

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 16 <i>Property, Plant and Equipment</i>, IAS 38 <i>Intangible Assets</i> and IFRIC 12 <i>Service Concession Arrangements</i>		
Paper topic	Variable payments for asset purchases and payments made by an operator to a grantor in a service concession arrangement—Simplified Examples		
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This paper has been prepared 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 the accounting for payments made by an operator in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*.
2. This project, together with the project on variable payments for the separate purchase of property, plant and equipment (PPE) and intangible assets, was put on hold pending completion of the redeliberations on the proposals in the *Leases Exposure Draft* ('the *Leases ED*').
3. The IASB has substantially completed its redeliberations of the proposals in the *Leases ED*. This paper provides examples illustrating the impact of applying the principles of the *Leases* project to variable payments for asset purchases. It also illustrates the impact of applying the Interpretation Committee's previous tentative decisions on subsequent accounting for variable payments for asset purchases and payments made by an operator to a grantor in a service concession arrangement. .
4. The following examples are presented:

- (a) Example 1: variable payments that are made if a milestone is reached in a research and development project;
- (b) Example 2: variable payment made by an operator to a grantor when the financial asset model in IFRIC 12 is applicable;
- (c) Example 3: variable payments made by an operator to a grantor when the intangible asset model is applicable (the variability is dependent on the number of users); and
- (d) Example 4: variable payments made by an operator to a grantor when the intangible asset model in IFRIC 12 is applicable (the variability is dependent on an index).

Example 1: variable payments that are made if a milestone is reached in a research and development project

5. On 1 January 20X0 Entity C acquires a patent related to a new chemical compound and agrees to make a first fixed payment of CU100¹ 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).
6. For the 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 per cent (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).

¹ In this paper, currency amounts are denominated in 'currency units' (CU).

Initial accounting:

7. Entity C includes in the initial measurement of the asset the fair value of the first fixed payment to be made. In accordance with the principles in the Leases project, the additional payment is not included in the initial measurement of the asset and liability, because this payment is not dependent on an index or a rate. As a result, on 1 January 20X0, Entity C makes the following entries:

Dr Intangible asset	CU100
Cr Cash	CU100

Subsequent accounting:

8. 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. In accordance with the principles in the Leases project, the payment will be recognised as an expense when incurred. As a result, at the date when the approval is obtained (ie 31 December 20X1), Entity C makes the following entries:

Dr Expense	CU55
Cr Cash	CU55

9. However, if the subsequent accounting for the variable payment follows the previous tentative decisions of the Interpretations Committee, the entity would have to assess whether the payment is associated with future economic benefit to be derived from the asset. In this example, the variable payment reflects 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

Example 2: variable payments made by an operator to a grantor—financial asset model

10. Entity O ('the operator') is the operator and Entity G ('the grantor') is the grantor in an 11-year service concession arrangement within the scope of IFRIC 12.
11. The operator begins constructing a toll road on behalf of the grantor at the beginning of Year 1, and following this the operator will operate the public toll road on behalf of the grantor for the remaining years of the concession period. The terms of the agreement state that the grantor will pay the operator a contractually agreed amount per year as consideration for the services (financial asset model).
12. The grantor agrees to pay to the operator an amount of CU10,000 each year from the start of Year 2 over the 11-year concession arrangement, ie CU100,000. However, at the end of the concession arrangement, if it is determined that the number of users of the public service over the concession term was below 50,000,000, then the operator will be required to make a payment to the grantor of CU10,000 (because it is assumed that if the users are above 50,000,000, this is an indication that the service was provided at an acceptable service level). The payment to the grantor does not represent a payment for a distinct good or service.
13. At the end of Year 1, the operator completes construction of the toll road and begins to operate the toll road at the start of Year 2. At the end of Year 1, the operator expects the number of users to be above 50,000,000 at the end of the concession arrangement. However, at the end of Year 2, the operator estimates that the number of users will be below 50,000,000 at the end of the concession arrangement.
14. For the purposes of this example, the time value of money has been ignored. Assume that the stand-alone selling price of the construction services is CU40,000 and the stand-alone selling price of the operation services is CU60,000. The operation services are assumed to be provided evenly over Years 2-11.

Proposed application of the revenue recognition principles:

15. The variable payment from the operator to the grantor can be viewed as a variable payment that will be either zero or CU10,000. At the end of Year 1, the overall consideration for the arrangement can be determined to be CU100,000 which is

calculated as the consideration of CU100,000 less the most likely concession payment of CU0².

16. The operator allocates the overall consideration to the separate elements of the arrangement based on their relative stand-alone selling prices. In other words, of the overall consideration of CU100,000, CU40,000 is allocated for the construction services and CU60,000 for the operation services.
17. At the end of Year 1, the construction services have been fully delivered, whereas none of the operation services have been delivered. Consequently, the journal entry at the end of Year 1 is:

Dr Receivable CU40,000

Cr Revenue CU40,000

Recognition of the revenue for Year 1 based on the overall consideration and the relative fair value of the goods and services provided.
18. At the end of Year 2, the operator updates its estimates of the overall consideration, taking into account the revised variable concession payment. The overall consideration is now CU90,000 which is calculated as the consideration of CU100,000 less the most likely concession payment of CU10,000.
19. The operator allocates the overall consideration to the separate elements of the arrangement based on their relative stand-alone selling prices. In other words, the overall consideration of CU90,000 is allocated as CU36,000 ($CU40,000 \times CU90,000 \div CU100,000$) for the construction services and CU54,000 ($CU60,000 \times CU90,000 \div CU100,000$) for the operation services.
20. At the end of Year 2, the construction services have been fully delivered and 1 year of the 10 years of the operation services have been delivered. The cumulative revenue that should be recorded at the end of Year 2 is therefore CU41,400. This is calculated

² Paragraph 53 of IFRS 15 states that an entity shall estimate an amount of variable consideration by using either the expected value (ie a sum of probability weighted amounts) or the most likely amount depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. The contract has only two possible outcomes and hence it is assumed for purposes of this example that the most likely amount better predicts the amount of consideration the entity will be entitled to.

as CU36,000 for the construction services plus $CU54,000 \times 1/10$ for the operation services.

21. Consequently, the journal entry at the end of year 2 is:

Dr Cash		CU10,000
	Cr Revenue	CU1,400
	Cr Receivable	CU8,600

Recognition of the revenue for Year 2 based on the overall consideration and the relative stand-alone selling prices of the goods and services provided.

Example 3: Variable payments made by an operator to a grantor—intangible asset model (variability dependent on number of users)

22. Entity O ('the operator') is the operator and Entity G ('the grantor') is the grantor in an 11-year service concession arrangement within the scope of IFRIC 12.
23. The operator begins constructing a toll road on behalf of the grantor at the beginning of Year 1, and following this the operator will have the right to operate the public toll road on behalf of the grantor for the remaining 10 years of the concession period. The terms of the agreement state that the operator has the right to charge users of the public service a fixed amount of CU10 per car over the concession term (intangible asset model).
24. The operator agrees to pay to the grantor an amount of CU1 per car over the period of the concession arrangement. The payment to the grantor does not represent the payment for a distinct good or service.
25. At the end of Year 1, the operator completes construction of the toll road and begins to operate the toll road at the start of Year 2. At the end of Year 1, the operator expects the number of users to be 11,000 over the life of the concession term, although the operator cannot be reasonably certain of this. At the end of Year 2, 1,200 users have made use of the toll road and the operator revises its estimate of total users over the life of the concession term to 12,000 users. Again the operator cannot

be reasonably certain of the estimate of the number of users over the life of the concession.

26. For the purposes of this example, the time value of money has been ignored. Assume that the stand-alone selling price of the construction services is CU40,000 and the stand-alone selling price of the operation services is CU60,000. The operation services are assumed to be provided evenly over Years 2-11.
27. Economically, the service concession is initially thought to be worth CU110,000 (CU10 per car × 11,000 cars), whereas the concession services are thought to be worth CU100,000 (construction of CU40,000 + operation of CU60,000). Consequently, the CU1 payment per car is intended to compensate the grantor for the fact that the service concession is relatively more valuable than the operator's services.

Proposed application of the principles for accounting for variable payments to acquire an intangible asset as explained in Agenda Paper 06A:

28. As explained in detail in Agenda Paper 06A, variable payments linked to the future performance of the purchaser (or the operator in this case), such as variable payments based on future revenues or other similar profit-sharing agreements, would not be initially included in the cost of the intangible asset and in the measurement of the liability.
29. The concession payments in this example are dependent on the future performance of the operator and are not based on an index or rate. Consequently, the future concession payment of CU1 per user would not be initially recognised in the cost of the intangible asset. In other words, at the end of Year 1, the construction services have been fully delivered, whereas none of the operation services have been delivered. Consequently, the journal entries at the end of Year 1 are:

Dr Concession asset CU40,000

Cr Revenue CU40,000

Recognition of the revenue for Year 1 based on the overall consideration and the relative fair value of the goods and services provided.

30. In accordance with the principles developed in the Leases project for subsequent accounting for variable payments, at the end of each period, when the CU1 per user becomes reasonably assured (ie when the corresponding revenue is recognised) the payment would be recorded as an expense for the period.
31. In accordance with previous tentative decisions for subsequent accounting for variable payments, the operator would need to determine whether the amount either represents a benefit for a future period or whether the benefit relates to a current or prior period.
32. In this example, because the payment of the CU1 per user does not represent a benefit for a future period (because the operator has already consumed the portion of the related intangible asset), the operator would recognise the CU1 per user in profit or loss for the period.
33. Consequently, the journal entries for Year 2 (under either the Leases principles or previous tentative decisions) are:

Dr Cash		CU12,000
	Cr Revenue	CU12,000

Dr Concession fee		CU1,200
	Cr Cash	CU1,200

This represents recognition of the revenue for Year 2 and recognition of an expense for the variable payment.

Example 4: Variable payment—intangible asset model (variability dependent on inflation index)

34. 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.
35. For the purposes of this example, assume that:

- (a) Operator's E incremental borrowing rate is 5 per cent on 1 January 20X0;
and
- (b) the variable payments are part of the consideration to acquire an intangible asset in accordance with IFRIC 12.

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

Year	Actual inflation rates	Expected 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%

37. The following are the expected cash flows (using spot inflation rate of the current period):

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

Initial accounting:

- 38. Using the principles developed in the Leases project for variable payments, the liability would be measured initially using the index or rate at 1 January.20X0.
- 39. 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 per cent).

Subsequent accounting:

40. In accordance with the principles developed in the Leases project, subsequent adjustments resulting from changes in the index or rate would be *recorded against the cost of the asset*.
41. The table below shows how the liability is amortised:

Year	Opening Balance	Interest expense (at 5%)	Adjustment - recorded against cost of the asset	Payments	Closing Balance
20X0	CU289.8	CU14.5	0	CU(103.2)	CU201.1
20X1	CU201.1	CU10.1	CU13.3	CU(110.9)	CU113.6**
20X2	CU113.6	CU5.7	(CU4.3)	CU(115.0)	0

** calculated as expected payment for year 20X2 of CU119.3 discounted at 5 percent.

42. In accordance with previous tentative decisions of the Interpretations Committee, the entity would first determine whether the liability was a fixed-rate liability or a floating rate liability. The Interpretations Committee had previously discussed whether paragraph AG7 or AG8 should be applied to a variable payment that is dependent on an inflation index. Agenda Paper 2 of the Interpretations Committee's meeting in January 2013 acknowledges the diversity in practice in this area (see paragraphs 8×11 of the [Agenda Paper](#)). As discussed in Agenda Paper 06A, the revised guidance in paragraphs B5.4.5 and B5.4.6 of IFRS 9 is similar to the guidance in paragraphs AG 7 and AG8 of IAS 39.
43. If the entity considers the instrument to be a floating-rate instrument, the adjustment would be recorded through profit or loss. If the instrument is not considered to be a floating rate instrument, the adjustment would be recorded against the cost of the asset (similar to the illustration above).