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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: **September 2007, London**

Project: **Appendix - Customer Contributions: Illustrative examples (Appendix 1 to Agenda Paper 4A)**

INTRODUCTION

1. At its July meeting, the IFRIC commenced its discussions about the accounting for Customer Contributions. Such contributions arise in situations in which a customer contributes an asset to a service provider that the service provider then uses to provide an ongoing service to the customer.

2. At that meeting, the IFRIC asked the staff to develop illustrative examples for the September meeting that show how an entity would account for the receipt of a customer contribution using the staff's proposed solution if:

   1.1 An entity concludes that it has received an asset that it may recognise and the ongoing service arrangement does not contain a lease;

   1.2 An entity concludes that it has received an asset that it may recognise and the ongoing service arrangement contains an operating lease.

   1.3 An entity concludes that it has received an asset that it may recognise and the ongoing service arrangement contains a finance lease;

3. No examples have been developed showing the treatment if an entity concludes that it has not received an asset because there would be no accounting implications in that situation.

4. This appendix contains 4 sections. Sections 1.1-1.3 show illustrative journal entries, balance sheets, and income statements reflecting each of the above situations. Section 1.4 shows an alternative approach for the accounting for a finance leaseback in situations in which an entity has a right and an intention to settle its finance lease receivable and obligation to provide services net.

5. The discussion of these examples is included in the main paper on customer contributions for the September IFRIC meeting.

Appendix 1.1: An entity concludes that it has received an asset that it may recognise and the ongoing service does not contain a lease

6. Entity A contributes asset X to Entity B. Asset X has a fair value of CU 400 and useful economic life of 10 years. Entity B is responsible for maintaining asset X. Entity A will pay entity B CU 250 pa for 10 years for an ongoing service that is provided using asset X. The cost to entity B of providing these services is CU 150 pa. If Entity A had not provided the asset, entity B would have charged entity A an additional 50 pa.

Question 1: Has an asset transferred to B?

7. Answer 1: Yes, entity B will receive the future economic benefits of the asset by way of cash inflows and profits. It can restrict access to the asset (no other parties are allowed to use it without B's permission).

Question 2: Is there a leaseback to customer A?

8. Answer 2: In this example, entity B concludes that there is no leaseback to customer A on the basis that, whilst the asset will be used to provide a service to customer A, it can also be used to provide services to any other of B's customers.

Question 3: What are the journal entries to record the transaction?

Time 0, when the asset is contributed

9. At t0, the asset is recognised by entity B (at fair value):

Dr PPE	400	
Cr Obligation to provide service		400

Years 1 - 10

10. During years 1 - 10, entity A incurs costs of CU 150, and makes sales of CU 250. The following journal entries are required:

Dr Obligation to provide service	40	
Cr Revenue		40

To recognise service performed and settlement of the obligation.

Dr Cost of sales	150	
Cr Cash		150

To record cash payments made by B to provide the ongoing services.

Dr Cash	250	
Cr Revenue		250

To record cash receipts from A for ongoing services.

Dr Depreciation	40	
Cr Asset		40

To record depreciation of the contributed asset.

Illustrative Income statement and balance sheet 1.1: an entity concludes that it has received an asset it may recognise and the ongoing service does not contain a lease

	Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**	**Year 10**
Revenue	-	290	290	290	290	290	290	290	290	290	290
Cost of sales	-	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)
Depreciation charge	-	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)
Profit	**-**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
PPE	400	360	320	280	240	200	160	120	80	40	-
Cash	-	100	200	300	400	500	600	700	800	900	1,000
Obligation	(400)	(360)	(320)	(280)	(240)	(200)	(160)	(120)	(80)	(40)	-
Equity	**-**	**100**	**200**	**300**	**400**	**500**	**600**	**700**	**800**	**900**	**1,000**

Appendix 1.2: An entity concludes that it has received an asset that it may recognise and the ongoing service contains an operating lease

11. Entity A contributes asset X to Entity B. Asset X has a fair value of CU 400 and useful economic life of 10 years. Entity B is responsible for maintaining asset X. Entity A will pay entity B CU 250 pa for 10 years for an ongoing service that is provided using asset X. The cost to entity B of providing these services is CU 150 pa. If Entity A had not provided the asset, entity B would have charged entity A an additional 50 pa.

Question 1: Has an asset transferred to B?

12. Answer 1: Yes, entity B will receive the future economic benefits of the asset by way of cash inflows and profits. It can restrict access to the asset (no other parties are allowed to use it without B's permission).

Question 2: Is there a leaseback to customer A?

13. Answer 2: In this example, entity B assesses whether the ongoing service arrangement contains a lease using IFRIC 4 and concludes that it does. Because the asset may only be used to provide a service to customer A, the service cannot be provided without the use of asset X, and customer A dictates the output from the asset, the arrangement contains a lease of asset X.

Question 3: Is the lease a finance or operating lease?

14. Answer 3: In this example, entity B assesses the lease arrangement in accordance with IAS 17. It determines that substantially all of the risks and rewards of ownership have remained with entity B and therefore concludes that the ongoing service contract contains an operating lease.

Question 4: What is the lease rental?

15. Answer 4: Entity B has leased an asset with a fair value of CU 400 to entity A. It computes a lease rental of CU 40 pa

Question 5: What are the journal entries to record the transaction?

Time 0, when the asset is contributed

16. At t0, the asset is recognised by entity B (at fair value):

Dr PPE	400	
Cr Obligation to provide service		400

Years 1 – 10

17. During years 1-10, entity A incurs costs of CU 150, and makes sales of CU 250 that includes a payment for the finance lease receivable. The following journal entries are required:

Dr Obligation to provide service	40	
Cr Rental Income		40

To recognise service performed and settlement of the obligation.

Dr Cost of sales	150	
Cr Cash		150

To record cash payments made by B as the cost of providing the ongoing service.

Dr Cash	250	
Cr Revenue		250

To record cash receipts from A.

Illustrative Income statement and balance sheet 1.2: an entity concludes that it has received an asset it may recognise and the ongoing service contains an operating lease

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Revenue	-	250	250	250	250	250	250	250	250	250	250
Rental Income	-	40	40	40	40	40	40	40	40	40	40
Cost of sales	-	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)
Depreciation charge	-	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)	(40)
Profit	**-**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
PPE	400	360	320	280	240	200	160	120	80	40	-
Cash	-	100	200	300	400	500	600	700	800	900	1,000
Obligation	(400)	(360)	(320)	(280)	(240)	(200)	(160)	(120)	(80)	(40)	-
Equity	**-**	**100**	**200**	**300**	**400**	**500**	**600**	**700**	**800**	**900**	**1,000**

Appendix 1.3: An entity concludes that it has received an asset that it may recognise and the ongoing service contains a finance lease

18. Entity A contributes asset X to Entity B. Asset X has a fair value of CU 400 and useful economic life of 10 years. Entity A will pay entity B CU 250 pa for 10 years for an ongoing service that is provided using asset X. The cost to entity B of providing these services is CU 150 pa. If Entity A had not provided the asset, entity B would have charged entity A an additional 50 pa.

Question 1: Has an asset transferred to B?

19. Answer 1: Yes, entity B will receive the future economic benefits of the asset by way of cash inflows and profits. It can restrict access to the asset (no other parties are allowed to use it without B's permission).

Question 2: Is there a leaseback to customer A?

20. Answer 2: In this example, entity B assesses whether the ongoing service arrangement contains a lease using IFRIC 4 and concludes that it does. Because the asset may only be used to provide a service to customer A, the service cannot be provided without the use of asset X, and customer A dictates the output from the asset, the arrangement contains a lease of asset X.

Question 3: Is the lease a finance or operating lease?

21. Answer 3: In this example, entity B assesses the lease arrangement in accordance with IAS 17. It determines that substantially all of the risks and rewards of ownership have transferred back to entity A and therefore concludes that the ongoing service contract contains a finance lease.

Question 4: What interest charges accrue under the lease?

22. Answer 4: Entity B has leased an asset with a fair value of CU 400 to entity A. The lease rental is CU 50 pa and the interest rate implicit in the lease is 4.25%. Based on these amounts, the following table can be derived.

Year	Lease receivable bfwd	Payment	Interest income	Lease receivable cfwd
1	400	-50	17	367
2	367	-50	16	333
3	333	-50	14	297
4	297	-50	13	260
5	260	-50	11	221
6	221	-50	9	180
7	180	-50	8	138
8	138	-50	6	94
9	94	-50	4	48
10	48	-50	2	0

Question 5: What are the journal entries to record the transaction?

Time 0, when the asset is contributed

23. At t0, the asset is recognised by entity B (at fair value):

Dr PPE	400	
Cr Obligation to provide service		400

24. The asset is then leased back to entity A:

Dr Finance lease receivable	400	
Cr PPE		400

Year 1

25. During year 1, entity A incurs costs of CU 150, and makes sales of CU 250 that includes a payment for the finance lease receivable. The following journal entries are required:

Dr Finance lease receivable	17	
Cr Interest income		17

To record the interest income for the period on the finance lease receivable

Dr Obligation to provide service	40	
Cr Revenue		40

To recognise service performed and settlement of the obligation.

Dr Cost of sales	150	
Cr Cash		150

To record cash payments made by B as the cost of providing the ongoing service.

Dr Cash	250	
Cr Revenue		200
Cr Finance lease receivable		50

To record cash receipts from A. Note that the cash receipt is split between payments for the ongoing service and the repayment of the finance lease receivable.

Years 2 – 10

26. During years 2 -10, the same journal entries are recorded as in year 1. The only change in each year is that the interest income is reduced reflecting the reduced finance lease receivable.

Illustrative Income statement and balance sheet 1.3: an entity concludes that it has received an asset it may recognise and the ongoing service contains a finance lease

	Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**	**Year 10**
Revenue	-	240	240	240	240	240	240	240	240	240	240
Interest Income	-	17	16	14	13	11	9	8	6	4	2
Cost of sales	-	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)
Profit	**-**	**107**	**106**	**104**	**103**	**101**	**99**	**98**	**96**	**94**	**92**
Finance lease receivable	400	367	333	297	260	221	180	138	94	48	-
Cash	-	100	200	300	400	500	600	700	800	900	1,000
Obligation	(400)	(360)	(320)	(280)	(240)	(200)	(160)	(120)	(80)	(40)	-
Equity	**-**	**107**	**213**	**317**	**420**	**521**	**620**	**718**	**814**	**908**	**1,000**

Appendix 1.4: An entity concludes that it has received an asset that it may recognise and the ongoing service contains a finance lease

27. Appendix 1.4 contains exactly the same example as appendix 1.3 except that in appendix 1.4, entity B determines that:

- it has a right to set off the finance lease receivable and the obligation to perform future services; and
- it intends to settle the finance lease receivable and the obligation to perform future services on a net basis.

28. Entity B therefore sets off the finance lease receivable and the obligation to perform future services in the balance sheet.

29. Questions 1 – 4 and the answers to those questions are identical to appendix 1.3 and so have not been repeated here.

Question 5: What are the journal entries to record the transaction?

Time 0, when the asset is contributed

30. At t0, the asset is recognised by entity B (at fair value):

Dr PPE	400	
Cr Amounts received for future services		400

31. The asset is then leased back to entity A:

Dr Finance lease receivable		400
Cr PPE		400

32. The obligation is considered to be a prepayment of the lease and so the finance lease receivable is reduced by the prepayment received:

Dr Amounts received for future services	400	
Cr Finance lease receivable		400

Years 1 - 10

33. During years 1-10, entity A incurs costs of CU 150, and makes sales of CU 250. The following journal entries are required:

Dr Cost of sales	150	
Cr Cash		150

To record cash payments made by B as the cost of providing the ongoing service.

Dr Cash	250	
Cr Revenue		250

To record cash receipts from A.

Illustrative Income statement and balance sheet 1.4: an entity concludes that it has received an asset it may recognise and the ongoing service contains a finance lease

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Revenue	-	250	250	250	250	250	250	250	250	250	250
Cost of sales	-	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)	(150)
Profit	**-**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Cash	-	100	200	300	400	500	600	700	800	900	1,000
Equity	**-**	**100**	**200**	**300**	**400**	**500**	**600**	**700**	**800**	**900**	**1,000**