



Berlin, 7 August 2015

## IFRS IC – POTENTIAL AGENDA ITEM REQUEST

### IFRIC 12

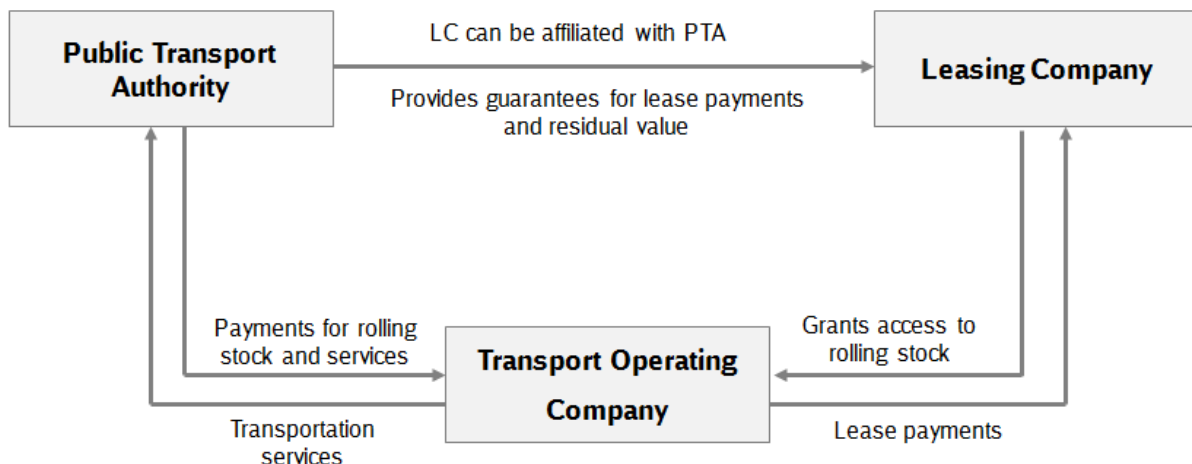
#### Combined service concession and lease arrangements

(Also referring to your outreach request as of 17 July 2015, Issue #2

‘Payments made by an operator to a grantor in a service concession arrangement’)

#### 1. The issue and fact pattern

The European public transport market, as evidenced in the UK, the Netherlands, Sweden, Denmark, and Germany, is characterized by tendering/franchising procedures whenever public funds are needed to make the business economically attractive. Many public transport authorities (“PTA”) have chosen to initiate service concession arrangements in conjunction with guaranteed lease contracts. One model, which is often initiated by the PTA, offers financing support such as lease payment guarantees, residual value guarantees, etc. The relationship between the PTA, the transport operating company (“TOC”) and the leasing companies (“LC”) can be depicted as follows:



[The railway tracks may be owned by the TOC or not. They are not subject to this analysis.]



The characteristics of these agreements can be described as follows:

#### *Service concession granted by the PTA*

- The public passenger transport contracts specify the kind of service the TOC must provide to the public. The price that can be charged for rendering the transport service is also determined or at least authorised by the PTA or the governmental body to which it belongs. Hence, the PTA determines all major aspects of the service the TOC must provide (type, price, frequency of service, quality level etc.)
- The TOC has the right to charge the PTA a fee for rendering the transport service. This fee will also cover any expenditure incurred by the TOC for entering into the lease arrangement, which is an integral part of the service concession arrangement initiated by the PTA (see below). However, the TOC will not be reimbursed if it is responsible for an interruption of the service.
- The passenger transport contract does not contain any construction services to be rendered as regards the tracks or any other equipment.

#### *Lease of infrastructure from the LC*

- The TOC leases the rolling stock from a LC under an arrangement with the following characteristics:
  - There is no residual value risk from the leased assets for the TOC.
  - The lease does not transfer substantially all the risks and rewards incidental to ownership so that the leasing contract qualifies for operating lease classification per IAS 17 on the part of the TOC. In particular, the lease term is not for the major part of the economic life of the assets and the lease payments usually do not cover all of the investment and financing costs.
  - The TOC is responsible for proper maintenance of the rolling stock so that the TOC hereby bears all technical risk – as well as the operational risk – during the lease term.
- The lease arrangement is economically linked to the PTA. Two types of arrangements can be distinguished in this respect:
  - Case 1: The LC is affiliated with the PTA and is, hence, controlled by the same governmental body.
  - Case 2: The LC is an unaffiliated third party. It is then provided with guarantees from the PTA regarding lease payments over and the residual value at the end of the lease term (= for the duration of the passenger transport contract). At the end of the passenger transport contract and at the option of the PTA, the PTA itself or the next TOC will continue the lease of the rolling stock.



## 2. The Questions

Three questions arise in practice with regard to the accounting under IFRS on the level of the PTA as operator:

1. Do the arrangements in the fact pattern fall under the scope of IFRIC 12?
2. If so, what accounting consequences do arise from the lease arrangement?
3. How does an agency role of the TOC with regard to the lease affect the accounting?

## 3. The Views

### ***Sub-Issue 1: Scoping of the fact pattern in the light of IFRIC 12***

There is diversity in practice as to whether the fact pattern falls within the scope of IFRIC 12:

#### *View A: In scope of IFRIC 12*

IFRIC 12 applies to the fact pattern of a public-to-private service concession arrangement above as the rolling stock leased is regarded as infrastructure and the grantor (PTA) regulates what services the operator (TOC) must provide with this infrastructure, to whom it must provide it, and at what price. Furthermore, the PTA controls any significant residual interest in the infrastructure at the end of the term of the arrangement: [IFRIC 12.5]

- In situations described in Case 1 in the fact pattern, the PTA controls the residual interest as the rolling stock is owned by the LC, which is controlled by the same governmental body. According to IFRIC 12.7(b) the regulation of IFRIC 12 also applies for contracts, where the PTA through the affiliated LC grants access to the rolling stock to the TOC.
- In situations described in Case 2 in the fact pattern, which would fall under IFRIC 12.7(a), the PTA controls the residual interest through the right and responsibility to step into the lease contract at the end of the transport contract (or at any other breakage point), or by naming a replacement TOC to step in, or through direct legal ownership.

Proponents of this view argue that the fact pattern is in the scope of IFRIC 12 regardless of how the leased infrastructure shall be categorised pursuant to IFRIC 12.7 and regardless of the type of services that are provided by the TOC according to IFRIC 12.12. Especially, construction or upgrade services for the infrastructure are not necessary as per IFRIC 12.7(b) also existing infrastructure to which the grantor gives access falls within the scope of IFRIC 12.

#### *View B: Out of scope of IFRIC 12*

From an economic perspective, an operating lease arrangement is not treated as an additional construction and upgrade service under the service concession. Following this view, the operator only provides a public service and operates and maintains the infrastructure (operation services) for a specified period of time.



Opponents of view A argue that IFRIC 12 shall only apply to service concession arrangements that cover (inter alia) a construction and upgrade service (which is not the case in the operating lease scenario of the fact pattern<sup>1</sup>).

This is because

- IFRIC 12.12 states that “The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.”
- IFRIC 12 does not provide specific accounting guidance for operation services. Under either view the operator shall recognise and measure revenue in accordance with IFRS 15 for the operation services it performs [IFRIC 12.20].

They conclude that such arrangements are not in scope of IFRIC 12 as they do not include any construction or upgrade services performed by the TOC. The specifications of the rolling stock are determined by the PTA and there is no value added by the TOC in relation to the rolling stock. They argue that, as only operation services are provided, the arrangement is not within the scope of IFRIC 12.

Proponents of view B would therefore account for the lease arrangement under IAS 17. Consequently, no leased asset and financial liability would be recognised, if the leasing contract qualifies for an operate lease under IAS 17.

Only applicable if the resulting view on Sub-Issue 1 is View A:

### ***Sub-Issue 2: Accounting consequences from the lease arrangement under IFRIC 12***

Under View A on Sub-Issue 1, the fact pattern described represents a service concession arrangement in the scope of IFRIC 12. As the operator does not have the right to control the use of the assets that are subject to the service concession arrangement, property, plant and equipment cannot be recognised [IFRIC 12.11]. Consequently, IAS 17 or the new leasing standard, respectively, are not applicable when accounting for the lease arrangement.

Instead, the following accounting treatments are seen in practice for the lease payments from the operator to the grantor:

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<sup>1</sup> Excursus finance lease: In this case the leased infrastructure can be seen as infrastructure that the operator acquires for the purpose of the service arrangement [IFRIC 12.7(a)]. From an economic perspective, the lease arrangement implies a capital investment of the TOC for the benefit of the service concession. This implies a construction or upgrade service in the meaning of IFRIC 12.12 as the operator constructs or upgrades the infrastructure of the grantor.



*View A: Accounting for assets and liabilities from the lease at the start of the concession (On-balance)*

The consideration given by the grantor to the operator covers both, operation and lease-related services. The portion of the fee received from the PTA for providing/leasing the infrastructure is a consideration that may be rights to a financial asset or an intangible asset (a concession asset similar to IFRIC 12.15).<sup>2</sup> As the fees for the lease-related services made by the PTA form an unconditional contractual right to receive cash, those passenger transport contracts fall most likely under the financial asset model per IFRIC 12.16.

The present value of the minimum lease payments to the LC is used as a cost basis for this asset. These payments are an integral part of the service concession arrangement. Hence, these payments are one prerequisite for the TOC to acquire the right to receive the fees for the transportation services. Accordingly, proponents of this view recognise a financial liability for the lease payments and a concession asset.

This approach is supported by decisions made by the Interpretations Committee in March 2013, when it proposed additional guidance to be added to IFRIC 12 for payments made from the operator to the grantor. In 2011, the IFRS Interpretations Committee (IFRS IC) received a request how payments of the operator to the grantor for the access to infrastructure should be accounted for. In March 2013, the IFRS IC decided to propose amendments to IFRIC 12. In applying these amendments the net present value of the lease payments is recognised as a financial liability. The payments are necessary to get the service concession granted. Accordingly, a concession asset is recognised at the same amount as that of the liability.

*View B: Deem the lease payments executory in nature (Off-balance)*

Contractual lease payments to be made by an operator under a service concession arrangement within the scope of IFRIC 12 are deemed executory in nature and are accounted for accordingly (i.e. they are recognised as expenses as they are incurred over the term of the concession arrangement).

Only applicable if the resulting view on Sub-Issue 2 is Treatment A:

***Sub-Issue 3: Role of the operator: Principal vs. Agent***

Proponents of View A of Sub-Issue 2 request that IFRIC 12 should also clarify in which circumstances the payments from the operator to the LC should not be included in the measurement of the liability and the corresponding asset at the start of the concession. Usually, the contracts do not grant the TOC with a right to offset the obligation to pay lease rates with the right to receive cash from the PTA, even if the LC is affiliated with the PTA.

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<sup>2</sup> The nature of the consideration given by the grantor to the operator shall be determined by reference to the contract terms and, when it exists, relevant contract law (IFRIC 12.19 by analogy).



Therefore, in both Cases of the fact pattern, offsetting under the principles of IAS 32 is not possible.

However, the question arises under which criteria the TOC would be classified as an agent with regard to the lease arrangement with the PTA.

#### *TOC as agent*

Some argue that the TOC is acting as an agent in the lease arrangement. Proponents of this view make reference to IFRIC 12.AG2 which says “*If the grantor is a public sector entity, the public sector as a whole, together with any regulators acting in the public interest, shall be regarded as related to the grantor for the purposes of this Interpretation.*” Following this argument one would conclude that in a situation, in which the legal entity acting as lessor and the PTA are controlled by the same governmental body, the payments from the PTA to the TOC and from the TOC to the leasing company of the PTA are, in essence, a seesaw of cash flows without economic substance. Consequently, the TOC can be regarded as an agent, such that no financial asset and financial liability would be recognised. This could particularly be the case, if the risk that the TOC has to provide the lease payments but will not receive the fees from the PTA upon an interruption of services is remote.

Some would even argue for Case 2 of the fact pattern that the TOC is not necessarily acting as a principal. In Case 2, where the LC is not affiliated with the PTA, the PTA provides the LC with substantial guarantees for the lease payments and the residual value and controls the lease arrangement following the first lease term. Another argument for the TOC not considering payments from the lease contract in the measurement basis of a concession asset would be that, economically, the PTA (and not the TOC) is the lessee.



#### **4. Reasons for the Interpretations Committee to address the issue**

##### ***Is the issue widespread and has a material effect on those affected?***

The issues concern major parts of the European passenger transport market. In Germany, a large number of PTAs has chosen to initiate service concession arrangements linked with guaranteed lease contracts. Similar models are also common in France (e.g. passenger rail transport in region Ile-de-France) or the Netherlands (e.g. line Arnhem-Nijmegen, fast ferry Breskens Vlissingen). In the UK, there are currently considerations of moving towards comparable service concession arrangements.

The identified diversities in the accounting practice have a significant impact on the balance sheet. While some TOCs gross up liabilities and receivables, other TOCs don't recognize them or claim the existence of an agency relationship. The different practices lead to limited comparability of the financial statements of TOCs.

##### ***Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?***

The objective of this letter is the presentation of the diversity of accounting practices in relation to passenger transport contracts linked with lease contracts of the underlying rolling stock. A clarification would assist TOCs in accounting for such public concession arrangements on a comparable basis.

##### ***Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?***

We have raised two major questions:

1. Sub-Issues 1 and 2 raise the question whether a passenger transport contract comprising operating services and a lease contract to finance the rolling stock (which is controlled by the PTA) without any construction services falls under the scope of IFRIC 12.
2. Sub-Issue 3 questions whether and how an agency relationship between the PTA and TOC should affect the recognition of the concession asset and financial liability in relation to the lease rates of the rolling stock.

In our opinion the questions could be answered efficiently within the existing IFRSs.

As mentioned above, the IFRIC already addressed some of the accounting issues that we raise in our submission. The amendments were postponed because the IASB decided in May 2013 to wait for the outcome of the discussions on the accounting for variable payments within the Leases project. As the Leases project has almost been finished, the proposed amendments could be brought back to the agenda.



***Is the issue sufficiently narrow in scope?***

We think that we have outlined three issues that are sufficiently narrow in scope. We are convinced that the IFRS IC can undertake the due process in an effective and efficient way.

***Will the solution developed by the Interpretations Committee be effective for a reasonable time period?***

IFRIC 12 remains effective even when the new leasing standard becomes effective. The changes to IFRIC 12 proposed in March 2013 do not fully cover the issues described in this letter. The upcoming improvements and changes of existing IFRSs do not eliminate the diverse accounting practices. The solution to be developed would therefore be effective for a reasonable period of time.

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Please don't hesitate to contact us in case of any question. We would also be pleased to discuss in person.

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