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IFRIC 12 – Service Concession Arrangements

On 30 November 2006, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 12 **Service Concession Arrangements**. The Interpretation addresses the accounting by private sector operators involved in the provision of public sector infrastructure assets and services, such as schools and roads. The Interpretation does not address the accounting for the government (grantor) side of such arrangements.

The Interpretation states that for arrangements falling within its scope (see below), the infrastructure assets are not recognised as property, plant and equipment of the operator. Rather, depending on the terms of the arrangement, the operator will recognise:

- a financial asset (where the operator has an unconditional right to receive a specified amount of cash or other financial asset over the life of the arrangement); or
- an intangible asset (where the operator's future cash flows are not specified – e.g. where they will vary according to usage of the infrastructure asset); or
- both a financial asset and an intangible asset where the operator's return is provided partially by a financial asset and partially by an intangible asset.

The Interpretation is effective for annual periods beginning on or after 1 January 2008, with early adoption permitted.

Ken Wild, Deloitte's global IFRS leader, says:

"IFRIC 12 is the culmination of an unusually long IFRIC project. The IFRIC has dedicated significant time and resources to understanding the financial reporting issues associated with public infrastructure projects. IFRIC 12 clarifies the accounting by private sector operators in such projects.

It has long been my personal opinion that the financial asset model developed by the IFRIC is preferable to the intangible asset model. However, it is an undeniable fact that there are arrangements in existence that do not result in the granting of a financial asset, and therefore cannot be accounted for as such. Some of the accounting outcomes in the intangible asset model, such as the double recognition of revenue, are not ideal. However, they are the technically correct outcome of applying the current accounting literature and, as an interpretive body, the IFRIC does not have the mandate to override that literature."

Scope

There are a wide variety of arrangements in operation globally whereby government or government agencies enter into contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of infrastructure for public services.

IFRIC 12 is concerned with the accounting by private sector operators for “public-to-private” service concession arrangements (which are also known by a variety of other titles, including “service concession” “build-operate-transfer” or “rehabilitate-operate-transfer” arrangements). These arrangements typically involve a private sector operator constructing (or upgrading) the infrastructure used to provide the public service, and then operating and maintaining the infrastructure for a specified period of time.

However, the Interpretation does not apply to all such arrangements. Its scope is limited to public-to-private service concession arrangements in which:

- the grantor controls the use of the infrastructure; and
- the grantor controls (through ownership, beneficial entitlement or otherwise) any significant residual interest in the infrastructure at the end of the term of the arrangement.

Controlling the use of the infrastructure

The grantor is considered to control the use of the infrastructure when it controls or regulates: the services to be provided with the infrastructure; to whom those services must be provided; and the price to be charged for those services.

This control could be by contract or otherwise (e.g. through a regulator). The application guidance issued as part of the Interpretation clarifies that it is not necessary that the grantor have complete control of the price – it is sufficient for the prices to be regulated by the grantor, contract or regulator, for example by a capping mechanism. The condition is to be applied to the substance of the agreement. Therefore, non-substantive features such as a cap that will apply only in remote circumstances are ignored.

Significant residual interest

For this condition, the grantor’s control over any significant residual interest should both restrict the operator’s practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement. Where a significant residual interest will exist in the infrastructure at the end of the service concession arrangement, that residual interest must revert to the grantor for the arrangement to be within the scope of the Interpretation.

Note that arrangements where **no** significant residual interest exists at the end of the term (commonly called “whole-of-life service concession arrangements”) are **not** excluded from the scope of the Interpretation. Where a whole-of-life service concession arrangement satisfies the control criterion discussed above, the arrangement will be within the scope of the Interpretation, irrespective of which party controls any remaining insignificant residual interest.

Accounting model

The key issue dealt with by the Interpretation is the accounting for the operator’s rights over the infrastructure.

The first principle established in IFRIC 12 is that, under arrangements meeting the ‘grantor control’ criteria discussed above, the infrastructure should not be recognised as property, plant and equipment of the operator because the operator does not control the use of the infrastructure. Rather, the right that the operator receives is the right to operate the infrastructure for the purpose of providing the public service on behalf of the grantor. On the basis of the economic benefits to which it is entitled under the arrangement, the operator must determine whether the nature of the asset it receives is a financial asset or an intangible asset (or a mixture of both of these).

The requirements of IFRIC 12 regarding the nature of the asset to be recognised can be summarised as follows:

| Operator’s rights | Classification | Examples |
|---|-------------------------------------|--|
| Unconditional, contractual right to receive cash or other financial asset from or at the direction of the the grantor. | Financial asset | <ul style="list-style-type: none"> • Operator receives a fixed amount from the grantor over the term of the arrangement. • Operator has a right to charge users over the term of the arrangement, but any shortfall will be reimbursed by the grantor. |
| Contractual right to charge based on usage of the services. Amounts to be received are contingent on the extent that the public uses the service. | Intangible asset | <ul style="list-style-type: none"> • Operator has a right to charge users over the term of the arrangement. • Operator has a right to charge the grantor based on usage of the services over the term of the arrangement. |
| Consideration received partly in the form of a financial asset and partly in the form of an intangible asset. | Financial and intangible components | <ul style="list-style-type: none"> • Operator receives a fixed amount from the grantor and a right to charge users over the term of the arrangement. |

The detailed accounting treatment under each of these models is discussed below. Each of these is illustrated by example in IFRIC 12.

Financial asset

A typical arrangement falling into this category is where an operator constructs or upgrades the infrastructure, and is permitted to operate it for a fixed period of time for an agreed revenue stream to be received during the period of operation.

Revenue and costs relating to the construction or upgrade are recognised in income over the construction phase of the arrangement in accordance with IAS 11 **Construction Contracts**. Therefore, subject to the requirements of IAS 11, costs are recognised by reference to the stage of completion of the construction project. Contract revenue is the fair value of the amount due from the grantor for the construction activity – which may be in practice be measured as the fair value of the asset under construction at the end of each reporting period, less amounts recognised as revenue in earlier periods.

The construction revenue recognised to date is recognised as a financial asset. The financial asset is accounted for in accordance with the requirements of IAS 39 **Financial Instruments: Recognition and Measurement** as:

- a loan or receivable; or
- an available-for-sale financial asset; or
- if so designated upon initial recognition, a financial asset at fair value through profit or loss, if the conditions for that classification are met.

If the financial asset is accounted for either as a loan or receivable, or as an available-for-sale financial asset, IAS 39 requires interest calculated using the effective interest method to be recognised in profit or loss.

Intangible asset

A typical arrangement falling into this category is where the operator constructs or upgrades the infrastructure, and is permitted to operate the infrastructure for a fixed period after completion of construction. The operator's revenues are contingent – e.g. on the usage of the infrastructure assets.

The accounting during the construction phase is the same as that described above for arrangements resulting in financial assets. Contract revenue is the fair value of the intangible asset received in exchange for construction services provided in the period. During this construction phase, the operator's asset is classified as an intangible asset.

Further revenue is recognised when money is actually received. This contrasts with the financial asset model, in which monies received are treated as partial repayment of the financial asset. In the intangible asset model, the intangible is reduced by amortisation rather than repayment. As a result, revenue is recognised twice in the intangible model – once on the exchange of construction services for the intangible asset, and a second time on receipt of payments.

Intangible assets recognised in accordance with the Interpretation should be amortised over their useful lives in accordance with the requirements of IAS 38 **Intangible Assets**. The IFRIC has explicitly stated that interest methods of depreciation are not acceptable. The IFRIC also considered the statement in IAS 38 that rarely, if ever, will there be persuasive evidence to support an amortisation method that results in a lower amount of accumulated amortisation than under the straight-line method. Note, however, that the International Accounting Standards Board has subsequently confirmed that this paragraph of IAS 38 should not be read as implying that amortisation methods based on reliable estimates of usage would never be appropriate.

Financial and intangible components

Where the operator receives a financial asset and an intangible asset as consideration, it is necessary to account separately for the component parts. At initial recognition, the assets are recognised at the fair value of consideration received or receivable. In practice this means that, to the extent the operator has received a contractual right to receive cash from or at the direction of the grantor, a financial asset will be recognised. Any excess of the fair value of the consideration paid over the fair value of the financial asset recognised will be recognised as an intangible asset.

Other issues

Borrowing costs

Borrowing costs incurred in connection with an arrangement falling within the scope of IFRIC 12 will be expensed as incurred, unless the operator has recognised an intangible asset under the Interpretation. In this case, borrowing costs may be capitalised in accordance with the general rules of IAS 23 **Borrowing Costs**.

Under the financial asset model, borrowing costs cannot be capitalised, because the financial asset will not meet the definition of a qualifying asset under IAS 23.

Repairs and maintenance

IFRIC 12 requires that any obligation to maintain or restore the infrastructure under the terms of the arrangement be recognised and measured in accordance with the requirements of IAS 37 **Provisions, Contingent Liabilities and Contingent Assets**.

Disclosure

IFRIC 12 does not contain any disclosure requirements. Requirements for disclosing information about service concession arrangements are set out in SIC 29 **Service Concession Arrangements: Disclosures** (previously titled "Disclosure – Service Concession Arrangements").

Consequential amendments to SIC 29 replace the terms “Concession Operator” and “Concession Provider” with “operator” and “grantor” respectively, to bring the terminology into line with IFRIC 12. In addition, SIC 29 will require the operator to disclose the following after the implementation of IFRIC 12:

- how the service arrangement has been classified; and
- the amount of revenue and profits or losses recognised in the period on exchanging construction services for a financial asset or an intangible asset.

Consequential amendments to IFRIC 4

A number of commentators on the Exposure Draft of IFRIC 12 raised concerns that there appeared to be some overlap between the proposed Interpretation and the scope of IFRIC 4 **Determining Whether an Arrangement Contains a Lease**. The IFRIC agreed that an overlap did exist, and it would be inappropriate for entities to be able to choose which Interpretation to apply when the scope criteria of both are met. In issuing IFRIC 12, the IFRIC has also amended the scope of IFRIC 4 such that if the scope criteria of both pronouncements are met, IFRIC 12 will prevail.

Effective date and transition

IFRIC 12 will apply to accounting periods beginning on or after 1 January 2008. Early application is permitted. If an entity applies IFRIC 12 for a period beginning before 1 January 2008, it shall disclose that fact.

In accordance with the general principles in IAS 8 **Accounting Policies, Changes in Accounting Estimates and Errors** any changes in accounting policies arising from the adoption of IFRIC 12 shall be applied retrospectively.

However, if retrospective application is impracticable for any particular service concession arrangement, the operator must:

- recognise the financial assets and intangible assets that existed at the start of the earliest financial reporting period presented;
- use the previous carrying amounts of those financial and intangible assets (however they were previously classified) as their carrying amounts as at that date; and
- test the resulting financial and intangible assets for impairment at that date, unless that is not practicable, in which case the assets should be tested for impairment as at the start of the current period.

First-time adopters

Entities adopting IFRSs for the first time in periods beginning on or after 1 January 2008 are permitted to apply the transitional provisions in IFRIC 12, as set out in the previous section.

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