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: **May 2007, London**

Project: **Customer Contributions (Agenda Paper 9)**

I. INTRODUCTION

Background to the issue

1. In November 2006, the IFRIC received a submission asking for guidance as to how a government or private sector utility company should account for customer contributions received. Such contributions arise when an entity enters into an arrangement with a customer as part of which the customer has to provide either an infrastructure asset or cash to fund the acquisition and/or construction of such an asset in order to obtain connection to the utility company's network. The contributed infrastructure asset is necessary for the utility entity to provide an ongoing utility service to the customer.

2. Examples of situations in which this kind of arrangement exist include:

   - house building, in which a builder may be required to contribute power cables, pipes, or other connections to a network so that a utility supplier can provide an ongoing service to the house;

- the supply of services, in which a connection fee is required in order for services to be supplied to a customer;
- the supply of utilities, in which an upfront connection fee must be paid in order for the customer to have ongoing access to the utility;
- out-sourcing arrangements, in which an entity is required to pay a one-off upfront contribution (or to contribute assets) to a service provider to allow it to develop facilities needed to provide the out-sourced service to the entity; and
- mobile telephones, in which a customer may be required to pay an upfront connection fee to obtain a connection to the supplier's network before receiving an ongoing mobile phone service.

3. The issue submitted to the IFRIC requested guidance on the accounting for such items by the company receiving the contributed asset. The IFRIC was not asked, and this paper does not address the question of how an entity determines whether contribution of the asset transfers ownership (for example if the customer has a right to re-acquire the asset after a period of time).

Purpose of the paper

4. The purpose of this paper is primarily to consider whether this issue meets the criteria for being taken onto the IFRIC agenda.
5. In considering that question, the paper also considers whether the IFRIC will be able to reach a consensus on the issue in a reasonable timeframe. To aid the discussion, the paper proposes ways in which the IFRIC may limit the scope of its work and ways to approach the project in order to maximise the likelihood of reaching a consensus.
6. The paper comprises five sections:

    I. Introduction

    II. Summary of the issue and divergent views

    III. Consideration of whether the issue should be taken onto the agenda

    IV. Scope of project

    V. Related Questions

    VI. Conclusions

II. SUMMARY OF THE ISSUE AND DIVERGENT VIEWS

7. In researching this issue, the staff became aware of a number of different views as to how customer contributions should be accounted for. This section provides a summary of those different views. It should be noted that these views are based solely on discussions about possible accounting treatments and the contents of the submission provided to the staff. The staff has not obtained evidence to support the existence of these methodologies in practice. Similarly, whilst the staff has presented a summary of all of the views that it has become aware of, at this stage the staff has not performed detailed work to ascertain whether it believes that any of these approaches can be supported by current accounting literature.

8. The differing views that the staff has become aware of can be summarised as follows:

   View 1 – a customer that contributes an asset only does so in order to receive access to an ongoing service. The contribution is, in effect, an advanced payment for the ongoing service and should therefore be recognised as revenue when that service is provided.

   View 2 – a customer that contributes an asset receives, in return, a right to access a network. Under IAS 16, an asset received in an exchange transaction should be accounted for at fair value. Since the contribution is given in exchange for another asset (the access right), and that other asset has been delivered, the revenue arising should be recognised in the income statement immediately.

   View 3 –a utility company receiving an asset as a contribution does not perform any service or give any asset in return for that contribution and so there is no exchange of assets. Instead, the transaction is similar to the receipt of a grant. The entity should account for the contribution using IAS 20 which deals with an analogous situation in which an entity receives a grant from government.

   View 4 – the receipt of a customer contribution gives rise to a gain (rather than revenue). The contributed asset should be accounted for at fair value with the gain deferred and recognised in the income statement in the periods in which the entity benefits from the contributed asset.

View 5 - the receipt of a customer contribution gives rise to a gain. The contributed asset should be accounted for at fair value and the gain recognised immediately net of any ongoing performance obligation.

9. Each of these views and their justifications are set out in further detail below.

View 1: A customer contribution is revenue and should be recognised as such over the life of the ongoing arrangement

10. IAS 18 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.*'

11. Supporters of view 1 note that the receipt of an infrastructure asset by a utility provider is an inflow of economic benefits. Furthermore, the receipt and management of such assets will fall within the ordinary activities of such an entity. The receipt of such assets should therefore be accounted for as revenue.

12. Since revenue is recorded at fair value,[1] the associated asset must be recorded at fair value in the balance sheet.

13. IAS 18.20 states:

'*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.'

[1] IAS 18.9 states that revenue is measured '*at the fair value of consideration received or receivable'*

14. Supporters of view 1 believe that an entity receiving a customer contribution does not undertake any activity on behalf of the customer at the time that it receives the contribution. The only service that it provides is the ongoing service which occurs subsequent to the initial investment.

15. Therefore, in order to recognise revenue as the service is provided, revenue arising from the upfront contribution should be deferred and recognised over the life of the ongoing service.

View 2: A customer contribution is revenue and should be recognised immediately

16. Supporters of view 2 agree that a customer contribution is revenue. However, supporters of this view believe that revenue should be recognised immediately on the basis that the utility company performs all of its obligations in respect of the receipt of the customer contribution when it receives the asset.

17. Supporters of this view believe that a customer contributes the asset in return for the receipt of an access right from the utility provider. By contributing the asset, the customer has gained access to the network. If the customer had not contributed the asset, then it would not have access to the network.

18. Supporters of view 2 may illustrate their case with the example of a house-builder. The builder constructs a small estate and is required to build an electricity sub-station and contribute it to the network. The value of the house-builder's estate is not reduced by the contribution of the asset to the network because the value of the access right it has received exceeds the value of the asset contributed.

19. Supporters of this view also note that, having received the contribution, the utility provider has no more of an ongoing obligation to the customer that contributed the asset than it does to any other customer. The utility provider would not recognise a liability in respect of its ability to make future sales to a 'normal' customer and so there is no reason why it should do so for a customer that has contributed an asset.

20. Since the utility provider has provided an asset (connection to its supply) in return for the customer contribution and has no further obligation in respect of it, it is appropriate for the service provider to recognise revenue at the point at which that asset is provided.

21. Supporters of this view therefore believe that the contributed asset should be recognised at fair value and the associated revenue recognised when it is received.

View 3: A customer contribution should be accounted for using IAS 20 by analogy

22. Supporters of view 3 point to the scope of IAS 18 which 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.’

23. A customer contribution given to a utility company does not arise from the sale of goods, rendering of services, or the use by others of the utility company’s assets. A customer contribution does not therefore fall within the scope of IAS 18.

24. Supporters of this view note that a customer contribution shares many key features with a government grant. In the case of a government grant, an asset is given to an entity which does not perform any related services or provide any goods in return. Similarly, a customer contribution is given to an entity and that entity does not provide any goods or services in return.

25. Supporters of view 3 believe that a government grant is the closest analogy to a customer contribution for which guidance exists. Supporters of this view therefore believe that it is appropriate to account for a customer contribution using any of the models for government grants in IAS 20 by analogy.

View 4: A customer contribution is a gain which should be deferred and recognised over the life of the ongoing service

26. Supporters of view 4 agree with the supporters of view 3 that the receipt of a customer contribution falls outside of the scope of IAS 18 since no upfront good or service is offered.

27. Supporters of this view also note the definition of government grants in IAS 20:

‘*Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.*’

28. Supporters of view 4 note that, in many utility industries, arrangements with customers routinely include the making of customer contributions. The receipt, management, and use of contributed assets forms part of the normal trading transactions of the entity.

29. Furthermore, these arrangements have fundamentally different characteristics to government grants. Government grants are made by governments and typically require an entity to comply with certain conditions which are not related to the normal trade of the entity. Entities receiving government grants are not required to trade with the government. For example, a grant may be given that specifies that the receiving entity has to employ a certain number of people in one location over the next 5 years. In contrast, customer contributions are made by customers to obtain access to ongoing trade with the service provider.

30. Supporters of view 4 do not therefore believe that accounting for customer contributions by using an analogy with government grants is appropriate.

31. Paragraph 70 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.*’

32. Supporters of view 4 consider that customer contributions meet the definition of income but, since they do not meet the definition of revenue, are gains.

33. Supporters of this view note paragraph 75 of the Framework, which states that ‘*gains represent increases in economic benefits and as such are no different in nature from revenue.*’ In the absence of detailed guidance on the recognition of gains, supporters of view 4 look to IAS 18 for principles as to how such gains should be recognised.

34. IAS 18 requires that revenue be recognised as services are provided. If this principle is applied to gains arising from customer contributions where no service is provided upfront, the gain should be deferred and recognised as the ongoing service is provided. In other words, the gain should be recognised in the income statement in the periods in which the customer receives benefits from making the contribution.

35. Supporters of this view therefore believe that the contributed asset should be recognised at fair value with the associated gain deferred and recognised over the life of the ongoing service.

View 5: A customer contribution is a gain which should be recognised in the income statement immediately

36. Supporters of view 5 agree with supporters of view 4 that customer contributions are gains and not revenue. They also agree that it is not appropriate to analogise with IAS 20.

37. Supporters of this view note that there is no specific guidance in IAS on the accounting for gains and so look to the Framework for principles that may be applied. Paragraphs 92 and 93 of the Framework state that:

'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).

'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.'

38. In the case of a customer contribution, the increase in net assets occurs when the contribution is received. At that point, receipt is certain and the gain can be

measured reliably. There is therefore no requirement to restrict or defer the recognition of income.

39. Supporters of this view therefore believe that the gain should be recognised in the income statement upon receipt of the contribution.

40. Supporters of this view note that, to the extent that there is an ongoing performance obligation associated with the contributed asset, this should be recognised as a liability at the point at which the gain is recognised.

III. CONSIDERATION OF WHETHER THE ISSUE SHOULD BE TAKEN ONTO THE AGENDA

41. The staff considered the criteria for taking an issue onto the IFRIC's agenda as set out in the IFRIC Due Process Handbook

Is the issue widespread and practical?

42. As discussed above, in its widest sense, this issue can apply to a wide range of situations including:

- the supply of utilities, including gas, electricity, water, sewerage, etc
- mobile telephones
- subcontracting
- house-building
- the provision of services

43. If a project on customer contributions was taken onto the Agenda, then the resulting Interpretation would provide practical guidance as to how entities should apply existing standards to account for the receipt of such contributions. This guidance would be of practical use to a wide range of entities in a range of different circumstances. The staff therefore considers that the issue is of widespread and practical relevance.

Does the issue involve significantly divergent interpretations?

44. The staff has been unable to identify specific instances of divergence from a review of publicly available information, largely because there is no disclosure requirement relating to the accounting for such transactions.

45. The staff does however consider that divergence is likely to exist in practice for a number of reasons including that:

- the issue involves answering a question about the recognition of upfront amounts received which shares a number of key features with the issue considered by the IFRIC in relation to fund managers. In that case, divergence in practice was identified. The staff considers that it is likely that similar divergence exists in the case of customer contributions.
- different local GAAP has historically given rise to different treatments for these types of contributions.
- during the course of the staff's research, a wide range of differing treatments and views were identified which, if repeated in practice, will lead to divergence.

46. The staff therefore considers that there is likely to be significant divergence in practice in this area.

Would financial reporting be improved through elimination of the diversity?

47. The staff notes that differing accounting treatments in this area will result in different revenue and profit profiles, as well as differing figures being reported for capital employed, property, plant and equipment and deferred income.

48. Eliminating this diversity will lead to increased comparability between reported results and increased understandability for users of financial statements.

49. The staff therefore considers that addressing this issue will result in improved financial reporting.

Is the issue sufficiently narrow to be capable of interpretation within the confines of IFRSs?

50. The staff considers that the key questions which need to be considered in resolving this issue are whether the asset received from the customer should be accounted for using IAS 16 or IAS 20 and how any resultant credit should be accounted for. These questions can be resolved within the confines of existing IFRS.

51. On the other hand, the issue may arise in a very wide range of different circumstances. For example:

- mobile telephones (the IFRIC has previously decided not to consider upfront customer acquisition costs in the mobile telephone industry as it is unlikely to be able to reach a consensus on that issue);
- outsourcing arrangements;
- leases;
- house building;
- the provision of utilities; and
- upfront fees similar to the ones that the IFRIC was unable to reach a consensus on as part of its project on the recognition of revenue in respect of fund managers.

52. Furthermore, if the wide range of different interpretations and views expressed to the staff are repeated amongst IFRIC members, then it may be difficult for the IFRIC to reach a consensus on the issue.

53. The staff considers that the above factors mean that there is a real risk that the IFRIC will not be able to reach a consensus on this issue.

54. Despite this risk, the staff considers that the IFRIC should be able to reach a consensus so long as it carefully manages the scope of and approach taken to the project. In section IV of this paper the staff has set out one way in which the scope of the proposed project may be limited in order to manage this risk.

Does the issue relate to a current or planned IASB project?

55. The issue touches on a number of IASB projects, and may be affected by the Board's work on Revenue and Liabilities. However, neither of these projects is expected to be completed in the immediate future, and neither is likely to address the issue specifically.

IV SCOPE OF PROJECT

56. The original submission considered situations in which a customer contributed a pre-existing asset to a service company. Following the contribution, the asset was owned and accounted for as an asset of the service provider.

57. It also considered situations in which the customer made an upfront payment of cash in return for which the supplier constructed an asset which was then owned and accounted for as an asset of the supplier.

Potential scope restrictions

58. As noted above, a project which considered all such transactions would include a very wide range of arrangements. The staff considers that a project to consider all such arrangements would be too wide for the IFRIC to be able to reach a consensus in a reasonable timescale. The staff has therefore considered ways in which the scope may be restricted:

- limiting the scope of the project to contributions of 'major' capital items;
- limiting the scope to contributions in the context of price regulated markets; and
- limiting the scope to the contribution of pre-existing property, plant and equipment.

59. The staff considered that limiting the scope on the basis of the size of the asset contributed (for example to 'major' property, plant and equipment) was not likely to be a viable solution as the current standards do not make any distinction between the accounting for large and small or major and minor items.

60. Similarly, the staff considered that 'price regulated markets' could refer to a wide range of different markets with a wide range of different types of regulation. Limiting the scope to price-regulated markets was not therefore likely to be a viable approach in all jurisdictions.

61. In considering this issue, the staff noted that the contribution of cash towards the acquisition or construction of an asset by the service provider introduced a range of additional issues that are not encountered where the upfront contribution is an item of property, plant and equipment. For example:

    - The upfront contribution of cash raises a question as to whether the construction or acquisition of an asset upfront by the service provider constitutes the provision of a service to the customer. The staff considers that this question is very similar in nature to the question as to whether a fund manager performs services upfront. Attempting to resolve it may result in difficulties similar to those encountered on the IFRIC's project on upfront fees received by fund managers.

- It may be difficult to determine whether an upfront payment is a payment in advance for ongoing services or a payment for an asset which has to be constructed in order to provide those services. The range of different payment patterns which may exist in practice may make this a difficult issue to resolve.

62. The staff therefore proposes that the scope be limited to situations where pre-existing assets are contributed to the property, plant and equipment of the service provider.

63. The staff notes that, even if the scope is limited in this way, entities will still be able to analogise in situations where cash is contributed and that contribution is, in substance, the same as the contribution of an item of property, plant and equipment.

V RELATED QUESTIONS

64. In order to resolve the question as to how to account for customer contributions, the IFRIC will need to consider a number of related questions. These can be summarised:

- Is the contributed asset accounted for as an asset of the service supplier or is it accounted for as if it has been leased back to the customer (using IFRIC 4)?
- Can contributed assets be accounted for using IAS 20 or must an entity apply IAS 16?
- If applying IAS 16, should an entity account for assets it receives at cost or fair value?
- If using an IAS 16 cost model, is the cost of a contributed asset the outflow of resources given in exchange for that asset (ie nil) or could it be the fair value of the asset acquired?
- Accounting for the asset received gives rise to a credit. Does the service supplier have an obligation? Should the credit be recognised immediately in

the income statement (as revenue? or as a gain?) or should it be deferred over the life of the ongoing service?

- How should any deferred credit be accounted for? As revenue or as a gain?

65. The IFRIC may find that it is able to resolve some of the above questions but not all of them. For example, the IFRIC may conclude that contributed assets should be accounted for using IAS 16 and recognised initially at fair value but may not be able to conclude as to whether the resultant credit should be deferred or recognised in income immediately. The staff considers that there is a risk that this may result in the IFRIC abandoning the project on the basis of being unable to reach consensus on one part of the problem.

66. To avoid this, the staff proposes that the IFRIC approach the question as a number of separate sub-issues. Attachment 1 to this paper shows a way which this could be achieved.

67. The staff considers that if the issue is tackled in this manner then, even if the IFRIC fails to reach consensus on all parts of the issue, it will have made worthwhile progress in addressing some of the questions arising in practice.

68. In the example above, if the IFRIC fails to conclude whether the deferred credit should be accounted for as income immediately or be deferred over the life of the ongoing service, then it will still be able to conclude that it is not acceptable to account for customer contributions using IAS 20 and that any asset arising must be carried at fair value (both of which are useful conclusions).

VI CONCLUSIONS

69. The staff considers that the issue meets the criteria for being taken onto the agenda so long as the IFRIC is able to reach a consensus in a reasonable timeframe.

70. The staff considers that the key risks that the IFRIC will not be able to reach a consensus are that:

    - the issue becomes too wide and involves too many potential scenarios for the IFRIC to be able to reach a consensus; or

    - the IFRIC is unable to resolve one part of the issue and that inability results in the whole project being abandoned.

71. The staff considers that, if the IFRIC believes that it will be able to successfully manage these risks, then it should take the issue onto its agenda.

72. Section IV of this paper sets out one way that the scope of this project may be limited to avoid some of these problems. Section V suggests an approach to the project which attempts to alleviate the potential problem of a lack of agreement in one area of the project resulting in the abandonment of the entire project.

73. In the light of the suggestions set forth in those two sections, the staff believes that it will be possible for the IFRIC to resolve the issue.

74. The staff therefore recommends that the IFRIC take this issue onto its agenda.

Does the IFRIC agree with the staff's recommendation that it should take this project onto its agenda?

75. The staff proposes that the scope be limited to situations where pre-existing assets are contributed to the service provider.

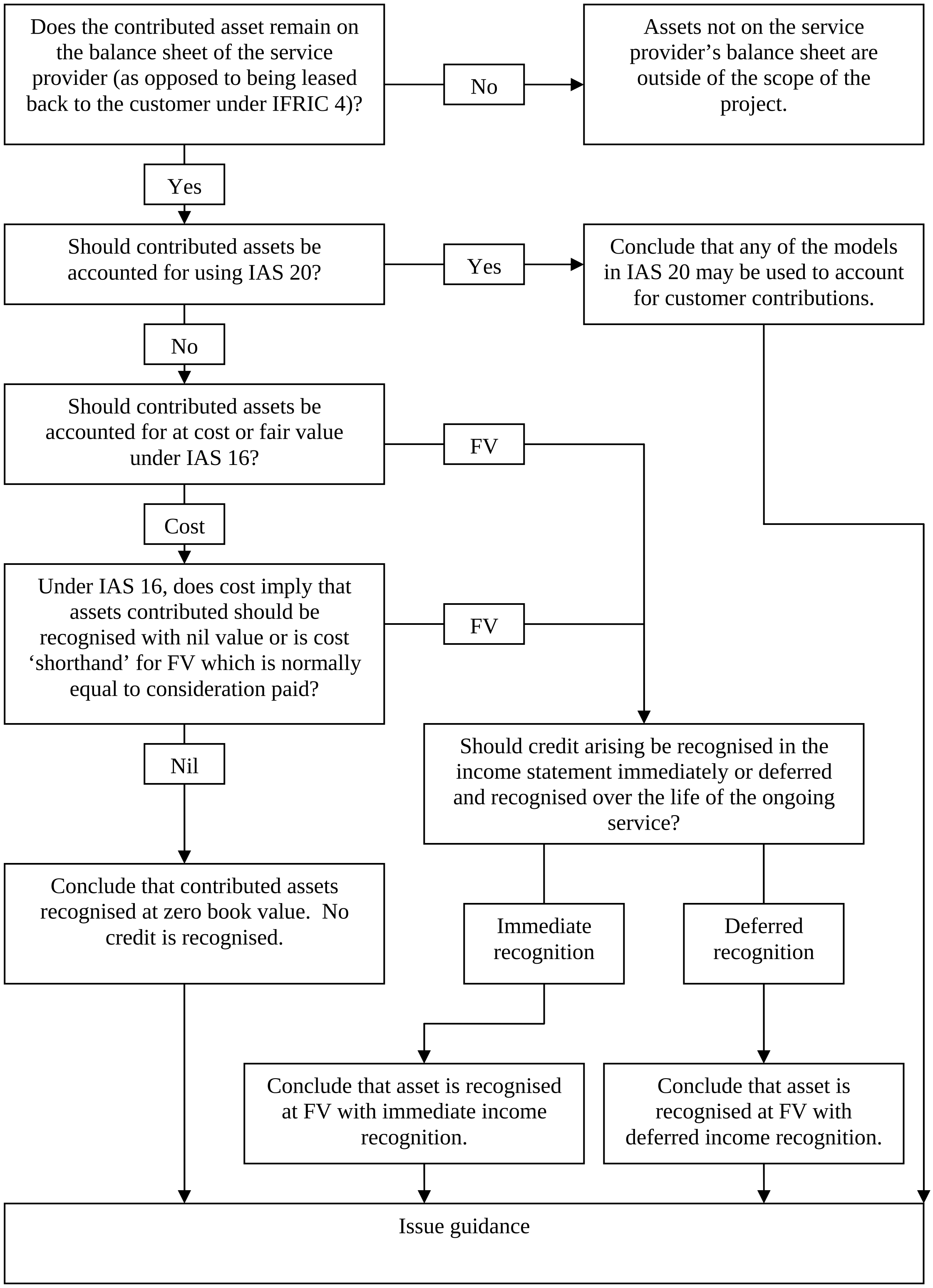
76. The staff notes that, even if the scope is limited in this way, entities will still be able to analogise in situations where cash is contributed and that contribution is, in substance, the same as the contribution of an item of property, plant and equipment.

Does the IFRIC agree with the staff's recommendation that the scope of the issue should be limited to the contribution of pre-existing assets to the property, plant and equipment of a supplier?

77. In order to resolve the question as to how to account for customer contributions, the IFRIC will need to consider a number of related questions. The staff considers that there is a risk that this may result in the IFRIC abandoning the project on the basis of being unable to reach consensus on one part of the problem. To avoid this, the staff proposes that the IFRIC approach the question as a number of separate sub-issues. Attachment 1 to this paper shows a way which this could be achieved.

Does the IFRIC agree with the proposed approach?

Attachment 1 – possible approach to resolving the issue



Notes on the proposed approach

Consideration of IFRIC 4

1. The staff considers that, since the proposed 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 staff therefore believes that, whilst this could be seen as a scoping issue, the question of how the issue interacts with IFRIC 4 warrants further discussion early in the process.

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, then 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 valued at fair value under IAS 16.24)?

    b. If the transaction is not an exchange transaction, then 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, then the IFRIC will need to consider how the associated credit balance should be accounted for in the income statement.

9. The staff has proposed that the scope of the project 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.

10. The staff notes that, even if the IFRIC is unable to reach consensus on this issue, it may be able to issue some helpful 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 which will reduce some of the divergence which currently exists in practice in this area.