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International  
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*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:** January 2006, London

**Project:** D14 - Service Concession Arrangements: Intangible Asset Model (Agenda Paper 6A)

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### Introduction

1. One aspect of D14 which drew significant criticism in the comment letters was the revenue recognition profile resulting under the draft interpretation D14 *Service Concession Arrangements - The Intangible Asset Model*. Under the proposals, over the course of the contract, the revenue recognised by the operator exceeds the total amount of cash flows from the contract. In the light of the comments received, and following the IFRIC's discussion in its September 2005 meeting, the IFRIC directed staff to prepare a paper addressing the double recognition of revenue as well as the recognition of profit during the construction phase. This paper addresses those issues but reaches different conclusions from those advocated by the staff at the September 2005 meeting. Paragraphs 50-58 of this paper recapitulate and extend the arguments of the September 2005 paper (henceforth called 'the Alternative View') for the benefit of IFRIC's discussion.
2. The recognition of revenue and profit/loss on construction was discussed in detail in September 2004 see agenda paper 2G from that meeting. This paper summarises the comment letters received and revisits the arguments discussed in agenda paper 2G

3. The staff note that the IFRIC have on numerous occasions re-confirmed their view that an intangible asset model is a critical part of the service concessions package. The IFRIC have expressed their view that arrangements do exist in which the service concession arrangement is merely providing the operator with an opportunity to exploit a commercial opportunity made available to it by the grantor. The absence of (even conditional) commitments from the grantor to the operator about the amount of cash flows arising from the arrangement, coupled with the fact that the physical asset is controlled from the start by the grantor, means that, from the perspective of the operator, these types of arrangement must continue to be treated as an intangible asset. That is, the capital expenditure for which the operator is trying to determine the appropriate accounting treatment generates an item without physical substance from which future economic benefits are expected to flow to the entity.
  
4. Given the necessity for an intangible asset model, it is necessary to determine how the construction services should be accounted for. At some point, the construction service provided by the operator is recognised by the operator as an intangible asset. The staff believe that there are essentially three alternatives as to how transformation from construction asset to intangible asset might be recognised, that is:
  - (a) Revenue and, where applicable, profit is recognised on an exchange transaction, whereby construction services are exchanged for an intangible asset;
  - (b) No revenue is recognised, however profit is recognised on an exchange transaction; or
  - (c) Construction costs incurred are capitalised directly into the cost of an intangible asset and no exchange transaction is accounted for.

#### **Summary of the three approaches**

5. For the purposes of this paper, we will consider a simple example, using the figures originally considered by the IFRIC. The operator constructs an asset at a cost of 100. The margin on the construction portion of the contract is 5. The total cash flows over the service concession period are expected to be 200.

(1) Revenue and profit are recognised

Dr	Costs of construction (B/S)	100	
Cr	Cash		100

*(to recognise payment of the costs of construction)*

Dr	Costs of construction (P&L)	100	
Dr	Intangible Asset	105	
Cr	Costs of construction (B/S)		100
Cr	Revenue		105

*(to recognise revenue and intangible asset)*

(2) Profit is recognised but revenue is not

Dr	Costs of construction (B/S)	100	
Cr	Cash		100

*(to recognise costs of construction)*

Dr	Intangible asset	105	
Cr	Profit on construction		5
	Costs of construction		100

*(to recognise exchange of construction services for intangible asset)*

(3) No profit or revenue is recognised

Dr	Intangible asset	100	
Cr	Cash		100

*(recognition of an intangible asset as the item is constructed)*

<b>Summary of Revenue and Profit recognised during construction</b>			
	(1)	(2)	(3)
Revenue on construction	105	0	0
Profit on construction	5	5	0

6. The staff seek the view of the IFRIC on which of the three approaches is the most appropriate under IFRS.

### **Summary of Comments Received**

7. This issue was addressed specifically in 54 of the comment letters received. Of the remainder, either the question was not addressed at all, or the proposals were rejected on the basis that the respondent did not agree with the intangible model in the first place.
8. The 54 responses were split evenly between those agreeing and those rejecting the proposals.

#### *Respondents agreeing with the proposals – but urging reconsideration*

9. Of the 27 respondents agreeing with the proposals, 4 specifically stated that, although they agreed with the IFRIC’s technical analysis, they were uncomfortable with the result. The following is an extract from CL3 received from Deloitte Touche Tohmatsu:

“We concur with the IFRIC that, if the intangible asset model is accepted, there does not appear to be any methodology within current IFRS that would allow the non-recognition of revenue and profit on the exchange transaction. We note that many parties, particularly user groups such as analysts, are concerned about the divergence this creates between accounting revenue and cash flows, and we share this concern. We believe this accounting obfuscates the actual economic nature of the arrangement. We therefore respectfully request that the IFRIC reconsider the application of this accounting model.”

10. Although the staff appreciate that the accounting result is counter-intuitive to some parties, they believe that the IFRIC should reach its conclusions on the basis of the technical material under review, and that the discomfort identified can be

dealt with by an appropriate explanation of the outcome in the final Interpretations. Should the IFRIC believe that the outcome under existing standards is inappropriate, the appropriate course of action would be to refer this matter to the IASB. Staff note that certain members of the Board expressed their support for the double recognition of revenue when the education session on service concessions was held in October 2005.

*Respondents agreeing with the proposals*

11. 23 respondents positively endorsed the proposals. The supporting arguments are highlighted in CL 32 (Vinci, France).

“Vinci agrees that the concession service arrangements should be viewed as giving rise to an exchange, the exchange of the infrastructure built by the operator for the right to operate it. The appropriate reference is paragraph 12 of IAS 18 as stated in BC 10 and Vinci sees no objection to this reasoning. This right allows the operator to be paid by the users of the infrastructure and the income derived from the operating of the infrastructure is in substance the revenue derived from the construction services.

This view confirms that a service concession arrangement should be separated in two subsequent phases, the first one being the providing of construction services, and the second one being the operating of the infrastructure according to the contract. The costs incurred during the construction phase together with the revenues deriving from the construction services should be accounted for as any other construction contracts, i.e. according to IAS 11, because this construction activity is a key factor for the operator when entering into a concession service arrangement. From the point of view of the grantor, the main purpose of the service concession contracts is the construction and the financing of a new infrastructure. As a consequence, the costs incurred to build the infrastructure should not be viewed as payment to acquire an intangible asset.

This rationale reflects properly the business of most entities operating service concession infrastructures. In BC 9 (a), it is argued that the service concession contracts would not fulfil the conditions necessary to be accounted for separately. On the contrary, Vinci thinks that even when there is only one tendering process, the price of the infrastructure can be one of the major financial factors considered by the grantor and is often indicated in the concession contract.

Would the construction costs of the infrastructure considered as the cost to acquire the right to operate it, the cost of this intangible asset would be different depending on the business structure of the operator :

- for an operator which would build the infrastructure by its own means, the cost of the intangible asset would be comprised of the direct and indirect costs associated with the construction services ;

- for an operator which would rely on third parties to build the infrastructure, the cost of the intangible asset would include the profit margins realised by the external parties.

Vinci could not agree with this outcome which would not provide identical figures for the same service concession arrangement and would not allow a fair competition among concession operators. The basis for conclusion does not refer to paragraphs 45, 46 and 47 of IAS 38 which address the acquisition of an intangible asset through the exchange of a non monetary asset. It would be useful that IFRIC indicates why these paragraphs are not relevant for dealing with the exchange.”

#### *Respondents disagreeing with proposals*

12. 27 respondents disagreed with the proposals – most commonly on the basis that the transactions are not separate, and that the construction costs represent payment for the intangible asset. This view is expressed in CL 39 (CNC, France)

“We take the view expressed in BC9 of D14 that there is no exchange and, as a consequence, no profit or loss recognition. We do not believe there is any commercial substance to an exchange on the grounds that it does not generate extra cash flows for the operator (see IAS 38.46). We regard the construction costs as payments to acquire an intangible asset. We disagree with the principle of the exchange on the grounds it has no contractual or economic basis. Furthermore, it leads to accounting for a “notional” turnover which does generate a cashflow and causes an artificial difference compared to the Financial Model. The recognition of profit or loss on an exchange is related to the segmentation issue examined in Q2 of D13. For the reasons already mentioned, we consider that the conditions for segmenting the concession contract are not generally met. For the above-mentioned reasons we disagree with the IFRIC proposal.”

13. The following extract from CL 16 (Murray and Roberts Concessions, South Africa) emphasises the point:

“At no point is there an exchange of assets. We acknowledge that construction assets may not be the physical assets of the concessionaire and that the concessionaire only has the right to operate the assets and, therefore, upon construction, the assets of the concessionaire are more intangible in nature and may not be considered as Property, Plant and Equipment. In fact, the concessionaire has the right to operate the entire asset, for example, an existing road as well as an additional road construction. Furthermore, the operation of the asset and thus the generation of revenue from the users will most often commence during the construction period i.e. construction milestones will be defined and as milestones are met, so will those completed assets be brought into use for revenue earning purposes. To eliminate doubt, the asset should therefore be recorded as an intangible asset

as and when the construction costs are incurred and at the value paid for such costs. This value, together with certain other upfront concession costs incurred, is considered to be the initial investment value assigned to the concession which investment will generate a required concessionaire return for the period of the concession.

### **The exchange transaction**

14. One of the key determinants as to whether any revenue or profit will be recognised is whether or not an exchange transaction has taken place. IAS 18.12 requires that where goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is a transaction that generates revenue. If the IFRIC continues to support the assertion that an exchange transaction as described by IAS 18.12 has taken place, then revenue must be recognised on that exchange.
15. Commentators had differing views in regards to an exchange transaction. While some of the commentators believed that an exchange transaction between construction service and the intangible right to charge users took place, others did not.

“TEG members have different views on the exchange. One view is that the proposal in the draft interpretation is correct, ie it is correct to follow the line of thinking in paragraph 12 of IAS 18 which states that when goods or services are rendered in exchange for dissimilar goods or services, the exchange should be regarded as a transaction that generates revenues. However, others expressed the view that they were not convinced that there is an exchange transaction where the entity exchanges construction services for an intangible asset. Rather the construction cost are payments to acquire an intangible asset and the cost are accumulated on the balance sheet in accordance with IAS 38.” (EFRAG, CL 9, page 10)

“In substance we do not believe that the operator actually has an asset to exchange in a barter transaction. Under the underlying premise of the interpretations, the operator does not control the infrastructure therefore it is only acting as agent for the grantor in the construction activity and has no tangible asset to barter for the intangible asset.” (The Institute for Chartered Accountants in Ireland, CL 44, Appendix 3)

#### View 1: An exchange takes place

16. Some commentators agreed with the IFRIC’s conclusion that an exchange transaction took place.

IFRIC has a correct understanding of the situation created by a service concession arrangement. When a concession arrangement implies the construction of the infrastructure, there is an exchange between the construction service and the right to charge users when the construction service has been completed (EIFFAGE, CL 28)

17. Under the intangible asset model, physical infrastructure (e.g. road) is recognised as an asset of the grantor. This means that the operator is not building the road for itself. It is providing construction services to the grantor, and receives in exchange an intangible asset – the right to collect the tolls. It is the staff view that, under the intangible asset model, this must be an exchange transaction.
18. IAS 18.9 requires revenue to be measured at the fair value of the consideration receivable. IAS 18.12 gives further guidance on accounting for barter transactions as follows:

When goods are sold or services rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction with generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

19. Although IAS 18 specifically refers only to goods or services supplied in exchange for other goods or services, it is the staff view that the principles can be no different when goods or services are supplied in exchange for an intangible asset. Staff also notes that, in another context, the Board has taken a very broad view of what constitutes goods acquired. IFRS 2 Share-based Payment applies to share-based payment transactions in which an entity acquires goods or services. IFRS 2.5 states that

Goods include inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets.

20. Construction services (the provision of labour, materials, equipment and expertise in order to design and construct a road) are very different in nature both from the road itself and from the intangible asset received. Therefore, the exchange is of dissimilar items, and the guidance in the second part of IAS 18.12 applies.

21. Staff note that if the IFRIC concludes an exchange transaction did occur, then it is possible to conclude either that revenue and profit should be recognised, or that no revenue should be recognised, only a profit element.

### **Recognition of Revenue and Profit**

22. Staff believe that the rules relating to an exchange of dissimilar assets exist in order to ensure that revenue is not manipulated by exchanging assets rather than making cash payments.
23. In recording a transaction in accordance with IAS 18.12, revenue must be measured at the fair value of the consideration received or receivable. The fair value of construction services is the cost of those services, plus an appropriate margin such that, if there were a market for the completed asset, the amount recognised is the amount that would be realised by selling the construction services in that market transaction.
24. Staff note that the IFRIC have raised a concern many times in the past about the determination of the appropriate margin. While staff believe that this is a significant issue, we note that both operators and their auditors have indicated to us that the determination of an appropriate margin on construction services is achievable. They note that the determination of this margin is considered necessary anyway for the purposes of internal reporting and reporting to analysts, and that this information can be reliably determined.
25. Furthermore, staff note that many commentators suggested the recognition of revenue and profit was consistent with the way in which management run the business, and the way in which they expect their performance to be assessed. That is, this treatment clearly shows the profitability of the two distinct activities (construction and operations) and allows meaningful conclusions to be drawn about those activities.
26. Staff believe that the recognition of revenue and profit is supportable under IFRS, and note that many commentators agreed that this would be the appropriate treatment. Staff believe that this is one of a number of alternatives which could be reasonably argued under IFRS. Furthermore, staff note that the while some of the

arguments below in support of the other alternatives are persuasive, many of them do not apply generically to the wide range of service concession arrangements.

### **Recognition of profit without revenue**

27. An alternative view, is to determine that the exchange transaction is akin to an exchange of non-monetary assets, as described in IAS 16.24. For an exchange of non-monetary assets accounted for in accordance with IAS 16, the asset recognised must be recognised at its fair value. In this case, the fair value of the intangible asset is the costs of construction plus an appropriate market margin. However, IAS 16.68 clarifies that in such a transaction the fair value uplift would be a gain, which should not be classified as revenue.
28. Staff note that none of the commentators who addressed this issue supported this approach to resolving the problem. Furthermore, staff note that the objective of IAS16.68 is to prevent the artificial inflation of revenue in circumstances where non-current assets have been disposed of. That is, it is the nature of the asset being disposed of (in the IAS 16 case, a non-current physical asset, in the service concession arrangement, construction services) which dictates whether or not revenue should be recognised. In the service concession arrangement the item being given up by the operator is services for which revenue should be recognised in accordance with IAS 18.
29. Some members have argued that the general provisions of IAS 1.34 apply.

IAS 18 *Revenue* defines revenue and requires it to be measured at the fair value of the consideration received or receivable, taking into account the amount of any trade discounts and volume rebates allowed by the entity. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. The results of such transactions are presented, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. For example:

- (a) gains and losses on the disposal of non-current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses; and
- (b) expenditure related to a provision that is recognised in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and

reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) may be netted against the related reimbursement.

30. Staff believe that it would be difficult to justify a statement that the construction activities are considered incidental to the revenue earning activities of the business. Without the transactions needed for the construction to take place (which staff acknowledge may involve the use of outsourcing), the revenue earning activity would not be able to be carried out. Indeed, the driving factor behind service concession arrangements in many countries is to encourage private funding of the development of infrastructure – if the private sector did not arrange for the construction or major capital maintenance of the infrastructure, the government would not permit that private sector entity to earn revenue from the infrastructure. Therefore staff do not believe it is reasonable to claim that construction services are considered incidental to the revenue earning activity.

View 2: No exchange takes place

31. Under this view, the operator accumulates costs in order to acquire the intangible asset; hence the construction of the infrastructure is not a revenue generating activity.

“We do not agree with the proposal. In our view, the construction costs arising for the infrastructure represent a payment for acquiring an intangible asset. Since the construction does not represent a revenue earning activity the total revenues cannot exceed the total cash inflows. (RIC, CL 23, page 7)

32. Some have suggested that accumulating the costs in order to acquire the intangible asset is not different from research and development activities or constructing a facility in order to manufacture goods or to provide services. In the September 2004 agenda paper, staff argued that there is a significant difference. A company that engages in research and development, or that constructs a facility etc, is spending on its own asset (intangible or PP&E etc), which it will then use in its business. It therefore agreed that there is no exchange in this case, so the company cannot recognise revenue or profit on this activity. By contrast, if the intangible asset model applies, the operator is carrying out work on an asset of the grantor

(the road in our example), in exchange for which the grantor is giving the operator an intangible asset. In this exchange:

- (a) the construction costs incurred by the operator are its cost of sales;
- (b) the grantor's cost of the road includes the fair value of the construction services received;
- (c) the fair value of those services is also the cost of the operator's intangible asset.

33. Staff do not believe that the construction services provided by the operator could be considered to be construction of an intangible asset. From a purely practical perspective, it is clear that those involved in construction are constructing a physical asset. In other construction services contracts where the operator works on an asset which it does not own, those operators recognise revenue on those construction services as they earn a right to future reimbursement. Staff do not believe that because the reimbursement comes in the form of an intangible asset rather than a financial asset that the revenue recognition during the construction period itself would differ.
34. A further alternative argument was provided in the Basis for Conclusions to D14, paragraphs BC 8 and BC9. That is, that because the contract does not meet the segmentation criteria in IAS 11 *Construction Contracts* it is inappropriate to endeavour to split the contract into two component parts, one for the construction and one for the operations. At the time of writing the draft Interpretations a majority of IFRIC members did not support this view. Staff continue to believe that the segmentation criteria of IAS 11 are not directly relevant to the question at hand. The IFRIC is not trying to determine how to separate some construction services from other construction services, rather the IFRIC is trying to determine how to account for the assets arising as a result of the entirety of construction services required under a service concession arrangement.
35. More than one IFRIC member has drawn attention to the restrictions on gain or loss recognition in respect of exchanges of assets set out in IASs 16 and 38. Under

those standards, the cost of a non-monetary item received in exchange for PP&E or an intangible is measured at fair value, unless either:

- (a) the exchange transaction lacks commercial substance, or
- (b) the fair value of neither the asset received nor the asset given up is reliably measurable, in which case the acquired item is measured at the cost of the item given up. (IAS 16.24, 38.45)

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, 38.46)

- 36. An IFRIC member has queried whether the configuration of the cash flows of the asset received (licence) differs significantly from that of cash flows of the asset transferred (road).
- 37. In the staff's view, IASs 16 and 38 are not relevant, and this is the wrong question to ask, because the transaction is not an exchange of assets. There is no transfer of the road, which is never the operator's asset. Rather, the operator provides construction services to the grantor in exchange for the intangible.
- 38. As noted in the September 2004 paper, it may however be helpful to consider how a configuration-of-cash-flows test might be applied to the exchange of services for the intangible. This is a little tricky because the test is not designed for exchanges of services for assets. It seems to staff that it would be necessary to attribute a notional configuration of cash flows to the services themselves, and the only way that staff can conceive of doing this is to attribute to them a right to be paid i.e. a receivable. (In the case of materials, the attributable cash flow might be their market price.) This notional configuration of cash flows would be very different from the configuration of cash flows associated with the intangible, which would support profit or loss recognition.

39. Even if paragraphs 37 and 38 were not correct, and it were necessary to compare the configuration of cash flows on the road with those on the intangible, staff believes that they would be significantly different, because:
- (a) The cash flows on the intangible are more limited in time than the cash flows on the road;
  - (b) If the operator owned the road outright it would be able to charge users whatever it wanted for using the road whereas the terms of the licence are sure to prohibit this;
  - (c) The terms of the licence will often also include caps and floors that would not exist if the operator owned the road outright, and may well result in the cash inflows being much more stable than those on a road would be, and more similar to those on a long-term receivable;
  - (d) Less significantly perhaps, the cash flows associated with the specific maintenance obligations imposed by the licence may differ from those which the operator would choose to incur if it owned the road outright.
40. Staff acknowledge that there is a valid alternative view that in fact the configuration of cash flows does not change. In most service concession arrangements there is not a clause which enables the operator to pass the rights to the grantor in exchange for cash at the completion of construction. Therefore the only possible way in which the operator could ever receive cash flows as a result of the services provided to date, is to operate the asset and receive the cash flows from operations. Accordingly the transaction does not have commercial substance – the configuration of cash flows does not change after the notional exchange transaction.
41. If this view were to be accepted by the IFRIC, the intangible asset would effectively be created during construction and no revenue or profit would be recognised on construction.
42. Staff note that some of the arguments supporting the absence of an exchange transaction do not appear to be valid in respect of all service concession arrangements. For example, an operator builds a road that is 100 km long. The

operator is entitled to charge users for access to 30 km of the road, and the remaining 70 km is operated as a freeway. If an exchange transaction is considered to have taken place, the operator exchanges the total of construction services for a right to charge users for driving along the 30 km. If an exchange transaction has not taken place it would be difficult to justify capitalising the costs associated with the 70 km directly into the intangible asset which relates only to the 30km.

View 3: The exchange transaction takes place at inception

43. A third alternative view of the exchange transaction has been proposed. That is, the exchange transaction occurs at the inception of the service concession arrangement, when the operator acquires the intangible asset. The cost of the intangible asset to the operator is the build up of the costs of construction of the infrastructure that occur in the future. Staff believe this would provide a neat solution in that it acknowledges the existence of an exchange transaction, but allows the accumulation of costs.

The right to charge users for concession services is not an intangible developed by the operator, rather it is previously owned by the grantor and acquired by the operator from the grantor in the course of the service concession transaction. ...and we propose an alternative 'acquired intangible model' where the intangible asset would be recognised at cost without recognition of any revenue. In our view, the fact that cash is not directly paid to the grantor but to a range of third party suppliers who constructed the infrastructure 'on behalf of' the grantor does not undermine the validity of using a purchased intangible asset model. (KPMG, CL 59).

44. However, staff are concerned that this treatment might open the floodgates to allowing the recognition of internally developed intangibles which would not otherwise meet the capitalisation criteria in IAS 38. For example an entity could acquire a brand or licence with little value and then seek to analogise to service concession arrangements that the amounts paid to increase that value should be capitalised into the value of that asset. Staff have been unable to determine a way forward which would prevent this undesirable outcome.

## **Conclusion**

45. Staff note that the IFRIC will reconsider the dividing line between the intangible asset model and the financial asset model at its March 2006 meeting. Staff believe that much of the discomfort that IFRIC members experience with the intangible asset model arises because the accounting is counter-intuitive for certain types of arrangement. Staff believe that the resolution of the boundary between the two models may enable IFRIC members to feel more comfortable that it is appropriate for arrangements accounted for under the intangible asset model to be accounted for as required by D14.
46. As noted in the comment letter from Vinci quoted in paragraph 11, it would be helpful for the IFRIC to provide an explanation in the basis for conclusions about why paragraphs 45, 46 and 47 of IAS 38 are not considered relevant. If the IFRIC agreed with the conclusion of the staff, the staff would draft some wording based on the arguments laid out in paragraph 31 to paragraph 42 of this paper.
47. On balance, staff believe that the proposals in D14 are the most technically robust across the wide range of service concession arrangements. Therefore while staff would be happy to further explore other alternatives under guidance from the IFRIC, staff recommend at this time that the original requirements of D14 should be retained.

48. Does the IFRIC believe an exchange transaction has taken place?

49. If so, does the IFRIC believe that the recognition of revenue is appropriate?

## **Alternative View**

### **Background**

50. As noted at paragraph 1, the paper presented at the September 2005 meeting proposed the opposite conclusion from that given above. The following paragraphs recapitulate and extend the arguments of the September 2005 paper (henceforth called ‘the Alternative View’) for the benefit of IFRIC’s discussion.

51. The principal argument for the Alternative View is that it is misleading for an entity to recognise revenue twice in respect of the same ultimate cash flow. It is

true that revenue does not necessarily require an immediate prospect of receipt of cash. Nevertheless, it is the ability to obtain future cash flows that supports the recognition of every asset. Normally the asset received in an exchange giving rise to revenue is debtors. If those debtors are subsequently 'sold' in a securitisation transaction, revenue is not recognised a second time. When the asset received in an exchange is an intangible representing the prospect of future cash flows, a similar situation exists, with the difference that it is the second transaction rather than the first that gives rise to revenue. The 'second transaction' is in this case multiple transactions with users of the infrastructure forming the subject of the concession. It is only the prospect of those cash flows that provides any value to the intangible.

52. Supporters of the Alternative View distinguish this situation from the typical barter transaction. In bartering the parties acquire goods that will need to be sold in different markets with different prospects for cash flows. In a concession accounted for under the Intangible Asset model there is no prospect of cash flows other than from exploitation of the intangible asset. The grantor does not give the intangible as a means of settling a debt that it owes to the operator. That would be an example of the Financial Asset model. In the Intangible Asset model the operator performs its services merely to obtain the right to operate the infrastructure and so earn future revenue.
53. Following the September meeting the staff discussed the Alternative View with certain Board members. That discussion confirmed the staff in that view but suggested an answer to one question left open in the September paper – whether profit, though not revenue, should be recognised at the time of construction.
54. The view now is that profit on the construction activity should be recognised at the time of construction. The asset under construction 'the infrastructure' is that of the grantor from the start. The role of the operator is that of an agent (a 'service provider') working on the grantor's asset. This can be seen most clearly in the case where the grantor provides an existing asset (a road, hospital, prison, etc.) which is enhanced by the operator before being brought into service under the concession. Under the Alternative View there would be no need to distinguish that part of the operator's activity which was mere enhancement (giving rise to

recognition of profit only) from that part which was new construction (giving rise, under the view set out in the main part of this paper, to recognition of gross revenue). Under the Alternative View the whole activity would be treated as a service, resulting in recognition of only the profit element.

55. The bookkeeping for the construction activity would be as follows:

Dr	Work in progress	
Cr		Cash
Dr	Intangible asset	
Cr		Work in progress (cost)
Cr		Revenue (profit element)

56. Why should this accounting differ from that required by IAS 11 for a normal construction contract? The answer lies in the overarching context of the concession arrangement. The operator does not sell to the grantor as to an external customer. The concession arrangement sets the terms under which the grantor has the asset from the start. The operator has no choice of constructing that asset for another customer. It is merely providing services to the grantor, which alone controls the asset.

57. One further aspect needs to be considered, which was not addressed in the September paper. In all that has been said so far it is the accounting of the operator that has been under discussion. Typically the operator will be a consortium, consisting of a construction company, one or more providers of finance and perhaps a separate entity to manage the running of the infrastructure once it is built. It is the consortium that enters into the concession arrangement with the grantor. What effect, if any, does the existence of the consortium have on the accounting by the construction company?

58. The construction company, of course, has to account for its interest in the consortium in accordance with IAS 31 *Interests in Joint Ventures*. However, the question that is relevant to this paper is how it should recognise revenue and profit in respect of its construction activity for the consortium. This question raises different issues from those relating to recognition of revenue by the consortium. The construction company's customer is the consortium. Except in relation to its

participation in the consortium, it is not dependent on the future cash flows to be obtained from operation of the infrastructure it has constructed. It is the consortium that pays. Accordingly, the cash flows from the consortium support recognition of revenue by the construction company in respect of its gross expenditures on construction of the infrastructure, as well as recognition of whatever profit element has been agreed with other members of the consortium. As in any transaction with a joint venture, the profit recognition is restricted to that portion that is attributable to the interests of the other venturers (IAS 31.48).