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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 Concession Arrangements – Determining the appropriate accounting model (Agenda Paper 2A)**

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### **Introduction and Purpose of this Paper**

1. Draft Interpretations D12-14 apply to service concession arrangements where the operator does not recognise the service concession infrastructure as its own property plant and equipment. Instead the operator is acting as a service provider of the infrastructure. D12 proposes that the nature of the operator's asset is determined by who has primary responsibility to pay the operator for the concession services.
2. In light of the comments received on the exposure drafts this paper aims to provide a comprehensive analysis of when the operator's asset meets the definition of a financial asset contained in IAS 32 *Financial Instruments: Presentation*.

### **Staff Recommendation**

3. In light of the comments received and subsequent discussions with preparers, auditors and regulators it has become apparent to staff that much of the discomfort expressed by commentators on the exposure draft can be addressed by clarifying the criterion in D12. The staff proposes amending the criterion contained in the Consensus of the draft Interpretation as follows:

10 If the operator provides infrastructure or other consideration in exchange for the right to the service concession, ~~one of two~~ the following accounting models applies to the rights received by the operator:

- (a) the financial asset model—the operator recognises a financial asset; or
- (b) the intangible asset model—the operator recognises an intangible asset.

11 The financial asset model, which is described in [draft] Interpretation [D13], applies ~~if to the extent that the grantor (rather than users) has the primary responsibility to pay the operator for the concession services; the operator has a contractual right to receive cash from the grantor for the concession services; and the grantor has little, if any, discretion to avoid the payment, usually because the agreement is enforceable by law.~~

12 The intangible asset model, which is described in [draft] Interpretation [D14], applies in all other cases.

13 Whether ~~the grantor (rather than users) has the primary responsibility to pay the operator~~ the operator has a contractual right to receive cash from the grantor for the concession services shall be determined by reference to the substance of the contractual arrangements.

- 4. The text of the revised criterion, using language taken directly from paragraphs 11 and 13 of IAS 32, better reflects that the grantor may remunerate the operator for the construction services provided in cash and/or by granting the operator a right to charge users for the services provided.
- 5. The main benefit of the proposed amendment is that it eliminates the artificiality that would result if certain arrangements had to be classified as either wholly a financial or wholly an intangible asset. Consequently, the operator’s accounting will reflect the economics of the arrangements. In addition, the revised text should reduce the likelihood that determination of the accounting model will be based on ‘the party through whom payment is routed’ rather than whether the operator has a contractual right to receive cash or other assets.

### **The service concession**

- 6. Project finance, refers to financing structures under which lenders look to project cash flows for debt repayment. In deciding whether or not to lend to a project, a lender bases its decision on an evaluation of a project’s—not the grantor’s—creditworthiness. In the event of default, the liability of the grantor and project developer is limited to their investment in a project.
- 7. Project finance techniques have been the preferred method of attracting equity investors and lenders to privately financed infrastructure facilities, such as power

plants, toll roads, ports, and airports; these projects are structured around a project's ability to generate a stable stream of future revenues. The financing decision is based primarily on a project's future cash flows rather than on the balance sheet of the government or the project developer. The direct link between a project's cash flow generation potential and funding gives the grantor, investors, and lenders strong incentives to ensure that projects are structured and operated to generate positive cash flows.

8. An example of a typical arrangement that falls within the scope of the draft Interpretations would be a build-operate-transfer or a rehabilitate-operate-transfer arrangement. These arrangements typically involve the operator (entity/shareholders) providing:

- a large capital investment;
- an initial construction, upgrading or major rehabilitation;
- operation and maintenance services post construction;

The operator is to be repaid from the revenue collected over the term of the concession—typically 25-30 years

Any significant residual at the end of the concession term is transferred to the grantor for little or no consideration

9. The concession is governed by a contract that sets out performance standards, arrangements for capital investments, mechanisms for adjusting tariffs, and arrangements for arbitrating disputes. It is common in these types of arrangements that a special purpose entity will be set up to run the concession, the shares of which cannot be freely transferred or pledged. Agenda Paper 2A1 sets out an example of a typical structure.
10. As noted at the outset draft Interpretations D12-14 apply to service concession arrangements where the operator does not recognise the service concession infrastructure as its own property plant and equipment.

## Proposals in D12- Determining the Accounting Model

11. D12 proposed that the nature of the operator's asset depended on who had primary responsibility to pay the operator for its services:

10 If the operator provides infrastructure or other consideration in exchange for the right to the service concession, one of two accounting models applies to the rights received by the operator:

- (a) the financial asset model—the operator recognises a financial asset; or
- (b) the intangible asset model—the operator recognises an intangible asset.

11 The financial asset model, which is described in [draft] Interpretation [D13], applies if the grantor (rather than users) has the primary responsibility to pay the operator for the concession services.

12 The intangible asset model, which is described in [draft] Interpretation [D14], applies in all other cases.

13 Whether the grantor (rather than users) has the primary responsibility to pay the operator for the concession services shall be determined by reference to the substance of the contractual arrangements.

12. C8 of the Application Guidance provides guidance on how to determine when the grantor has primary responsibility to pay.

### **Determining the accounting model**

C7 The financial asset model applies when the grantor has the primary responsibility to pay the operator for the concession services.

C8 The grantor has the primary responsibility to pay the operator for the concession services if the operator looks first to the grantor for payment. The grantor does not have the primary responsibility to pay the operator if users pay for the services, even if the grantor guarantees the payments, making up any shortfall below a specified amount itself. However, guarantees from the grantor may constitute financial assets in their own right. The treatment of such assets is discussed in [draft] Interpretation [D14].

13. The Basis for Conclusions sets out the rationale underlying the guidance on determining the appropriate accounting model.

BC 26 Paragraph 11 of IAS 32 *Financial Instruments: Disclosure and 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.' Paragraph 13 of the draft Interpretation therefore notes that the identity of the party with primary responsibility for paying for the concession services should be determined by reference to the substance of the contractual arrangements.

BC27 The contractual rights that the operator receives in return for its investment in a service concession can take a variety of forms. They are not necessarily rights to receive cash or another financial asset.

14. The analysis in BC44 states:

BC44 Whether the financial asset model applies therefore depends on the operator's contractual rights. However, the IFRIC did not wish to overemphasise the importance of legal form. Paragraph 13 of the draft Interpretation therefore notes that the identity of the party with primary responsibility for paying for the concession services should be determined by reference to the substance of the contractual arrangements.

### Summary of analysis of comments received

15. Question 3 of D12 highlights the substance over form objective of the draft Interpretations.

As explained in paragraph BC44 of the Basis for Conclusions, paragraph 13 of the draft Interpretation proposes that the identity of the party or parties with primary responsibility to pay for the concession services should be determined by reference to the substance of the contractual arrangements (which would not be affected by, for example, changing the parties through whom payment is routed) [emphasis added]. Do you agree with this proposal?

16. Respondents to this question unanimously agreed with the proposal. However they argued that:

- the IFRIC had not implemented a substance based approach to determining the appropriate accounting model; they pointed out that D12.11 and C8 of the Application Guidance were contradictory; or alternatively
- the current basis for determining the accounting model was form driven and could lead to a focus on form rather than substance; they stated that the substance over form objective in BC 44 was not effective and requested more guidance on how to implement the criterion.

17. Respondents to question 2 of D12 expressed similar concerns (see analysis of comments received in Agenda Paper 2A from the August 2005 IFRIC meeting).

Q2 D12 Paragraph 11 of the draft Interpretation proposes that the operator should apply the financial asset model only if the grantor has primary responsibility to pay for the concession services. The rationale is explained in paragraphs BC24-BC43 of the Basis for Conclusions. Do you agree with this proposal? If not, what criteria would you use to determine whether the financial asset model should apply? How would you reconcile those criteria to the definition of a financial asset set out in IAS 32 *Financial Instruments: Disclosure and Presentation*?

18. Many respondents noted that even though the IFRIC acknowledged (D12 paragraph BC44) that it is the substance of the arrangement that is paramount, it was clear that a legal form interpretation had been reached, because IFRIC rejected the arguments of economic substance (D12 paragraph BC41). Thus, 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 reflected the economic substance of the arrangement.

19. Other respondents were concerned that the proposal could require operators with essentially identical cash flows and risks to adopt very different accounting models. Apart from the fact that the identity of the payer is different, the substance and cash flows of the contractual arrangement may be identical. Several gave the example of a shadow toll road and a toll road, where the economics of the arrangements would be very similar, pointing out that under the draft proposals the two arrangements would be accounted for very differently.

#### Staff Comment

20. It is clear from the comments received that the Interpretations as they are currently drafted do not convey the “substance over legal form” objective noted in paragraph 13 of the Consensus and paragraph BC44 of D12. IFRIC needs to consider whether it can be clearer that the objective is to distinguish arrangements giving the operator no more than a right to charge third parties from those in which the grantor gives some sort of commitment regarding the operator’s return. In order to do this without making changes to existing IFRSs, it is necessary to re-evaluate how to determine the dividing line between an intangible and a financial asset under the Standards as they are today.

#### **Application of IFRSs to Service Concessions**

21. IAS 11 *Construction Contracts* and IAS 18 *Revenue* apply to the rendering of services and require revenue to be recognised on the basis of the stage of completion. The resulting asset recognised under IAS 11/18 represents a right to be paid for services rendered, for which revenue has been recognised by the service provider. However, those standards do not specify the nature of the resulting asset. While it is clear that the government has an obligation to pay the operator for the construction services provided, the payment need not be in the form of cash.
22. The questions are:
  - In what circumstances does the operator’s asset meet the definition of a financial asset contained in IAS 32 *Financial Instruments: Presentation*?

- Where the operator's asset does not meet IAS 32's definition what type of asset is it?

#### Definition of a financial asset

23. The IASB *Framework* states that “an asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.” This definition highlights two important characteristics of an asset:
  - a. The resources must be controlled by the entity; and
  - b. future economic benefits of the resource must flow to the entity.
24. An asset is recognised on the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be reliably measured.
25. IAS 32.11 defines a financial asset as “a contractual right to receive cash or another financial asset from another entity”. IAS 32.13 defines a contract as “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.” That is, it is the contract that creates the rights to future economic benefits (cash). The cash flows must be reliably measurable.
26. A financial asset is recognised in IAS 39 *Financial Instruments: Recognition and Measurement* when the entity becomes party to the contractual provisions of the asset.
27. IAS 39.9 defines four categories of financial instruments;
  - A financial asset or financial liability at fair value through profit and loss;
  - Held-to-maturity investments
  - Loans and receivables
  - Available-for-sale financial assets

## Definition of an intangible asset

28. IAS 38.8 defines an intangible asset as “an identifiable non-monetary asset without physical substance.” IAS 38.12 states that “an asset meets the identifiability criterion in the definition of an intangible asset when it: (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.”.

## Staff Analysis

29. A variety of economic circumstances may exist in service concessions. The financial and the intangible asset models reflect the essentially different rights and obligations arising at either end of the spectrum. If all concession arrangements fell ‘cleanly’ into one or the other model, few respondents would probably have disputed the models proposed.
30. However, the nature of these contracts is that they are often ‘not clean’—ie the arrangements do not fall neatly into either the financial or the intangible asset models. Both parties to the contract share the risks that the cash flows (revenue) generated by the project will not be sufficient to recover the operator’s capital investment, ie the construction services rendered.
31. In these types of arrangements the government is pushing some of the commercial risk (market or customer risk and operational risk) to the private sector. Market risk is the demand (ability and willingness to pay) risk and credit or payment risk experienced in a particular public sector (eg transportation, water and prisons). Generally, credit risk is low. In situations where the government agency purchasing the output is not considered creditworthy, lenders require some form of credit support from state or other third party (see Agenda Paper 2A1). In order to achieve the desired sharing of risk, the parties often agree to arrangements under which the operator obtains only a limited commitment from the grantor and is obliged to rely on the third party users of the infrastructure in order to secure a commercial return on its investment.

32. The above analysis suggests that it may then often be necessary to bifurcate the operator's right to cash flows into a receivable component (for any guaranteed minimum ie contractual right to receive cash from the government ) and an intangible component (for the remainder).
33. The analysis in the Basis for Conclusions of D12 (BC28-44) suggested that bifurcation would not often be necessary. The consequent tension between the economic reality and the financial reporting led to the discomfort expressed by commentators on the exposure drafts.
34. Some believe that bifurcation may complicate matters in practice and, furthermore, that the amounts will not be reliably measurable—a requirement for recognition under IFRS.
35. However, staff does not believe that bifurcation will necessarily lead to complication. The identification of the operator's contractual right to receive cash in return for the construction services provided to the grantor can be determined from the contractual terms of the contract signed by the grantor and the operator, ie the terms included in the implementation and purchase agreements (Agenda Paper 2A1). The purchase agreement secures the project's revenue streams and is probably the most important commercial agreement. Generally, the purchase agreement is for the length of the concession (eg 30 years), it defines the interface between the government (often a public body set up for the purpose) and the operator.
36. Because a financial asset is defined as “a contractual right” factors outside the terms of the contract should not normally be considered.
37. Consider a basic example. A build-operate-transfer arrangement in which an entity provides construction services for CU 100
- the entity is to be repaid from the revenue collected over the term of the arrangement, which is 30-years
  - any significant residual is transferred to the grantor for no consideration at the end of term.
38. Where the government guarantees the operator's revenue by agreeing to purchase a minimum amount of the service over the life of the contract (take-or-pay contract),

these contracts oblige payment by the government whether or not the service is used. Where the guaranteed amount corresponds to the fair value of the construction service the operator would recognise a financial asset for the full amount, ie CU 100 in this example. This arrangement is consistent with the definition of a financial asset under IAS 32. All commercial risk is with the government—see table 1 below.

39. On the other hand the operator's revenue may be based on usage, ie government purchases are based on usage (eg shadow tolls) and the government provides no further purchase commitments or guarantees. In these types of arrangements the government does not have the ability (power/regulation lever) to create future economic benefits (cash) that will flow to the entity. Instead the users (who are not party to the contract) create the cash flows that will flow to the entity. The government makes no commitment to direct users to use the public service ie for example, to turn on the water tap (faucet) or use the bridge, albeit that no alternative viable option exists. The government has no obligation to purchase until the user uses the service. Arrangements of this type do not meet the definition of a financial asset under IAS 32.
40. Rather, the government has granted the operator a right to charge users for the public service. The operator has an opportunity to generate economic benefits (cash flows) when users use the service. This is a licence arrangement under IAS 38. In the example above the operator would recognise an intangible asset of CU 100. All the commercial risk is with the operator—see table 1 below.
41. The nature of the operator's asset is not changed whether the operator or the government collects tolls from the users; (the operator may or may not operate the tollbooths as part of an operation and maintenance agreement). The government has no obligation other than to act as a collection agent for the operator.
42. Arrangements exist where the grantor and the operator want to share/limit their exposure to commercial risks with the use of revenue caps, floors and collars.
43. One example is where the government guarantees the operator a minimum amount (per annum or over the term of the concession) or a minimum number of users. Such arrangements are designed to limit the operator's downside risk. Where the contractual right to receive cash from the government is below the fair value of the construction,

say CU 70 in the example above, the operator would recognise a financial asset for CU 70 and the balance of 30 as an intangible asset.

44. Where the operator's return is capped at a certain level, say CU 150 in the example immediately above, this would not change the value of the recognition of the financial and/or the intangible. The operator would have an obligation under IAS 37 to repay the government amounts collected above CU 150. The operator would still have a financial asset of 70 and an intangible asset of 30, representing the future economic benefits that have arisen from the capital expenditure.
45. Arrangements exist, for example a prison or hospital, where the operator's revenue is based on availability rather than usage. The risk that the service will not be used is remote. The government has little or no discretion to avoid purchasing the service because the terms of the contract provide that the government is obliged to purchase from the operator's facility first, for example in the event that an alternative facility (prison or hospital) exists or becomes available. The contract requires the operator to maintain a certain number of beds or prison places available for use or suffer deduction from its revenue. These types of arrangements are consistent with IAS 32's definition of a financial asset. The government is party to a contract, under which it has little or no discretion to avoid the future economic benefits (cash) flowing to the other party to the contract ie the operator.
46. The government may agree to pay a higher price (per user) ie an additional amount on top of the guaranteed amount, for example for keeping the prison or hospital fully operational or when the number of users increases above a certain level. Whether the operator recognises these amounts up to the fair value of the construction as a financial asset or an intangible asset depends on the facts of each case and will be based on judgement. The ability of the government or the operator to avoid such payments or obligations needs to be carefully considered.
47. Arrangements exist where the maturity date of the concession contract is not fixed. Instead under the terms of the contract the operator is permitted to collect usage based revenues from users or the government (shadow toll) until it achieves a fixed or determinable return on its investment, at which point the concession comes to an end and the infrastructure is transferred to the government. The risk that the service will not be used is remote. The revenue stream to the operator is secured under a variable

term concession contract. This contract is no different from the contract described in paragraphs 40 and 41 of this paper. A contractual right to receive cash does not exist because the government has no obligation to purchase the service until the user (who is not party to the agreement) uses the public service. This arrangement is akin to a variable term licence; in the example above the operator would recognise an intangible asset of CU 100. The commercial risk is with the operator.

## Staff Proposal

48. As noted above it is clear from the comments received that commentators unanimously agree that the draft Interpretations as they currently stand do not convey the ‘substance over legal form’ objective noted in paragraph 13 of the Consensus of the draft Interpretations and paragraph BC44 of D12.
49. In light of comments received, staff is concerned that basing the determination of the accounting model on ‘who has primary responsibility to pay’ the operator for the concession services will often lead to a formal test being applied to the cash flows of the project. Consequently, determination of the accounting model will be based on ‘the party through whom payment is routed’ rather than whether the operator has a contractual right to receive cash or other assets.
50. As explained above, the staff believe that much of the confusion and resulting discomfort stems from the fact that the variety of service concession arrangements is not captured by requiring the use of one model or another to report the arrangements in the financial statements of the operator.
51. In light of the comments received and subsequent discussions with preparers, auditors and regulators it has become apparent to staff that much of the discomfort expressed by commentators on the exposure draft can be addressed by clarifying the criterion in D12. The staff proposes amending the criterion contained in the Consensus of the draft Interpretation as follows:

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- (a) the financial asset model—the operator recognises a financial asset; or
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12 The intangible asset model, which is described in [draft] Interpretation [D14], applies in all other cases.

13 Whether ~~the grantor (rather than users) has the primary responsibility to pay the operator~~ the operator has a contractual right to receive cash from the grantor for the concession services shall be determined by reference to the substance of the contractual arrangements.

52. The text of the revised criterion, using language taken directly from paragraphs 11 and 13 of IAS 32, better reflects that the grantor may remunerate the operator for the construction services provided in cash and/or by granting the operator a right to charge users for the services provided.
53. The benefits of the proposed amendment are that it more closely reflects the economics of the arrangement and eliminates the artificiality that would result if certain arrangements had to be classified as either wholly a financial or wholly an intangible asset.

*Does the IFRIC agree with the staff proposal?*

## The financial asset model - Classification

54. The initial recognition, measurement and classification proposals in draft Interpretation D13 reflect the requirements of IAS 39. The staff does not intend to make any changes to these requirements.

Classification of the amount due from the grantor in respect of construction or other services

9 Subject to paragraph 10, the amount due from the grantor in respect of construction or other services shall be accounted for in accordance with IAS 39 as:

- (a) a loan or receivable;
- (b) an available-for-sale financial asset; or
- (c) if so designated upon initial recognition, a financial asset at fair value through profit or loss.

10 If, for reasons other than credit deterioration, the operator may not recover substantially all of the initial amount due from the grantor in respect of construction or other services, the financial asset will not meet the criteria in IAS 39 for classification as a loan or receivable. This situation might arise if the amounts receivable from the grantor are not fixed but vary, for example on the basis of demand or availability.

11 If the amount due from the grantor 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.

*Does the IFRIC agree?*

Table 1 –Determination of the appropriate accounting model

Category	Main Options	Asset ownership	Operations and maintenance	Capital investment	Typical Duration	Residual Interest	Commercial Risk and determination of the appropriate accounting model		
							Grantor	Shared	Operator
<b>Service Provider</b>	Concession (eg rehabilitate-operate-transfer, build –operate-transfer or lease- operate-transfer )	Grantor	Operator	Operator	25-30 years	Grantor	D13	D13 and D14	D14