Service Concession Arrangements – IFRIC 12

No IFRS or IAS exists for arrangements in the nature of public-private partnerships. On account of growing number of such arrangements between the government and private players, it was important to provide for a basis to account for such arrangements or understanding. By the introduction of IFRIC 12, the interpretation provides a ground of how different IFRS/IAS pronouncements are to be used in accounting for such arrangements, based on the substance of the transaction rather than its form. This article traces various aspects of the arrangement and explains how IFRIC views such arrangements, keeping in view of the nuances and subtleties embedded in the contracts. The article is an attempt to simplify the interpretation and to draw attention to various issues involved in income recognition, asset classification and measurement aspects relating to them.

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Service Concession Arrangements (SCA) is in the nature of public-private partnership involving a long-term contract between the government, or a public sector authority, and private parties. As part of its obligation, governments and public authorities are responsible in providing public services such as national highways, state highways, airports, port terminals, transmission of electricity, roads, railways, bridges, and telecommunication networks, among others. The government has traditionally raised resources from the public by way of direct and indirect taxes. However, on account of reforms in the last part of the 20th century, public-private partnerships have come to the fore, which are providing lessons for sharing responsibilities and resources between the public and the private sector to undertake long-gestation projects of public interest. These types of projects seek for participation from the private sector to put in its own capital at risk and to deliver projects on a long-term basis. This enables the Government to provide services to the public without having to raise resources in advance. The private sector will invest its capital to recoup the cost of investment and return, over the arrangement period. The government also participates in providing concessions to the project, so as to ensure viability of the project to the private participant.

The Service Concession Arrangements are contained in IFRIC-12 of IFRS, which was issued in November 2006, and has become effective for periods

beginning on or after 1st January 2008. A similar issue is contained in Appendix A to Indian Accounting Standard (Ind AS) 11 – Construction Contracts.

Characteristics of SCA

One of the main features of SCA is that it gives right for public and private sectors to provide services that give access to the general public for major economic and social facilities, which were only being provided by the Government. The right is exercised by the private sector by providing its own capital, to build-own-operate-transfer (BOOT) or build-operate-transfer (BOT) the assets that are created through this arrangement. Sometimes the arrangement is extended for its maintenance as well. There are many more variants to the public and private arrangements that have seen the light of day in various countries.

The grantor (the government or the public authority) provides concessions, provides incentives and allows private participants to make public collections over the arrangement period. It is essential that these arrangements are covered by 'Contract Act' or other regulations, so as to ensure its enforcement. This arrangement casts an obligation on the private operator to the hand over the infrastructure irrespective of the financing arrangement. One peculiarity of this arrangement is that the government continues to be the owner of the existing and the developed infrastructure during the continuance of the arrangement from its inception.

Terms and Conditions of the Contract

The contract of SCA like any other contract will provide for the following:

- Standards of performance;
- Payment mechanism;
- Adjustment to payments during the concession period; and
- Arrangement for settling disputes.

The above conditions are special requirements of SCA, besides all other requirements that are contained in any arrangement or contract. Each contract will be different depending upon the type of project, the complexities involved, the gestation period and the duration of the concession arrangement. Except for the broad mechanisms of operating projects, which are common to any other project, specific issues will have to be determined and considered on a case-to-case basis. Even if they are similar projects, the change in location and the strengths and weaknesses of the participating private sector may alter the terms of the contract significantly.

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Objective and Scope

The arrangements between the public authority and private participant in SCAs have to be reduced to such terms, so as to enable a fair accounting practice and disclosure in the accounting records of the private participant. The objectives as envisaged by IFRIC – 12 are as detailed below:

- The treatment of operator's rights over the infrastructure.
- Recognition and measurement of consideration.
- Construction and upgrade services.
- Operation services.
- Borrowing costs.
- Subsequent accounting treating of a financial asset and an intangible asset.
- Items provided to the operator by grantor.

It is interesting to understand that in a SCA, the grantor continues to have control on the assets right from inception to the time the asset is physically handed over to the grantor. In view of this control, it is important to understand that the accounting treatment will be different in SCA contracts, which is aided by the pronouncement in IFRIC -12.

The scope of every SCA will be decided by the government or the public authority. The government stands in the position of grantor and, therefore, controls or regulates, as to what services or infrastructure the private operator shall provide. The grantor dictates on the price, beneficial entitlement, residual interest, the type of public service, the type of infrastructure, etc., while the private participant has to only prove his ability and dexterity to take up the project. Hence, the scope of any SCA will vary based on the type of industry, the type of service, the location and the prevailing laws of country in which such arrangements are entered into and so on and so forth.

Price Controls and Residual Interest in SCA Type of Contracts

Initially, the private service provider is allowed to collect a service fee or infrastructure fee at fixed amounts. Sometimes, the grantor provides mechanism or a formula through which the private participant operating the project may be able to collect a maximum price, thus creating a capping mechanism. However, if there

are excess profits that can be generated as per the directions of the grantor, the same may go to reduce the period of holding the infrastructure or the asset by the private operator. Conditions of grantor's control over the asset and pricing bring in peculiarity for the private operator both in terms of operating flexibility and revenue recognition. A new feature comes into existence, and IFRIC – 12 has exhaustively dealt with such nuances under the changed circumstances.

Apart from control of the asset or infrastructure, created out of the capital of the private participant, the Government or the grantor will have the additional benefit of controlling the residual interest as well. It restricts the operator's choice to sell or pledge the infrastructure. The operator will only have functional access to the infrastructure, while the government reserves the right of a call option at fair value. This provides an uninhibited right to the grantor to short close the contract through the call option process.

Accounting for SCA

The scope of IFRIC 12 is limited only to accounting books of the private operator. It does not provide answers to how the books of the grantor should reflect SCA transactions. Here, the essence of the interpretation is that, since the private operator is not the owner of the assets, the right to recognise the value of property, plant and equipment (IAS 16) is lost altogether.

Irrespective of whether the infrastructure is acquired or constructed by the private partner, acquired or provided by the grantor, all the assets from inception, during accretion or on completion will always belong to the government or the public authority. The operator in fact is only managing the asset on behalf of the grantor, though the private participant has abundant managerial and operational bandwidth. All types and risks and rewards associated with the asset rests with the Government, and this is regardless of which party has the legal title to the asset.

The service provider receives his revenue flow or the consideration for the services that he renders and not from the infrastructure that he constructs for the public or the grantor. The operator has no right to consider this as a leased asset, as it does not fulfil the conditions contained in IAS 17. Further, the control and residual interest rests with the grantor, the private operator under the SCA shall have no right to sell or pledge the infrastructure or the asset created under the contract.

Let us consider the example of a public private partnership in building and operating super-class stretches of roads for public use, where users pay tolls at toll counters. The private participant is required

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to finance, build, and maintain such user roads. The grantor, usually the government, sets the toll charges and has complete control over the public infrastructure and its residual interest. The private partner has to bear the risk relating to construction, maintenance costs and the demand risk that emanates from public use or non-use of such infrastructure. In spite of all these impediments to the private operator, the grantor has complete control of the infrastructure.

As against the costs incurred and risks borne by the private partner, the grantor provides the following rights to the operator:

- A financial asset;
- An intangible asset;
- May be a portion of tangible asset for use;

The control, therefore, is on the right to collect the revenue, which was the primary right of the government. However, this is restricted by the conditions of the grantor, either by way of restriction on the quantum or the duration of collection. Therefore, this brings in the concept of valuing the above assets, or the right, in fair value terms. Hence, recognition of tangible assets as property, plant and equipment, though the private partner has made substantial investment is of no consequence and the recognition of asset creation under IAS 16, is denied.

Recognition of Financial Asset

Prudence plays a very important role in recognition of the financial assets in the books of the operator. Obviously, recognition of tangible assets being denied to the operator, he has to only recognise the financial asset as stated above. While doing so, the operator should recognise the financial asset to the extent there is an unconditional contractual right to receive cash or other consideration from, or at the direction of the grantor.

While revenue or the financial assets are being considered by the operator, he has also to be sensitive in recognising penalties for underperformance, poor quality of performance, not meeting performance or efficiency targets, etc. The ability to enforce a contractual right may be absolute or may be contingent upon

the happening or non-happening of a future event. Fair value accounting takes into its ambit such subtle issues emerging from any transactions from such contracts. A shortfall in user payments may sometimes be guaranteed by the grantor. Such assurances will also form part of financial asset recognition in the books of the private service provider.

Concept of Demand Risk in SCA

The private operator has a projection of the density of users, based on surveys conducted by the grantor or by the operator himself. If the density does not happen as projected, the service provider is put into double jeopardy of having spent huge resources on the project and is unable to recover the revenue from the users. There is a demand risk to the operator if the shortfall is not guaranteed and protected. Therefore, SCA provides for a clause, wherein the demand risk, in the initial stages, is borne by the grantor, or sometimes it is shared between the partners. The operator's cash flow gets effectively secured and the shortfall in collections gets protected. Depending on such protection and the extent of such guarantee by the grantor, the private operator has to suitably recognise the financial asset. In reality, the operator collects tolls from users on behalf of the government and receives compensation from the government irrespective of collections made.

On the other hand, if the operator is allowed to charge the users directly and is made to bear the demand risk, then instead of being a financial asset (where collections are made on behalf of the grantor and the demand risk is borne by the grantor), it will be an intangible asset in the books of the service provider. In other words, it is more a licence of collecting fees by bearing demand risk. It is a financial asset if there is an assurance or a guarantee of inflow to the operator, and an intangible asset on the basis of licence to operate with a demand risk. In other words, the intangible asset is recognised and contingent upon the extent of user demand or the traffic density of the infrastructure facility.

In situations where the demand risk is shared by the grantor and the operator, it may so happen that operator may receive user charges more than the minimum guarantee. Since the demand risk is divided, any consideration received from users over and above the minimum anticipated, is also divided between the partners in the agreed proportion. Here, it is a combination of assurance and a licence to receive additional amount based on usage and therefore the anticipated inflows will be recognised both as financial and intangible asset.

It is well understood that the private operator is only a service provider to the grantor. He either earns revenue from Construction Contracts (IAS 11) or earns service operating revenue as enshrined in IAS 11. The construction part of SCA is in the form of construction or upgrade services, and the operating revenue is from collecting user fees from consumers of the facility.

Revenue Recognition and Measurement

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The construction or the upgrade revenue during the construction phase is subjected to percentage of completion treatment based on the stages of completion. It is measured at the fair value of the consideration received or receivable. Since the public-private participation arrangements are a conglomerate of both construction and service engagements, it becomes important that that due allocation is made between various activities for a proper recognition as per the requirements of accounting standards. This is so because IAS 18 clearly indicates that the recognition criterion is to be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction.

It is pertinent to note that the contract revenue from construction of the infrastructure is not paid immediately, but is deferred for the entire arrangement period. It creates a financial asset on account of certainty of receiving the amount along with revenue from other services. The fair value of the consideration attributable to the construction services is determined, and the financial asset is recognised on the face of the balance sheet. All other services are separately identified for recognition of revenue in the profit and loss account, and financial or intangible asset in the balance sheet. The revenue from the construction part of the contract can also create an intangible asset, depending on whether the amounts received or receivable is guaranteed by the grantor or provides a licence to collect user fees along with demand risk.

On account of recognising the intangible asset, it may so happen that revenue may not be equal to the total cash flow. IFRIC 12 has been criticised for additional revenue recognition without actually matching it with the future cash flows. This peculiarity may be attributed to two sets of inflows and outflows arising

from SCA. The construction services are exchanged for an intangible asset as in a barter system, which conforms to the requirements of IAS 18. Then the same intangible is further deployed to earn revenues from users. The proponents of IFRIC 12 have argued that this is so with any transaction dealing with dissimilar assets or services and is not peculiar to SCA. Hence, it has been argued that the criticism against IFRIC 12 is without any sound logic.

Having recognised the financial or the intangible asset in the books of the private participant, the inflows during the operating phase is allocated between settling the financial asset that is already recognised in the balance sheet, and the balance is considered as current year's revenue for providing maintenance and operating services.

Financial Asset Recognition and Measurement

The recognition stems from the contents of IAS 39 (IAS 9 when it becomes effective). It is going to be initially recognised at fair value based on the NPV of all future cash flows, with a discount rate of interest for a similar instrument. Once the financial asset is recognised and measured, classification and disclosure becomes important. It is classified under anyone of the following categories depending on the substance of the transaction:

- a loan or receivable;
- an available-for-sale financial asset; and
- at fair value through profit or loss, if so designated at initial recognition.

All subsequent measurements of loans and receivables are measured at amortised cost using the effective interest method. The other two are measured at fair value, and the changes being recognised in the other comprehensive income. However, the amortised cost of available-for-sale financial asset must be calculated using effective interest method to determine interest income just like interest income is determined for an asset classified as a loan or a receivable. The interest income so determined is credited to revenue in the profit and loss account. The asset has also to be tested for impairment at each balance sheet date as per the requirements of IAS 39.

Right to charge users (license) brings in the element of intangible asset for recognition. It begins from the day the construction starts, and continues to get accumulated until the work ceases. IAS 38 plays its role in defining how the asset is recognised. Since the asset is not traded in an active market, it is measured at cost less accumulated amortisation and impairment losses.

Service Concession Arrangements, applicable to public-private partnership endeavours, are a class by themselves and require an in-depth understanding of the issues involved. If substance has to rule over form and the nuances of IFRIC 12 have to be applied in letter and spirit, a great deal of understanding is required about the arrangements between the government and the private partner, in long-term projects having the characteristics of BOT, BOOT or any of its variants.

Intangible Asset Recognition and Measurement

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Conclusion

From the above exposition it should be clear to the reader that Service Concession Arrangements, applicable to public-private partnership endeavours, are a class by themselves and require an in-depth understanding of the issues involved. If substance has to rule over form and the nuances of IFRIC 12 have to be applied in letter and spirit, a great deal of understanding is required about the arrangements between the government and the private partner, in long-term projects having the characteristics of BOT, BOOT or any of its variants. ■