30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: 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:	**November 2007, London**
Project:	**Customer Contributions – cover note to draft Interpretation (Agenda Paper 4A)**

INTRODUCTION

1. In September 2007 the IFRIC asked the staff to develop a draft Interpretation on customer contributions. The staff has now prepared that draft and it will be presented as agenda paper 4B[1] at the November IFRIC meeting.

2. This paper summarises the key points in that draft Interpretation and asks the IFRIC whether it agrees that the draft Interpretation reflects its discussions to date. This paper also considers some sundry matters that the IFRIC needs to discuss before the draft Interpretation can be issued.

3. It should be noted that, to the extent that the IFRIC has not yet reached a consensus on a particular question, the draft Interpretation assumes that it will agree with the staff's recommendation included in the papers for the November meeting. The staff particularly draws the IFRIC's attention to the following:

[1] Agenda paper 4B is omitted from the observer notes.

- the staff has based the proposed treatment of cash contributions on its recommendations in paper 4; and
- the staff has based the effective date and transitional provisions on the recommendations in this paper.

Guidance on the accounting for contributions of property, plant and equipment (paragraphs 1 – 17 and BC1 – BC21)

4. Paragraphs 1 - 17 and BC1 – BC 21 of the draft Interpretation discuss the accounting for contributions of property, plant and equipment. The staff particularly draws the IFRIC's attention to the following:

    a. The staff has discussed the period over which the entity receiving a customer contribution is obliged to provide access to a supply of goods or services in paragraphs 13 – 17 and BC15 – BC21. Paragraph 16 describes how an entity may have a constructive obligation to provide access to a supply of goods or services.

    b. The staff has described the service that is given in return for the receipt of a customer contribution as being the provision of access to a supply of goods or services. In the basis for conclusions, the staff has made clear that the obligation to provide that access may exist only for a short period of time.

    c. The guidance included in paragraphs 12 and BC 13 – BC14 of the draft Interpretation are intended to permit entities that have a finance leaseback to set off the finance lease receivable and the obligation to provide a service if certain conditions are met.

Accounting for a cash contribution (paragraphs 18 - 20 and BC22 - BC26)

5. The staff has included guidance on the accounting for a cash contribution in the draft Interpretation based on its recommendations in paper 4. The staff does not intend to discuss this guidance unless the IFRIC agrees with the staff's recommendations in that paper. If the IFRIC does agree, the staff will ask the IFRIC whether the draft Interpretation correctly reflects its views.

Transitional provisions (paragraphs 22 and BC27 – BC 29)

6. IAS 8 requires an entity to apply a change in accounting policy resulting from the initial application of an Interpretation retrospectively unless there are specific transitional provisions applying to that change.

7. The staff has therefore considered whether a specific exemption from the requirement for retrospective application should be included in the draft Interpretation.

8. The staff noted that retrospective application of the draft Interpretation may require entities to:

   - establish an opening balance for their obligation to provide access to a supply of goods or services;
   - revalue certain contributed assets to a value based on their fair values at the date at which the contribution took place; and
   - identify which assets have been contributed in the past.

9. The staff also notes that many assets that may fall within the scope of the interpretation, for example infrastructure for utility services, have extremely long useful economic lives.

10. Furthermore, many utility entities that may fall within the scope of the draft Interpretation have historically been government owned. These entities may not have detailed historic records stretching back to the date at which infrastructure was acquired.

11. The staff also notes IAS 8.52 which states that, in order to retrospectively apply a change in accounting policy, an entity must distinguish information that:

    ‘*(a)* *provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and*

    (b) *would have been available when the financial statements for that prior period were authorised for issue’*

    …For some types of estimates (eg an estimate of fair value not based on an observable price or observable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is

impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.'

12. Since retrospective application would require some entities to compute the historic fair value of assets that had not been previously measured at fair value, and because IAS 8.52 states that an estimate of fair value cannot distinguish these types of information, the staff considers that it is impracticable to apply the draft Interpretation retrospectively.

13. The staff therefore recommends that the draft Interpretation contain an exclusion from the principle that a change in policy should be applied retrospectively. Instead, the staff proposes that the draft Interpretation prescribes prospective application.

Fair value guidance

14. During the course of the IFRIC's deliberations about customer contributions the staff has become aware that measuring the fair value of a contributed asset may not always be straightforward. In particular, the staff has noted:

    - A contributed asset is typically located in one place and there may be restrictions on its use. For example, an electricity sub-station may only serve existing and future customers in its local area.
    - There may not be an active market for assets in the location that a contributed asset is situated.
    - It may be difficult to separate the fair value of the contributed asset from the fair value of the customer relationship created when the asset is contributed.

15. The staff has therefore considered whether it is necessary to include additional guidance on how an entity should determine fair value in the draft Interpretation.

16. The staff notes that, in many cases, determining fair value is difficult, and requires the use of judgement.

17. The staff also notes that the Board is currently undertaking a project to develop guidance as to how fair value should be determined. To date the Board has issued a discussion paper and a round table is planned in 2008 to consider this

issue. The staff considers that it may be difficult for the IFRIC to develop guidance as to how to measure fair value whilst this project is underway.

18. In the light of the Board's project on fair value measurement and because many of the problems associated with measuring the fair value of a contributed asset are the same problems that affect the measurement of the fair value of any asset, the staff concludes that the IFRIC should not develop further guidance on the measurement of fair value in its draft Interpretation.

Other issues

19. In September 2007 the staff received a letter commenting on the current status of the IFRIC's customer contributions project. The letter disagreed with some of the tentative decisions that the IFRIC has made to date. Some of the points raised in the letter have been discussed elsewhere in the papers considered by the IFRIC. The staff has set out below a summary of the issues raised that have not been considered elsewhere.

20. The letter argued that the receipt of customer contributions does not give rise to revenue 'because those assets [are] not for resale (like trading stock) but comprise part of the capital base of the company in the form of fixed assets (plant and equipment).' The writer 'takes the view that the receipts are capital in nature and should be taken directly to reserves.'

21. The letter also argues that many entities that receive customer contributions operate under regulatory pricing regimes. Those regimes may set sales prices to achieve a prescribed return on assets for the regulated entity. In some cases, those regimes oblige entities 'to exclude contributed infrastructure from the regulatory asset base and no depreciation is charged on that infrastructure for the purpose of computing the return on assets. In effect, [the entity] is disadvantaged under the regulatory pricing model as it excludes any return on or of contributed infrastructure. This disadvantage manifests itself in the form of a cash outflow due to the payment of Income tax on (notional) contributed income with no consequential increase in revenue.'

22. The letter concludes that, 'because the contributed infrastructure is excluded from the price setting mechanism by the regulator, it follows that no future economic benefits will flow to [the entity] that are specifically attributable to the contributed infrastructure.'

23. The staff considers that the receipt of a customer contribution arises in the course of the ordinary activities of an entity. It results in an increase in equity but does not relate to a contribution from an equity participant.

24. IAS 18.7 states:

Revenue is 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.

25. The staff therefore concludes that the receipt of a customer contribution gives rise to revenue and not an equity contribution.

26. The staff also notes that economic benefits can arise for more than one reason. A price increase arising from a price setting mechanism is one reason. Another is an increase in sales volume made possible by the use of a contributed asset. Similarly, the ability to use an asset to provide services provides an economic benefit.

27. The fact that a contributed item does not form part of a price setting mechanism does not therefore imply that the item is not an asset of the entity.

28. The staff notes that, by definition, a customer contribution is used to provide access to a supply of goods or services. The fact that it can be used for that purpose implies that the entity can receive economic benefits from its usage. The staff concludes that a contributed asset can be an asset of the entity regardless of whether it forms part of a price setting mechanism.

29. In reaching this conclusion the staff noted that, in rare cases, a contributed asset may have no value to the recipient. If that is the case, the entity receiving the asset may conclude that no future economic benefits are likely to flow to it from the use of the asset. In such situations, the entity may conclude that it has not received an asset that meets the recognition criteria in the Framework.

30. The staff considered that it would not be possible to develop guidance specific to all regulatory regimes. Furthermore, factors which may lead to an asset having no value to the recipient would be taken into account in determining whether an asset had transferred and its value. The staff therefore considers that

it is not necessary for the draft Interpretation to include additional guidance considering such situations.

31. The staff does not therefore propose amending the draft Interpretation in respect of these points.