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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: May 2006, London

Project: Service Concession Arrangements

Paper: D12 – Service Concession Arrangements – Significance of Residual Value (Agenda Paper 5(iii))

Introduction

- 1 Draft Interpretation D12 *Service Concession Arrangements – Determining the Accounting Model* proposed that an infrastructure asset should be considered to be controlled by the grantor when, amongst other things, the residual interest in the infrastructure returned to the grantor at the end of its life, and that residual interest was significant. At the March 2006 IFRIC meeting the IFRIC considered whether the ‘significant residual interest’ criterion was a necessary scope criterion, and agreed that this criterion should be amended. The IFRIC agreed that if a significant residual interest exists, that interest must be transferred to the grantor at the end of the concession arrangement for the arrangement to fall within the scope of D12. Therefore, if a residual interest exists which is not significant, the party that controls that interest at the end of the service concession arrangement is not considered relevant in determining whether the arrangement is or is not within the scope of D12.
- 2 At the March 2006 meeting staff were asked to complete an analysis as to the meaning of ‘significance’ in this context, and particularly which aspect of the

arrangement the residual interest should be compared to in order to determine whether it is significant.

- 3 In order to aid the IFRIC in determining whether it should provide specific guidance on this matter, the staff considers the role of the significant interest criterion in the Interpretations and then considers the way in which 'significant' is used throughout IFRS, in particular staff highlight those instances in which the meaning of 'significant' is clarified. The paper proposes adding guidance to the Application Guidance section of the Interpretation as set out in paragraphs 33-37 of this paper.

Role of 'significant' in the draft Interpretation

- 4 The term 'significant' plays a role in determining whether an arrangement is within the scope of the draft Interpretation, and will therefore have a substantial impact on the accounting approach adopted for the entire arrangement. This means the interpretation of the word has a more substantial impact in this Interpretation than in many of the other contexts in which it arises in IFRS.
- 5 If the residual interest is considered to be insignificant, then, whether it transfers to the grantor or remains with the operator at the end of the service concession arrangement, the arrangement will be within the scope of D12, provided that the scope criteria in paragraph 5(a) are met, that is the grantor controls the services provided, to whom they must be provided, and at what price.
- 6 If a residual interest is considered to be significant and it transfers to the grantor at the end of the service concession arrangement, the arrangement will (subject to the scope criteria of paragraph 5(a)) be within the scope of D12.
- 7 It is only if a significant residual interest is identified that does not transfer to the grantor at the end of the concession that the arrangement will not be within the scope of D12. In such a scenario the operator will be required to analyse the nature of its infrastructure asset under IAS 16 and IAS 17.

The issue

- 8 The issue is that the determination of whether a significant residual interest exists can be measured in a number of ways. As a consequence, in arrangements where the residual interest does not transfer to the grantor, one entity (operator) could determine that the residual interest is insignificant and so be within the scope of the Interpretations provided the conditions in 5 (a) are met. Another entity with a similar economic arrangement could determine that the residual interest is significant and so be required to analyse the arrangement under IAS 16 or IAS 17 ie because the grantor does not control the infrastructure in the manner described in paragraph 5 (b). This can lead to different accounting treatments for contracts that have similar economic effects. The staff regards this inconsistency as inappropriate because it will affect the comparability and usefulness of the financial statements of companies involved in providing service concession arrangements.

Staff Recommendation

- 9 For the purpose of condition 5 (b) staff recommended adding Application Guidance to specify the meaning of the term residual interest. The residual interest is the estimated value of the infrastructure at the end of the term of the concession, if the infrastructure were already of the age and in the condition expected at the end of the term of the concession. The text for inclusion in the Application Guidance is set out in paragraph 32 of this paper. The rationale for inclusion in the BC is contained in paragraph 36.
- 10 The amendment, which is consistent with the definition of ‘residual value’ contained in IAS 16, would provide preparers with useful guidance without limiting their ability to exercise professional judgement. Furthermore, it would reduce the likelihood of different accounting treatments being applied to arrangements with similar economic effects.

Use of the term 'significant' in IFRS

11 Staff have considered the manner in which the term significant is used throughout IFRS. 'Significant' is a term used frequently in IFRS, and this paper does not attempt to identify or explain all examples of its usage¹. Broadly speaking the term significant is used in three main ways:

- (a) requirements to disclose 'significant information';
- (b) requirements for a certain accounting outcome or action where a specified significant event occurs, with no specific guidance as to how significance should be assessed; and
- (c) requirements for a certain accounting outcome or action based on the significance of a certain amount, with a specification of what that amount should be compared to in determining its significance.

Disclosure of significant information

12 There are numerous examples throughout IFRS of requirements to disclose significant information, or the effects of significant changes. For example

- (a) The requirements to disclose significant accounting policies (IAS1.8), significant judgments taken by management in the preparation of the financial statements (IAS1.113) and estimations which have a significant risk of resulting in a material restatement in future periods (IAS1.116);
- (b) A requirement to disclose all significant cash and cash equivalent balances that are not available for use by the entity (IAS7.48)
- (c) Disclosure of a significant change in an estimate of an amount reported in an interim period (IAS34.26).

13 None of the examples identified by staff specified how items should be assessed to determine whether they are significant. Staff believe that entities will not always assess the significance of certain items or events based on the same criteria. For instance, disclosure of a significant change in estimate in

¹ Note that for the purposes of this analysis the term 'significant influence' as used in IAS 28 *Investments in Associates* has not been considered as it is not directly relevant.

accordance with IAS 34.26 might be considered necessary where the change is significant in relation to:

- (a) the total profit and loss effect of the estimate in the accounting period;
- (b) the total balance sheet amount arising from the estimate at the end of the period;
- (c) the results of the entity as a whole; or
- (d) the results of the particular operation to which that estimate is related.

14 Staff believe that IFRS is deliberately non-prescriptive as to when disclosures would be considered significant in order to allow preparers to appropriately exercise their professional judgment.

Accounting outcomes arising from ‘significant’ events

15 There are numerous examples in IFRS of instances where particular accounting outcomes occur as a result of the occurrence of significant events, for example:

- (a) Recognition of revenue when significant risks and rewards have been transferred [IAS18.14];
- (b) Performance of impairment testing when certain significant deviations from expected cash flows associated with an asset occur [IAS 36.14];
and
- (c) recognition of impairment of an available for sale financial instrument when there is a significant or prolonged decline in value [IAS 39.61].

16 In some circumstances there is extensive guidance on when a significant event is considered to have taken place. For example, paragraphs 15 – 17 of IAS 18 *Revenue* provide qualitative guidance on when the significant risks and rewards associated with an item can be considered to have been transferred to the buyer.

17 In other circumstances, the use of the word significant is in the context of providing guidance about another aspect of a standard. For example, paragraph 14 of IAS 36 and paragraph 61 of IAS 39 provide guidance as to when the

trigger for impairment testing and recognition of impairment losses respectively can be considered to have been met.

- 18 None of these instances explicitly specify in what context ‘significant’ should be determined. However, the context is generally obvious. It seems logical that in the case of a ‘significant or prolonged decline in value’, the significance should be measured with reference to the value of that financial asset. In the case of revenue recognition, the significant risks and rewards should be considered in comparison with the complete set of risks and rewards associated with the asset.

Specific requirements for determination of significance

- 19 There are a limited number of examples in IFRS where the standard specifies a certain accounting outcome if an item is significant and mandates the context in which significance should be assessed. Staff have identified the examples set out in the following paragraphs.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

- (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
- (b) the entity specific value of the portion of the entity’s operations affected by the transaction changes as a result of the exchange; and
- (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

[IAS 16.25, IAS 38.46, Emphasis added.]

Each part of an item of property, plant and equipment, with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

[IAS16.43, Emphasis added.]

Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

(a)

(c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from the renewal.

[IAS 38.96, Emphasis added]

An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer....

[IAS39.21 excerpt]

...In other circumstances it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer....

[IAS39.22 excerpt, emphasis added.]

Staff Analysis

- 20 Staff note that there are very limited circumstances in which the context in which significance should be determined is specified in IFRS, however there are several others in which the context is obvious.
- 21 As noted above the issue is that the determination of whether a significant residual interest exists at the end of the term of the concession can be measured in a number of ways. As a consequence, this can lead to different accounting treatments for contracts that have similar economic effects. In arrangements where the residual interest does not transfer to the grantor at the end of the term of the concession, one entity (operator) could determine that its residual interest is insignificant and so the arrangement would be within the scope of the Interpretations, provided the conditions in 5 (a) were met. Another with a similar economic arrangement could determine that its residual interest is significant and so be required to analyse the arrangement under IAS 16 or IAS 17 ie because the grantor does not control the infrastructure in the manner described in paragraph 5 (b).

- 22 Staff believe that there are a number of valid contexts in which significance could be measured for the purpose of determining whether a significant residual interest exists. For example, the residual interest could be considered significant with reference to its value as a proportion of:
- (a) The fair value of total capital expenditure by the operator under the contract (which would include major restoration works);
 - (b) The fair value of total capital expenditure on initial construction services (which would exclude major restoration works);
 - (c) The fair value at inception of the specific asset (or group of assets) to which the residual value relates; or
 - (d) The fair value of expected cash flows under the contract.
- 23 Staff note that it is currently not clear from the Interpretation whether the term ‘residual interest’ should be interpreted in the same manner as ‘residual value’ in IAS 16. The definition of residual value in IAS 16 is as follows

The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

[IAS 16.6]

- 24 If this approach was taken, the entity would determine the estimated value of the infrastructure asset at inception of the arrangement as if that asset were already of the age and in the condition it is expected to be in at the end of the service concession arrangement. Staff note there may be limitations in directly applying this approach, which include
- (a) The end of the service concession arrangement, and the end of the asset’s useful life are not necessarily the same period, and where those periods differ it would be inappropriate for entities to ascertain the expected value at the end of the asset’s useful life and use that to determine whether that residual interest is significant in the context of the service concession arrangement as a whole.

- (b) The definition refers to the ‘estimated amount the entity would currently obtain’ – a phrase which is not directly relevant to the service concession arrangement. In many circumstances the amount to be obtained is nil as there is a transfer to the grantor at the end of the service concession arrangement, however this would not necessarily mean that the residual interest is of insignificant value.
- (c) Similarly, in cases where the residual interest does not transfer at the end of the service concession arrangement and the useful life exceeds the term of the arrangement, the entity may have no plans to dispose of the asset at the end of the arrangement, and to require the IAS 16 approach to be used would be to require the entity to make two estimates about the current value of an asset in a particular condition.

25 Staff therefore note that while this guidance in IAS 16 will be useful to entities, it is probably not helpful to require it to be used. Staff note that the concerns noted in paragraph 24 could equally apply to some items of property, plant and equipment.

Arguments in support of providing explicit guidance

26 The advantage of mandating a particular approach is that this would provide clarity to preparers. They would be able to determine without any degree of doubt whether the residual interest was considered significant for the purposes of applying the [draft] Interpretation. This would lead to consistent accounting treatment in all cases.

Arguments in support of remaining silent

27 However, there are a number of disadvantages to mandating a particular approach. In considering whether a residual interest is ‘significant’, it would seem reasonable to take into account a range of qualitative characteristics in addition to considering any of the values suggested in paragraph 22. For example, the only infrastructure in a particular jurisdiction capable of supplying certain services (such as water or electricity infrastructure) may not be expected to have a significant market value at the end of the service concession

arrangement, but would almost certainly be considered significant by the government of that jurisdiction.

- 28 Staff also note that to mandate any of the measures suggested in paragraph 22 would create some uncertainty for projects which are only partially completed at the end of an accounting period. It appears logical that a consideration of whether an arrangement is or is not within the scope of D12 should be made at the beginning of an arrangement.
- 29 Staff believe that the identifiable advantage of providing clarity by mandating the use of a particular measure is contrary to the requirement for the IFRIC to apply a principles-based approach in providing interpretive guidance (IFRIC Preface .4). Furthermore, staff note that even if the IFRIC did specify the specific element to which the residual interest should be compared in determining its significance, the IFRIC should not, consistent with other IFRS, provide any indication as to what a 'significant' portion of that value would be considered to be. To provide such an indication would run the risk that IFRIC would be perceived to have interpreted the meaning of 'significant' throughout IFRS rather than in relation to service concession arrangements alone.

Staff Recommendation

- 30 Staff note that the Interpretation contains application guidance in relation to certain aspects of the Interpretation. Staff believe that it would be helpful to include a paragraph within the Scope section of the Application Guidance to specify that for the purposes of condition 5 (b) the residual interest is the estimated value of the infrastructure at the end of the term of the concession, if the infrastructure were already of the age and in the condition expected at the end of the term of the concession. This guidance is consistent with the residual value definition contained in IAS 16.
- 31 The amendment would provide preparers with useful guidance without limiting their ability to exercise professional judgement and would reduce the likelihood of different accounting treatments being applied to contracts with similar economic effects.

32 Staff propose that the following text is included in the Application Guidance of the Interpretation:

AG 4A For the purpose of condition (b) quantitative analysis should be carried out to determine whether the residual interest at the end of the term of the concession is significant. The residual interest is the estimated value of the infrastructure at the end of the term of the concession, if the infrastructure were already of the age and in the condition expected at the end of the term of the concession could be compared to, for example:

- (a) total capital expenditure by the operator under the contract (which would include major restoration works);
- (b) the fair value of initial construction services (which would exclude major restoration works);
- (c) the fair value at inception of the specific asset (or group of assets) to which the residual value relates; or
- (d) the fair value of expected cash flows under the contract.

In addition to quantitative analysis, it is necessary for preparers to consider the qualitative characteristics of the residual interest in determining whether that interest should be considered to be significant.

33	Does the IFRIC agree with specifying in the Application Guidance the meaning of the term residual interest as set out above?
34	Does the IFRIC agree with not mandating which value the residual interest should be compared to in determining whether the residual interest is significant or what portion/percentage would be regarded as significant but rather include the above list of examples in the Application Guidance of the Interpretation?
35	If so, does the IFRIC consider that any of the examples suggested would be considered unacceptable for determining whether a residual interest should be considered to be significant? Or that any additional approaches should be suggested?

36 In addition staff propose that the IFRIC explain its rationale in the Basis for Conclusions as follows:

The IFRIC considered whether the requirement at paragraph 5(b) that any significant residual interest had to be controlled by the grantor needed amplification to avoid different accounting treatments for contracts that have similar economic effects. The IFRIC decided to provide Application Guidance to specify the meaning of residual interest and to clarify that for the purpose of condition 5 (b) quantitative analysis should be carried out to determine whether the residual interest at the end of the term of the concession is significant. The IFRIC considered whether it should mandate which aspect of an arrangement the residual interest should be compared to in determining whether it is significant. The IFRIC noted that there existed a range of possible alternatives that could be considered acceptable for this purpose, some of which are detailed in AG4A. In view of this and of the need also for qualitative analysis, the IFRIC decided that it was inappropriate to mandate the use of a particular approach, and that preparers should use their judgment.

37	Does the IFRIC agree with the above rationale?
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38 In addition it may be useful for entities to disclose their methodology for determining whether a residual interest is significant as an accounting policy. If the IFRIC believe that such a disclosure is necessary, the following text could be included as a consequential amendment to SIC 29:

The methodology used to determine whether the residual interest in an infrastructure that remains with the operator at the end of the service concession arrangement is considered to be significant should be disclosed.

39	Does the IFRIC believe that such a disclosure is necessary and, if so, does the IFRIC agree with the proposed text?
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