UITF abstract 36
Contracts for sales of capacity

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The issue

Entities in some industries enter into contracts that convey the right to use some or all of the capacity of a physical asset. Examples are found in the telecommunications and electricity industries where entities buy and sell capacity on each others' networks. Whilst the capacity provider will retain ownership of the network assets, some contracts convey indefeasible rights of use (usually referred to as IRUs) to the buyer for an agreed period of time. Some contracts convey the right to use identifiable physical assets (or identifiable physical components of larger infrastructure assets); others convey the right to use a specified amount of capacity, defined in terms of an asset's output, rather than the right to use a specific physical item. The UITF decided that it should develop guidance on certain issues that arise in accounting for such transactions. 1

In this Abstract the parties to a contract that conveys a right of use are referred to as 'seller' and 'buyer', notwithstanding that analysis of the transaction may have the effect that the 'seller' continues to recognise the asset in its balance sheet. 2

The issues addressed in this Abstract are: 3

(a) Should the seller report the transaction as a sale (thereby derecognising an asset or a component of a larger asset), or should the seller continue to recognise existing assets in their entirety (thereby recognising income over the life of the contract)?

(b) In the performance statements, should the seller present gains and losses arising from the transaction as operating revenues and costs or as gains and losses on the disposal of fixed assets?

(c) How should transactions be accounted for where, rather than selling capacity for cash (or the right to receive cash), an entity exchanges capacity on its own network for capacity on another entity's network?

Derecognition issue

Contracts that convey rights of use are in many respects akin to leases. SSAP 21 *Accounting for leases and hire purchase contracts* defines a lease as: 4

"a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. The term 'lease' as used in this statement also applies to other arrangements in which one party retains ownership of an asset but conveys the right to the use of the asset to another party for an agreed period of time in return for specified payments".

From the lessor's perspective, SSAP 21 precludes accounting for the lease as a sale (thereby derecognising the asset that is the subject of the lease) unless the lease is a finance lease, ie "a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee". Assets held under operating leases should continue to be recognised in their entirety (as fixed assets) and rental income from the lease should be recognised (normally on a straight-line basis) over the period of the lease.

5 The derecognition principles in FRS 5 *Reporting the Substance of Transactions* (paragraph 22) require that a previously recognised asset should cease to be recognised (and should, therefore, be accounted for as an outright sale) where the transaction transfers (a) all significant rights or other access to benefits relating to that asset, and (b) all significant exposure to the risks inherent in those benefits. FRS 5 also addresses (in paragraph 23) special cases where transactions do not completely transfer all significant benefits and risks, but nonetheless result in a significant change in an entity's rights to benefits and exposure to risks. In such cases an entity needs to consider whether the description or monetary amount of the asset needs to be changed and also whether a liability needs to be recognised for any obligations assumed or risks retained. A contract that transfers an item for all of its life but where the seller retains some significant right to benefits or exposure to risk is an example of such special cases. Paragraph 24 of FRS 5 emphasises that where the amount of any resulting gain or loss is uncertain, full provision should be made for any probable loss but recognition of any gain, to the extent it is in doubt, should be deferred.

6 Derecognition of an asset by the seller and recognition of the same asset by the buyer implies that control is transferred to the buyer. Control is defined in FRS 5 as "the ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits".

7 It follows from the principles in FRS 5 and SSAP 21 that the criteria for derecognition in relation to a contract for rights of use cannot be satisfied unless a specific asset component can be identified as having been 'sold' to the buyer. The UITF considers that the purchaser's right of use should be exclusive and irrevocable, such that no other party, including the seller, would have the right to use the capacity that is the subject of the contract, even if the buyer is not using it. The term of the contract should be for a major part of the asset's useful economic life. An asset component might be tangibly separable (such as a specific cable or specific fibres) or the technology might allow an asset component to be intangibly separable (such as a specific wavelength); however, in either case the buyer's exclusivity must be guaranteed. If the seller had the right to perform its contractual obligations to deliver capacity by substituting other assets, the contract would not convey the right to use a specific asset and would not, therefore, qualify to be reported as the sale of an asset.

Where the capacity 'sold' is part of a larger infrastructure, it may be difficult to measure its cost or carrying value reliably, with the result that any gain or loss that would be recognised would be uncertain. Where the cost or carrying value cannot be measured reliably, the UITF takes the view that a specific asset component cannot be identified and the seller should not report the transaction as the sale of an asset. 8

In contracts for rights to use components of networks, the seller will often have some continuing involvement in making the asset available to the buyer, which may result in the seller retaining significant risks. In practical terms, this means there is no sale. The following are examples of risks that, if they are significant and are borne by the seller, serve as indicators that the seller should continue to recognise an asset in its entirety: 9

(a) risk of changes in asset value;

(b) risk of obsolescence or changes in technology;

(c) risk of damage;

(d) risk of unsatisfactory performance (arising, for example, from performance guarantees);

(e) risks relating to the seller's obligations to provide continuing access by operating and maintaining the assets (arising, for example, from exposure to costs that cannot be recovered from the buyer).

Performance reporting issue

As discussed above, some contracts for sales of capacity result in the seller continuing to recognise existing assets in their entirety. Income from the contract is then recognised over the life of the contract. Both income and expenses (including depreciation of the relevant fixed assets) are reported in operating results in accordance with FRS 3 *Reporting Financial Performance*. 10

Other contracts are reported as sales of assets. It is necessary to determine whether the asset that is the subject of such a contract is a fixed asset or a current asset (ie stock). The classification determines whether any gain or loss is reported as a profit or loss on the disposal of a fixed asset or whether the sale proceeds and the costs of sale are reported respectively as turnover and operating costs.* 11

FRS 15's definition of tangible fixed assets refers to assets "held for use in the production or supply of goods or services, for rental to others, or for administrative purposes on a continuing basis in the reporting entity's activities". The business models of some entities include investment in capacity for resale as well as for use in 12

* Treating proceeds of sale of fixed assets as turnover would contravene FRS 3. Paragraph 20 requires profit or losses on the disposal of fixed assets (except for marginal adjustments to depreciation) to be shown after operating profit.

the supply of services, such that similar assets may be held as current assets and fixed assets. The UITF takes the view that proceeds from disposals should not be reported in turnover unless the assets were designated as held for resale (and classified as stock) when they were acquired or on completion of construction. Capacity that was acquired or constructed to be used to supply ongoing services should not be transferred from fixed assets to stocks if capacity subsequently becomes surplus to the business' own requirements.

13 If sales of assets are reported in operating results, and within the same reportable segment as the supply of ongoing services, the UITF takes the view that an analysis of turnover and profits should be clearly disclosed.

Exchange transactions

14 An entity may sell capacity on a network in exchange for receiving capacity on another entity's network. In some cases the two capacities are of a similar value and little or no cash is exchanged. In other cases, capacity is sold wholly or in part for cash (or the right to receive cash) and a separate agreement is entered into with the buyer at approximately the same time to purchase capacity of a similar value. Such cases are referred to in this Abstract as 'reciprocal transactions' where this reflects the substance of the transaction, even though the agreements may contain no reference to reciprocity.

15 No accounting recognition should be given to transactions that are artificial or lacking in substance, which would be the case, for example, if exchange or reciprocal transactions were entered into for capacity for which the transacting parties had no current need and which would be unlikely otherwise to be saleable. Accordingly, in the following discussion it is assumed that there is a proper commercial rationale for entering into exchange or reciprocal transactions and that they provide economic benefits to the transacting parties.

16 The derecognition issues considered in paragraphs 4 to 9 above are relevant in determining whether or not capacity provided in an exchange transaction should be accounted for as the sale of an asset or the provision of a service. If the appropriate treatment is to report the sale of an asset, the presentation issues considered in paragraphs 10 to 13 above are relevant in determining how recognised gains and losses, if any, should be presented in the performance statements. If continued recognition is the appropriate treatment, turnover, if any, is recognised over the life of the contract. Recognition of gains and turnover is, however, subject to the criteria set out below.

17 The recognition criteria in the *Statement of Principles for Financial Reporting* require (a) sufficient evidence and (b) measurement at a monetary amount with sufficient reliability. Where a contract to provide capacity is for a cash consideration, the transaction evidences the fair value of the asset or services provided. In contrast, measurement of the fair value of the asset or services provided (and received) is much more difficult where capacity is provided in exchange for capacity received. Where

reciprocal transactions are entered into, an exchange of cash between the transacting parties for equal or substantially equal amounts does not provide reliable evidence of fair value. An exchange that involves part cash consideration does not provide reliable evidence of the fair value of the entire transaction.

The UITF decided that it would be appropriate to recognise turnover or gains in respect of exchange and reciprocal transactions only if fair value can be determined by reference to observable transactions in an active market, ie where the assets or services provided or received have a readily ascertainable market value as defined in FRS 10 *Goodwill and Intangible Assets*. 18

Application to smaller entities

Reporting entities applying the *Financial Reporting Standard for Smaller Entities* currently applicable are exempt from this Abstract. 19

UITF consensus

A seller of a right to use capacity should not report the transaction as the sale of an asset, or of a component of a larger asset, unless: 20

(a) the purchaser's right of use is exclusive and irrevocable;

(b) the asset component is specific and separable (such that the buyer's exclusivity is guaranteed and the seller has no right to substitute other assets);

(c) the term of the contract is for a major part of the asset's useful economic life;

(d) the attributable cost or carrying value can be measured reliably; and

(e) no significant risks, as indicated in paragraph 9, are retained by the seller.

Where a transaction is reported as the sale of an asset, the proceeds should be reported as turnover only if the assets were designated as held for resale (and classified as stock) when they were acquired or on completion of construction. Otherwise such transactions should be reported as disposals of fixed assets. 21

Where transactions are reported as asset sales in operating results, amounts included in turnover and profits from these transactions should be clearly disclosed. 22

Turnover or gains in respect of contracts to provide capacity in exchange for receiving capacity should be recognised only if the assets or services provided or received have a readily ascertainable market value. The same principle applies to reciprocal transactions to provide capacity entered into wholly or in part for a cash consideration. No accounting recognition should be given to transactions that are artificial or lacking in substance. 23

Date from which effective

24 The accounting treatment required by this Abstract should be adopted in financial statements relating to accounting periods ending on or after 22 June 2003, but earlier adoption is encouraged.

References

ASB pronouncements

FRS 3 *Reporting Financial Performance*
FRS 5 *Reporting the Substance of Transactions* – paragraphs 14, 21-25, 67-75
FRS 10 *Goodwill and Intangible Assets* – paragraph 2
FRS 15 *Tangible Fixed Assets* – paragraph 2
SSAP 21 *Accounting for leases and hire purchase contracts* – paragraphs 14-15
UITF Abstract 26 *Barter transactions for advertising*
ASB *Statement of Principles for Financial Reporting* – Chapter 5