

9 May 2008

D24 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam,

Re: IFRIC Draft Interpretation D24 *Customer Contributions*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC Draft Interpretation D24 *Customer Contributions* (D24). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretation.

The IFRIC undertook this project to clarify the amount at which items of property, plant and equipment contributed to an access provider should be recognised and what the accounting for any resulting credit should be.

EFRAG supports the IFRIC in its efforts to provide interpretive guidance on the area of customer contributions. Furthermore, based on our understanding of D24, we support the accounting solution suggested when the recipient of the contribution enters into an obligation of the type described in the draft Interpretation. However:

- (a) we are concerned that the wording in the consensus seems to assume that in all cases the access provider accepts an ongoing obligation to provide access in return for the contribution. We believe this is only one of the many possible scenarios, and that in the other scenarios the accounting described will generally not be appropriate. We further believe that it would be helpful to include in the draft Interpretation examples of types of transactions being addressed by the draft Interpretation.
- (b) we believe that the way the IFRIC has approached the issues makes the rationale much more complex than it needs to be as we believe that the question surrounds deferred revenue and advanced payments. Therefore we think the draft Interpretation would benefit significantly, if this was clearly stated in the consensus and basis for conclusion and if the analysis would start from an IAS 18 perspective.
- (c) we note that currently neither the consensus nor the basis for conclusion refer to IAS 18 in connection with the obligation to be accounted for. We believe the draft Interpretation would benefit further if clear reference to IAS 18 were made.

Our detail comments are set out in the appendix to this letter.

If you would like further clarification of the points raised in this letter, Thomas Oversberg or I would be happy to discuss the letter with you further.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix – EFRAG’s detailed comments on IFRIC D24

GENERAL COMMENTS

Accounting solution proposed by D24

- 1 As we did not find D24 a particularly easy read, we believed it useful, before commenting on it, to set out our understanding of what it is proposing.
 - (a) When someone (typically a customer) contributes a non-cash asset of property, plant and equipment (PP&E) to an access provider (an entity that provides access to a supply of goods or services), the access provider should establish whether it has received an asset of PP&E that should be recognised. If it has, it should recognise that asset at its fair value and should simultaneously recognise a liability for the same amount—unless the asset is deemed to have been finance leased to another party (perhaps back to the contributor or the end-user), in which case there is no asset or liability to recognise. The obligation recognised should be released into the income statement over the shorter of the life of the asset or the period over which the access provider has an obligation to provide access.
 - (b) An entity that receives a cash contribution shall first consider whether the asset that must be acquired or constructed as a result of receiving the cash contribution will meet the criteria for recognition as an item of PP&E of the entity. If it will not, the entity shall account for the cash contribution as proceeds for providing the asset to the customer, using IAS 11 or IAS 18 as applicable. If the asset meets the applicable recognition criteria, the asset shall be recognised as PP&E in accordance with IAS 16 and at the same time the entity should recognise a liability equal in amount to the cash contributed. That obligation should be released into the income statement over the shorter of the life of the asset or the period over which the access provider has an obligation to provide access.

Summary of EFRAG’s position

- 2 EFRAG broadly agrees with the accounting result achieved by applying this draft Interpretation when the recipient of the contribution enters into an obligation of the type described in the draft Interpretation. However :
 - (a) we are concerned that some of the wording in the consensus seems to assume that in all cases the access provider accepts an ongoing obligation to provide access in return for the contribution. We think the draft needs to state more clearly that whether the access provider has accepted such an obligation will depend on the terms of the transaction and the circumstances involved; and that if it receives a contribution but has no obligation then the whole of the value of the contribution is an immediate gain. Alternatively, the scope needs to be clarified to ensure that constituents understand that D24 is dealing only with customer contributions that involve ongoing obligations of the type described in the draft Interpretation.
 - (b) we further think that it is unclear if the draft Interpretation is limited to cases where the access provider must provide access with the specific item contributed. (see paragraph 8 below). If that would be the case, we agree with the proposed capping of the period over which revenue can be recognised. However, an obligation to provide access using the specific asset contributed is only one of many possible scenarios. We think that in many other cases the proposed capping would be inappropriate. As indicated above in paragraph 2(a), we are of

the opinion the obligation should always be released over the period over which the terms of the transaction give the customer the right of access.

- 3 We think the draft approaches the transaction in an overly complex way, and the result is an Interpretation that is difficult to follow and understand. In particular, we think it would have been much clearer had the draft first looked at cash contributions. That would have emphasised that the central issue to be answered in order to characterise the transaction correctly is whether there has been a sale and, if there has not been a sale, what, if anything, has the access provider given up or accepted in return for the contribution. Having established the method to be adopted to characterise a cash contribution, that same method could then have been applied to a non-cash contribution (ie a customer contribution). We believe that this is a more intuitive approach to the question at hand.
- 4 This approach would in particular cause us to look at the transaction in the following way. 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.
- 5 As the form of payment should not impact the accounting treatment, this would be the approach regardless of whether the contribution is cash or non-cash.

DETAILED COMMENTS

Scope

- 6 According to paragraph 4 of the draft Interpretation, the Interpretation will apply to all situations in which an entity receives an item of property, plant & equipment (PP&E) or cash to construct or acquire an item of PP&E that must be used to provide access to a supply of goods or services. We think this scope paragraph is unclear in a number of respects.
- 7 Firstly, although paragraph 4's wording seems to indicate that the draft proposals apply to *all* customer contributions, the Basis for Conclusions (in particular BC 17-19) seem to limit D24's application to cases where there is an ongoing obligation to provide access; in other words, the Basis appears to suggest that the scope excludes transactions where the access provider's sole obligation is to connect the contributor and where the contributor would pay for the ongoing access separately. We believe that the IFRIC should clarify this.

- 8 Additionally, it is unclear if the draft Interpretation is limited to cases where the access must be provided with the specific item contributed. If for example the access provider is able to replace the asset received, would that be out of scope? We think that the Interpretation would be much more useful, if those transactions would be in the scope, but recognise that this would result in the need to make consequential changes to the proposed accounting treatment (see for example our comments in paragraph 2 above).
- 9 Similarly, 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. Again we think it would be useful if the IFRIC could clarify to which parties the draft Interpretation would be applicable.
- 10 Fourthly, if one reads paragraph 4 literally, it would suggest that, in the case of cash contributions, the draft Interpretation applies only when the access provider does not have the item(s) of PP&E involved and must either acquire or construct them. However, we suspect it is not the IFRIC's intention to exclude those cases where the access provider uses PP&E already in stock. We suggest that another look is taken at the wording to ensure it reflects the IFRIC's intentions here.

Recognition of a customer contribution as an asset

Does the Interpretation need to say anything on this issue?

- 11 The draft Interpretation points out in paragraph 8 that an entity that has received a customer contribution shall assess whether the contributed item qualifies for recognition as an asset and, if it does qualify, that item should be recognised as PP&E and measured on initial recognition at its fair value.
- 12 To that end, the draft says the entity needs to assess whether it controls the item and whether future economic benefits are expected to flow to it from the item. The IFRIC noted (BC 7) that determining whether a contributed item qualifies for recognition is no different from determining in any other circumstance whether an item of PP&E should be recognised. For that reason, the IFRIC decided that, beyond emphasising the need to consider all the terms and conditions of the arrangement, no further guidance should be provided on whether to recognise an asset.
- 13 EFRAG has the impression, a point seemingly acknowledged in BC4, that in practice the uncertainties surrounding customer contributions relate more to the question of measurement of the asset and liability than to recognition. If that understanding is correct, we wonder whether it would be better to omit the little that is said in the draft Interpretation on recognition.

Definition and recognition of an asset

- 14 Putting that aside, EFRAG has some concerns about the current drafting of this part of the consensus. In particular, although the title of this part of the consensus refers to 'recognition', the text in paragraphs 9 – 10 is about whether what the recipient has received is an asset (ie whether an asset exists). We think therefore the discussion is mixing two separate issues, namely the existence of an asset and the recognition of an asset that exists. We suggest that:
 - (a) the heading is amended to make clear that the section is about both "existence" and "recognition";
 - (b) the material in paragraphs 9 – 10 on the existence of an asset is, subject to the comments in the next paragraph, retained; and

- (c) some material is added after paragraphs 9 – 10 on the recognition of an asset. As the scope of D24 explicitly refers to items of PP&E only, EFRAG believes that the additional material should refer to the existing guidance in IAS 16.
- 15 The material in paragraphs 9 – 10 is, we think, useful in assessing the existence of an asset (although we have doubts as to whether any guidance on this issue is needed - see paragraph 13 above). However:
- (a) we think that it would be much more useful if it would be elaborated on by the inclusion of additional application or implementation guidance; and
 - (b) we note that the wording used in paragraph 10 (“power to restrict others’ access to those benefits”) seems not to come from the Framework. Although we appreciate that these words are sometimes used to describe the notion of control (and the new Framework might go in that direction), the IFRIC should use existing Framework language to avoid any confusion.

Measurement of the asset

- 16 Although EFRAG believes that measuring the asset received at its fair value is an appropriate accounting outcome, we find the reasoning in the basis for conclusions rather unhelpful. That is because the conclusion that the asset received should be fair valued is based on IAS 16.24; and, although that paragraph applies only if, inter alia, PP&E has been exchanged for a non-monetary asset or assets (or a combination of monetary and non-monetary assets) and that exchange transaction has commercial substance, the IFRIC does not explained convincingly how those criteria are met.
- 17 For example, it seems questionable to us whether the access provider has given a non-monetary asset in exchange for the contributed PP&E. We note that the basis argues that the access provider has given in exchange an ability to access a supply of goods or services, but we think it will depend on the facts in each case. In this context we note that in some jurisdictions there is a legal obligation on the electricity network provider under the terms of its licence to provide everybody with access to electricity, a point that the basis itself acknowledges¹. In such circumstances it seems questionable whether the access provider is actually in a position to enter into a transaction where it gives away a right it does not control.² Another question would be how the cash flows exchanged are different enough to meet the commercial substance requirement.

Obligation to provide access to a supply of goods of services and provision of access to a supply of goods or services

Identification of the obligation

- 18 Paragraph 11 of the draft Interpretation states that an entity receiving a contributed asset that should be recognised has an obligation to provide access to a supply of goods or services. This obligation shall be recognised in the statement of financial position and measured on initial recognition at the fair value of the contribution (i.e. asset) received. Subsequently, the obligation shall be “reduced” and revenue recognised as access to the supply of goods or service is provided.
- 19 The obligation to provide access to a supply of goods or service may be to the contributor or to another party not identified (and maybe not identifiable) at the time of

¹ This is referred to in D24.18, although the implications for the discussion about the possible exchange of non-monetary assets are not discussed.

² In connection with the obligation – see paragraphs 18 – 21 – it also raises the question if in such industries all assets actually have an obligation attached to them.

the contribution. The IFRIC suggests in paragraphs 18 -19 that the obligation might arise as a result of a contract or of law or regulation or as a result of the entity's past action.

- 20 We think the draft Interpretation is not very clear about what this obligation represents and it would be much improved if it was clear on this point.
- (a) We recognise that this is an issue that is being addressed currently in the joint IASB/FASB Revenue Recognition project, but D24 deals with existing IFRS and under existing IFRS (IAS 18) we think the liability represents deferred revenue; revenue that is being deferred because payment has been received in advance of performance. We think the text of the consensus and basis for conclusions could be greatly simplified if this were made clear.
- (b) Even if we are wrong, we would strongly encourage the IFRIC to make it clear which standard is being interpreted in the material relating to the identification of and accounting for the obligation. Currently, no standard is referred to in the consensus or in the basis for conclusions.
- 21 We would also like to repeat a point we made in paragraph 2(a) above—there seems to be an assumption in the draft text that the access provider always has an ongoing obligation to provide access. We think that as a matter of fact this is not a correct assumption—it will depend on the facts in each case—unless the IFRIC's intention is to limit the scope of the proposed Interpretation to those circumstances in which the access provider does have ongoing access obligations.

Measurement of the obligation

- 22 It is difficult to comment on what D24 says about the measurement of the obligation when it is not clear (see paragraph 20 above) what the obligation represents and therefore which standard should be applied.
- 23 We think that measuring the obligation (if any) recognised at the fair value of the asset received is often appropriate, particularly as we believe the liability represents deferred revenue.
- 24 However, the value of the asset contributed might relate not only to the provision of access, but also to other parts (services, goods etc.) of the total contract. In such cases, the value of the obligation to provide access does not equal the value of contributed asset, but rather a fraction thereof. We therefore believe that reference to IAS 18.13 ("unbundling") is necessary to ensure that the facts and circumstance of the individual arrangement are taken into account and services are considered individually.

Recognition of revenue

- 25 In paragraphs 16 – 20 of the draft Interpretation, the IFRIC proposes that the period over which revenue is recognised (and therefore over which the obligation shall be reduced) shall be the period over which the entity has an obligation to continue to provide access to a supply of goods or services using the contributed asset. Paragraph 20 proposes that the period over which an entity has an obligation to provide access to a supply of goods or service using a contributed asset may be shorter than the useful economic life of the contributed asset, but it cannot be longer.
- 26 EFRAG agrees that the accounting treatment of the revenue should reflect the facts and circumstances involved. That means recognising revenue over the period to which it relates. In particular we agree that if the scope of the interpretation would be limited

to cases where it would not be possible to deliver access by the use of a different asset (see also our question in paragraph 9 above), we would agree that for this case the useful economic life indeed would be the upper limit. However, EFRAG believes that there are many other types of transactions where such a conclusion is worrisome:

- (a) EFRAG believes that, if full performance occurs at the time the contributed asset (the revenue) is received – in other words, if there is no obligation - the revenue should be recognised in full immediately in the income statement.

As we have already mentioned, we think the current draft is unclear on this issue. We think that the scope paragraphs imply that transactions where there is no ongoing access obligation are within the scope of the proposed Interpretation. Furthermore, BC17(b) acknowledges that one possibility is that the access provider's obligation is merely "to provide a connection to a network supplying goods and services. Once that connection has been made, the obligation is settled." Finally, D24.20 would not prevent an entity from recognising the revenue in full immediately.

However, BC18 and 19 explain that the IFRIC rejected the possibility that, once the connection has been made, the obligation is settled "because, in many cases, once the supplier receives the asset it has an ongoing obligation to maintain the asset in order to allow the customer to access a supply of goods or services. (...) The IFRIC therefore concluded that the obligation was to provide ongoing access to a supply of goods or services." And D24.11 and D24.16 seem to imply there is an ongoing access obligation.

We do not understand how the IFRIC could, having correctly concluded that *in many cases* there is an ongoing access obligation (BC18), have concluded that there is *always* an ongoing access obligation (BC19). BC9 is right to point out that ability to access (and therefore the access provider's access obligation) "may exist over a specific period of time, for example a contract period", but things would have been much clearer if it had said that the contract may impose no such obligation at all.

As we have already explained, we are of the opinion that 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.

- (b) If full performance does not occur at the time the contributed asset (the revenue) is received, EFRAG agrees that revenue should be recognised in the income statement (and the liability reduced) over time. EFRAG believes that the period over which revenue should be recognised depends on the terms of the transaction. Thus, if the access provider has an obligation to provide access for ten years, then that is the period over which the revenue should be recognised.

However, EFRAG does not agree with the proposal in D24 that this period cannot be longer than the useful economic life of the contributed asset. As we keep saying, it depends on the terms of the transaction, and therefore could be longer than the life of the contributed asset.

We therefore believe that D24 provides the correct solution for a very limited type of transactions (i.e. those where there is an ongoing access obligation using the specific

asset contributed), while it does not allow an appropriate accounting for many other types of arrangements that include customer contributions.

Determining whether the ongoing arrangement contains a lease

Application of IAS 17

27 The draft Interpretation indicates in paragraphs 12 – 15 that an entity that has received an asset as a result of a customer contribution shall assess—based on IAS 17 and IFRIC 4—whether the ongoing arrangement to provide access to a supply of goods or services using that the asset contains a lease. In the event that the entity concludes that the ongoing arrangement has resulted in a finance lease, the IFRIC proposes that the entity does not have an asset and has settled its obligation to provide the customer with access. The entity therefore recognises neither the contribution nor an obligation. If the entity determines that the ongoing service arrangement contains an operating lease, it shall account for that lease in accordance with IAS 17. EFRAG agrees with this.

Application of IFRIC 4

28 D24 does not contain any specific guidance to help preparers determine whether their customer contribution arrangements involve a lease. Rather, it refers to the existing guidance in IFRIC 4.

29 IFRIC 4 states that, to determine whether an arrangement is, or contains, a lease, one needs to assess whether:

- (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets; and
- (b) the arrangement conveys a right to use the asset.

30 IFRIC 4.8 indicates that an asset might have been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practical for the supplier to perform its obligation through the use of alternative assets. EFRAG believes that, in the cases discussed in D24, the fulfilment *is* implicitly dependent on the use of a specific asset³.

31 IFRIC 4.9 sets out the conditions that must be met to convey a right to use the asset. One of the conditions refers to the end-customer's ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output.

32 EFRAG understands that it has been suggested that in the vast majority of cases customer contribution arrangements (at least for “whole life asset” arrangement) will meet this test, which means that for many customer contributions nothing at all would be accounted for. If that is indeed the case, it would be helpful if the final Interpretation made that clear and the drafting of paragraph 14 of the consensus improved to simplify the message been given. In any case, we think some kind of application guidance on this aspect of the Interpretation would be useful.

³ IFRIC 4.8 indicates that an asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

Accounting for a cash contribution

- 33 Under paragraph 21 of the draft Interpretation, an entity that receives a cash contribution shall first consider whether the asset that must be acquired or constructed as a result of receiving the cash contribution would meet the criteria for recognition by the entity as an item of PP&E.
- (a) If it would not meet the criteria, the entity shall account for the cash contribution as proceeds for providing the asset to the customer (using IAS 11 or IAS 18).
 - (b) If it would meet the criteria, it shall be recognised as PP&E and measured in accordance with IAS 16. At the same time, an obligation shall be recognised and accounted for in the way described above.
- 34 The IFRIC argues in the basis of conclusion (BC23) that the economic effect of a cash contribution is similar to the effect of a contribution of an item of PP&E. The IFRIC therefore concludes that an entity receiving a cash contribution has the same obligation as an entity receiving an item of PP&E. The IFRIC further concludes (BC27) that the network provider was constructing an asset for its own use in providing access; and, whilst that might be an activity that is necessary to provide that service, it is not, in itself, a service to the customer that generates revenue. Based on this, the IFRIC rejected various alternative solutions in favour of the proposal laid out in paragraph 33 above.
- 35 We think the discussion in the basis relating to this part of the consensus perfectly illustrates our earlier comments about the rationale underlying D24. For example, it seems odd to us that it is only when we get to cash contributions that the different ways of looking at the contributions are raised and discussed—this should have been discussed when the non-cash contribution was being analysed. We wonder in particular, why the term “advance payment” has not been used in the draft.
- 36 Another concern that we have is that it would appear from the consensus and basis of conclusion that, in case of a cash contribution, there is no need to consider the existence of a lease. It is not clear to us why that should be so, we thus suggest the IFRIC clarify its proposal in this respect.

Transition

- 37 The IFRIC proposes in D24.24 that the final Interpretation should be applied prospectively. Although EFRAG normally prefers a retrospective application (because it enhances the comparability of financial information), we agree with the concerns raised by the IFRIC in BC33 and therefore support prospective application in this case.

Other comments

- 38 The label ‘customer contribution’ is misleading, because it actually refers to contributions that might not be from a customer and it refers to only certain types of contribution (ie non-cash). We suggest the draft uses ‘cash contribution’ and ‘non-cash contribution’.
- 39 We think the scope of the Interpretation would be easier for the reader to grasp if its opening paragraphs set out some examples of the types of transaction being addressed.
- 40 We are somewhat concerned that there might be a potential overlap between D24 and other IFRSs, such as IFRIC 12 and IAS 20. We believe that the IFRIC should work out and explain more clearly the distinguishing factors between the different parts of the

IFRS literature in order to avoid confusion as to which part of the IFRSs should be applied in the various situations.