**30 Cannon Street, London EC4M 6XH, United Kingdom**
**Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411**
**Email: iasb@iasb.org Website: www.iasb.org**

**International Accounting Standards Board**

*This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.*

*Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.*

**INFORMATION FOR OBSERVERS**

**IFRIC meeting:** **July 2007, London**

**Project:** **Customer Contributions - Overview (Agenda Paper 2A)**

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## Background

1. In November 2006, the IFRIC received a request for guidance on the accounting for customer contributions. Such contributions arise in a number of industries in which a customer is required to contribute an asset (or cash towards the construction or acquisition of an asset) that is then used to provide an ongoing service or an ongoing supply of goods to the customer.

2. The request considered the accounting for the receipt of the contributed asset by the service provider. It did not consider, and this paper does not deal with, the accounting for the contribution by the contributor.

3. The request identified a number of different possible accounting treatments, including that the asset should be accounted for using one of the methods available in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance,* at cost (of nil) or at fair value. If the contributed asset is initially recognised at fair value, different accounting treatments were identified for the resultant credit including that it should be recognised in the

profit and loss account immediately or that it should be deferred and recognised over the life of the ongoing service.

4. The issue has widespread applicability and has implications for a wide range of different situations including:

   - the accounting for contributed assets and connection charges by utility companies;
   - the accounting for contributions of assets at the beginning of service contracts;
   - the accounting for set-up fees in IT contracts;
   - the accounting for contributed assets or set-up fees in outsourcing arrangements;
   - initial fees charged by mobile phone companies; and
   - some types of public-private partnerships.

5. In May 2007, the IFRIC agreed to take a project onto its agenda to consider the accounting for the receipt of customer contributions. In doing so, it agreed that it should approach the project in a number of steps:

   i. Consider whether an asset transfer has occurred (including considering the effect of IFRIC 4).

   ii. Consider whether IAS 20 is an appropriate accounting standard to use to account for a contributed asset.

   iii. Discuss whether an asset received should be measured at cost or fair value on initial recognition.

   iv. Consider how any resulting credit should be accounted for.

6. A summary of this approach is set out in Attachment 1 to this paper.

7. At its July meeting, the staff will present the IFRIC with 5 papers considering each of the points highlighted in the flowchart in attachment 1 in turn.

8. This paper provides a brief overview of the papers to be presented at the July IFRIC meeting, and how these relate to the approach set out in attachment 1.

## Scope

9. At its May meeting, the IFRIC agreed that the staff should limit its initial work to contributions of property, plant and equipment and not consider the contribution of cash towards the acquisition or construction of such an asset.

10. If the IFRIC is able to reach a consensus relating to the contribution of property, plant and equipment, then the staff will present a paper to a future meeting considering whether the conclusions reached can be extended to contributions of other types of assets (including cash).

11. The papers presented to the July meeting therefore only consider contributions of property, plant and equipment.

## Summary of papers to be presented

12. At the July meeting, the staff will present 5 papers :

    i. A – Overview

    ii. B – Has an asset transferred?

    iii. C – Is IAS 20 an appropriate model?

    iv. D – Should contributed assets be initially recognised at fair value or at cost?

    v. E – What is the resulting credit?

***A – Overview***

13. This paper sets out a brief overview of the papers to be presented at the July meeting. It does not ask the IFRIC to make any decision.

***B – Has an asset transferred?***

14. This paper considers two questions. Firstly, whether the contributed resource may be recognised as an asset by the service provider. In particular, it considers whether the service provider can control a resource which it is required to use to provide a service to a customer.

15. Secondly, it considers whether an ongoing service arrangement using a contributed asset results in the lease of the contributed asset back to the customer.

16. The paper concludes that, in some situations, the asset will remain on the balance sheet of the contributor and that these situations should fall outside of the scope of the proposed Interpretation. Similarly, in some situations, the ongoing service arrangement will include a lease of the asset back to the customer.

17. The paper recommends that both of these situations should be excluded from the scope of the IFRIC's work Furthermore, the staff recommends that any proposed Interpretation includes wording stating that:

- if an entity receives a customer contribution, it should first consider whether it has obtained an asset that it may recognise; and
- entities that have received customer contributions should consider whether the ongoing service arrangement includes a lease (with particular reference to IFRIC 4).

18. The remaining papers consider only situations in which an asset has transferred that may be recognised by the service provider and which has not been leased back to the customer.

***C – Is IAS 20 an appropriate model?***

19. Paper C considers whether it is appropriate to account for the receipt of a contributed asset using IAS 20.

20. The paper concludes that it is not appropriate to analogise to IAS 20 and therefore that entities should seek guidance in other standards to account for the receipt of customer contributions.

***D – Should contributed assets be initially recognised at fair value or at cost?***

21. Assuming that the IFRIC concludes that it is not appropriate to account for the receipt of customer contributions using IAS 20, it will be necessary to consider how such assets should be accounted for.

22. Paper D considers whether such contributions should be accounted for at fair value or at cost (which will be nil in the case of a contributed asset).

23. The staff concludes that such assets are property, plant and equipment that should be accounted for using IAS 16. Furthermore, the staff concludes that an

exchange transaction has occurred and so, in accordance with IAS 16, the contributed assets should be measured on initial recognition at fair value.

***E – What is the resulting credit?***

24. If the contributed assets are initially recognised by the receiving entity at fair value, then it is necessary to consider how the resulting credit should be accounted for. Paper E considers whether the credit arises as a result of the reduction in value of an asset, the existence of a liability, an equity contribution, or the receipt of income.

25. The paper concludes that the credit represents an obligation to provide future services. This obligation should be recognised on the balance sheet as deferred income. The related income should be recognised as revenue in the income statement as the ongoing services are provided.

## Other issues

26. The staff is aware that there are a number of other issues that arise as a result of this approach that will need to be considered by the IFRIC before any Interpretation is issued. However, the staff wished to establish the principles to be applied in advance of considering these more detailed practical issues.

27. If the IFRIC agrees with the staff's proposals at the July meeting, the staff will present a paper considering these further issues at a future meeting. In particular, the staff will consider the following issues:

- In many cases, the entity that contributes the assets will not be the same as the entity or entities that receive the ongoing service (for example if a house builder contributes infrastructure assets relating to a newly constructed house). The staff will consider the linkage between the party contributing the asset and the party receiving the service as part of a subsequent paper.

- There are a number of issues surrounding the period over which deferred revenue should be recognised including:

    - the life of the contributed assets may be extremely long;

    - the length of the customer relationship may be undefined;

    - there may be a number of subsequent users of the contributed assets; and

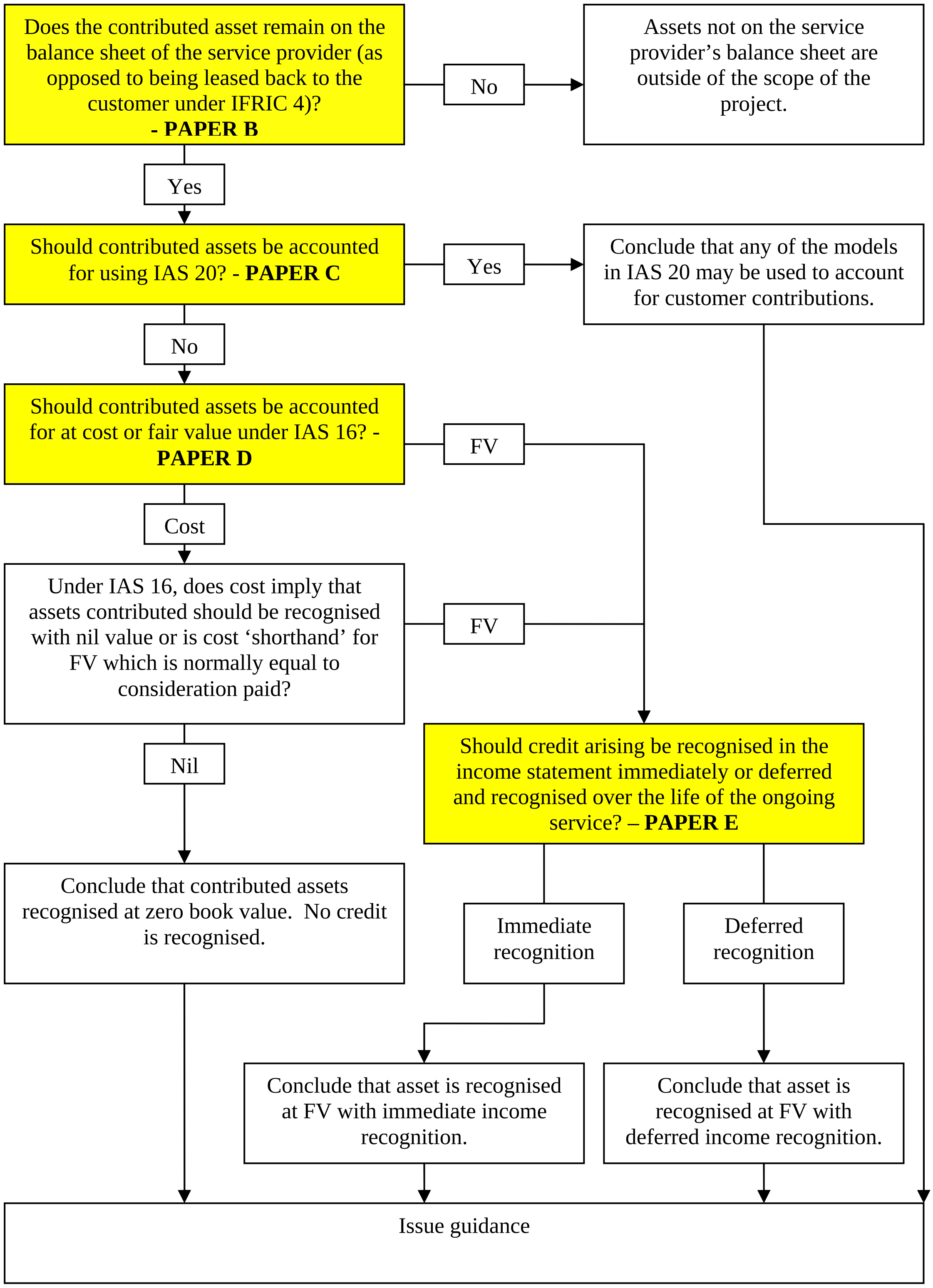
    - ceasing to use the contributed asset may result in the accelerated recognition of revenue.

  The staff will consider these issues and whether detailed guidance is needed in this area as part of a subsequent paper.

- The fair value of the asset contributed may be difficult to establish.
- Retrospective application may be extremely difficult when assets have very long lives. The staff will present a paper considering transitional provisions when the IFRIC has reached a consensus on the other issues.

28. The staff is also aware that, when the IFRIC set the scope of its project on Customer Contributions, it agreed that it would commence its work using the example of a contributed item of property, plant and equipment and then consider the situation in which cash or some other asset is contributed. The staff intends to present a paper to a future IFRIC meeting considering how the principles developed above can be applied to other types of contributions.

## Attachment 1 – Agreed approach to resolving the issue



## Notes on the agreed approach

***Consideration of IFRIC 4***

1. The staff considers that, since the initial scope of the project is limited to contributions of existing assets to the property, plant and equipment of the service provider, any assets that are deemed to be leased back to the customer after contribution will fall outside of the scope of the project.

2. The staff believes that this may exclude certain types of contributed asset from the scope of the project. For example, a customer may contribute a telephone wire connecting their property to the telephone network that can only ever be used for providing services to that customer. Since the telephone line can only be used to supply that customer, the staff considers that the line is likely to be accounted for as the customer's asset and be excluded from the scope of this project.

3. The question of how the issue interacts with IFRIC 4 will be discussed as part of paper 2B.

***Use of IAS 20***

4. Determining whether IAS 20 may be used to account for customer contributions will be of use to preparers even if the IFRIC fails to reach consensus on the subsequent steps.

5. Not only will tackling this issue give useful guidance to preparers but, by tackling this issue early on in its deliberations, the IFRIC will be able to focus subsequent discussions on just one standard (either IAS 16 or IAS 20).

***Use of IAS 16***

6. IAS 16.24 states that:

> *One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received*

*nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.*

7. Assuming that the IFRIC agrees that contributed assets should be accounted for using IAS 16, the IFRIC will need to conclude on two questions as to how that standard should be applied:

    a. Is the contribution an exchange transaction (implying that the asset should be initially recognised at fair value under IAS 16.24)?

    b. If the transaction is not an exchange transaction, the asset should initially be recognised at cost. In this case, does cost equate to the economic outflow given to obtain the asset (in this case nil) or is it shorthand for the fair value of the asset acquired which can normally be measured as the cost of acquiring the asset in an arms-length transaction?

***Recognition of the upfront contribution in the income statement***

8. If the contributed asset is accounted for at fair value, the IFRIC will need to consider how the associated credit should be accounted for in the income statement.

9. In May 2007, the IFRIC agreed that the initial scope of the project should be limited so that situations in which a customer contributes cash and the supplier builds the asset are excluded from the scope of the transaction. By doing so, the staff hope to avoid some of the issues that were faced in the IFRIC's initial fees project. If the IFRIC is able to conclude on this limited scope of work, the staff will present a paper considering whether its conclusions can be extended to other situations.

10. The staff notes that, even if the IFRIC is unable to reach consensus on this issue, it may be able to issue some guidance on how IAS 18 should be applied. Even if it is unable to do that, in order to have reached this position, the IFRIC will already have concluded that contributed assets should be recognised at fair value and be accounted for using IAS 16, which will reduce some of the divergence which currently exists in practice in this area.