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**International
Accounting Standards
Board**

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

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

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

Project: Service Concession Arrangements (Agenda paper 4)

Introduction and Purpose of this Paper

1. Draft Interpretations D12-14 apply to service concession arrangements where the operator does not recognise the service concession infrastructure as its own property plant and equipment. Instead, depending on the contractual terms of the arrangement it recognises either a financial asset, ie a receivable, or an intangible asset, ie the right to charge users for the construction services provided.
2. At its March 2006 meeting, the IFRIC considered the comments received on the differing accounting treatments for operations and maintenance obligations under the financial (D13) and the intangible (D14) asset models. Some respondents questioned the proposal stating that it would cause identical operations and maintenance obligations to be accounted for differently. Others acknowledged their unease but noted that the proposals were consistent with IFRS.
3. At the May 2006 IASB meeting, an education session was held on service concession arrangements. Generally the work of the IFRIC in the post-exposure

deliberations was well received by the Board. However, some Board members expressed concern at the different accounting treatments for similar operations and maintenance obligations.

4. This paper summarises the requirements under D13 and D14 and sets out the findings of further research conducted by staff to obtain an understanding of how the contractual commitments for operations and maintenance obligations of service concession arrangements work in practice. The paper then sets out the staff conclusions and recommends that the IFRIC modify certain aspects of the proposals. The IFRIC is asked whether it agrees with the amendments. Appendix A of the paper includes some background to the specific contractual commitments existing in practice.

Summary of Staff Recommendation

5. The operator recognises revenue for providing construction services equal to the fair value consideration received for that service on a percentage of completion basis. The consideration received can be cash, a receivable or an intangible asset. Under the proposals in D12-14 the nature of the asset recognised as a result of the operator providing construction services dictates the subsequent accounting for the operation and maintenance activities of the arrangement.
6. Under D14 the operator's revenue is contingent on usage; the operator recognises revenue at the same time as users receive the services. Day-to-day operating and maintenance costs are recognised in the income statement as incurred and obligations to maintain the infrastructure at its current level of serviceability ('infrastructure maintenance') are accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Asset*, ie provision is made for the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
7. In contrast, under D13 the grantor separately guarantees the operator's return on each activity; hence the guidance requires all activities to be treated as revenue generating, ie each activity (day-to-day operation and maintenance and infrastructure maintenance) is revenue generating and is measured under the proposals at the fair value of the consideration received or receivable. The

operator recognises contract revenue and costs in accordance with IASs 11 *Construction Contracts* and IAS 18 *Revenue* ie on a percentage of completion basis.

8. In light of the comments received and subsequent discussions with constituents, staff recommend that the application guidance of the financial asset model set out in D13 be modified to reflect the economic situation that exists in practice. In most cases the result will be that the operation and maintenance obligations under the financial asset model should be accounted for in the same way as under as under the application guidance of D14.

Accounting treatment under D13 and D14

Financial asset— the grantor guarantees the operator’s returns on each activity

9. Under the application guidance included in D13, revenue in the operational phase of the contract is allocated on a basis that assumes that the grantor separately guarantees the operator’s return on each activity, ie construction, day-to-day operation and maintenance and infrastructure maintenance. Each activity is treated as revenue generating and is measured under the proposals at the fair value of the consideration received or receivable. The operator recognises contract revenue and costs in accordance with IAS 11 ie on a percentage of completion basis. The costs of each activity—construction, day to day operation maintenance and infrastructure maintenance—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. The receivable is settled (similarly to a long-term loan), together with interest accrued, by payments to the operator over the term of the concession.
10. In these types of arrangements operational risk and demand risk are generally with the grantor. The main drawback of these types of arrangements is that they give little incentive to the operator to cut costs; consequently they are rare in practice.

Intangible asset—operator's returns are contingent on usage levels

11. *Construction service*: under the proposals the operator recognises revenue and costs of the construction service in accordance with IAS 11 ie on a percentage of completion basis. The intangible asset represents that the grantor has made a non-cash payment for the construction services rendered, ie the grantor has granted the operator a right to charge users for the services provided. The operator then uses the intangible asset to generate further revenues from users of the infrastructure, from which is deducted the amortisation of the intangible.
12. *Subsequent accounting*: the operator is paid for the concession services in proportion to the take-up by users; the operator recognises revenue at the same time as users receive the services. Day-to-day operating and maintenance costs are recognised in the income statement as incurred.
13. Paragraph 10 of D14 requires operators applying the intangible asset model to exclude repair and maintenance obligations (infrastructure maintenance) from the consideration given for the intangible asset. It requires the operator to account for such obligations in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ie provision should be made for the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
14. Under these types of arrangements the operator generally assumes all operational risk and demand risk. The main idea is to provide an incentive to the operator to cut costs and improve productive efficiency above the levels set by the regulator when calculating the user fee (tariff or price cap). The larger the gap between the tariff and the incurred cost, the larger the profit rate. The payoff from an increase in that gap is what drives the operator's incentive to cut costs.

Findings of Staff Research

15. An example of a typical arrangement that falls within the scope of the draft Interpretations would be a build-operate-transfer or a rehabilitate-operate-transfer arrangement. These arrangements are essentially multiple element service arrangements, typically they involve the operator providing two distinguishable services:

- an initial construction, upgrading or major rehabilitation;
- operation and maintenance services of the utility;

The operator is paid for its services from the revenue collected over the term of the concession—typically 25-30 years

16. The concession is governed by a contract that sets out performance standards, arrangements for capital investments, mechanisms for adjusting tariffs, and arrangements for arbitrating disputes.
17. In these types of arrangements the key matter that needs to be determined is the amount of revenue (ie the consideration) that the operator is allowed to earn for its services. In setting the revenue that the operator is allowed to earn, governments and regulators need to consider not just the full cost of services described above, but also the annual cash needs of the utility, and the financial ratios required by lenders.
18. For example, if assets are financed with loans whose term is shorter than the asset life, the utility will need to earn enough cash to repay the loan before the full revenues from the project have been received, which may mean that revenues would need to be higher than implied by a standard cost recovery calculation.

Determination of the operator’s revenue under the arrangement

19. There is a wide range of operation and maintenance arrangements in practice. The terms of the agreement depend on the objectives of the grantor and the operator in negotiating the arrangement, the jurisdiction and the industry sector.
20. The input staff has received on this matter indicates that service concession arrangements are almost always negotiated as one contract that is, the operations and maintenance aspects are negotiated in conjunction with the construction aspects. The revenue for each activity is not negotiated separately as implied by the application guidance included in D13.
21. The level of revenue that the operator is allowed to earn is set (either through tariff rates or according to a formula agreed between the operator and the

grantor) after taking into account the cost structure of the entire arrangement. The objective is that the concession arrangement yields enough revenue to enable the operator to recover the costs of the services and obtain a commercial return.

22. Typically the cost of the service has three main elements:
 - i. Construction or rehabilitation;
 - ii. Operating and maintenance
 - i. day-to-day expenses involved in providing services and keeping the infrastructure functioning, including labour costs, electricity, chemicals, repairs to equipment, and the like;
 - ii. infrastructure maintenance ie restoration of the reduction in value of the infrastructure over time; this is roughly equivalent to the amount of money needed to replace assets as they wear out – infrastructure assets like power generators, treatment plants, pipes and road surfaces do not generally wear out and then get replaced all at once, but rather are maintained and renewed in a continual process; and
 - iii. Return on capital, ie the interest on debt and the return on equity. The so-called weighted average cost of (debt and equity) capital is usually considered an appropriate measure of the required rate of return on capital.
23. Once there is a clear idea of total costs of the service, the next step is to decide whether the users or the grantor, through subsidies, should pay for the services. Some infrastructure sectors (power supply, ports, airports, telecommunications) depend wholly on direct user fees, while others (water supply, urban transport, roads) depend on the grantor guaranteeing to pay for a specified amount of output (take-or-pay contracts) whether or not the service is used. For the arrangement to be viable the sum of the users' fees and subsidies must add up to the cost of the services and provide the operator with a commercial return.
24. Although total revenues are determined by reference to the entire costs of the contract, in most circumstances the operator does not earn additional revenue for

additional costs incurred (ie the operator is not paid for its services on a 'cost plus' basis) as set out in the application guidance in D13. Rather as noted above, the operator's revenue for the operational phase of the contract is set through a tariff (user fee) structure or through a formula agreed between the grantor and the operator. In each case the revenue is earned for the service provided not simply because costs have been incurred.

Staff conclusions

25. Under the proposals in D12-14 the nature of the asset recognised as a result of the operator providing construction services dictates the subsequent accounting for the operation and maintenance activities of the arrangement.
26. The above analysis indicates that the nature of operations and maintenance obligations is not directly affected by the nature of the underlying asset recognised in accordance with D12. That is, the nature of an entity's operations and maintenance obligations is not directly affected by the type of asset resulting from the construction services provided. Consequently, the staff agrees with respondents who protested that under the proposals identical operation and maintenance arrangements would be accounted for differently.
27. The staff believes that the following accounting treatments for operation and maintenance services are appropriate because they reflect the different economic situations that exist in practice ie:
 - i. In rare circumstances, the operations and maintenance arrangements are on a 'cost plus' basis as illustrated in the worked example included in D13. In these circumstances the fulfilment of the operations and maintenance obligations will result in the operator earning additional revenue. That is the operator is reimbursed for its operations and maintenance spend (day-to-day costs and infrastructure maintenance), plus an agreed margin. Hence each service activity is revenue generating and costs and revenue are recognised in accordance with IAS 11, ie percentage of completion basis. The accounting treatment for these types of arrangements is more fully described in paragraphs 9-10 of this paper and illustrated in the worked example included in D14.

- ii. More often the operator is not specifically reimbursed for the operations and maintenance costs. Instead the revenue for the operational phase is included in the tariff that the operator is allowed to charge for its services or in the payment formula agreed between the grantor and the operator. Unlike the ‘cost plus’ approach described above, in these circumstances the operational phase of the contract will not generate specific revenue streams; however an entity will have operation and maintenance obligations under the contract. These will generally include day-to-day operation and maintenance and infrastructure maintenance including an obligation to return the infrastructure in a specified state of serviceability. The accounting treatment for these types of arrangements is described in paragraphs 11-14 of this paper and illustrated in the worked example included in D14.

Take a basic example, the total amount of consideration for a service concession arrangement is CU 120 million. The fair value of the construction services is CU 100 million, and the fair value of the operation and maintenance services is CU 20 million (day-to-day operation and maintenance CU 15 million and infrastructure maintenance of CU 5 million). The grantor contractually guarantees the operator’s consideration of CU 100 million ie the fair value of the construction services. In this situation the operator would recognise revenue (and associated costs) of CU 100 million in accordance with IAS 11, ie percentage of completion accounting, and a corresponding amount as a financial asset. The remainder of the consideration would be recognised as the consumers use the service. Day-to-day operation and maintenance costs (CU 15 million) would be expensed as incurred and infrastructure maintenance obligations of CU 5 million would be accounted for in accordance with IAS 37, ie provision should be made for the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

Treatment of infrastructure maintenance

28. The staff believes that the accounting treatment of infrastructure maintenance obligations in accordance with IAS 37 is a reasonable one. By excluding ‘infrastructure maintenance’ costs from the consideration given for the intangible asset, the IFRIC is viewing them as a cost of operating the service for

users—not as services performed for (and paid for by) the grantor. The work does not generate revenue directly—for example a road user is paying for the access to the grantor’s road, not for its upkeep. Once a road-user has driven down the road, he has received all the benefit for which he paid the toll. The toll should be recognised as revenue immediately. The damage to the road gives rise to a future cost for which there is no related revenue. It should therefore be provided for in accordance with IAS 37.

29. This ‘infrastructure maintenance’ approach focuses on measuring the expenditure needed to maintain assets at their current level of serviceability. This approach recognises that infrastructure assets like power generators, treatment plants, pipes and road surfaces do not generally wear out and then get replaced all at once, but rather are maintained and renewed in a continual process. It is the operator’s responsibility to maintain the infrastructure (surface of the road, pipes etc) to a specified level of serviceability. The obligation to maintain the infrastructure is measured by the amount of deterioration to the infrastructure.

Staff Recommendation

30. The operator recognises revenue for providing construction services equal to the fair value of consideration received for that service on a percentage of completion basis. The consideration received can be cash, a receivable or an intangible asset. Under the proposals in D12-14 the nature of the asset recognised as a result of the operator providing construction services dictates the subsequent accounting for the operation and maintenance activities of the arrangement. As a result, the costs and revenues associated with fulfilling these obligations will not be recognised at the same time under the two models.
31. Under D14 the operator’s revenue is contingent on usage ie the operator is paid for the concession services in proportion to the take-up by users; the operator recognises revenue at the same time as users receive the services. Day-to-day operating and maintenance costs are recognised in the income statement as incurred and obligations to maintain the infrastructure at their current level of serviceability (‘infrastructure maintenance’) are accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie

provision should be made for the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

32. In contrast, under D13 the grantor separately guarantees the operator's return on each activity; hence the guidance requires all activities to be treated as revenue generating, ie each activity (day-to-day operation and maintenance and infrastructure maintenance) is revenue generating and is measured under the proposals at the fair value of the consideration received or receivable. The operator recognises contract revenue and costs in accordance with IASs 11 *Construction Contracts* and IAS 18 *Revenue* ie on a percentage of completion basis.
33. In light of the comments received and subsequent discussions with constituents' in France, Germany, Spain, Australia and the United Kingdom staff recommend that the application guidance of the financial asset model set out in D13 be modified to reflect the economic situation that exists in practice see paragraph 27 (ii). In most cases the result will be that the operation and maintenance obligations under the financial asset model should be accounted for as described in paragraphs 12-14 of this paper and set out in the application guidance in D14. The benefit of this amendment is that the guidance does not apply different accounting to similar obligations.
34. In addition the staff believe that it is necessary to clarify the distinction between the treatment of day-to-day operation and maintenance services and infrastructure maintenance in the draft Interpretations. The text in paragraph 22 (ii) could be used to achieve this.

35. Does the IFRIC agree?

Appendix A

Level of Detail

The level of detail involved in the repairs and maintenance clauses of service concession arrangements varies greatly by industry, jurisdiction, and objective of the grantor in entering into the arrangement. They may contain very specific clauses such as

The exact parts which must be replaced and the timing on which they must be replaced (possibly even expressed in days)

Target levels of expenditure in given periods

Other contracts may have very general clauses such as

The road must be maintained in ‘good working order’; or

The water network must be maintained so as to ensure no more than x% leakage;
or

The hospital must be maintained such that it has y years of useful life remaining at the end of the service concession arrangement.

Furthermore, irrespective of the level of detail in the contract, actual repairs and maintenance will vary from that set out in the contract. For example, a water supply contract might state that all pipes with a 5cm diameter in an area will be replaced in year one, and all of the pipes with a 7.5cm diameter will be replaced in year two. If, during year one, one of the pipes with a 7.5cm diameter springs a leak, it will not be left to leak until its due date for replacement. Accordingly, it should be noted even the most detailed contractual terms will not accurately capture all of the actual repairs and maintenance activities during the term of the contract.

Major overhaul

Some contracts require major overhaul of the infrastructure asset at some point during the service concession arrangements, for example, re-surfacing of a road or replacement of rolling stock in a public transport arrangement. Commonly no

additional payments are made by the grantor when this cyclical maintenance is completed, rather it is funded by the total cash flows received over the duration of the arrangement.

Hand back clauses

Many contracts have specific hand back clauses. A common clause is that the infrastructure must be handed back at the end of the service concession arrangement with x remaining years of useful life.

Penalties

There is a range of régimes in place for penalising the operator where repairs and maintenance obligations are not met. Some are direct (i.e. failure to comply with a specific repair and maintenance clause leads directly to a financial penalty), others are indirect (i.e. failure to comply with repairs and maintenance clauses might lead to non-availability of the infrastructure asset which would lead to a financial penalty). In most, but not all, jurisdictions the greater the level of detail in the concession contract the more direct the relationship between a failure to comply and a financial penalty.

Use of an Escrow account

In some jurisdictions, an escrow account is required to be used. This requires an operator to place funds in a separate trust account that will finance the significant repairs and maintenance requirements in the later years of the contract. This structure is designed to incentivise operators to see the concession arrangement through to its completion rather than defaulting under the concession deed. Some grantors take the view that as cash flows over the concession are generally flat, and some of the cash received in early years is paid to reimburse the operator for repairs and maintenance spend in the later years, that those operators should be required to ring fence that cash until such time as the operator has completed the activities for which it was being compensated.

Cost Plus contracts

In rare (but not unheard of) circumstances, the repairs and maintenance arrangements are organised on a 'cost plus' basis. That is the operator is reimbursed for its repairs and maintenance spend, plus an agreed margin.