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International
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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: **July 2008, London**

Project: **D24 *Customer Contributions* – Comment letter analysis (Agenda Paper 4A)**

Introduction

1. In April 2008, the IFRIC published for public comment the draft Interpretation D24 *Customer Contributions*. In response to its proposals, the IFRIC received 58 comment letters.

2. The draft Interpretation aims to provide guidance on the accounting for customer contributions received by an access provider. Divergence had arisen in practice with some entities recognising the contributed asset at fair value and others recognising it at a cost of nil. Amongst those that recorded the asset at fair value, some recognised the resulting credit as revenue immediately while others recognised it over the period of the ongoing service.

3. This paper is a summary of the main comments. For illustration purposes, the staff quote or refer to some comment letters. The staff did not intend to draw a quantitative analysis but to focus on the arguments put forward.

Staff analysis

4. Most respondents to D24 supported the IFRIC's efforts to provide interpretative guidance on the issue of customer contributions. Some observed diversity in practice (CL32, CL51) and supported the IFRIC for that reason. However, almost all supporters of D24 expressed concerns about some aspects of the proposals. In particular, they believed that the draft Interpretation addresses a wide range of customer contributions and that the principles do not clearly appear in the draft. Some suggested addressing the issue through a revenue recognition approach using IAS 18 guidance.

5. A few respondents (CL39, CL42) pointed out that the IFRIC discussed a similar issue in respect of initial fees and could not agree on whether and to what extent an initial service had been provided. Similarly, they concluded that the IFRIC should not seek to issue an Interpretation on customer contributions and should remove the project from its agenda.

6. This paper discusses the following concerns expressed by respondents:

   - Whether the entity receiving the customer contributions *always* has an obligation to provide ongoing access to a supply of goods or service;
   - If such an obligation exists, when revenue should be recognised?
   - Clarify the criteria for recognising a customer contribution as an asset;
   - Provide further guidance on determining whether the ongoing arrangement contains a lease;
   - Clarify the role of each party to the transaction and which party the Interpretation would apply to;
   - Could the Interpretation be applied by analogy?
   - Other issues.

Whether the entity receiving the customer contributions *always* has an obligation to provide ongoing access to a supply of goods or service

7. Many respondents to D24 questioned whether the entity receiving the customer contributions *always* has an obligation to provide ongoing access to a supply of

goods or services. They noted that paragraph BC17 of D24 states three possible alternatives:

(a) The obligation arises as a result of the supplier agreeing to provide goods or services to the customer at a reduced price in the future.

(b) The obligation is to provide a connection to a network supplying goods and services. Once that connection has been made, the obligation is settled.

(c) The obligation is to provide an ongoing access to a supply of goods or services.

8. These respondents concurred with these alternatives but they noted that, after having dismissed alternatives (a) and (b), the IFRIC concluded in paragraph BC19 that 'the obligation was to provide ongoing access to a supply of goods or services'. However, these respondents argued that the scope of the draft Interpretation is very wide as it covers 'all situations in which an entity receives an item of property, plant and equipment or cash it is required to use to construct or acquire an item of property, plant and equipment that must be used to provide access to a supply of goods or services' (see paragraph 4 of D24).

We agree with the three possible situations described (based on law, regulation or contractual agreement) but for us each of them has a different economic substance which may result in a different accounting treatment. We therefore disagree with the rationale in paragraphs BC 18 and BC 19 and believe that IFRIC has only two possible ways to deal with these three alternatives: either to clearly exclude alternatives A and B from the scope of the interpretation (the present wording of paragraph 4 does not seem to exclude any of the two) or to recommend separate accounting treatments for each of the three alternatives, which is our recommendation. (CL51)

9. Some respondents suggested addressing the issue through an IAS 18 approach (CL54, CL32) as a way to simplify the Interpretation and focus more on the principles.

When the access provider receives something (e.g. an item of PP&E or cash), it will have done so for providing some sort of a goods or services (because the contributor would not have contributed something if it did not expect to receive something in return). Therefore, the starting point for the analysis is IAS 18; the access provider needs to apply the guidance in IAS 18 to determine if and how, based on the substance of the transaction, revenue should be recognised. In this connection we note that e.g. Example 17 in the Appendix to IAS 18 contains some guidance on a similar question, and we suggest reference is made to that *example in the final Interpretation. If the facts and circumstances of the transaction mean that the requirements of IAS 18 for the recognition of revenue are fulfilled on receipt of the contribution, revenue should be recognised. If the requirements are not met at that point, the access provider should defer the revenue (or account for an advanced payment in the case of a cash contribution) and instead recognise it over the period of ongoing service (ie contract term) in line with the terms and conditions of the agreement. The accounting for the item received follows the guidance in the relevant standards. Subsequently, the access provider needs to apply the guidance in IFRIC 4 in order to determine if a lease arrangement has been entered into and if it has, apply IFRIC 4 and IAS 17 to account for such an arrangement. We believe that the issue addressed in D24 relate to deferred revenue and advanced payments and we think the draft Interpretation would benefit significantly if this was clearly stated in the consensus and basis for conclusion.* [CL54]

10. One respondent (CL 32) also suggested using the guidance in paragraph 12 of IAS 18 for the exchange of dissimilar goods or services as a conceptual basis to support the proposed accounting for contributions of both PP&E and cash.

11. Some respondents (CL36, CL21) pointed out that, for example, when a utility provider is required by law or regulation to provide access to a supply of a commodity to all customers at the same price, the access provider may not have any further obligation once the connection has been made and therefore revenue should be recognised once the connection is made.

12. Many respondents (CL18, CL25, CL42, CL45), believed that an obligation to provide ongoing services to the customer who contributed the asset exists only if the customer obtains in exchange an exclusive access to goods or services, eg at a reduced price.

    We believe that the IFRIC should reach a consensus whereby revenue is deferred only if there is objective evidence that the entity is committed to transfer economic resources in exchange for the customer cash contributions beyond the date the connection is made. In all other circumstances, revenue should not be deferred. (CL18)

If such an obligation exists, when revenue should be recognised?

13. Almost all respondents to D24 raised questions about the period over which revenue should be recognised. For example they stated:

    - *paragraph 20 of D24 seems to be an arbitrary rule, unrelated to the principles of IAS 18* (CL39)

- *we would like to see some further guidance on how renewal provisions in access agreements impact the revenue recognition period* (CL10)
- *what would be the period for deferring revenue when customers leave and 'transfer' their right to access to a supply of goods or services to new occupants?* (CL45)
- *the period over which an entity has an obligation to provide access is subject to the facts and circumstances underlying the individual transaction. There might be no obligation at all; the obligation could be limited to, for example, the useful economic life of the asset or a contractual period; or there could be an indefinite obligation to provide access* (CL54)
- *depending on the circumstances, the period of time over which a customer contribution should be amortised as revenue might exceed the useful life of the contributed asset… if so, that period might be infinite or perpetual. If it were, it would be problematic to identify when the customer contribution should be recognised as revenue* (CL49)

Clarify the criteria for recognising a customer contribution as an asset

14. Many respondents agreed with the IFRIC's proposal in paragraphs 8-10 of D24, including measurement at fair value. However, some of them believed that the Interpretation would benefit from providing additional guidance as to how to apply the recognition criteria.

15. Some of them also believed that the drafting could be improved referring more specifically to the *Framework* to avoid any confusion around the notion of control (CL18, CL 50, CL54).

16. Some respondents questioned whether *control* was given priority over *risks and rewards* (CL19, CL37)

    In arriving at a conclusion as to whether the contribution qualifies for recognition as an asset, it is unclear whether physical control is a key factor (the document often refers to "use" of the asset) as opposed to the risks and rewards approach (as is required for example, by IAS 17 – Leases). (CL37)

Provide further guidance on determining whether the ongoing arrangement contains a lease

17. Some respondents (CL9, CL36) asked for additional guidance on determining whether the ongoing arrangement contains a lease.

The accounting when the ongoing arrangement contains a lease may be confusing to some preparers, since it adds the application of IFRIC 4 on top of the application of Draft Interpretation D 24, and can result in an entity not recording the customer contribution and related obligation. We suggest that illustrative examples be provided to assist in understanding this issue. (CL9)

Clarify the role of each party to the transaction and which party the Interpretation would apply to

18. Some respondents were confused about the role of each party to the transaction and which party the Interpretation would apply to:

- Some questioned what ‘access provider’ means and asked the IFRIC to define such a term. *The meaning of “provide access” and “access provider” is critical to understanding the scope of the Interpretation. It would be helpful if examples were provided, including one involving access to goods.* (CL9)
- *although much of the wording of the consensus focuses on the accounting treatment of the access provider, the scope paragraph seems to be saying that the draft interpretation is applicable to all the parties involved* (CL54)
- What *another party* means in the last sentence of paragraph 4 of D24 that states that ‘the customer that receives access to a supply of goods or services may contribute the asset or it may be contributed by another party’?
- *Would the Interpretation apply if the access provider already holds the asset in inventory, that is, if the access provider is also the constructor of the asset?* (CL51)

Could the Interpretation be applied by analogy?

19. Many respondents were unclear whether D24 applies to utility entities and, if so, whether it could apply by analogy to other industries.

20. For example, some respondents took the example of the automotive industry (CL5, CL46, CL48).

In the Automotive industry (and other manufacturing entities), moulds or ‘tooling’ are produced by the manufacturer, which are then used to manufacture parts for a specific customer. The customer often contributes cash for the production of the moulds or tooling, which may or may not cover the full cost of its production. The mould or tooling is often produced from items already held in inventory. Economically there is an expectation that the manufacturer will recover excess costs from the supply of products, although there are often no contractual commitments from the customer. The cash contribution to construct the mould or tooling appears to be within the scope of the Draft, as the manufacturer provides access to a service by holding the mould or tooling. The uncertainty around the questions leaves doubt as to whether such transactions *would be within the scope of the Draft or not and may lead to further diversity.* (CL46)

21. Another example quoted by some respondents is connection fees for landline telephone services:

    The landline telephone network may be owned by one telecommunication company, with other telecommunication companies being allowed to provide services to customers using the first company's network. In such a case customers are charged a connection fee by the network owner and pay a separate fee for telephone services to the service provider. Typically the network owner recognises revenue upon setting up the connection. (CL32)

22. Other examples quoted by respondents are:

    - Customer contributions involving intangible assets such as software or patents;
    - Outsourcing arrangements (CL41).

Other issues

23. *Potential overlap with IFRIC 12 and IAS 20.* Many respondents were concerned that D24 could create unintended overlaps with existing IFRSs such as IFRIC 12 and IAS 20. For example, they recommend excluding agreements in which the contributor is a government.

24. *Whether the obligation to provide ongoing access to a supply of goods or service is an obligation within the scope of IAS 37 or IAS 18.* Some respondents pointed out that paragraphs 11 and BC16-BC22 of D24 are silent on which IFRS applies to account for the obligation to provide ongoing access to a supply of goods or services (IAS 37 or IAS 18?). They asked the IFRIC to clarify this point.

25. *Accounting for cash contribution.* Some respondents (CL10) asked the IFRIC to clarify whether, in the case of a cash contribution, there is no need to consider the existence of a lease.

26. *Time value of money.* Almost all respondents did not agree with the IFRIC that the time value of money should be taken into account when measuring revenue. Paragraph 11 of IAS 18 requires taking into account the time value of money when payments are *deferred* but does not require the same approach in respect of payments *received upfront*.

Staff recommendation

27. The staff note that most respondents to D24 were generally supportive of the IFRIC's work on this issue. Therefore, the staff recommend that the IFRIC should continue deliberating the issue and should address the concerns expressed by respondents to D24.

28. As a starting point of the redeliberation, the staff suggest discussing the key issue of whether the entity that receives the contribution has an obligation once connection has been made (see agenda paper 4B).

29. Question to IFRIC members: Do you have any comments on the staff analysis of comment letters?