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IFRS industry insights

The Revenue Recognition Project – An update for the telecommunications industry

Many telecom respondents expressed concerns about the proposal to identify separate performance obligations …

In June 2010, the IASB and FASB ('the Boards') took a major step towards developing an entirely new revenue recognition standard by issuing a set of proposals in the form of an exposure draft (ED). These proposals would significantly affect the recognition of revenue recognised in the telecommunications industry. Since issuing the ED, the Boards have conducted extensive outreach. The comment period on the ED, which ended on December 15 2010, garnered over 950 responses, and afterwards the Boards hosted roundtable sessions that included participants from all constituencies, including preparers, users and auditors, from a wide cross section of industries. Respondents from the telecommunications industry expressed concern over a number of proposals in the ED, including the identification of separate performance obligations, contract costs, the onerous contract test and modifications of contracts. The Boards recently discussed those topics and made some tentative decisions which differ from the proposals in the ED. The Boards have been reaching out to constituents to gather feedback on some of these tentative decisions.

Identification of separate performance obligations

The ED would require that an entity evaluates all goods and services promised in a contract to determine whether there are separate performance obligations. An entity would account separately for all goods and services that are 'distinct', meaning that the good or service is either:

a) sold separately in the customer's market; or

b) could be sold separately because it would be useful in itself or in conjunction with another product that is available separately and has a distinct profit margin.

Once separate performance obligations are identified, revenue would be allocated to each based on their standalone selling prices.

Many telecom respondents expressed concerns about the proposal to identify separate performance obligations because it 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. Telecom respondents indicated that they view the supply of a handset as being incidental to, rather than separate from, the provision of airtime under the contract.

In February 2011, the Boards tentatively decided to retain the distinct concept with some revisions and add an additional criterion for identifying separate performance obligations. The additional criterion would require an entity to account for a bundle of promised goods or services as one performance obligation if the entity provides a service of integrating those goods or services into a single item that the entity provides the customer. The Boards indicated that this additional criterion should address concerns from the construction industry where a construction contractor is hired to construct an asset and provides both the materials and services. If that criterion is not met, a promised good or service, or a bundle of goods or services, would be treated as a separate performance obligation if the good or service has a distinct function, and the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract. The proposal that the good or service would need a distinct profit margin to be regarded as 'distinct' was tentatively eliminated.

The Boards requested the staff to perform further research and outreach to gather feedback from constituents on the tentative decision relating to indentifying separate performance obligations. It is unclear at this time if the Boards will revise further the proposals to address the concerns of the telecommunications industry.

Contract costs

The ED would require contract costs to be capitalised 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.

Subscriber acquisition costs are significant for many telecoms and the proposed treatment was an area highlighted in many comment letters. Some telecoms 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. Therefore, sales commissions and other costs incurred by telecoms that would not have been incurred if a customer contract had not been obtained would be capitalised. All other costs would be expensed when incurred. An asset would be recognised for capitalised costs and presented on the statement of financial position and subsequently measured on a systematic basis.

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.

The Boards' tentative decision to conduct the onerous test at the contract level will alleviate many concerns about losses at the inception of a contract but telecoms may still 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.

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Contract modifications

The ED would require that contract modifications be accounted for together with the existing contract if the prices of the modification and the existing contract are interdependent. In such a scenario, the cumulative effective of a modification would be recognised in the period in which the modification occurs. If prices of the contract modification and the existing contract are not interdependent; the contract modification would be accounted for as a separate contract.

Many telecom respondents commented that the ED was confusing and would not result in consistent application in practice as they thought that the principle of price interdependence was insufficient to help an entity determine whether to account for a contract modification as a separate contract or as a modification of an existing contract. Respondents also expressed concerns that they would encounter practical difficulties in accounting for contract modifications on a cumulative catch-up basis because they have large populations of contract modifications relating to changes in future goods or services to be delivered. The respondents believe that accounting for contract modifications on a prospective basis would provide a better reflection of the underlying economics of the arrangement.

In February 2011, the Boards tentatively decided that if a contract modification results in the addition of a separate performance obligation at a price that is commensurate with that additional performance obligation, the entity should account for the contract modification as a separate contract. Otherwise, the entity should re-evaluate the performance obligation and reallocate the transaction price to each separate performance obligation.

The Boards' tentative decision provides some clarity around the accounting for contract modifications. Telecom operators that modify their contracts by providing new distinct goods or services at a market price may be able to treat that modification as a separate contract. However, extensions of a contract at below market price may not be able to be treated as a separate contract resulting in a reallocation of the transaction price.

Another important issue highlighted in comment letters related to determining the transaction price when there is uncertain consideration. This issue was discussed in late March but no tentative decisions were reached, The Boards will discuss this issue along with a number of other issues before finalising the project and issuing a final standard. We will provide you periodic updates as significant decisions are made by the Boards.

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