IFRS

STAFF PAPER

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Project	**IFRIC 12 *Service Concession Arrangements***
Paper topic	Service concession arrangements with leased infrastructure

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify how an operator accounts for a service concession arrangement in which the infrastructure is leased and the operator is not required to provide any construction or upgrade services in relation to the infrastructure. The submitter asked the Interpretations Committee to clarify whether:

   (a) the arrangement is within the scope of IFRIC 12 *Service Concession Arrangements* (hereafter referred to as the 'scope issue')*;*

   (b) the operator recognises assets and liabilities arising from the lease arrangement (hereafter referred to as the 'recognition issue');[1] and

   (c) the operator can present the assets and liabilities arising from the lease arrangement on a net basis (hereafter referred to as the 'presentation issue').[2]

[1] The recognition issue is relevant if the arrangement is within the scope of IFRIC 12.

[2] The presentation issue is relevant only if the operator is required to recognise assets and liabilities arising from the lease arrangement.

2. The Interpretations Committee discussed this issue at its meetings in November 2015 and March 2016. With respect to the scope issue, the Interpretations Committee observed that:[3]

   (a) assessing whether a particular arrangement is within the scope of IFRIC 12 requires consideration of all facts and circumstances. In particular, the operator assesses whether the control conditions in paragraph 5 of IFRIC 12 and the condition relating to the infrastructure in paragraph 7 of IFRIC 12 apply; and

   (b) the operator is not required to provide construction or upgrade services with respect to the infrastructure to conclude that the arrangement is within the scope of IFRIC 12.

3. With respect to the recognition and presentation issues, the Interpretations Committee directed the staff to perform further analysis of the issues.

4. The purpose of this paper is:

   (a) to provide an analysis of the recognition and presentation issues;

   (b) to ask the Interpretations Committee whether it agrees with the staff recommendation not to add this issue to its agenda; and

   (c) to propose wording for a tentative agenda decision.

5. We have not included any discussion and analysis of the scope issue because the Interpretations Committee concluded upon this issue at its previous meetings (see paragraph 2 of this paper). For the purpose of our analysis of the recognition and presentation issues, we have assumed that the arrangement is within the scope of IFRIC 12 (because these issues are relevant only if that is the case).

6. Appendix B provides further information on the background and the issues identified by the submitter.

[3] Agenda Paper 13 from the Interpretations Committee's meeting in November 2015 provides further details on the staff analysis of this issue.

Structure of the paper

7. This paper is organised as follows:

   (a) staff analysis;

   (b) assessment against the Interpretations Committee's agenda criteria;

   (c) staff recommendation and questions for the Interpretations Committee;

   (d) Appendix A—Proposed wording for tentative agenda decision; and

   (e) Appendix B—Background information.

Staff analysis

8. In our previous analysis of the recognition and presentation issues[4], we noted that the lessor and grantor should be considered together for arrangements in which they are both controlled by the same governmental body. This analysis was based on paragraph AG2 of IFRIC 12, which states that (emphasis added):

   > 'The control or regulation referred to in condition (a) **[paragraph 5(a)]** could be by contract or otherwise (such as through a regulator), and includes circumstances in which the grantor buys all of the output as well as those in which some or all of the output is bought by other users. In applying *this condition*, the grantor and any related parties shall be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any regulators acting in the public interest, shall be regarded as related to the grantor for the purposes of this Interpretation.'

9. We agree with the comments made by some members of the Interpretations Committee that paragraph AG2 is applicable in applying the control condition of paragraph 5(a) of IFRIC 12 (ie whether the grantor control or regulates what services the operator must provide with the infrastructure, to whom it must provide them and

[4] see Agenda Paper 6 from the Interpretations Committee meeting in March 2016 and Agenda Paper 13 from the Interpretations Committee meeting in November 2015.

at what price). Accordingly, paragraph AG2 of IFRIC 12 may not be relevant to the recognition and presentation issues.

10. Consequently, we have revisited our previous analysis. We think that the analysis of the recognition and presentation issues is similar both for arrangements in which the lessor and the grantor are controlled by the same governmental body and for arrangements in which they are not. This is because we do not think that the relationship between the grantor and lessor affects the assessment of whether the operator has rights and obligations that give rise to assets and liabilities. Our analysis is presented in the following paragraphs.

Recognition issue

11. To assess whether the operator recognises a liability to make lease-related payments to the lessor, the operator first assesses whether it is obliged to make those lease-related payments.

12. The analysis of which party (ie the operator or the grantor) is obliged to make lease-related payments requires consideration of all facts and circumstances.

13. In making this assessment, among other things, the operator considers:

    (a) which party (ie the operator or the grantor) is contractually required to make the lease-related payments?

    (b) if the operator is contractually obliged to make the lease-related payments, does this obligation exist regardless of whether the operator has received, or expects to receive, the corresponding cash from the grantor?

    (c) does the operator have any right to offset the lease-related payments against the right to receive cash from the grantor?

14. We understand that, in some cases, the grantor may provide a guarantee to the lessor in respect of the lease-related payments. We do not think that the guarantee is, in itself, relevant to the assessment of whether the operator has an obligation to make the lease-related payments. The guarantee is secondary and does not extinguish the operator's obligation to make the lease-related payments.

15. If the operator determines that it is obliged to make the lease-related payments to the lessor, it must then assess when it should recognise the liability associated with this obligation.

16. The obligation to make lease-related payments arises from a contract, and thus meets the definition of a financial liability[5].

17. Paragraph 3.1.1 of IFRS 9 *Financial Instruments* states:

> An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2) …

18. Paragraph B3.1.2(b) states (emphasis added):

> Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised *until at least one of the parties has performed under the agreement*. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered…

19. Consequently, in assessing when it recognises the financial liability to make lease-related payments, the operator assesses whether the counterparty (ie the lessor) has performed under the contract.

20. Because this arrangement is a service concession arrangement, the operator does not have the right to control the use of the infrastructure.[6] This means that the arrangement with the lessor is not within the scope of IFRS 16 *Leases* (IAS 17 *Leases*) for the operator. Nonetheless, because the counterparty is a lessor in this arrangement, we think that it is useful to consider the Board's explanation in the Basis

[5] Paragraph 11 of IAS 32 further specifies that a financial liability is a contractual obligation to deliver cash or another financial asset to another entity.

[6] Paragraph 11 of IFRIC 12.

for Conclusions on IFRS 16 to assess whether the lessor has performed under the contract.

21. Paragraph BC25 of IFRS 16 states (emphasis added):

> The Conceptual Framework defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. The IASB concluded that the lessee's obligation to make lease payments meets the definition of a liability for the following reasons:
>
> (a) the lessee has a present obligation to make lease payments once the *underlying asset has been made available to the lessee*. That obligation arises from past events—not only the *commitment to the lease contract* but also the *underlying asset being made available for use by the lessee*. Unless the lessee renegotiates the lease, the lessee has no right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term.
>
> (b) the obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments in accordance with the terms and conditions of the lease.

22. We think that the operator's obligation to make lease-related payments meets the definition of a liability at the start of the service concession arrangement (once the underlying asset is made available by the lessor). This is because:

(a) the operator has a present obligation to make lease-related payments once the underlying asset is made available by the lessor. That obligation arises from past events—not only the commitment to the service concession arrangement, but also the underlying asset being made available by the lessor. Unless the operator renegotiates the service concession arrangement, the operator has no right to cancel the arrangement with the lessor and thereby avoid the contractual lease-related payments before the end of the term of the service concession arrangement; and

(b) the obligation results in a future outflow of economic benefits from the operator—typically, contractual cash payments in accordance with the terms and conditions of the lease arrangement.

23. Consequently, at the start of the concession arrangement when the infrastructure is made available by the lessor, we think that the operator recognises a financial liability and a corresponding concession asset.

24. In this arrangement, the grantor would typically obtain the right to use the infrastructure and, if the operator is obliged to make lease-related payments to the lessor, then the grantor would have an obligation to pay the operator. The submitter notes that the operator receives an unconditional contractual right to receive cash from the grantor in relation to the provision of the lease-related services. We therefore think that the corresponding concession asset recognised by the operator is a financial asset (ie a receivable from the grantor).

Presentation issue

25. Paragraph 42 of IAS 32 states that (emphasis added):

> A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position *when, and only when*, an entity:
>
> (a) currently has a legally enforceable right to set off the recognised amounts; and
>
> (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

26. The submitter notes that the contracts that form part of the service concession arrangement do not grant the operator a right to offset the obligation to make lease-related payments against the right to receive cash from the grantor. Applying the requirements in IAS 32, the operator is therefore unable to offset its liability to make lease-related payments to the lessor and its right to receive cash from the grantor.

Staff conclusion

27. We think that the requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for the arrangement described by the submitter. In particular, for the recognition and presentation issues, we think that:

    (a) the operator assesses whether it is obliged to make payments to the lessor for the lease. This assessment requires consideration of all facts and circumstances.

    (b) if the operator has an obligation to make lease-related payments to the lessor, then the operator recognises a liability for this obligation when it is committed to the service concession arrangement and the infrastructure is made available by the lessor. At the time that the operator recognises the liability, it also recognises a financial asset because the operator has a contractual right to receive cash from the grantor to reimburse those payments.

    (c) the operator offsets the liability to make lease-related payments against the corresponding receivable from the grantor only when the criteria for offsetting a financial asset and a financial liability in IAS 32 are met.

Assessment against the Interpretations Committee's agenda criteria

28. We have assessed this issue against the agenda criteria of the current *Due Process Handbook* as follows:

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Yes.** On the basis of the feedback received from our outreach, the issue is common in some jurisdictions and can have a material effect on those affected.[7]
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No.** We think that the requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for the arrangement described in the submission. In addition, on the basis of the outreach feedback received, we think that diversity in practice is limited.
that can be resolved efficiently within the confines of existing IFRS Standards and the *Conceptual Framework for Financial Reporting*.	Not applicable.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable.

[7] See Agenda Paper 13 of the Interpretations Committee's meeting in November 2015 for a summary of the responses received to the outreach request on this issue.

Staff recommendation

29. On the basis of our analysis and our assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not add the issue to its agenda.

30. We have set out the proposed wording for a tentative agenda decision in **Appendix A** to this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation not to add this issue to its agenda? 2. Does the Interpretations Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A
Proposed wording for the tentative agenda decision

IFRIC 12 *Service Concession Arrangements*—Accounting for service concession arrangements for which the infrastructure is leased

The IFRS Interpretations Committee (‘the Interpretations Committee’) received a request to clarify how an operator accounts for a service concession arrangement for which the infrastructure is leased. In this arrangement, the operator is not required to provide any construction or upgrade services with respect to the infrastructure.

The submitter describes an arrangement that involves three parties: a grantor, an operator and a lessor. The operator enters into an arrangement with the grantor to operate a public service. The infrastructure in the arrangement is leased from the lessor. The lessor and the grantor may be controlled by the same governmental body. The operator is contractually required to pay the lessor for the lease of the infrastructure. The operator has an unconditional contractual right to receive cash from the grantor to reimburse those payments. In arrangements in which the lessor and the grantor are not controlled by the same governmental body, the grantor provides a guarantee of the lease payments to be made during the lease term, and of any residual value at the end of the lease term. The grantor also has an option to renew the lease at the end of the initial non-cancellable period of the contract.

The submitter asked the Interpretations Committee to clarify whether the arrangement is within the scope of IFRIC 12 *Service Concession Arrangements* (the ‘scope issue’). If the arrangement is within the scope of IFRIC 12, the submitter notes that the lease of the infrastructure is not within the scope of IFRS 16 *Leases* (IAS 17 *Leases*) for the operator. Consequently, the submitter also asked the Interpretations Committee to clarify how the operator accounts for any assets and liabilities arising from the arrangement with the lessor (‘recognition and presentation issues’).

With respect to the scope issue, the Interpretations Committee observed that:

(a) assessing whether a particular arrangement is within the scope of IFRIC 12 requires consideration of all facts and circumstances. In particular, the operator assesses whether the control conditions in paragraph 5 of IFRIC 12 and the condition relating to the infrastructure in paragraph 7 of IFRIC 12 apply; and

(b) the operator is not required to provide construction or upgrade services with respect to the infrastructure to conclude that the arrangement is within the scope of IFRIC 12.

With respect to the recognition and presentation issues, if the arrangement is within the scope of IFRIC 12, the Interpretations Committee observed that:

(i) the operator assesses whether it is obliged to make payments to the lessor for the lease. This assessment requires consideration of all facts and circumstances.

(ii) if the operator is obliged to make payments to the lessor, then the operator recognises a liability for this obligation when it is committed to the service concession arrangement and the infrastructure is made available by the lessor. At the time that the operator recognises the liability, it also recognises a financial asset because the operator has a contractual right to receive cash from the grantor to reimburse those payments.

(iii) the operator's liability is a financial liability. Accordingly, the operator offsets the liability to make payments to the lessor against the corresponding receivable from the grantor only when the criteria for offsetting a financial asset and a financial liability in IAS 32 *Financial Instruments: Presentation* are met.

The Interpretations Committee noted that the requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for the arrangement.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B
Background information

B1. The submitter describes an arrangement that involves three parties: a grantor (governmental body), an operator and a lessor. The operator enters into an arrangement with the grantor to provide a public service (such as the provision of rail services). The infrastructure used in the arrangement is leased from the lessor. The lessor may, in some cases, be controlled by the same governmental body that controls the grantor. The arrangements are collectively referred to as the 'service concession arrangement'.

B2. We describe below some key terms and conditions relating to the concession arrangement between the grantor and the operator, and the arrangement with the lessor.

Key terms and conditions relating to the service concession arrangement

Concession arrangement

B3. The grantor determines the major aspects of the service that the operator must provide (ie type of service, pricing of the service, frequency of service, quality level, etc).

B4. The operator has the right to receive a fee for providing the public service. This fee also covers the costs incurred by the operator for the lease arrangement, which is an integral part of the service concession arrangement initiated by the grantor.

B5. The operator does not provide any construction or upgrade services with respect to the infrastructure that is used in the arrangement.

Arrangement with the lessor

B6. The operator makes lease payments to the lessor (hereafter referred to as 'lease-related payments') in relation to the infrastructure and is responsible for proper maintenance of the infrastructure during the term of the arrangement.

B7. The lease does not transfer substantially all the risks and rewards incidental to ownership of the infrastructure to the operator. In particular, the lease term is not for the major part of the economic life of the infrastructure. The operator does not have any residual value risk associated with the infrastructure. If the lessor is not controlled by the same government body as the grantor, the grantor provides a guarantee of the lease payments during the lease term, and also of the residual value at the end of the lease term. The grantor has an option to renew the lease at the end of the initial non-cancellable period of the contract (ie at the option of the grantor, either the grantor itself, or the next operator, can continue the lease).

Other key terms and conditions

B9. We understand from the submission that:

(a) the operator may receive a right to charge users of the public service or it may receive an unconditional contractual right to receive cash from the grantor in exchange for operating the public service. Regardless of the nature of its rights arising from operating the public service, the operator receives an unconditional contractual right to receive cash from the grantor in relation to the provision of the lease-related services (ie entering into the lease and making lease payments); and

(b) in general, the contracts do not provide the operator with a right to offset the lease-related payments to be made to the lessor with the right to receive cash from the grantor, even if the lessor and the grantor are controlled by the same governmental body.

Issues identified

B10. The submitter identifies three issues with respect to this arrangement.

Scope issue and recognition issue

B11. The submitter asks whether the arrangement is a service concession arrangement within the scope of IFRIC 12. If so, the submitter notes that paragraph 11 of IFRIC 12 specifies that the operator does not have the right to control the use of the infrastructure. Consequently, the arrangement with the lessor is outside the scope of IFRS 16 (IAS 17) for the operator.

B12. The submitter identifies two differing views on how the operator accounts for the lease-related payments:

(a) recognise the lease-related payments as expenses when incurred over the term of the arrangement, because the lease-related payments are deemed to be executory in nature; or

(b) at the start of the concession arrangement, recognise a financial liability for the present value of the lease-related payments and a corresponding asset.

Presentation issue

B13. The submitter notes that some may argue that the operator is acting as an agent in setting up and managing the arrangement with the lessor. In that case, some think that the operator would either net, or not recognise, any financial asset and financial liability arising as a consequence of the arrangement with the lessor at the start of the service concession arrangement. This is because:

(a) in arrangements in which the lessor and the grantor are controlled by the same governmental body, the lease-related payments are, in essence, a movement of cash without economic substance.

(b) in arrangements in which the lessor and the grantor are not controlled by the same governmental body, the grantor provides the lessor with guarantees for the lease-related payments and any residual value, and controls the arrangement with the lessor following the initial non-cancellable lease term. In addition, those who view the operator as an agent explain that, economically, it is the grantor that is the lessee in the lease arrangement. Consequently, the operator merely acts as a conduit that receives payments from the grantor and then passes those payments to the lessor on the grantor’s behalf.