STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets***		
Paper topic	Variable payments for the separate acquisition of PPE and intangible assets		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to address an issue that is related to contractual payments to be made by an operator under a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*. Specifically, the submitter requested that the Interpretations Committee should clarify in what circumstances (if any) those payments should:

   (a) be included in the measurement of an asset and liability at the start of the concession; or

   (b) be accounted for as executory in nature (ie be recognised as expenses as they are incurred over the term of the concession arrangement).

2. The Interpretations Committee noted that the issue of variable concession fees payable by an operator under a service concession arrangement is linked to the broader issue of variable payments for the separate acquisition of PPE and intangible assets outside of a business combination. This broader issue was previously discussed, but not concluded on, by the Interpretations Committee in 2011.

3. At the November 2012 meeting, the Interpretations Committee was presented with a summary of:

   (a) the requirements in the current IFRSs regarding the accounting for variable payments for the separate purchase of an asset;

   (b) the requirements in IFRS 3 *Business Combinations* regarding the accounting for contingent consideration; and

   (c) the tentative decisions taken so far by the boards in the Leases project regarding the accounting for variable lease payments.

4. The Interpretations Committee discussed the initial accounting for variable payments. The Interpretations Committee could not reach a consensus on whether:

   (a) the fair value of all variable payments should be included in the initial measurement of the liability on the date of purchase of the asset; or

   (b) the fair value of variable payments that are **not** dependent on the purchaser's future activity should be **included** in the initial measurement of the liability on the date of purchase of the asset and the variable payments that are dependent on the purchaser's future activity should be **excluded** from the initial measurement of the liability until the activity is performed.

5. The Interpretations Committee also discussed the subsequent accounting for variable payments. The Interpretations Committee agreed that adjustments to the liability, other than finance costs, should be recognised as a corresponding adjustment to the cost of the asset acquired, but only in some specific circumstances. The Interpretations Committee directed the staff to prepare a paper to be presented at a future meeting:

   (a) that would propose some examples that would illustrate cases in which the cost of the asset would be adjusted; and

   (b) that would discuss whether the initial accounting affects the subsequent accounting for variable payments.

Structure of the paper

6. This paper does not rediscuss the initial accounting for variable payments for the separate purchase of an asset. This paper focuses on the subsequent accounting for variable payments. The structure of the paper is as follows:

   (a) Summary of the staff's analysis regarding the subsequent accounting for variable payments;

   (b) Definition of a floating rate instrument;

   (c) Accounting for floating rate instruments;

   (d) Accounting for fixed rate instruments;

   (e) Examples of variable payments;

   (f) Next steps;

   (g) Amendments to IFRIC 12;

   (h) Appendix A: Simplified examples;

   (i) Appendix B: Summary of the Committee's tentative decisions regarding the proposed amendment to IFRIC 12; and

   (j) Appendix C: Proposed amendment to IFRIC 12.

Summary of the staff's analysis regarding the subsequent accounting for variable payments

7. We present below a summary of the staff's analysis regarding the subsequent accounting for variable payments presented at the November 2012 meeting (Agenda Paper 2):

   (a) Embedded derivatives that are not closely related to the economic characteristics and risks of the financial liability should be accounted for separately as derivatives (ie at fair value through profit or loss). If the cash flows are modified according to a non-financial variable that is specific to a party to the contract, then the instrument does not meet the definition of a derivative (and thus should not be separated). Profits,

revenues, sales or other indicators such as EBITDA of the entity are generally considered to be non-financial variables that are specific to a party to the contract.

(b) A financial liability arising from the separate purchase of an asset is generally subsequently accounted for at amortised cost in accordance with the effective interest method. Paragraphs AG6-AG8 of IAS 39 provide guidance on the effective interest method.

(c) Paragraph AG7 of IAS 39 applies to the accounting for floating rate instruments. We think that the remeasurement of the liability in accordance with paragraph AG7 normally corresponds entirely to an interest expense (calculated using the revised EIR) that should be recognised in profit or loss.

(d) Paragraph AG8 of IAS 39 applies to the accounting for financial instruments that are not floating rate instruments. We think that the adjustment of the carrying amount of the liability resulting from the application of paragraph AG8 (referred to as the '**AG8 adjustment**' in this paper) is not an interest expense (or an interest income). Instead, we think that this adjustment relates to the purchase transaction itself (when dealing with variable payments for the separate purchase of an asset).

(e) We think that the appropriate interpretation of the current requirements in IAS 39 is that an entity should recognise the AG8 adjustment of a financial liability in profit or loss unless another Standard requires otherwise. Indeed, we do not think that the fact that IAS 39 specifies that the AG8 adjustment of the liability should be recognised in profit or loss prevents another IFRS from requiring its capitalisation. For example, IAS 23 *Borrowing Costs* requires interest expenses (that are otherwise recognised in profit or loss according to IAS 39) to be **capitalised** in accordance with IAS 23.

(f) The requirements in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IFRIC 1 *Changes in Existing Decommissioning,*

Restoration and Similar Liabilities suggest that the AG8 adjustment should be entirely or partially capitalised in the cost of the asset depending on whether the adjustment is a change of estimate or not.

(g) We think that if the variable payments are initially included in the measurement of the liability, the AG8 adjustment corresponds to a **change of estimate** and should be recognised entirely as a corresponding adjustment to the cost of the asset (as in IFRIC 1). If the variable payments are **not** initially included in the measurement of the liability, the AG8 adjustment of the liability does **not** correspond, in our view, to a change of estimate. In that case, we think that this AG8 adjustment should be accounted for as an asset to the extent that it relates to future economic benefits (as in the Leases project).

Definition of a floating rate instrument

8. At the November 2012 meeting, some Interpretations Committee members asked whether variable payments that are dependent on an inflation index would be accounted for in accordance with paragraph AG7 or paragraph AG8 of IAS 39. As mentioned in the section above, floating rate financial instruments are accounted for in accordance with paragraph AG7. Other financial instruments (that are not considered to be floating rate financial instruments) are accounted for in accordance with paragraph AG8.

9. For variable payments that are dependent on an interest rate (such as LIBOR), it is clear that paragraph AG7 should be applied (see Example 4 in Appendix A below). For variable payments that are dependent on an inflation index, it is not clear whether (and how) paragraph AG7 should be applied. The IFRIC (as it was then called) discussed this issue in an agenda decision published in IFRIC *Update* (July 2008). The IFRIC noted that judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8. The IFRIC referred this issue to the IASB with a recommendation that the IASB should consider clarifying or expanding that application guidance.

10. The IASB discussed the issue during its meeting in October 2008. In the October 2008 IASB *Update*, the IASB tentatively decided that a floating rate financial instrument is an instrument with contractual variable cash flow amounts arising from changes in **market variables**. We understand that instruments that are dependent on an inflation index (such as CPI) would meet the definition of a floating rate instrument. However, the IASB has not yet completed the amortised cost and impairment component of IFRS 9, and we understand that the IASB will not rediscuss this issue soon.

11. Consequently, entities must in practice make an accounting policy choice and apply either AG7 or AG8 to all similar instruments that are dependent on an inflation index. We understand that most entities in practice apply paragraph AG7 for instruments that are dependent on an inflation index (and not paragraph AG8). Indeed, paragraph AG7 tends to 'smooth' the recognition of expense related to changes in inflation, because the interest expense that is recognised in profit or loss relates only to the current period. Conversely, paragraph AG8 tends to create volatility in profit or loss, if the AG8 adjustment is recognised in profit or loss. Indeed, the AG8 adjustment includes the effects of changes in the index or rate related to the future periods.

12. However, if the Interpretations Committee follows the staff's recommendation, the AG8 adjustment that would result from re-estimating future inflation rates would be entirely recognised as an adjustment to the cost of the asset. We note that the outcome of applying paragraph AG8 with the AG8 adjustment being capitalised in the cost of the asset would also tend to 'smooth' the expense recognition (see Example 5 in Appendix A below).

Accounting for floating rate instruments (paragraph AG7 of IAS 39)

13. According to paragraph AG7, periodic re-estimating of cash flows to reflect movements in market rates of interest alters the effective interest rate (EIR). This means that the carrying amount of the liability does not need to be adjusted when re-estimating future interest payments. As a result, we think that the remeasurement of the liability in accordance with paragraph AG7 normally

corresponds entirely to an interest expense (calculated using the revised EIR) that should be recognised in profit or loss.

14. The objective of this section is to illustrate how to calculate the EIR for a floating rate instrument in a simple example and how to apply paragraph AG7 of IAS 39. It should be noted that two different methods can be used when applying paragraph AG7.

> Example: a 2-year licence agreement specifies that Entity A has a right to use a specific technology in exchange for payments made to the seller during the 2-year licence period. At the inception of the contract on 1 January 20X0, Entity A and the seller agree that the price for the licence is CU1,000[1]. Entity A and the seller also agree that Entity A will pay the price in full on 31 December 20X1 and that interest payments set at the one-year LIBOR rate (plus the contractual spread) are due on 31 December 20X0 and 31 December 20X1. Entity A initially accounts for an asset and a liability of CU1,000.

15. The actual and expected interest rates are the following:

		Expected interest rates	
Year	**Actual interest rates**	**On 1.1.2010**	**On 1.1.2011**
20X0	**5%**	**5%**	**-**
20X1	**12%**	**10%**	**12%**

First method (using the spot interest rate)

16. Under this method, the EIR is set to equal the spot interest rate applicable to the current reporting period. This method is simple because entities do not need to use expectations about future interest rates. The table below illustrates the application of this method:

Year	Initial carrying amount	Interest expense (at EIR=spot rate)	Interest paid	Principal paid	Ending carrying amount
20X0	**CU1,000**	**CU50**	**CU(50)**	**0**	**CU1,000**
20X1	**CU1,000**	**CU120**	**CU(120)**	**CU(1,000)**	**0**

[1] In this Staff Paper, currency amounts are denominated in "currency units" (CU).

Second method (using expectations about future interest rates)

17. Under this method, the interest expense in each period is based on an adjusted EIR, calculated by discounting the expected cash flows to equal the carrying amount at the beginning of each period. The expected cash flows include current expectations about future interest rates. This would result in the EIR and the spot interest rate for the current period (and hence any cash payments for the current period) being different if the yield curve for the maturity of the instrument is not flat. The table below illustrates the application of this method:

Year	Initial carrying amount	Interest expense (at EIR)	Interest paid	Principal paid	Ending carrying amount
20X0	**CU1,000**	**CU74**	**CU(50)**	**0**	**CU1,024**
20X1	**CU1,024**	**CU96**	**CU(120)**	**CU(1,000)**	**0**

In 20X0, the EIR is 7.41%: it is the rate that discounts the expected cash flows (ie CU50 and CU1,100) to equal the carrying amount of the liability on 1 January 2010 (ie CU1,000). In 20X1, the EIR is 9.37%: it is the rate that discounts the future cash flows (ie CU1,120) to equal the carrying amount of the liability on 1 January 20X1 (ie CU1,024).

18. It should be noted that this method tends to 'smooth' expense recognition related to changes in the one year LIBOR rate (ie interest expense of CU74 and CU96 in 20X0 and 20X1, respectively, instead of CU50 and CU120 for those periods in the first method).

Application of paragraph AG7: first method versus second method

19. We understand that in practice most entities do not take into account expectations about future interest rates when calculating the EIR for 'vanilla' instruments, and apply the first method above. However, there is diversity in practice relative to the application of the effective interest method to 'non-vanilla' instruments. If the first method is applied to 'non-vanilla features' (such as a link to inflation), this tends to amplify the profit or loss effects in the current reporting period that are due to inflation rate movements (see Example 5 in Appendix A below).

20. It should be noted that in the October 2008 IASB *Update*, the IASB tentatively decided that expectations (and changes in expectations) of future cash flows should **not** be considered when calculating the EIR for floating rate instruments.

In other words, the IASB tentatively decided to follow the first method described above for floating rate instruments (a floating rate instrument being an instrument with contractual variable cash flow amounts arising from changes in market variables). However, the IASB has not yet completed the amortised cost and impairment component of IFRS 9, and we understand that the IASB will not rediscuss this issue soon. Consequently, entities, in practice, make an accounting policy choice and apply one of the methods described above to all similar instruments.

Accounting for fixed rate instruments (paragraph AG8 of IAS 39)

21. Paragraph AG8 of IAS 39 applies to the accounting for financial instruments that are not floating rate instruments. As a result, paragraph AG8 should be applied to the subsequent accounting for:

    (a) a liability to make variable payments if the asset acquired complies with agreed-upon specifications at specific dates in the future (see Example 1 in Appendix A below); and

    (b) a liability to make variable payments that depend on the purchaser's future activity (see Examples 2 and 3 in Appendix A below).

22. According to paragraph AG8, remeasurements of the liability that are due to the revision of estimated cash flows do not alter the EIR. The entity recalculates the carrying amount of the liability by computing the present value of estimated future cash flows at the financial instrument's original EIR. The result is that the entity accounts for an **adjustment** to the carrying amount of the liability (referred to as the '**AG8 adjustment**' in this paper).

23. We think that the interest expense in each period (that is recognised in profit or loss) corresponds to the amount calculated using the original EIR. In our view, the AG8 adjustment of the liability that relates to the effect of the revision of estimated future cash flows is not an interest expense (or interest income). Instead, we think that this adjustment relates to the purchase transaction itself (when dealing with variable payments for the separate purchase of an asset).

24. We also think that the original EIR (within the context of applying paragraph AG8 to the separate acquisition of an asset) should be initially set to equal the purchaser's incremental borrowing rate on the date of purchase of the asset. The purchaser's incremental borrowing rate is the interest rate that reflects the rate at which the purchaser could borrow a similar amount in the same currency, for the same duration and with similar collateral as in the purchase agreement.

Examples of variable payments

25. We provide in Appendix A simplified examples of variable payments for the separate acquisition of PPE and intangible assets. The objective is to apply the staff's proposals to the subsequent accounting for variable payments in various examples.

26. A variable payment refers to a payment that is not fixed. Examples of variable payments include:

    (a) Variable payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future (such as a standard production capacity or a standard performance). These are payments that the purchaser will have to make if the asset acquired is capable of providing at specific dates in the future a specific performance agreed with the seller. These payments are not dependent on the purchaser's future activity.

    (b) Variable payments that are dependent on the purchaser's future activity derived from the underlying asset. These variable payments are common in licence agreements or service concession arrangements. For example, a contract for the purchase of an intangible asset (such as a licence) may specify that the payments are based on a specified percentage of sales made from using the licence. Other examples include variable payments that are made if the purchaser reaches a specific milestone when using the asset purchased in a research and development project. These payments are common, for example, at

various stages of the research and development of a new drug in the pharmaceutical industry.

(c) Variable payments that are dependent on an index or a rate (such as LIBOR, inflation or a consumer price index). These variable payments are common in licence agreements or service concession arrangements. For example, an operator in a service concession arrangement agrees to pay an annual concession fee to the grantor, with the principal amount increasing at the end of each year based on the consumer price index.

Next steps

27. As illustrated in the examples included in Appendix A, we think that the adjustment of the carrying amount of a financial liability resulting from the application of paragraph AG8 of IAS 39 should be recognised as a corresponding adjustment to the cost of the asset to the extent that another Standard (such as IAS 16 or IAS 38) requires so. If the Interpretation Committee agrees with the staff's proposal, we think that this should be addressed through a proposed amendment to the current IFRSs as part of a narrow-scope project together with the proposed amendments to IFRIC 12 that were previously discussed by the Interpretations Committee (see below). We think that paragraph AG8 of IAS 39 should be amended as follows (new text is underlined):

> AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense unless another Standard requires otherwise.

28. We do not think that further guidance should be provided on how to apply paragraph AG6-AG8 of IAS 39. This issue is related to the application of the effective interest method and has been reported to the IASB. It is currently being discussed by the IASB as part of its project to replace IAS 39.

29. Moreover, we do not think that IAS 16 and IAS 38 need to be amended. We note that IFRIC 1 already acknowledges that the cost of an asset should be subsequently adjusted in a similar situation (ie when a decommissioning liability is remeasured). If paragraph AG8 is amended as proposed above, we think that applying the current requirements in IAS 16, IAS 38 and IFRIC 1 will result in recognising the AG8 adjustment as a corresponding adjustment to the cost of the asset purchased:

    (a) entirely when the adjustment is a change of estimate; and

    (b) to the extent that it relates to future economic benefits to be derived from the asset when the adjustment is not a change of estimate. We acknowledge that judgement might be required to make the allocation between past economic benefits and future economic benefits, but we do not think that guidance should be provided on how to make this allocation.

Questions to the Interpretations Committee
Does the Interpretations Committee agree to recommend to the IASB that it should amend paragraph AG8 of IAS 39 as proposed in this paper?

Amendments to IFRIC 12

30. We note that the Interpretations Committee tentatively decided to amend IFRIC 12 during its March and May 2012 meetings. A summary of the Interpretations Committee's tentative decisions is included in Appendix B. We think that the Interpretations Committee should proceed with these amendments, even if it does not reach a conclusion on the accounting for variable payments for the separate purchase of assets. The proposed draft amendment to IFRIC 12 that was previously discussed by the Interpretations Committee is included in Appendix C.

Appendix A—Simplified examples

31. We provide below the following examples:

    (a) Example 1: variable payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future;

    (b) Example 2: variable payments that are dependent on revenues derived from the use of the asset;

    (c) Example 3: variable payments that are made if a milestone is reached in a research and development project;

    (d) Example 4: accounting for variable payments that are dependent on a rate analysed as a floating rate (such as LIBOR); and

    (e) Example 5: accounting for variable payments that are dependent on an index such as inflation or CPI.

Example 1: variable payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future

32. Entity A acquires a communication satellite on 1 January 20X0. Entity A agrees to make a first fixed payment of CU100 at the date of acquisition and one additional payment of CU121 if the communication satellite is **capable** of operating according to a standard performance **two** years after the satellite has been in operation. According to the purchase contract, if the satellite is not capable of operating at the agreed standard performance on 31 December 20X1, the additional payment is reduced or not made. On 1 January 20X0, Entity A expects to make an additional payment of CU121.

33. For the purposes of this example, assume that:

    (a) Entity A's incremental borrowing rate at the date of acquisition is 10%;

    (b) During 20X0, Entity A revises its estimates and expects to make an additional payment of CU90. The actual additional payment on 31 December 20X1 is CU90.

    (c) The satellite will stay in operation for a five-year period.

Initial accounting:

34. The additional payment is not dependent on the purchaser's future activity. It is dependent on whether the satellite is capable of operating at an agreed standard performance. As a result, the fair value of the estimated additional payment, ie CU100 (the fair value of CU121 discounted at a rate of 10%) is initially included in the measurement of the asset and liability. On 1 January 2010, Entity A recognises an asset and a liability as follows:

Dr Asset	CU200	
Cr Liability		CU100
Cr Cash		CU100

35. The table below illustrates how the liability is expected to be amortised (on the basis of expected cash flows):

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	**CU100**	**CU10**	**0**	**0**	**CU110**
20X1	**CU110**	**CU11**	**CU(121)**	**0**	**0**

Subsequent accounting:

36. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. The table below illustrates how the liability is amortised (on the basis of actual cash flows):

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	**CU100**	**CU10**	**0**	**CU(28)**	**CU82**
20X1	**CU82**	**CU8**	**CU(90)**	**0**	**0**

37. Because the satellite is not capable of operating at the standard performance agreed in the contract, Entity A revises its estimate during 20X0 and expects to make an additional payment of CU90. As a result, the AG8 adjustment in 20X0 is CU28 (so that the EIR remains constant at 10%). This adjustment is entirely recognised as a corresponding adjustment to the cost of the asset. As a result, the cost of the asset is reduced and this reduction will affect the depreciation expense

of the current and future periods. It should be noted that the calculation of the depreciation expense should be revised prospectively. However, for the purpose of this simplified example, we assume that Entity A prepares only annual financial statements and that Entity A revises the calculation of the depreciation expense for the current period, ie 20X0. As a result, the depreciation expense in 20X0 is 34.4 ((200-28)/5). On 31 December 20X0, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU10	
Cr Liability		CU10
Dr Liability (AG8 Adjustment)	CU28	
Cr Asset		CU28
Dr Depreciation Expense	CU34.4	
Cr Asset (depreciation)		CU34.4

Example 2: variable payments that are dependent on revenues derived from the use of the asset

38. A 3-year service concession arrangement specifies that Operator B has a right to charge users for a public service in exchange for annual payments made to a grantor. Payments correspond to 20% of the annual revenues generated though the sale of the public service to the users during the 3-year service concession period. The concession starts on 1 January 20X0. Payments are made at the end of each calendar year.

39. For the purposes of this example, assume that:

(a) Operator B's incremental borrowing rate is 10% on 1 January 20X0; and

(b) the variable payments are part of the consideration to acquire an intangible asset in accordance with IFRIC 12.

40. The actual and expected payments are the following:

			Expected payments		
Year	**Actual revenues**	**Actual payments**	**On 1.1.20X0**	**On 1.1.20X1**	**On 1.1.20X2**
20X0	**CU40**	**CU8**	**CU8**	**0**	**0**
20X1	**CU60**	**CU12**	**CU12**	**CU12**	**0**

20X2	**CU60**	**CU12**	**CU15**	**CU12**	**CU12**

41. The Interpretations Committee could not reach a consensus on the initial accounting for variable payments. As a result, we present two different cases:

    (a) Case A: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability.

    (b) Case B: the fair value of all variables payments is included in the initial measurement of the liability on the date of purchase of the asset.

42. It should be noted that in real-life fact patterns, service concession arrangements typically last between 20 and 50 years. This is why we think that to require the recognition of a liability on the date of purchase of the asset for variable payments that are dependent on the purchaser's activity is too complex and would not provide sufficiently useful information to users to outweigh the cost. We think that the reasons put forward by the boards in the Leases project for excluding certain variable payments from the initial measurement of the liability are also valid within the context of the separate acquisition of assets (see Agenda Paper 2 presented at the November 2012 Interpretations Committee meeting).

43. We also think that the features of variable payments for the separate acquisition of assets are different from the features of contingent considerations paid in business combinations. Business combinations are one-time, discrete transactions. Contingent considerations in a business combination are typically paid within the next two or three years following the business combination. Acquisitions of assets are common transactions and variable payments might be made over a long period (as in leases). For these reasons, we can see a distinction between contingent considerations paid in business combinations and the obligation to make variable payments under a lease or for the separate purchase of an asset. We therefore think that a different accounting approach is justified.

Case A: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability

Initial accounting:

44. Variable payments are not included in the initial measurement of the asset and liability because they are dependent on the purchaser's future activity (the generation of future revenues). There are no amounts to record on 1 January 20X0.

Subsequent accounting:

45. Operator B recognises a liability when the corresponding revenues requiring the payments are generated. In that case, the debit side of the liability should be accounted for as an asset to the extent that it relates to future economic benefits. In this example, the debit side of the liability is an expense, because each payment made at the end of a calendar year is related to the current period (ie it is related to the revenues generated in the current period). We do not think that in that case the debit side of the liability should be accounted for as a change of estimate and as an asset. Such an outcome would not make sense. As a result, Operator B recognises the following entries in 20X0:

Dr Revenues	CU40	
Cr Cash		CU40
Dr Expense (concession fee)	CU8	
Cr Cash		CU8

Case B: the fair value of all variable payments is initially included in the measurement of the liability

Initial accounting:

46. The fair value of expected variable payments is initially included in the measurement of the asset and liability on the date of purchase of the asset. The fair value is CU28.5 (it is the fair value of the three expected payments of CU8, CU12 and CU15 discounted at a rate of 10%). As a result, Operator B initially accounts for an asset and a liability as follows:

Dr Intangible asset	CU28.5	
Cr Liability		CU28.5

47. The table below shows how the liability is expected to be amortised (on the basis of the expected payments).

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	**CU28.5**	**CU2.8**	**CU(8)**	**0**	**CU23.3**
20X1	**CU23.3**	**CU2.3**	**CU(12)**	**0**	**CU13.6**
20X2	**CU13.6**	**CU1.4**	**CU(15)**	**0**	**0**

Subsequent accounting:

48. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. In 20X1, the expected payments are revised and the revised expected payments equal the actual payments. The table below shows how the liability is amortised:

Year	Initial carrying amount	Interest expense (at 10%)	Actual payments	AG8 adjustment	Ending carrying amount
20X0	**CU28.5**	**CU2.8**	**CU(8)**	**0**	**CU23.3**
20X1	**CU23.3**	**CU2.3**	**CU(12)**	**CU(2.7)**	**CU10.9**
20X2	**CU10.9**	**CU1.1**	**CU(12)**	**0**	**0**

49. In 20X1, the liability is adjusted, because the expected payments are revised. Under the staff's proposals, this adjustment would be entirely accounted for as a corresponding adjustment to the cost of the asset. It should be noted that the calculation of the depreciation expense should be revised prospectively. For the purpose of this example, we assume that Entity B prepares only annual financial statements and revises the calculation of the depreciation expense for the current period, ie 20X1. As a result, the depreciation expense for 20X0 is CU9.5 (CU28.5/3) and the depreciation expense for 20X1 is revised prospectively. On 31 December 20X0, Operator B makes the following entries:

Dr Interest expense	CU2.8	
Cr Liability		CU2.8
Dr Liability (payment)	CU8	

Cr Cash CU8

Condensed data and comparison

		Expenses Case A	Expenses Case B		
Year	**Actual revenues**	**Concession fee**	**Interest expense**	**Depreciation**	**Total**
20X0	**CU40**	**CU8**	**CU2.8**	**CU9.5**	**CU12.3**
20X1	**CU60**	**CU12**	**CU2.3**	**CU8.15**	**CU10.45**
20X2	**CU60**	**CU12**	**CU1.1**	**CU8.15**	**CU9.25**
Total	**CU160**	**CU32**	**CU6.2**	**CU25.8**	**CU32**

Example 3: variable payments that are made if a milestone is reached in a research and development project

50. On 1 January 20X0 Entity C acquires a patent related to a new compound and agrees to make a first fixed payment of CU100 at the date of acquisition. Entity C intends to use the compound in order to develop a new drug as part of a research and development project. Entity C has agreed to make an additional payment of CU55 to the vendor if an approval to sell the new drug in a specific market is obtained. Entity C expects to make the payment on 31 December 20X0 (one year after the acquisition of the patent).

51. For purposes of this example, assume that the patent acquired meets the definition of an intangible asset in accordance with IAS 38 and that the approval is obtained on 31 December 20X1 (ie **two** years after the acquisition of the patent and one year later than expected). The additional payment of CU55 is made when the approval is obtained. Entity C's incremental borrowing rate is 10% (which reflects the rate at which Entity C could borrow). Entity C expects to sell the new drug on the market for a five-year period (following the approval).

52. The Interpretations Committee could not reach a consensus on the initial accounting for variable payments. As a result, we present two different cases:

    (a) Case A: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability.

    (b) Case B: the fair value of all variable payments is included in the initial measurement of the liability on the date of purchase of the asset.

Case A: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability

Initial accounting:

53. Entity C initially includes in the initial measurement of the asset the fair value of the first fixed payment to be made. The additional payment is not included in the initial measurement of the asset and liability, because this payment is dependent on the purchaser's future activity (a research and development project). As a result, on 1 January 20X0, Entity C makes the following entries:

Dr Intangible asset	CU100	
Cr Cash		CU100

Subsequent accounting:

54. Entity C subsequently includes in the measurement of the liability the fair value of the additional payment when the approval to sell the new drug on the market is obtained. Changes in the measurement of the liability that are due to this additional payment are recognised as an adjustment to the cost of the intangible asset (the compound). Those changes reflect additional costs associated with acquiring the compound and are related to future economic benefits (the future revenues expected to be generated through the sales of the new drug in the future). As a result, at the date when the approval is obtained (ie 31 December 20X1), Entity C makes the following entries:

Dr Intangible asset	CU55	
Cr Cash		CU55

Case B: the fair value of all variable payments is initially included in the measurement of the liability

Initial accounting:

55. The fair value of the expected variable payments is initially included in the measurement of the asset and liability on the date of purchase of the asset. The fair value of the expected additional payment on 1 January 20X0 is CU50 (CU55/1.1), because Entity C expects to make the payment one year after the

acquisition of the patent. As a result, on 1 January 20X0, Entity C initially accounts for an asset and a liability as follows:

Dr Intangible asset	CU150	
Cr Liability		CU50
Cr Cash		CU100

56. The table below shows how the liability is expected to be amortised.

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount (adjusted)
20X0	**CU50**	**CU5**	**CU(55)**	**0**	**0**

Subsequent accounting:

57. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. In 20X0, Entity C revises its estimate about the timing of the additional payment (ie it expects to make the additional payment on 31 December 20X1). As a result, the liability is adjusted to reflect the fact that the additional payment is paid later than expected. The table below shows how the liability is amortised:

Year	Initial carrying amount	Interest expense (at 10%)	Actual/Expected payments	AG8 adjustment	Ending carrying amount (adjusted)
20X0	**CU50**	**CU5**	**0**	**CU(5)**	**CU50**
20X1	**CU50**	**CU5**	**CU(55)**	**0**	**0**

58. The AG8 adjustment of CU5 is recognised entirely as a corresponding adjustment to the cost of the asset, because it is a change of estimate. As a result, the cost of the intangible asset after adjustment is CU145 (versus CU155 in Case A). On 31 December 20X0, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU5	
Cr Liability		CU5
Dr Liability (AG8 Adjustment)	CU5	
Cr Intangible asset		CU5

59. On 31 December 20X1, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU5	
Cr Liability		CU5
Dr Liability	CU55	
Cr Cash		CU55

Example 4: accounting for variable payments that are dependent on a rate analysed as a floating rate (such as LIBOR)

60. A 3-year licence agreement specifies that Entity D has a right to use a specific technology in exchange for annual payments made to the seller during the 3-year licence period. At the inception of the contract on 1 January 20X0, Entity D and the seller agree that the price for the licence is CU900. Entity D agrees to reimburse CU300 at the end of each calendar year and to pay interest on the outstanding principal amount at the beginning of each calendar year on the basis of the one-year LIBOR rate + 150 basis points.

61. For the purposes of this example, assume that the licence acquired meets the definition of an intangible asset in accordance with IAS 38. The expected and actual interest rates are the following:

		Expected interest rates		
Year	**Actual interest rates**	**On 1.1.20X0**	**On 1.1.20X1**	**On 1.1.20X2**
20X0	**5%**	**5%**	**0**	**0**
20X1	**12%**	**6%**	**12%**	**0**
20X2	**7%**	**10%**	**7%**	**7%**

Initial accounting:

62. Those variable payments are not dependent on the purchaser's future activity. As a result, Entity D initially accounts for an asset and a liability for CU900.

Subsequent accounting:

63. The liability is accounted for at amortised cost in accordance with IAS 39. Because LIBOR is a floating rate, the liability is amortised in accordance with paragraph AG7 of IAS 39. The table below shows how the liability is amortised using the first method described in this paper:

Year	Initial carrying amount	Interest expense (EIR=spot rate)	Interest paid	Principal paid	Ending carrying amount
20X0	CU900	CU45	CU(45)	CU(300)	CU600
20X1	CU600	CU72	CU(72)	CU(300)	CU300
20X2	CU300	CU21	CU(21)	CU(300)	0

64. The following table shows how the liability is amortised using the second method described in this paper:

Year	Initial carrying amount	Interest expense (at EIR)	Interest paid	Principal paid	Ending carrying amount
20X0	CU900	CU54.9	CU(45)	CU(300)	CU609.9
20X1	CU609.9	CU56.1	CU(72)	CU(300)	CU294.0
20X2	CU294.0	CU27.0	CU(21)	CU(300)	0

In 20X0, the EIR is 6.1%: it is the rate that discounts the expected cash flows (ie CU345, CU336 and CU330) to equal the carrying amount of the liability on 1 January 20X0 (ie CU900). In 20X1, the EIR is 9.2%: it is the rate that discounts the expected cash flows (CU372 and CU321) to equal the carrying amount of the liability on 1 January 20X1 (ie CU609.9). The EIR is not subsequently revised.

65. In any case, the cost of the asset is not adjusted, because the remeasurement of the carrying amount of the liability relates entirely to an interest expense of the current period that is recognised in profit or loss.

Condensed data and comparison

Year	AG7 First method Interest expense	AG7 Second method Interest expense
20X0	CU45	CU54.9
20X1	CU72	CU56.1
20X2	CU21	CU27.0
Total	CU138	CU138

Example 5: accounting for variable payments that are dependent on an index such as inflation or CPI

66. A three-year service concession arrangement specifies that Operator E has a right to charge users for a public service in exchange for annual payments made to a grantor during the three-year service concession period. Payments to the grantor are made at the end of each calendar year. At the inception of the contract on 1 January 20X0, Operator E agrees to pay a concession fee of CU100, with the amount increasing at the end of each year based on an inflation rate.

67. For the purposes of this example, assume that:

(a) Operator's E incremental borrowing rate is 5% on 1 January 20X0; and

(b) the variable payments are part of the consideration to acquire an intangible asset in accordance with IFRIC 12.

68. The following are data for actual annual inflation rates and annual expected inflation rates:

		Expected inflation rates		
Year	**Actual inflation rates**	**On 1.1.20X0**	**On 1.1.20X1**	**On 1.1.20X2**
20X0	**3.2%**	**3.2%**		
20X1	**7.5%**	**3.8%**	**7.5%**	
20X2	**3.7%**	**3.8%**	**4.1%**	**3.7%**

69. We present below the following alternatives:

(a) Alternative 1: Operator E applies paragraph AG7 (First method);

(b) Alternative 2: Operator E applies paragraph AG7 (Second method);

(c) Alternative 3: Operator E applies paragraph AG8.

70. In Alternatives 1 and 2, the financial liability is treated as a floating rate debt instrument (with the inflation being part of the floating-rate mechanism). In Alternative 3, the financial liability is treated as a fixed interest rate instrument.

Alternative 1 (AG7 First method)

Initial accounting:

71. Under the first method described in this paper for the application of paragraph AG7, Operator E projects future cash flows using the spot inflation rate of the current reporting period. The following are the expected cash flows:

Year	**Expected cash flows on 1.1.20X0**	**Calculation**
20X0	**CU103.2**	**CU100*1.032**
20X1	**CU106.5**	**CU100*1.032*1.032**
20X2	**CU109.9**	**CU100*1.032*1.032*1.032**

Year	**Expected cash flows on 1.1.20X1**	**Calculation**

20X1	**CU110.9**	**CU100*1.032*1.075**
20X2	**CU119.3**	**CU100*1.032*1.075*1.075**

Year	Expected cash flows on 1.1.20X2	Calculation
20X2	**CU115.0**	**CU100*1.032*1.075*1.037**

72. On 1 January 20X0, Entity C initially accounts for an asset and a liability for CU289.8 (ie the fair value of the three expected payments at that date, discounted at the rate of 5%).

Subsequent accounting:

73. The liability is accounted for at amortised cost in accordance with IAS 39. The table below shows how the liability is amortised using the first method described in this paper:

Year	Initial carrying amount	Interest expense (at EIR)	Payments	Ending carrying amount
20X0	**CU289.8**	**CU14.5**	**CU(103.2)**	**CU201.1**
20X1	**CU201.1**	**CU18.9**	**CU(110.9)**	**CU109.1**
20X2	**CU109.1**	**CU5.9**	**CU(115.0)**	**0**

In 20X0, the EIR is 5%. In 20X1, the EIR is 9.4%: it is the rate that discounts the expected cash flows (CU110.9 and CU119.3) to equal the carrying amount of the liability on 1 January 20X1 (ie CU201.1). In 20X2, the EIR is 5.4%: it is the rate that discounts the expected cash flows (CU115.0) to equal the carrying amount of the liability on 1 January 20X2 (ie CU109.1).

74. In any case, the cost of the asset is not adjusted, because the remeasurement of the carrying amount of the liability relates entirely to an interest expense of the current period that is recognised in profit or loss.

Alternative 2 (AG7 Second method)

Initial accounting:

75. Under the second method described in this paper for the application of paragraph AG7, Operator E projects future cash flows on the basis of expectations about future inflation rates. The following are the expected cash flows:

Year	Expected cash flows on 1.1.20X0	Calculation
20X0	**CU103.2**	**CU100*1.032**
20X1	**CU107.1**	**CU100*1.032*1.038**
20X2	**CU111.2**	**CU100*1.032*1.038*1.038**

Year	Expected cash flows on 1.1.20X1	Calculation
20X1	CU110.9	CU100*1.032*1.075
20X2	CU115.5	CU100*1.032*1.075*1.041

Year	Expected cash flows on 1.1.20X2	Calculation
20X2	CU115.0	CU100*1.032*1.075*1.037

76. On 1 January 20X0, Operator E initially accounts for an asset and a liability for CU291.5 (ie the fair value of the three expected payments at that date discounted at the rate of 5%).

Subsequent accounting:

77. The liability is accounted for at amortised cost in accordance with IAS 39. The table below shows how the liability is amortised using the second method described in this paper:

Year	Initial carrying amount	Interest expense (at EIR)	Payments	Ending carrying amount
20X0	CU291.5	CU14.6	CU(103.2)	CU202.9
20X1	CU202.9	CU15.4	CU(110.9)	CU107.4
20X2	CU107.4	CU7.6	CU(115.0)	0

In 20X0, the EIR is 5%. In 20X1, the EIR is 7.6%: it is the rate that discounts the expected cash flows (CU110.9 and CU115.5) to equal the carrying amount of the liability on 1 January 20X1 (ie CU202.9). In 20X2, the EIR is 7.1%: it is the rate that discounts the expected cash flows (CU115.0) to equal the carrying amount of the liability on 1 January 20X2 (ie CU107.4).

78. In any case, the cost of the asset is not adjusted, because the remeasurement of the carrying amount of the liability relates entirely to an interest expense of the current period that is recognised in profit or loss.

Alternative 3 (AG8)

79. If the entity considers that inflation is not a floating rate, the liability is amortised in accordance with paragraph AG8 of IAS 39. The interest expense is calculated using the original effective interest rate. Cash flows are normally projected using expectations about future inflation rates (as in Alternative 2 above). This is the method that we use below. In that case, the initial accounting is the same as in Alternative 2 above.

80. A simpler method would be to project cash flows using the spot inflation rate of the current reporting period (as in Alternative 1 above). We acknowledge that this method does not seem to strictly comply with paragraph AG8. However, we note that it might be difficult and burdensome to forecast future inflation rates or indexes.

81. We do not think that the fact that the entity uses expected inflation rates or spot inflation rates to project the expected cash flows should affect the subsequent accounting. Indeed, in both cases, we think that the AG8 adjustment relates to the purchase transaction itself, because it is a 'correction' of estimates used for the initial accounting (whether those estimates are initially based on expected inflation rates or spot inflation rates). As a result, the AG8 adjustment should be entirely recognised as an adjustment to the cost of the asset.

82. The table below shows how the liability is amortised (using expectations about future inflation rates):

Year	Initial carrying amount	Interest expense (at 5%)	AG8 Adjustment	Payments	Ending carrying amount
20X0	**CU291.5**	**CU14.6**	**0**	**CU(103.2)**	**CU202.9**
20X1	**CU202.9**	**CU10.1**	**CU7.9**	**CU(110.9)**	**CU110.0**
20X2	**CU110.0**	**CU5.5**	**CU(0.5)**	**CU(115.0)**	**0**

Condensed data and comparison

	AG7 First method	AG7 Second method	AG8 Adjustment in P/L(1)	AG8 Adjustment capitalised
20X0 Interest expense	**CU14.5**	**CU14.6**	**CU14.6**	**CU14.6**
20X1 Interest expense	**CU18.9**	**CU15.4**	**CU18**	**CU10.1**
20X2 Interest expense	**CU5.9**	**CU7.6**	**CU5.0**	**CU5.5**
Interest expense (2)	**CU39.3**	**CU37.6**	**CU37.6**	**CU30.2**
Depreciation expense (3)	**CU289.8**	**CU291.5**	**CU291.5**	**CU298.9**
Total expense	**CU329.1**	**CU329.1**	**CU329.1**	**CU329.1**

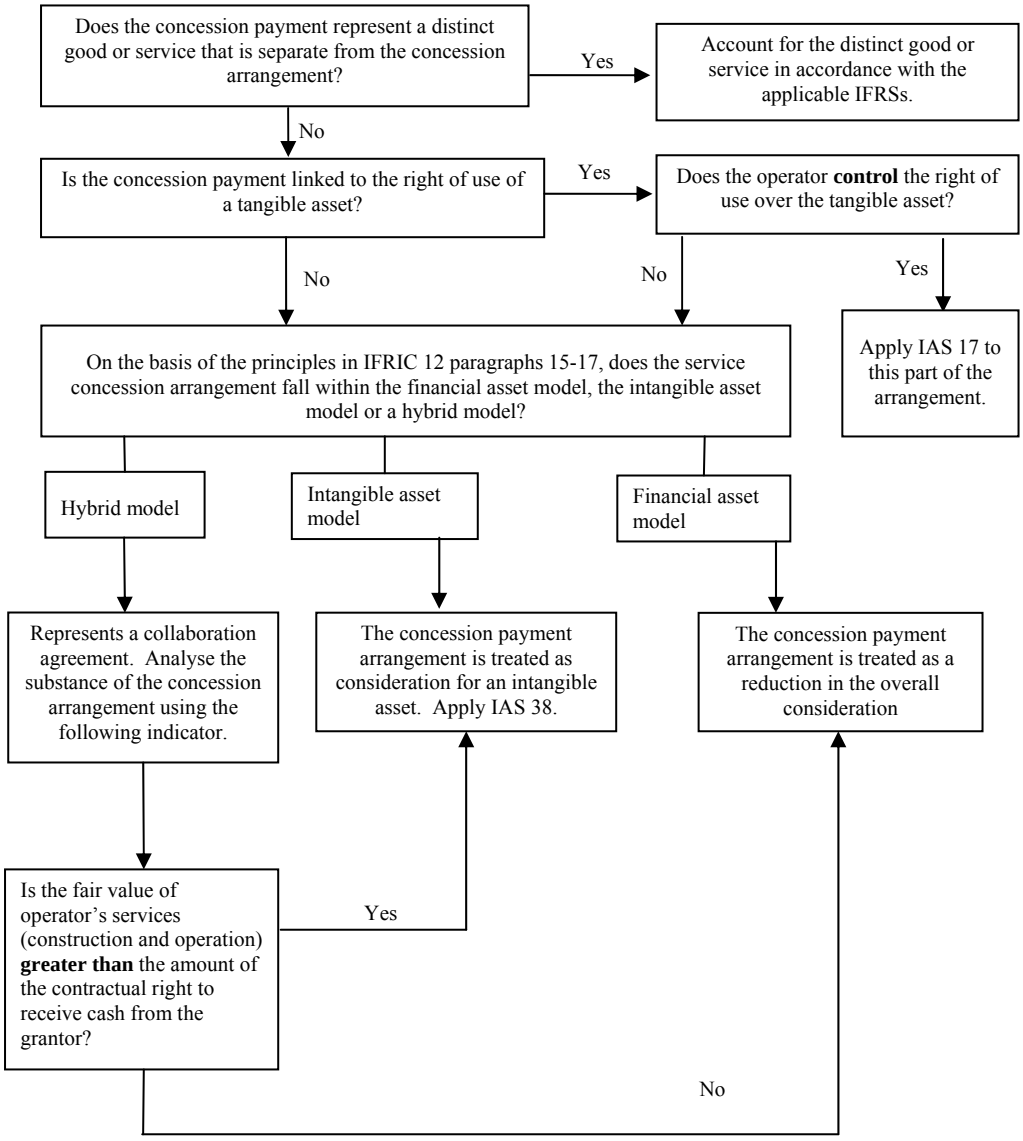
(1) This approach is shown for illustration purposes only. The staff's recommendation is to capitalise the AG8 adjustment (if paragraph AG8 is applied).

(2) It should be noted that in Example 4, the total interest expense was the same under both AG7 methods. This is not the case in this example.

(3) Over the three year life of the intangible asset/concession.

83. We note that the application of paragraph AG 7 (second method) or paragraph AG8 (with the AG8 adjustment being capitalised in the cost of the asset) tends to 'smooth' expense recognition related to changes in the inflation rate. Conversely, the application of paragraph AG7 (first method) or paragraph AG8 (with the AG8 adjustment being recognised in profit or loss) tends to result in more volatility in the income statement.

Appendix B—summary of tentative Committee decisions regarding the proposed amendment to IFRIC 12



Appendix C—proposed amendment to IFRIC 12

Amendment to IFRIC 12 *Service Concession Arrangements*

Paragraphs 10 and 27 are amended as follows (new text is underlined) and paragraphs 7A and 27A are added. Paragraph 7 is not proposed for amendment but is included here for ease of reference:

7 This Interpretation applies to both:

(a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and

(b) existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.

7A If the operator is given access to assets (either directly or indirectly via third party arrangements involving the grantor) in exchange for payments, the operator shall assess whether the assets provided are infrastructure within the scope of this Interpretation, or whether the access represents a lease in the scope of IAS 17 *Leases*. The following factors indicate that the assets are infrastructure within the scope of this Interpretation:

(a) the grantor retains control over the use to which the asset is put, by controlling or regulating what services the operator must provide, to whom it must provide them, and at what price, as described in paragraph 5(a);

(b) the grantor retains control over any significant residual interest in the asset at the end of the period of the arrangement; and

(c) the operator does not have a right of use of the underlying asset but rather access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

10 This Interpretation sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements. Requirements for disclosing information about service concession arrangements are in SIC-29. The issues addressed in this Interpretation are:

(a) treatment of the operator's rights over the infrastructure;

…

(f) subsequent accounting treatment of a financial asset and an intangible asset; ~~and~~

(g) items provided to the operator by the grantor~~.~~; and

(h) payments made by the operator to the grantor.

27 In accordance with paragraph 11, infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator. If the grantor provides the operator access to the infrastructure and the operator is required to make payments to the grantor in exchange for this access, the operator shall account for these payments in accordance with paragraph 27A of this Interpretation. The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in IAS 20. They are recognised as assets of the operator, measured at fair value on initial recognition. The operator shall recognise a liability in respect of unfulfilled obligations it has assumed in exchange for the assets.

Payments made by the operator to the grantor

27A As part of the service concession arrangement, the operator may be required to make payments to the grantor, or in some cases, third parties. When this is the case, the operator should analyse the payments in the following way:

(i) if the payment gives the operator a right to a good or service that is distinct from the service concession arrangement (for example if the payment represents an embedded lease payment as explained in paragraph 7A above), the operator should account for that distinct good or service in accordance with the applicable IFRS;

(ii) if the concession payment does not give the operator a right to a distinct good or service, the type of service concession arrangement should be considered to determine the accounting for the concession payment:

1. if the service concession results in the operator having a contractual right to receive cash from only the grantor as described in paragraph 16, then the concession payment is accounted for as an adjustment to the consideration in a manner consistent with IAS 18;
2. if the service concession arrangement results in the operator having only a right to charge users of the public service as explained in paragraph 17, then the concession payment is accounted for as incremental

consideration for the intangible asset when applying paragraph 26; and

3. if the operator has both a right to charge users of the public service and a contractual right to receive cash from the grantor as explained in paragraph 18, then the amount of the contractual right to receive cash from the grantor needs to be compared with the fair value of the operator's services (construction and operation) in making the judgement of whether the concession payment represents an adjustment to the consideration or incremental consideration for the intangible asset.