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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

**Project: IAS 11 Construction Contracts / IAS 18 Revenue
Allocation of profit in unsegmented contracts
(Agenda paper 10(iv))**

Introduction

NB: This Observer Note is almost identical to the one presented at the May 2006 IFRIC meeting. There are few amendments incorporated in paragraph 9.

1. *“At the meeting in March 2006, the IFRIC noted the comments received on the proposal in D13 [Service Concession Arrangements – The Financial Asset Model] to require allocation of revenue to the different activities of a service concession arrangement by reference to their fair values. The IFRIC noted that this issue had ramifications beyond service concessions arrangements and asked the staff to give priority to a separate project to analyse IAS 11 and IAS 18 to determine whether it is appropriate in an unsegmented contract to allocate different project margins to the different components.”*[IFRIC UPDATE, March 2006]
2. The background to this issue comes from two different projects parts of which are intrinsically linked:
 - a) **Combining and segmenting contracts:** the staff performed an analysis of guidance provided by the US guidance, SOP 81-1, and presented its

conclusions at the April 2005 IFRIC meeting. The IFRIC members identified a fundamental difference between IAS 11 and SOP 81-1: *“The difference related to revenue recognition on construction contracts that involved different activities but did not meet the conditions in IAS 11 for segmentation. The IFRIC had observed that IAS 11 required gross recognition of revenue and costs (the ‘gross approach’), while US GAAP required recognition of a percentage of expected contract profit (the ‘net approach’). Arguably, the use of the gross approach (unlike the net approach) could result in the recognition of different profit margins on different activities within an unsegmented contract.”* (See extract from IFRIC Update April 2005 in appendix 1 for further details).

- b) **Service concession arrangements:** under D13, contract obligations and related rights are recognised and measured under IASs 11 and 18. Consequently, operators might recognise different profit margins on different activities undertaken within a single service concession contract. However, D13 does not give guidance on determining the fair value of services provided by operators and assumes implicitly in the Illustrative Example that services are measured at their fair value. In March 2006, the staff recommended that the IFRIC strengthen the Basis for Conclusions of D13 and asked for its views on revenue recognition within the financial asset model.
3. Though no decision was reached on either project concerning the allocation of profit within an unsegmented contract, in March 2006, the IFRIC asked the staff to deal with this issue in a separate project. This paper analyses the key issues and sets out staff recommendations for how the IFRIC might make its views known.

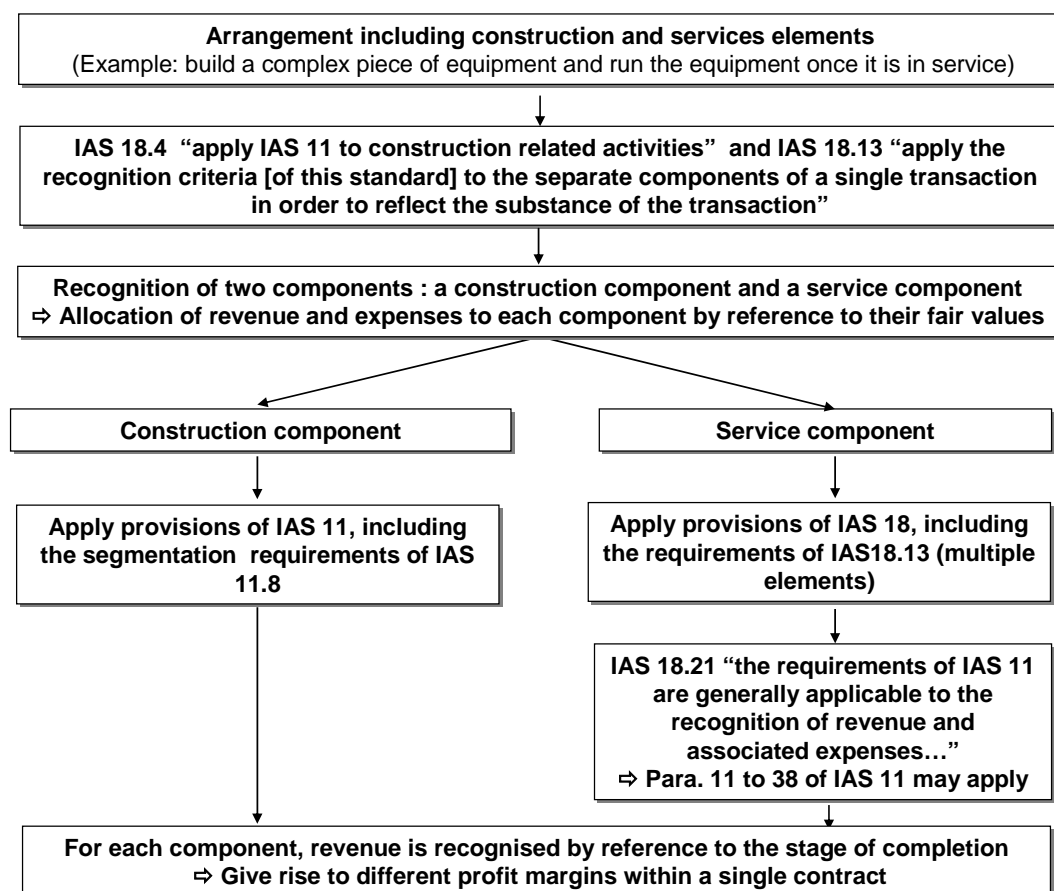
Staff analysis

4. At this stage, the staff have analysed:
- a) Guidance provided on the treatment of construction and services arrangements under current IFRSs;
 - b) The comment letters received on D13 question 2.

a) Guidance provided on the treatment of construction and services arrangements under current IFRSs:

5. A practical weakness of IAS 18 is that it gives insufficient guidance on contracts that provide more than one good or service to the customer. In some situations it is unclear when contracts should be divided into components and how much revenue should be attributed to each component. The IFRIC receives frequent requests for guidance on the application of IAS 18. The Board and the US FASB are conducting a long-term joint project to develop concepts for revenue recognition and a general standard based on those concepts. The general standard would replace the existing standards on revenue recognition, IAS 11 Construction Contracts and IAS 18 Revenue.
6. In March 2005, the staff analysed IAS 18 and IAS 11 to assess guidance actually provided on the revenue recognition of transactions including multiple elements. The scope section of IAS 18 Revenue (paragraph 4) states: *“Some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is not dealt with in this Standard but is dealt with in accordance with the requirements for construction contracts as specified in IAS 11 Construction Contracts.”*
7. Secondly IAS 18 paragraph 13 states: *“The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.”*
8. Thus, arrangements that have a construction and service element would be separated under either paragraph 4 or 13 of IAS 18; further separation of the construction element is governed by the three segmenting conditions in paragraph 8 of IAS 11. Revenue would be recognised pursuant to IASs 11 and 18 and in particular the stage of completion guidance of IAS 11.

9. The following diagramme, an extract from agenda paper 7B from March 2005, sets out these requirements:



10. [Paragraph omitted from observer notes].
11. [Paragraph omitted from observer notes]

b) Comment letters received on D13 question 2¹:

12. Question 2 of D13 was very explicit: “As explained in paragraphs BC6 and BC7, the IFRIC has concluded that, applying IAS 11 Construction Contracts, operators might recognise different profit margins on different activities undertaken within a single service concession contract. Do you agree with this conclusion?”

13. The table below sets out the comments received:

Respondents	Q2 addressed specifically				Q2 not specifically addressed	Total
	Yes	Yes but*	No	Total		
Standard-Setters	6	0	3	9	5	14
Liaison Standard-Setters	2	0	1	3	3	6
Other Standard Setters	4	0	2	6	2	8
Regulators	2	0	0	2	1	3
Accounting Firms	1	2	2	5	1	6
Accountancy Bodies	8	1	0	9	3	12
Preparers	14	1	3	18	16	34
Representative Bodies	7	0	1	8	6	14
Companies	7	1	2	10	10	20
Academics	2	0	0	2	0	2
Others	2	0	0	2	3	5
TOTAL	35	4	8	47	29	76

74%	9%	17%	100%
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(*) Yes but express concerns on FV measurement

Respondents agreeing with the proposals

14. While thirty-nine respondents agreed with the principle of the proposal, some of those respondents raised concerns with regard to the difficulty in establishing the fair values in practice.

“We agree with this conclusion in principle. Different profit margins can arise on different activities within a single contract because the services they represent are provided in different markets. However, establishing the fair values will often be very difficult, so margins will be correspondingly difficult to ascertain...” (ICAEW, CL 11)

“We fully agree that the operator might recognise different profit margins on different activities undertaken within a single concession contract, providing that these margins can be reliably estimated. (Eiffage, CL 28)

¹ See also IFRIC agenda paper 2C from the March 2006 meeting

15. The staff note that despite the concerns raised in the comment letters, discussions with many preparers indicate that they can and do reliably estimate the fair value of respective parts of the contract. In fact, many have expressed a view that if they were not able to do so, they would be failing in their duties. That is, if they are unable to accurately determine the return on different phases of the project they should not be entering into the contracts. Preparers indicate that such profiling is completed before the entity has decided whether or not to participate in the bid process. Some operators also argue they are able to assess reliably the revenue of the different activities because they deal with different business sectors in these activities.

16. [Paragraph omitted from observer notes]

Respondents disagreeing with the proposals

17. Of the eight respondents who disagreed with the proposal, some referred to IAS 11.8 and stated that these requirements should be met in order to allocate different profit margins to the activities of service concession arrangements. Others opposed by stating that the method would not result in a reliable measurement.

“We do not agree with the conclusion that, by applying IAS 11, *Construction Contracts*, operators might recognise different profit margins on different activities undertaken within a single service concession contract. Especially, we do not believe the paragraph 30 of IAS 11 permits revenue to be allocated to different activities within a single contract by reference to the fair values of those activities. Such method of revenue-allocation intends to separate different activities within a single contract and determine the stage of completion of each activity independently. However, such a method is unacceptable unless the requirements for segmenting contracts (paragraph 8 of IAS 11) are satisfied. That is to say, it is necessary to segment contracts in accordance with paragraph 8 of IAS 11 so that contract revenue may be allocated to different activities within a single contract by reference to the fair values of those activities....”
(International Accounting Standards Review Committee of KASB, CL 30)

“BG does not agree with this conclusion. BG considers that the contract should be considered as a whole rather than a set of different activities.” *(BG Group plc, CL 46)*

Staff recommendations

18. The staff recommend that the output of this project should either be a ‘rejection’ wording as set out in paragraph 19 of this paper or amendments to paragraphs BC6 and BC7 of the Basis for Conclusions of D13 *Service Concession Arrangements – The Financial Asset Model*. (See appendix 2). If the second course is preferred, proposals will be brought to IFRIC as part of the Concessions project.

What are your views on this issue?

19. [Paragraph omitted from observer notes]

Appendix 1 (IFRIC Update, April 2005)

IAS 11 *Construction Contracts*: Combining and Segmenting Contracts

The IFRIC has been considering whether it could enhance convergence with US GAAP by adding guidance on the requirements in IAS 11 *Construction Contracts* on combining and segmenting contracts.

The prompt for this project came from the Board in May 2003, when it asked the IFRIC to consider the guidance for combining and segmenting contracts in AICPA SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* with a view to adding similar guidance to IAS 11. At its meeting in February 2005, the IFRIC agreed to communicate its conclusions to the Board before proceeding with its work on this project.

At the meeting in March 2005, the IFRIC considered a draft report to the Board. The report first explained the IFRIC's decision not to proceed with a draft Interpretation on combining and segmenting construction contracts. The IFRIC had concluded that the matter was not a priority for the IFRIC at this time:

- an IFRS preparer with a US listing should be able to get to the same answer under both frameworks, as the conditions for combining and segmenting under IFRS and US GAAP were not inconsistent, (US GAAP is elective whereas under IAS 11 contracts must be combined or segmented when certain conditions are met)
- IFRIC members were not aware of any significant divergence in practice.

These conclusions applied only to the matter of combining and segmenting construction contracts within the scope of SOP 81-1. The IFRIC directed the staff to add to the report its conclusion that full convergence of the conditions for combining and segmenting construction contracts could not be achieved through interpretation. The main obstacle was that paragraphs 40 and 41 of SOP 81-1 provided two routes to segmenting a construction contract, only one of which was available in IAS 11.

The draft report also discussed the interrelationship between the conditions for combining and segmenting construction contracts and the treatment of multiple-element arrangements. EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* provides specific guidance on the treatment of such arrangements. The staff had concluded that IFRSs also provide guidance on their treatment and that, for a combined construction and service arrangement, an IFRS preparer with a US listing could get to the same accounting treatment under both frameworks (provided the outcome of the arrangement was not loss-making and could be estimated reliably). Some IFRIC members questioned those conclusions and agreed to send their comments on the draft report to staff.

Lastly, the draft report considered a fundamental difference between IAS 11 and SOP 81-1. The difference related to revenue recognition on construction contracts that involved different activities but did not meet the conditions in IAS 11 for segmentation. The IFRIC had observed that IAS 11 required gross recognition of revenue and costs (the 'gross approach'), while US GAAP required recognition of a percentage of expected contract profit (the 'net approach'). Arguably, the use of the gross approach (unlike the net approach) could result in the recognition of different

profit margins on different activities within an unsegmented contract. The IFRIC concluded that it would progress this matter as a separate project and directed the staff to analyse the matter further and present it for consideration at a future Agenda Committee meeting.

Appendix 2

D13 *Service Concession Arrangements – The Financial Asset Model* Recognition and measurement principles

BC6 IAS 11 requires contract revenue to be measured at the fair value of the consideration received or receivable. It requires the revenue to be recognised by reference to the stage of completion of the contract activity. Paragraph 30 of IAS 11 notes that the stage of completion may be determined in a variety of ways and that the entity should use the method that measures reliably the work performed. The IFRIC concluded that this requirement permits revenue to be allocated to different activities within a single contract by reference to the fair values of those activities.

BC7 The IFRIC noted that, if the revenue attributable to different activities is allocated by reference to their fair values, the entity might report different profit margins on these different activities, even though the contract has not been segmented for the purposes of applying IAS 11. This outcome is illustrated in the Illustrative Example that accompanies the draft Interpretation: different profit margins are recognised on the construction, operating and resurfacing activities that take place within one overall contract.