IFRIC 12 Service Concession Arrangements is the first specific guidance for operators on how to account for this important class of transactions under International Financial Reporting Standards (IFRSs).

The interpretation is the culmination of one of the most demanding and long running projects undertaken by the International Financial Reporting Interpretations Committee (IFRIC). Indeed, the IFRIC first agreed to discuss the issues addressed by IFRIC 12 at its inaugural meeting in February 2002.

The time taken to complete the project reflects the variety of service concession arrangements that exist and the number and complexity of the accounting issues that they raise. Members of the International Accounting Standards Board have described IFRIC 12 as “almost a standard.” It is certainly a substantial document: the interpretation cites fourteen IFRSs as references and the main text is accompanied by two appendices, two information notes, three illustrative examples and a lengthy basis for conclusions. However, it is important to remember that IFRIC 12 remains an interpretation.

As an interpretation IFRIC 12 provides guidance on how to apply IFRSs to a group of problematic service concession arrangements. It is not designed to vary or provide exemptions from the requirements of IFRSs. This constraint has proved controversial, as have some of its consequences. This publication discusses some of these issues, such as the recognition of revenue in excess of cash receipts when an intangible asset is recognised.

Notwithstanding these concerns, it is likely that IFRIC 12 will achieve its primary objective of decreasing the diversity of current accounting practice for service concession arrangements or at least for those within its scope. It is helpful to have definitive accounting guidance after a long period of uncertainty, at least for some aspects of service concession arrangements. Since IFRIC 12 does not address all service concession arrangements diversity will remain, if only because of diversity in the types of service concession arrangements.

Adoption of the interpretation will require some entities to make significant changes in their accounting. It also will require a change in mindset by those accustomed to analysing the accounting treatment of service concession arrangements solely by reference to the distribution of risks and rewards between the public and private sector parties, given IFRIC 12’s increased emphasis on which party controls the concession infrastructure. As this publication makes clear, entities will face many implementation issues.

We hope that this issue of First Impressions: Service Concession Arrangements will assist in the initial assessment of the impact of IFRIC 12.
About this publication

Content
This publication has been produced by the KPMG International Financial Reporting Group (part of KPMG IFRG Limited).

Our First Impressions publications are prepared upon the release of a new International Financial Reporting Standard (IFRS), interpretation or other significant amendment to the requirements of IFRSs. They include a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to assist an assessment of the impact of implementation.

This edition of First Impressions considers the requirements of IFRIC 12 Service Concession Arrangements.

The text of this publication is referenced to IFRIC 12 and to selected other current IFRS literature, standards and interpretations, in issue at 31 December 2006. References in the left-hand margin identify the relevant paragraphs of the standards and interpretations.

In many cases further interpretation will be needed in order for an entity to apply IFRSs to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on interpretations of IFRSs developed by the KPMG International Financial Reporting Group and these interpretations may change as practice develops. This is particularly relevant to recently published requirements such as those of IFRIC 12, for which there little or no application experience.

We will update and supplement the interpretative guidance and examples in this publication by adding additional interpretative guidance to Insights into IFRS, our practical guide to International Financial Reporting Standards.

Other ways KPMG member firms’ professionals can help
We have a range of publications that can assist you further, including Insights into IFRS, The Application of IFRS: Disclosures in Practice, IFRS: An Overview, Disclosure checklist, banking and non-banking illustrative financial statements, and illustrative condensed interim financial statements. Technical information is available at www.kpmgifrg.com.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG’s Accounting Research Online. This Web-based subscription service can be a valuable tool for anyone who wants to stay informed in today’s dynamic environment. For a free 15-day trial, go to www.aro.kpmg.com and register today.
Contents

1. Overview 2

2. Introduction 3
   2.1 Background 3
   2.2 Summary of key requirements 3
   2.3 Structure of this document 5

3. Scope 7
   3.1 Introduction 7
   3.2 What is a public-to-private service concession arrangement? 7
   3.3 Which arrangements are within the scope? 9
   3.4 Relationship with IFRIC 4 11

4. The construction / upgrade phase 12
   4.1 Introduction 12
   4.2 The operator’s rights over the infrastructure 12
   4.3 Recognition of construction / upgrade revenue 13
   4.4 Recognition of consideration receivable for construction / upgrade services 15
   4.5 Borrowing costs 20
   4.6 Items provided by the grantor 23

5. The operational phase 25
   5.1 Introduction 25
   5.2 Operation revenue 25
   5.3 Maintenance obligations 27
   5.4 Subsequent accounting for a financial asset 29
   5.5 Subsequent accounting for an intangible asset 31

6. Disclosures 33
   6.1 IFRIC 12 33
   6.2 SIC–29 33

7. Other matters 34
   7.1 Introduction 34
   7.2 Service concession arrangements outside the scope of IFRIC 12 34
   7.3 Grantor accounting 35

8. Effective date and transition 36
   8.1 Effective date 36
   8.2 Transition 36

Appendices

Appendix I: Simple worked example 39
   Introduction 39
   Facts and circumstances 39
   Analysis 39

Appendix II: More complex case studies 41
   Case study 1 – toll road 41
   Case study 2 – hospital 41
   Case study 3 – rail link 42
1. Overview

- IFRIC 12 provides guidance on the accounting by private sector entities (operators) for public-to-private service concession arrangements.

- IFRIC 12 applies only to those service concession arrangements in which the public sector (the grantor) controls or regulates the services provided with the infrastructure and their prices, and controls any significant residual interest in the infrastructure.

- In these circumstances, the operator does not recognise the infrastructure as its property, plant and equipment if the infrastructure is existing infrastructure of the grantor or is infrastructure constructed or purchased by the operator as part of the service concession arrangement. The operator recognises either a financial asset or an intangible asset, or both, at fair value as compensation for any construction services that it provides.

- If the grantor provides other items to the operator that the operator may retain or sell at its option, then the operator recognises those items as its assets together with a liability for unfulfilled obligations.

- The operator recognises and measures revenue for providing construction services in accordance with IAS 11 Construction Contracts and revenue for other services in accordance with IAS 18 Revenue.

- The operator recognises consideration receivable from the grantor for construction services, including upgrades of existing infrastructure, as a financial asset and/or an intangible asset.

- The operator recognises a financial asset to the extent that it has an unconditional right to receive cash irrespective of the usage of the infrastructure.

- The operator recognises an intangible asset to the extent that it has a right to charge for usage of the infrastructure.

- Any financial asset recognised is accounted for in accordance with the financial instruments standards, and any intangible asset in accordance with IAS 38 Intangible Assets. There are no exemptions from these standards for operators.

- The operator recognises and measures obligations to maintain or restore infrastructure, except for any upgrade element, in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

- The operator expenses borrowing costs as incurred, unless it has a right to receive an intangible asset and adopts a policy of capitalisation under IAS 23 Borrowing Costs, in which case it capitalises attributable borrowing costs during construction periods.

- IFRIC 12 is applicable for accounting periods beginning on or after 1 January 2008; earlier application is encouraged.

- IFRIC 12 is applied retrospectively unless this is impracticable, in which case special transitional rules apply.
2. Introduction

2.1 Background

IFRIC 12 Service Concession Arrangements was published on 30 November 2006. The interpretation provides guidance to operators on certain recognition and measurement issues that arise in accounting for public-to-private service concession arrangements. The interpretation also makes consequential amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards, IFRIC 4 Determining whether an Arrangement contains a Lease and SIC–29 Disclosure – Service Concession Arrangements.

IFRIC 12 focuses on arrangements in which the operator incurs expenditure in the early years of the arrangement as it constructs or upgrades public service infrastructure. Typically the operator receives cash, either from the grantor or users, only once the infrastructure is available for use. Historically, IFRSs have not provided specific guidance to operators on questions such as: Should the operator record existing public service infrastructure as its property, plant and equipment? How should the operator account for public service infrastructure that it acquires or constructs? How should the operator account for the total consideration it receives under the terms of the arrangement, i.e., cash and other items such as rights over the infrastructure? IFRIC 12 was developed to provide guidance to operators on these and related questions.

IFRIC 12 does not seek to address all forms of infrastructure service arrangements. Nor does it seek to address all of the accounting issues faced by private sector entities participating in such arrangements. Instead, IFRIC 12 limits its scope to a subset of infrastructure service arrangements and, for arrangements within its scope, addresses seven issues.

The scope of IFRIC 12 is public-to-private service concession arrangements in which the public sector controls or regulates the services provided with the infrastructure and their prices, and controls any significant residual interest in the infrastructure. For such arrangements the interpretation addresses:

- the treatment of the operator’s rights over the infrastructure
- the recognition and measurement of consideration
- construction or upgrade services
- operation services
- borrowing costs
- the subsequent accounting of a financial asset and an intangible asset
- items provided to the operator by the grantor.

The interpretation refers to the public sector body that awards the concession as the grantor and the entity that provides the services as the operator. This terminology is used throughout this publication.

2.2 Summary of key requirements

The following example illustrates the key requirements of IFRIC 12.

A grantor awards a concession to an operator to build and operate a new road. The grantor transfers to the operator the land on which the road is to be constructed, together with adjacent land that the operator may redevelop or sell at its discretion. Construction is expected to take five years, after which the operator will operate the road for 25 years. During these 25 years the operator has a contractual obligation to perform routine maintenance on the road and to resurface it as necessary, which is expected to be three times. At the end of the arrangement the road will revert to grantor. The road is to be used by the general public. Tolls for use of the road are set annually by the grantor.
This arrangement is a public-to-private arrangement as the road is constructed pursuant to general transport policy and is to be used by the public. The arrangement is within the scope of the IFRIC 12 as:

- the grantor controls the services to be provided using the infrastructure and the price charged for those services, i.e., the grantor requires the infrastructure to be used as a road available to the public and sets the tolls

IFRIC 12.5
- the grantor controls the significant residual interest in the infrastructure, as the road reverts to the grantor at the end of the arrangement.

The key requirements of IFRIC 12 in relation to the operator’s participation in the arrangement are as follows:

<table>
<thead>
<tr>
<th>Issue</th>
<th>Key requirement of IFRIC 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRIC 12.11</td>
<td>The operator’s rights over the infrastructure The operator does not recognise the road as its property, plant and equipment, as the operator is considered to have a right of access rather than a right of use.</td>
</tr>
<tr>
<td>IFRIC 12.14</td>
<td>Construction or upgrade services: revenue recognition The operator recognises and measures revenue and costs related to the construction of the road in accordance with IAS 11. That is, the operator applies the stage of completion method and measures revenue at the fair value of the consideration receivable.</td>
</tr>
</tbody>
</table>
| IFRIC 12.16 | Construction or upgrade services: consideration given by the grantor to the operator The operator recognises the consideration receivable from the grantor for providing construction services as a financial asset and/or an intangible asset:  
  - The operator recognises a financial asset to the extent that it has an unconditional right to receive cash irrespective of the usage of the road (i.e., Dr Financial asset, Cr Revenue during the construction phase). For example, if the grantor pays the operator a fixed amount over the term of the arrangement, then the operator will recognise a financial asset.  
  - The operator recognises an intangible asset to the extent that it receives a right to charge for usage of the asset (i.e., Dr Intangible asset, Cr Revenue during the construction phase). For example, if the operator collects and retains tolls paid by users, then it will recognise an intangible asset, being the right to charge those tolls.  
  - It is possible that the operator will recognise both a financial asset and an intangible asset. For example, if the operator collects and retains tolls from users but the grantor guarantees a minimum level of revenue, then the operator will recognise a financial asset being the right to receive cash up to the minimum guaranteed amount and an intangible asset representing the right to collect and retain tolls above that amount. |
| IFRIC 12.17 | Operation services The operator recognises revenue and costs relating to operation services in accordance with IAS 18. The operator will recognise and measure contractual obligations to restore (resurface) the road in accordance with IAS 37. |
### Issue | Key requirement of IFRIC 12
--- | ---
IFRIC 12.22 Borrowing costs | When the operator recognises an intangible asset it may capitalise attributable borrowing costs into the carrying amount of the intangible asset prior to the operating phase commencing if it applies the allowed alternative treatment in IAS 23. The operator may not capitalise borrowing costs into the carrying amount of any financial asset recognised, though the operator will accrue financial income receivable if it classifies the financial asset as a loan or receivable or as available-for-sale.

IFRIC 12.23, 26 Subsequent accounting of a financial asset and an intangible asset | The operator accounts for any financial asset it recognises in accordance with IAS 39 Financial Instruments: Recognition and Measurement; the operator accounts for any intangible asset it recognises in accordance with IAS 38. There are no exemptions from the requirements of these standards for operators.

IFRIC 12.27 Items provided to the operator by the grantor | The operator accounts for the interest in the surplus land that it receives from the grantor as its asset. The operator measures the surplus land at fair value on initial recognition, and recognises a liability for the obligation to provide services in the future that it has accepted in exchange for the surplus land.

### 2.3 Structure of this document
Most service concession arrangements are more complex than the simple example discussed above. In order to explain the requirements of IFRIC 12 and illustrate the application of those requirements to more realistic examples, the remainder of this document is structured as follows.

- Section 3 discusses the scope of IFRIC 12.
- Section 4 discusses the issues that arise primarily in the construction phase of a typical service concession arrangement and on which IFRIC 12 provides guidance.
- Section 5 discusses the issues that arise primarily in the operational phase of a typical service concession arrangement and on which IFRIC 12 provides guidance.
- Section 6 discusses the disclosure requirements of IFRIC 12 and SIC–29.
- Section 7 discusses other matters, including the relevance of IFRIC 12 to arrangements that are outside its scope and grantor accounting.
- Section 8 discusses the effective date and transitional requirements of IFRIC 12.

Throughout this publication, the application of IFRIC 12 is illustrated through the following case studies:

- Case study 1 – a toll road, involving the upgrade of a single lane road to a three-lane highway. In this case the operator collects tolls from users once the upgrade is available for use (i.e., the grantor gives the operator an intangible asset).
- Case study 2 – a hospital, involving the transfer to the operator of an existing hospital site and the construction of a new hospital. In this case the operator is paid a fixed amount by a public sector health body during the period that the hospital is available for use (i.e., the grantor gives the operator a financial asset).
Case study 3 – a light rail system, involving the operation and extension of an existing system. In this case the operator receives fixed cash payments from the transport authority during the first half of the concession and collects and retains fares from passengers in the second half of the concession (i.e., the grantor gives the operator both a financial asset and an intangible asset).

Additional information on these case studies is given in the main text as the case studies are developed. Appendix II provides a comprehensive description of the case studies and summarises the relevant issues.

Other points are illustrated by reference to other common types of service concession arrangements throughout the publication.
3. Scope

3.1 Introduction

IFRIC 12 applies to public-to-private service concession arrangements in which the grantor controls and / or regulates the services provided with the infrastructure and their price, and controls any significant residual interest in the infrastructure.

Whether or not an arrangement is within the scope of IFRIC 12 will affect the nature of the assets that the operator recognises. For example, for an arrangement that is within the scope of IFRIC 12 the operator does not recognise public service infrastructure as its property, plant and equipment; nor does the operator recognise a finance lease receivable for leasing that public service infrastructure to the grantor.

This section explains the scope of IFRIC 12 and illustrates the application of the scope criteria through a series of examples. Section 7 discusses further the boundary between IFRIC 12 and other accounting models, and the circumstances in which it may be appropriate to apply IFRIC 12 by analogy to arrangements that are not directly within its scope.

3.2 What is a public-to-private service concession arrangement?

3.2.1 Typical features

While IFRIC 12 does not define “public-to-private service concession arrangements”, it does describe the typical features of such arrangements. Typically a public-to-private service concession arrangement within the scope of IFRIC 12 will involve most of the following:

- **Infrastructure is used to deliver public services.** The infrastructure can take many forms and may be transport related (e.g., roads, bridges, tunnels), a type of building (e.g., hospitals, prisons), or utility related (e.g., water distribution network, electricity supply plant). The infrastructure may include moveable and immovable items, e.g., it may include a hospital building and related plant and equipment.

- **A contractual arrangement between the grantor and the operator.** This is the agreement, referred to as a “concession agreement” in this publication, under which the grantor specifies the services that the operator is to provide and which governs the basis upon which the operator will be remunerated. The arrangements vary greatly in duration, but terms of 30 years or more are not unusual.

- **Supply of services by the operator.** These services may include the construction / upgrade of the infrastructure and the operation and maintenance of that infrastructure. Service concessions involving a significant construction or upgrade element are sometimes called “build-operate-transfer” or “rehabilitate-operate-transfer” arrangements. Often the construction / upgrade services are provided during the early years of the concession, but they also may be provided in stages during the concession period.

- **Payment of the operator over the term of the arrangement.** In many cases the operator will receive no payment during the initial construction / upgrade phase. Instead, the operator will be paid by the grantor directly or will charge users during the period that the infrastructure is available for use.

- **Return of the infrastructure to the grantor at the end of the arrangement.** For example, if the operator has legal title to the infrastructure during the term of the arrangement, then legal title may transfer to the grantor at the end of the arrangement, often for no additional consideration.
The obligations and cash flows of the operator in a typical service concession can be summarised as follows:

The above features give a broad indication of the types of arrangements to which the interpretation may relate. A wide variety of service concession arrangements exist in practice and not all of the arrangements that are within the scope of IFRIC 12 will have all of the features listed above.

**Application to the case studies**

Our three case studies have the above features. Taking case study 1 – toll road as an example:

- The arrangement concerns an item of infrastructure, the road, that provides a public service.
- There is a concession agreement that specifies the services to be provided by the operator and the basis on which tolls for usage of the road will be set.
- The services to be provided by the operator include initial construction services to upgrade the road to a three-lane highway, subsequent maintenance services, periodic resurfacing of the road, and the operation of a toll collection system.
- The operator will receive no cash consideration during the initial construction phase. Instead, the operator will collect tolls from users of the upgraded road.
- At the end of the arrangement the ownership of the road and the toll collection system, and all rights to collect tolls, will revert to the grantor for no additional consideration.

### 3.2.2 The public service obligation

IFRIC 12 states that a feature of public-to-private arrangements is “the public service nature of the obligation undertaken by the operator”. In general, it is not necessary for the operator itself to provide services directly to the general public for an arrangement to be a public-to-private arrangement.
Consider the following examples:

- An operator constructs and maintains a hospital building. The grantor employs the doctors and nurses and provides medical services directly to the general public from the hospital building.
- An operator constructs and maintains a railway line, including tracks and stations. The grantor owns the trains that run on the line, employs the train drivers and station staff, and collects ticket revenues from passengers.

In our view, both arrangements are public-to-private arrangements as the services provided using the infrastructure are provided to the public.

### 3.3 Which arrangements are within the scope?

#### 3.3.1 General requirement

The scope of IFRIC 12 is defined by reference to control of the infrastructure. An arrangement is within the scope of the interpretation if:

- the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
- 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.

#### Application to the case studies

The three case studies are within the scope of IFRIC 12:

- **Case study 1 – toll road.** The grantor controls the services to be provided and sets the tolls. The road reverts to the grantor at the end of the arrangement.
- **Case study 2 – hospital.** The grantor controls the services to be provided and the amounts payable to the operator are set in the concession agreement. The hospital reverts to the grantor at the end of the arrangement.
- **Case study 3 – light rail system.** The grantor controls the services to be provided. The amounts payable to the operator in the first half of the concession are set in the concession agreement; the grantor regulates the fares that the operator may charge in the second half of the concession. The light rail system reverts to the grantor at the end of the arrangement.

#### 3.3.2 Control of services

The grantor may control the services to be provided by the operator in a number of different ways. For example, the services may be specified through the terms of the concession agreement and / or a license agreement and / or some other form of regulation. All of these forms of control are consistent with the scope criteria of IFRIC 12.

Furthermore, the degree of specification of the services may vary in practice. In some cases the grantor will specify the services to be provided in detail and by reference to specific tasks to be undertaken by the operator (e.g., “build a hospital according to the design and timetable in schedule A”, “complete the cleaning tasks in schedule B in each ward each evening” etc.). In other cases the grantor will specify the services that the infrastructure should have the capacity to deliver (e.g., “provide hospital accommodation suitable to support delivery of acute healthcare services to a local population of 10,000”). In our view, the latter approach, using what sometimes is called an “output specification”, also is consistent with the scope criteria of IFRIC 12.
3.3.3  Control of pricing

IFRIC 12.5,
AG3  The grantor may control or regulate the pricing of the services to be provided using the infrastructure in a variety of ways. In our view, generally the criterion in IFRIC 12 is satisfied when the service concession involves explicit and substantive control or regulation of prices. We discuss below examples of price control, including price-setting by an independent economic regulator.

In some cases, particularly when the grantor pays the operator directly, prices (or a price formula) may be set out in the concession agreement. In other cases prices may be re-set periodically by the grantor, or the grantor may give the operator discretion to set unit prices but set a maximum level of revenue or profits that the operator may retain. All of these forms of arrangement are consistent with the control criteria in IFRIC 12.

In some cases prices may be indexed by, or re-set periodically by reference to, a factor that is outside the control of the grantor. For example, prices may be indexed annually by a consumer price index (CPI), or a regulator may establish a price formula that depends on the value of an index, e.g., the regulator may specify that prices may rise by a maximum of CPI – X, where X is a value that is re-set periodically by the regulator. Although the grantor cannot control the value of CPI, the grantor is controlling the framework in which the price is set. In our view, such price-setting mechanisms constitute price regulation that is consistent with the scope criterion in IFRIC 12.

IFRIC 12.AG2  An arrangement may be within the scope of IFRIC 12 when either the services to be provided or pricing is controlled by an economic regulator acting in the public interest. For example, when the operator is a monopoly supplier of services in a geographic area, an “independent economic regulator” may be established to set prices and to monitor the operator’s compliance with the conditions of its license. The duties and powers of the regulator may be set out in legislation that requires the regulator to act in the public interest and also constrains the ability of the government to direct the operations of the regulator.

3.3.4  Control and valuation of the residual

IFRIC 12.3, 5  The simplest way in which the grantor may control the residual is for the concession agreement to require the operator to return all concession assets to the grantor, or to transfer the infrastructure to a new operator, at the end of the arrangement for no consideration. Such a requirement is a common feature of service concession arrangements involving concession assets with long useful lives, such as road and rail infrastructure. However, other forms of arrangement also are within the scope criteria of IFRIC 12.

The residual interest criterion may be met when the grantor holds an option to acquire the infrastructure assets at the end of the concession. Such an option gives the grantor the ability to control the use of the asset at the end of the concession period and restricts the operator’s practical ability to sell or pledge any significant interest in the infrastructure. For example, an operator may acquire a site and develop a building that is to be used as a public healthcare facility. At the end of the arrangement the grantor may have an option to acquire the site for its then fair value. This is an example of an arrangement in which the grantor controls the residual interest in the infrastructure but the operator bears residual value risk.

IFRIC 12.6,
AG4, AG6  “Whole-of-life” arrangements, that is, arrangements for which the residual interest in the infrastructure is not significant, are within the scope of IFRIC 12 if the other scope criteria are met. The application guidance to IFRIC 12 states that the residual interest in the infrastructure is the estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement. For example, concession arrangements for providing specialist medical equipment or IT infrastructure may have terms equivalent to the expected useful life of the equipment. Even if the operator retained ownership of the equipment at the end of the arrangement, the arrangement would be within scope as the equipment is not expected to have a significant residual value at the end of the arrangement.
3.4 Relationship with IFRIC 4

IFRIC 12 amends the scope of IFRIC 4 so that IFRIC 4 does not apply to arrangements that are within the scope of IFRIC 12. The basis for conclusions to IFRIC 4 explains that this change was intended to eliminate the possibility of entities having a choice of accounting treatment for similar arrangements. This matter is discussed further in section 7.2.2 Private-to-private arrangements.
4. The construction / upgrade phase

4.1 Introduction

Typically service concession arrangements involve the construction or upgrade of the public service infrastructure by the operator. IFRIC 12 includes guidance to operators on the following issues that may arise in the construction / upgrade phase:

- How should the operator account for the interest in the existing public service infrastructure that it receives from the grantor?
- How should the operator recognise and measure revenue and costs relating to construction / upgrade services?
- How should the operator recognise and measure consideration receivable from the grantor, e.g., cash and other items such as rights over the infrastructure, for providing construction / upgrade services?
- How should the operator account for borrowing costs incurred during the construction / upgrade phase?
- How should the operator account for other items provided by the grantor?

These issues are discussed below.

4.2 The operator’s rights over the infrastructure

4.2.1 General requirement

The operator should not recognise public service infrastructure within the scope of IFRIC 12 as its property, plant and equipment. This requirement applies to existing infrastructure of the grantor and also to infrastructure that the operator constructs or acquires for the purposes of the concession.

Application to the case studies

- Case study 1 – toll road. The operator does not recognise the existing toll road or the additional lanes that it constructs as its property, plant and equipment.
- Case study 2 – hospital. The operator does not recognise the new hospital that it constructs as its property, plant and equipment.
- Case study 3 – light rail system. The operator does not recognise the existing light rail system, or the extension that it constructs, as its property, plant and equipment.

4.2.2 The operator does not control the public service infrastructure

The operator does not recognise public service infrastructure as its property, plant and equipment, for arrangements within the scope of IFRIC 12, the operator does not control the public service infrastructure. The control requirement is determinative irrespective of the extent to which the operator bears the risks and rewards of ownership of the infrastructure. This emphasis on “control” rather than “risks and rewards” distinguishes the approach in IFRIC 12 from practices under some national GAAPs that have been applied by operators reporting under IFRSs.

The distinction between a “control” approach and a “risks and rewards” approach can be illustrated by reference to case study 1, in which the operator operates an existing road, upgrades that road to become a multi-lane highway and is remunerated solely by tolls collected from users.

In this case the grantor controls the services to be provided, sets the tolls and controls the residual interest in the infrastructure. In contrast, the operator bears construction risk, cost risks associated with its maintenance obligations and demand risk associated with usage of the road throughout the concession period. In addition, the present value of the residual value risk borne by the grantor may
be small at the inception of the arrangement. However, the operator does not control the road and therefore does not recognise the road as its property, plant and equipment.

**IFRIC 12.AG7**
In some cases the operator may retain discretion to operate a small part of the infrastructure in order to earn additional revenue from other services that are not regulated by the concession agreement. For example, in case study 2 the operator builds and operates a hospital for the grantor and earns a small amount of rental income by letting units to retailers. The operator will not recognise the rental units as its property, plant and equipment because the rental activities are ancillary.

### 4.2.3 Existing plant of the operator

**IFRIC 12.8**
IFRIC 12 does not apply to existing property, plant and equipment of the operator. The operator applies the derecognition criteria of IAS 16 *Property, Plant and Equipment* to such items.

**Example: Existing plant of the operator**

Consider case study 3 in which the operator undertakes to operate and extend an existing light rail system. The operator will use its existing plant to construct the extension. The operator’s plant includes some non-specialised items (cranes, bulldozers etc.) that will be used subsequently on other projects, and a specialist boring machine that will be used in the construction of a tunnel. The boring machine is not expected to have a future use after completion of this project.

In this case, the operator applies IFRIC 12 to:

- the extension to the rail link infrastructure that the operator constructed
- the existing rail link infrastructure to which the grantor gives the operator access.

Therefore the operator will not recognise these items as its property, plant and equipment.

However, the operator will not apply IFRIC 12 to its existing plant that it uses to construct the extension to the rail link. Instead, the operator will apply IAS 16, and possibly IAS 17 *Leases* and IFRIC 4, to this plant. Depending on the precise terms of the arrangement, the following is possible:

- The non-specialised plant, which is expected to be used on other projects, is not the subject of a lease. The operator will continue to account for this plant as property, plant and equipment in accordance with IAS 16.
- The boring machine, which may be specified implicitly or explicitly in the concession arrangement and is expected to be used for the remainder of its life on this project, is the subject of a lease from the operator to the grantor. If the operator concludes that this lease is a finance lease, then the operator will derecognise the boring machine in accordance with IAS 17.

The accounting treatment of other items provided to the operator by the grantor is discussed in section 4.6 *Items provided by the grantor*.

### 4.3 Recognition of construction / upgrade revenue

#### 4.3.1 General requirement

**IFRIC 12.13-15**
IFRIC 12 characterises operators as “service providers”, who should recognise revenue in accordance with IAS 11 and IAS 18. Therefore operators recognise revenue and costs relating to construction and upgrade services in accordance with IAS 11. Revenue recognised in accordance with IAS 11 is based on the stage of completion of the services and is measured by reference to the fair value of the consideration receivable.
Application to the case studies

- Case study 1 – toll road. The operator recognises revenue for providing construction services to upgrade the road to a three-lane highway.
- Case study 2 – hospital. The operator recognises revenue for providing construction services to build the new hospital.
- Case study 3 – light rail system. The operator recognises revenue for providing construction services as it builds the extension to the light rail system.

4.3.2 Determination of construction / upgrade revenue

An operator may need to exercise considerable judgement in determining the amount to be recorded as construction / upgrade revenue. In many cases the concession agreement will not specify an amount of consideration for construction / upgrade services. Instead, the concession agreement will specify the total consideration to be received by the operator during the concession period. In such cases the operator will need to allocate the total consideration receivable over the concession period to determine the amount to be recognised as construction / upgrade revenue.

IFRIC 12.13, When the operator provides more than one service, it allocates the consideration between services “by reference to the relative fair values of the services delivered when the amounts are separately identifiable”. This requirement appears consistent with the proposals in the IFRIC’s draft interpretation D20 Customer Loyalty Programmes. We note, however, that IAS 18 does not mandate that consideration be allocated between the separate elements of a sales transaction according to the relative fair values of the separate elements. For example, the appendix to IAS 18 illustrates a residual method of allocation, whereby the amount allocated to the undelivered element is equal to its cost plus a reasonable profit margin.

IAS 18.13, A11, Similarly, judgement may be required to determine margins to be recognised as services are provided. In particular, an operator may have to recognise different margins for providing construction and operation services under a single concession agreement, even if the concession agreement does not meet the conditions for the segmentation of construction contracts in IAS 11. This is because services that are separately identifiable are required to be accounted for separately under IAS 18. The operator then will apply the requirements of IAS 11 to the separately identifiable components of the arrangement, if applicable.

For example, consider case study 2 in which the operator constructs and operates a hospital building, receiving a fixed amount of cash from the grantor over the concession term. The operator accounts for the total consideration as revenue in accordance with IAS 18. Under IAS 18 the operator determines that it is appropriate to apply the revenue recognition criteria separately to the construction and maintenance services, in which case the operator will recognise and measure the revenue (and hence costs) relating to the construction services in accordance with IAS 11. In that case, the operator will apply the segmentation criteria in IAS 11 to decide whether it should segment the construction services further. However, in our view the contract segmentation criteria of IAS 11 do not apply to the segmentation of construction from non-construction services to the extent that these services are separately identifiable.

4.3.3 “Double counting” of revenue

Operators recognise revenue relating to construction / upgrade services irrespective of whether the consideration received is classified as a financial asset or as an intangible asset. The operator recognises revenue for construction or upgrade services if it receives an intangible asset as consideration as the arrangement includes a barter transaction in which construction / upgrade services are exchanged for an intangible asset, being the right to charge for use of the infrastructure.

One consequence of this requirement is that the total amount of revenue recognised by an operator over the life of a concession arrangement may exceed the total cash received by the operator. For example, in case study 1 the operator upgrades a road and then collects tolls from users, receiving
First Impressions: IFRIC 12 – Service Concession Arrangements
January 2007

no cash or guaranteed minimum remuneration from the grantor. Suppose that the fair value of the construction services provided in upgrading the road is 100 and the total tolls collected from users are 120. In this case the operator will recognise total revenue of 220 over the life of the concession, but will receive total cash of only 120.

Critics of this approach have suggested that this amounts to a “double counting” of revenue and the basis for conclusions to IFRIC 12 notes that some IFRIC members felt uncomfortable with this conclusion. However, they accepted that it is consistent with the treatment accorded to a barter transaction, i.e., an exchange of dissimilar goods or services.

4.4 Recognition of consideration receivable for construction / upgrade services

4.4.1 General requirement

The operator recognises consideration received or receivable for providing construction / upgrade services as a financial asset and / or as an intangible asset:

- The operator recognises a financial asset to the extent that it has an unconditional right to receive cash irrespective of the usage of the infrastructure.
- The operator recognises an intangible asset to the extent that it has a right to charge fees for usage of the infrastructure.

Application to the case studies

- Case study 1 – toll road. The operator receives a right to collect tolls from users of the road as consideration for providing construction services. The operator recognises this right as an intangible asset.
- Case study 2 – hospital. The operator receives a right to receive cash from the grantor as consideration for providing construction services. The operator recognises a financial asset.
- Case study 3 – light rail system. The operator receives a guaranteed amount of cash (which may be collected from either the users or the grantor) and also receives a right to collect fares from users of the system. The operator recognises a financial asset and an intangible asset.

4.4.2 The role of demand risk

The operator recognises a financial asset only when its right to receive cash is not dependent upon usage of the infrastructure. That is, the nature of the asset recognised by the operator will depend on the allocation of demand risk between the operator and the grantor. In simple cases the operator recognises a financial asset to the extent that the grantor bears demand risk, and an intangible asset to the extent that it bears demand risk.

For example, suppose an operator enters into two separate service concession arrangements, each involving the construction and operation of a hospital. In the first case (Hospital A), the operator receives fixed payments from the grantor during the concession period. In this case the grantor bears demand risk, as the cash flows of the operator do not depend on the usage of the hospital. The operator therefore recognises a financial asset as the consideration received for its construction services. In the second case (Hospital B), the grantor pays the operator an amount calculated by reference to the average number of beds occupied by patients each month, i.e., the payment is calculated as average occupancy multiplied by a rate per bed. In this case the operator bears demand risk as the cash flows of the operator depend on usage of the hospital. Therefore the operator recognises an intangible asset as the consideration received for its construction services.

In more complex cases the operator may recognise both a financial asset and an intangible asset. Consider a third service concession arrangement in which the operator constructs and operates a hospital (Hospital C). In this case the grantor pays the operator based on occupancy as for Hospital B above except that the monthly payment is subject to a minimum level: the monthly payment by the
grantor is calculated as the higher of (1) average occupancy multiplied by a rate per bed; and (2) a fixed monetary amount. In this case the operator recognises a financial asset representing the right to receive the fixed monetary amount and an intangible asset representing the right to charge for usage of the hospital above this fixed monetary amount.

These simple examples can be summarised as follows:

<table>
<thead>
<tr>
<th>Hospital</th>
<th>Payment mechanism</th>
<th>Asset(s) recognised by operator</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Grantor pays the operator a fixed monetary amount</td>
<td>Financial asset</td>
</tr>
<tr>
<td>B</td>
<td>Grantor pays the operator a variable amount depending on usage</td>
<td>Intangible asset</td>
</tr>
<tr>
<td>C</td>
<td>Grantor pays the operator a variable amount depending on usage, subject to a minimum fixed monetary amount</td>
<td>Financial asset and intangible asset</td>
</tr>
</tbody>
</table>

4.4.3 Identity of the payer is unimportant

The identity of the party that makes payments to the operator once the infrastructure is available for use does not affect how the operator classifies consideration receivable for construction / upgrade services.

Consider two separate service concession arrangements in which the operator constructs and operates a road. In the first case users of the road pay tolls to the operator based on usage. In the second case the grantor makes payments to the operator based on the number of users of the road; sometimes such an arrangement is described as a “shadow toll”. In both cases the operator bears demand risk and does not have an unconditional right to receive cash irrespective of usage; therefore the operator recognises an intangible asset as consideration for construction services.

It is not necessary for the operator to be able to identify in advance the identity of the party that will make specific payments in order to recognise a financial asset. Suppose that in a road concession the users pay the operator based on usage, but in addition the grantor guarantees that it will pay to the operator any shortfall between a fixed monetary amount, say 100 million, and actual tolls collected. In this case the operator has an unconditional right to receive cash of 100 million as consideration for constructing and operating the road irrespective of the extent to which the road is used. The operator will recognise a financial asset notwithstanding that it cannot identify in advance the party that will make specific cash payments. In addition, the operator will recognise an intangible asset representing the right to charge for usage of the road above this minimum level.

4.4.4 Quantum of demand risk is unimportant

The nature of the asset recognised by the operator depends on the allocation of demand risk, not the significance of demand risk in the context of the arrangement as a whole.

For example, consider two service concession arrangements in which the operator upgrades and operates a road. In both cases the operator collects tolls from users of the road and has no minimum guaranteed payment. The two projects have different demand risk profiles as follows:

- The first road runs between two large towns and is the primary commuter route between them. Alternative routes between the two towns involve long detours resulting in significantly longer journey times. Users have had to pay tolls on the road for many years. Studies of usage of the road over the last 10 years have shown that traffic levels are not subject to significant variation, showing a high degree of correlation with employment levels in the two towns.
• The second road runs from a large population centre to an industrial area. The grantor is seeking to upgrade the road in order to help regenerate the industrial area, which is receiving significant levels of government grants. The grantor’s traffic consultants have estimated that usage of the road could grow by up to 100 percent over the next 10 years. Users do not at present pay in order to use the road but tolls will be introduced once the upgrade work is complete.

The first road appears likely to yield a generally stable income stream for the operator. In contrast, the level of usage of the second road appears to be subject to a number of material uncertainties: Will the construction of the road and the other investment generate the expected economic expansion in the industrial area? Will the employment growth predicted materialise? What will be the impact on road usage of the introduction of tolls? If there is traffic growth, will it happen at the rate predicted by the traffic consultants? Overall the first road appears to be a relatively low risk investment for the operator, whereas the second road appears to be a relatively high risk investment for the operator.

However, the expected level of risk is not relevant to determining what kind of consideration is receivable for the upgrade services. In both cases the operator recognises an intangible asset as it does not have an unconditional right to receive cash irrespective of usage of the road.

### 4.4.5 Performance and availability risk

IFRIC 12.BC44 The operator’s right to receive cash is considered unconditional even when payment is contingent upon the operator meeting future quality or efficiency performance requirements. For example, an operator may have a right to receive fixed amounts of cash from the grantor in return for the construction services, subject to deductions if the infrastructure is not available for use or is operating below a specified standard. In this case the operator recognises a financial asset even though its right to receive cash is contingent upon the satisfaction of other contractual conditions.

In some cases the concession agreement may describe payments to be made by the grantor to the operator as “availability payments.” That is, the grantor will pay the operator a fixed amount for each day that the infrastructure is available for use. If for any reason within the control of the operator the infrastructure is not available for use, then the grantor will not make a payment to the operator on that day. In our view, to the extent that the amount described as an “availability payment” is in substance consideration payable for construction or upgrade services, the operator should recognise a financial asset.

### 4.4.6 Minimum and substantially fixed returns

Additional complexities may arise when applying IFRIC 12’s “demand risk” approach to cases in which the grantor guarantees that the operator will receive a minimum or a substantially fixed profit or return.

Consider, for example, an arrangement in which the operator collects tolls from users and the grantor undertakes to pay to the operator any shortfall between the operator’s actual earnings before interest and taxation (EBIT) and 10 million. In this case the operator has an intangible asset reflecting its right to collect tolls such that it may achieve EBIT above 10 million. But should the operator classify its right to earn a guaranteed minimum EBIT of 10 million as a financial asset or an intangible asset?

The amount receivable by the operator varies not only with usage of the infrastructure (demand risk) but also with variations in the operator’s own costs (cost risk). However, the operator has a right to receive a determinable amount of cash, i.e., the shortfall, if any, between the operator’s actual EBIT and 10 million. Taking the arrangement as a whole, the operator’s net cash flows are not conditional upon usage of the infrastructure for levels of EBIT below 10 million. In our view, the operator should recognise a financial asset.

IFRIC 12.BC50-52 This example should be distinguished from cases in which the grantor regulates the prices that the operator may charge, such that the operator earns a substantially fixed return. In such cases the operator’s return may be low risk but it does not have a unconditional contractual right to receive cash, and so the operator recognises an intangible asset.
### Additional examples

The table below illustrates the application of IFRIC 12’s “demand risk” approach to a range of typical payment mechanisms:

**Examples of typical payment mechanisms**

<table>
<thead>
<tr>
<th>Ref</th>
<th>Description</th>
<th>Asset(s) recognised by operator</th>
<th>Typically found in</th>
</tr>
</thead>
</table>
| 1   | ● Grantor pays operator  
● Amounts payable do not depend on usage of the infrastructure | Financial asset | Prison, hospital etc. with an “availability payment”  
Note: The operator recognises a financial asset even if the amounts payable by the grantor depend on the performance of the infrastructure during the operational phase. |
| 2   | ● Users pay operator  
● Amounts payable depend on usage of the infrastructure  
● No minimum amount | Intangible asset | Toll road  
Note: The operator recognises an intangible asset even if the amounts receivable by the operator are subject to little variation in practice, e.g., a toll road on an established route that generates a highly predictable level of tolls. |
| 3   | ● Grantor pays operator  
● Amounts payable depend on usage of the asset  
● No minimum amount | Intangible asset | Road with “shadow tolls.” |
| 4   | ● Users pay operator  
● Amounts payable depend on usage of the infrastructure  
● Grantor guarantees that operator revenue will not fall below a specified level (“shortfall guarantee”) | Financial asset and intangible asset. The financial asset arises from the right to receive a minimum amount of cash; the intangible asset arises from the right to earn additional amounts above that minimum. | Toll road for which operator receives a guarantee of minimum revenue. |
| 5   | ● Grantor pays operator  
● Amounts payable depend on usage of the infrastructure  
● Grantor guarantees that operator revenue will not fall below a specified level (“shortfall guarantee”) | Financial asset and intangible asset. The financial asset arises from the right to receive a minimum amount of cash; the intangible asset arises from the right to earn additional amounts above that minimum. | Prison, hospital etc. with payments based on occupancy subject to a guaranteed minimum income. |
<table>
<thead>
<tr>
<th>Ref</th>
<th>Description</th>
<th>Asset(s) recognised by operator</th>
<th>Typically found in</th>
</tr>
</thead>
</table>
| 6   | ● Users pay operator  
    ● Grantor regulates the unit prices that the operator may charge users, based on a targeted rate of return that may be revised | Intangible asset | Fixed term utility concession  
Note: The operator recognises an intangible asset rather than a financial asset even if it expects the grantor to regulate prices and / or adjust the duration of the concession based on the targeted return. |
| 7   | ● Users pay operator  
    ● Amounts payable depend on usage of the infrastructure  
    ● Grantor agrees to pay to the operator any shortfall between actual earnings before interest and taxation and a fixed minimum | Financial asset and intangible asset. The financial asset arises from the right to receive a determinable amount of cash from users and / or the grantor; the intangible asset arises from the right to earn additional amounts above that determinable amount. | Fixed term utility contracts. |
| 8   | ● Grantor pays operator  
    ● Amounts payable do not depend on usage of the infrastructure during the first half of the concession  
    ● Amounts payable depend on usage of the infrastructure during the second half of the concession period | Financial asset and intangible asset. The financial asset arises from the right to receive cash from the grantor during the first half of the concession irrespective of usage; the intangible asset arises from the right to charge the grantor according to usage in the second half of the concession. | Rail concession that begins with “availability payment” and switches to usage payment. |
| 9   | ● Grantor pays operator a fixed “availability payment”  
    ● Users pay operator according to usage | Financial asset and intangible asset. The financial asset arises from the right to receive the fixed “availability payment”; the intangible asset arises from the right to charge users. | Toll bridge |
| 10  | ● Users pay operator  
    ● Amounts payable depend on usage  
    ● Concession has variable term and terminates when total revenues collected by the operator reach a predetermined level | Intangible asset | Toll bridge |
4.4.8 Payments from the operator to the grantor

IFRIC 12 addresses scenarios in which the operator receives consideration from the grantor for construction or upgrade services. In addition, in some cases the operator may make a payment to the grantor at inception of a service concession arrangement. In our view, the operator should recognise and measure any assets arising from such payments according to their substance, having regard to the terms of the arrangement as a whole.

For example, consider a case in which the operator makes a payment to the grantor at inception of a service concession arrangement relating to an existing toll road. The operator has the right to collect tolls from users from commencement of the arrangement and also an obligation to upgrade sections of the road in later years. In this case it appears that the initial payment by the operator is made as consideration for the right to collect tolls on the existing toll road. The operator should recognise an intangible asset at inception of the arrangement; the subsequent performance of upgrade services will result in an enhancement of this intangible asset.

Conversely, consider a case in which the operator makes a payment to the grantor at inception of a service concession arrangement relating to a new hospital. Under the terms of the arrangement, the operator is required to construct a new hospital building. Once the hospital is available for use, the operator will receive monthly payments from the grantor that do not depend on usage of the hospital. The total cash receivable from the grantor exceeds the fair value of the construction and operation services to be provided by the operator. In this case it appears that the initial payment by the operator gives rise to a financial asset receivable by the operator from the grantor.

4.4.9 Timing of recognition

In accordance with general practice for executory contracts, the operator recognises consideration receivable as it performs the construction / upgrade services. Generally, the nature of the asset(s) that the operator recognises once the infrastructure is available for use determines the nature of the asset(s) that the operator recognises as it performs construction / upgrade services. For example, when the operator receives a licence to charge users once the infrastructure is available for use, the IFRIC concluded that the asset that the operator recognises as it performs construction / upgrade services is itself an intangible asset.

4.5 Borrowing costs

4.5.1 General requirement

If the operator receives a right to charge for usage of the public service infrastructure and adopts the allowed alternative treatment in IAS 23 of capitalising certain borrowing costs, then the operator capitalises attributable borrowing costs for qualifying assets incurred during the construction or upgrade phase. Otherwise, the operator expenses borrowing costs as incurred. However, the capitalisation of interest will be relevant only in respect of intangible assets, since a financial asset cannot be a qualifying asset.

Application to the case studies

- Case study 1 – toll road. The operator recognises an intangible asset as consideration for construction services. If the operator adopts the allowed alternative treatment in IAS 23, then it should capitalise attributable borrowing costs incurred in respect of the intangible asset recognised before the infrastructure is available for use. Otherwise, the operator should expense borrowing costs as incurred.
- Case study 2 – hospital. The operator recognises a financial asset as consideration for construction services. Therefore the operator expenses borrowing costs as incurred, regardless of the policy it selects under IAS 23.
- Case study 3 – light rail system. The operator recognises both a financial asset and an intangible asset as consideration for construction services. If the operator adopts the allowed
alternative treatment in IAS 23, then it capitalises attributable borrowing costs insofar as they relate to the intangible asset recognised before the infrastructure is available for use. Otherwise, the operator should expense borrowing costs as incurred.

**IAS 11.18**
In addition, the operator may capitalise borrowing costs into the carrying amount of construction work in progress in accordance with the general requirements for construction contracts. However, as the operator recognises a financial / intangible asset as the work is performed, the carrying amount of construction work in progress at any time, and hence the amount of borrowing costs eligible for capitalisation in this way, may not be material.

**4.5.2 Operator receives an intangible asset**

**IFRIC 12.IE15**
An operator that receives an intangible asset as consideration for construction or upgrade services classifies the asset accumulating during the construction / upgrade phase as an intangible asset. Some commentators on the draft version of the interpretation suggested that the asset to be recognised by the operator during the construction / upgrade phase is some form of receivable, that is, a right to receive an intangible asset once construction / upgrade services have been completed. However, the illustrative examples included in IFRIC 12 state that the right to receive an intangible asset is itself an intangible asset.

**IAS 23.4,**

**IFRIC 12.BC58**
This intangible asset meets the definition of a qualifying asset under IAS 23, being “an asset that necessarily takes a substantial period of time to get ready for intended use or sale.” The IFRIC concluded that the intangible asset recognised during the construction / upgrade phase meets this definition because the license to charge the public is not ready for use until the infrastructure used to deliver the public service is constructed.

An operator that recognises an intangible asset during the construction phase and adopts the allowed alternative treatment in IAS 23 capitalises attributable borrowing costs as part of the carrying amount of the intangible asset. The borrowing costs to be included in the carrying amount of the intangible asset are the actual borrowing costs of the operator.

Other requirements of IAS 23 also affect the operator. For example:

**IAS 8.13,**

- The operator capitalises all borrowing costs on all qualifying assets. Furthermore, if an entity consolidates a number of operators, then it should apply the accounting policy choice consistently to all of the entities included in the consolidation. Similarly, the group financial statements should reflect the same accounting policy choice for investees that it includes in its financial statements through equity accounting and proportionate consolidation.

**IAS 23.11, 13**
- The operator capitalises only those borrowing costs that would have been avoided if the operator had not undertaken the construction / upgrade services. This may include interest on borrowings made specifically for purposes of the construction, as well as the cost of borrowings that otherwise could have been repaid.

**IAS 23.20-25**
- Capitalisation commences when borrowing costs are being incurred and the construction phase of the arrangement is in progress. Capitalisation ceases when the infrastructure, and therefore the intangible asset, is ready for its intended use. If construction work is interrupted for extended periods, then the capitalisation of borrowing costs is suspended.

These requirements are illustrated by case study 1. If the operator elects the alternative treatment under IAS 23, then it will capitalise any borrowing costs directly attributable to upgrading sections of the road to become a three-lane highway. Capitalisation commences when borrowing costs are incurred and upgrade work has started, and ceases when the upgrade work is complete. Capitalised borrowing costs are included in the cost of the intangible asset recognised during the upgrade phase.

Conversely, if the operator does not adopt the allowed alternative treatment in IAS 23, then it should expense all borrowing costs as they are incurred.
4.5.3 Operator receives a financial asset

**IFRIC 12.22, BC58**
If an operator recognises a financial asset as consideration for construction or upgrade services, then it expenses borrowing costs as incurred. IFRIC 12 notes that a financial asset does not meet the definition of a qualifying asset under IAS 23. Consequently, the operator does not capitalise borrowing costs.

**IAS 39.55, 56** If the operator classifies its financial asset as a loan or receivable, or as an available-for-sale financial asset (see section 5.4 Subsequent accounting for a financial asset), then it will recognise interest income. This interest income will be accreted between the date that the receivable is recognised and the date that the receivable is collected and calculated on an effective interest basis in accordance with IAS 39.

4.5.4 Practical issues

As discussed in section 4.3 Recognition of construction / upgrade revenue, total revenue over the service concession arrangement will vary based on whether the operator recognises a financial asset or an intangible asset. However, generally an operator will record the same total revenue and operating profit for construction services irrespective of whether it recognises a financial asset, an intangible asset or some combination thereof as the consideration receivable, provided that the fair value of the consideration receivable is the same in each case. However, the operator’s pre-tax result during the construction phase may differ due to the different treatment of borrowing costs.

**IFRIC 12.IE9, IE21** In particular, during the construction phase the pre-tax result of an operator that recognises a financial asset may differ from the pre-tax result of an operator that recognises an intangible asset and capitalises borrowing costs, even if all other terms of the concession agreement are the same. An operator that recognises a financial asset will recognise interest income at the effective interest rate of the receivable due from the grantor and also recognise interest expense on its own borrowings. Conversely, an operator that recognises an intangible asset may capitalise its own borrowing costs that are directly attributable to the construction of the infrastructure.

In cases in which the operator recognises both an intangible asset and a financial asset, the pre-tax result of the operator could be different depending on whether it assumes that it earns the financial asset or the intangible asset first during the construction phase. The third illustrative example in IFRIC 12 assumes that the operator recognises a financial asset and an intangible asset on a pro rata basis throughout construction. However, the examples are illustrative only and other approaches may be acceptable depending on the terms of the arrangement.

Additional complexities may arise in cases in which the operator receives another asset from the grantor as partial payment for construction services. Suppose for example that an operator provides construction services with a fair value of 300 over three years. The operator receives consideration comprising a tangible asset with a fair value of 100 on inception of the arrangement and an intangible asset with a fair value of 200 once construction is complete.

On inception of the arrangement, the operator records the asset received at its fair value, that is, Dr Asset 100, Cr Deferred revenue 100 (see section 4.6 Items provided by the grantor). Over the course of the three years, the operator records total construction revenue of 300, that is, Dr Intangible asset 200, Dr Deferred revenue 100, Cr Revenue 300. However, if the operator provides construction services of 100 in year 1, then should the operator recognise an intangible asset of 100, or reduce the carrying amount of deferred revenue by 100, or adopt a pro rata approach? This will in turn determine the extent of borrowing costs, if any, that the operator may capitalise in year 1. The illustrative examples in IFRIC 12 do not illustrate this issue.

4.5.5 Future developments

The exposure draft of Proposed Amendments to IAS 23, published by the IASB in May 2006, proposes eliminating the option currently available in IAS 23 to recognise borrowing costs immediately as an expense. If amendments are issued consistent with the proposals, then the
capitalisation of borrowing costs directly attributable to the intangible asset accumulated during the construction phase will become mandatory. The exposure draft proposes that the amendments should be applied prospectively on or after the effective date. However, an entity would be able to choose to apply the requirements from any date prior to the effective date.

4.6 Items provided by the grantor

4.6.1 General requirement

IFRIC 12.27 If the grantor provides items to the operator that the operator may retain or sell at its discretion, and those items form part of the consideration for the services provided, then the operator recognises those items as assets. The operator measures the items at fair value on initial recognition, recognising a corresponding liability representing the obligation to provide services in the future. This publication refers to such items as “keep or deal” items.

Application to the case studies

- Case study 1 – toll road. The operator receives surplus land from the grantor and has the discretion to occupy, redevelop or sell the land as it sees fit. The operator should recognise the land as an asset at its fair value. The operator recognises a corresponding liability, representing the obligation to provide services in the future.
- Case study 2 – hospital. The operator receives an additional building from the grantor and has the discretion to occupy, redevelop or sell the building as it sees fit. The operator should recognise the building as an asset at its fair value. The operator recognises a corresponding liability, representing the obligation to provide services in the future.
- Case study 3 – light rail system. The operator receives no other items from the grantor.

4.6.2 “Keep or deal” items are not government grants

IFRIC 12 states that “keep or deal” items that the grantor transfers to the operator in consideration for services are not government grants. The distinction is important as the operator will account for “keep or deal” items and government grants in different ways. For example, the operator may account for a non-monetary government grant either at fair value or at nominal value. In contrast, the operator must measure “keep or deal” items at fair value on initial recognition.

4.6.3 Distinguishing “keep or deal” items from concession infrastructure

The operator needs to distinguish “keep or deal” items from concession infrastructure, as it will account for the two classes of items in different ways. The operator recognises “keep or deal” items as assets, whereas the operator does not recognise existing public sector infrastructure of the grantor as its asset.

For example, suppose that the grantor transfers to the operator a property interest in a site containing a hospital building and a separate office building. Under the terms of the concession, the operator must rehabilitate and operate the hospital building for 20 years and then return the hospital building to the grantor in a specified state. Conversely, the operator has discretion as to the future use of the office building, which in practice it may occupy itself, redevelop and / or sell.

In this case the hospital building is infrastructure within the scope of IFRIC 12 and so the operator will not recognise the hospital building as its property, plant and equipment. However, the operator has discretion to “keep or deal” the office building. Assuming that the office building forms part of the overall arrangement consideration, the operator will recognise the office building as its asset, measured at fair value on initial recognition.
4.6.4 Classification and subsequent accounting

IFRIC 12 does not specify how operators should classify “keep or deal” items on initial recognition, or account for such items subsequently.

In our view, the operator should classify such items in accordance with applicable IFRSs. In the example above, the operator may recognise the building as property, plant and equipment, investment property or inventory, depending on its intended use of the building. The classification on initial recognition determines the subsequent accounting.

4.6.5 Practical issues

Some of the practical issues that may arise in applying IFRIC 12’s requirements to items provided by the grantor can be illustrated by more complex examples.

**Licenses to operate existing infrastructure**

Suppose that, as in case study 1, the grantor transfers to the operator an interest in an existing road, together with adjoining land. The adjoining land will be used primarily to expand the number of lanes of the road, though the operator will receive some surplus land that it may “keep or deal.” Unlike case study 1, the operator receives a right to collect tolls from users of the road from the commencement of the concession, that is, the operator has the right to collect tolls from users of the existing infrastructure before the upgrade work is completed.

In this case the operator should not recognise the existing road or the land to be used for the purpose of the concession as property, plant and equipment. However, it will recognise the surplus land that it may “keep or deal” as an asset. But should the operator recognise an intangible asset on commencement of the concession, representing the right to collect tolls in relation to the existing infrastructure?

**Items that may be sold only after a period of usage**

Suppose that the grantor transfers to the operator an existing hospital. The operator must operate the existing hospital while constructing a new hospital on a different site. Once the operator has completed construction of the new hospital and transferred services from the existing hospital to the new hospital, it may occupy, redevelop or sell the existing hospital site. How should the operator account for its interest in the existing hospital?

In this case it might be argued that the existing hospital, considered in isolation, is not concession infrastructure within the scope of IFRIC 12, as the grantor does not control the residual interest in the existing hospital. This argument suggests that the operator should recognise the existing hospital as property, plant and equipment. Conversely, it might be argued that, considering the arrangement as a whole, the grantor requires the operator to provide an operational hospital at all times during the concession term. This argument suggests that the existing hospital is part of the concession infrastructure so the operator should not recognise the existing hospital as an asset, at least initially.

The above examples touch on questions concerning whether there are circumstances in which an operator should segment a service concession arrangement, and whether an operator should adopt a holistic or a discrete approach to concession infrastructure. Generally IFRIC 12 does not address such issues.
5. The operational phase

5.1 Introduction

Typically service concession arrangements require the operator to provide a range of services in addition to construction or upgrade of the public service infrastructure by the operator. These services may include maintenance of the infrastructure and other services provided directly to the grantor or to users.

IFRIC 12.10 Issues addressed by IFRIC 12 relating primarily to the operational phase are:

- How should the operator recognise and measure service revenue during the operational phase?
- How should the operator account for obligations to maintain the infrastructure?
- How should the operator account subsequently for any financial asset that it recognises initially during the construction / upgrade phase of the arrangement?
- How should the operator account subsequently for any intangible asset it recognises initially during the construction / upgrade phase of the arrangement?

These issues are discussed below.

5.2 Operation revenue

5.2.1 General requirement

IFRIC 12.20, IAS 18.9 The operator should recognise and measure revenue related to operation services in accordance with IAS 18. The general principle in IAS 18 is for revenue to be measured at the fair value of consideration received or receivable for services provided.

Application to the case studies

- Case study 1 – toll road. The operator collects and retains tolls paid by users of the road. The operator should recognise tolls collected as revenue as they are earned.
- Case study 2 – hospital. The operator receives cash from the grantor during the operational phase. The operator allocates cash receipts between amounts that settle the financial asset received in consideration for the construction services and amounts that are consideration for the operation services. The operator recognises the latter as revenue as earned.
- Case study 3 – light rail system. During the first 10 years of the operational phase the operator receives a fixed monthly amount for services provided. During the second 10 years the operator retains and collects fares from passengers during the operational phase. The operator allocates cash receipts between amounts that reduce the financial asset received in consideration for the construction services and amounts that are consideration for the operation services. The operator recognises the latter as revenue as earned.

The recognition and measurement of revenue in each of the three case studies is discussed in more detail below.

5.2.2 Operator recognises an intangible asset

IAS 18.9, 20 The operator recognises an intangible asset when it receives a right to collect fees that are contingent upon the extent of use of the public service (i.e., to the extent that the operator bears the demand risk). The operator then recognises revenue as earned.

IAS 18.20 For example, in case study 1 the operator recognises tolls as revenue from the operational phase as the tolls are earned. If users paid in advance in order to use the road for a specified period of time, then the operator will apply the recognition and measurement principles of IAS 18 in order to determine an appropriate basis on which to recognise revenue.
The terms of the arrangement also may obligate the operator to perform repairs and maintenance necessary to keep the infrastructure in a specified condition. If the obligations to perform such repairs and maintenance arise from use of the asset during the license term, then the “make good” obligations are measured and recognised in accordance with IAS 37, as discussed further in section 5.3 Maintenance obligations.

5.2.3 Operator recognises a financial asset

The operator recognises a financial asset when it receives an unconditional right to receive cash that is not dependent upon the extent of use of the public service. In a typical service concession arrangement the operator provides additional maintenance services in relation to the infrastructure. If the requirement to perform repairs and maintenance is not a result of the use of the asset under license then the operator recognises revenue from maintenance services and the resulting financial asset as revenue is earned, and measures revenue at the fair value of consideration received or receivable.

For example, in case study 2 the operator provides maintenance services to the grantor during the operational phase of the service concession arrangement. The operator recognises revenue arising from maintenance services as it is earned.

Judgement may be required to measure revenue relating to a specific operation service, e.g., maintenance of the infrastructure, when several services are provided in a single service concession arrangement. In arrangements such as case study 2, for example, it is common for the grantor to pay a single periodic amount to the operator during the operational phase. The concession agreement may describe this payment as an “availability payment” or a “unitary payment” without analysing the payment between the various services. In addition, often the periodic payment is indexed, in whole or in part, for example by reference to a consumer price index.

As a general principle, IFRIC 12 requires the operator to allocate the total consideration received or receivable to the various services provided “by reference to the relative fair values of the services delivered when the amounts are separately identifiable”. The allocation is performed by reference to the fair values of the services provided even if the contract stipulates individual prices for certain services. This is because the amounts specified in the contract may not necessarily be representative of the fair values of the services provided or the prices that would be charged if the services were sold on stand alone basis. In practice the operator might estimate the relative fair values of the services by reference to the costs of providing each service plus a reasonable profit margin.

In determining the fair value of the total consideration to be allocated, future cash receipts are discounted using an imputed rate of interest in accordance with IAS 18. That standard defines an imputed rate of interest as the more clearly determinable of either (1) the prevailing rate of lending to a borrower with a similar credit rating; or (2) the rate of interest that discounts nominal amounts receivable to the current sales price of the goods or services. Accordingly, in practice total consideration receivable may be discounted to the amount equal to the total fair value of services rendered, or it may be discounted using a prevailing rate of lending to the grantor with the resulting amount allocated in a manner proportionate to the estimated fair values of services rendered.

In our view, one appropriate method for the recognition of revenue in case study 2 is as follows: The operator forecasts future monthly payments receivable from the grantor using estimates of a consumer price index and any future deductions. The operator discounts those payments using an appropriate imputed rate (see above) to determine the net present value of the total consideration receivable in the arrangement. The operator allocates this total consideration to construction of the new hospital (construction phase), maintenance of the hospital (operation services), and replacements of specialist plant, by reference to the relative fair values of these services. The operator then recognises revenue as services are performed, based on this allocation. However, IFRIC 12 does not prescribe a specific method of recognising revenue in service concession arrangements, and other methods that reflect the general principles set out above also would be acceptable.
Difficulties in practice may arise if actual guaranteed cash payments differ from the original estimate, for example due to the actual consumer price index or performance deductions being different from original expectations. Changes in estimate should be accounted for prospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

5.2.4 Operator recognises a financial and an intangible asset

Further complexities may arise in service concession arrangements in which the operator recognises an intangible asset and a financial asset. In such cases the fair value of consideration receivable under the arrangement will be allocated between a financial asset and an intangible asset. Revenue is recognised as earned at the fair value of consideration received or receivable. A portion of payments collected is allocated to the repayment of the financial asset.

Consider an arrangement in which the operator collects fees from users, but is guaranteed to receive a minimum monthly amount, with any shortfall paid by the grantor. One way to allocate the consideration receivable between a financial asset and an intangible asset is to:

- measure the consideration receivable for construction services by reference to the fair value of construction services, which may be estimated at cost plus a reasonable margin (e.g., 350,000)
- measure the financial asset received in exchange for construction services by discounting future guaranteed payments using an imputed rate (see 5.2.3 Operator recognises a financial asset above, e.g., 260,000)
- measure the intangible asset received as the difference between the consideration allocated to construction services and the financial asset recognised (e.g., 90,000).

Guaranteed payments received during the operational phase then would be allocated to repayment of the financial asset, while any fees received in excess of the guaranteed amount would be recognised as revenue is earned. A simple case using this method is illustrated in Appendix I.

5.3 Maintenance obligations

5.3.1 General requirement

Typically concession agreements require the operator to maintain the infrastructure such that the infrastructure can deliver a specified standard of service at all times. In addition, generally service concession arrangements other than “whole-of-life” arrangements require the operator to hand back the infrastructure to the grantor or another party in a specified state at the end of the concession period.

The operator recognises and measures contractual obligations to maintain or restore infrastructure in accordance with IAS 37, except for any upgrade element for which the operator should recognise revenue and costs in accordance with IAS 11.

Application to the case studies

- Case study 1 – toll road. The operator has an obligation to maintain the road to a specified standard. In order to comply with this obligation the operator must resurface the road periodically. The operator will recognise and measure a provision for the resurfacing obligation in the manner discussed below.
- Case study 2 – hospital. The operator is required under the terms of the concession agreement to provide maintenance services, including major overhauls of certain specialised plant at the hospital. The operator recognises revenue as the services are provided. The operator accounts for the overhauls of specialised plant as a revenue-generating element of the arrangement, and allocates a portion of the consideration received or receivable to this element.
- Case study 3 – light rail system. The operator has an obligation to maintain the light rail system to a specified standard. In order to comply with this obligation the operator must replace certain tracks. The operator will recognise and measure a provision for this obligation in the manner discussed below.
5.3.2 Accounting for obligations

The general requirements of IAS 37 are discussed in KPMG’s publication Insights into IFRS, section 3.12 Provisions; this publication addresses the application and interpretation of these requirements only in the context of contractual obligations recognised under a service concession arrangement.

IAS 37.14,
IAS 37 requires provisions to be measured at the best estimate of the amount at which the present obligation could be settled at the reporting date. If the effect of the time value of money is material, then the provision is measured by discounting amounts expected to be paid to settle the obligation using a pre-tax rate that reflects the time value of money and the risks specific to the liability. A provision is recognised when an entity has a present obligation as a result of a past event, the outflow of economic resources to settle the obligation is probable, and the obligation can be measured reliably.

Typically routine maintenance costs will be expensed as incurred when maintenance is not identified as a revenue-generating activity.

5.3.3 Distinguishing obligations from services

Judgement may be required to determine whether a particular programme of maintenance to be undertaken by an operator is an obligation arising under the terms of its license to be recognised under IAS 37, or a service provided under the terms of the arrangement and therefore a revenue generating activity.

IFRIC 12.E4,
The illustrative examples in IFRIC 12 demonstrate situations in which major maintenance is accounted for as a provision, and when it is accounted for as a revenue-generating activity. For example, in a case in which the operator is required to resurface a road at a specified time during the concession period, the resurfacing work is viewed as a revenue-generating activity and is accounted for as a revenue component of the arrangement. In cases in which the operator is required to maintain the road in a specified state, but the exact nature and extent of work is not specified but varies according to use, the obligation to resurface the road is measured and recognised in accordance with IAS 37.

In many arrangements in which the operator recognises an intangible asset it may be appropriate to regard maintenance activities as a “make good” obligation (a condition of the licence), and in many arrangements in which the operator recognises a financial asset it may be appropriate to regard maintenance activities as a revenue-generating activity (a service to the grantor). The Illustrative Examples to IFRIC 12 demonstrate these approaches. However, different approaches may be appropriate in some cases.

In our view, the most appropriate accounting treatment of maintenance activities will depend on the facts and circumstances of each arrangement, not on whether the operator recognises a financial asset or an intangible asset as consideration for construction / upgrade services.

5.3.4 Recognition and measurement

Judgement will be required in measuring an obligation to maintain or restore a concession asset and in determining the timing of its recognition. Generally IAS 37 requires a provision to be measured at the estimated amount at which it could be settled at the reporting date. Often it will be appropriate to recognise a provision for an obligation to restore a concession asset as the asset deteriorates. In such a case the provision is likely to be measured at the estimated costs expected to be incurred to perform maintenance or restoration work, discounted using a rate that reflects the time value of money and the risks involved.

In case study 1, for example, the operator has a contractual obligation to maintain the road in a specified condition. Usage of the road will lead to deterioration of the upper layers of the road surface. In order to fulfil its contractual obligation, the operator will need to resurface the road
periodically, say once every seven years or so. Therefore the operator will recognise a provision and charge actual resurfacing expenditure against the provision.

The operator recognises the unwinding of the discount of the provision as a finance cost. The illustrative examples provided in IFRIC 12 show the total increase in provision for the period in a single line in the income statement. We presume that this presentation was selected because the effect of unwinding the discount was considered to be immaterial in that case.

5.4 Subsequent accounting for a financial asset

5.4.1 General requirement

IFRIC 12.23 The operator accounts for any financial asset it recognises in accordance with the financial instruments standards. There are no exemptions from these standards for operators. General requirements applying to financial instruments are discussed in KPMG’s publication *Insights into IFRS*, section 3.6 Financial instruments. This publication addresses the application and interpretation of these requirements only in the context of financial assets recognised as consideration for services performed under a service concession arrangement.

Application to the case studies

- Case study 1 – toll road. Not applicable as the operator does not recognise a financial asset.
- Case study 2 – hospital. The operator recognises a financial asset received as consideration for the construction services. The operator classifies the financial asset as a loan or receivable, as available-for-sale or, if the designation criteria are met, at fair value through profit or loss.
- Case study 3 – light rail system. The operator recognises a financial asset received as partial consideration for the construction services. The operator classifies the financial asset as a loan or receivable, as available-for-sale or, if the designation criteria are met, at fair value through profit or loss.

5.4.2 Classification

IFRIC 12.24 IFRIC 12 requires that a financial asset received as consideration in a service concession arrangement be accounted for and disclosed in accordance with the financial instruments standards. IFRIC 12 requires the operator to classify the financial asset as a loan or receivable, available-for-sale, or at fair value through profit or loss if so designated.

IFRIC 12.BC44 The fact that recovery of the financial asset may be dependent upon the infrastructure meeting performance targets during the operational phase of a service concession arrangement does not preclude classification of the financial asset as a loan or receivable. Performance targets in this context refer to the infrastructure’s ability to deliver the required public service and may include, for example, quality and efficiency targets.

IAS 39.9, 11A An entity may designate a financial asset at fair value through profit or loss in accordance with IAS 39 only:

1. when doing so results in more relevant information because either:
   - it eliminates or significantly reduces a measurement or recognition inconsistency that would result from measuring assets or liabilities or recognising gains or losses on them on different bases (an “accounting mismatch”); or
   - a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis in accordance with the entity’s documented risk management or investment strategy, and information is provided to key management personnel on this basis;
2. in respect of an entire combined contract when such contract contains one or more embedded derivatives, unless those embedded derivatives either:

- do not significantly modify the cash flows that otherwise would be required by the contract; or
- are ones for which it is clear with little or no analysis when first considering a similar hybrid instrument that separation is prohibited.

IFRIC 12.BC62 In its deliberations the IFRIC concluded that a contract would not include an embedded derivative for the potential variability if the amount receivable by the operator could vary with quality or efficiency targets achieved, or other services provided by the operator. This is because IAS 39 defines a derivative as an instrument whose value changes in response to a variable not specific to a party to the contract, while performance criteria are an operator-specific variable.

An embedded derivative may be present when payments receivable under the arrangement vary with a consumer price index or a similar variable. However, it is unlikely that such a variable would modify the contract cash flows significantly, and therefore the derivative would not meet criterion 2 above.

IFRIC 12.BC61, IAS 39.9 The IFRIC noted in the basis for conclusions that a financial asset arising from a service concession arrangement is unlikely to meet the definition of a held-to-maturity investment, because this would be possible only if the asset was quoted in an active market. This is consistent with the definitions of held-to-maturity investments and loans and receivables in IAS 39. IAS 39 defines held-to-maturity investments as “non-derivative financial assets with fixed or determinable payments and fixed maturity” that the entity intends and is able to hold to maturity, and states that this category excludes financial assets that meet the definition of loans and receivables. IAS 39 defines loans and receivables as “non-derivative financial assets with fixed or determinable payments”, and states that this category excludes investments quoted in an active market, financial assets at fair value through profit or loss, financial assets designated as available-for-sale, and assets for which the initial investment may not be substantially recovered. If the initial investment may not be substantially recovered, then IAS 39 requires such assets to be classified as available-for-sale. Therefore a financial asset with fixed and determinable payments can be classified as held-to-maturity only if it is quoted in an active market. Otherwise, it will meet the definition of loans and receivables, unless it is designated as an asset at fair value through profit or loss or as available-for-sale.

IAS 39.9 As such, in most cases in practice an operator will have a choice only as to whether to classify a financial asset as a loan or receivable or as available-for-sale. IAS 39 mandates available-for-sale classification if substantially all of the initial investment may not be recovered other than due to credit deterioration.

The operator classifies financial assets on an asset-by-asset basis; there is no requirement for an entity that recognises a number of financial assets arising from different service concession arrangement to apply the same classification in all cases.

5.4.3 Accounting treatment IAS 39.46, 48 Subsequent to initial recognition, loans and receivables are measured at amortised cost using the effective interest method, whereas financial assets designated at fair value through profit or loss and financial assets classified as available-for-sale are measured at fair value. Determination of the fair value of a financial asset recognised in a service concession arrangement may be difficult, and substantial judgement may be required, because there is unlikely to be an active market for a right to receive guaranteed payments under a service concession arrangement. In the absence of quoted market prices, IAS 39 requires the use of valuation techniques to determine the fair value of a financial asset and provides guidance on their use.

IAS 39.46, 58, 59 Financial assets that are designated as hedged items are subject to the hedge accounting requirements of IAS 39. All financial assets except those measured at fair value through profit or loss are reviewed for impairment at each reporting date in accordance with IAS 39. An impairment loss is
First Impressions: IFRIC 12 – Service Concession Arrangements
January 2007

recognised if objective evidence indicates that an event occurring after initial recognition has an
impact on the asset’s estimated future cash flows. For example, if some payments receivable under
the service concession arrangement are not expected to be recovered following payment defaults by
the grantor, then the financial asset would be considered impaired and an impairment loss would be
recognised and measured.

IAS 39.55, 56 Interest earned on a receivable or an available-for-sale financial asset should be calculated using the
effective interest method and recognised in profit or loss in accordance with IAS 39. A change in the
fair value of an available-for-sale financial asset is recognised directly in equity, except for
impairment losses and foreign exchange gains and losses, until the financial asset is derecognised
(e.g., exchanged for cash when payments due under the arrangement are received). A change in the
fair value of a financial asset at fair value through profit or loss is recognised in profit or loss.

5.5 Subsequent accounting for an intangible asset

5.5.1 General requirement

IFRIC 12.26 The operator accounts for any intangible asset it recognises in accordance with IAS 38 and IAS 36
Impairment of Assets. There are no exemptions from these standards for operators. General
requirements applying to intangible assets and impairment of non-financial assets are discussed in
KPMG’s publication Insights into IFRS, sections 3.3 Intangible assets and goodwill and 3.10
Impairment. This publication addresses the application and interpretation of these requirements only
in the context of intangible assets recognised as consideration for services performed under a
service concession arrangement.

Application to the case studies

● Case study 1 – toll road. The operator recognises an intangible asset received in consideration
for the construction services. The operator measures the intangible asset in accordance with
IAS 38, amortising it over the life of the concession.
● Case study 2 – hospital. Not applicable as the operator does not recognise an intangible asset.
● Case study 3 – light rail system. The operator recognises an intangible asset received in
consideration for the construction services. The operator measures the intangible asset in
accordance with IAS 38, amortising it over the life of the concession.

5.5.2 Measurement

IAS 38 allows intangible assets to be measured using either the cost model or the revaluation model,
extcept that an asset must be measured using the cost model if it cannot be revalued because there
is no active market for that asset. In most cases there will be no active market for intangible assets
recognised under service concession arrangements, and therefore the cost model will be used.

Under the cost model the intangible asset is measured at its cost less any accumulated amortisation
(see below) and any accumulated impairment losses.

Intangible assets recognised under service concession arrangements within the scope of IFRIC 12,
other than whole-of-life arrangements, will have finite useful lives, because one of the scope
requirements of IFRIC 12 is for the grantor to control the residual interest in the infrastructure. Under
IAS 36 intangible assets with finite useful lives are assessed at each reporting date to determine
whether there is any indication that an asset might be impaired. A recoverable amount of the asset
is estimated if such an indication exists. The standard provides examples of circumstances that may
indicate impairment. In a service concession arrangement, an example of an impairment indicator
would be a change in market conditions whereby the use of the asset by the public may be lower
than expected originally. However, if an intangible asset is not yet available for use (e.g., the operator
cannot begin charging the public because the concession asset is not ready for use), then an
intangible asset should be tested for impairment annually.
The recoverable amount of an intangible asset recognised in a service concession arrangement will be based on value in use calculations in most cases, because there is unlikely to be a basis for determining its fair value less costs to sell, i.e., an amount obtainable from the sale of an asset in an arm’s length transaction. Such value in use calculations would require forecasts of amounts obtainable from the public in the future years and will involve considerable judgement. An impairment loss should be recognised if the recoverable amount of the intangible asset is less than its carrying amount.

In accordance with IAS 36, recoverable amount should be determined for a cash-generating unit to which an asset belongs, if the intangible asset does not generate cash inflows that are largely independent from other assets or a group of assets. Generally, intangible assets recognised under a service concession arrangement will have independent cash flows, because they represent a right to charge the public for use of the infrastructure maintained for purposes of the arrangement.

**5.5.3 Amortisation**

IAS 38 requires an intangible asset to be amortised over its expected useful life. The useful life of an intangible asset recognised in a service concession arrangement is the concession period. In our view, amortisation should begin when the asset is available for use, i.e., when the operator is able to charge the public for use of the infrastructure.

For example, in case study 3 the operator does not begin to collect fares from the public until ten years after the start of the concession period. In our view, in this case any intangible asset recognised would not be amortised until the second 10-year period, i.e., when the operator can start receiving fares from the public for services provided. During the first 10-year period the intangible asset would not be considered “available for use” and would be tested for impairment annually, as discussed above.

IAS 38 allows a variety of amortisation methods to be used to allocate the intangible asset’s depreciable amount over its useful life, including the straight-line method, the diminishing balance method, and the units of production method. The method selected should be consistent with how the benefits from the intangible asset are expected to be consumed.

While the straight-line method may be appropriate for many service concession arrangements, different methods also may be acceptable. However, at present IAS 38 states that an amortisation method that results in an amortisation charge lower than would result from the straight-line method would be appropriate only in rare circumstances. Although the IASB has indicated its intention to amend this statement in IAS 38, prior to any change care should be taken in determining an appropriate method of amortisation. In our view, it is not acceptable under IAS 38 to adopt an amortisation method that is based on the revenues that are generated through an intangible asset because such methods normally do not reflect the pattern in which the economic benefits of an asset are consumed.

IAS 38 and IFRIC 12 do not allow the use of “interest” methods of amortisation, including the “annuity method”, which take into account the time value of money.
6. Disclosures

6.1 IFRIC 12

IFRIC 12 contains no disclosure requirements, other than the requirement that if an entity adopts the interpretation prior to its effective date, then it should disclose that fact. Disclosure requirements applicable to service concession arrangements are contained in SIC–29 Service Concession Arrangements: Disclosures.

6.2 SIC–29

SIC–29, as amended by IFRIC 12, applies to both grantors and operators in all service concession arrangements whereby the operator receives a right and assumes an obligation to provide services to the public. Not all service concession arrangements within the scope of SIC–29 are within the scope of IFRIC 12. SIC–29 requires all aspects of the arrangement to be considered in making appropriate disclosures, including at a minimum:

- a description of the service concession arrangement, and significant terms affecting the timing, amount and certainty of future cash flows
- the nature and extent (including timing and amount as applicable) of:
  - rights to use concession assets
  - obligations to provide services to the public
  - obligations to acquire or build concession assets
  - obligations to deliver concession assets at the end of the period
  - renewal and termination clauses
  - other rights and obligations
- changes in service arrangements during the period
- the classification of assets arising from the arrangement
- the amount of revenue and profits or losses recognised on exchange of construction services for a financial or intangible asset.

Disclosures may be provided individually for each service arrangement or in the aggregate for each class of service arrangements involving services of similar nature.
7. Other matters

7.1 Introduction
One key objective of the IFRIC’s work on service concession arrangements was to eliminate, or at least reduce, the diversity of accounting models observed in practice. IFRIC 12 addresses operator accounting for service concession arrangements with specific characteristics. It does not seek to address all service concession arrangements, or grantor accounting. This section discusses the relevance of IFRIC 12 to other types of service concession arrangements and to grantors.

7.2 Service concession arrangements outside the scope of IFRIC 12

7.2.1 Public-to-private arrangements
Not all service concession arrangements fall within the scope of IFRIC 12. In preparing IFRIC 12 the IFRIC noted that service concession arrangements can take many forms. In the view of the IFRIC, developing comprehensive guidance for all such arrangements “would have significantly delayed the interpretation.”

Information note 2 to IFRIC 12 provides references to IFRSs that apply to typical types of public-to-private arrangements, including arrangements that are outside the scope of IFRIC 12. The information note refers to “a continuum of arrangements” and acknowledges that there are no “bright lines” between the different types of arrangement or, therefore, the relevant accounting requirements.

7.2.2 Private-to-private arrangements
IFRIC 12 addresses public-to-private arrangements. In many cases the grantor will be a public sector body and the operator will be a private sector body. It also is possible that the grantor may be a private sector body that itself has a public service obligation. The latter arrangements, in which both parties are private sector bodies, are within the scope of IFRIC 12 because of the public service obligation.

In addition, it may be appropriate to apply IFRIC 12 to some private-to-private arrangements. The basis for conclusions to IFRIC 12 states that application by analogy to private-to-private arrangements “would be appropriate” for arrangements that:

- “meet the requirements set out in paragraph 5,” i.e., meet the scope criteria that establish that the grantor controls the use of the infrastructure
- “have the characteristics described in paragraph 3,” i.e., have the general features of service arrangements described in that paragraph.

IFRIC 12 identifies types of arrangement that may be very similar to leases. In some cases the accounting by operators would be significantly different under IFRIC 4 / IAS 17 and IFRIC 12. However, the scope of IFRIC 12 defines the border between leases and service concession arrangements that are within its scope: leases convey a right to control the use of an asset whereas the grantor retains control of the right to use the infrastructure in arrangements that are within the scope of IFRIC 12.

Our first impression is that the reference in IFRIC 12 to application by analogy is not intended to signify a free choice as to whether to account for other arrangements either under IFRIC 4 / IAS 17 or as service concession arrangements under IFRIC 12. Rather, IFRIC 12 may be relevant for identifying and accounting for those private-to-private arrangements in which the grantor retains control of the right to use the infrastructure.
7.3 Grantor accounting

IFRIC 12 does not address the accounting by grantors. However, in practice grantors may wish to look to IFRIC 12 in order to develop appropriate accounting policies for service concession arrangements.

Our first impression is that a key issue for such grantors will be to assess the extent to which it is necessary or appropriate for grantor accounting to maintain symmetry with operator accounting. Consider the following:

- **Recognition and measurement of infrastructure**

  Suppose the operator constructs infrastructure and receives an intangible asset with a fair value of 100. The current value of the residual interest in the infrastructure at the end of the concession period is 20. In this case the operator will not recognise the infrastructure as its property, plant and equipment. Instead, it will recognise an intangible asset of 100 that it will amortise over the concession period.

  Should the grantor recognise property, plant and equipment of 100 as construction is completed? Or should it record as an asset only its interest in the residual of 20? The grantor has rights to control the infrastructure such that the operator should not recognise the infrastructure as property, plant and equipment. This at least implies that the grantor should recognise the property, plant and equipment.

- **Measurement of a financial liability**

  Suppose that in the above case the operator receives a right to collect tolls from users, but the grantor agrees to pay to the operator any shortfall between actual tolls and 100. In this case the operator will recognise a financial asset of 100.

  How should the grantor measure the financial liability arising from this minimum revenue guarantee? The grantor may be obliged to deliver cash of up to 100 to the grantor. However, the grantor should measure any financial liability at fair value on initial recognition. If tolls are expected to be 100 and are not expected to be subject to significant variation, then the fair value of any financial liability recognised by the grantor may be significantly smaller than the 100 recognised as a financial asset by the operator.

  One historical criticism of “risks and rewards” models for accounting for service concession arrangements is that in practice there were arrangements for which neither the grantor nor the operator recognised the concession infrastructure on its balance sheet, and for which the operator recognised a financial asset without the grantor recognising a financial liability.

  Our first impression is that the application of IFRIC 12 will not necessarily result in symmetry between operator and grantor accounting.
8. Effective date and transition

8.1 Effective date

IFRIC 12 is effective for annual periods beginning on or after 1 January 2008; early adoption is permitted. If an entity early adopts the interpretation, then it should disclose that fact.

8.2 Transition

8.2.1 General requirement

IFRIC 12 is to be applied retrospectively unless this is impracticable. If application of the interpretation results in a change of an accounting policy, then that change is accounted for in accordance with IAS 8.

IFRIC 12 provides transition relief when retrospective application is impracticable. This relief is available to existing users of IFRSs and, through a consequential amendment to IFRS 1 First-time Adoption of International Financial Reporting Standards, to first-time adopters of IFRSs. If retrospective application at the start of the earliest period presented is impracticable for any service concession arrangement, then an operator should:

- reclassify assets recognised previously under the service concession arrangement as intangible and/or financial assets at the start of the earliest period presented, measured at the previous carrying amount of the assets recognised previously, i.e., without remeasurement; and
- test financial and intangible assets for impairment as of the start of the earliest period presented, or if this is impracticable, at the start of the current period.

Application to the case studies

- Case study 1 – toll road. If the toll road and surplus land were recognised previously as the operator’s property, plant and equipment and retrospective application is impracticable, then the operator would reclassify the carrying amount of the road as an intangible asset as of the start of the earliest period presented. The operator then would test the intangible asset for impairment in accordance with IAS 36 as of the start of the earliest period presented. If impairment testing as of that date is impracticable, then it would be performed as of the start of the current period.

- Case study 2 – hospital. If the new hospital building and the old administration building were recognised previously as the operator’s property, plant and equipment and retrospective application is impracticable, then the operator would reclassify the carrying amount of the building and specialist plant as a financial asset as of the start of the earliest period presented. The operator would classify this financial asset as a loan or receivable, as available-for-sale, or at fair value through profit or loss if it meets the criteria for such designation. If the financial asset is classified as an available-for-sale asset or as a receivable measured at amortised cost, then the operator would review this financial asset for impairment in accordance with IAS 39 as of the start of the earliest period presented. If performance of impairment test as of that date is impracticable, then it would be performed as of the start of the current period.

- Case study 3 – light rail system. If the rail system was recognised previously as the operator’s property, plant and equipment and retrospective application is impracticable, then the operator would reclassify the carrying amount of the rail system and split it between a financial asset and an intangible asset as of the start of the earliest period presented. There is no explicit guidance in IFRIC 12 regarding how to allocate between the financial and intangible asset, although presumably the same approach would be used as for a new service concession arrangement with both intangible and financial assets. The financial and intangible assets then would be tested for impairment in accordance with IAS 39 and IAS 36.
respectively as of the start of the earliest period presented, or if that is impracticable, as of the start of the current period.

8.2.2 Practical issues in applying the transition relief

Full retrospective application of the interpretation's measurement requirements may be impracticable for service arrangements that have been in existence for a long period of time. For example, obtaining information about construction costs incurred and estimating what would have been an appropriate service margin on construction services may be difficult for arrangements that started many years ago. In such cases the carrying amounts of existing assets would be reclassified as intangible and/or financial assets.

Practical difficulties may arise, for example, when an operator recognises a financial asset on transition. Suppose that previously the operator recognised an item of property, plant and equipment that it depreciated on a straight-line basis and accounted for all cash receipts from the grantor as revenue. Assume that the operator recognises a financial asset classified as a loan or receivable on transition.

In this case the initial carrying amount of the receivable should equal the previous carrying amount of the property, plant and equipment. This results in the operator recognising a different carrying amount for the receivable on transition than if the operator had recognised a loan or receivable throughout. This is because the carrying amount of the property, plant and equipment was reduced on a straight-line basis through depreciation, whereas the carrying amount of the loan or receivable initially would have been measured at amortised cost so as to reflect accretion at the effective interest rate and repayments.

In accounting for the loan or receivable subsequently, should the operator:

- Assess the effective interest rate at which it would lend to the grantor, use this rate to determine the proportion of future cash receipts from the grantor to regard as repaying the financial asset and account for the balance of cash receipts as service revenue, i.e., begin with a realistic effective interest rate and impute a possibly unrealistic service margin?
- Assess the fair value of the future operating services to be provided to the grantor, use this fair value to estimate the proportion of future cash receipts from the grantor that represent service revenue and account for the balance of the cash receipts as repaying the financial asset, i.e., begin with a realistic service margin and impute a possibly unrealistic effective interest rate?
- Estimate both effective interest rate of lending to the grantor and a reasonable service margin and use relative fair value approach to allocate subsequent cash receipts between repayment of the financial asset and service revenue?

Our first impression is that the last method would be the easiest to support, but most difficult to apply in practice.

The interpretation does not specify how the operator should account for a financial asset recognised on transition at the carrying amount of the assets recognised previously.

Further complexities may arise when an operator recognises both a financial asset and an intangible asset on transition. It is not clear how the carrying amounts of previously recognised assets should be allocated between the assets now recognised. Judgement will be required in performing this allocation. In our view, one acceptable method would be to allocate the carrying amount to the financial and the intangible asset based on their relative fair values. Another method would be to measure the financial asset by discounting the future guaranteed payments using a reasonable rate of lending to the grantor, and assign the remainder of the carrying amount to the intangible asset.
Again, the interpretation does not specify how the allocation between a financial and an intangible asset is performed when assets recognised previously are reclassified on transition.

The interpretation also does not specify how the operator should account on transition for existing liabilities that are directly related to the service concession infrastructure. Our first impression is that transition relief applies only to intangible and financial assets recognised in a service concession arrangement, regardless of how they were classified previously. Other assets and liabilities related to a service concession arrangement, for example “keep or deal” items, should be accounted for in accordance with the requirements of IFRIC 12 with full retrospective application.
Appendix I: Simple worked example

Introduction
This simple worked example illustrates the mechanics of applying the key requirements of IFRIC 12 regarding the recognition and measurement of revenue, and recognition and measurement of the consideration for construction services. For simplicity it does not illustrate the other requirements of IFRIC 12.

Facts and circumstances
Municipality A (the grantor) contracts with Entity B (the operator) to build diagnostic medical equipment (a scanner) that will be used in providing public health services. The equipment will take one year to build. After its construction the operator will provide maintenance services and make the scanner available to the public health service facility for a period of five years. The operator does not expect major repairs to be necessary during the concession period. At the end of the concession period the operator must return the equipment to the Grantor for no additional consideration. The patient will pay the operator 100 each time that the machine is used, with the grantor guaranteeing a minimum annual payment of 60,000.

The operator also sells similar equipment in the normal course of business and estimates that the fair value of services provided in building the scanner is 350,000. The estimated average interest rate of lending to the grantor is five percent.

Analysis

Asset recognition
In exchange for construction services, the operator receives a right to a fixed and determinable amount of cash of 60,000 per year for five years. The operator also receives a right to charge patients for the use of the scanner and to retain the amount collected over and above the monthly minimum. Therefore the operator receives a financial asset and an intangible asset.

Measuring the financial asset
The operator classifies the financial asset received in the arrangement as a receivable under IAS 39, and accordingly measures it initially at fair value and subsequently at amortised cost. Fair value at the end of the first year (upon completion of construction) is estimated by discounting the guaranteed future cash flows of 60,000 per year for five years at a discount rate of five percent per annum. The amount of consideration allocated to the financial asset is 259,769.

Measuring the intangible asset
The fair value of an intangible asset can be difficult to measure; therefore, our first impression is that in practice the fair value of construction services may be the most appropriate way of measuring the fair value of the consideration received. When both financial and intangible assets are recognised, the fair value of the intangible asset can be measured as the difference between the fair value of the total consideration and the fair value of the financial asset received in the arrangement.

The total revenue from construction services will be equal to the fair value of the construction services, i.e., 350,000. 259,769 of consideration is received in the form of a financial asset (see above). In this example, the remaining balance of 90,231 is allocated to the intangible asset, representing the right to charge patients.

Accounting for revenue
Revenue for services provided is accounted for in accordance with IAS 11 and IAS 18. In year 1 the operator recognises revenue from construction services of 350,000.
Assume that actual demand for the scanner over the five years of operation is as follows:

<table>
<thead>
<tr>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of times used</td>
<td>480</td>
<td>780</td>
<td>960</td>
<td>840</td>
</tr>
</tbody>
</table>

Based on the illustrative examples in IFRIC 12, we believe that the cash receipts should be allocated between repayment of the receivable and revenue as follows:

<table>
<thead>
<tr>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Usage x 100</td>
<td>48,000</td>
<td>78,000</td>
<td>96,000</td>
<td>84,000</td>
</tr>
<tr>
<td>Amount received (subject to 60,000 minimum)</td>
<td>60,000</td>
<td>78,000</td>
<td>96,000</td>
<td>84,000</td>
</tr>
<tr>
<td>Allocated to receivable paydown</td>
<td>60,000</td>
<td>60,000</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Allocated to revenue from operation</td>
<td>-</td>
<td>18,000</td>
<td>36,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

Relevant income statement and balance sheet amounts over the concession period are as follows:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>350,000</td>
<td>-</td>
<td>18,000</td>
<td>36,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Finance income*</td>
<td>-</td>
<td>12,988</td>
<td>10,638</td>
<td>8,170</td>
<td>5,578</td>
</tr>
<tr>
<td>Amortisation expense**</td>
<td>-</td>
<td>-18,046</td>
<td>-18,046</td>
<td>-18,046</td>
<td>-18,046</td>
</tr>
<tr>
<td>Receivable***</td>
<td>259,769</td>
<td>212,757</td>
<td>163,395</td>
<td>111,565</td>
<td>57,143</td>
</tr>
<tr>
<td>Intangible asset</td>
<td>90,231</td>
<td>72,185</td>
<td>54,139</td>
<td>36,093</td>
<td>18,047</td>
</tr>
</tbody>
</table>

* Receivable at the end of the previous period x five percent  
** Intangible asset’s initial carrying amount / five years  
*** Receivable at the end of the previous period + finance income for the period - payments for the period
Appendix II: More complex case studies

Case study 1 – toll road
The grantor transfers to the operator an existing single lane toll road, together with adjacent land. Under the terms of the arrangement the operator is required to operate the existing road and, during the early years of the concession, to expand sections of the road to three lanes.

The operator will use its existing equipment to perform the construction work. Once construction is complete, the operator will redeploy the equipment on other contracts.

Not all of the land transferred by the grantor to the operator is required in order to upgrade the road. The operator plans to upgrade the surplus land by installing basic infrastructure (e.g., sewage) and then sell that land to property developers.

The operator is required to resurface the road as frequently as necessary to maintain the road in a specified state throughout the concession period. Deterioration and damages to the road are expected to be largely a consequence of use in operations. The operator expects that in order to comply with the requirements of the concession it will resurface the road three times during the concession period.

The operator will collect tolls from users of the road. Each year the grantor will re-set the unit tolls that the operator may charge each class of road user.

The concession period is thirty years. At the end of the concession period the operator must return the upgraded road to the grantor for no additional consideration at that point. The operator need not return the surplus land.

Case study 2 – hospital
The grantor transfers to the operator an existing hospital complex, comprising a hospital building and an adjacent administration block. Under the terms of the arrangement the operator is required to demolish the hospital building and construct a new hospital containing specified items of specialist equipment. The concession agreement allows the operator to use the administration block as it sees fit, subject to normal planning restrictions. The operator plans to redevelop the administration block as a mixed-use office and retail development.

The operator will use its existing plant to complete the construction work on both the new hospital and the redevelopment of the administration block.

Once the new hospital building is complete, the grantor will use it to provide medical services to the general public. The grantor will employ all medical and administrative staff. The operator is required to maintain the hospital building for the remainder of the concession term. In addition, the operator is required to overhaul the specialist equipment every five years.

The grantor will pay the operator a monthly fee each period that the new hospital is open for use. The monthly fee will be indexed annually by the consumer price index and will be subject to deductions if the maintenance requirements are not performed to standards set out in the concession agreement. If these deductions exceed a certain level in any month, then the operator will receive no payment from the grantor for that month.

The hospital building includes a small retail area on the ground floor that will be let to retailers. The operator will retain all rentals received from the retailers.
The concession period is thirty years. At the end of the concession period the operator must return the hospital to the grantor for no additional consideration. The operator need not return the redeveloped administration block.

**Case study 3 – rail link**

The grantor transfers to the operator an existing light rail system, comprising track, stations and trains, together with land along the route of a proposed five-mile extension of the system. Under the terms of the arrangement the operator is required to operate the existing system and to construct the proposed extension. Completion of the extension will include the construction of new track and stations and the purchase of additional rolling stock.

Generally the operator will use its existing equipment for the construction work and will redeploy that equipment on other projects subsequently. However, the construction work will include boring a new tunnel, for which a specialist boring machine is required. The boring machine will have no material remaining useful life after construction of this tunnel.

The operator is required to maintain the rail system in a specified state throughout the concession period and replace tracks as necessary to achieve that state. The operator expects that in order to comply with the requirements of the concession it will replace the track on the existing system once during the concession period, and will refurbish the stations towards the end of the concession period.

During the first 10 years of the concession period, the grantor will specify the timetable according to which trains must be operated and will set the fares that the operator may charge to passengers. The grantor will pay the operator a monthly fee and the operator will owe all fares collected from passengers to the grantor. The monthly fee payable by the grantor will be subject to indexation by a consumer price index and will increase by 50 percent from the first month in which the extension is available for use. The monthly fee will be subject to deductions each time a train runs late or fails to run.

During the second 10 years of the concession period, the operator will have discretion regarding the timetable provided that it runs a minimum number of services as set out in the concession agreement. The operator will retain all fares collected from passengers during this period and will not be entitled to any minimum or guaranteed payments from the grantor.

After 20 years the concession will end. The grantor envisages that it will run a tender to select a new operator to whom the incumbent operator must transfer all system assets for no consideration.
### Key requirements of IFRIC 12

<table>
<thead>
<tr>
<th>Issue</th>
<th>Case study 1 – Toll Road</th>
<th>Case study 2 – Hospital</th>
<th>Case study 3 – Light Rail System</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRIC 12.4, 5</td>
<td>Is the arrangement within the scope of IFRIC 12?</td>
<td>Yes – the grantor controls the services to be provided with the infrastructure and the price, and the grantor controls the residual interest in the infrastructure.</td>
<td>Yes – the grantor controls the services to be provided with the infrastructure and the price, and the grantor controls the residual interest in the infrastructure.</td>
</tr>
<tr>
<td>IFRIC 12.8</td>
<td>Treatment of the operator’s existing plant</td>
<td>The operator will consider the derecognition requirements of IAS 16, and whether there is a lease of its equipment to the grantor. In this case, as the operator will redeploy the equipment on other projects, it appears likely that the operator will continue to recognise its existing equipment as property, plant and equipment.</td>
<td>The operator will consider the derecognition requirements of IAS 16, and whether there is a lease of its equipment to the grantor. In this case, as the operator will use its equipment both on construction of the hospital and on redevelopment of the administration block, it appears likely that the operator will continue to recognise its existing equipment as property, plant and equipment.</td>
</tr>
</tbody>
</table>

First Impressions: IFRIC 12 – Service Concession Arrangements

January 2007

© 2007 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.
<table>
<thead>
<tr>
<th>Issue</th>
<th>Case study 1 – Toll Road</th>
<th>Case study 2 – Hospital</th>
<th>Case study 3 – Light Rail System</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Treatment of the operator’s right over the infrastructure</strong></td>
<td>The operator will not recognise the existing single lane toll road or the additional lanes that it constructs as its property, plant and equipment.</td>
<td>The operator will not recognise the new hospital that it constructs as its property, plant and equipment. The retail units appear to be a small part of the new hospital and the rental income earned by the operator from the units appears to be small and incidental to the arrangement as a whole, so the operator will not recognise those units as its property, plant and equipment.</td>
<td>The operator will not recognise any of the existing light rail system, the new track and stations that it constructs or the new trains that it purchases as its property, plant and equipment.</td>
</tr>
<tr>
<td><strong>Construction / upgrade revenue</strong></td>
<td>The operator will recognise revenue for construction services provided to upgrade the road to three lanes using the percentage of completion method. Construction revenue will be measured at the fair value of the consideration received.</td>
<td>The operator will recognise revenue for construction of the new hospital using the percentage of completion method. Construction revenue will be measured at the fair value of the consideration received.</td>
<td>The operator will recognise revenue for construction of the extension to the light rail system using the percentage of completion method. Construction revenue will be measured at the fair value of the consideration received.</td>
</tr>
<tr>
<td><strong>Recognition and measurement of arrangement consideration</strong></td>
<td>The operator will recognise consideration received from the grantor for the construction services as an intangible asset, being the right to collect tolls from users of the road. The intangible asset will be measured at fair value on initial recognition.</td>
<td>The operator will recognise consideration received for the performance of construction services as a financial asset, being a right to receive cash from the grantor irrespective of the usage of the hospital. The financial asset will be measured at fair value on initial recognition.</td>
<td>The operator will recognise consideration received from the grantor for the performance of construction services as a financial asset and an intangible asset: the financial asset represents the right to receive cash from the grantor during the first 10 years of the concession, irrespective of the usage of the light rail system; and the intangible asset represents the right to collect fares from users during the second 10 years of the concession.</td>
</tr>
<tr>
<td>Issue</td>
<td>Case study 1 – Toll Road</td>
<td>Case study 2 – Hospital</td>
<td>Case study 3 – Light Rail System</td>
</tr>
<tr>
<td>-------</td>
<td>--------------------------</td>
<td>-------------------------</td>
<td>---------------------------------</td>
</tr>
<tr>
<td>Borrowing costs</td>
<td>The operator expenses its borrowing costs as incurred, unless it adopts the allowed alternative treatment in IAS 23, in which case it will capitalise attributable borrowing costs incurred before the road is available as part of the carrying amount of the intangible asset.</td>
<td>The operator expenses its borrowing costs as incurred. Assuming that operator classifies its financial asset as either a loan or receivable or as available-for-sale, the operator recognises interest income on the financial asset using the effective interest method.</td>
<td>The operator expenses its borrowing costs as incurred, unless it adopts the allowed alternative treatment in IAS 23, in which case it will capitalise attributable borrowing costs incurred before the light rail system is available for use as part of the carrying amount of the intangible asset.</td>
</tr>
<tr>
<td>Operation services: revenue</td>
<td>The operator recognises tolls from users as revenue as they are earned.</td>
<td>The operator recognises revenue for the maintenance services to the grantor, and for services in relation to the major overhauls of the specialised equipment as required by the concession agreement. The operator allocates the total cash receivable from the grantor between the construction, maintenance and overhaul services according to the relative fair values of the respective services. Overhaul services are accounted for as a revenue-generating activity.</td>
<td>During the first 10 years of the concession, the operator will recognise as revenue any element of the cash receivable from the grantor that is attributable to the maintenance services. During the second 10 years of the concession, the operator recognises fares from passengers as revenue as they are earned.</td>
</tr>
<tr>
<td>Operation services: other obligations</td>
<td>The operator recognises a provision for its obligation to resurface the road, measured in accordance with IAS 37.</td>
<td>Not applicable. Major overhauls of specialised equipment are not accounted for in accordance with IAS 37, but as a revenue-generating activity; see above.</td>
<td>The operator recognises a provision for its obligation to replace the existing track, measured in accordance with IAS 37.</td>
</tr>
<tr>
<td>Issue</td>
<td>Case study 1 – Toll Road</td>
<td>Case study 2 – Hospital</td>
<td>Case study 3 – Light Rail System</td>
</tr>
<tr>
<td>-------</td>
<td>--------------------------</td>
<td>--------------------------</td>
<td>---------------------------------</td>
</tr>
</tbody>
</table>
| Financial asset: subsequent accounting | Not applicable. | The operator classifies the financial asset as one of the following:  
• a loan or receivable, in which case it measures the asset at amortised cost using the effective interest method; the fact that receipt of cash from the grantor is contingent upon the achievement of performance standards does not preclude this classification  
• available-for-sale, in which case it measures the asset at fair value, records valuation movements other than impairments in equity, and recognises interest income at the effective interest rate  
• at fair value through profit or loss, if the relevant designation criteria are met, in which case it does not recognise interest income. | The operator classifies the financial asset as one of the following:  
• a loan or receivable, in which case it measures the asset at amortised cost using the effective interest method; the fact that receipt of cash from the grantor is contingent upon the achievement of performance standards does not preclude this classification  
• available-for-sale, in which case it measures the asset at fair value, records valuation movements other than impairments in equity, and recognises interest income at the effective interest rate  
• at fair value through profit or loss, if the relevant designation criteria are met, in which case it does not recognise interest income. |
<p>| Intangible asset: subsequent accounting | The operator amortises the intangible asset over its useful life on a straight-line basis or, if appropriate, on a usage basis. The operator may not apply an interest method of amortisation. | Not applicable. | The operator amortises the intangible asset over its useful life on a straight-line basis or, if appropriate, on a usage basis. The operator may not apply an interest method of amortisation. |</p>
<table>
<thead>
<tr>
<th>Issue</th>
<th>Case study 1 – Toll Road</th>
<th>Case study 2 – Hospital</th>
<th>Case study 3 – Light Rail System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other items provided by the grantor to the operator</td>
<td>The operator recognises the surplus land as its asset, measured initially at fair value. The operator recognises a liability (deferred revenue) for services to be provided in exchange for receipt of the surplus land. As construction services are provided, these amounts will be recognised as revenue.</td>
<td>The operator recognises the administration building as its asset, measured initially at fair value. The operator recognises a corresponding liability for services to be provided.</td>
<td>Not applicable.</td>
</tr>
</tbody>
</table>