur when the operator inherits an ageing infrastructure from the grantor, which it is obliged to replace under the terms of the concession. In these circumstances, if the control conditions set out above are met, the items contributed by the grantor will generally not be derecognised by the grantor under IAS 16, and so will not be assets of the operator. Thus, the old and replacement infrastructure would be treated consistently.

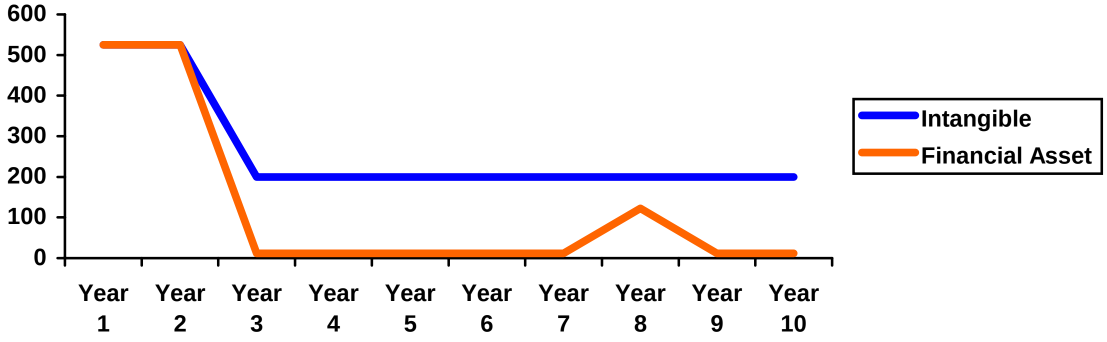
49. The IFRIC also discussed the implications when the use of infrastructure is partly regulated in the manner described in condition (a) (see paragraph 30 above) of the control criterion and partly unregulated. It noted that there were too many variables to give guidance on all possible situations, but agreed that:

- any infrastructure that is physically separable and capable of being operated independently should be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.

- where purely ancillary activities (such as a hospital shop) are unregulated, the control tests should be applied as if those services did not exist, because their existence does not detract from the grantor's control of the relevant infrastructure (in cases where it has such control).

Graphs (based on examples included in D13 and D14)

Total Revenues



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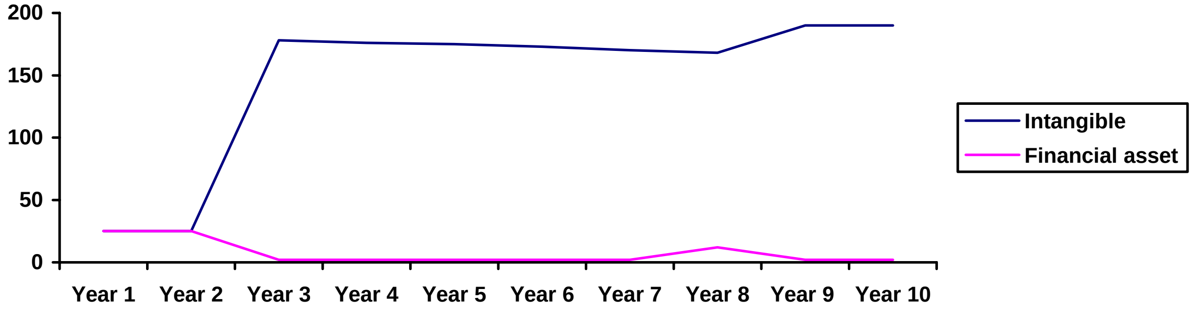

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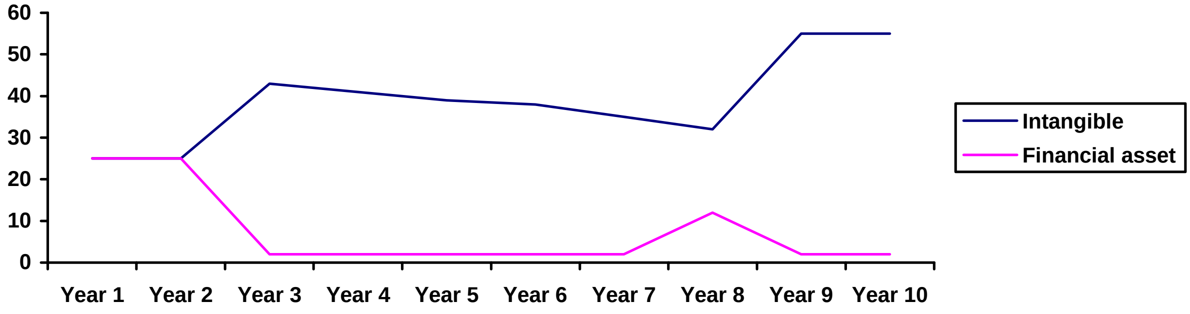

Net income