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**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 – Has an asset transferred?  
(Agenda Paper 2B)**

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### **Introduction**

1. At its May meeting, the IFRIC agreed to take a project onto its agenda to consider the accounting for customer contributions. In doing so, the IFRIC directed the staff to first consider which entity should recognise the contributed resource as an asset. In particular, the IFRIC directed the staff to consider whether the asset had transferred, and whether it was leased back to the contributor as part of the ongoing service contract.
2. This paper sets out the staff's analysis of whether a contributed resource becomes an asset of the service provider and whether the ongoing service agreement contains a lease of the asset back to the customer.
3. The paper also recommends how the conclusions from this work should be reflected in any draft Interpretation issued as a result of the project.
4. In developing this paper, the staff has considered two differing situations; those in which the asset contributed can be used only to service the contributor and

those in which the asset contributed can be used to service a number of different customers.

5. The staff has illustrated these situations further below.

***Asset contributed can only be used to service the contributor***

6. The staff considered the example of a new house. When building the house, the house builder was responsible for putting in place a water pipe from the property to the water main in the street. The pipe from the property boundary to the water main is then contributed to the water company. In this situation, the water pipe cannot be used for any purpose other than supplying the new house. For example, it cannot be removed and used to supply a new house further up the road (or, if it were, it would have to be replaced by the water company for the house to be supplied with water).
7. Other similar examples exist with assets contributed at the outset of an outsourcing arrangement. For example, an entity may contribute computer hardware and software, which has previously been used to run its payroll systems, when it outsources its payroll function. In this case, it may include a clause in the contract stating that that hardware and software may only be used to support that entity.

***Asset contributed can be used to service the contributor and for other purposes***

8. In contrast to the above examples, in some situations, the assets may be contributed and then may be used by the service provider for other purposes.
9. For example, a developer may build a small development of 5 houses on the edge of town. As part of the planning permission, the developer may be required to build an electricity sub-station to serve the 5 houses, and to contribute that sub-station to the electricity company. In this case, whilst the electricity company may have an obligation to supply the 5 houses, it may also be able to use the substation for other purposes. For example, if a second developer builds a new development nearby, the substation may also be used to service that development.
10. Another example may be a situation in which an entity outsources its payroll department and, as part of the outsourcing contract, hands over the offices that previously housed its payroll department to the outsource service provider. In

this case, whilst the service provider may have an obligation to continue to supply payroll services under a contract, it may be able to use the offices for any purpose. For example, it may be able to choose to close the office and sell it, or relocate the payroll processing function and use the office for some entirely different purpose.

## **Staff Analysis**

11. The staff considers that two main questions need to be addressed.
12. Firstly, does the contribution of a resource to the service provider result in the recognition of an asset by the service provider. Secondly, if the resource has transferred, does the ongoing service contract result in the contributed resource being leased back to the customer. The staff has considered these two questions separately.
13. The staff has used the following example:

Entity A contributes a resource to entity B. Entity B receives the resource and then provides an ongoing service to entity A. The transfer of the resource from entity A to entity B is the customer contribution. If the resource qualifies as an asset that entity B should recognise, but the asset is subsequently leased back from entity B to entity A, that has been described as a leaseback.
14. The first question can therefore be described as whether the contribution from entity A to entity B results in the recognition of the contributed resource as an asset by B.
15. The second can be described as whether a leaseback from entity B to entity A has occurred.

### **Does a customer contribution result in a transfer of an asset?**

16. The staff first considered whether the service provider (entity B) has a resource that qualifies as an asset that it must recognise after the contribution has occurred.
17. Paragraph 49(a) of the Framework defines an asset as:

*‘a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.’*

18. The staff considers that it is clear that the service provider (entity B) will receive future economic benefits from using the resource in that it will be able to use it to supply a utility or service to the customer for which it will be paid (at a profit).
19. The staff therefore considers that the key question is whether entity B controls the resource.
20. The Framework discusses control of a resource in terms of control of benefits that are expected to flow from it. Paragraph 57 states:

*‘Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.’*
21. This theme is expanded upon in a number of places in the standards. For example, IAS 38.12 states:

*An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.*
22. The staff notes that, in the case of a contributed resource, the service provider (entity B) will be able to access the future economic benefits of that resource by way of the increased revenues (and profits) that it will make from using it to supply a service. Furthermore, the service provider will be able to restrict the access of others to the resource. For example, if the contributed resource is an electricity cable, the service provider can use that cable to provide electricity and so obtain the benefit of providing an ongoing electricity service. Furthermore, other electricity providers cannot use the contributed cable in order to provide a service to the customer unless permitted to do so by entity B.

23. The staff therefore considers that, in the case of a resource contributed by a customer, control of the resource generally passes to the service supplier. However, the staff considers that in some cases, this may not be the case. For example, a side-contract may be entered into as a result of the contribution which stipulates that the contributed resource must be returned to the customer (entity A) without full consideration at the customer's request. In this case, Entity B will not be able to restrict access to the benefits of the resource and so will not have control.
24. The staff therefore recommends that any draft Interpretation developed include guidance reminding entities that, if they believe that they have received a customer contribution, they must first consider whether control has passed.
25. This may be achieved using wording similar to the following:

In some situations, a service provider receives a contribution of assets from a customer as part of an arrangement under which it provides services or supplies goods to the customer. The entity receiving the assets should first consider whether it should recognise the asset in its financial statements. In particular, it should consider whether it can obtain the future economic benefits flowing from the asset and can restrict the access of others to those benefits, and whether it has control over those assets. This Interpretation considers the accounting for contributed assets that meet the criteria for recognition as assets of the service provider.

**Does the ongoing service agreement contain a lease of the contributed asset?**

26. The staff next considered the impact of IFRIC 4 *Determining whether an Arrangement contains a Lease*, and specifically whether the ongoing service agreement contains a lease of the contributed asset to the customer.

27. IFRIC 4.6 states:

*'Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:*

*(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and*

*(b) the arrangement conveys a right to use the asset.'*

28. The staff considers that in many (but not all) cases, if an asset is contributed, the fulfilment of the ongoing service will be dependent on the use of a specific asset or assets. For example, if a property developer has contributed a cable from a house to the nearest electricity pylon, it is likely that the supply of electricity will be dependent on that cable.
29. An example of a situation in which the fulfilment of the arrangement may not be dependent on the use of a specific asset is if an entity outsources its administration and contributes to the service provider the building which housed its administrative staff. If the service provider is required to use the building to provide the services under the contract, it is likely that provision of the services is dependent on the use of the asset. However, if no such provision exists in the contract and the service provider is not required to use the building, the supply of the service is unlikely to be dependent on the contributed asset.
30. If the contributed asset is not essential for the provision of the ongoing service, it is necessary to consider whether the contribution is merely a non-cash payment for ongoing services or whether the contribution of the asset should be considered separately from the ongoing service arrangement.
31. IFRIC 4.9 states:

*'An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:*

- (a) *The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.*
- (b) *The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.*
- (c) *Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated*

*by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.'*

32. The staff considers that, in some (but not all) cases the ongoing service arrangement may result in the contributed asset being leased back to the supplier. The staff considered the following examples:
- (i) Suppose that a house builder constructs a house on a brownfield site in a major city. As part of constructing the house, the house builder installs a pipe from the house to the water in front of the house. The house builder contributes the pipe that runs from the edge of the property to the water main to the water company that provides an ongoing water supply to the house. In this case, the house will receive all of the output from that pipe. The house-owner will dictate how much water flows through the pipe, and can restrict the water company from using the pipe for any purpose other than supplying the customer. Furthermore, no other user can use that piece of pipe. In accordance with IFRIC 4, the ongoing service arrangement is therefore likely to be or contain a lease of the pipe from the water supplier to its customer.
  - (ii) Now suppose that the house is built on a greenfield site some distance from the nearest house. Again, a pipe is built which connects the house to the nearest water main (some distance away in a local town), and this is contributed to the water company. The house is in an area which is being rapidly developed, and future houses may connect to the water pipe. In this case, there is a significant probability that other customers will have access to a significant part of the water pipe's output, and so it is unlikely that a lease will exist in accordance with IFRIC 4.
33. The staff considers that the above two examples illustrate that whether there is a leaseback is a matter of facts and circumstances and will not be the same for all contributed assets.

34. The staff considers that any Interpretation issued will not be able to address all possible scenarios. Instead, the staff proposes that any Interpretation include wording similar to:

An entity that has received an asset as a customer contribution shall assess whether the provision of the ongoing service to the customer contains a lease in accordance with IFRIC 4. If so, the entity should account for the lease of the asset to the customer in accordance with IAS 17.

35. The staff does not propose providing further detail as to how the lease should be accounted for as this is considered in detail in IAS 17.

### **Recommendations**

36. The staff therefore recommends that any Interpretation issued include:
- a. A reminder that, if an entity receives a customer contribution, it should first consider whether it has an asset it should recognise. In particular, it should consider whether it has control of the resource, access to the future economic benefits associated with it, and the ability to restrict the access of others to those benefits.
  - b. A statement that an entity providing an ongoing service to customers using a contributed asset to provide that service should assess whether the ongoing service agreement contains a lease of the asset to the customer (with reference to the conditions in IFRIC 4).
  - c. A statement that, if the ongoing service arrangement does contain a lease, that lease should be accounted for using IAS 17.
  - d. No further guidance on the accounting for situations in which an asset may not be recognised by the service provider or situations in which the ongoing service arrangement contains a lease of the asset to the customer.