



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor  
New York, New York 10017  
Internet: <http://www.ifac.org>

Tel: (212) 286-9344  
Fax: (212) 286-9570

## Agenda Item **7**

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**DATE:** February 9, 2009  
**MEMO TO:** Members of the IPSASB  
**FROM:** Joy Keenan  
**SUBJECT:** Service Concession Arrangements

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### **OBJECTIVE OF THIS SESSION**

**Consider** an analysis of issues arising from comments on the March 2008 Consultation Paper, “Accounting and Financial Reporting for Service Concession Arrangements.”

### **AGENDA MATERIAL**

**7.1** Analysis of Issues Arising from Consultation Paper

**7.2** IFRIC 12 Information Notes and Illustrative Examples (for information)

### **ACTION REQUIRED**

**Confirm** appropriateness of proposed resolutions to issues; and

**Provide additional direction** for development of an Exposure Draft.

### **BACKGROUND**

Although the International Accounting Standards Board’s (IASB) International Financial Reporting Interpretations Committee (IFRIC) has issued Interpretation 12, “Service Concession Arrangements” (IFRIC 12), this interpretation provides guidance on reporting the property associated with SCAs that meet specified criteria related to control over the property. However, the guidance in this interpretation only specifically applies to private sector entities, generally the operator in such arrangements. It does not apply to the grantor entity in SCAs.

In March 2008, the IPSASB issued a Consultation Paper (CP) on “Service Concession Arrangements (SCA).” Because the public sector entity is generally the grantor in these arrangements, the CP focused on the accounting and financial reporting issues of these arrangements from the perspective of the public sector entity, the grantor. The project is intended to develop an International Public Sector Accounting Standard (IPSAS) dealing with this prevalent public sector issue. Because of the difference in focus of this project from IFRIC 12, this is not a “convergence” project, *per se*.

The IPSASB received strong support for proceeding with the project from respondents to the CP. However, respondents asked for more guidance and/or clarification on a number of issues, which the IPSASB discussed at the October 2008 meeting.

### **KEY ISSUES**

The IPSASB directed staff to develop further analysis of the following issues before drafting the Exposure Draft:

1. Control over use
  - (a) Provide a “bridge” between the control over use approach and the risks and benefits approach
  - (b) Provide guidance on how the “regulate” criterion works in practice in the public sector
  - (c) Assess the pros and cons of retaining the “significant residual value” criterion
2. Discount rate – provide guidance on the appropriate discount rate to use
3. Inflows of resources – consider how these constitute liabilities of the entity under the current conceptual framework
4. Control criteria not met – provide guidance for cases when some or all of the control over use criteria are not met
5. Develop examples to show how the various components of the control over use criterion interact when assessing whether or not the entity should recognize an asset related to a SCA

These issues are addressed in Agenda Paper 7.1

**KEY ISSUES FOR DISCUSSION**

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## **1. Control-focused approach**

The March 2008 Consultation Paper (CP), discussed approaches for determining whether the public sector (grantor) entity should recognize the underlying property of a service concession arrangement as an asset.

In determining whether the public sector has an asset arising from a service concession arrangement, the CP considered the definition of an asset set out in IPSAS1:

“... resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity ...”

The CP also discussed the “risks and rewards incidental to ownership” approach; however, the CP proposed a control-focused approach be adopted for determining whether the grantor entity should recognize an asset. Respondents generally supported the control-focused approach, but they requested more guidance on a number of issues set out below.

### Overall Staff Recommendation – Asset Recognition Principle:

On examination of the specific issues related to the control-focused approach, staff noted that the control-focused approach proposal was based on IFRIC wording, which is guidance related to other standards (in particular IFRS Framework, paragraph 89 which is the asset recognition principle). Staff is of the view that this IPSAS should also treat the control-focused material as guidance rather than as the underlying recognition principle. Accordingly, the recognition principle proposed in Issue #1(a) below is analogous to that in paragraph 14 of IPSAS 17, “Property, Plant and Equipment.” While not specifically espoused as a proposal in the CP, this proposal is not inconsistent with the discussion in the CP on related matters (e.g., risks and benefits, service potential), nor is it inconsistent with the treatment and level of authority of the issue in IFRIC 12. Staff also noted that in IFRIC 12, the control-focused approach is used to show why the operator does not recognize an asset related to the underlying property, which does not necessarily mean that it provides sufficient support for why the grantor does have an asset.

If this proposed change is made, some of respondents’ concerns with the control-focused approach versus a risks and rewards approach are lessened, because both approaches are guidance supporting the recognition principle, rather than alternatives to asset recognition in the first case. If both approaches are treated as guidance on applying the basic recognition principle, there is also less focus on one specific condition indicating control from IPSAS 12 (e.g., significant residual value) or one of the risks/rewards as a “bright line” test for determining whether the grantor should recognize an asset. This notion of looking at the factors in totality is noted in the last paragraph of the guidance set out in Issue #1(a) and is consistent with guidance in FRS Application Note 5 (F49).

It is recognized that some may oppose this proposal on the basis that it may result in inconsistent application of the standard because of the greater degree of judgment required, such that some legitimate assets are not recognized. Conceptually, however, it is

easier to support consistency with an existing principles-based asset recognition standard (IPSAS 16, IPSAS 17, ED 40) than consistency with rules-based guidance (IFRIC 12).

The proposed structure would be as follows (See Issue #1(a) below for wording):

Asset recognition principle

Guidance on control criteria from IFRIC 12

Guidance on risks and rewards

Guidance to consider all facts and circumstances together

The rationale for this change in focus for recognizing the grantor's asset, if agreed to by the IPSASB, will be explained in the Basis for Conclusions in the Exposure Draft.

- (a) *Provide a “bridge” between the control-focused approach and the risks and rewards approach*

Some respondents to the CP requested an improved linkage of risk and rewards to control. They advocated that it be done at a more individual component risk level (e.g., how does control by one party align with who has demand risk?). Staff does not believe an analysis on a risk-by-risk basis would be effective or particularly useful, as it is not necessary for the accounting of the counterparties to the arrangement to mirror each other. Moreover, staff believes it is important to look at the allocation of the various risks in a service concession arrangement as a whole, and not in isolation. Generally, transference of one element of risk alone will not be sufficient to cause the service concession arrangement to be accounted for differently, and different risks will have more prominence from one service concession arrangement to another (i.e., the transference of a particular risk or reward incidental to ownership is not a “bright line” test).

Staff believes the control-focused and risks and rewards<sup>1</sup> approaches are not mutually exclusive; indeed, they are closely linked. Although the CP sets out the view that the control-focused approach to determine the financial reporting for the property underlying a service concession arrangement by the grantor is appropriate, this focus on control does not mean that the flow of future economic benefits or service potential through the assumption of risks and rewards is not implicitly considered in the overall approach.

Paragraph 12 of IPSAS 13, “Leases” contains the following discussion of “risks and rewards incidental to ownership” that could be used in developing guidance:

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<sup>1</sup> It should be noted that the term “risks and rewards” as used in the standards is “risks and rewards incidental to ownership.”

“Risks include the possibilities of losses from idle capacity, technological obsolescence or changes in value because of changing economic conditions. Rewards may be represented by the expectation of service potential or profitable operation over the asset’s economic life and of gain from appreciation in value or realization of a residual value.”

Paragraph 21 of IPSAS 16, “Investment Property” also contains a relevant discussion of risks and rewards:

“In determining whether an item satisfies the first criterion for recognition, an entity needs to assess the degree of certainty attaching to the flow of future economic benefits or service potential on the basis of the available evidence at the time of initial recognition. Existence of sufficient certainty that the future economic benefits or service potential will flow to the entity necessitates an assurance that the entity will receive the rewards attaching to the asset and will undertake the associated risks. This assurance is usually only available when the risks and rewards have passed to the entity. Before this occurs, the transaction to acquire the asset can usually be cancelled without significant penalty and, therefore, the asset is not recognized.”

In staff’s view, regardless of the form of service delivery, the public sector entity remains accountable for the availability of services provided either directly or indirectly to the public through the service concession arrangement property. The grantor is, therefore, subject to the service delivery risks and rewards incidental to ownership of the property.

Examples of specific service delivery risks<sup>2</sup> that may or may not be transferred in a service concession arrangement include:

- Construction risk (e.g., timely completion, conformity with design specifications, cost overruns, operation risk during construction period);<sup>3</sup>
- Operation risk (e.g., idle capacity, availability of service, maintenance, obsolescence, insurance claims and other legal issues, fraud, physical or environmental risks, and employee management issues such as unions, employee benefits and training);
- Credit risk and interest rate risk (e.g., ability of operator to finance a project, government guarantees, private sector cost of capital vs. government cost of capital); and
- Market risk (e.g., changing demographics, fiscal and economic factors and demand).

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<sup>2</sup> The descriptions of operation risk, credit risk, interest rate risk and market risk are based on those in Basel II; therefore there has been some revision from the list of risks set out in CP paragraph 3.

<sup>3</sup> Guidance would need to be developed on how construction risk affects asset recognition by the grantor (see CP paragraphs 36, 38, 40, 91, 106, 109, 110, 135).

Examples of service delivery rewards include future economic benefits and service potential.

Staff Recommendation:

Even if the IPSASB does not support using IPSAS 17.14 as the basis for the asset recognition principle, as a practical solution staff believes it is possible to link the concept of risks and benefits incidental to ownership to the control-based approach by explicitly indicating that the rewards associated with a service concession arrangement pertain to the economic benefits and service potential, and that an assessment would be made of the various risks (including those indicated above) in determining whether the entity should recognize the asset and liability related to the service concession arrangement.

Wording similar to the guidance that follows the proposed recognition principle would provide an appropriate balance between the control-focused approach and the “risks and rewards approach without undertaking a “matching” of each possible risk to the control criteria.

Although this proposal is facilitated by using similar wording to IPSAS 17.14, rather than using control as the basis for recognition, it is not a necessary condition for using wording similar to that in the proposed guidance below to link the control-focused approach to the risks and rewards approach.

**Proposed Asset Recognition Principle:**

**At inception of a service concession arrangement, a grantor should recognize the cost of an item of property underlying a service concession arrangement as an asset, if and only if:**

- (a) **It is probable that future economic benefits or service potential associated with the item will flow to the grantor; and**
- (b) **The cost or fair value of the item can be measured reliably.**

**Proposed Guidance:**

It is presumed the future economic benefits or service potential associated with the item will flow to the grantor when the grantor controls the property for financial reporting purposes.<sup>4</sup> Control exists when:

- (a) The grantor controls or regulates<sup>5</sup> what services the operator must provide with the underlying property, to whom it must provide them, and the price ranges or rates that can be charged for services; and

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<sup>4</sup> Modified slightly from CP 102-103, taking into account some of the wording from IPSAS 13 and IPSAS 16.

- (b) The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest<sup>6</sup> in the property at the end of the term of the arrangement.

The grantor's control over the property underlying the service concession arrangement evidences that it remains accountable for the services provided either directly or indirectly to the public through the property. This accountability subjects the grantor to risks and rewards related to service delivery that are associated with the property.

In assessing whether the grantor controls the property under a service concession arrangement, the grantor also considers whether it retains the risks and rewards incidental to ownership of an asset.

The risks include the following:

- Construction risk (e.g., timely completion, conformity with design specifications, cost overruns, operation risk during construction period);<sup>7</sup>
- Operation risk (e.g., idle capacity, lack of availability of service, cost of maintenance, obsolescence, insurance claims and other legal issues, fraud, physical or environmental risks, and employee management issues such as unions, employee benefits and training);
- Credit risk and interest rate risk (e.g., ability of operator to finance a project, government guarantees, private sector cost of capital vs. government cost of capital); and
- Market risk (e.g., changing demographics, fiscal and economic factors and demand).

The rewards include economic benefits (e.g., cost savings in providing a service and appreciation in residual value accruing to the grantor) and service potential of the property (including any residual value of the property).

These examples of risks and rewards are not intended to be all-inclusive, nor do all of these risks and rewards necessarily apply to every service concession arrangement. The entity considers these risks and rewards together and weighs

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<sup>5</sup> See discussion of regulation below. The related guidance on regulation would follow the guidance on control and risks and rewards.

<sup>6</sup> See discussion of residual interest below. The related guidance on regulation would follow the guidance on control, risks and rewards and regulation.

<sup>7</sup> Guidance would need to describe how construction risk affects asset recognition by the grantor (see CP paragraphs 36, 38, 40, 91, 106, 109, 110, 135). In some cases, it may not be a question of whether asset recognition is affected, but when to recognize an asset.



their relative importance to the service concession arrangement in determining whether they indicate the entity controls the service concession arrangement property. No one risk or benefit alone is sufficient to draw such a conclusion.

Issue #1(a) – Control over use/risks and rewards

**Confirm** staff's recommended approach for the recognition principle wording and accompanying guidance that links the "control over use" and the "risks and rewards incidental to ownership" approaches to determining whether an asset should be recognized.

- (b) *Provide guidance on how the "regulate" condition works in practice in the public sector*

The definition of control highlighted above is based on that in IFRIC 12. From the operator's point of view, regulation has a different meaning than when used for a public sector grantor.

Paragraph 37 of IPSAS 6, "Consolidated and Separate Financial Statements" contains the following wording:

"Governments and their agencies have the power to regulate the behavior of many entities by use of their sovereign or legislative powers. Regulatory [and purchase] powers do not constitute control for the purposes of financial reporting."

In paragraph 1 of the proposed asset recognition principle in 1(a) above, "regulate" is not used in the sense of a government's overall power to regulate. Instead, it is used as an integral part of the phrase "... *regulate what services the operator must provide with the underlying property, to whom it must provide them, and the price ranges or rates that can be charged for services.*"

In this context, "regulate" refers to the terms and conditions of the service concession arrangement, rather than the more general sense of a government's regulatory power. That is to say, under the service concession arrangement the grantor would have a continuing right to require the property to be operated to meet its public service objectives. As such, under the terms and conditions of the service concession arrangement, the grantor controls key operational aspects of the property, such as the rates to be charged for its use while the operator is operating the property on behalf of the grantor. Even if such a requirement were ultimately enforced by another public sector entity, such as a regulator, this form of regulation would generally be referenced in the service concession arrangement (e.g., the service concession arrangement stipulates that the operator of a hospital is required to provide services to all citizens as required under health care regulations in the jurisdiction). This differs from, for example, government regulation of the banking industry.

IFRIC12 BC27 supports the view that the grantor's control is supported by its continuing involvement with the underlying asset. It states,

“The grantor retains continuing managerial involvement to the degree usually associated with ownership and control over the infrastructure...”

This is a more specific type of regulation than government's overall power to regulate.

Based on the above analysis, staff has identified two options for addressing the use of the term “regulate” in the asset recognition principle:

- 1) Define the term (or phrase) for the purposes of the standard
  - The terminology is consistent with that in IFRIC 12, which will make it easier for both public and private sector parties to a service concession arrangement to understand how the accounting is affected. In an analogous situation, IPSAS 13. 14 states,  
  
“Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions.”
  - This option would still likely require additional discussion such as that above to avoid any confusion.
  - The possibility still exists for misapplication in practice as use of the term “regulate” in the public sector generally understood to connote a more centralized, imposed government role, rather than pertaining to the specific agreed-upon terms and conditions of the service concession arrangement.
- 2) Use another term such as “directs (though the terms and conditions of the service concession arrangement)”
  - This option is more appropriate in the context of a contractual arrangement whose terms and conditions, agreed to by both parties, set out the responsibilities of the operator.
  - There is no ambiguity because the same term is used differently in different standards.

Staff Recommendation:

Staff recommends that the first option noted above be used, including providing guidance on what ‘regulate’ means. Note that, because of the proposal to have the control criteria moved from a principle to guidance in Issue 1(a), the term

“regulate” will have less impact on the assessment of a service concession arrangement for accounting purposes.

Issue #1(b) – “Regulate” condition

**Confirm** staff’s recommended approach of providing guidance on use of the term “regulate” in the public sector application of the control criterion.

(c) *Assess the pros and cons of retaining the “significant residual value” condition*

IFRIC 12 .5(b) wording is as follows:

The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.

The CP proposed to delete “significant” from this phrase so that whole of life arrangements would not be excluded because they have no significant residual interest.

As indicated above, staff proposes to demote the control criteria from IFRIC 12 to guidance, to provide additional guidance on risks and rewards and to indicate that all facts and circumstances in an arrangement need to be considered. On that basis, any one condition will generally have reduced importance.

Staff was persuaded by the commentary in paragraphs 80-84 of the CP that most service concession arrangements will have a significant residual interest.

“The Board believes that, in most cases, a significant residual interest in the underlying property will exist at the end of a SCA. This is mainly because of the long-lived nature of the underlying property, and the frequent inclusion of a contractual requirement for the operator to return the property in a state of good condition at the end of the arrangement.

Even where the contract does not require this return, fulfillment by the operator of often imposed maintenance requirements throughout the term of the arrangement helps ensure that the property is in operational condition at the end of the SCA. Given the core nature of the public services provided through the property, it would seem that such property, if in operational condition at the end of the SCA, would provide future service potential or future economic benefit, and therefore, have a significant residual interest.

In considering this notion of control over the residual interest, it must be determined whether the residual interest itself must also be significant to establish control over the property for financial reporting purposes. It can be argued that if the residual interest is insignificant, then whether or not the grantor controls the residual interest is (virtually by definition) inconsequential, and should have no bearing on who controls the property for financial reporting purposes. Therefore, if control over residual interest must be present to establish control for financial reporting purposes, it can be argued that the residual interest also should be significant for this test to be meaningful.

The above argument would be persuasive if the residual interest control criterion was established solely to preserve the public sector use of the property after the term of the

arrangement. However, as discussed previously, controlling the residual interest in the property serves to preserve the grantor's continuous use of the property during the arrangement as well. This does not appear to depend on the significance of the residual interest at the end of the arrangement—the fact that the grantor controls the residual interest in the property would appear to preserve this right of continuous use.”

IFRIC 12 AG.4 states, “For the purposes of condition (b), the grantor's control over any significant residual interest should both restrict the operator's practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement.” This assumption seems contrary to the commentary in the last paragraph above (“...solely to preserve the public sector use after the term...”, “during the arrangement as well”), as IFRIC 12 is concerned only with the service concession arrangement period.

IFRIC 12.6 also provides an exception to condition (b) for whole of life assets, even though it noted the inclusion of the two conditions for control were likely to be met in most of the public-to-private arrangements for which guidance had been sought (IFRIC 12 BC 11).

*Pros of retaining*

- 1) The basis for removing the term differs from the stated purpose of the condition set out in IFRIC 12, which is to give the grantor continuing right of use throughout the period.
- 2) If “significant” is removed, the treatment of whole of life assets takes precedence over the majority of service concession arrangements because when there is any residual interest, condition (a) would be the deciding factor (assuming staff proposals above are not adopted).
- 3) Whether or not the IPSASB agrees with staff's previous proposals, this issue could be more practically addressed by retaining “significant” and providing guidance (in the body of the standard and the examples) for whole of life situations, rather than changing the condition entirely.
- 4) Although it is not a condition that the principles of this IPSAS be converged with IFRIC 12, for practical purposes, it is reasonable to use the same terminology to permit both parties to the service concession arrangement to better understand the impact of the terms and conditions negotiated.

*Cons of retaining*

- 1) Retaining “significant” absent any other changes (e.g., demoting the control over use criteria to guidance along with other guidance) would mean whole of life assets, which in substance would be an asset, would not fall within the scope of the guidance.

Staff Recommendation:

Staff believes the IFRIC 12 approach on this issue is reasonable—if, as asserted in the CP, the majority of service concession arrangements do result in a significant residual interest the standard should focus on those circumstances. The exception (whole of life assets) should be treated as such.

Accordingly, staff proposes retaining “significant” in condition (b) of the control guidance (see 1(a) above) and including guidance similar to IFRIC 12.AG4.

Note: this recommendation is valid whether or not the IPSASB agrees with staff’s recommendation in 1(a).

Issue #1(c) – Significant residual interest condition

**Confirm** staff’s recommended approach of retaining “significant” in the residual interest condition of the control criterion, and including guidance for whole of life assets from the public sector (grantor) point of view.

**2. Discount rate – provide guidance on the appropriate discount rate to use**

Paragraph 122 of the CP indicated that the discount rate used for initial valuation of the service concession asset and liability should be “... an estimate of the operator’s cost of capital specific to the SCA...”

This rate may not be readily determinable, given that this rate may also embody the operator’s profit margin in addition to the finance rate and the complex structure of many service concession arrangements.

IPSAS 13.28 contains the following requirement:

**“The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee’s incremental borrowing rate shall be used.”**

FRS Application Note 5 (F16) contains the following guidance on the appropriate rate:

“Where the service element is perceived as being riskier, relative to the property, this will give rise to a rate that is too high. Since a prerequisite for using SSAP 21 is that the payments for the property have been separated from those for the services, it will usually be possible to derive such a property-specific rate from the PFI contract. Where sufficient information is not available, the rate should be estimated by reference to the rate that would be expected on a similar lease (ie a lease of a similar property, in a similar location and for a similar term). The estimate of the rate should be reviewed together with (i) the present value of the lease payments, (ii) the assumed fair value of the property, and (iii) the assumed residual value, to ensure all figures are reasonable and mutually consistent.”

Eurostat's "Long term contracts between government units and nongovernment partners (Public-private partnerships)" contains some additional points related to financing:

"However it is not unusual that government takes part itself in the financing. This is different from a possible capital injection in a given structure in the form of equity stake. This may be justified by the fact that frequently a private partner is not able to borrow at the same rate of interest as government, thus increasing the cost of the project. Therefore, government may offer a certain level of financing for the PPP project, to entice greater interest by private sector entities in the project and/or to reduce the total cost of financing."

Staff views these cases of public sector involvement in the financing of the asset as an indicator that the grantor's incremental borrowing rate would be appropriate in these cases.

Staff Recommendation:

Staff's view is that the requirement for the appropriate discount rate should be consistent with that in IPSAS 13.28. In addition, staff recommends that guidance be developed, based on the material above, to take into account the impact of the grantor's involvement in financing as well as to ensure that only the operator's rate related to the property (and not to the services as well) is used, when known.

Issue #2 – Discount rate

**Confirm** staff's recommendation to make the principle for the discount rate consistent with IPSAS 13.28 and to provide guidance related to the impact of the grantor's involvement in financing and using the rate related solely to the property.

**3. Consider how inflows of resources, fees received by the operator directly and non-cash amounts constitute liabilities of the grantor entity under the current conceptual framework**

The CP addresses two liabilities associated with a service concession arrangement. The first relates to the recording of the asset and the associated liability of the grantor to compensate the operator for its construction/acquisition and the second to the liability for unearned amounts of inflows for payments from the operator to the grantor.

IPSAS 1 defines a liability as follows:

"Liabilities are present obligations 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 or service potential."

*Initial liability (cash or non-cash consideration)*

This proposal applies to assets constructed for the service concession arrangement.

Paragraph 135 of the CP proposes that for service concession arrangements meeting the proposed control criteria, the criteria in IPSAS 17 for recognizing property, plant and equipment should be used to determine when to recognize the underlying property as an asset (for example, during construction, or when it is in place and operational), along with a liability reflecting the grantor's obligation to provide compensation (either cash or non-cash) to the operator for that property.

Paragraph 138 of the CP notes that in some service concession arrangements cash payments made by the grantor to the operator for construction of the property are reduced or eliminated because the operator is directly collecting third-party usage fees or receiving other non-cash compensation from the grantor (typically through granting the operator use of additional grantor-owned land for a nominal amount). In that case, it was proposed that the liability reflecting the receipt of consideration in advance of performance (which in this case is the provision of access to the property) also should be initially reported at the same amount, adjusted for cash received or paid (or to be paid) by the grantor.

This liability would reflect consideration received in advance of performance, because the grantor is receiving an inflow of resources in the form of the property (adjusted for cash received, paid or to be paid) without having delivered on its portion of the exchange—the provision of access to the property. The grantor has an unconditional present obligation to compensate the operator for construction services and the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law.<sup>8</sup> This obligation will result in an outflow of resources in the form of cash outflows and/or service potential associated with the underlying property.

IFRIC 12 BC42(b) notes that whether the users or the grantor pay the contractual amount receivable directly to the operator, the method of payment is a matter of form only. In both cases the operator has a present, unconditional contractual right to receive the specified or determinable cash flows from or at the direction of the grantor. The nature of the operator's asset is not altered solely because the contractual amount receivable may be paid directly by users of the public service. The IFRIC observed that accounting for these contractual cash flows as financial assets faithfully reflects the economics of the arrangements, which is to provide finance to the grantor for the construction of the infrastructure. The CP is not concerned with which type of asset the operator recognizes. However, the argument that either form of payment results in an asset for the operator also provides support for the position that the method of payment also results in a liability for the grantor.

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<sup>8</sup> This issue is dealt with in IFRIC 12 from the operator's point of view – the operator may have a financial and/or an intangible asset arising from the service concession arrangement, depending on the terms and conditions of the arrangement.

*Unearned inflows received in advance of performance*

Paragraph 196 of the CP proposed that “... contractually determined inflows to be received by a grantor from an operator should be recognized as revenue by the grantor as they are earned over the life of the service concession arrangement, beginning at the commencement of the concession term, that is, when the property is fully operational and the operator has the ability to use the property to generate third-party usage fees. The Board believes that before this point the grantor cannot begin to deliver on its side of the exchange—generally, providing access to the property to the operator. ... any consideration received from the operator in advance of performance should be reported by the grantor as a liability until it is earned.”

Grantors may receive payments from operators related to upfront payments/payments over time for use of the property. These contractually determined inflows most often occur when the service concession arrangement involves existing infrastructure or public facilities. However, these inflows may also occur in service concession arrangements involving construction of new property.

The proposed treatment of such amounts as liabilities is based on the premise that the grantor has an obligation to perform throughout the term of the service concession arrangement—in other words, the grantor has not fulfilled its contractual responsibilities at execution of the contract. Generally, in service concession arrangements featuring contractually determined inflows from the operator, the consideration provided by the grantor in exchange is the right to operate the property underlying the service concession arrangement. Given this exchange, the grantor would continue to have some obligation to perform throughout the life of the agreement, even if that performance is nothing more than allowing the operator access to the property. In the case when there is an upfront payment by the operator to the grantor, the grantor’s liability arises from its obligation to provide future access to the property’s service potential.

Staff Recommendation:

As indicated in the CP, the two of liabilities discussed above meet the existing definition of a liability in IPSAS 1. This treatment may need to be revisited as the IPSASB Conceptual Framework (Phase 2) proceeds. The rationale for treatment of these items as liabilities will be explained in the Basis for Conclusions in the Exposure Draft.

Issue #3 – Support for liability recognition

**Confirm** the appropriateness of recognition of the two types of liabilities related to service concession arrangements under the current definition of a liability.



**4. Provide guidance for cases when some or all of the control over use criteria are not met.**

Note that staff did not have the opportunity to review the GASB's material on this issue prior to drafting the following commentary. However, it is premised on the proposal in Issue #1. Under that proposal, staff believes the relative importance of any one condition in the control-focused IFRIC 12 material or any one risk or reward will be significantly reduced under the proposal, such that it will not be a case of "no significant residual interest = no asset," which seemed to be the underlying concern with various conditions in the control criteria in the CP. Therefore, such guidance will be best addressed in a series of examples that would show the interaction of all of the factors for a variety of facts and circumstances and other guidance (see Issue #5 below).

In this case, Flowchart 2 from the CP would not be necessary. Rather, the examples should serve to illustrate the interaction of the factors indicate whether or not the grantor should recognize an asset in respect of a service concession arrangement, as discussed in Issue #5.

See question below for Issue #4 and Issue #5.

**5. Develop examples to show how the various components of the control over use criterion interact when assessing whether or not the entity should recognize an asset related to a service concession arrangement.**

IFRIC 12 contains the following guidance (see PDF file for Agenda Paper 7.2 for details of this guidance):

- Information Note 1, which is a diagram that summarizes the accounting for service concession arrangements;
- Information Note 2, which is a table that sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to IFRSs that apply to those arrangements; and
- Illustrative Examples, which are examples of service concession arrangements with specific facts and circumstances and the private sector (operator) accounting for each case.

Staff holds the view that Information Note 1 could be adapted to the broadened scope of asset recognition guidance proposed for Issue #1, and Information Note 2 could be expanded to identify other types of risks and rewards in addition to demand risk. Inclusion of this material would also assist in addressing Issue #4. As noted under Issue #4, the examples would be used as a starting point (taking into account the

additional conditions proposed in Issue #1 for determining whether the grantor should recognize an asset).

Flowchart 1 from the CP would be combined with Information Note 1 material as necessary.

Staff Recommendation:

Staff proposes that the guidance from IFRIC 12 be adapted to the public sector point of view the IPSAS principles and guidance and included in the IPSAS on service concession arrangements.

With respect to the examples, staff believes the stated facts and circumstances in IFRIC 12 are well suited for use in the public sector. To the extent the IPSASB considers it necessary to illustrate principles in the IPSAS that were not addressed in the IFRIC examples, staff will develop specific public sector examples. This may be required, for example, if the IPSASB agrees with the proposals in Issue #1, to illustrate how the various risks and rewards in the recognition principle would be considered.

As indicated previously, an example dealing with whole of life assets may be required.

Because development of guidance depends to a significant extent on the IPSASB's decisions related to the other issues noted previously, staff proposes to develop this guidance subsequent to the February 2009 IPSASB meeting, and post it for members' comments and input prior to the May 2009 IPSASB meeting.

Issue #4 and Issue #5 – Develop examples and guidance

**Confirm** staff's proposal that the IFRIC 12 Information Notes and Illustrative Examples should be adapted to the public sector entity (grantor) point of view and that additional guidance should be developed as necessary to illustrate specific public sector principles and issues. Flowchart 1 from the CP would be amended as necessary to show the decision process.

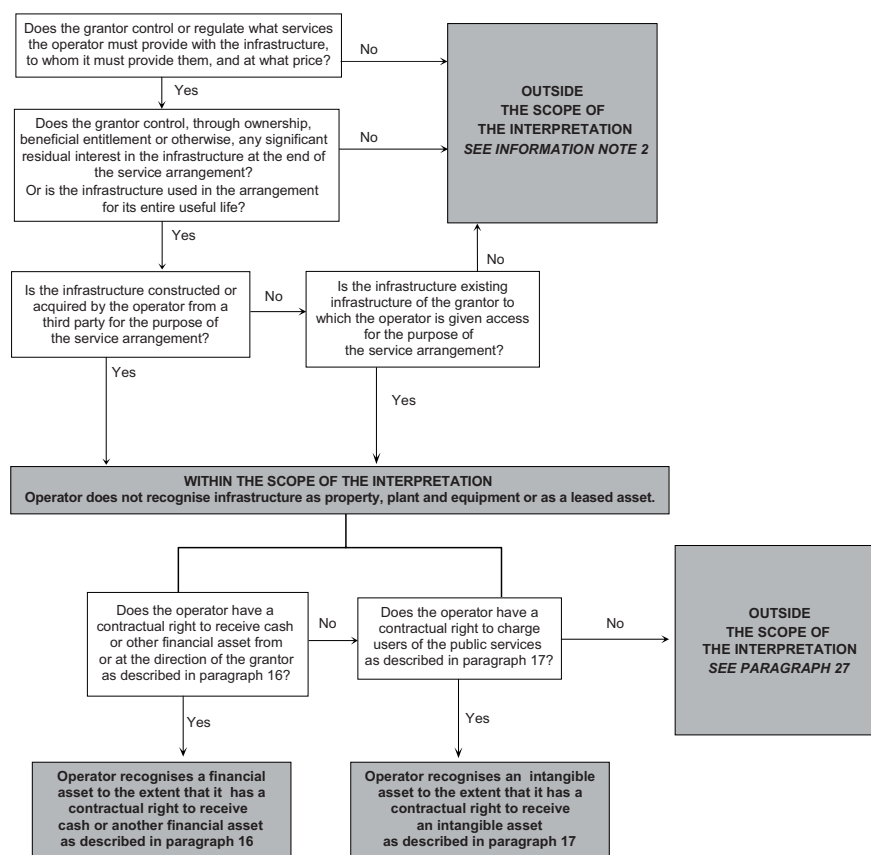
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## Information note 1

### Accounting framework for public-to-private service arrangements

*This note accompanies, but is not part of, IFRIC 12.*

The diagram below summarises the accounting for service arrangements established by IFRIC 12.



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## Information note 2

### References to IFRSs that apply to typical types of public-to-private arrangements

*This note accompanies, but is not part of, IFRIC 12.*

The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to IFRSs that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not the IFRIC's intention to convey the impression that bright lines exist between the accounting requirements for public-to-private arrangements.

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (eg Operator leases assets from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/ Privatisation/ Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8–20 years	1–5 years	25–30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant IFRSs	IAS 17	IAS 18	IFRIC 12		IAS 16	

## Illustrative examples

*These examples accompany, but are not part of, IFRIC 12.*

### Example 1: The grantor gives the operator a financial asset

#### Arrangement terms

- IE1 The terms of the arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3–10). The terms of the arrangement also require the operator to resurface the road at the end of year 8—the resurfacing activity is revenue-generating. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

**Table 1.1 Contract costs**

	Year	CU <sup>(a)</sup>
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

(a) in this example, monetary amounts are denominated in ‘currency units’ (CU).

- IE2 The terms of the arrangement require the grantor to pay the operator 200 currency units (CU200) per year in years 3–10 for making the road available to the public.
- IE3 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

#### Contract revenue

- IE4 The operator recognises contract revenue and costs in accordance with IAS 11 *Construction Contracts* and IAS 18 *Revenue*. The costs of each activity—construction, operation and resurfacing—are recognised as expenses by reference to the stage of completion of that activity. Contract revenue—the fair value of the amount due from the grantor for the activity undertaken—is recognised at the same time. Under the terms of the arrangement the operator is obliged to resurface the road at the end of year 8. In year 8 the operator will be reimbursed by the grantor for resurfacing the road. The obligation to resurface the road is measured at zero in the statement of financial position and the revenue and expense are not recognised in profit or loss until the resurfacing work is performed.

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- IE5 The total consideration (CU200 in each of years 3–8) reflects the fair values for each of the services, which are:

**Table 1.2 Fair values of the consideration received or receivable**

	Fair value		
Construction services	Forecast cost	+	5%
Operation services	" "	+	20%
Road resurfacing	" "	+	10%
Effective interest rate	6.18% per year		

- IE6 In year 1, for example, construction costs of CU500, construction revenue of CU525 (cost plus 5 per cent), and hence construction profit of CU25 are recognised in profit or loss.

### Financial asset

- IE7 The amounts due from the grantor meet the definition of a receivable in IAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.
- IE8 If the cash flows and fair values remain the same as those forecast, the effective interest rate is 6.18 per cent per year and the receivable recognised at the end of years 1–3 will be:

**Table 1.3 Measurement of receivable**

	CU
Amount due for construction in year 1	525
<b>Receivable at end of year 1<sup>(a)</sup></b>	<b>525</b>
Effective interest in year 2 on receivable at the end of year 1 (6.18% × CU525)	32
Amount due for construction in year 2	525
<b>Receivable at end of year 2</b>	<b>1,082</b>
Effective interest in year 3 on receivable at the end of year 2 (6.18% × CU1,082)	67
Amount due for operation in year 3 (CU10 × (1 + 20%))	12
Cash receipts in year 3	(200)
<b>Receivable at end of year 3</b>	<b>961</b>

- (a) No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year.

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## Overview of cash flows, statement of comprehensive income and statement of financial position

IE9 For the purpose of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be:

**Table 1.4 Cash flows** (currency units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs <sup>(a)</sup>	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs <sup>(b)</sup>	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

(a) Table 1.1

(b) Debt at start of year (table 1.6) × 6.7%

**Table 1.5 Statement of comprehensive income** (currency units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	12	12	12	12	12	122	12	12	1,256
Contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income <sup>(a)</sup>	-	32	67	59	51	43	34	25	22	11	344
Borrowing costs <sup>(b)</sup>	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	25	23	-	-	-	2	3	14	5	6	78

(a) Amount due from grantor at start of year (table 1.6) × 6.18%

(b) Cash/(debt) (table 1.6) × 6.7%

**Table 1.6 Statement of financial position** (currency units)

End of year	1	2	3	4	5	6	7	8	9	10
Amount due from grantor <sup>(a)</sup>	525	1,082	961	832	695	550	396	343	177	-
Cash/(debt) <sup>(b)</sup>	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Net assets	25	48	48	48	48	50	53	67	72	78

(a) Amount due from grantor at start of year, plus revenue and finance income earned in year (table 1.5), less receipts in year (table 1.4)

(b) Debt at start of year plus net cash flow in year (table 1.4)

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- IE10 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

### **Example 2: The grantor gives the operator an intangible asset (a licence to charge users)**

#### **Arrangement terms**

- IE11 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3–10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of the year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

**Table 2.1 Contract costs**

	Year	CU <sup>(a)</sup>
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

(a) in this example, monetary amounts are denominated in 'currency units' (CU).

- IE12 The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of 200 currency units (CU200) in each of years 3–10.
- IE13 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

#### **Intangible asset**

- IE14 The operator provides construction services to the grantor in exchange for an intangible asset, ie a right to collect tolls from road users in years 3–10. In accordance with IAS 38 *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of consideration transferred to acquire the asset, which is the fair value of the consideration received or receivable for the construction services delivered.



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- IE15 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) is classified as an intangible asset (licence to charge users of the infrastructure). The operator estimates the fair value of its consideration received to be equal to the forecast construction costs plus 5 per cent margin. It is also assumed that, in accordance with IAS 23 *Borrowing Costs*, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase of the arrangement:

**Table 2.2 Initial measurement of intangible asset**

	CU
Construction services in year 1 ( $\text{CU}500 \times (1 + 5\%)$ )	525
Capitalisation of borrowing costs (table 2.4)	34
Construction services in year 2 ( $\text{CU}500 \times (1 + 5\%)$ )	525
<b>Intangible asset at end of year 2</b>	<b>1,084</b>

- IE16 In accordance with IAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3–10. The depreciable amount of the intangible asset (CU1,084) is allocated using a straight-line method. The annual amortisation charge is therefore CU1,084 divided by 8 years, ie CU135 per year.

**Construction costs and revenue**

- IE17 The operator recognises the revenue and costs in accordance with IAS 11 *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration received or receivable. Thus in each of years 1 and 2 it recognises in its profit or loss construction costs of CU500, construction revenue of CU525 (cost plus 5 per cent) and, hence, construction profit of CU25.

**Toll revenue**

- IE18 The road users pay for the public services at the same time as they receive them, ie when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

**Resurfacing obligations**

- IE19 The operator's resurfacing obligation arises as a consequence of use of the road during the operating phase. It is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

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- IE20 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 (discounted to a current value) each year. The operator discounts the provision to its present value in accordance with IAS 37. The charge recognised each period in profit or loss is:

**Table 2.3 Resurfacing obligation** (currency units)

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	12	14	15	17	20	22	100

### Overview of cash flows, statement of comprehensive income and statement of financial position

- IE21 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be:

**Table 2.4 Cash flows** (currency units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs <sup>(a)</sup>	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs <sup>(b)</sup>	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

(a) Table 2.1

(b) Debt at start of year (table 2.6) × 6.7%

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**Table 2.5 Statement of comprehensive income (currency units)**

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	200	200	200	200	200	200	200	200	2,650
Amortisation	-	-	(135)	(135)	(136)	(136)	(136)	(136)	(135)	(135)	(1,084)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Other contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(1,080)
Borrowing costs <sup>(a)(b)</sup>	-	-	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(308)
Net profit	25	25	(26)	(20)	(14)	(6)	1	9	36	48	78

(a) Borrowing costs are capitalised during the construction phase.

(b) Table 2.4

**Table 2.6 Statement of financial position (currency units)**

End of year	1	2	3	4	5	6	7	8	9	10
Intangible asset	525	1,084	949	814	678	542	406	270	135	-
Cash/(debt) <sup>(a)</sup>	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	50	24	4	(10)	(16)	(15)	(6)	30	78

(a) Debt at start of year plus net cash flow in year (table 2.4)

IE22 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

### Example 3: The grantor gives the operator a financial asset and an intangible asset

#### Arrangement terms

IE23 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and to operate the road and maintain it to a specified standard for eight years (ie years 3–10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

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**Table 3.1 Contract costs**

	Year	CU <sup>(a)</sup>
Construction services	1	500
	2	500
Operation services (per year)	3–10	10
Road resurfacing	8	100

(a) in this example, monetary amounts are denominated in 'currency units' (CU).

- IE24 The operator estimates the consideration in respect of construction services to be cost plus 5 per cent.
- IE25 The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of CU700 and interest at a specified rate of 6.18 per cent to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3–10.
- IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

**Dividing the arrangement**

- IE27 The contractual right to receive cash from the grantor for the services and the right to charge users for the public services should be regarded as two separate assets under IFRSs. Therefore in this arrangement it is necessary to divide the operator's consideration into two components—a financial asset component based on the guaranteed amount and an intangible asset for the remainder.

**Table 3.2 Dividing the operator's consideration**

Year	Total	Financial asset	Intangible asset
Construction services in year 1 (CU500 × (1 + 5%))	525	350	175
Construction services in year 2 (CU500 × (1 + 5%))	525	350	175
Total construction services	1,050	700	350
	100%	67% <sup>(a)</sup>	33%
Finance income, at specified rate of 6.18% on receivable (see table 3.3)	22	22	-
Borrowing costs capitalised (interest paid in years 1 and 2 × 33%) (see table 3.7)	11	-	11
Total fair value of the operator's consideration	1,083	722	361

(a) Amount guaranteed by the grantor as a proportion of the construction services

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### Financial asset

- IE28 The amount due from or at the direction of the grantor in exchange for the construction services meets the definition of a receivable in IAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments.
- IE29 On this basis the receivable recognised at the end of years 2 and 3 will be:

**Table 3.3 Measurement of receivable**

	CU
Construction services in year 1 allocated to the financial asset	350
<b>Receivable at end of year 1</b>	<b>350</b>
Construction services in year 2 allocated to the financial asset	350
Interest in year 2 on receivable at end of year 1 ( $6.18\% \times \text{CU}350$ )	22
<b>Receivable at end of year 2</b>	<b>722</b>
Interest in year 3 on receivable at end of year 2 ( $6.18\% \times \text{CU}722$ )	45
Cash receipts in year 3 (see table 3.5)	(117)
<b>Receivable at end of year 3</b>	<b>650</b>

### Intangible asset

- IE30 In accordance with IAS 38 *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of the consideration received or receivable.
- IE31 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) is classified as a right to receive a licence to charge users of the infrastructure. The operator estimates the fair value of its consideration received or receivable as equal to the forecast construction costs plus 5 per cent. It is also assumed that, in accordance with IAS 23 *Borrowing Costs*, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase:

**Table 3.4 Initial measurement of intangible asset**

	CU
Construction services in year 1 ( $\text{CU}500 \times (1 + 5\%) \times 33\%$ )	175
Borrowing costs (interest paid in years 1 and 2 $\times 33\%$ ) (see table 3.7)	11
Construction services in year 2 ( $\text{CU}500 \times (1 + 5\%) \times 33\%$ )	175
<b>Intangible asset at the end of year 2</b>	<b>361</b>

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- IE32 In accordance with IAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3–10. The depreciable amount of the intangible asset (CU361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore CU361 divided by 8 years, ie CU45 per year.

### Contract revenue and costs

- IE33 The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator recognises contract revenue and costs in accordance with IAS 11 *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration receivable. Thus in each of years 1 and 2 it recognises in profit or loss construction costs of CU500 and construction revenue of CU525 (cost plus 5 per cent).

### Toll revenue

- IE34 The road users pay for the public services at the same time as they receive them, ie when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset:

**Table 3.5 Allocation of toll receipts**

Year	CU
Guaranteed receipt from grantor	700
Finance income (see table 3.8)	237
Total	937
<b>Cash allocated to realisation of the financial asset per year (CU937/8 years)</b>	<b>117</b>
Receipts attributable to intangible asset (CU200 × 8 years – CU937)	663
<b>Annual receipt from intangible asset (CU663/8 years)</b>	<b>83</b>

### Resurfacing obligations

- IE35 The operator's resurfacing obligation arises as a consequence of use of the road during the operation phase. It is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- IE36 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 each year. The operator discounts the provision to its present value in accordance with IAS 37. The charge recognised each period in profit or loss is:

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**Table 3.6 Resurfacing obligation** (currency units)

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	12	14	15	17	20	22	100

### Overview of cash flows, statement of comprehensive income and statement of financial position

IE37 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be:

**Table 3.7 Cash flows** (currency units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs <sup>(a)</sup>	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs <sup>(b)</sup>	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

(a) Table 3.1

(b) Debt at start of year (table 3.9) × 6.7%

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**Table 3.8 Statement of comprehensive income (currency units)**

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue on construction	525	525	-	-	-	-	-	-	-	-	1,050
Revenue from intangible asset	-	-	83	83	83	83	83	83	83	83	663
Finance income <sup>(a)</sup>	-	22	45	40	35	30	25	19	13	7	237
Amortisation	-	-	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(46)	(361)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Construction costs	(500)	(500)									(1,000)
Other contract costs <sup>(b)</sup>			(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(80)
Borrowing costs (table 3.7) <sup>(c)</sup>	-	(23)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(331)
Net profit	25	24	(8)	(7)	(5)	(2)	0	2	22	27	78

(a) Interest on receivable

(b) Table 3.1

(c) In year 2, borrowing costs are stated net of amount capitalised in the intangible (see table 3.4).

**Table 3.9 Statement of financial position (currency units)**

End of year	1	2	3	4	5	6	7	8	9	10
Receivable	350	722	650	573	491	404	312	214	110	-
Intangible asset	175	361	316	271	226	181	136	91	46	-
Cash/(debt) <sup>(a)</sup>	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	49	41	34	29	27	27	29	51	78

(a) Debt at start of year plus net cash flow in year (table 3.7)

IE38 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.