STAFF PAPER

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IASB Meeting

Previous meetings:
IFRS IC: Nov 2011

Project	**Annual Improvements**
Paper topic	Classification of cash flows for service concession arrangements

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Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to address an issue related to classification of cash flows for an operator in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*.

2. Specifically, the submitter requested that the Committee clarify whether:

   (a) Cash inflows relating to construction services under a service concession arrangement should be classified as operating or investing cash flows or a combination of both; and

   (b) Cash outflows relating to construction services under a service concession arrangement should be classified as operating or investing cash flows.

3. The Committee discussed the issue at its meeting in November 2011[1]. At that meeting, the Committee recommended that the Board should include a proposed amendment to paragraph 14 of IAS 7 within the next exposure draft of *Improvements to IFRSs*.

[1] Refer to Agenda paper 11 - http://www.ifrs.org/Meetings/Interpretations+Committee+Nov+11.htm

Purpose of the paper

4. The purpose of this paper is to ask the Board whether it approves the proposed annual improvement to IAS 7 paragraph 14, which would have the effect of ensuring that the cash flow classification for construction or upgrade services within the scope of IFRIC 12 *Service Concession Arrangements* is made in a consistent manner.
5. This paper will therefore:
   (a) provide a brief explanation of the issue;
   (b) provide an assessment of the proposed amendments against the criteria for inclusion in Annual Improvements;
   (c) make a recommendation for the proposed amendment to IAS 7 as presented in Appendix A; and
   (d) ask the Board whether they agree with the recommendation.

Explanation of the issue

6. IFRIC 12 and IAS 7 *Statement of cash flows* do not provide explicit guidance for the classification of cash flows relating to service concession arrangements.
7. Because construction services under IFRIC 12 result in the recognition of either an intangible asset or financial asset, the submitter of the issue stated that this could in turn impact the classification of the related cash flows.
8. The submitter explained that there are various ways in which an entity might apply IAS 7 to the relevant cash inflows and outflows for construction or upgrade services within the scope of IFRIC 12 (for ease of reference, we have included extracts from the November 2011 Committee Meeting paper in Appendix B which explain the rationale for the alternative views). The alternatives that were presented to the Committee are summarised in the following table:

	Financial asset model		Intangible asset model	
	Cash outflows	**Cash inflows**	**Cash outflows**	**Cash inflows**
View 1	Operating	Investing[2]	Operating	Operating
View 2	Operating	Operating	n/a	n/a
View 3	n/a	n/a	Investing	Operating
View 4	Operating	Operating	Operating	Operating

9. After analysing the issue, we presented our view to the Committee which was that *all* the cash flows from construction or upgrade services in a service concession arrangement should be classified as *operating* cash flows (View 4).

10. In summary, we reached this preliminary conclusion for the following reasons:

   (a) If an entity is in the business of providing construction services under service concession arrangements, then we think that the most faithful presentation of the cash flows related to this activity would be operating. IAS 7 paragraph 6 defines operating activities as '*the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.*'

   (b) IAS 7 paragraph 14 provides examples of the types of inflows and outflows that would be considered operating in nature. Since the inflows and the outflows from the construction services under a service concession arrangement represent receipts from the rendering of services and the payments to suppliers for goods and services, these appear to most closely align with operating cash flows (Refer IAS 7 paragraphs 14(a) and 14(c)).

   (c) The different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow

[2] Assume that the entity's policy for interest income is to present this as an investing cash flow

presentation. The different accounting models, for construction services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. However this does not change the *activity* to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the government (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements i.e. an operating cash flow.

(d) As noted by the submitter in their explanation of View 2, the Board amended IAS 7 paragraph 14 as part of the 2008 Annual Improvements Project. This amendment was made to ensure that an entity's ordinary activities would be classified as operating activities:

> 14. …Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of IAS 16 *Property, Plant and Equipment* are cash flows operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

As explained above, we think that in most cases the cash inflows from a service concession arrangement are in fact ordinary activities for an entity in that business. In addition to this, IAS 16 *Property, plant and equipment* paragraph BC35E explains that even though an asset may be constructed and recognised as an asset in the statement of financial position, the expenditure related to this should be presented as an operating cash outflow if it relates to the ordinary activities of the entity. In other words, if an outflow of cash results in the recognition of an asset, this does not mean that the cash flow should automatically be presented as an investing activity.

11. The Committee agreed with our recommendation that *all* the cash flows from construction or upgrade services in a service concession arrangement should be classified as *operating* cash flows.

Annual Improvements criteria assessment

12. We assessed the potential amendment to IAS 7 to clarify the classification of cash inflows and cash outflows for construction or upgrade services in the scope of IFRIC 12 against the annual improvements criteria. The assessment is reproduced in full in Appendix C to this paper.
13. Based on the assessment, we recommended to the Committee that the proposed amendment be made through Annual Improvements. The Committee agreed with this recommendation.

Transition provisions

14. We think that the proposed amendment should be applied retrospectively as of the beginning of the annual period in which it is initially applied in order to ensure comparability. Consequently, we are not proposing any specific transitional guidance and the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply to the proposed amendment.

The Committee's recommendation to the Board

15. The Committee recommends that the Board should proceed with the proposed improvement to amend paragraph 14 of IAS 7. We have included the draft wording that was presented to the Committee for the proposed amendment in Appendix A to this paper.

Questions for the Board
1. Does the Board agree with the Interpretations Committee's recommendation to amend paragraph 14 of IAS 7 through Annual Improvements? 2. If the Board agrees with the Interpretation Committee's recommendation, does the Board agree with the proposed wording for the Annual Improvement in Appendix A?

Appendix A – proposed annual improvement to IAS 7

A1. The proposed amendment to IAS 7 is presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 14 is amended as follows (new text is underlined):

14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

…

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; ~~and~~

(g) cash receipts and payments from contracts held for dealing or trading purposes~~.~~<u>; and</u>

<u>(h) cash receipts and payments from construction or upgrade services related to service concession arrangements within the scope of IFRIC 12.</u>

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Cash payments for contingent and deferred considerations

BC1 The Board received a request to clarify how an operator, in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*, should classify the cash inflows and cash outflows resulting from construction or upgrade services.

The Board thinks that the different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow presentation. The different accounting models, for construction or upgrade services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. However the Board noted that this does not change the activity to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the grantor (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements, ie an operating cash flow. For this reason, the Board proposes to include these types of arrangements in IAS 7 paragraph 14(h) to clarify that the cash inflows and cash outflows resulting from construction or upgrade services should be classified as operating cash flows.

Appendix B – Extract from Agenda paper 11

B1. A copy of the original Agenda Paper 11 which was discussed at the IFRS Interpretations Committee meeting in November 2011, can be accessed from the IASB website - http://www.ifrs.org/Meetings/Interpretations+Committee+Nov+11.htm. For ease of reference, we have included the relevant extract below:

6. The submitter provides the rationale for each of the views in their submission (Refer to Appendix A for the extract from the submission describing the rationale for the various alternatives). In summary, the rationale for each view is as follows:

(a) **View 1:** The construction services are seen to be the cash outflows in a construction contract, and consistent with IAS 11 *Construction Contracts* are classified as operating cash flows. However, the cash inflows for the financial asset model is the collection of a debt instrument, split as appropriate between the redemption component (investing cash flow) and an interest element (operating or investing cash flow depending on entity policy choice).

(b) **View 2:** Does not address the intangible asset model. However, this view argues against view 1. It states that for the financial asset model, mixing the classification of the cash inflows as financing cash flows and the cash outflows as operating cash flows is inappropriate as operators would only report operating cash outflows from construction services with no corresponding cash inflows. The arrangement is a single contractual arrangement and the cash flow classification should be consistent with this (Reference is also made to IAS 7 paragraph 14).

(c) **View 3:** Does not address the financial asset model. However, for the intangible asset model, this view draws on the guidance in IAS 7 paragraph 16. Since the cash outflows result in the recognition of a non-financial asset, the cash flows are required to be recognised as investing.

(d) **View 4:** States that the IFRIC 12 model is not relevant in determining the classification of the cash flows – all cash flows should be classified as operating. Operators who engage in construction services do so because this is their operating activity, regardless of the IFRIC 12 model that is applied in the statement of financial position.

7. The submitter further states that:

> Where the intangible asset model applies, current practice favours classification of cash outflows relating to construction services as investing cash flows. This may be because before IFRIC 12 was applied, most concession operators reported expenditures to construct an infrastructure as PP&E in the balance sheet and hence associated cash flows as investing in the cash flow statement.
>
> We understand that practice may be mixed with regard to the financial asset model. Some entities classify cash inflows and outflows as operating cash flows but others may report inflows as from a debt instrument, i.e. as investing cash inflows in respect of the amount that relates to the repayment of the financial asset.

Staff analysis

8. We think that View 2 and View 4 from the table in paragraph 6 are the most appropriate accounting treatment. In other words, we think that all the cash flows from construction services in a service concession arrangement should be classified as operating cash flows.

9. We reached this preliminary conclusion for the following reasons:

   (a) If an entity is in the business of providing construction services under service concession arrangements, then the most faithful presentation of the cash flows related to this activity would be operating. IAS 7 paragraph 6 defines operating activities as '*the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.*'

(b) IAS 7 paragraph 14 provides examples of the types of inflows and outflows that would be considered operating in nature. Since the inflows and the outflows from the construction services under a service concession arrangement represent receipts from the rendering of services and the payments to suppliers for goods and services, these appear to most closely align with operating cash flows (Refer IAS 7 paragraphs 14(a) and 14(c)).

(c) The different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow presentation. The different accounting models, for construction services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. However this does not change the *activity* to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the government (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements i.e. an operating cash flow.

(d) As noted by the submitter in their explanation of View 2, the Board amended IAS 7 paragraph 14 as part of the 2008 Annual Improvements Project. This amendment was made to ensure that an entity’s ordinary activities would be classified as operating activities. As explained above, we think that in most cases the cash inflows from a service concession arrangement are in fact ordinary activities for an entity in that business. In addition to this, IAS 16 *Property, plant and equipment* paragraph BC35E explains that even though an asset may be constructed and recognised as an asset in the statement of financial position, the expenditure related to this should be presented as an operating cash outflow if it relates to the ordinary activities of the entity. In other words, if an outflow of cash results in the recognition of an asset, this does not mean that the cash flow should automatically be presented as an investing activity.

10. In reaching this preliminary view, we considered the alternative views put forward by the submitter as follows:

(a) **View 1** argues that the cash inflows under the financial asset model will be reported as inflows from a debt instrument and will be presented as an investing cash inflow. We do not agree with this because the recovery of a debt instrument does not change the nature of the related activity which resulted in the recognition of the instrument. For example, when a manufacturer sells a tangible asset on credit to its customers, this results in the recognition of revenue and a related receivable. When the receivable is recovered from the customer at a later point in time, the related cash flow is still presented as part of the cash flows from operations and not investing as the underlying activity which generated the debt instrument (receivable) was an operating activity.

(b) **View 2** is consistent with our tentative conclusion explained above in paragraph 9.

(c) **View 3** notes the amendment to IAS 7 paragraph 16. We think view 3 is proposing that the cash outflow must be classified as an investing cash flow since it relates to the capitalisation of an asset. We do not agree with this view. IAS 7 Paragraph 16 was amended to clarify that an entity *may* only present a cash flow as investing if it relates to the capitalisation of an asset in the statement of financial position. In other words, an entity can only classify an item as an investing activity if it relates to the recognition of an asset, however, recognition of an asset does not mean that the cash outflow is automatically investing. We think that the reference to the word “can” rather than “should” in IAS 7 paragraph BC6 makes this clear. View 3 proponents might also argue that construction of the intangible is analogous to the construction of an item of PP&E, which would be classified as an investing cash flow. We disagree with this argument because construction of an item of PP&E does not give rise to revenue, whereas construction of the intangible asset under IFRIC 12 does give rise to revenue. Therefore the two activities are different.

Staff recommendation

17. On the basis of our analysis and the assessment under the annual improvements criteria, we think that the Committee should recommend to the Board to amend IAS 7 to clarify the classification in the statement of cash flows of cash inflows and outflows related to construction services in the scope of IFRIC 12. This amendment should be included in the 2010-2012 AIP cycle.
18. We support the presentation of both cash inflows and cash outflows as operating cash flow, regardless of the model (financial or intangible) applied in IFRIC 12, for the reasons set out in the Staff Analysis.

Appendix C – Annual Improvements assessment criteria

C1. In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.

(a) The proposed amendment has one or both of the following characteristics:

(i) clarifying–the proposed amendment would improve IFRSs by:

- clarifying unclear wording in existing IFRSs, or providing guidance where an absence of guidance is causing concern.
- A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) correcting–the proposed amendment would improve IFRSs by:

- resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.
- addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle.

[Staff analysis—this criterion is satisfied. The proposed amendment clarifies the classification in the statement of cash flows for cash inflows and cash outflows related to construction services in the scope of IFRIC 12 where the absence of explicit guidance is causing diversity in practice. The proposed amendment maintains consistency with the existing principles in IAS 7 for the presentation of a statement of cash flows.]

(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.

[Staff analysis— this criterion is satisfied. The issue is sufficiently narrow in scope to ensure that the proposed change has been considered sufficiently and identified.]

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

[Staff analysis—this criterion is satisfied. We think that the Committee will be able to address these issues on a timely basis and we think that the Board should be in a position to also reach a conclusion on a timely basis.]

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.

[Staff analysis—this criterion is satisfied. There is no current IASB project on IAS 7.]