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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting:	**November 2007, London**
Project:	**Customer contributions – Cash contributions (Agenda Paper 4)**

INTRODUCTION

1. In September 2007 the IFRIC agreed to extend the scope of its customer contributions project to include cash contributions. Such contributions arise when a customer contributes cash to a supplier. As a result of receiving the cash, the supplier is required to construct or acquire an item of property, plant and equipment that is then used to supply goods or services to the customer. The property, plant and equipment is an asset of the supplier. However, the ongoing service arrangement may contain a lease of the asset to the customer.

2. In deciding to include cash contributions in its project on customer contributions, the IFRIC agreed that the contribution of cash has a similar economic effect to the contribution of an item of property, plant and equipment. The two should therefore result in similar accounting consequences.

3. This paper considers how cash contributions should be accounted for by the entity receiving them.

POSSIBLE SOLUTIONS

4. In determining how an entity should account for the receipt of a cash contribution, the staff considered 5 possible approaches. A summary of each of these five approaches is set out below. Attachment 1 sets out example journal entries to illustrate each of these approaches.

Approach 1*: *the construction or acquisition of the property, plant and equipment is not a service to the customer

5. Supporters of this approach consider that the construction or acquisition of the property, plant and equipment is not a service to the customer.

6. The only service that the customer would be willing to pay for is access to the ongoing supply of goods or services. The construction of property, plant and equipment by a supplier for its own use in delivering its services to its customers is not a service to those customers and does not give rise to the recognition of revenue.

7. The cash contribution should therefore be considered to be an advance payment for ongoing access that is recorded as an obligation when it is received and recognised in revenue as access to the supply of goods or services is given.

Approach 2: the cash contribution should be allocated between the construction or acquisition of the asset and the ongoing service based on fair value

8. Supporters of this approach believe that both the upfront acquisition or construction of an asset and the provision of access to an ongoing supply of goods or services are services of value to the customer.

9. IAS 18 requires revenue to be recognised by reference to the stage of completion of the transaction. The cash contribution should be allocated between the two services based on their relative fair values and recognised as revenue as those services are provided.

10. The staff notes that, in allocating the cash received to services, the service provider should also consider any ongoing fee that will be received for providing access to the supply of goods or services. In many cases, the ongoing fee will be for the fair value of the ongoing access. Similarly, the cash contribution will be for the fair value of the asset constructed or acquired. If this is the case then this method will result in the recognition of the cash

contribution as revenue when the construction or acquisition of the property, plant and equipment takes place.

Approach 3: Recognition of the cash contribution as revenue immediately

11. Supporters of this view consider that a cash contribution is paid for the construction or acquisition of an item of property, plant and equipment. Once that asset has been constructed or acquired, the customer will typically make separate payments for ongoing services.

12. Supporters of this view therefore believe that revenue (equal to the amount of the cash contribution) should be recognised when the construction or acquisition of the item of property, plant and equipment takes place.

Approach 4: The construction or acquisition of an item of property, plant and equipment is a service to the customer but no revenue should be allocated to it

13. Supporters of this view believe that the construction or acquisition of an asset on behalf of a customer is a service to the customer. Similarly, the provision of access to an ongoing supply of goods or services is a service to the customer.

14. However, supporters of this view believe that the acquisition or construction of an asset that remains an asset of the service provider has no value to the customer in the absence of access to a supply of goods or services that are provided using that asset. The acquisition or construction of the asset is an integral part of providing the access to a supply of goods or services to the customer. The customer would not therefore be willing to make a cash contribution without receiving access to a supply of goods or services.

15. To allocate revenue between the acquisition or construction of the asset and the provision of access to a supply of goods or services, no revenue should therefore be allocated to the construction or acquisition of the asset. Instead, revenue arising from the receipt of the customer contribution should be recognised as access to the supply of goods or services is provided.

16. This approach would result in the same accounting outcome as approach 1 but for different reasons.

Approach 5: Two transactions take place. The construction or acquisition of an asset in return for a cash contribution and the provision of access to a supply of goods or services in return for contribution of that asset

17. Supporters of this view consider that two transactions take place. One is the acquisition or construction of the asset in return for the cash contribution. The second is the provision of access to the ongoing service in return for the contribution of an asset.

18. Revenue equal to the cash contribution should be recognised as the acquisition or construction takes place. Revenue equal to the fair value of the asset contributed should be recognised as ongoing access is provided.

STAFF ANALYSIS

Recognition of property, plant and equipment

19. The staff first considered the treatment of the item of property, plant and equipment that the supplier is required to construct or acquire as a result of receiving the cash contribution.

20. Approaches 2 and 3 above result in the recognition of revenue immediately for the construction or acquisition of that item of property, plant and equipment.

21. In both of these cases, the staff considers that the cost of sales associated with earning that revenue is the cost of acquiring or constructing the item of property, plant and equipment.

22. The staff therefore believes that, if one of these approaches were used, the cost of the asset should be recognised as an expense in profit or loss when the asset is acquired or constructed. If this is the case, the entity will not recognise the property, plant and equipment as an asset in its statement of financial position. However, the staff notes that the item of property, plant and equipment is an asset of that entity.

23. The staff does not therefore consider that approaches 2 or 3 are appropriate as they result in the property, plant and equipment not being recognised as an asset by the service provider. Furthermore, they result in a different accounting outcome to situations in which customer contribute an item of property, plant and equipment.

24. For the remainder of this paper, the staff has therefore considered only approaches, 1, 4 and 5.

Recognition of revenue

25. IAS 18 requires revenue to be recognised when goods or services are supplied so long as certain criteria are met (for example, the costs of providing the service must be measurable with sufficient reliability and there must be sufficient probability that the economic benefits associated with the transaction will flow to the supplier).

26. In assessing how to recognise revenue in respect of a cash contribution, the first step is therefore to assess which services the supplier provides in return for that contribution. Once the services have been identified, it is then necessary to consider how much revenue should be allocated to each of those services and when the revenue should be recognised.

27. The staff notes that, in considering this issue, the IFRIC has already concluded that one service that a supplier provides is the provision of access to a supply of goods or services using the contributed asset.

28. In the case of a cash contribution, the supplier also constructs or acquires an asset on behalf of the customer. The staff has therefore considered whether the construction or acquisition of this asset represents the provision of a service to the customer.

Is the construction or acquisition of the asset a service to the customer?

29. The staff considered the following example. Customer A wishes to connect to supplier B's network. B will supply A with access to a utility that can be provided using that network. To the extent that A uses the utility, it will pay for it separately at market rates. To connect to the network, A may either pay B CU 100 or contribute asset X with a fair value of CU 100. If A contributes cash then B must construct asset X (which is used to supply the service). If A wishes to contribute X, then it must acquire it from another entity, C (an unrelated constructor).

30. If entity A acquires asset X from entity C then C will recognise revenue on the basis that it has provided the service of constructing the asset for A.

31. The staff considers that, if A contributes cash and B constructs the asset instead of C then B undertakes exactly the same activities on behalf of A as C would have done if it had constructed the asset. Since these activities constitute a service to A when performed by C, they must also be a service to A when performed by B.

32. The staff therefore concludes that the construction or acquisition of the asset by entity B represents a service to entity A.

33. The staff concludes that approach 1, under which the construction of the asset is not a service, is not therefore appropriate. For the remainder of this paper, the staff has therefore only considered approaches 4 and 5.

What is the consideration paid for the construction or acquisition of the asset?

34. The staff noted that there are two significant differences between approaches 4 and 5:

- Approach 5 considers that the cash contribution is the consideration for the construction or acquisition of the asset. Approach 4 considers that no consideration should be allocated to the construction or acquisition of the asset.
- Approach 5 considers that there are two transactions. First, the sale of the property, plant and equipment in return for a cash contribution. Second, the provision of access to a supply of goods or services in return for the contribution of property, plant and equipment. Approach 4 only considers one transaction, the payment of a cash contribution for the provision of access to a supply of goods or services. Using this approach, the acquisition or construction of the property, plant and equipment is considered an integral part of providing access to the supply of goods or services.

35. The staff has considered these two differences separately. First, the staff considered how much of the consideration received should be allocated as revenue for the construction or acquisition of the property, plant and equipment.

36. The staff considered the example discussed above. In that example, entity A may pay entity C CU 100 to construct asset X. It will then contribute asset X to entity B. Alternatively, it may contribute CU 100 to entity B. In that case,

entity B will be required to construct asset X. If entity C constructed the asset then it would recognise CU 100 as revenue.

37. Supporters of approach 5 argue that A would be prepared to pay a third party, entity C, CU 100 to construct the asset. This gives evidence that:

- entity A is prepared to pay CU 100 as consideration for the construction of asset X; and
- the fair value of the asset once constructed is CU 100.

38. Supporters of this view therefore argue that, for consistency, entity B should also allocate CU 100 revenue to the construction of the asset.

39. In contrast, supporters of approach 4 believe that customers are only prepared to pay a cash contribution because they will receive access to a supply of goods or services. Whilst the upfront acquisition or construction of the asset is a service to the customer, the customer places little or no value on it. Instead, the customer places value on receiving the ongoing access.

40. Supporters of this view believe that the relationship between A and B is fundamentally different from the relationship between A and C. A pays C CU 100 for the construction of asset X. In return, A receives asset X. A may then use that asset for any purpose, for example, A may sell X on the open market instead of connecting to B’s network. In contrast, A pays B for the construction of asset X as part of a larger arrangement to provide access to a supply of goods or services. If A makes a cash contribution to B, it cannot use asset X for any other purpose than connecting to B’s network.

41. Supporters of this view do not therefore believe that there is any inconsistency between entity C recognising revenue of CU 100 for the construction of asset X and entity B recognising no revenue for the construction of the same asset.

42. Supporters of this view also note that there is no reason why a cash contribution should be for the fair value of the asset to be constructed. In some cases, a cash contribution may be paid of 50% of the cost of the property, plant and equipment as part of a cost sharing arrangement. Supporters of this view note that approach 5 would result in a significant loss on the construction or acquisition of the asset if this were the case.

One transaction or two

43. The staff next considered whether the payment of a cash contribution followed by the acquisition or construction of an item of property, plant and equipment and the provision of access to a supply of goods or services should be considered as being one transaction or two. Supporters of approach 4 consider that there is one transaction, ie the contribution of cash in return for the provision of access to a supply of goods or services. The construction or acquisition of the asset is an integral part of providing that service. Supporters of approach 5 consider that there are two transactions. The first is the acquisition of property, plant and equipment in return for a cash contribution. The second is the contribution of property plant and equipment in return for access to a supply of goods or services.

44. Supporters of approach 5 note that, if approach 4 was adopted, entities could achieve the same result as approach 5 by changing their contracts. A contract that required a cash contribution in return for the construction or acquisition of an item of property, plant and equipment and the provision of access to a supply of goods or services could be replaced by two contracts. The first would be for the construction of property, plant and equipment in return for cash. The second would be for the provision of access to a supply of goods or services in return for a cash contribution.

45. IAS 18.13 states that 'the [revenue] recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.' The staff considers that, in many cases, even if an entity were able to create separate contracts for the construction of the asset and providing the ongoing service, IAS 18.13 would require that the contracts be considered together.

46. As discussed above, supporters of approach 5 also consider that approach 4 would result in inconsistent revenue recognition with revenue recognised for the construction or acquisition of the asset if it were carried out by a third party, but not if it were carried out by the entity providing access to the supply of goods or services.

47. In contrast, supporters of approach 4 note that almost any contract to deliver a service will require the service provider to use an asset to deliver that service. If approach 5 is adopted then entities may be able to manipulate their results to recognise additional revenue if they receive a cash contribution.

48. The staff considered the following example. Entity A pays Entity B CU 100 pa for 10 years for services provided over that period. Entity B must use an asset (asset X with a cost of 150) to provide these services. Entity B will recognise revenue of CU 100 pa for 10 years.

49. Now suppose that B re-negotiates its contract with A such that:

- A is required to make a cash contribution of CU 200 for asset X.
- The cash contribution is payable in instalments of CU 20 pa over 10 years.
- A also pays fees for the ongoing service of CU 80 pa over 10 years.

50. In this situation, A and B have the same cashflows and provide and receive the same services as in the example above. However, if approach 5 is used then entity B will:

- Recognise Revenue of CU 200 and profit of 50 when asset X is constructed.
- Recognise a contributed asset with a fair value of 200 and a corresponding obligation to provide services.
- Recognise additional revenue of CU 100 pa for 10 years (being 20 amortisation of the obligation and 80 cash paid in the year).

51. The entity will therefore be able to recognise an additional CU 200 revenue upfront by re-negotiating its contract. Supporters of approach 4 argue that this could be seen as resulting in the 'double-recognition' or revenue.

CONCLUSIONS AND STAFF RECOMMENDATION

52. The staff concludes that approaches 2 and 3 are not appropriate because they result in property, plant and equipment that is an asset of the service provider not being recognised by that entity. The staff also concludes that approach 1 is not appropriate because the construction or acquisition of the property, plant and equipment is a service to the customer.

53. The staff therefore considers that the IFRIC must chose between approaches 4 and 5, ie:

- to recognise an obligation to provide services on receipt of the cash contribution and recognise that amount as revenue as access to a supply of goods or services is provided; or
- to recognise two transactions. The first being the construction or acquisition of the property, plant and equipment in return for a cash contribution. The second being the provision of access to a supply of goods or services in return for the contribution of property, plant and equipment.

54. The staff notes IAS 18.7 which 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.*

55. The staff considers that approach 5 will result in revenue being recognised for more than the amount of the cash contribution received. In other words, revenue may exceed the 'inflow of economic benefits'.

56. The staff also notes that there is no reason why a customer contribution should be for the fair value of the property, plant and equipment acquired or constructed. In some cases, customer contributions may exceed this amount. In others, they may be based on a portion of the costs of property, plant and equipment. In these cases, approach 5 may result in unusual gains and losses being recognised on the construction or acquisition of the asset.

57. The staff is also concerned about the potential for manipulating revenue recognition if approach 5 is adopted.

58. The staff notes that entities may be able to achieve a similar result to approach 5 if approach 4 is applied, by separating the contracts. However, the staff considers that, if an entity is genuinely able to split its contracts in this way then it is more likely that both parts will be exchanged at fair value. Furthermore, it is more likely that the two contracts will mirror the economic effects of acquiring the property, plant and equipment separately from the acquisition of access to the supply of goods or services. The staff also considers that, while entities may be able to legally create separate contracts, in many cases, IAS

18.13 would dictate that the two contracts should be considered together for the purpose of recognising revenue.

59. The staff therefore recommends that the IFRIC pursue approach 4 in its draft Interpretation.

ATTACHMENT 1: SUMMARY JOURNAL ENTRIES

1. This attachment shows example journal entries for each of the approaches described in the paper.

2. These are based on the following example. Entity A receives a cash contribution of CU 100 at T0. As a result it is required to construct an item of property, plant and equipment. Construction occurs at T0. The cost of construction is CU 90. The property, plant and equipment has a useful economic life of 5 years and entity A will use the asset to provide access to a supply of goods or services to the customer for a period of 5 years.

3. The journal entries do not include entries for cash receipts that may arise from providing the ongoing service. Similarly, they do not include entries relating to the costs of providing the ongoing service.

Approach 1: the construction or acquisition of the property, plant and equipment is not a service to the customer

4. At T0 record the receipt of cash and the construction of the asset:

Dr Cash	100	
Cr Obligation to provide a future service		100

To account for the receipt of the cash contribution

Dr Property, plant and equipment	90	
Cr Cash		90

To account for the construction of the property, plant and equipment

5. At T1–T5 record a depreciation charge and the revenue arising from settling the obligation:

Dr Depreciation charge (in profit or loss)	18	
Cr Property, plant and equipment		18

To record depreciation on the item of property, plant and equipment

Dr Obligation to provide a service	20	
Cr Revenue		20

To record revenue arising from settling the obligation

Approach 2: the cash contribution should be allocated between the construction or acquisition and the ongoing service based on fair value

6. The staff has assumed that the cash contribution is recognised as revenue as construction takes place as described in paragraph 10 of this document.

7. At T0 record the receipt of cash and the construction of the asset:

Dr Cash	100	
Cr Revenue		100

To account for the receipt of the cash contribution as revenue

Dr Cost of goods sold	90	
Cr Cash		90

To account for the construction of the asset as a cost of sale

8. At T1–T5 record a depreciation charge and revenue arising from settling the obligation:

No further entries are recorded after T0.

Approach 3: Recognition of the cash contribution as revenue immediately

9. This approach results in identical journal entries to approach 2 above. The staff has not duplicated these entries here.

Approach 4: The construction or acquisition of an item of property, plant and equipment is a service to the customer but no revenue should be allocated to it

10. This approach results in identical journal entries to approach 1 above. The staff has not duplicated these entries here.

Approach 5: Two transactions take place. The construction or acquisition of an asset in return for a cash contribution and the provision of access to a supply of goods or services in return for contribution of that asset

11. At T0 record the receipt of cash in return for the construction of the asset and the receipt of the asset as a customer contribution:

Dr Cash	100	
Cr Revenue		100

To account for the receipt of the cash contribution as revenue

Dr Cost of goods sold	90	
Cr Cash		90

To account for the construction of the asset as a cost of sale

Dr Property, plant and equipment	90	
Cr Obligation to provide a service		90

To account for the receipt of the property, plant and equipment as a customer contribution

12. At T1–T5 record depreciation and revenue arising from settling the obligation:

Dr Depreciation charge (in profit or loss)	18	
Cr Property, plant and equipment		18

To record depreciation on the item of property, plant and equipment

Dr Obligation to provide a service	18	
Cr Revenue		18

To record revenue arising from settling the obligation