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**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **September 2006, London**

Project: **Provision of Public Sector Services by the Private Sector
[Service Concession Arrangements] Timing of the
Recognition of the Intangible Asset (Agenda Paper 2(ii))**

Introduction and purpose of this paper

1. At the July 2006 IFRIC meeting, staff agreed to consider further whether the IFRIC should specify in IFRIC X the timing of the recognition of the intangible asset. Draft Interpretation D14 was silent on this matter although the IFRIC did invite comments on it.¹
2. Generally under the terms of construction contracts, the consideration that an entity receives is cash. However, in some public-to-private service arrangements, the operator is paid for its construction services by the grantor granting the operator a contractual right to receive a licence to operate the infrastructure, ie a licence to charge users of the service that the operator provides to the public on the grantor's behalf. The operator accounts for the licence in accordance with IAS 38 *Intangible Assets*. Under that standard the

¹ Appendix A includes an extract from the analysis of comments received considered by the IFRIC at its March 2006 meeting.

licence is measured at the fair value of the consideration received for the construction services delivered by the operator. The intangible asset is amortised over its useful life.

3. The purpose of this paper is to consider whether the IFRIC should specify in IFRIC X when the operator should first recognise the intangible asset.

Accounting for exchange contracts

4. The operator receives the licence in exchange for providing construction services. The licence should therefore be recognised in accordance with general principles applicable to contracts for the exchange of assets or services. Exchange contracts generally pass through three stages. Initially they are executory, ie the contracts have been signed but neither party has performed any of its obligations, then one party performs and then the other party performs. Two or more of these stages may occur simultaneously or the three stages may be passed at different times for different elements of the contract.
5. Under IFRS, the rights and obligations arising in executory contracts are generally not recognised unless they are onerous. As noted in paragraph 91 of the *Framework*: “In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.”
6. Thus, the signing of a sales contract does not in itself lead an entity to recognise the consideration it has a right to receive, nor to derecognise the goods and services that it has an obligation to deliver.
7. The situation changes when one party performs some or all of its obligations under the contract . At that point, both parties must recognise the rights and obligations arising from that performance.
8. To help the IFRIC decide whether it should specify in IFRIC X when the operator should first recognise the intangible asset, staff considers below whether it is possible to specify the time at which delivery of the licence

occurs and how the accumulating rights arising during construction should be accounted for.

View A: The licence is delivered at inception of the arrangement

9. A view expressed by some is that the operating licence is delivered to the operator when the contracts are signed. They argue that the signing of the contract delivers the licence—the grantor has no further obligations to discharge so must have performed its side of the exchange.
10. If an operator were to recognise the licence at the inception of the arrangement, it would also have to recognise its contractual obligation at the same time—ie to construct the infrastructure. Construction contracts are accounted for under IAS 11. IAS 11 requires revenue to be recognised on a percentage of completion basis (ie in proportion to the value of the construction service delivered). The difference between the amount recognised as revenue and payments made by the customer is recognised as an asset or liability. Thus, the operator would measure its obligation at the value of the licence (ie the fair value of the total construction contract) less the fair value of the construction services delivered. As construction progressed, the obligation would be discharged and the liability would decline to zero.
11. Those supporting this view acknowledge that the operating licence cannot be exploited as long as the infrastructure has not been built and is ready for its intended use. In many cases the licence is conditional on the operator constructing the infrastructure in accordance with specified quality requirements. But they argue that these factors should not prevent its recognition, the party that performs first always does so on condition that the other party will also perform its obligations in accordance with the terms of the contract.

View B: The licence is delivered when construction is complete (the operator earns its right to the licence as construction progresses)

12. An alternative view is that the grantor does not deliver the operating licence to the operator until construction is complete. In support of this view, it can be

argued that the grantor cannot deliver a licence to operate the infrastructure until the infrastructure exists. Until then, the grantor can only promise to deliver the licence in future. On signing the contract the operator becomes entitled to the right to be paid for its construction services, the operator should therefore recognise its accumulating right to the licence as construction progresses.

13. Taking this view,
 - a) the arrangement would initially be regarded as an executory contract—the operator would not recognise any assets or liabilities on signing the contract.
 - b) the contract would remain executory until the operator started to perform by providing construction services. Applying IAS 11, the operator recognises revenue as the construction progresses and an asset (which represents the operator’s right to be paid by a licence) for the consideration that it has a right to receive in respect of these services.

Comparison of the two views

14. The rights and obligations under service arrangements within the scope of IFRIC X are generally executory at inception. Neither party has performed any of its obligations under the contract when the contract is signed. For that reason staff believes that the licence should not be recognised at inception unless it is onerous. When the operator performs some or all of its obligations under the contract, at that point it must recognise the rights and obligations arising from that performance.
15. The following draft text is included in IFRIC X (Agenda Paper 2 (i) for this meeting):

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| BC66 The IFRIC considered whether to specify within the Interpretation when the operator should first recognise the intangible asset. The IFRIC concluded that the intangible asset (the licence to charge users of the public service) received in exchange for construction services should be recognised in accordance with general principles applicable to contracts for the exchange of assets or services. The operator should recognise the operating licence when the grantor performs its side of the exchange by delivering the licence. |
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BC67 The IFRIC decided not to specify when the operator should first recognise the intangible asset because the timing of the delivery of the licence may be determinable from the terms of the contract. (Emphasis added)

BC68 The IFRIC noted that it is current practice not to recognise executory contracts to the extent that they are unperformed by both parties (unless the contract is onerous). IAS 37 describes executory contracts as ‘contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent’. Paragraph 91 of the Framework states:

In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

16. However if the IFRIC were to specify one approach, the staff believes that specifying the approach based on View B is appropriate on the grounds that:
- a) the contract is executory at the outset; and
 - b) the grantor cannot deliver a licence to operate its infrastructure until that infrastructure exists (as argued in paragraph 12).

Classification of the operator’s asset during the construction phase of the contract

17. The staff is aware of uncertainty in practice about how the operator’s asset (which represents the operator’s accumulating right to be paid by a licence) arising during construction should be classified in the financial statements of an entity when the construction phase spans two or more financial year-ends of that entity.²
18. The staff propose that the IFRIC clarify that the operator should classify its accumulating right to be paid as an intangible asset provided it meets the recognition criteria of IAS 38 (there is an identifiable asset that will generate expected future economic benefits and its costs can be measured reliably). The operator’s right to be paid is outside the scope of IAS 2 *Inventories* because the operator has recognised the related revenue (paragraph 8 of IAS 2).

² In circumstances where the operator receives a contractual right to receive cash for its construction services, the operator accounts for its accumulating right to receive cash during the construction phase of the contract in accordance with the financial instruments standards (IASs 32, 39 and IFRS 7).

Proposed text for inclusion in IFRIC X (*this text would replace the text set out in BC66-68 of IFRIC X*)

19. The IFRIC considered whether to specify when the operator should first recognise the intangible asset. The IFRIC concluded that an intangible asset received in exchange for construction services should be recognised in accordance with the principles applicable to contracts for the exchange of assets or services.
20. The operator's asset (ie its accumulating right to be paid arising as construction proceeds) should be classified as an intangible asset provided the asset qualifies for recognition under IAS 38. In accordance with that standard amortisation begins when the asset is available for use. The asset is outside the scope of IAS 2 *Inventories* because the operator has recognised the related revenue under IAS 11.
21. The IFRIC noted that service arrangements within the scope of IFRIC X are generally executory when contracts are signed and that it is current practice not to recognise executory contracts unless they are onerous. IAS 37 describes executory contracts as 'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent'. Paragraph 91 of the *Framework* states:

In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

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| 22. Does the IFRIC agree with this proposal? |
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Appendix A

Extract from Agenda Paper AP060302

Timing of recognition of the intangible asset

Issues Summary

- 1 In question two of the Invitation to Comment in D14, IFRIC asked constituents:

As explained in paragraph BC6 of the Basis for Conclusions, the draft Interpretation does not specify the timing of recognition of the intangible asset. The IFRIC identified three possible approaches. Do you agree that the proposed Interpretation should remain silent on this matter? If not, which of the three approaches do you think should be specified and in what circumstances?

- 2 Paragraph BC6 is quoted below:

BC6 The IFRIC considered whether to address within the Interpretation the timing of recognition of the intangible asset. It noted that an operator could be regarded as receiving its right to charge users at three different points in time: (a) at the outset of the contract (with a corresponding obligation to provide construction services in exchange); (b) as construction services are provided, by reference to the stage of completion; or (c) once construction is complete, in settlement of the amount due by the grantor for the construction services. The IFRIC decided not to specify when the operator should first recognise an intangible asset. The draft Interpretation is therefore silent on this matter.

Analysis of Comments Received

- 3 Fifty-five commentators on the exposure draft specifically addressed the issue. An overwhelming majority (forty-eight) of those respondents preferred that the IFRIC identify the point when the operator starts to recognise an intangible asset.
- 4 In addition, most of the respondents who gave a view on which approach to choose acknowledged that if the IFRIC chose to be silent on the timing of the recognition of intangible assets, inclusion of examples illustrating the different alternatives would be helpful³.

³ CL6, CLCL26 and CL67

Respondents agreeing with the proposals

- 5 Five respondents (mostly operators) agreed that the IFRIC should remain silent on this issue. Most who supported this view believed that the nature of each concession contract is so specialised that the point at which an entity recognises the intangible asset can vary for each contract. Therefore, the operator should be able to choose when to recognise the intangible asset based on the substance of the arrangement. Lend Lease (CL29) and Companies Operating Highway concessions in San Paulo (CL48) also proposed that when the operator chooses the basis of recognition, that basis should be disclosed.

Respondents disagreeing with the proposals

- 6 Four respondents who support approach (a) agreed with the basis for conclusions that a corresponding obligation would have to be recognised when an intangible asset is recognised at the onset of the contract. Mazars (CL24) noted the right to access the asset, even if not yet built, exists at the beginning of the contract as an in-progress intangible asset. Other respondents noted that approach (a) results in the recognition of an executory contract and therefore should not be adopted.
- 7 The seven respondents who support approach (b) believe that the operator is in effect ‘purchasing’ or ‘building’ a right to operate an asset as it earns the right to charge users for services that the infrastructure will provide.
- 8 Twenty-six commentators specifically believed that an intangible asset should be recognised when construction is complete. Most of these respondents reasoned that the operator’s right to operate is normally conditional upon completion of the concession asset. Another reason supporting approach (c) is that it better evidences the exchange that underpins the barter transaction that gives rise to the revenue, and it could be argued that no intangible asset exists prior to that time. Most of the respondents chose this approach based on the presumption that the IFRIC would accept the intangible asset model as proposed in the draft Interpretation. A sample of some of the respondents’ caveats is given below:

“If the intangible asset model is accepted, ... given that the accounting model being proposed is vastly different from what has been applied in practice, We believe the use of alternative (c) is technically correct.” (*Deloitte, CL3*)

“If the line is taken as above, that the contract should not be segmented then, arguably the intangible asset builds up as construction occurs, with no revenue/profit recognised during the construction phase, in accord with the argumentation at BC9. If, however, profit is recognised at the completion of the construction phase the alternative (c) (as employed in the illustrative example) would appear to be the most appropriate approach.” (*NAO, CL31*)

- 9 The remaining respondents either did not express a preference on which alternative to choose or could not decide between two different recognition points simultaneously.