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International Financial Reporting Interpretations Committee

IFRIC DRAFT INTERPRETATION D13

Service Concession Arrangements—The Financial Asset Model

Comments to be received by 3 May 2005

IFRIC Draft Interpretation D13 *Service Concession Arrangements—The Financial Asset Model* is published by the International Accounting Standards Board (IASB) for comment only. Comments on the draft Interpretation should be submitted in writing so as to be received by **3 May 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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INVITATION TO COMMENT

The International Accounting Standards Board's International Financial Reporting Interpretations Committee (IFRIC) invites comments on any aspect of this draft Interpretation *Service Concession Arrangements—The Financial Asset Model.* It would particularly welcome answers to the questions below. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **3 May 2005**.

Questions

1 As discussed in paragraphs BC3-BC5, the proposals in the draft Interpretation are based on a conclusion by the IFRIC that the discharge of each contractual obligation (including obligations to repair and maintain the infrastructure) gives rise to revenue for the operator. Do you agree with this conclusion? (Question 3 in the Invitation to Comment on draft Interpretation D14 *Service Concession Arrangements—the Intangible Asset Model* poses a similar question in relation to the intangible asset model.)

2 As explained in paragraphs BC6 and BC7, the IFRIC has concluded that, applying IAS 11 *Construction Contracts,* operators might recognise different profit margins on different activities undertaken within a single service concession contract. Do you agree with this conclusion?

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IFRIC [draft] Interpretation X *Service Concession Arrangements—The Financial Asset Model* ([draft] IFRIC X) is set out in paragraphs 1-19 and the Appendix. [Draft] IFRIC X is accompanied by an Illustrative Example and a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 1 and 8-10 of the IFRIC *Preface*.

References

- IFRS 1 *First-time Adoption of International Financial Reporting Standards*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- IAS 23 *Borrowing Costs*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IAS 39 *Financial Instruments: Recognition and Measurement*
- [Draft] Interpretation [D12] *Service Concession Arrangements—Determining the Accounting Model*
- [Draft] Interpretation [D14] *Service Concession Arrangements—The Intangible Asset Model*

Background

1 [Draft] Interpretation [D12] and its Basis for Conclusions set out the background to the IFRIC's project on accounting for service concession arrangements and explain that, because of the range of issues to be covered, the IFRIC decided to prepare a series of related Interpretations, rather than a single document.

2 [D12] states that, for service concession arrangements within its scope, the operator should not recognise the infrastructure used to provide the concession services as its property, plant and equipment. Rather, the operator should account for the rights it receives in exchange for constructing the infrastructure using:

(a) the financial asset model—if the grantor has the primary responsibility to pay the operator for the concession services; or

(b) the intangible asset model—if users have the primary responsibility to pay the operator for the concession services.

3 Under the financial asset model, the right received by the operator in exchange for construction services or other consideration is accounted for as a financial asset. This [draft] Interpretation describes how the financial asset model should be applied.

Scope

4 This [draft] Interpretation applies to the accounting by the operator in all service concession arrangements to which [D12] requires the financial asset model to be applied. This [draft] Interpretation does not specify the accounting by grantors.

Issues

5 This [draft] Interpretation sets out general principles on recognising and measuring the obligations and related rights in a service concession arrangement and addresses how, under the financial asset model, the following items should be accounted for by the operator:

(a) the amount due from the grantor in respect of construction or other services;

(b) borrowing costs incurred by the operator;

(c) items provided to the operator by the grantor; and

(d) commitments to transfer or return infrastructure to the grantor at the end of the service concession.

Consensus

Recognition and measurement

6 Contract obligations and related rights shall be recognised and measured in accordance with IASs 11 and 18, and with the principles set out below, which are consistent with those Standards.

7 As regards recognition:

(a) if it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.

(b) otherwise, no obligation or related right shall be recognised to the extent that contracts are, and remain, executory.

(c) an obligation shall be recognised when consideration is received in advance of performance.

(d) a financial asset, being an amount due from the grantor under a contract, shall be recognised when the operator performs in advance of receiving consideration.

8 As regards initial measurement:

(a) obligations under contracts shall be measured on the basis of the consideration received for their performance.

(b) financial assets shall be measured at fair value.

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

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

(a) a loan or receivable;

(b) an available-for-sale financial asset; or

(c) if so designated upon initial recognition, a financial asset at fair value through profit or loss.

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

11 If the amount due from the grantor is accounted for either as a loan or receivable or as an available-for-sale financial asset, IAS 39 requires interest calculated using the effective interest method to be recognised in profit or loss.

Borrowing costs incurred by the operator

12 If the operator adopts the allowed alternative treatment in IAS 23, it shall capitalise borrowing costs attributable to contract activity in accordance with that Standard. Capitalisation shall cease when required by IAS 23, which is no later than when revenue is recognised in relation to the relevant activity.

Items provided to the operator by the grantor

13 In accordance with [D12], infrastructure items to which the operator is given access by the grantor for the purpose of the service concession are not recognised as property, plant and equipment of the operator.

14 The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the concession services, they are not government grants as defined in IAS 20. They shall be recognised as assets of the operator, measured at fair value on initial recognition. A liability shall be recognised in respect of unfulfilled obligations assumed in exchange for the assets.

Commitments to transfer or return assets to the grantor at the end of the concession

15 As infrastructure within the scope of this [draft] Interpretation is not recognised as property, plant and equipment of the operator, the operator shall not recognise any liability in respect of its commitment to transfer or return the infrastructure to the grantor at the end of the service concession.

16 Contractual obligations that the operator must fulfil before the transfer or return—such as obligations to restore the infrastructure to a specified condition—shall be accounted for in accordance with paragraphs 6-8 above.

Effective date

17 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [1 January 2006]. Earlier application is encouraged. If an entity applies this [draft] Interpretation for a period beginning before [1 January 2006], it shall disclose that fact.

Transition

18 Subject to paragraph 19, changes in accounting policies shall be accounted for in accordance with IAS 8.

19 If, for any particular service concession arrangement, it is impracticable for an operator to apply this [draft] Interpretation retrospectively at the start of the earliest period presented, it shall:

(a) recognise financial assets that existed at the start of the earliest period presented;

(b) use the previous carrying amounts of those financial assets (however previously classified) as their carrying amounts as at that date; and

(c) test recognised financial assets for impairment as at that date, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

Appendix

Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*

The amendments in this appendix shall be applied for annual periods beginning on or after [1 January 2006]. If an entity applies the [draft] Interpretation for an earlier period, these amendments shall be applied for that earlier period.

A1 IFRS 1 *First-time Adoption of International Financial Reporting Standards* is amended as described below. New text is underlined and deleted text struck through.

Paragraph 9 is amended to include an additional reference to a new paragraph 25H:

9 The transitional provisions in other IFRSs apply to changes in accounting policies made by an entity that already uses IFRSs; they do not apply to a *first-time adopter's* transition to IFRSs, except as specified in paragraphs 25D, 25H, 34A and 34B.

In paragraph 12(a), the reference to paragraphs 13-25F is changed to 13-25H.

In paragraph 13, subparagraphs (k) and (l) are amended, and subparagraph (m) is inserted, as follows:

(k) leases (paragraph 25F); ~~and~~

(l) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph 25G)~~.~~; and

(m) service concession assets accounted for using the financial or intangible asset models (paragraph 25H).

After paragraph 25G, a new heading and paragraph 25H are inserted as follows:

Service concession arrangements

25H A first-time adopter may apply the transitional provisions in [draft] IFRIC Interpretations [D13] *Service Concession Arrangements—The Financial Asset Model* and [D14] *Service Concession Arrangements—The Intangible Asset Model.*

Illustrative Example – The Financial Asset Model

This [draft] example accompanies, but is not part of, the [draft] Interpretation.

Concession terms

IE1 The terms of a service concession 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 concession also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator forecasts that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the concession will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1 *Contract costs*

	Year	Currency units
Construction	1	500
	2	500
Operation and maintenance (per year)	3-10	10
Road resurfacing	8	100

IE2 The terms of the concession 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*. The costs of each activity—construction, operation, maintenance 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.

IE5 The total receipts from the grantor (CU200 in each of years 3-8) reflect the fair values for each of the activities, which are:

Table 2 *Fair values of services provided by operator*

	Fair value		
Construction	Forecast cost	+	5%
Operation and maintenance	“ “	+	20%
Road resurfacing	“ “	+	10%
Lending rate to grantor	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 the income statement.

Financial asset

IE7 The operator determines that the amount due from the grantor 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 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 and the receivable recognised at the end of years 1-3 will be:

Table 3 ***Measurement of receivable***

	Currency units
Amount due for construction in year 1	525
Receivable at end of year 1*	525
Effective interest in year 2 (6.18% x CU525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	1,082
Effective interest in year 3 (6.18% x CU1,082)	67
Amount due for operation in year 3 (CU10 + 20%)	12
Cash receipts in year 3	(200)
Receivable at end of year 3	961

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

Overview of cash flows, income statement and balance sheet

IE9 For the purpose of this illustration, it is assumed that the operator finances the concession 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, income statement and balance sheet over the duration of the concession will be:

Table 4 ***Cash flows*** (currency units)

Year	1	2	3	4	5	6	7	8	9	10
Receipts	-	-	200	200	200	200	200	200	200	200
Contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)
Finance costs**	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183

* Table 1
** Debt at start of year (table 6) x 6.7%

Table 5 ***Income statement*** (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
Operating costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income*	-	32	67	59	51	43	34	25	22	11	344
Finance costs**	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	25	23	-	-	-	2	3	14	5	6	78

* Amount due from grantor at start of year (table 6) x 6.18%
** Table 4

Table 6 *Balance sheet* (currency units)

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

* Amount due from grantor at start of year, plus revenue and finance income earned in year (table 5), less receipts in year (table 4).

** Debt at start of year plus net cash flow in year (table 4).

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft Interpretation.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Scope

BC2 The IFRIC agreed that the scope of this draft Interpretation should be consistent with that of draft Interpretation D12 *Service Concession Arrangements—Determining the Accounting Model.* Therefore, it applies only to those arrangements for which D12 specifies that the financial asset model should be applied, and deals only with the accounting by the operator.

Recognition and measurement principles

BC3 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* describes executory contracts as 'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent'. It is current practice not to recognise executory contracts to the extent that they are unperformed by both parties (unless the contract is onerous). Therefore, the IFRIC agreed that an obligation should be recognised only when consideration is received in advance of performance. Likewise, the rights arising from fulfilling obligations (ie an amount receivable under a contract) should be recognised only when an entity fulfils these obligations in advance of receiving consideration.

BC4 The accounting requirements for revenue and profit recognition on construction and service contracts are addressed in IAS 11 *Construction Contracts* and IAS 18 *Revenue*. Under those Standards, no gain or loss is recognised on entering into a contract. Revenue and profit arise only as outputs are produced (and, in some cases, not until they are delivered). Therefore:

(a) unfulfilled obligations are measured on the basis of the consideration received for their performance.

(b) consideration receivable is measured initially at fair value.

If an obligation is discharged through a revenue-earning activity (for example, the construction of a new item of infrastructure on which a margin is earned), revenue and profit are not recognised until the work is performed.

BC5 The IFRIC noted that all contractual obligations (including obligations to repair and maintain the infrastructure) recognised using the financial asset model are obligations in respect of which revenue is recognised. Consequently, in accordance with IAS 11, they are measured on the basis of the amount of revenue received in advance of their performance, rather than in accordance with IAS 37, which might give a different measure.

BC6 IAS 11 requires contract revenue to be measured at the fair value of the consideration received or receivable. It requires the revenue to be recognised by reference to the stage of completion of the contract activity. Paragraph 30 of IAS 11 notes that the stage of completion may be determined in a variety of ways and that the entity should use the method that measures reliably the work performed. The IFRIC concluded that this requirement permits revenue to be allocated to different activities within a single contract by reference to the fair values of those activities.

BC7 The IFRIC noted that, if the revenue attributable to different activities is allocated by reference to their fair values, the entity might report different profit margins on these different activities, even though the contract has not been segmented for the purposes of applying IAS 11. This outcome is illustrated in the Illustrative Example that accompanies the draft Interpretation: different profit margins are recognised on the construction, operating and resurfacing activities that take place within one overall contract.

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

BC8 Paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* identifies and defines four categories of financial asset: (i) those held at fair value through profit or loss; (ii) held-to-maturity investments; (iii) loans and receivables; and (iv) available-for-sale financial assets.

BC9 Paragraph 10 of the draft Interpretation assumes that service concession assets will not be categorised as held-to-maturity investments. Paragraph 9 of IAS 39 states that a financial asset may not be classified as a held-to-maturity investment if it meets the definition of a loan or receivable. An asset that meets the definition of a held-to-maturity investment will meet the definition of a loan or receivable unless:

(a) it is quoted in an active market; or

(b) the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

It is not envisaged that a service concession asset will ever be quoted in an active market. Hence the circumstances of (a) will not arise. In the circumstances of (b), the asset must be classified as available for sale (if not designated upon initial recognition as at fair value through profit or loss).

BC10 The IFRIC believes that there may be circumstances other than credit deterioration in which an operator may not recover substantially all of its initial investment. Such circumstances may arise if the amount receivable from the grantor for the initial construction is not fixed but could vary, for example on the basis of demand or availability.

BC11 The IFRIC also discussed whether, if the amount to be received by the operator could vary either with demand or the quality of subsequent services, the contract would include an embedded derivative. The IFRIC concluded that it could not, because the definition of a derivative in IAS 39 requires, among other things, that the variable is not specific to a party to the contract. The consequence is that the contract's provision for variations in payments does not meet the definition of a derivative and, accordingly, the requirements of IAS 39 in relation to embedded derivatives do not apply.

Borrowing costs incurred by the operator

BC12 IAS 11 states that costs that may be attributable to contract activity in general and can be allocated to specific contracts include borrowing costs when the contractor adopts the allowed alternative treatment in IAS 23 *Borrowing Costs*. IAS 18 provides that costs of contracts for services should be accounted for on a basis similar to that for costs of construction contracts under IAS 11.

BC13 The IFRIC noted that IASs 11 and 18 require all contract costs to be recognised as expenses as they are incurred, unless they are costs of future activity and specified conditions are met. The IFRIC concluded that an activity can be a future activity only if revenue in respect of that activity will not be recognised until a future date. Therefore, borrowing costs cannot be capitalised on a contract after revenue has been recognised in relation to the relevant expenditure. (In practice, borrowing costs attributable to contract activity for which revenue has not yet been recognised may be immaterial.)

BC14 This approach is consistent with that of IAS 23, which requires the capitalisation of borrowing costs to cease when substantially all the activities necessary to prepare a qualifying asset for its intended use or sale are complete: once revenue is recognised on an item it has been sold, and therefore must have been ready for sale. The IFRIC concluded that any resulting financial asset is not itself a qualifying asset for the purpose of IAS 23.

BC15 The IFRIC noted that, after revenue has been recognised, an operator applying the financial asset model will, instead of capitalising interest on its borrowing costs, recognise interest income on the amount due from the grantor (which is a discounted amount), unless it elects to account for the amount due as at fair value through profit or loss.

Items provided to the operator by the grantor

BC16 For concession arrangements within the scope of this draft Interpretation, pre-existing infrastructure items made available to the operator by the grantor for the purpose of the service concession are not recognised as property, plant and equipment of the operator.

BC17 However, different considerations apply to other assets provided to the operator by the grantor if the operator can keep or deal with the assets as it wishes. Such assets become assets of the operator and so should be accounted for in accordance with general recognition and measurement principles, as should the obligations undertaken in exchange for them.

BC18 The IFRIC considered whether such assets would represent government grants, as defined in paragraph 3 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*:

> Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

The IFRIC concluded that if such assets were part of the overall consideration payable by the grantor on an arms' length basis for the operator's services, they would not constitute 'assistance'. So they would not meet the definition of government grants in IAS 20 and that standard would not apply.

Transition

BC19 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that an entity shall account for a change in accounting policy resulting from initial application of an Interpretation in accordance with any specific transitional provisions in that Interpretation. In the absence of any specific transitional provisions, the general requirements of IAS 8 apply. The general requirement in IAS 8 is that the changes should be accounted for retrospectively, except to the extent that retrospective application would be impracticable.

BC20 The IFRIC noted that there are two aspects to retrospective determination: reclassification and remeasurement. The IFRIC took the view that it will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in an operator's balance sheet, but that retrospective remeasurement of concession assets might not always be practicable.

BC21 The IFRIC noted that, where retrospective restatement is not practicable, IAS 8 requires prospective application from the earliest practicable date, which could be the start of the current period. Under prospective application, the operator could be applying different accounting models to similar transactions, which the IFRIC agreed would be inappropriate. The IFRIC regarded it as important that the correct accounting model should be consistently applied.

BC22 The draft Interpretation reflects these conclusions.

Amendments to IFRS 1

BC23 The proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* are necessary to ensure that the transitional arrangements proposed are available to both existing users and first-time adopters of IFRSs. The IFRIC believes that the requirements will ensure that the balance sheet will exclude any items that would not qualify for recognition as assets and liabilities under IFRSs.