



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: September 2007, London

**Project: Customer Contributions: Extending the scope
(Agenda Paper 4B)**

INTRODUCTION

1. At its July meeting, the IFRIC commenced its discussions on the accounting for customer contributions. Such contributions arise in situations in which a customer contributes an asset to a service provider which the service provider then uses to provide an ongoing service to the customer.
2. At that meeting, the IFRIC considered situations in which an existing item of property, plant and equipment was contributed to the service provider. The IFRIC asked the staff to develop a paper for the September meeting considering how this scope could be extended.
3. This paper sets out the staff's views as to how the scope could be extended.

POTENTIAL SCOPE EXTENSIONS

4. In considering how the scope may be extended, the staff has considered the following approaches:
 - Extend the scope to the contribution of any asset so long as the contribution results in the receipt of an access right.
 - Limit the scope of the project to contributions of PPE or cash which is contributed for the construction and / or acquisition of specific items of PPE.
 - Limit the scope of the project to the contribution of PPE.
5. A more detailed description of each of these approaches is set out below.

Extend the scope to the contribution of any asset

6. This approach gives rise to the widest possible scope for the project and includes the contribution of any asset so long as that contribution results in ongoing access to a service.
7. A scope developed in this way may read:

This Interpretation applies to the accounting for the receipt of assets by an entity when those assets are contributed by a customer in return for the provision of ongoing access to a service.
8. Such a scope would include the contribution of PPE in return for an ongoing access right as well as contributions of cash, inventory and other assets.
9. The advantage of this approach is that it would ensure a consistent accounting model regardless of what the contributed asset was. Furthermore, it would provide the widest scope and therefore ensure that the largest number of accounting issues were resolved.
10. The disadvantage of this approach is that it may widen the scope to include a wide range of situations that the IFRIC has not considered. This may result in the IFRIC spending a significant amount of time considering the accounting for situations which rarely occur in practice.
11. For example, to widen the scope in this way would require the IFRIC to consider the accounting for situations in which a previously unrecognised intangible asset was contributed in return for an access right.

Contributions of cash towards the construction of PPE

12. Including the contribution of cash that the service provider then uses for the acquisition or construction of an item of PPE will result in consistent accounting in situations in which a customer is given the choice between contributing an asset to the service provider or allowing the service provider to construct that asset in return for a cash payment from the customer.
13. The potential difficulty with this approach is that a service provider that receives cash in place of an item of PPE then has to acquire and / or construct that item of PPE. A question will arise as to whether the acquisition and / or construction of this asset constitutes the provision of a service to the customer. If it is a service to the customer then it will be appropriate to recognise revenue in respect of this service as well as the ongoing service.
14. A question will also arise as to whether a service provider may recognise profit upfront in situations in which it makes a profit on the construction or acquisition of the asset.
15. In order to pursue this scope, the IFRIC will need to resolve these issues.

Contributions of PPE

16. This is the narrowest scope and relates solely to the contribution of PPE.
17. The advantage of this scope is that the IFRIC has already largely concluded as to how to account for the contribution of such assets. The IFRIC will not have to consider additional questions, for example whether acquiring or constructing an asset for a customer is a service which results in the recognition of revenue when it is performed.
18. The disadvantage is that the scope is narrow and so potentially excludes a number of situations that exist in practice. In particular, it excludes situations in which customers pay cash for assets which they could otherwise contribute.
19. Failing to address these issues may lead to structuring opportunities with entities choosing between the contribution of PPE and the contribution of cash based on the accounting outcome that they wish to achieve.

STAFF ANALYSIS

20. The staff considers that, for consistency, it is desirable to have the widest scope possible. The staff also considers that it is important to limit the scope in such a way that the IFRIC will be able to reach a consensus on a timely basis. The staff therefore believes that a compromise is required between expanding the scope of the project and being able to reach a consensus.
21. The staff notes that, when the IFRIC initially started to consider this issue, the scope was limited to ensure that the IFRIC could reach a consensus. In considering how the scope should be extended, the staff has started by considering the limited scope that the IFRIC has previously discussed and then ways in which it may be extended. The staff has not considered the alternative approach of starting with the widest possible scope (the contribution of any asset) and then narrowing it.
22. The staff first considered whether the scope could be extended beyond the contribution of an item of PPE to the contribution of cash for the acquisition and / or construction of an item of PPE.
23. As described above, the staff considers that the key question that needs to be considered in extending the scope is whether the IFRIC will be able to reach a consensus on a timely basis on the extended scope.
24. The staff considered the following example. Entity A wishes to acquire an ongoing service from entity B. In order to obtain that service, an asset (asset X) with a fair value of 100 is required. Entity A has two choices. It can either contribute asset X to entity B or it can contribute cash of 100 to entity B. If it contributes asset X, it will have to first acquire the asset from a third party (entity C) for 100. The cost to entity B or entity C of constructing the asset would be 90. Entity A cannot construct the asset itself as it does not have the expertise. Both B and C routinely construct similar assets for sale to third parties as part of their ordinary activities.
25. In this situation, entity B will receive either asset X or cash of 100 that it is required to use to construct asset X. It could be argued that, regardless of whether the cash or the asset is contributed, the economic substance of the transaction is the same. Furthermore, immediately after the asset has been constructed, the relationship between entity A and entity B will be the same

regardless of which route is pursued. Supporters of this view believe that the accounting for the two situations by B should therefore be the same.

26. To illustrate this view, the staff has set out below the journal entries that would be required to reflect the receipt of asset X or of cash if both are accounted for in the same way:

Entity A contributes asset X

Dr PPE (fair value of asset X)	100	
Cr Obligation to perform an ongoing service		100

Entity A contributes cash of 100

Dr Cash	100	
Cr Obligation to perform an ongoing service		100

To record the receipt of cash

Dr PPE	90	
Cr Cash		90

To record the construction of the PPE

27. The staff notes that, in this situation, the contribution of cash results in the recognition of PPE at cost rather than at fair value and so entity B's balance sheet will differ depending on whether it has received cash or an asset. If no further entries are booked, then the additional 'profit' earned by B for constructing the asset will be spread over the life of the asset by way of reduced depreciation charges.
28. This could be resolved by recording the following additional journal entry on day 1 to record asset X at fair value and record the profit on construction of the asset immediately:

Dr PPE	10	
Cr Profit		10

29. **The staff considers that, if the scope is extended to the contribution of cash, then the first question that the IFRIC will need to address is whether any difference between the cost of the asset and its fair value should be recognised as profit on day 1.**

30. A possible solution to this issue would be to increase the scope of the project to the contribution of cash, but only to cash contributions equal to the cost of the PPE constructed. The staff has considered this option further below.
31. The second issue that the staff considers that the IFRIC will need to resolve, if it extends the scope to the contribution of cash, is whether the construction of an asset is a service to the customer.
32. Using the above example, if entity A contributes asset X to entity B, then it must first acquire the asset from entity C. Entity C will receive cash of 100 and incur costs of 90 to construct the asset. It will recognise revenue of 100 and costs of 90.
33. If entity B undertakes exactly the same activities as entity C (constructing the asset on behalf of entity A), it could be argued that for consistency it should also record revenue of 100 when the asset is constructed. Supporters of this view consider that it would be inconsistent to require entity C to recognise revenue for constructing the asset on the basis that it has performed a service for entity A and not allow entity B to record revenue on the basis that it has not performed a service for entity A when both have undertaken identical activities.
34. Supporters of this view consider that entity B should record revenue for providing the service of constructing and / or acquiring the asset on behalf of entity A.
35. This could be achieved by recording the following entries in the books of entity B.

Dr Cash	100	
Cr Revenue		100
<i>To record the receipt of cash for the service of constructing the asset</i>		
Dr Cost of sales	90	
Cr Cash		90
<i>To record the cost of constructing the asset</i>		

Cr Obligation to provide access to an ongoing service 100

To record the receipt of the constructed asset

36. Opponents of this view consider that this will result in the double-recognition of revenue with revenue of 100 recognised on the construction of the asset and a further 100 deferred to be recognised as revenue as access to the ongoing service is provided. Furthermore, opponents of this view consider that it will result in a difference between the accounting treatment when an item of PPE is contributed and the accounting treatment when a cash contribution is made.
37. **The staff considers that, if the scope is extended to include the contribution of cash, then the second question that the IFRIC will need to address is whether the construction and / or acquisition of an asset to be contributed to the service provider is a service to the customer that leads to the recognition of revenue.**
38. The staff believes that questions as to whether profit can be recognised on the construction of the asset and whether the construction of that asset is a service to the customer are significant questions that will need to be addressed by the IFRIC if it wishes to extend the scope in this way.
39. The staff believes that more questions will need to be answered if the scope is extended further. In particular, a number of issues will arise if the asset that is transferred is an intangible asset that either was not recognised before the transfer or did not exist before the transfer.
40. Whilst the staff believes that the contribution of cash may be widespread, the staff does not believe that the contribution of other assets is sufficiently widespread to warrant the IFRIC spending time considering the issues associated with it.
41. Furthermore, even if such transfers of assets did occur any Interpretation the IFRIC issues would include helpful guidance that may be applied by analogy.
42. For the remainder of this paper, the staff has therefore limited its discussion to the contribution of PPE or cash to be used for the construction and / or acquisition of such PPE.

43. The staff has particularly focussed on how the IFRIC can address the following questions:
- how to deal with cash contributions that give rise to profit; and
 - whether the construction of an asset is a service to a customer that gives rise to the recognition of revenue.

How to deal with cash contributions that give rise to profit

44. The staff considers that, in many cases, entities that receive customer contributions for the acquisition and/or construction of PPE will make a profit as a result of those transactions. As discussed above, if the IFRIC decides to include cash contributions in the scope of its project, it will need to address whether this profit may be recognised immediately or whether it should be deferred and recognised over the life of the contract (this would be achieved by carrying the asset at a reduced carrying value – its cost – and therefore recognising reduced depreciation in future years).
45. One approach to resolving this issue would be to limit the scope of the Interpretation to the contribution of PPE or cash to acquire PPE *at cost*.
46. Whilst the staff considers that this approach would resolve the issue, the staff also considers that, in most cases, an entity that accepts a contribution of cash for the construction and / or acquisition of PPE will make a profit from the construction and / or acquisition of the asset. The staff does not therefore consider that limiting the scope of the project in this way will result in the scope of the project being significantly wider than if it were restricted to the contribution of PPE.
47. Furthermore, the staff considers that, if the scope were limited in this way entities may then be able to change whether they are or are not within the scope by making small changes to the amount of the cash contribution or the cost of the asset.
48. The staff considered the example above in which A contributes 100 for asset X that costs B 90 to construct. In this situation, it could be argued that entity B has made a profit of 10 on the sale of asset X (the difference between the cost of 90 and payment from A of 100).

49. Paragraph 92 of the Framework states 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).’*
50. Supporters of the view that profit of 10 should be recognised immediately note that entity B has received 100 cash and has only been required to pay 90 for the construction of the asset. Entity B has therefore received an increase in economic benefits because of an increase in assets. The increase can be measured reliably and the entity has fulfilled its duty to provide the asset. Supporters of this view therefore believe that it is correct to recognise profit in respect of the construction of the asset immediately.
51. Opponents of this view consider that the additional sum of 10 paid over the cost of the asset is an advance payment for access to ongoing services. They believe that the customer is primarily interested in the receipt of the ongoing service and that the upfront cash payment would not have been made were it not for the ongoing service. The provision of the asset is one part of an ongoing service arrangement that exists over the period that access to the ongoing service arrangement is given.
52. Supporters of this view therefore consider that any profit should be recognised over the period that access to the ongoing service arrangement is given.
53. Supporters of this view also note that, if the gain is allowed to be recognised immediately entity B would be able to structure the sales transaction such that an advance payment for ongoing services could be recognised upfront. In the example above, this could be achieved by increasing the upfront contribution to 110 and reducing the ongoing service cost by 10.

54. If the IFRIC decided that the gain should be recognised upfront but also wanted to avoid the potential for structuring transactions in this way, then the staff notes that an Interpretation could be issued requiring entities to recognise as profit immediately the difference between:
- the lower of the cash contribution and the fair value of the asset constructed; and
 - the cost of constructing and / or acquiring that asset.
55. Any excess of the contribution over the fair value of the asset would then be carried forward as an advance payment for future services which would be recognised as revenue as those services are provided. Any deficit would be recognised as a loss to the extent that the overall contract is onerous in accordance with IAS 37.
56. The problem with this approach is that it may be complicated and difficult to implement in practice.
57. The staff considers that, for the IFRIC to extend the scope of its project to consider cash contributions, it must be able to reach consensus on this issue in a reasonable time. If the IFRIC is able to reach consensus on this and the other questions surrounding this change in scope the IFRIC should pursue this extended scope.

Does the construction of an asset constitute a service to a customer that gives rise to the recognition of revenue?

58. As discussed above, the staff considers that, in order to expand the scope of the Interpretation to contributions of cash towards the acquisition and / or construction of an item of PPE, the IFRIC will need to conclude whether the construction and / or acquisition of the PPE is a service to the customer that results in the recognition of revenue.
59. If the IFRIC concludes that the construction of the PPE is a service to the customer that results in the recognition of revenue, it will need to conclude how the revenue should be recognised.

60. The staff considers that three alternative views may exist:
- that the construction of the contributed asset is a valuable service to the customer but it is part of a single arrangement to provide ongoing services to the customer and so no revenue should be recognised upfront;
 - that the construction of the contributed asset is a separate service and the revenue (equal to the cash paid) should be allocated between the construction of the asset and the ongoing service based on their respective fair values. This would result in some revenue being recognised upfront and some being deferred;
 - that the construction of the contributed asset is a separate service. Revenue should be recognised upfront for that service. The contribution of the PPE is then a separate transaction that should be accounted for with the PPE recognised at fair value (using the model described in paragraph 35 above).
61. The staff notes that this issue is very similar to the one that the IFRIC was unable to resolve in its discussions about the accounting for upfront fees received by fund managers. The staff therefore considers that there is significant risk that the IFRIC will be unable to resolve this issue on a timely basis.
62. In contrast, the staff also notes that the third option, which involves the recognition of revenue on the construction and / or acquisition of the asset followed by the recognition of additional revenue on the contribution of the asset, shares many key features with the IFRIC's previous project relating to service concessions. In that case, the IFRIC was able to reach a consensus on a similar revenue recognition issue.
63. The staff considers that concluding that the upfront construction of an asset is not a service is likely to raise questions as to the consistency of this approach with the construction of the same asset by a third party.
64. Conversely, the staff considers that concluding that the cash receipt should be recognised as revenue upfront may be seen as being inconsistent with the contribution of an item of PPE.
65. Furthermore, recognising revenue upfront in respect of the construction and / or acquisition of the asset and then recognising revenue for the contribution of the

PPE over the life of the service may be considered to be recognising revenue twice. The IFRIC was able to reach a similar conclusion to this in the case of service concessions. However, extending this conclusion to other service arrangements may raise concerns about opportunities for entities to manipulate their revenue recognition by allocating part of a fee for the provision of ongoing services to the provision of the assets required to provide those services.

66. The staff considers that this issue is further complicated by the wide range of facts and circumstances that exist in this area in practice. For example, installing a pipe will have little value to a customer without ongoing access to the product delivered by that pipe. Installation of the pipe could therefore be argued to not be a valuable service to the customer. In contrast, if planning regulations require a house builder to install a substation before it can sell its houses, then the building of that substation may be seen as being a service of value to the builder. As well as such utility services, the scope of the project will also include outsourcing arrangements, mobile telephony, and the provision of other services.
67. The staff considers that the IFRIC is likely to be able to reach a consensus on this issue in respect of contributions of property, plant and equipment. The staff notes the wide range of diverse arrangements that may fall into the scope of the project, as well as the need to ensure that structuring opportunities are not created. In the light of these factors, the staff considers that the IFRIC may not be able to reach a consensus in a reasonable time if the scope of the project is extended beyond the contribution of property, plant and equipment.

Summary and Conclusions

68. The staff has considered three ways in which the scope of the IFRIC project on customer contributions may be extended:
 - Extend the scope to the contribution of any asset so long as the contribution results in the receipt of an access right.
 - Limit the scope of the project to contributions of PPE or cash which is contributed for the construction and / or acquisition of specific items of PPE.
 - Limit the scope of the project to the contribution of PPE.

69. The staff considers that, to extend the scope to the contribution of any asset will require significant additional work. Furthermore, the staff considers that contributions other than PPE and cash for the construction of PPE are likely to be rare. The staff does not therefore propose that the scope be extended to this extent.
70. The staff considers that there are two key issues that need to be addressed in order to extend the scope of the Interpretation to contributions of cash:
- How should an entity account for profit that arises on the acquisition and / or construction of an asset in return for a cash contribution?
 - Does the acquisition and / or construction of an asset in return for a cash contribution constitute a service to the customer that gives rise to the recognition of revenue and, if so, how should that contribution be accounted for?
71. If the IFRIC feels that it is likely to be able to resolve these issues the scope should be extended to include cash contributions. If not, the staff considers that the scope should be limited to contributions of PPE.
72. The staff notes that one of the solutions that the IFRIC could reach is very similar to the solution that it reached in the case of Service Concessions in IFRIC 12. If the IFRIC were able to reach a similar conclusion in the case of customer contributions, it should be able to reach a consensus on a timely basis.
73. In contrast, the staff notes that the IFRIC was unable to reach a consensus on a very similar issue in the case of fund managers. The staff also notes that there are a very wide range of transactions and circumstances in which cash contributions towards the construction and / or acquisition of an asset may take place. Furthermore, if the solution in IFRIC 12 were applied to customer contributions, it could be seen as allowing people to recognise revenue twice.
74. In the light of the wide range of fact patterns that may exist in practice and concerns about manipulation of revenue recognition, the staff concludes that the IFRIC is unlikely to be able to reach a consensus on this issue on a timely basis.
75. The staff notes that, even if the scope is limited to contributions of PPE, entities will be able to extend the scope by analogy to situations that are, in substance, the same. Whilst this extension would be a matter of judgement, the staff

considers that in the light of the number of different scenarios that exist, the IFRIC is unlikely to be able to develop an Interpretation that covers all similar situations. Regardless of the scope, there will still be need for judgement.

76. The staff therefore concludes that the scope should not be extended but should instead be limited to the contribution of PPE.