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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: March 2006, London

**Project: Service Concessions – The interaction of D12 with IFRIC 4
(Agenda Paper 2B)**

Introduction

- 1 At its September 2005 meeting, the IFRIC considered a range of scope issues relating to service concessions. One of the issues considered was the distinction between IFRIC 4 *Determining Whether an Arrangement Contains a Lease* and D12. Another was whether the 'significant residual interest' criterion was a necessary part of the scope requirements of D12. In further analysing the distinctions between the scope of IFRIC 4 and D12, staff have become aware that these two issues are intrinsically linked, and should be considered in tandem.

- 2 Accordingly, this paper explains the distinction between the scope of D12 and IFRIC 4 as currently drafted, and examines the importance of the significant residual interest criterion to that distinction. The paper contemplates placing more reliance on the concept of a public service obligation, or amending the scope of IFRIC 4 as alternative methods of achieving a clear distinction between the pronouncements. The paper then makes a recommendation about a way to move forward using the significant residual interest criterion, including an analysis of the impact on whole of life assets.

Staff Recommendation

3 The paper recommends that no amendment be made to the significant residual interest criterion contained in paragraph 5(b) of D12:

(b) the grantor controls – through ownership, beneficial entitlement or otherwise –the residual interest in the infrastructure at the end of the concession, and the residual interest is significant.

4 Does the IFRIC agree?

IFRIC 4 and D12

Scope Analysis

5 The criteria for determining whether a lease arrangement exists in IFRIC 4 as follows:

6 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

- (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and
- (b) the arrangement conveys a right to use the asset.

9 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

- (a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset
- (b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset
- (c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

6 The scope criteria contained in paragraph 5 of D12 are as follows:

This [draft] interpretation applies to service concession arrangements involving public service obligations as described in paragraph 2. It applies to infrastructure used in such arrangements if:

- (a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and
- (b) the grantor controls – through ownership, beneficial entitlement or otherwise – the residual interest in the infrastructure at the end of the concession, and the residual interest is significant.

7 As noted in the table in Appendix A, if the significant residual interest criterion in D12 was not present, the criteria in paragraph 5(a) of D12 would be sufficiently similar to those indicators in IFRIC 4 paragraph 9 to create confusion as to which of the pronouncements should be applied to any particular scenario.

8 Staff have recently considered a number of real life examples, and attempted to determine for each whether IFRIC 4 or D12 is the appropriate pronouncement to apply. In each case considered, the significant residual interest criterion was the key scope requirement that created a clear distinction between the two pronouncements. The following example illustrates the point.

9 Entity A builds a new pre-fabricated office building for a University, and enters into a service contract to maintain and operate that office block for twenty years. The University owns the land on which the office block is located. The offices contained therein will be used to house visiting professors. At the end of the twenty years Entity A has the right to the residual interest in the building, and may choose to negotiate with the University to continue to operate the building on University land, or may choose to relocate the buildings.

10 The University regulates the services that must be provided (provision of well maintained office accommodation), to whom they must be provided (those individuals nominated by the university to have their office facilities housed in the building) and at what price (as the ‘rental’ paid by the University is agreed at inception). Therefore, absent the significant residual interest criterion, this arrangement would seem to be

within the scope of D12. However, in this scenario, the University also appears to have a right to direct the use of the asset as described in IFRIC 4.

- 11 However, when the significant residual interest criterion is considered, this arrangement is outwith D12, and clearly within IFRIC 4, which staff believe to be the appropriate accounting treatment. Entity A has constructed an asset which will provide economic benefits to Entity A for the entirety of its useful life.

Public Service Obligation

- 12 Staff note that there is one additional difference between the scope of IFRIC 4 and the scope of D12. That is, that D12 applies to arrangements in which a public sector entity is seeking to fulfil its public service obligation. Accordingly, one solution would be for entities to determine whether IFRIC 4 or D12 should apply by reference to whether the counter party is fulfilling a public service obligation.
- 13 Staff believe that there is an argument that could support different accounting between two like agreements solely because of a public service obligation. This is because in many scenarios the public sector body will be obliged (in a non-accounting sense) to continue to make the services available even if usage is not as predicted. In these cases, private sector entities have somewhat more bargaining power than might be suggested by their signed contract, as the public sector entity ordinarily has a vested interest in not allowing the private sector entity to walk away from the arrangement. By contrast, where the entities are both private sector entities, the counter party may not ordinarily be as committed to continuing to be involved in the service as the government normally is. Accordingly, the scope for renegotiation if usage is not as predicted may be less.
- 14 However, staff believe that while this might be true in some jurisdictions, it is not necessarily true in all jurisdictions. The manner in which the courts have enforced contractual law in a particular jurisdiction will have an impact on the validity of this assumption. In addition, the extent of the commitment of the government to a particular public policy arrangement will affect the negotiating position of the private sector entity.
- 15 Therefore, while there may be some minor economic distinctions based on whether the counter party is a private sector entity or not, staff do not believe those distinctions

are sufficiently significant, nor sufficiently widespread, to justify different accounting solely on the basis of the status of the counterparty. Staff note that in many situations entities would perceive similar arrangements as being economically identical, and would therefore find it difficult to understand the rationale for applying different accounting treatments.

- 16 Furthermore, staff believe that ‘public service obligation’ will be interpreted differently in different jurisdictions, based on the local understanding of that phrase. Many comments received on the exposure draft also made this point. In the example in paragraph 9 of this paper, some would conclude that this would be partially in fulfilment of a public service obligation (to provide tertiary education), while others would consider that as universities might be endorsed by the government, and receive significant government funding, the significant degree of choice universities have in how they deliver these services would preclude this arrangement from being considered to be a service concession arrangement.
- 17 Staff therefore believe that it is not possible to define ‘public service obligation’ in a manner, which is sufficiently robust that it would be workable for it to be the only distinction between D12 and IFRIC 4.
- 18 Staff therefore believe that the significant residual interest criterion is essential to scope of D12.

19 Does the IFRIC agree that the concept of a public service obligation is not able to be defined in a manner that would make it sufficiently robust to form a deciding part of the D12 scope criteria?

Amendment to IFRIC 4

- 20 It has been suggested to staff that the best way of resolving the scope issues between D12 and IFRIC 4 would be to amend the scope of IFRIC 4 to specifically exclude service concession arrangements.
- 21 Staff do not support this proposal because it does not seem likely that a sufficiently robust definition of ‘service concession arrangements’ could be developed to ensure that the correct pronouncement was consistently applied to like situations around the world. Furthermore, staff believe that where an arrangement is considered to be a

service concession arrangement (in terms of the public service obligation etc) but the control of the asset does not pass to the grantor, it would be inappropriate to exclude these arrangements from the scope of IFRIC 4.

22	Does the IFRIC agree that the scope of IFRIC 4 should not be amended?
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Significant Residual Interest Criterion – A Way forward

23 At the September 2005 meeting, further work was requested in respect of two aspects of the significant residual interest criterion:

- (a) The impact on whole-of-life assets; and
- (b) The appropriateness of changing that criterion such that if there was a significant residual interest and that residual interest passed back to the grantor an arrangement would be within the scope of D12.

24 Staff note that these two items are inter-linked. If the change proposed in paragraph 18(b) is made, then whole of life assets would be within the scope of the interpretations.

Whole of Life Assets

25 Staff have considered some arrangements where the asset is used in the service concession arrangement for the whole of its useful life.

26 Example: The government has identified an area in which there will be a severe shortage of primary school education facilities in three years time. The sudden growth in the population of expected primary school children has been driven by construction of a power plant in the area. The entity constructing and commissioning the power plant has provided temporary housing to house the employees and their families while construction is undertaken. The whole period of construction and commissioning is expected to take 15 years. Entity C builds school buildings designed to last for 15 years, that is, the design of the school takes account of the fact that the buildings are only required to be serviceable for 15 years. After that time they will be scrapped, it is expected that the costs of dismantling the assets will be

approximately equal to any proceeds from the sale of scrap. In any case, Entity C will be responsible for the disposal of the buildings.

- 27 In this scenario, there is no significant residual interest. Under the scope criterion proposed in D12 this arrangement would be outside of the scope of D12. However, as the government has significant control over the use of the asset, it is likely that it would fall within IFRIC 4 and therefore the leasing model would apply. This seems wholly appropriate to staff. Entity C has constructed an asset for use which will be used to Entity C's economic benefit over the whole of the asset's useful life. As the party using the asset has already been identified, it appears logical that a lease arrangement exists.
- 28 If the wording of D12 was changed to specify that D12 applied in scenarios where if there was a significant residual, that residual reverted to the grantor, then the example described in paragraph 21 would fall within the scope of D12, because the arrangement meets all of the criteria in paragraph 5(a) of D12 and there is no significant residual. The residual interest part of the scope criteria would be considered irrelevant.. Staff do not believe this result is appropriate.
- 29 The main reason staff believe this arrangement should be within IFRIC 4, is that the IFRIC 4 accounting is adequate, and faithfully represents the economics of the transaction. To widen the scope of D12 such that an entity would effectively be torn between applying D12 or IFRIC 4 seems both unhelpful and un-necessary. Staff do not see any benefit in applying D12 to whole of life arrangements as the alternative accounting treatments (IAS 16 if there is no lease agreement, or IAS 17 if there is) would seem to adequately represent the operator's interest in the physical asset.

Staff Recommendation

- 30 The staff recommends that the residual interest criterion proposed in D12 should remain unchanged

(b) the grantor controls – through ownership, beneficial entitlement or otherwise –the residual interest in the infrastructure at the end of the concession, and the residual interest is significant

31 Does the IFRIC agree?

Further work

- 32 Staff note that a number of concerns were raised about the application of the ‘significant residual interest’ criterion by commentators which were discussed in the September 2005 meeting. Examples include:
- (a) Whether to incorporate the effect of discounting in determining whether a residual interest is significant;
 - (b) Whether the grantor is considered to have the significant residual interest in scenarios where the grantor will obtain the physical asset but will have to pay material compensation at the end of the arrangement to do so;
 - (c) How to consider this criterion when the residual interest is shared between the grantor and the operator; and
 - (d) How to apply this criterion in scenarios where the period of the service concession arrangement is defined in a manner other than by the passage of time.
- 33 However, as noted above, it does not appear possible to draft an interpretation with a scope that is mutually exclusive to IFRIC 4 without that criterion, and accordingly the criterion should be retained. Staff believe that it is possible to analyse these concerns and develop application guidance to address the concerns, and would plan to present that guidance at the May 2006 IFRIC meeting.

APPENDIX A

1 The following table highlights the scope criteria of each pronouncement and indicates how those criteria would apply to arrangements that staff expected to be accounted for in accordance with the alternative pronouncement.

Criteria	IFRIC 4	D12 – D14
Use of a specified asset	Required for the interpretation to apply	Not specifically required, but in most service concession arrangements the specific asset under consideration is obvious
Right to use the asset or direct the use of the asset	One of the criteria which would indicate a lease arrangement	<p>If the operator has a right of use, then D12 – D14 do not apply. D12 – D14 apply where a right of access by the operator exists, but a right of use does not. If the operator only has a right of access, then it follows the grantor must have a right which is more significant than a right of use.</p> <p>When D12 – D14 apply the grantor does not ordinarily have a ‘right of use’ that needs to be considered, because in fact they have overall control of the asset, and consideration of whether a lease arrangement exists is un-necessary.</p>
Ability or right to control the physical access to the asset while controlling more than an insignificant amount of the output	One of the criteria which would indicate a lease arrangement	This criterion is not normally directly relevant to service concession arrangements, as control over physical access is ordinarily driven by the grantor as a reaction to the purpose of the asset in fulfilling its public service obligations.
Remote that other parties will take output and pricing guidance	One of the criteria which would indicate a lease arrangement	Again, this guidance is difficult to apply to service concession arrangements in a directly relevant way. The output could be considered to be taken by a range of users (the public) or by the grantor (as the entity reaping the benefit of fulfilling its public service obligation). In accordance with the criteria discussed below, the grantor controls the asset, and therefore the use of output and pricing is also regulated by the grantor. But an

Criteria	IFRIC 4	D12 – D14
		analysis of whether a lease exists is un-necessary because the grantor controls the asset, and the operator has only a right of access.
The grantor controls or regulates the services the operator must provide with the infrastructure, to whom it must provide them and at what price.	Where control to this extent, together with the residual interest criterion exists the grantor controls the asset as a whole – there is no need to consider the existence of a lease arrangement, because the accounting ownership of the asset is clear. The operator could not possibly lease an asset which it does not control to the grantor.	One of two criteria for D12 – D14 to apply.
The grantor controls a significant residual interest at the end of the arrangement.	Where the grantor controls a significant residual interest, and the use of the asset, the grantor controls the asset itself. Therefore while an operating lease from the grantor to the operator might exist, a finance lease could not because the grantor has overall control of the asset.	One of two criteria for D12 – D14 to apply.