STAFF PAPER

IFRS Interpretations Committee Meeting

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Project	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 presentation 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 IFRIC clarify whether:

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

Explanation of the issue

3. IFRIC 12 and IAS 7 *Statement of cash flows* do not provide explicit guidance for the presentation of cash flows relating to service concession arrangements.

4. Because construction services under IFRIC 12 result in the recognition of either an intangible asset or financial asset, the submitter states that this could in turn impact the classification of the related cash flows.

5. The submitter explains that there are various ways in which an entity might apply IAS 7 to the relevant cash inflows and outflows. The alternatives put forward by the submitter are summarised in the following table:

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

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

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

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.

Outreach conducted

11. We sent out a request for information to the National Standard Setters Group in order to help assess the Committee's agenda criteria. Specifically, we asked:

    (a) *What is the prevalence of this issue in practice in your experience?*

    (b) *What diversity in accounting for such transactions do you see in practice, specifically relating to the issues described by the submitter?*

12. An additional question asked to the National Standard Setters Group where the issue was common in their relevant territory was:

    Is there any clear preference by reporting entities regarding in which category (operating or investing) the cash inflows and cash outflows are presented for 'construction services'?

13. The views expressed below are informal feedback from the National Standard Setters. They do not reflect the formal views of the Boards of those organisations The geographic breakdown for the responses is as follows:

Geographic area	Number of respondents

Central/South America	1
Asia/Oceania	5
Africa	1
Europe	3
North America	1
Total respondents	**11**

14. Several respondents stated that the issue was prevalent in their jurisdiction.

15. For those respondents where the issue was prevalent, we observed that the accounting treatments were not consistent. We also noted that the diversity appeared to be consistent with the submitters assertion ie, that current practice favours classification of cash outflows relating to construction services as investing cash flows.

Assessment against the annual improvements criteria

16. We have assessed a potential amendment to IAS 7 against the annual improvements criteria to clarify the classification of cash inflows and cash outflows for construction services in the scope of IFRIC 12, which are reproduced in full below:

> 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.]

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.

Questions to the Interpretations Committee

Questions
1. Does the Committee agree with the staff view that cash inflows and cash outflows relating to construction or upgrade services in the scope of IFRIC 12 should be classified as operating cash flows? If not, does the Committee believe one of the alternative views is more appropriate? 2. Does the Committee agree with the staff recommendation to amend IAS 7 to clarify the classification of cash inflows and cash outflows related to construction or upgrade services in the scope of IFRIC 12? 3. Does the Committee agree with the proposed amendments to paragraph 14 of IAS 7 in Appendix A?

Appendix A—proposed changes

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~~.~~; and

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

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 submission

[Submitter] request the IFRS Interpretations Committee to address the following issue with respect to the application of IAS 7 *Statement of Cash flows* and IFRIC 12 *Service Concession Arrangements*

The issue:
The issue is the classification of cash inflows received and cash outflow paid by a concession operator when the service concession arrangement is within the scope of IFRIC 12.

With the amendment of IAS 7 paragraph 16 in April 2009, the Board clarified that a cash flow is only a cash flow from investing activities if it results in a recognised asset in the statement of financial position. The impetus for the amendment came from divergent treatment of some types of expenditure in the statement of cash flows. In practice some entities classified expenditure, including those for exploration and evaluation activities that were not recognised as assets under IFRS, as cash flows from operating activities, while others classified them as part of investing activities.

IFRIC 12 paragraph 14 requires an operator to account for 'construction services' provided to the grantor in accordance with IAS 11. Generally, cash outflows that relate to contract expenses under IAS 11 are operating cash outflows under IAS 7. The inference is that cash outflows for construction services, which will be reflected as contract costs in the statement of comprehensive income as contract activity progresses, should also be classified as operating cash outflows. Unlike most construction contracts, it is not usual for the operator to receive cash inflows during the construction phase as grantors normally only make payments once the infrastructure has been completed and services are being provided. Instead, IFRIC 12 requires the operator to recognise a non-current asset as the consideration for the construction services, either a financial asset, repayable over the concession term, or an intangible asset.

A literal reading of IAS 7 ('View 1') suggests that the treatment of cash inflows relating to construction services will depend on the model that applies and be as follows:

- cash inflows under the intangible asset model will be reported as operating cash flows,
- cash inflows under the financial asset model will be reported as inflows from a debt instrument, split as appropriate between the redemption component, an investing cash flow and an interest element that will be an operating or investing cash flow, according to the entity's accounting policy.

The consequence of a cash flow analysis that follows the interpretation outlined above is that:

- arrangements that are accounted for under the intangible asset model would report all cash inflows and outflows as operating;
- arrangements that are accounted for under the financial asset model would report operating cash outflows and investing cash inflows, to the extent that the cash flows represent a repayment of a financial instrument. The interest

element is presented as operating, investing or financing according to the accounting policy of the entity.

Alternative views

Some argue that the circumstances of service concession arrangements mean that this analysis does not necessarily result in the most appropriate presentation of their cash flows in the financial statements of operators. There are a number of different arguments, some of which relate only to one or another of IFRIC 12's accounting models.

View 2 Some consider that the analysis in view 1 above is inappropriate for transactions under the financial asset model. Operators applying this model would report only cash outflows and no cash inflows as arising from their operating activities. They consider that in order to properly present the cash flows arising from a single contractual arrangement, both cash inflows and cash outflows should be classified as arising from operating activities.

In this context, it is noted that there is a precedent for a clarification of the treatment of cash flows. An amendment was made to paragraph 14 of IAS 7 by the 2008 Annual Improvements Project that allowed an entity which requires an entity to report as operating all cash outflows incurred in manufacturing or acquiring assets held for rental and subsequently for sale and all cash inflows received from rents and subsequent sales. Paragraphs BC.35B-35C explain the reason for the amendment as being to better reflect the ordinary activities of the such entities and allow users to include these cash flows in their evaluation of past and future cash flows in the course of the entity's ordinary activities.

View 3 Others note that the amendment to IAS 7 paragraph 16 was drafted to address circumstances in which entities treated cash flows as investing in nature when the expenditure was always treated as an expense in the statement of comprehensive income. They question whether this is appropriate in the case of service concession arrangements when these cash flows are associated with an accounting model that requires the entity to recognise a non-current asset in all circumstances. Although they are providing construction services, entities note that under the intangible asset model they are required to recognise an intangible asset as a consequence of the cash outflows.

As a consequence, they argue that cash outflows relating to construction services under the intangible asset model ought to be classified as investing outflows. Cash inflows would be classified as operating cash inflows.

View 4 Others question whether an inconsistent treatment of cash inflows depending on the model is the most appropriate treatment and whether all cash flows relating to service concession arrangements ought to be treated as operating in nature

Operators often have contracts that are accounted for under both models. Service concession operators argue that their business is not to hold investments in order to generate financial income, so classification of cash inflows as investing or financing in nature does not necessarily result in the most appropriate treatment. Moreover, it is common in practice to encounter bifurcated arrangements accounted for partly under the financial asset model and partly under the intangible asset model.

It follows from this argument that operators of service concession arrangements ought to record all cash inflows and outflows as operating in nature.

The four views can be summarised as follows:

	Financial asset model	**Intangible asset model**		
	cash outflows	*cash inflows*	*cash outflows*	*cash inflows*
View 1	operating	investing*	operating	operating
View 2	operating	operating	n/a	n/a
View 3	n/a	n/a	investing	operating
View 4	operating	operating	operating	operating

* The interest element of the cash inflow would be classified as operating, investing or financing according to the accounting policy of the entity

Current practice:
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.

Reasons for the IFRS Interpretations Committee to address the issue:
(a) The issue is widespread and has practical relevance
The issue is relevant to all operators of service concession arrangements.

(b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice).
As described above, current practice differs from the interpretation of IAS7 outlined above. Divergence in practice is likely to increase as time passes.

(c) Would financial reporting be improved through the elimination of the diversity?
Yes, financial reporting would be improved if there were clarity about the appropriate treatment of these cash flows

(d) Is the issue a narrow implementation or application issue that can be resolved using existing IFRSs?
Yes, we believe that it is possible to clarify the appropriate treatment of cash flows arising from service concession arrangements.

(e) If the issue is related to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?

We are unaware of any current or planned IASB project that will address this issue.

Submitted by
[Submitter]