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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 – Should contributions received be measured on initial recognition at cost or fair value? (Agenda Paper 2D)**

Introduction

1. This paper considers whether customer contributions received should be measured on initial recognition at cost or fair value. In doing so, it assumes that the IFRIC has agreed with the staff recommendation in paper 2C that it is not appropriate to account for such customer contributions using IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

2. The paper considers only whether contributions should be accounted for on recognition at fair value or cost. If the IFRIC concludes that such contributions should be initially recognised at fair value then the staff will present a separate paper considering how to account for the resulting credit.

Choosing an accounting standard

3. Having decided that it is not appropriate to use IAS 20 to account for the receipt of customer contributions, it is necessary to consider which accounting standard should be used to account for the receipt of such assets.

4. IAS 16 *Property, Plant and Equipment* paragraph 6 defines property, plant and equipment as '*tangible items that:*

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.'

5. The staff notes that customer contributions received by an entity are, by definition, tangible items (the project is initially only considering the contribution of tangible assets). Such assets are, again by definition, held for the supply of goods or services to an ongoing customer, and typically are held to be used during more than one accounting period.

6. The staff therefore considers that customer contributions received meet the definition of property, plant and equipment and should be accounted for using IAS 16.

Measurement on Initial Recognition

7. The question which then arises is how the contributed assets should be valued by the recipient on initial recognition?

8. The staff is aware of two views. View 1 is that the contributed asset should be measured on initial recognition at cost (which in the case of a contributed asset may be nil). View 2 is that it should be measured on initial recognition at the fair value of the asset received.

View 1 – the contributed asset should be initially measured at cost

9. IAS 16.15 states:

'*An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost*.'

10. Supporters of the view that the contributed asset should be recognised at cost note that the initial recognition of property, plant and equipment at cost is a fundamental principle in IAS 16. The only situation in which IAS 16 permits the use of fair value on initial recognition if an exchange transaction has occurred in accordance with IAS 16.24-25. In other words, the use of fair value on initial recognition is only permitted if '*one or more items of property, plant*

and equipment [have been] acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets.' (IAS 16.24)

11. Supporters of this view believe that, in the case of a customer contribution, no exchange has occurred. They therefore believe that initial recognition at cost is the only appropriate model to account for such contributions.

12. In support of the view that no exchange transaction has occurred, supporters of this view cite the example of a property developer who develops a housing estate. Once the estate is built, the developer contributes an electricity substation, the sewage and water pipes, the roads, power cables, and telephone cables to the relevant utility service providers. The developer never intends to receive an ongoing service in respect of these assets since the developer will sell the properties before any ongoing service is received.

13. Supporters of view 1 argue that the developer does not receive an executory contract in return for the asset as there are no ongoing services provided. Similarly, it does not receive any access right as it has no desire to access any future service.

14. Supporters of this view therefore conclude that there is no exchange of assets. In accordance with IAS 16, contributed assets should therefore be initially recognised at cost.

View 2 – the contributed asset should be initially measured at fair value

15. Supporters of view 2 note IAS 16.24-25 which state:

'*24* *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.*

25 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.'

16. Supporters of the view that the contributed asset should be recognised initially at fair value note that the contributor of the asset and the entity receiving the asset are not related parties. The contribution is made as part of a series of transactions to obtain an ongoing service. In the example of the property developer, that is the provision of services to the housing estate. The acquired access to those services is a component of the property sold by the developer. Supporters of this view conclude that the asset is contributed as part of a commercial transaction.

17. Furthermore, supporters of this view consider that the contribution is part of an exchange of assets. They argue that, in return for the contributed asset, the customer may receive:

- an access right to receive an ongoing service; and / or
- an executory contract to receive a supply of goods or an ongoing service; and / or
- an ongoing service.

18. Supporters of this view argue that the contributor does not recognise an expense as a result of making the contribution. The contributor must therefore consider that they still have an asset post-contribution. For example, the access right to utility services that enhances the value of the property.

19. Supporters of this view also point to IFRIC 8 which states that there is a presumption that an exchange occurs in the case of share based payments even if the intangible asset received cannot be identified. Using a similar logic, a contributor of an asset in an arms-length commercial transaction is unlikely to have contributed the asset for nil return. Even if it is hard to identify the asset received, it may be assumed that the contributor expects to receive some asset in return.

20. Since the contributor receives an asset in return for contributing, supporters of this view consider that an exchange transaction has taken place. As an exchange of an item of property, plant and equipment for a non-monetary asset has occurred, under IAS 16.24, the asset should be accounted for at fair value.

21. Supporters of this view therefore believe that the asset should be measured on initial recognition at fair value.

Staff analysis and conclusion

22. The staff considers that a customer contribution generally forms part of an arm's length transaction between two unrelated entities. The staff also considers that, in a commercial transaction, it is reasonable to presume that entities do not give away assets in return for no consideration.

23. Given that this is the case, the staff considers that an entity making a contribution makes it in anticipation of receiving some form of benefit in return. The precise nature of this benefit varies depending on the circumstances, but may include access rights and / or executory contracts or agreements, and / or rights to the receipt of future services.

24. The staff considers that an entity making such a contribution does not see it as reducing the value of the assets that it owns. For example, if a property developer has built a housing estate, it is unlikely to believe that the value of the estate is reduced on the day that it contributes an electricity substation, sewer, water main, or gas pipe that it has constructed.

25. Furthermore, the staff considers that the expected benefit from making the contribution is likely to meet the definition of an asset of the contributor. The Framework defines an asset as:

'*An asset is 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.*'

26. The staff considers that an access right, executory contract or agreement, or right to receive a future service is a resource. The resource has arisen as a result of past events (the contribution of the asset) and is likely to result in future economic benefits for the contributing entity (the receipt of an ongoing service or an increased price on sale of the asset).

27. Furthermore, the staff considers that the contributing entity can control access to the benefits of that resource. For example, whilst other entities may gain similar access rights, the contributing entity can control its access right to the extent that it can prevent other entities from taking it away. Similarly, it has control over its access to any contract or arrangement that arises and its right to receive future services.

28. The staff therefore concludes that the access right, executory contract, or right to receive a service received by the contributor meets the definition of an asset.

29. As an item of property, plant and equipment has been contributed and the contributor has received a non-monetary asset in return, the staff concludes that an exchange transaction has occurred. In accordance with IAS 16.24, the staff therefore concludes that the contributed asset should be initially measured at fair value.