30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

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: **January 2006, London**

Project: **Service Concession Arrangements (Agenda Paper 6)**

PURPOSE AND STRUCTURE OF THIS PAPER

1 This paper sets out a proposed framework that the staff believes will address much of the concerns expressed by respondents to the exposure drafts. The paper includes a timeline and the key milestones have been identified to get to publication of final Interpretations. Appendix A of the paper contains a log of the current status of comments received on the exposure drafts. Appendix B contains an extract from the 2003 report of the IASB working group on service concessions— 'Accessing the risks and rewards of service concession arrangements'.

2 The paper also includes a summary of an economic analysis of service concessions. The staff believes this summary is useful as a "refresher" because a considerable amount of time has elapsed since the commencement of this project and certain IFRIC members joined the committee during or subsequent to many of the deliberations.

STAFF RECOMMENDATION

3 Based on the research and analysis set out in this paper the staff has reached the conclusion that much of the criticisms and concerns of constituents can be

addressed by developing a broader framework of accounting guidance for service concessions for operators. The proposal for this broader guidance builds off D12-14, SIC-29 *Disclosures Service Concession Arrangements* and other portions of IFRSs. The framework for the Interpretations is set out in paragraphs 14-19. The broader framework involves providing guidance for:

(a) Classification of service concession arrangements into one of three categories; lessee; service provider (eg construction, funding and operation and maintenance services); or owner.

(b) Application of applicable IFRSs to those three categories; and

(c) Disclosures about those classifications.

The key milestones and a timeline to final publication are included in paragraph 17.

4 **The staff recommends developing the broader framework of interpretative guidance for service concessions. The IFRIC are asked for their views.**

PROPOSAL IN D12

5 D12 proposed if the following conditions applied the infrastructure would be the property of the grantor (in summary):

(a) the grantor controlled the services that the operator must provide with the infrastructure;

(b) the grantor controlled the residual interest in the infrastructure at the end of the concession, and the residual interest would be significant; and

6 The nature of the operator's asset depended on who had primary responsibility to pay the operator for its services.

7 D12-14 provides interpretative guidance for situations where the infrastructure forming part of the concession was either (a) constructed or acquired for the

purpose of the concession, or (b) pre-existing infrastructure of the grantor, made available to the operator for the duration of the concession.

Summary of IFRIC's post exposure deliberations

8 Several commentators criticised the proposals for their narrow scope. In their view the scope exclusions limited the usefulness of the guidance. In addition, many expressed confusion over certain aspects of the proposals and argued that the nature of the grantor's and operator assets should be analysed under lease accounting, many believed there were inconsistencies with IFRIC 4 XX.

9 Others argued the assets should be analysed under property plant and equipment (PP&E) accounting. Some accused the IFRIC of introducing a new asset recognition model for PP&E that was not recognised under the *Framework*.

10 Many asked for clarification on the scope, especially regarding the significant interest test criteria (b) from D12.5, some queried was it significance in terms of value or risks and rewards. In particular it was believed that a concession for the whole period of an assets physical life should not be excluded.

11 In essence many respondents believed that that the proposed guidance was fundamentally flawed because when applied to many types of service concession arrangements the economic substance of those arrangements would not be reflected in the financial statements of an entity. This may impact users (in particular investors, creditors and regulators) understanding of the companies involved in providing concession services.

12 In the meetings held since receipt of comments, the IFRIC acknowledged that the reasons for not taking a risks and rewards approach had not been adequately explained. IFRIC members acknowledged that certain aspects of the proposals should be revisited and some members expressed a desire to reconsider whether the application of the financial asset model (D13) or the intangible asset model (D14) should incorporate more of a demand risk approach, which might mitigate some of the concerns about the control-based focus of D12's scope criteria.

13 Staff was directed to explore whether there was a better way to explain the reasons for the scope restrictions and whether the guidance could be broadened.

STAFF PROPOSAL

14 The proposal for this broader guidance builds off D12-14, SIC-29 and other portions of IFRSs. A framework for the Interpretations is set out below. The main tasks are identified and a timeline is included in paragraph 17.

15 The broader framework of interpretations would provide guidance for operators on the accounting treatment of service concession arrangements for each of three categories: lessee, service provider (eg construction, funding and operation and maintenance services) and owner.

16 . The interpretations would contain guidance for:

a. **Classification of arrangements:** expand the interpretations by building off the guidance in D12 to include classification guidance for the each of the above three categories.

- ***Task***: identify the critical distinguishing factors (key economic indicators) for each of the three categories.

b. **Application of IFRS:** expand the interpretations by building off the guidance in D13-14, to provide application guidance for the each of the above three categories.

- ***Task*:** determine the accounting standards that apply to each of the three categories and the areas of IFRSs where the accounting treatment is not clear for each category.

c. **Disclosure:** expand the interpretations by building off existing IFRSs disclosure requirements (eg SIC-29, IASs 11, 23 and the financial instruments standards). Because determination of the appropriate accounting treatment (ie classification) is based on professional judgement,

disclosure of the distinguishing factors of the arrangements will help users understanding of an entity's financial statements.

- ***Task:*** determine whether any additional disclosures are required.

17 Determining who bears the responsibility of ownership may be difficult for some arrangements, however this is not the case for most.[1] To ensure businesses objectives are met, the economic consequences of these arrangements need to be understood by both parties (private and public). Many concession arrangements are complex by nature and involve vast amounts of inbound and outbound cash flows (borrowings and capital investment). It may be expected that projects with a higher level of private sector involvement deliver more efficiency gains. However, the level of complexity of the projects and the consequent risk of failure grows correspondingly. From a business perspective the risks are high as are the opportunities for rewards. Before the parties enter into a service concession arrangement the economic risks and rewards of the arrangement will be analysed by industry experts ie lawyers, business analysts, engineers and bankers.

Table 1 - Key Milestones and Timing for Next Document

Topic and Tasks	Current Status	Key Milestone	Next Document 2006
Classification *(i below)* o Identify the critical distinguishing factors for each of three categories: owner, lessee and service provider	Staff research	o Clarify the role of IFRIC 4 for service concession arrangements o Classification guidance	March March/May
Application: *(iii below)* o Determine the applicable accounting	Complete		

[1] Staff has discussed the broader framework with preparers, auditors, certain Board members and other groups who have been closely following the IFRIC's deliberations

Topic and Tasks	Current Status	Key Milestone	Next Document 2006
standards and the areas of IFRS that are unclear o Develop necessary guidance	Staff research	o **Service Provider**: (i) Application of IAS 11 to construction service; and (ii) nature of the operator's asset. o **Lessee, Service Provider and Owner**: Requirements for repair and maintenance obligations	January and March March
Consideration of remaining comments received	Staff Analysis	See c of appendix A	March
Disclosure *(iii below)***:** o Determine whether any additional disclosures are required	Planning		May
Draft of revised interpretations			May
Final Interpretations *(vi below)*		Once decisions are finalised—draft final interpretations, approval by the IFRIC and publication.	Q3 (tentative)

i. D12 and the report of the working group (see appendix B) includes much of the analysis.

ii. Much of the work has been completed in developing D13-14.

iii. Building off the disclosure requirements in SIC 29 and applicable Standards.

iv. Whether the proposals need to be re-exposed depends on the outcome of the deliberations.

18 Under the above framework the operator would first identify whether it is: a lessee of the infrastructure; a service provider to the infrastructure; or an owner of the infrastructure. The accounting treatment and required disclosures would flow from that classification.

19 If the IFRIC agrees with the proposal, staff will expand the interpretations as outlined above.

The unit of measurement

20 The analysis will also consider the term *infrastructure* as certain questions have arisen concerning its the meaning. The staff recognises that in some cases, the infrastructure will be specified in the contract. In addition an arrangement may be structured so that the assets comprising or included in the infrastructure may be a combination of private (operator) and public sector (grantor) owned assets and in addition different risks may be attached to assets. The question is how should an operator determine what assets to include in the infrastructure and would the significance of some dictate the accounting treatment.

ANALYSIS SUPPORTING THE PROPOSED APPROACH

21 The difficulty with developing accounting guidance for concessions arises because the scope of the topic is so great. The arrangements take many forms. The continued involvement of both grantor and operator over the length of the concession period, accompanied by heavy upfront capital investment raises questions over what assets and liabilities should be recognised by which party. Notwithstanding the wide range of concessions available, operators must deal with these major accounting issues: the determination of the point or points at which revenue and costs should be recognised, when assets and liabilities

should be recognised and how recognised assets and liabilities should be measured.

22 At its November 2005 meeting the IFRIC considered the allocation of key responsibilities under the main options for private participation in public services see table 2. The table captures the key elements driving the complexity of many of the accounting issues involved with concession arrangements and the reasons the IFRIC focused its attention where it did.

Table 2 - Allocation of Key Responsibilities under the main options for private sector participation in the provision of public services

Category	**Main Options**	**Asset ownership**	**Operations and maintenance**	**Capital investment**	**Commercial risk**	**Typical Duration**	**Residual Value**	**Examples of Applicable IFRS (**that may apply)
Lessee	Lease (eg Operator leases asset from grantor)	Public	Private and or public	Public	Shared	8-20 years	Public	*IASs 17*
Service Provider	Service and or maintenance contract (eg specific tasks Debt collection)	Public	Public and or private	Public	Public	1-5 years	Public	*IASs 18*
	Concession (eg Operation & maintenance)	Public	Private	Private	Private and Public	25-30 years	Public	*IASs 18, 23 32, 38,*
	Concession (eg Build-operate-transfer)	Public	Private	Private	Private and Public	25-30 years	Public	*IASs 11, 18, 23 32, 38*
Owner	Concession eg (Build-own-operate)	Private	Private	Private	Private	25-30 years	Private	*IASs* 16, 23 *32*

Category	Main Options	Asset ownership	Operations and maintenance	Capital investment	Commercial risk	Typical Duration	Residual Value		Examples of Applicable IFRS (that may apply)
	100% Divestiture/ Privatisation	Private	Private	Private	Private	Indefinite or (may be limited by licence	Private		

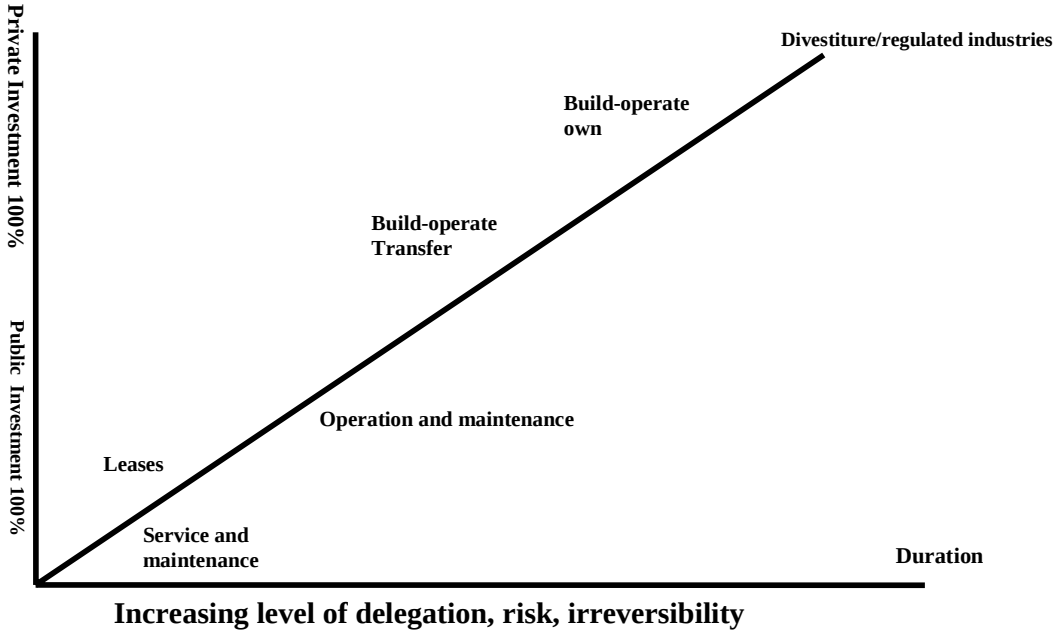
23 These options can also be ranged along a spectrum (see figure 1 at paragraph 26). At one end of the spectrum are service contracts where the government retains full responsibility for operations, maintenance, capital investment, financing, and commercial risk—at the other divestitures, where the private sector takes on this responsibility. The level of irreversibility and the allocation of key risks grow correspondingly.

24 The application of IFRS is clear at both ends of the spectrum, ie in situations where the operator is providing a single service, for example a service contract for operations or maintenance (IAS 18 applies to services). IFRSs is also clear where the operator is the owner of the infrastructure (IAS 16 applies to items of property plant and equipment) and is relatively clear in situations when the operator is the lessee of the infrastructure. Where the arrangement leaves the responsibility for financing and planning investments with the government (IAS 17 applies to leasehold improvements). The level of accounting complexity is at its greatest when the allocation of responsibilities between the grantor and the operator (ie risks and rewards) is not clear-cut.

25 In BOT arrangements for example see paragraphs 55, where the services provided by the operator may comprise of design, construction, financing and operations and maintenance. In many, the risks associated with these services are largely transferred to the operator. However, any residual interest in the

infrastructure assets is transferred to the government at the end of the concession period, usually without any consideration in return. The government has two primary responsibilities: to ensure the assets (which the government continues to own) are used well and returned in good condition at the end of the concession and to protect consumers from monopolistic pricing including ensuring access to the services for the disadvantaged in some situations.

26



The accounting issue for the operator

27 In preparing an entity's financial statements the task of the operator is to access the entities economic position under the terms of the arrangement and determine the appropriate accounting treatment. As noted above notwithstanding the wide range of concessions available, operators must deal with these major accounting issues: the determination of the point or points at which revenue and costs should be recognised, when assets and liabilities should be recognised and how recognised assets and liabilities should be measured.

Determining the appropriate accounting treatment—classification

28 In evaluating the accounting alternatives, the operator has to reach a conclusion regarding the entity's exposure to risk under the terms of the arrangement. The assessment is a matter of professional judgement and is based on determination of who bears responsibility for the key risks under the terms of the arrangement.

29 Depending on the number and nature of services provided (design, construction, financing, operations and maintenance) the assessment might include consideration of for example, who bears operational risk, investment risk and commercial risk.

30 Consideration of whether the operator makes the key decisions on how the property is designed and built, and who bears the consequent costs and risks, may provide evidence that the infrastructure is property of the operator. Design risk is the risk that the design of the property is such that, even if it is constructed satisfactorily, it will not fully meet the requirements of the agreement. In contrast, construction risk refers to who bears the financial implications of cost and time overruns during the construction period. Construction risk is not generally relevant to determining which party has an asset of the property once construction is completed, because such risk normally has no impact during the property's operational life. However, construction risk may be relevant when it calls into question the other evidence. In particular, if the concession operator is bearing construction risk in an agreement in which the property is claimed to be that of the operator, it will be necessary to look closely at the other terms of the transaction to determine whether the property really is the operator's asset and is not actually an asset of the operator.[2]

31 Consideration of whether the operator makes the key decisions on how the property is operated, and who bears the consequent costs and risks, may provide evidence that the infrastructure is property of the operator. Some arrangement are on a cost plus basis, providing that virtually all operating

[2]For more analysis on risks and rewards see appendix B

costs to be incurred are covered by a cost plus mechanism, so that little operating risk remains with the operator.

32 In relation to consideration of who bears the commercial risk, arrangements may provide for fixed revenue providing that virtually all demand risk is with the grantor and therefore operating risk may still remain with the operator.

Classification guidance contained in D12 and IFRIC 4

33 D12-14 provides some classification guidance. For example paragraph 5 of D12 identifies two indicators of ownership. Where the residual interest in the infrastructure is significant it may provide evidence of who should record the asset as property. Paragraph 5 also requires consideration of the amount of managerial involvement exercised by each party, (ie the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price).

34 IFRIC 4 provides interpretative guidance to determine whether arrangements are or contain a lease. Paragraph 9 states that, an arrangement conveys the right to use an asset when the purchaser (lessee) operator controls the use of the underlying asset. The Interpretation determines this as being when the lessee has the ability to control physically the use of the underlying asset through access (while obtaining or controlling more than a minor amount of the output of the asset). The IFRIC noted in the Basis for Conclusions of IFRIC 4 that in such arrangements the lessee would have the ability to restrict the access of others to the economic benefits of the underlying asset.

35 BC25 of D12 states that where the grantor controls the use of the infrastructure in the manner described in paragraph 5 of D12 the operator only has right of access to the infrastructure to provide the specified services on the specified terms. The right of use is with the grantor. It goes on to state that the operating lease model does not apply to arrangements within the scope of the draft Interpretations.

36 The broader framework of interpretative guidance proposed above would build off D12's classification guidance and would clarify the interaction of service

concessions arrangements with IFRIC 4, in particular whether any amendments are required to the scope criteria of IFRIC 4.

The three main areas where existing IFRSs are unclear

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

37 Under the proposed broader framework of guidance the issue of 'double' recognition of revenue under D14 goes away. This is because the operator is either providing construction services to the government, in BOT arrangements for example or building the infrastructure for itself as part of a BOO type arrangement.

38 IAS 11 *Construction Contracts* and percentage of completion accounting applies to construction services. This is considered further in paper 2X (ALLAN, THIS IS THE DELOITTE PAPER).

ii. *Nature of the operator's asset*

39 In BOT type arrangements where the infrastructure is the PPE of the government, the operator acts as a service provider to the government and provides services on behalf of the government to the public.

40 Under these types of arrangements the two key risks for the operator is the return on its capital investment (credit risk) and the risk that it (the operator) the will not perform as planned (performance risk).

41 D12 proposed that the nature of the operator's asset depended on who had primary responsibility to pay the operator for its services; it describes the test and applicable IFRSs in some detail. This proposal caused most concern amongst respondents.

42 Under the proposed broader framework of guidance this section of the draft interpretations would be redrafted and expanded to highlight the need for consideration of demand risk in determining the nature of the operators asset. It is expected that staff will further develop this risk analysis for consideration by the IFRIC at its March 2006 meeting.

iii. *The requirements for operation and maintenance*

43 Question X in the exposure drafts asked …… comments received on this questions will be analysed for consideration by the IFRIC at its March 2006 meeting.

BACKGROUND RESEARCH SUPPORTING THE PROPOSED APPROACH

Basis for Research

44 The difficulty with developing accounting guidance for concessions arises because the scope of the topic is potentially vast. The arrangements can take many forms. To identify the alternatives for broadening the guidance it was first necessary to determine the boundaries of the subject.

45 In order to understand better the many different elements of concession arrangements, staff has read specialised industry publications, the Report of the Working Group (April 2003) and many of the IFRIC papers prepared for this project, as well the comment letters received on the exposure draft. Staff has read portions of existing accounting literature applicable to service concession arrangements including IFRSs, and from other standard setters (Australia, Spain, UK, France South America, and US). Staff has discussed this project and the proposed approach with certain IFRIC and Board members, preparers and other groups who have closely followed the IFRIC's deliberations.

Economic analysis of service concessions

46 Concessions have gained in popularity recently, but the theory dates back at least to the nineteenth century. The famous nineteenth century economist Alfred Marshall outlined the case for concessions as follows:

> A public authority may be able to own the franchise and, in some cases, part of the fixed capital of a semi-public undertaking, and to lease them for a limited number of years to a Corporation who shall be bound to perform services, or deliver goods, at a certain price and subject to certain other regulations … the special point of the proposal is that, where possible, the competition for the franchise shall turn on the price or the quality, or both, of the services or the goods, rather

> than on the annual sum paid for the lease. (quoted in Ekelund and Hebert 1981: 471).

47 The practice dates back even further to the Middle Ages, private water companies developed much of the early water infrastructure in France, Britain and the United States.

The rationale [3]

48 Concessions are normally used in areas where they are most likely to aid development, they are most likely to help development when they are used to regulate natural monopolies—i.e. services can be provided more efficiently by one entity rather than two or more. The bidding process between private entities allows some of the benefits of competition to enter the market for the service. To win the bid forms are forced to offer a price for water not much higher than their cost of supplying it. The firm that wins is likely to be one of the most efficient.

Landscape – defining concessions

49 Concessions could be broadly referred to as arrangements including contractual arrangements where a private entity (operator) obtains the right from government to provide a service under conditions of significant market power. The private sector entity has an obligation to provide the services specified by the public sector to the public and/or the public sector during the concession period.

50 The options for private sector participation in the provision of public services can be ranged along a spectrum. At one end are those in which the government retains full responsibility for operations, maintenance, capital investment, financing, and commercial risk—at the other, those in which the private sector takes on much of this responsibility. But even where the private sector takes on full responsibility for operations and financing, as in some concessions and asset sales, it does so within a framework created by the government. The most important parts of this framework are regulatory arrangements to protect consumers from monopolistic pricing and enforce health and environmental

[3] For more on the rationale of concessions see Dnes (1995)

standards, and subsidy regimes to ensure access to services for the disadvantaged.

51 The main options for private participation in the provision of public services can be grouped as follows:

(a) *Service and maintenance contracts*—the objective of these type of arrangements is to secure private sector assistance for performing specific tasks—repairing pipes, provision of road markings, debt collection, call centres, canteen facilities or computer services. Service and maintenance contracts are widely used. Contracts typically provide for a performance-related payment, part of the operating risk of the business may be transferred from the government to the operator, since the operator profits may vary with the operating performance of the company. All responsibility for capital investment is with the government.

(b) *Leases*: a private entity leases the assets of a utility from the government. The lessor effectively buys the rights to the income stream from the utility, it therefore assumes much of the commercial risk of the operations, and hence its operating profits are dependant on the operating profits of the arrangement. Leases leave the responsibility for financing and planning investments with the government. So if major new investments are needed, the government must raise the finance and coordinate its investment program with the operator's operational and commercial program. Leases are most appropriate where there is scope for big gains in operating efficiency but only limited need or scope for new investments. Pure leases are rare however. Many place some responsibility for investment with the private sector if only for revamping. These contracts operate as a hybrid between a lease and a concession arrangement (see below).

(c) *Concessions: operation and maintenance:* a private entity takes on responsibility for operation and maintenance of an already existing government asset for a given period during which it also assumes significant investment risk eg major rehabilitation or technological

upgrade. The government may grant a concession to the private entity to charge consumers (users) directly. These types of agreements are similar in scope and approach to what is required and negotiated in a typical BOT-type arrangement (see below).

(d) *Concessions BOT-type:* under these type of arrangements build operate transfers (BOTs), rehabilitate operate transfer (ROTs), build-lease operate (BLO) the private sector undertakes investments and both operating and investment risks are substantially transferred to the private firm[4]. The arrangements comprise an initial construction, upgrading or major rehabilitation component. Massive investment and consequent mobilisation of private funding sources is therefore required from this entity and is to be repaid from the revenue collected. Asset ownership remains with the government and full use rights to all the assets revert to the government when the contract ends—typically after 25-30 years. The concession is governed by contract that sets out performance standards, arrangements for capital investments, mechanisms for adjusting tariffs, and arrangements for arbitrating disputes.

The contract might be on a take-or-pay basis obligating the government to pay for a specified output whether or not that quantity is consumed. Alternatively government payments may be contingent on usage levels. Or the government may grant a concession to the private participants to charge users for the services provided (eg. road, tolls to help finance the improved operation and maintenance of the road). Or contracts may grant a concession to the private participants to charge users for the services provided and the government may guarantee the private sectors returns. In effect all these *concessions* arrangements confer long-term monopoly to the private entity. The government has two primary responsibilities: to ensure the assets (which the government continues to own) are used well and returned in good condition at the end of the concession and to protect consumers from

[4] For more of these types of arrangements see Guislain and Kerf (1995)

monopolistic pricing. The quality of regulation is therefore important in determining the success of the operation.

(e) *Concessions BOO-type:* under these type of arrangements build operate own (BOOs), the private sector undertakes investments and both operating and investment risks are substantially transferred to the private firm[5]. The arrangements comprise an initial construction or acquisition, upgrading or major rehabilitation component. Massive investment and consequent mobilisation of private funding sources is therefore required from the private entity and is to be repaid from the revenue collected. Asset ownership remains with the private sector, full rights to all the assets remain with the operator when the contract ends—typically after 25-30 years.

(f) *Divestitures*: (also referred to as 'privatisations', 'corporations') can be structured as public, private or semi-private organisations. A complete divestiture through a sale of assets, or shares or through a management buyout gives full responsibility for operations, maintenance and investment to the private sector in addition it transfers ownership of the assets to the private sector. The entity is free to collect revenue for its own development. A divestiture only leaves the government the task of regulation. Like concessions a divestiture confers long-term monopoly to the private sector, the quality of regulation is therefore important in determining the success of the operation.

52 In practice private sector arrangements for the provision of public services are often combinations of the above models. For example, service contracts may have revenue sharing agreements that make them a little like a lease and a BOT might be combined with a management contract for operating parts of the distribution system. To run concession arrangements it is common in some countries for governments to establish joint ventures or consortiums with the private sector in others such as South Africa (see CL 33 *The South African Institute of Chartered Accountan*ts).

[5] For more of these types of arrangements see Guislain and Kerf (1995)

53 No two concession agreements are exactly the same: technical provisions vary by sector and the scope of the private operator's responsibilities can also vary with different types of contracts. Substantial differences also appear between contracts of the same type concluded in the same sector, as the parties tailor each agreement to their specific situation and needs. Finally, the form of the contractual agreement depends on the specific features of the overall legal framework of the particular country. Cross-sectoral concession laws, where they exist, may contain provisions that do not have to be repeated in individual contracts. In analysing a concession one must look beyond the arrangement's name and consider the details of its provisions relating to rights, obligations, and the allocation of risk.

APPENDIX A

Status of comments received, status and timing for Next Document

Given the range of comments received staff has developed a tracking mechanism. It is not intended that this be discussed in detail at the meeting. Members should contract staff directly with any comments.

a. Log of comments received – Scope and basis for recognition of PPE

D12 Scope and basis for recognition of PPE	Last discussed at IFRIC Meeting 2005	Decision reached	Next Step	**Next Document 2006**
Reconcile scope of the exposure drafts (EDs) to IFRIC 4	September	Clarify interaction of IFRIC 4 with service concessions	IFRIC deliberation (classification guidance)	March
Reasons for not taking a risks and rewards approach	August	Communicate better	IFRIC deliberation (classification guidance)	May
Scope exclusion - Grantor accounting	September	Re-confirmed that the interpretations will not provide guidance for grantor accounting- staff was directed to better explain the reasons	Drafting	May
Scope exclusion - Existing assets of operator	September	Include signposts to relevant IFRSs	Drafting	May
Scope exclusion - Private to Private arrangements	September	Apply by analogy where appropriate under IAS 8	Drafting	May
Scope exclusion - Whole of life assets	September	Clarify that whole of life assets fall within the scope	Drafting	May
Clarify treatment of infrastructure subject to renewal	September	Clarify treatment of infrastructure subject to	Drafting	May

options		renewal options		
Reconcile scope of the EDs to SIC- 29	November	Reconcile scope of the D12-14 to SIC- 29	Drafting	May
Clarify guidance for partly regulated assets	September	Clarify guidance for partly regulated assets	Drafting	May
Clarify meaning of 'public service obligation'	September	Clarify meaning of 'public service obligation'	Drafting	May
Sale and leaseback	August	May be the subject of a separate interpretation	Drafting	May

b. Log of comments received – Dividing line between D13-D14

Dividing line between D13-14	Last discussed at IFRIC Meeting 2005	Decision reached	Next Step	**Next Document 2006**
Nature of operator's asset	September	Staff directed to research further	IFRIC deliberation	March
Whether users and grantor should be regarded as separate parties	-	-	-	TBD

c. Log of comments received – Recognition of profit on construction under D14

Recognition of profit on construction under D14	Last discussed at IFRIC Meeting 2005	Decision Reached	Next Step	**Next Document 2006**
Recognition of profit or loss on construction services	September	Staff directed to research further	IFRIC deliberation	January

d. Analysis of remaining comments received

Remaining comments	Last discussed at IFRIC Meeting **2005**	Decision reached	Next Step	**Next Document 2006**
Mainly, combining and segmenting service concession	-	-	IFRIC deliberation	March

contracts; timing of the recognition of the intangible asset; requirements for repair and maintenance obligations; and deprecation under the intangible asset model.				

APPENDIX B

IASB RESEARCH PROJECT: ACCOUNTING FOR SERVICE CONCESSION ARRANGEMENTS – EXTRACT FROM 2003 REPORT

Annex four: assessing risks and rewards in a service concession arrangement (based on existing UK literature)[6]

Introduction

1 Under the principles of IAS 17, whether a party has an asset of the property will depend on the extent to which it has substantially all the risks and rewards incident to ownership of the asset. This annex provides guidance on the risks and rewards incident to ownership that can arise in infrastructure concession arrangements. As explained in paragraph 3.16(b) of the main report, the group is suggesting that, rather than apply a 'risks and rewards incident to ownership' test that asks whether the lessee has substantially *all* the risks and rewards incident to ownership, a variant of that test should be applied in which the focus is on where the *balance* of the risks and rewards incident to ownership lies. This annex illustrates the form such a test might take.

2 Determining the substance of transactions is a matter of professional judgement, which involves weighing up all the relevant indicators of which party has an asset of the property. The following paragraphs explain the factors that will need to be taken into account.

Demand risk

3 This exposure reflects the fact that the property may be used more or less than was anticipated, for example because demand for the property is higher or lower than expected. Where demand risk is significant, it will normally give the clearest evidence of who should record as asset of the property. Demand risk is imposed by the economic conditions of the market in which the agreement is made. Its existence and significance cannot be altered by the terms of the agreement; the agreement can only allocate

---

[6] The existing UK literature is FRS 5 Application Note F, 'Private Finance Initiative and Similar Contracts'. In the time available it has not been possible for the group to discuss this annex fully or to agree it.

demand risk between the parties to the agreement, for example by allowing renegotiation of the agreement at certain demand levels.

4 The first step is to identify whether demand risk is a significant risk. There may be service concession arrangements where there is little genuine uncertainty about the level of future demand for the services provided by the property. In other cases, there may be much genuine uncertainty over the extent to which the property will be used. Understanding which party bears demand risk, and whether that risk is significant, is a relevant factor in determining which party has an asset of the property.

5 The length of the service concession arrangement may also impact on the significance of demand risk. Generally, there will be more of a risk the longer the term of the agreement. This is because it is usually more difficult to forecast use over the long term.

6 It is also important to distinguish where demand risk is insignificant from where the terms of the agreement are such that it is passed to one or other party. For example, there might be much uncertainty over the demand for a certain type of property in the long term. However, the terms of a long term service concession may be that the concession provider would fill the concession property, in preference to properties that are not subject to a concession, with the effect that it is very unlikely that the concession property will not be full. In such cases, the concession provider has retained demand risk.

7 Where it is established that demand risk is significant, it is necessary to determine which party will bear it, ie who will bear the effects of reasonably likely changes in demand. This will depend on the following:

(a) Do the payments between the concession operator and the concession provider reflect usage of the property? Alternatively, does the concession provider have to pay the concession operator regardless of the level of usage?

(b) Will the concession provider or the concession operator benefit if demand is greater than expected?

8 If the contractual payments do not vary substantially with demand or usage of the property, the concession provider will be obliged to pay for the output of the property whether or not it is needed. This is evidence that the

property is an asset of the concession provider and that they have a liability to pay for it. In particular, if the concession provider is obliged to pay a minimum amount (ie there is no genuine commercial possibility of non-payment) whether or not it will need the property, and the minimum amount more than covers the cost of the property, this is evidence that the property is an asset of the concession provider. In making this assessment, any penalties or reductions in payments for non-availability of the property should be ignored: these relate to whether the property is in a state fit for use and do not affect the incidence of demand risk.

9 Conversely, where the payments vary proportionately over all the reasonably likely levels of demand, this is evidence that the property is the concession operator's asset.

10 In addition, there may be variations in property profits if usage is greater than expected. If the concession provider benefits from additional usage of the property at little or no extra property cost, then this provides evidence that the property is an asset of the concession provider. For example, if payment for a hospital facility is largely independent of usage, the concession provider will benefit from additional patients being treated when usage is high at little or no extra cost. Conversely, if the concession operator benefits from the increased payments that result from any additional usage of the property, again at little or no extra property cost, this is evidence that the property is an asset of the concession operator. For example, if payment for a hospital facility is based on throughput, the concession operator will benefit from additional usage payments when usage is high, although it may bear little or no extra property cost.

Technological obsolescence

11 Whether the concession provider or the concession operator bears the costs and benefits associated with the technological obsolescence of the property is an indication of which party has an asset of that property. The extent to which technological obsolescence is a factor will, of course, depend on the nature of the service concession agreement.

12 Where the risk of technological obsolescence is high, the entity that bears the cost and associated benefits will be the one for whom there is evidence that the property is its asset.

13 The risks that arise from technological obsolescence may also arise from which entity decides upon the nature of property used in the concession arrangement. Where the concession provider determines the key features of the property, and how it is to be operated, bearing the cost implications of any changes to the method of operation, this is evidence that the property is its asset. The concession provider may determine the key features of the property explicitly by agreeing them as terms of the contract or, for example, through a contractual acceptance provision at the end of the construction phase. Alternatively, the concession provider may implicitly determine the key features of the property. For example, a contract for a road may specify that the road will revert to the purchaser in a predefined state after a relatively short period; this may have the effect that the concession operator has little discretion over standard of road built in the first instance or how it is maintained subsequently.

14 Alternatively, the concession operator might have significant and ongoing discretion as how to fulfil the concession arrangement and makes the key decisions on what property is built and how it is operated, bearing the consequent costs and risks. This is evidence that the property is an asset of the concession operator. For example, this would be the case if the concession operator is free to redesign the property extensively during the term of the agreement (perhaps even to scrap the original property and build a replacement) in the hope of reducing its costs. Similarly, in a service concession agreement to design, build and operate a road, the concession operator might have complete discretion over the balance between the quality of the original road built and the consequent level of maintenance costs.

15 Design risk is the risk that the design of the property is such that, even if it is constructed satisfactorily, it will not fully meet the requirements of the agreement. This is part of the question of who determines the nature of the property, discussed above. In contrast, construction risk refers to who bears the financial implications of cost and time overruns during the construction period (and related warranty repairs caused by poor building work after the asset has been completed). Construction risk is not generally relevant to determining which party has an asset of the property once construction is completed, because such risk normally has no impact during the property's operational life. However, construction risk may be relevant when it calls into question the other evidence. In particular, if the concession provider is bearing construction risk in an agreement in which the property is claimed to

be that of the operator, it will be necessary to look closely at the other terms of the transaction to determine whether the property really is the operator's asset and is not actually an asset of the concession provider.

Cost and net income variations

16 The service concession agreement may have the effect that any significant future cost increases are, or can be, passed on to the concession provider. This is evidence that the property is an asset of the concession provider. Conversely, where the concession operator's costs are both significant and highly uncertain, and there is no provision for cost variations to be passed on to the concession provider, this is evidence that the property is an asset of the concession operator.

17 The existence of tariff regulation is sometimes part of a service concession arrangement. The prices charged by the concession operator may be designed to recover the costs of providing the concession during the expected life of the operation. The existence of such price regulation may impact in different ways on the operator's exposure to risk.

18 On the one hand, it could increase the certainty of expectation of profitable operation over the asset's economic life. Certain public-private concessions include guarantees to reduce the concession operator's exposure to risks and rewards. The public service nature of the activities conducted by concession operators and the long-term nature of concession projects often means that tariffs are not directly related to the costs incurred in each period. Rather, the regulator seeks to mitigate the impact of the guarantees arranged over the term of the concession.

19 Alternatively, tariff regulation may increase the operators' risk if they are not able to adjust the selling price of the services provided under the concession arrangement (which are based on contractual terms and conditions negotiated at the outset of the arrangement).

Appreciation in value/gain from residual value

20 The actual residual value of the property at the end of the agreement may be different to the expected value. This is more of a factor the shorter the agreement is in relation to the useful economic life of the property. Where it is significant, residual value risk will normally give clear evidence of who should record an asset of the property. In part, residual value risk stems

directly from the economic conditions of the market for the property; in other words, the rise or fall in prices relevant to the property. The contract can only influence those aspects of residual value risk relating to the condition of the property at the end of the contract.

21 Where this risk is significant, who bears it will depend on the arrangements at the end of the contract. The concession provider will bear the residual value risk where:

(a) it will acquire the property for a substantially fixed or nominal amount at the end of the agreement;

(b) the property will be transferred to a new operator, selected by the purchaser, for a substantially fixed or nominal amount; or

(c) payments over the term of the agreement are sufficiently large for the concession operator not to rely on an uncertain residual value for its return.

22 Where the concession provider has the option to purchase the property, or, alternatively, an option to 'walk' and leave the property with the operator, the practical effect of the option should be carefully analysed. In particular, where there is no genuine possibility that a purchase option will not be exercised (or, alternatively, that a 'walk' option will be exercised), the option will not transfer residual value risk to the operator.

23 The significance of a minimal payment for the residual interest at the end of the contract depends on other features of the contract. If the property has a significant remaining useful life, a minimal payment for the residual interest at the end of the contract will provide evidence that the concession provider paid for the property over the term of the agreement. This is evidence that the property is an asset of the concession provider.

24 Conversely, the concession operator will bear residual value risk where it retains the property at the end of the agreement or the property will be transferred to the concession provider or another operator at the prevailing market price. This provides evidence that the property is its asset.

Penalties for underperformance and non-availability

25 Many service concession agreements provide for penalties if the property is below a specified standard or is unavailable because of operator fault. Penalties that relate purely to service are not relevant and should not be brought into the assessment. The penalties may take the form of either cash payments or reductions in revenue.

26 It will be important to assess both the likelihood of the penalty occurring in practice and whether the likely payments are significant. For example, a penalty may have little impact in practice because the contract gives the concession operator ample time to rectify the fault or the penalty is invoked only if the property is completely unavailable. Where, as in this example, potential penalties are either not significant or are unlikely to occur, this is evidence that the property is an asset of the concession provider.

Conversely, the penalty mechanism may have the effect that the concession operator's profits associated with the property are subject to significant potential variation. For example, a concession for a road may contain penalty clauses if lanes are closed, with the penalty being significant and having a reasonable possibility of occurring. This would be evidence that the property is an asset of the operator.