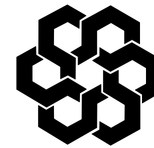

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International Accounting Standards Board

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 – What is the credit? (Agenda Paper 2E)**

Introduction

1. This paper considers how the credit that arises from the recognition of a customer contributed asset at fair value should be accounted for. In doing so, it assumes that the IFRIC has agreed with the staff recommendation in paper 2D that customer contributions should be accounted for using IAS 16 and be initially recognised at fair value.

2. The paper considers a number of related questions. Firstly, whether the credit arises because of a reduction in an asset, the existence of a liability, an equity contribution, or because of a change in the value of the receiving entity's net assets that is not due to a contribution from equity participants. If the credit is a liability, it considers what type of liability it represents and how it should be accounted for after initial recognition. If it arises because of a change in the receiving entity's net assets that is not due to a contribution from equity participants, it considers whether that change is a gain or revenue, and how it should be recognised in the income statement.

3. In considering these questions, the paper considers two views. The first is that the contribution creates no ongoing obligation and so the credit should be recognised in the income statement immediately. The second is that the credit arises from an obligation to provide ongoing services. Supporters of this view consider that the credit should be treated as deferred revenue and recognised in the income statement as the ongoing services are provided.

Is the credit a reduction in an asset?

4. One possibility is that the credit arises because of a reduction in the value of an asset. If this is the case then, the staff considers that, the only asset that it could relate to would be the contributed asset.

5. There are 3 reasons why credits may be booked to reduce asset carrying values. Firstly, an asset may have become impaired and a credit may be booked to reduce its carrying value to its recoverable amount. Secondly, a credit may be booked to reflect the usage of an asset (for example by way of a depreciation charge). Thirdly, in some cases, IFRS allows the netting of credit and debit balances on the balance sheet (for example IAS19 *Employee Benefits* requires the net presentation of scheme assets and scheme liabilities).

6. The staff has considered below whether the credit should be offset against the carrying value of the contributed asset for any of these reasons.

7. Paragraph 18 of IAS 36 *Impairment of Assets* defines recoverable amount as '*the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use.*' IAS 36.8 states '*An asset is impaired when its carrying amount exceeds its recoverable amount.*' Since the contributed asset is initially recognised at fair value, and its recoverable amount must be at least fair value, the staff considers that an impairment cannot have occurred on initial recognition. As such, it would not be appropriate to set the credit against the carrying value of the asset as an impairment.

8. Similarly, paragraph 60 of IAS 16 *Property, Plant and Equipment* states that '*The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.'* Since none of the economic benefits of owning the contributed asset have been consumed at

the point at which it is received, the staff considers that it would not be appropriate to reduce the carrying value of the asset for this reason.

9. Paragraph 32 of IAS 1 *Presentation of Financial Statements* states that '*assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation*.' In paper 2C, the staff has considered in detail whether it is appropriate to analogise to IAS 20 in accounting for customer contributions. That paper concludes that it is not appropriate to account for customer contributions by analogising to IAS 20. The staff therefore concludes that IAS 20 cannot be seen as permitting the offsetting of assets and liabilities arising from customer contributions.

10. The staff notes that there is no requirement or permission in any other current standard or interpretation for credits arising from customer contributions to be offset against assets. The staff does not therefore consider that this is an appropriate justification to net the credit against the carrying value of the contributed asset.

11. The staff therefore concludes that it is not appropriate to offset the credit arising on the initial recognition of the contributed asset against the carrying value of that asset. The remainder of this paper assumes that this treatment is not appropriate.

Is the credit a liability, or an equity contribution or income?

12. Having concluded that it is not appropriate to offset the credit that arises on the initial recognition of a contributed asset against the carrying value of that asset, it is necessary to consider whether the credit represents a liability. If not, it is necessary to consider whether it represents a contribution by an equity participant or whether it represents income arising from an increase in assets due to the receipt of the contribution.

13. Two differing views are discussed in detail below.

View 1 the credit does not represent a liability or an equity contribution but instead gives rise to income

Is there a liability?

14. The Framework defines a liability as:

    '*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.'*

15. The credit arising from the recognition of a contributed asset clearly arises from past events (the receipt of the asset). In order to determine whether the credit represents a liability, it is therefore necessary to consider whether the entity has a present obligation that is expected to result in an outflow from the entity.

16. Supporters of view 1 believe that the entity that has received the customer contribution does not have a present obligation. This can be illustrated using the example of the development of a housing estate in which the builder contributes a sub-station to an electricity company. Whilst the contribution gives the housing estate the ability to receive electricity (an access right) and the electricity company the ability to supply it, it does not require the customer to take electricity or the electricity company to supply it.

17. Supporters of this view consider that the contribution is a mutually beneficial transaction, as it allows the future supply and receipt of electricity, but that the supply and receipt comes about as a result of a different contract. This view is supported by the fact that a house-builder may contribute a sub-station to an electricity company, but the subsequent supply of electricity (including the decision as to who the customer acquires electricity from) is agreed by the subsequent owners of the house.

18. Even if there were a present obligation to supply electricity, supporters of this view do not believe that it results in an outflow of resources embodying economic benefits. In the case of an electricity supply, the electricity price will typically be the same for a customer that has made a contribution of an asset and one that is using existing infrastructure or infrastructure constructed by the electricity company.

19. In both cases, the electricity company will intend to supply electricity at a profit regardless of the contribution of an asset.

20. Supporters of view 1 do not believe that a contract to sell electricity at a variable price set by a supplier in order for that supplier to make a profit is a liability as it will not result in a net outflow from the electricity supplier of resources embodying economic benefits. The fact that the entity would anticipate making a profit means that it expects a net <u>inflow</u> of resources embodying economic benefits.

21. Supporters of this view therefore do not believe that the credit represents a liability for the entity.

Does the credit arise from an equity contribution?

22. Having concluded that the credit does not represent a liability, it is next necessary to consider whether it represents an equity contribution or an investment by owners.

23. Since customer contributions are typically third party transactions that are not made by owners or equity holders of the entity, supporters of this view do not believe that they are equity items or that they should be recorded in equity.

24. Having concluded that the credit arising from the contribution is not a liability and is not an equity item, supporters of this view conclude that the credit is likely to be an income statement item.

Is the credit income?

25. Paragraph 70(a) of the Framework defines income as:

    '*increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.'*

26. Supporters of view 1 note that the credit arises from the receipt and initial recognition of a contributed asset at fair value with no associated liability. This receipt gives rise to an increase in economic benefits. The receipt is an inflow of assets that (as discussed above) does not relate to those from equity participants. The credit that arises therefore meets the definition of income.

27. Supporters of view 1 conclude that the receipt of a customer contribution gives rise to income.

When should the income be recognised?

28. Having concluded that the receipt of the customer contribution gives rise to income, it is next necessary to consider whether it should be recognised in the income statement immediately or be deferred and recognised over the life of the ongoing service arrangement. It is also necessary to consider whether the income is revenue or a gain.

29. Supporters of view 1 argue that, as there is no obligation and so no liability, it would be inappropriate to defer the credit in the balance sheet as deferred income. Supporters of this view believe that the income should be recognised in the income statement immediately.

30. Paragraphs 92 - 93 of the Framework state:

> '*92* *Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).*
>
> *93* *The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.'*

31. As discussed above, supporters of view 1 believe that the entity receiving a customer contribution has received an asset and does not have a liability. Its net assets have therefore increased. Paragraph 92 of the Framework states that income is generally recognised at the same time as an increase in assets. Since

an increase in assets has occurred, supporters of this view believe that it is appropriate to recognise the income in the income statement immediately.

32. Paragraph 93 of the Framework states that the purpose of procedures for recognising income are directed at restricting recognition in the income statement to items '*that can be measured reliably and have a high degree of certainty*'. In the case of a customer contribution received the value can be measured reliably and, since it has already been received, there is a sufficient degree of certainty. There is therefore no purpose in restricting the recognition of the income beyond the point at which the contribution is received.

33. Supporters of this view believe that, if the income is revenue, immediate recognition in the income statement is further supported by IAS 18.

34. IAS 18 requires that revenue be recognised as goods are delivered or services are provided. As discussed above, supporters of view 1 do not believe that the receipt of a customer contribution gives rise to any ongoing obligation. As there is no obligation to provide future services, the contribution cannot have been given in return for such future services.

35. Furthermore, considering the illustration set out in paragraph 16 above, the fair value of the customer contribution received is equal to the fair value of the access right given. As the contribution has not created an obligation to perform future services and its fair value equals the fair value of 'goods' delivered (the access right) it is reasonable to treat the contribution as consideration received for the delivery of that access right. Since the access right has been delivered, it is appropriate for revenue to be recognised immediately.

36. The IASB Framework does not regard gains as a separate element. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of the entity. Gains may or may not arise in the course of the ordinary activities of the entity. This is discussed in detail in paragraphs 70(a), 74 and 75 of the Framework.

37. Supporters of this view therefore believe that, whether the income is revenue or a gain, it should be recognised in the income statement immediately.

Is the income a gain or revenue?

38. IAS 18.7 defines revenue as:

'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.'

39. Supporters of view 1 note that the receipt of a customer contribution gives rise to increases in equity and does not arise from equity participants. Since no obligation or liability arises from the receipt of the contribution, the receipt of the asset represents an inflow of economic benefits.

40. Furthermore, the receipt of such an inflow arises as a result of an agreement to provide trade and services to customers. In many cases, the receipt of such contributions occurs regularly and so forms part of the normal trading transactions of the entity. For example, some utility suppliers will require that all new customers joining their networks pay a connection charge before they are connected to the ongoing supply.

41. Supporters of this view therefore believe that the receipt of a customer contribution is part of the ordinary activities of the receiving entity and as such meets the definition of revenue.

42. Supporters of this view also note that, in many cases, the receipt of the upfront contribution will come about as part of a contract to provide an ongoing supply of goods or services. As it is an asset that is received as part of a wider contract to provide services, they believe that the receipt of the customer contribution must be considered to be part of ordinary trading activities and so be revenue.

43. Supporters of View 1 therefore conclude that the credit arising from the recognition of a contributed asset at fair value is revenue and that this revenue should be recognised in the income statement immediately on receipt of the contributed asset.

Summary of view 1

44. In summary, supporters of view 1 believe that the receipt of a contributed asset does not give rise to an ongoing obligation for the recipient. Instead, the recipient provides an access right in return for a contributed asset. A separate agreement is then entered into for the supply of ongoing services.

45. Supporters of this view consider that the receipt of the customer contribution gives rise to revenue which should be recognised immediately that the access right is given.

46. Supporters of this view conclude that the credit should be recognised as revenue upon receipt of the contributed asset.

View 2 the credit represents a liability which should be recorded as deferred revenue and recognised over the life of the ongoing service

Is there a liability?

47. The Framework defines a liability as:

    '*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.'*

48. Supporters of view 2 believe that an entity that has received a customer contribution has an obligation to deliver goods or services to its customer. The customer would not have contributed the asset had it not anticipated receiving future services. The obligation may be a contractual, constructive, or legal obligation.

49. For example, in an out-sourcing arrangement, it is likely that the contract that includes the contribution of an asset will also include a requirement that future services are provided to the contributor. Similarly, there may be a legal requirement on a water company to maintain a supply of water to domestic customers connected to its network or to continue to provide sewerage services. The situation may differ in differing industries so an electricity supplier may not be required by law to continue to supply electricity to domestic customers but there may be a constructive obligation to continue to supply customers that have provided a customer contribution and have no history of non-payment.

50. Supporters of view 2 believe that the entity receiving the customer contribution therefore has a present obligation to supply a service that has arisen as a result of a past event (the receipt of the customer contribution) and that the obligation will result in the outflow of economic benefits (the provision of the ongoing service).

51. This view is supported by the definition of a constructive obligation in IAS 37:

'A constructive obligation is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.'

52. Supporters of view 2 believe that, for a customer to make a contribution of an asset, that customer must have an expectation that the service provider will use that asset to provide a service in the future. If there is no such expectation, the customer would not contribute the asset.

53. That expectation will have arisen either through the past practices of the supplier (for example an electricity company that has a practice of supplying electricity using contributed assets), through a contractual arrangement, through a statement or advertisement, or through some other means. As such, supporters of this view consider that the expectation can be assumed to be a valid expectation.

54. Supporters of this view therefore conclude that, at the very least, an entity receiving a customer contribution will have a constructive obligation to provide services using that asset.

How to account for the liability?

55. IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets* addresses the accounting for:

'provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) [deleted]

(c) those covered by another Standard.' (IAS37.1)

56. IAS 37.6 states:

> *'Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. IAS 18 Revenue identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of IAS 18.'*

57. In order to conclude as to whether the liability that arises should be accounted for using IAS 37, it is therefore first necessary to consider whether it should be accounted for using IAS 18.

58. IAS 18.7 defines revenue as:

> *'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.'*

59. Supporters of view 2 note that the receipt of a customer contribution gives rise to an increase in equity which does not arise from equity participants.

60. Furthermore, the receipt of a contribution arises as a result of an agreement to provide goods and/or services to a customer. In many cases, the receipt of such contributions occurs regularly and so forms part of the normal trading transactions of the entity. For example, some utility suppliers will require that all new customers joining their networks pay a connection charge before they are connected to the ongoing supply.

61. Supporters of view 2 therefore believe that the receipt of a customer contribution is part of the ordinary activities of the receiving entity and as such meets the definition of revenue.

62. Supporters of this view also note that, in many cases, the receipt of the upfront contribution will come about as part of a contract to provide an ongoing supply of goods or an ongoing service. As it is an asset that is received as part of a wider contract to provide services, they believe that the receipt of the customer contribution must be considered to be part of the entity's trading activities and so be revenue.

63. The scope of IAS 18 states:

'This Standard shall be applied in accounting for revenue arising from the following transactions and events:

(a) the sale of goods;

(b) the rendering of services; and

(c) the use by others of entity assets yielding interest, royalties and dividends.' (IAS18.1)

64. As the customer contribution is given to obtain a future supply of services, the revenue arises as a result of a transaction for the rendering of services (or, in some cases, the supply of goods).

65. Supporters of view 2 therefore believe that the liability that arises as a result of the receipt of a customer contribution arises as part of a revenue transaction that falls within the scope of IAS 18. The credit balance should therefore be accounted for in accordance with IAS 18.

How should the revenue arising from the receipt of a customer contribution be recognised?

66. Having concluded that the receipt of a customer contribution gives rise to a credit that should be accounted for as revenue under IAS 18, it is next necessary to consider how that credit balance should be accounted for.

67. IAS 18.20 states that:

'When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.'

68. A customer contribution that has been received can be measured reliably. Since the economic benefits associated with the contribution have already transferred to the entity, the second condition in IAS 18.20 is met and the costs incurred in the transaction can be measured reliably. Under IAS 18, the revenue should therefore be recognised as the service is provided.

69. Supporters of this view note that, on day 1, the service provider has received the asset but has undertaken no other activity. The activities of the service provider commence when it uses the asset to provide the ongoing service.

70. Since the service provider has provided no service on day 1 and IAS 18 requires the recognition of revenue as services are provided, no revenue should be recognised at that point.

71. Supporters of view 2 believe that the asset is contributed in order to gain access to the ongoing service and that this is the only service that the service provider provides. In order to recognise revenue as the service is provided it is therefore necessary to recognise revenue over the periods in which that ongoing service is delivered.

72. Supporters of this view therefore believe that revenue should be deferred and recognised over the period in which the ongoing service is provided.

73. The liability that has been identified above should therefore be recorded in the balance sheet as deferred revenue under IAS 18 and be recognised as revenue as the ongoing service is provided.

Summary of view 2

74. In summary, supporters of view 2 consider that the credit balance that has arisen from the recognition of the contributed asset represents a liability. That liability relates to revenue and so should be accounted for in accordance with IAS 18.

75. IAS 18 requires an entity to recognise revenue as services are provided. In the case of an entity that has received property, plant and equipment as a contributed asset, the only services provided are the ongoing services to the customer.

76. Under IAS 18, the credit should therefore be recorded in the balance sheet as deferred income and recognised in the income statement over the periods in which the ongoing services are provided.

STAFF ANALYSIS

77. The staff considers that the critical difference between views 1 and 2 is whether the contribution of an asset gives rise to an ongoing obligation to perform services. If the contribution gives rise to an obligation, the income arising from the receipt of the contribution should be deferred and recognised as the ongoing services are performed. If the contribution does not give rise to such an obligation, the income arising from the receipt of the contribution must have been received in return for the granting of an access right to the customer. As that access right has been delivered, it is appropriate to recognise the income immediately.

78. The staff first considered the following example. Entity A wishes to outsource its payroll function. Historically, the function has been located in a separate building to the trading operations of the entity. Entity A enters into negotiations with entity B such that entity B will provide payroll services for the coming 10 years. Two different arrangements are possible. Under arrangement 1, entity A will contribute the building housing the payroll function (which has a market value of CU 20m) to entity B. Entity A will then pay entity B a sum of CU 2m pa for payroll services. Under arrangement 2, entity A will not contribute the building, but will instead pay entity B a sum of CU 4m pa for payroll services.

79. The staff considers that in this example, since the contribution of the building gives rise to a reduction in the ongoing fee, it must be considered as a payment in advance for ongoing services. Once B has received it, it has an obligation to provide services at a reduced cost for the next 10 years. It therefore has an obligation that should be accounted for as deferred revenue under IAS 18 and recognised in the income statement over the period of the ongoing service.

80. The staff considers that this example demonstrates that it is not possible to conclude that an obligation will never arise for an entity receiving a customer contribution. The staff therefore concludes that, either all customer contributions give rise to an ongoing obligation or some do, depending on individual facts and circumstances.

81. The staff also considered an argument proposed by the initial submission. This stated that, in some utility markets, utility prices are regulated. Whether or not a

customer gives a contribution, the price for the ongoing service is the same. The original submission proposed an argument that, since no deferred liability is recognised in the case of customers who have not made a contribution, it is inappropriate and inconsistent to recognise deferred income in respect of customers who have made a contribution.

82. The staff rejected this argument on the basis that a customer that has contributed an asset has paid more for services than a customer that has not. If the only services provided to the customer are ongoing services then it is appropriate that more revenue is recognised in respect of those ongoing services in situations in which a customer contribution has been received. The resulting credit on the balance sheet represents a payment in advance for those services. If no contribution has been made, the consideration for the ongoing services is lower and no credit is recorded on the balance sheet as there has been no payment in advance.

83. The staff then considered whether there are examples in which it can be demonstrated that the initial contribution does not give rise to an obligation in respect of the ongoing service.

84. The staff noted that a customer that contributed an asset would only do so in expectation of that asset being used to provide future services. If there was no expectation that the asset would be used to provide services, the contributor would not make the contribution.

85. The staff considers that, because of this, it would be extremely difficult for an entity that had received a contributed asset in its ordinary course of business to demonstrate that the receipt of that asset has not given rise to any obligation to provide a service. It would also be extremely difficult to demonstrate that the receipt of the asset was not, in any part, an advance payment for future services.

86. The staff therefore concludes that it is unlikely that an entity would be able to demonstrate that, having received a customer contribution, it did not have an obligation to provide future services.

87. As discussed in view 2 above, this obligation to provide future services gives rise to a liability which, in turn, results in the deferred recognition of revenue.

88. The staff therefore supports view 2, ie that the revenue arising from the receipt of a customer contribution should be deferred and recognised over the life of the ongoing service.