

Documents published to accompany

IFRIC 12

Service Concession Arrangements

The text of the unaccompanied Interpretation, IFRIC 12, is contained in Part A of this edition. Its effective date when issued was 1 January 2008. The text of the Accompanying Guidance on IFRIC 12 is contained in Part B of this edition. This part presents the following document:

BASIS FOR CONCLUSIONS

Basis for Conclusions on IFRIC Interpretation 12 *Service Concession Arrangements*

This Basis for Conclusions accompanies, but is not part of, IFRIC 12.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1–3)

BC2 SIC-29 *Service Concession Arrangements: Disclosures* (formerly *Disclosure – Service Concession Arrangements*) contains disclosure requirements in respect of public-to-private service arrangements, but does not specify how they should be accounted for.

BC3 There was widespread concern about the lack of such guidance. In particular, operators wished to know how to account for infrastructure that they either constructed or acquired for the purpose of a public-to-private service concession arrangement, or were given access to for the purpose of providing the public service. They also wanted to know how to account for other rights and obligations arising from these types of arrangements.

BC4 In response to this concern, the International Accounting Standards Board asked a working group comprising representatives of the standard-setters of Australia, France, Spain and the United Kingdom (four of the countries that had expressed such concern) to carry out initial research on the subject. The working group recommended that the IFRIC should seek to clarify how certain aspects of existing accounting standards were to be applied.

BC5 In March 2005 the IFRIC published for public comment three 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 response to the proposals 77 comment letters were received. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretations, IASB staff met various interested parties, including preparers, auditors and regulators.

BC6 Most respondents to D12–D14 supported the IFRIC's proposal to develop an Interpretation. However, nearly all respondents expressed concern with fundamental aspects of the proposals, some urging that the project be passed to the Board to develop a comprehensive standard.

BC7 In its redeliberation of the proposals the IFRIC acknowledged that the project was a large undertaking but concluded that it should continue its work because, given the limited scope of the project, it was by then better placed than the Board to deal with the issues in a timely way.

Terminology

- BC8 SIC-29 used the terms ‘Concession Provider’ and ‘Concession Operator’ to describe, respectively, the grantor and operator of the service arrangement. Some commentators, and some members of the IFRIC, found these terms confusingly similar. The IFRIC decided to adopt the terms ‘grantor’ and ‘operator’, and amended SIC-29 accordingly.

Scope (paragraphs 4–9)

- BC9 The IFRIC observed that public-to-private service arrangements take a variety of forms. The continued involvement of both grantor and operator over the term of the arrangement, accompanied by heavy upfront investment, raises questions over what assets and liabilities should be recognised by the operator.
- BC10 The working group recommended that the scope of the IFRIC’s project should be restricted to public-to-private service concession arrangements.
- BC11 In developing the proposals the IFRIC decided to address only arrangements in which the grantor (a) controlled or regulated the services provided by the operator, and (b) controlled any significant residual interest in the infrastructure at the end of the term of the arrangement. It also decided to specify the accounting treatment only for infrastructure that the operator constructed or acquired from a third party, or to which it was given access by the grantor, for the purpose of the arrangement. The IFRIC concluded that these conditions were likely to be met in most of the public-to-private arrangements for which guidance had been sought.
- BC12 Commentators on the draft Interpretations argued that the proposals ignored many arrangements that were found in practice, in particular, when the infrastructure was leased to the operator or, conversely, when it was held as the property, plant and equipment of the operator before the start of the service arrangement.
- BC13 In considering these comments, the IFRIC decided that the scope of the project should not be expanded because it already included the arrangements most in need of interpretative guidance and expansion would have significantly delayed the Interpretation. The scope of the project was considered at length during the initial stage, as indicated above. The IFRIC confirmed its view that the proposed Interpretation should address the issues set out in paragraph 10. Nonetheless, during its redeliberation the IFRIC considered the range of typical arrangements for private sector participation in the provision of public services, including some that were outside the scope of the proposed Interpretation. The IFRIC decided that the Interpretation could provide references to relevant standards that apply to arrangements outside the scope of the Interpretation without giving guidance on their application. If experience showed that such guidance was needed, a separate project could be undertaken at a later date. Information Note 2 contains a table of references to relevant standards for the types of arrangements considered by the IFRIC.

Private-to-private arrangements

- BC14 Some respondents to the draft Interpretations suggested that the scope of the proposed Interpretation should be extended to include private-to-private service arrangements. The IFRIC noted that addressing the accounting for such arrangements was not the primary purpose of the project because the IFRIC had been asked to provide guidance for public-to-private arrangements that meet the requirements set out in paragraph 5 and have the characteristics described in paragraph 3. The IFRIC noted that application by analogy would be appropriate under the hierarchy set out in paragraphs 7–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Grantor accounting

- BC15 The Interpretation does not specify the accounting by grantors, because the IFRIC's objective and priority were to establish guidance for operators. Some commentators asked the IFRIC to establish guidance for the accounting by grantors. The IFRIC discussed these comments but reaffirmed its view. It noted that in many cases the grantor is a government body, and that IFRSs are not designed to apply to not-for-profit activities in the private sector, public sector or government, though entities with such activities may find them appropriate (see *Preface to IFRSs* paragraph 9).¹

Existing assets of the operator

- BC16 The Interpretation does not specify the treatment of existing assets of the operator because the IFRIC decided that it was unnecessary to address the derecognition requirements of existing standards.
- BC17 Some respondents asked the IFRIC to provide guidance on the accounting for existing assets of the operator, stating that the scope exclusion would create uncertainty about the treatment of these assets.
- BC18 In its redeliberations the IFRIC noted that one objective of the Interpretation is to address whether the operator should recognise as its property, plant and equipment the infrastructure it constructs or to which it is given access. The accounting issue to be addressed for existing assets of the operator is one of derecognition, which is already addressed in IFRSs (IAS 16 *Property, Plant and Equipment*). In the light of the comments received from respondents, the IFRIC decided to clarify that certain public-to-private service arrangements may convey to the grantor a right to use existing assets of the operator, in which case the operator would apply the derecognition requirements of IFRSs to determine whether it should derecognise its existing assets.

¹ *Preface to International Financial Reporting Standards* renamed *Preface to IFRS Standards*, December 2018.

The significant residual interest criterion

BC19 Paragraph 5(b) of D12 proposed that for a service arrangement to be within its scope the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. Respondents argued, and the IFRIC agreed, that the significant residual interest criterion would limit the usefulness of the guidance because a service arrangement for the entire physical life of the infrastructure would be excluded from the scope of the guidance. That result was not the IFRIC's intention. In its redeliberation of the proposals, the IFRIC decided that it would not retain the proposal that the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. As a consequence, 'whole of life' infrastructure (ie where the infrastructure is used in a public-to-private service arrangement for the entirety of its useful life) is within the scope of the Interpretation.

Treatment of the operator's rights over the infrastructure (paragraph 11)

BC20 The IFRIC considered the nature of the rights conveyed to the operator in a service concession arrangement. It first examined whether the infrastructure used to provide public services could be classified as property, plant and equipment of the operator under IAS 16. It started from the principle that infrastructure used to provide public services should be recognised as property, plant and equipment of the party that controls its use. This principle determines which party should recognise the property, plant and equipment as its own. The reference to control stems from the *Framework*:²

- (a) an asset is defined by the *Framework* as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'
- (b) the *Framework* notes that many assets are associated with legal rights, including the right of ownership. It goes on to clarify that the right of ownership is not essential.
- (c) rights are often unbundled. For example, they may be divided proportionately (undivided interests in land) or by specified cash flows (principal and interest on a bond) or over time (a lease).

BC21 The IFRIC concluded that treatment of infrastructure that the operator constructs or acquires or to which the grantor gives the operator access for the purpose of the service arrangement should be determined by whether it is controlled by the grantor in the manner described in paragraph 5. If it is so controlled (as will be the case for all arrangements within the scope of the Interpretation), then, regardless of which party has legal title to it during the arrangement, the infrastructure should not be recognised as property, plant

² References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Interpretation was developed.

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and equipment of the operator because the operator does not control the use of the public service infrastructure.

- BC22 In reaching this conclusion the IFRIC observed that it is control of the right to use an asset that determines recognition under IAS 16 and the creation of a lease under IAS 17 *Leases*. IAS 16 defines property, plant and equipment as tangible items that ‘are held for use in the production or supply of goods or services, for rental to others or for administrative purposes ...’. It requires items within this definition to be recognised as property, plant and equipment unless another standard requires or permits a different approach. As an example of a different approach, it highlights the requirement in IAS 17 for recognition of leased property, plant and equipment to be evaluated on the basis of the transfer of risks and rewards. That standard defines a lease as ‘an agreement whereby the lessor conveys to the lessee in return for a series of payments the right to use an asset’ and it sets out the requirements for classification of leases. IFRIC 4 *Determining whether an Arrangement contains a Lease* interprets the meaning of right to use an asset as ‘the arrangement conveys the right to control the use of the underlying asset.’
- BC23 Accordingly, it is only if an arrangement conveys the right to control the use of the underlying asset that reference is made to IAS 17 to determine how such a lease should be classified. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
- BC24 The IFRIC considered whether arrangements within the scope of IFRIC 12 convey ‘the right to control the use of the underlying asset’ (the public service infrastructure) to the operator. The IFRIC decided that, if an arrangement met the conditions in paragraph 5, the operator would not have the right to control the use of the underlying asset and should therefore not recognise the infrastructure as a leased asset.
- BC25 In arrangements within the scope of the Interpretation the operator acts as a service provider. The operator constructs or upgrades infrastructure used to provide a public service. Under the terms of the contract the operator has access to operate the infrastructure to provide the public service on the grantor’s behalf. The asset recognised by the operator is the consideration it receives in exchange for its services, not the public service infrastructure that it constructs or upgrades.
- BC26 Respondents to the draft Interpretations disagreed that recognition should be determined solely on the basis of control of use without any assessment of the extent to which the operator or the grantor bears the risks and rewards of ownership. They questioned how the proposed approach could be reconciled to IAS 17, in which the leased asset is recognised by the party that bears substantially all the risks and rewards incidental to ownership.
- BC27 During its redeliberation the IFRIC affirmed its decision that if an arrangement met the control conditions in paragraph 5 of the Interpretation the operator would not have the right to control the use of the underlying asset (public service infrastructure) and should therefore not recognise the

infrastructure as its property, plant and equipment under IAS 16 or the creation of a lease under IAS 17. The contractual service arrangement between the grantor and operator would not convey the right to use the infrastructure to the operator. The IFRIC concluded that this treatment is also consistent with IAS 18 *Revenue*³ because, for arrangements within the scope of the Interpretation, the second condition of paragraph 14 of IAS 18 is not satisfied. The grantor retains continuing managerial involvement to the degree usually associated with ownership and control over the infrastructure as described in paragraph 5.

- BC28 In service concession arrangements rights are usually conveyed for a limited period, which is similar to a lease. However, for arrangements within the scope of the Interpretation, the operator's right is different from that of a lessee: the grantor retains control over the use to which the infrastructure is put, by controlling or regulating what services the operator must provide, to whom it must provide them, and at what price, as described in paragraph 5(a). The grantor also retains control over any significant residual interest in the infrastructure throughout the period of the arrangement. Unlike a lessee, the operator does not have a right of use of the underlying asset: rather it has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.
- BC29 The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 4. In particular, it noted the views expressed by some respondents that the contractual terms of certain service arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion set out in paragraph 5 of IFRIC 12. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. In the light of comments received the IFRIC amended the scope of IFRIC 4 to specify that if a service arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

³ IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.

Recognition and measurement of arrangement consideration (paragraphs 12 and 13)

- BC30 The accounting requirements for construction and service contracts are addressed in IAS 11 *Construction Contracts*⁴ and IAS 18⁵. They require revenue to be recognised by reference to the stage of completion of the contract activity. IAS 18 states the general principle that revenue is measured at the fair value of the consideration received or receivable. However, the IFRIC observed that the fair value of the construction services delivered may in practice be the most appropriate method of establishing the fair value of the consideration received or receivable for the construction services. This will be the case in service concession arrangements, because the consideration attributable to the construction activity often has to be apportioned from a total sum receivable on the contract as a whole and, if it consists of an intangible asset, may also be subject to uncertainty in measurement.
- BC31 The IFRIC noted that IAS 18⁶ requires its recognition criteria to be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and is recognised as revenue over the period during which the service is performed. The IFRIC concluded that this requirement was relevant to service arrangements within the scope of the Interpretation. Arrangements within the scope of the Interpretation involve an operator providing more than one service, ie construction or upgrade services, and operation services. Although the contract for each service is generally negotiated as a single contract, its terms call for separate phases or elements because each separate phase or element has its own distinct skills, requirements and risks. The IFRIC noted that, in these circumstances, IAS 18 paragraphs 4 and 13 require the contract to be separated into two separate

4 IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts* and IAS 18 *Revenue*. IFRS 15 requires revenue to be recognised when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer. IFRS 15 measures the revenue by (a) determining the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer; and (b) allocating that amount to the performance obligations.

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phases or elements, a construction element within the scope of IAS 11⁷ and an operations element within the scope of IAS 18. Thus the operator might report different profit margins on each phase or element. The IFRIC noted that the amount for each service would be identifiable because such services were often provided as a single service. The IFRIC also noted that the combining and segmenting criteria of IAS 11 applied only to the construction element of the arrangement.

BC32 In some circumstances, the grantor makes a non-cash payment for the construction services, ie it gives the operator an intangible asset (a right to charge users of the public service) in exchange for the operator providing construction services. The operator then uses the intangible asset to generate further revenues from users of the public service.

BC33 Paragraph 12 of IAS 18⁸ states:

When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

BC34 The IFRIC noted that total revenue does not equal total cash inflows. The reason for this outcome is that, when the operator receives an intangible asset in exchange for its construction services, there are two sets of inflows and outflows rather than one. In the first set, the construction services are exchanged for the intangible asset in a barter transaction with the grantor. In the second set, the intangible asset received from the grantor is used up to generate cash flows from users of the public service. This result is not unique to service arrangements within the scope of the Interpretation. Any situation in which an entity provides goods or services in exchange for another dissimilar asset that is subsequently used to generate cash revenues would lead to a similar result.

BC35 Some IFRIC members were uncomfortable with such a result, and would have preferred a method of accounting under which total revenues were limited to the cash inflows. However, they accepted that it is consistent with the treatment accorded to a barter transaction, ie an exchange of dissimilar goods or services.

⁷ IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts* and IAS 18 *Revenue*. IFRS 15 requires revenue to be recognised when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer. IFRS 15 measures the revenue by (a) determining the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer; and (b) allocating that amount to the performance obligations.

⁸ IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 requires an entity to measure non-cash consideration at fair value, unless the entity cannot reasonably estimate the fair value of the non-cash consideration. In such cases, IFRS 15 requires the entity to measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration.

**Consideration given by the grantor to the operator
(paragraphs 14–19)**

- BC36 The IFRIC observed that the contractual rights that the operator receives in exchange for providing construction services can take a variety of forms. They are not necessarily rights to receive cash or other financial assets.
- BC37 The draft Interpretations proposed that the nature of the operator's asset depended on who had the primary responsibility to pay the operator for the services. The operator should recognise a financial asset when the grantor had the primary responsibility to pay the operator for the services. The operator should recognise an intangible asset in all other cases.
- BC38 Respondents to the draft Interpretations argued that determining which accounting model to apply by looking at who has the primary responsibility to pay the operator for the services, irrespective of who bears demand risk (ie ability and willingness of users to pay for the service), would result in an accounting treatment that did not reflect the economic substance of the arrangement. Respondents were concerned that the proposal would require operators with essentially identical cash flow streams to adopt different accounting models. This would impair users' understanding of entities involved in providing public-to-private service concession arrangements. Several gave the example of a shadow toll road and a toll road, where the economics (demand risk) of the arrangements would be similar, pointing out that under the proposals the two arrangements would be accounted for differently. In the light of comments received on the proposals, the IFRIC decided to clarify (see paragraphs 15–19) the extent to which an operator should recognise a financial asset and an intangible asset.
- BC39 Responses to the draft Interpretations provided only limited information about the impact of the proposals. To obtain additional information, IASB staff arranged for discussions with preparers, auditors and regulators. The consensus of those consulted was that the identity of the payer has no effect on the risks to the operator's cash flow stream. The operator typically relies on the terms of the service arrangement contract to determine the risks to its cash flow stream. The operator's cash flows may be guaranteed by the grantor, in which case the grantor bears demand risk, or the operator's cash flows may be conditional on usage levels, in which case the operator bears demand risk.
- BC40 The IFRIC noted that the operator's cash flows are guaranteed when (a) the grantor agrees to pay the operator specified or determinable amounts whether or not the public service is used (sometimes known as take-or-pay arrangements) or (b) the grantor grants a right to the operator to charge users of the public service and the grantor guarantees the operator's cash flows by way of a shortfall guarantee described in paragraph 16. The operator's cash flows are conditional on usage when it has no such guarantee but must obtain its revenue either directly from users of the public service or from the grantor in proportion to public usage of the service (road tolls or shadow tolls for example).

A financial asset (operator's cash flows are guaranteed by the grantor)

- BC41 Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a financial asset to include 'a contractual right to receive cash or another financial asset from another entity'. Paragraph 13 of that standard clarifies that 'contractual' refers to 'an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.'
- BC42 The IFRIC decided that a financial asset should be recognised to the extent that the operator has an unconditional present right to receive cash from or at the direction of the grantor for the construction services; and the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has a contractual right to receive cash for the construction services if the grantor contractually guarantees the operator's cash flows, in the manner described in paragraph 16. The IFRIC noted that the operator has an unconditional right to receive cash to the extent that the grantor bears the risk (demand risk) that the cash flows generated by the users of the public service will not be sufficient to recover the operator's investment.
- BC43 The IFRIC noted that:
- (a) an agreement to pay for the shortfall, if any, between amounts received from users of the service and specified or determinable amounts does not meet the definition of a financial guarantee in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*⁹ because the operator has an unconditional contractual right to receive cash from the grantor. Furthermore, the amendments made to IAS 39 in August 2005 by *Financial Guarantee Contracts* do not address the treatment of financial guarantee contracts by the holder. The objective of the amendments was to ensure that issuers of financial guarantee contracts recognise a liability for the obligations the grantor has undertaken in issuing that guarantee.
 - (b) users or the grantor may pay the contractual amount receivable directly to the operator. The method of payment is a matter of form only. In both cases the operator has a present, unconditional, contractual right to receive the specified or determinable cash flows from or at the direction of the grantor. The nature of the operator's asset is not altered solely because the contractual amount receivable may be paid directly by users of the public service. The IFRIC observed that accounting for these contractual cash flows in accordance with IASs 32 and 39 faithfully reflects the economics of the arrangements, which is to provide finance to the operator for the construction of the infrastructure.

⁹ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Operator's cash flows are contingent on the operator meeting specified quality or efficiency requirements

- BC44 The IFRIC concluded that the definition of a financial asset is met even if the contractual right to receive cash is contingent on the operator meeting specified quality or efficiency requirements or targets. Before the grantor is required to pay the operator for its construction services, the operator may have to ensure that the infrastructure is capable of generating the public services specified by the grantor or that the infrastructure is up to or exceeds operating standards or efficiency targets specified by the grantor to ensure a specified level of service and capacity can be delivered. In this respect the operator's position is the same as that of any other entity in which payment for goods or services is contingent on subsequent performance of the goods or service sold.
- BC45 Therefore IFRIC 12 treats the consideration given by the grantor to the operator as giving rise to a financial asset irrespective of whether the contractual amounts receivable are contingent on the operator meeting levels of performance or efficiency targets.¹⁰

An intangible asset (operator's cash flows are conditional on usage)

- BC46 IAS 38 *Intangible Assets* defines an intangible asset as 'an identifiable non-monetary asset without physical substance'. It mentions licences as examples of intangible assets. It describes an asset as being identifiable when it arises from contractual rights.
- BC47 The IFRIC concluded that the right of an operator to charge users of the public service meets the definition of an intangible asset, and therefore should be accounted for in accordance with IAS 38. In these circumstances the operator's revenue is conditional on usage and it bears the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover its investment.
- BC48 In the absence of contractual arrangements designed to ensure that the operator receives a minimum amount (see paragraphs BC53 and BC54), the operator has no contractual right to receive cash even if receipt of the cash is highly probable. Rather, the operator has an opportunity to charge those who use the public service in the future. The operator bears the demand risk and hence its commercial return is contingent on users using the public service. The operator's asset is a licence, which would be classified as an intangible asset within the scope of IAS 38. And, as clarified in paragraph AG10 of the application guidance in IAS 32:

¹⁰ IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 requires an entity to recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset. This is also discussed in paragraph 16 of IFRIC 12.

Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

- BC49 The IFRIC considered whether a right to charge users unsupported by any shortfall guarantee from the grantor could be regarded as an indirect right to receive cash arising from the contract with the grantor. It concluded that although the operator's asset might have characteristics that are similar to those of a financial asset, it would not meet the definition of a financial asset in IAS 32: the operator would not at the balance sheet date have a contractual right to receive cash from another entity. That other entity (ie the user) would still have the ability to avoid any obligation. The grantor would be passing to the operator an opportunity to charge users in future, not a present right to receive cash.

Contractual arrangements that eliminate substantially all variability in the operator's return

- BC50 The IFRIC considered whether agreements incorporating contractual arrangements designed to eliminate substantially all variability in the operator's return would meet the definition of a financial asset, for example:
- (a) the price charged by the operator would be varied by regulation designed to ensure that the operator received a substantially fixed return; or
 - (b) the operator would be permitted to collect revenues from users or the grantor until it achieved a specified return on its investment, at which point the arrangement would come to an end.
- BC51 The IFRIC noted that, as a result of such contractual arrangements, the operator's return would be low risk. Only if usage were extremely low would the contractual mechanisms fail to give the operator the specified return. The likelihood of usage being that low could be remote. Commercially, the operator's return would be regarded as fixed, giving its asset many of the characteristics of a financial asset.
- BC52 However, the IFRIC concluded that the fact that the operator's asset was low risk did not influence its classification. IAS 32 does not define financial assets by reference to the amount of risk in the return—it defines them solely by reference to the existence or absence of an unconditional contractual right to receive cash. There are other examples of licences that offer the holders of the rights predictable, low risk returns, but such licences are not regarded as giving the holder a contractual right to cash. And there are other industries in which price regulation is designed to provide the operators with substantially fixed returns—but the rights of operators in these other industries are not classified as financial assets as a result. The operator's asset is a variable term licence, which would be classified as an intangible asset within the scope of IAS 38.

A financial asset and an intangible asset

- BC53 The IFRIC concluded that if the operator is paid for its construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The IFRIC included the requirement to account separately for each component (sometimes known as a bifurcated arrangement) of the operator's consideration in response to a concern raised on the draft Interpretations. The concern was that, in some arrangements, both parties to the contract share the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover the operator's investment. In order to achieve the desired sharing of risk, the parties often agree to arrangements under which the grantor pays the operator for its services partly by a financial asset and partly by granting a right to charge users of the public service (an intangible asset). The IFRIC concluded that in these circumstances it would be necessary to divide the operator's consideration into a financial asset component for any guaranteed amount of cash or other financial asset and an intangible asset for the remainder.
- BC54 The IFRIC concluded that the nature of consideration given by the grantor to the operator is determined by reference to the contract terms and when it exists, relevant contract law. The IFRIC noted public-to-private service agreements are rarely if ever the same; technical requirements vary by sector and country. Furthermore, the terms of the contractual agreement may also depend on the specific features of the overall legal framework of the particular country. Public-to-private service contract laws, where they exist, may contain terms that do not have to be repeated in individual contracts.

Contractual obligations to restore the infrastructure to a specified level of serviceability (paragraph 21)

- BC55 The IFRIC noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prohibits an entity from providing for the replacement of parts of its own property, plant and equipment. IAS 16 requires such costs to be recognised in the carrying amount of an item of property, plant and equipment if the recognition criteria in paragraph 7 are met. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The IFRIC concluded that this prohibition would not apply to arrangements within the scope of the Interpretation because the operator does not recognise the infrastructure as its own property, plant and equipment. The operator has an unavoidable obligation that it owes to a third party, the grantor, in respect of the infrastructure. The operator should recognise its obligations in accordance with IAS 37.
- BC56 The IFRIC considered whether the Interpretation should contain guidance on the timing of recognition of the obligations. It noted that the precise terms and circumstances of the obligations would vary from contract to contract. It concluded that the requirements and guidance in IAS 37 were sufficiently

clear to enable an operator to identify the period(s) in which different obligations should be recognised.

Borrowing costs (paragraph 22)

- BC57 IAS 23 *Borrowing Costs* permits borrowing costs to be capitalised as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That Standard defines a qualifying asset as ‘an asset that necessarily takes a substantial period of time to get ready for its intended use or sale’.
- BC58 For arrangements within the scope of the Interpretation, the IFRIC decided that an intangible asset (ie the grantor gives the operator a right to charge users of the public service in return for construction services) meets the definition of a qualifying asset of the operator because generally the licence would not be ready for use until the infrastructure was constructed or upgraded. A financial asset (ie the grantor gives the operator a contractual right to receive cash or other financial asset in return for construction services) does not meet the definition of a qualifying asset of the operator. The IFRIC observed that interest is generally accreted on the carrying value of financial assets.
- BC59 The IFRIC noted that financing arrangements may result in an operator obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure relating to construction or operation services. In such circumstances the funds are often temporarily invested. Any investment income earned on such funds is recognised in accordance with IAS 39,¹¹ unless the operator adopts the allowed alternative treatment, in which case investment income earned during the construction phase of the arrangement is accounted for in accordance with paragraph 16 of IAS 23.¹²

Financial asset (paragraphs 23–25)¹³

- BC60 Paragraph 9 of IAS 39 identifies and defines four categories of financial asset: (i) those held at fair value through profit or loss; (ii) held-to-maturity investments; (iii) loans and receivables; and (iv) available-for-sale financial assets.

11 IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

12 In March 2007, IAS 23 was revised to require the previously allowed alternative treatment of capitalisation. Therefore, an entity is required to capitalise borrowing costs as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That revision does not affect the reasoning set out in this Basis for Conclusions.

13 IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

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BC61 Paragraph 24 of IFRIC 12 assumes that public-to-private service arrangement financial assets will not be categorised as held-to-maturity investments. Paragraph 9 of IAS 39 states that a financial asset may not be classified as a held-to-maturity investment if it meets the definition of a loan or receivable. An asset that meets the definition of a held-to-maturity investment will meet the definition of a loan or receivable unless:

- (a) it is quoted in an active market; or
- (b) the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

It is not envisaged that a public-to-private service arrangement financial asset will be quoted in an active market. Hence the circumstances of (a) will not arise. In the circumstances of (b), the asset must be classified as available for sale (if not designated upon initial recognition as at fair value through profit or loss).

BC62 The IFRIC considered whether the contract would include an embedded derivative if the amount to be received by the operator could vary with the quality of subsequent services to be provided by the operator or performance or efficiency targets to be achieved by the operator. The IFRIC concluded that it would not, because the definition of a derivative in IAS 39 requires, among other things, that the variable is not specific to a party to the contract. The consequence is that the contract's provision for variations in payments does not meet the definition of a derivative and, accordingly, the requirements of IAS 39 in relation to embedded derivatives do not apply. The IFRIC observed that if the amount to be received by the operator is conditional on the infrastructure meeting quality or performance or efficiency targets as described in paragraph BC44, this would not prevent the amount from being classified as a financial asset. The IFRIC also concluded that during the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) should be classified as a financial asset when it represents cash or another financial asset due from or at the direction of the grantor.

Intangible asset (paragraph 26)

BC63 The Interpretation requires the operator to account for its intangible asset in accordance with IAS 38. Among other requirements, IAS 38 requires an intangible asset with a finite useful economic life to be amortised over that life. Paragraph 97 states that 'the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.'

BC64 The IFRIC considered whether it would be appropriate for intangible assets under paragraph 26 to be amortised using an 'interest' method of amortisation, ie one that takes account of the time value of money in addition to the consumption of the intangible asset, treating the asset more like a monetary than a non-monetary asset. However, the IFRIC concluded that there was nothing unique about these intangible assets that would justify use

of a method of depreciation different from that used for other intangible assets. The IFRIC noted that paragraph 98 of IAS 38 provides for a number of amortisation methods for intangible assets with finite useful lives. These methods include the straight-line method, the diminishing balance method and the units of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits.

BC65 The IFRIC noted that interest methods of amortisation are not permitted under IAS 38. Therefore, IFRIC 12 does not provide exceptions to permit use of interest methods of amortisation.

BC66 The IFRIC considered when the operator should first recognise the intangible asset. The IFRIC concluded that the intangible asset (the licence) received in exchange for construction services should be recognised in accordance with general principles applicable to contracts for the exchange of assets or services.

BC67 The IFRIC noted that it is current practice not to recognise executory contracts to the extent that they are unperformed by both parties (unless the contract is onerous). IAS 37 describes executory contracts as 'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent'. Paragraph 91 of the *Framework* states:

In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

BC68 Therefore, the IFRIC concluded that contracts within the scope of the Interpretation should not be recognised to the extent that they are executory. The IFRIC noted that service concession arrangements within the scope of the Interpretation are generally executory when the contracts are signed. The IFRIC also concluded that during the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) should be classified as an intangible asset to the extent that it represents a right to receive a right (licence) to charge users of the public service (an intangible asset).

Items provided to the operator by the grantor (paragraph 27)

BC69 For service arrangements within the scope of the Interpretation, pre-existing infrastructure items made available to the operator by the grantor for the purpose of the service arrangement are not recognised as property, plant and equipment of the operator.

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BC70 However, different considerations apply to other assets provided to the operator by the grantor if the operator can keep or deal with the assets as it wishes. Such assets become assets of the operator and so should be accounted for in accordance with general recognition and measurement principles, as should the obligations undertaken in exchange for them.

BC71 The IFRIC considered whether such assets would represent government grants, as defined in paragraph 3 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*:

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

The IFRIC concluded that if such assets were part of the overall consideration payable by the grantor on an arms' length basis for the operator's services, they would not constitute 'assistance'. Therefore, they would not meet the definition of government grants in IAS 20 and that standard would not apply.

Transition (paragraphs 29 and 30)

BC72 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that an entity shall account for a change in accounting policy resulting from initial application of an Interpretation in accordance with any specific transitional provisions in that Interpretation. In the absence of any specific transitional provisions, the general requirements of IAS 8 apply. The general requirement in IAS 8 is that the changes should be accounted for retrospectively, except to the extent that retrospective application would be impracticable.

BC73 The IFRIC noted that there are two aspects to retrospective determination: reclassification and remeasurement. The IFRIC took the view that it will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in an operator's balance sheet, but that retrospective remeasurement of service arrangement assets might not always be practicable.

BC74 The IFRIC noted that, when retrospective restatement is not practicable, IAS 8 requires prospective application from the earliest practicable date, which could be the start of the current period. Under prospective application, the operator could be applying different accounting models to similar transactions, which the IFRIC decided would be inappropriate. The IFRIC regarded it as important that the correct accounting model should be consistently applied.

BC75 The Interpretation reflects these conclusions.

Amendments to IFRS 1

BC76 The amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* are necessary to ensure that the transitional arrangements are available to both existing users and first-time adopters of IFRSs. The IFRIC believes that the requirements will ensure that the balance sheet will exclude any items that would not qualify for recognition as assets and liabilities under IFRSs.

Summary of changes from the draft Interpretations

BC77 The main changes from the IFRIC's proposals are as follows:

- (a) The proposals were published 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 12, the IFRIC combined the three draft Interpretations.
- (b) By contrast with IFRIC 12 the draft Interpretations did not explain the reasons for the scope limitations and the reasons for the control approach adopted by the IFRIC in paragraph 5. The IFRIC added Information Note 2 to IFRIC 12 to provide references to standards that apply to arrangements outside the scope of the Interpretation.
- (c) The scope of the proposals did not include 'whole of life infrastructure' (ie infrastructure used in a public-to-private service arrangement for its entire useful life). IFRIC 12 includes 'whole of life infrastructure' within its scope.
- (d) Under the approach proposed, an entity determined the appropriate accounting model by reference to whether the grantor or the user had primary responsibility to pay the operator for the services provided. IFRIC 12 requires an entity to recognise a financial asset to the extent that the operator has an unconditional contractual right to receive cash from or at the direction of the grantor. The operator should recognise an intangible asset to the extent that it receives a right to charge users of the public service.
- (e) By contrast with IFRIC 12, the draft Interpretations implied that the nature of asset recognised (a financial asset or an intangible asset) by the operator as consideration for providing construction services determined the accounting for the operation phase of the arrangement.
- (f) Under the approach proposed in the draft Interpretations, an entity could capitalise borrowing costs under the allowed alternative treatment in IAS 23. IFRIC 12 requires borrowing costs to be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service), in which case

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borrowing costs attributable to the arrangement may be capitalised in accordance with the allowed alternative treatment under IAS 23.¹⁴

- (g) In finalising IFRIC 12, the IFRIC decided to amend IFRIC 4.

¹⁴ In March 2007, IAS 23 was revised to require the previously allowed alternative treatment of capitalisation. Therefore, an entity is required to capitalise borrowing costs as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That revision does not affect the reasoning set out in this Basis for Conclusions.