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IFRS industry insights

The Revenue Recognition Project – An update for the telecommunications industry

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During April – June 2011, the IASB and FASB ('the Boards') continued their discussions on the revenue recognition project and made a number of tentative decisions, some of which differed from the proposals in the exposure draft (ED) that was issued last year. Specifically the Boards reached tentative decisions on uncertain consideration, licences and rights to use intangible assets and financial statement disclosures and modified their previous tentative decisions on contract costs and the onerous contract test. These are some of the topics that the telecommunications industry respondents expressed concern over in their comment letters on the ED. Also, the Boards tentatively decided to re-expose their tentative decisions for public comment. In this issue of our IFRS Industry Insights series for the telecommunications industry, we discuss these topics and effects the tentative decisions may have on the telecommunications industry.

During May 2011, the Boards hosted an education session with invited representatives from the telecommunications industry. The purpose of this meeting was to provide an opportunity for the representatives to discuss industry views and concerns about the proposed revenue recognition model. The representatives supported the Boards' objectives for convergence, consistency and simplification for revenue recognition. However, the representatives expressed concern that the tentative decisions reached by the Boards would not accurately portray the economics of the transactions entered into by telecommunications entities thus reducing the decision usefulness of financial statements of entities within the telecommunications industry.

The representatives expressed concern about the proposal to identify separate performance obligations because doing so may significantly change the way mobile operators recognise revenue relating to subsidised handsets.

It is commonplace in a number of markets for handsets to be offered for free or at a heavily subsidised price upon a customer entering into an airtime contract for an extended period of time. The representatives indicated that the industry generally views the supply of a handset as being incidental to, rather than separate from, the provision of airtime under the contract. An industry representative proposed introducing a contingent revenue cap such that allocation of the transaction price to a satisfied performance obligation would not exceed the amount receivable without satisfying a future separate performance. Concern was expressed about applying the proposed requirements at the individual contract level and suggested that requirements should be conducted at a portfolio level (i.e., allow for contract aggregation) because that is the level at which contracts are generally evaluated today. The representatives indicated that changing to a portfolio level would reduce complexity and costs because billing systems are currently tied into the accounting systems at an aggregated level and not at the individual contract level.

In June 2011, the Boards tentatively decided not to revise the proposed model to address the concerns of the telecom industry. Several Board members noted that the objective of the revenue project was to create a single model that would be applied consistently across various transactions and industries and that it would not be possible to achieve that objective without affecting the accounting for some transactions and industries. In addition, other Board members noted that if they were to revise the proposed model in response to the concerns of the telecom industry, other industries might expect the Boards to revise the proposed model in response to their particular concerns.

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Uncertain consideration

The ED provides that an entity should measure revenue at the amount the entity expects to receive in exchange for satisfying a performance obligation. The ED proposed that an entity would estimate the amount of consideration that it expects to receive using an expected value method (i.e., probability weighted method).

Several telecom industry respondents expressed concern that estimating the transaction price using an expected value technique may not be suitable for all situations and may be overly complex to apply. The large number of possible combinations of services and products with different prices that are provided by the telecom industry makes the use of an expected value technique complex and costly to implement. In addition, due to the rapid and continuing change in the offerings and the short-time life cycle of the products, an entity's experience with similar types of contracts would not necessarily be useful for making reasonable estimates. The telecom respondents also noted that the recognition of contingent or variable revenue would result in the recognition of revenue that is not yet fixed and determinable which could result in an overstatement of revenue.

In April 2011, the Boards tentatively decided that an entity would generally determine the transaction price using an expected value technique. In applying an expected value technique, an entity would not be required to identify all possible scenarios but it is unclear as to the extent to which scenarios can be excluded. If an entity does not have the information to use an expected value technique or the distribution of the possible outcomes is such that the use of an expected value technique would not provide a reasonable estimate of the transaction price (e.g., binary outcomes), the entity would determine the transaction price using a best estimate technique.

The Boards also tentatively decided that an entity should recognise revenue at the amount allocated to a satisfied performance obligation unless the entity is not reasonably assured to be entitled to that amount. The entity would not be reasonably assured if:

- the customer could avoid paying an additional amount of consideration without breaching the contract;
- the entity has no experience with similar types of contracts; or
- the entity has experience, but that experience is not predictive of the outcome of the contract.

The tentative decision to require an expected value technique in most circumstances would require telecom participants that have the necessary information to apply an expected value technique to estimate the transaction price using multiple scenarios. This would be likely to require a significant amount of judgment and may result in financial statement volatility if there are changes in estimates. However, the tentative decision to allow for the use of a best estimate approach in certain circumstances would alleviate some of the respondents' concerns relating to unreliable estimates when there is a lack of information or only two possible outcomes.

An entity would need to consider in a separate step whether it is reasonably assured that they are entitled to the revenue allocated to a satisfied performance obligation. The terms of the contract and the extent of an entity's historical experience with similar types of contracts will be key factors in determining whether the reasonably assured threshold is met.

Example

A telecoms entity enters into a contract to provide telecom services and equipment to a customer and provides the customer a 'mail-in rebate' of CU50 related to the purchase of the equipment. Mail-in rebates are paid by the entity only if the voucher given to the customer at the point of sale is mailed back to the entity. The entity regularly enters into these types of contracts with customers and the outcome is binary (either the coupon will be redeemed in full or not). Based on its historical information, the entity estimates that there is a 70 percent probability that the customer will mail-in the rebate. In this case, the entity would be likely to use a best estimate technique which would result in a reduction of the transaction price of CU50. The transaction price would be allocated to the product and service if they are considered separate performance obligations. Revenue allocated to a satisfied performance obligation only would be recognised if the entity is reasonably assured to be entitled to the allocated amount.

Example

A telecoms entity enters into a two year contract with a retail customer to provide telecom voice services. The contract specifies that the entity will provide voice services which are priced at CU20 per line per month, for a minimum annual commitment of CU2.4 million revenues. The customer receives a 10 percent discount when revenues exceed the minimum annual commitment. Based on historical information and the entity's experience with similar contracts, the entity can reasonably estimate the likelihood of the customer receiving the discount. The entity uses an expected value method and estimates total expected consideration over the two years to be CU5,697,600 at the inception of the contract.

In April 2011, the Boards tentatively decided that the final standard should not distinguish between exclusive and non-exclusive licences.

Year 1

Monthly average voice services*	Monthly voice services fee**	Total consideration	Probability	Expected consideration
10,000	20.00	2,400,000	40%	960,000
12,000	18.00	2,592,000	25%	648,000
14,000	18.00	3,024,000	20%	604,800
16,000	18.00	3,456,000	15%	518,400
				2,731,200

Year 2

Monthly average voice services*	Monthly voice services fee**	Total consideration	Probability	Expected consideration
10,000	20.00	2,400,000	30%	720,000
12,000	18.00	2,592,000	20%	518,400
14,000	18.00	3,024,000	25%	756,000
18,000	18.00	3,888,000	25%	972,000
				2,966,400

* represents the range of expected monthly average voice services based on the entity's experience – with a minimum monthly base of 10,000 voice services to meet the annual minimum commitment of CU2.4 million (10,000 monthly average voice services * CU20 monthly voice services fee * 12 months).

** represents the monthly voice services fee of CU20 for a minimum monthly base of 10,000 voice services reduced by 10 percent discount for expected monthly average voice services that exceed the annual minimum commitment.

Licences and rights to use intangible assets

The ED provides guidance on how an entity would account for the licensing of its intellectual property. A licence that transfers control of the entire licensed intellectual property to the customer (e.g., an exclusive licence for the entire economic life) would be treated as a sale. An entity that licenses the use of its intellectual property but does not transfer control of the entire licensed intellectual property to the customer (e.g., a licence for less than its economic life) would need to determine whether the licence is exclusive or non-exclusive. For exclusive licences, the performance obligation would be extinguished over time so revenue would be recognised over the term of the licence. For non-exclusive licences, the performance obligation would relate only to transfer of the licence and therefore revenue would often be recognised at the date the customer is able to use the licence.

The granting of licences and other rights of use are prevalent for those in the telecoms industry that provide software to customers, typically as part of managed service or network solutions or the right to use excess capacity on network systems of other telecoms entities. Several telecom industry respondents indicated that exclusivity is not reliable evidence to determine which party is controlling the benefits. These respondents noted that exclusivity does not affect the nature of an entity's performance obligation and therefore it would be counterintuitive to have different patterns of revenue recognition depending on whether a licence is exclusive. These respondents noted that whether a performance obligation has been satisfied or not should be assessed with regard to the continuing involvement of the entity.

In April 2011, the Boards tentatively decided that the final standard should not distinguish between exclusive and non-exclusive licences. The Boards tentatively decided that in a contract in which an entity grants a licence to a customer, the promised asset is the licence and the promise to grant that licence represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the licence (i.e., when the customer obtains control). However, in some circumstances, the entity would recognise licence revenue continuously because either (a) the licence is not separable from other performance obligations in the contract or (b) the contract includes an amount of the transaction price allocated to the performance obligation that is not reasonably assured to be received.

The tentative decision not to distinguish between exclusive and non-exclusive licences would address the concerns of some in telecom industry respondents. However, there may be circumstances when an entity would recognise licence revenue continuously over the contract term depending on the terms of the contract.

Contract costs

The ED would require contract costs to be capitalised only if the costs give rise to an asset in accordance with other IFRSs, or relate directly to the contract, generate or enhance resources of the entity that will be used in satisfying future performance obligation and are expected to be recovered. Therefore, amounts paid to obtain a customer contract such as costs of selling, marketing, advertising and negotiations would be expensed when incurred.

In February 2011, the Boards changed their view and tentatively decided that "incremental costs" expected to be recovered would be capitalised.

Subscriber acquisition costs are significant for many telecoms entities and the proposed treatment was an area highlighted in many comment letters. Some telecoms entities treat subscriber acquisition costs as an intangible asset and these costs typically include sales commissions. The ED would require these types of costs to be expensed when incurred.

In February 2011, the Boards changed their view and tentatively decided that "incremental costs" expected to be recovered would be capitalised. Incremental costs are those costs that are directly attributable to obtaining a contract that would not have been incurred if the contract had not been obtained (e.g., commissions).

Additionally, in May 2011, the Boards tentatively decided to permit the recognition of contract acquisition costs as a period cost (as opposed to capitalising these costs) for contracts with an expected duration of one year or less. The Boards also tentatively decided that capitalised contract acquisition costs should be amortised on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates, which may include goods or services beyond those that are promised in the initial contract (e.g., renewal periods). The Boards supported only permitting an entity to look forward beyond the initial contract period if the entity has demonstrated that it has sufficient historical experience indicating that the contract will be renewed with the same customer.

The tentative decisions clarify the accounting for typical acquisition costs incurred by many telecom entities. The tentative decisions would require some types of acquisition costs (e.g., marketing and selling expenses) to be expensed as incurred while other types of acquisition costs (e.g., sales commissions) would be capitalisable. Telecom industry respondents would also need to determine their accounting policy in relation to acquisition costs for contracts with duration of one year or less.

Onerous contract test

The ED would require an entity to evaluate an individual performance obligation to determine whether it is onerous. A performance obligation would be onerous if the direct costs that would be incurred to satisfy the obligation are greater than the allocated transaction price. If so, a separate liability would be recognised for that individual performance obligation.

Some respondents from the telecommunications industry expressed concern about applying the onerous test at the performance obligation level and suggested that the onerous test be conducted at the contract level as they were concerned about performance obligations being identified as onerous at contract inception even if the contract as a whole is profitable – leading to a loss at inception of the contract (the common practice of offering free, or heavily subsidised, handsets as an incentive to enter into an airtime contract was cited as a situation in which the ED's proposals would not reflect the economics of the transaction).

These respondents believe that the contract is the right unit of account because items are often not priced at a performance obligation level but rather at a contract level.

In February and March 2011, the Boards changed their view and tentatively decided that an entity would conduct the onerous test at the contract level. The Boards also discussed whether an entity should recognise an onerous liability at the contract level or a higher unit of account upon entering into a contract that is priced at a loss in the expectation of obtaining future profitable contracts ('loss leader contracts'). The Boards tentatively decided that an exception should not be provided for loss leader contracts and therefore the onerous test would be applied at the contract level.

In May 2011, the Boards tentatively decided to limit the scope of the onerous contract test to long-term service contracts. The definition of long-term will be discussed at a future meeting. Any entity would be required to separate goods and long-term services from a single contract and apply the onerous contract test to the long-term services using the allocated transaction price. The Boards also tentatively decided to modify the onerous test such that when more than one contract is satisfied at the same time by a single act, an entity would recognise an onerous liability only when those contracts are (collectively) expected to be onerous. For example, contracts to individual customers for airline tickets or an entertainment show would not be subject to an onerous contract test.

While the Boards' tentative decision to conduct the onerous test at the contract level will alleviate some concerns about recognising losses at the inception of a profitable long-term service contract, some telecoms entities may still need to recognise losses at inception for those entities that supply certain products or services as a loss leader on the basis of an expected future profitable contract with the same customer. However, as discussed above, some individuals from the telecom industry believe that the assessment of many of the requirements of the final standard should be performed at a higher unit of account than the contract level (i.e., the portfolio level) as that is the level at which many contracts are assessed today.

Disclosures

The ED would require the entity to disclose extensive quantitative and qualitative information about its contracts and the significant judgements made in applying the proposals to those contracts. The ED would require that an entity provide, at minimum, revenue disaggregated into categories, a reconciliation of contract balances, a description of the entity's performance obligation including a maturity analysis of outstanding performance obligations and liabilities recognised for onerous performance obligations.

Several respondents suggested that the disclosures should not be mandatory but be presented as an indicative list of possible disclosures for management to consider.

While there was general support from the telecom industry respondents for the disclosure objective, most of the telecom respondents did not agree with the proposed package of disclosures. Several respondents suggested that the disclosures should not be mandatory but be presented as an indicative list of possible disclosures for management to consider. The respondents also noted that some of the disclosures proposed may provide useful information only to users of the financial statements of entities that operate in particular industries. Some respondents also noted that some of the disclosures proposed might duplicate other disclosure requirements such as the segment reporting disclosures required by IFRS 8 *Operating Segments.*

The Boards tentatively decided to retain the disclosures proposed in paragraphs 69-83 of the ED, subject to the following clarifications and changes:

In the disaggregation of revenues:

- include additional examples of potential categories (e.g., contract duration, timing of transfer and sales channel) of which to disaggregate but should not prescribe how an entity should disaggregate revenue;
- require an entity to use several categories to disaggregate revenue if necessary to meet the disaggregation objectives outlined in the ED;
- not require an entity to disaggregate any expected impairment loss; and
- permit an entity to disaggregate revenues either on the face of the statement of comprehensive income or in the notes to the financial statements.

In the presentation of contract assets and liabilities:

- require the presentation of net contract assets and net contract liabilities as separate line items in the statement of financial position;
- permit provision of additional detail about contract assets and receivables either on the face of the financial statements or in the notes to the financial statements;
- permit the use of labels other than ‘contract asset’ or ‘contract liability’ on the statement of financial position in describing these balances, assuming sufficient information is available to users to distinguish between conditional and unconditional rights to consideration; and
- require a reconciliation of contract assets and contract liabilities during the period.

In relation to the remaining performance obligations as of period end:

- require a maturity analysis of remaining performance obligations from contracts with an original expected duration of more than one year on the basis of the transaction price determined under the proposed model.

In relation to assets derived from acquisition and fulfilment costs:

- require reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfil a contact with a customer, by major classification, at the beginning and end of the period, in conjunction with separate disclosure of additions, amortisation, impairments and impairment losses reversed.

The Boards’ tentative decision to clarify certain disclosure requirements will ease some of the concerns raised by the telecom respondents. However, many of the telecom industry’s concerns that the disclosure package would be costly and difficult to implement continue to exist.

Transition requirements

The ED would require that an entity should apply the new standard retrospectively in accordance with IAS 8 *Accounting Policies*, *Changes in Accounting Estimates and Errors*.

The majority of the telecoms respondents noted that while retrospective application would provide users with useful trend and comparable information, they felt that retrospective application of the proposed model was not feasible for telecommunications companies because it would require the assessment of a significant number of contracts over at least three years. These respondents also noted that most of the data required by the proposed model are currently not recorded and that the implementation of the appropriate procedures would be expected to take a significant time and be cost prohibitive.

The Boards tentatively decided to re-expose the revenue standard.

In June 2011, the Boards tentatively decided that an entity would adopt the revenue standard either by applying a full retrospective approach or adopting a retrospective approach subject to the following reliefs:

- not require restatement of contracts that begin and end within the same prior accounting period to be restated;
- allow the use of hindsight in estimating variable consideration;
- not require recognition as assets of fulfilment and acquisition costs recognised as an expense in prior periods;
- not require the onerous test to be performed in comparative periods but only at the effective date unless an onerous contract liability was recognised previously; and
- not require disclosure for prior periods of the maturity analyses of remaining performance obligations in the first year of application.

The Boards also tentatively decided that if an entity adopts the standard retrospectively subject to any of the above reliefs, it would be required to state which reliefs have been employed by the entity and provide a qualitative assessment of the likely effect of applying those reliefs.

The tentative decisions to include some relief from full retrospective application of the new standard will alleviate some concerns from the telecom industry. However, even with the availability of the reliefs, a significant amount of cost and effort would be required to adopt the revenue standard.

Re-exposure of tentative decisions

The Boards tentatively decided to re-expose the revenue standard. The Boards will seek comments from constituents on the understandability, clarity, operationality, interaction of paragraphs and wording of the overall re-exposure draft. The Boards will re-expose the tentative decisions in the third quarter of 2011 with a comment period of 120 days.

The Boards also tentatively decided to invite comments on four specific areas where constituents generally have not had the opportunity to comment on the revised requirements:

- determining when a performance obligation is satisfied over time (i.e. the additional guidance in response to concerns about control and services);
- presenting the effects of credit risk adjacent to revenue;
- constraining the cumulative amount of revenue recognised to amounts that are reasonably assured (rather than constraining the transaction price to amounts that can be reasonably estimated); and
- applying the onerous test to a performance obligation satisfied over a long period of time.

We will provide you periodic updates as significant decisions are reached by the Boards.

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