

Accounting for revenue in the telecommunications industry

Counting the cost



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Overview of the revised proposals

The revised ED's core principle is that “an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services.”

The proposals

On 14 November 2011, the IASB and FASB (collectively “the Boards”) issued a re-exposure draft ED/2011/6 *Revenue from Contracts with Customers*. The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and deliberations on the proposals in the original ED that was issued in June 2010. Although the underlying conceptual basis is unchanged, the Boards changed many detailed aspects of the original ED's proposals. As a result of these changes, and given the importance of the revenue line item to users of financial statements, the Boards decided to expose for public comment a revised ED. The Boards are seeking comments from constituents on whether the proposals are clear and can be applied in a way that effectively communicates to users of financial statements the economic substance of an entity's contracts with customers.

The revised ED's core principle is that “an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services.” The proposals list five key steps for entities to follow in recognising revenue for contracts within the revised ED's scope:

- Step 1 – identify the contract with a customer;
- Step 2 – identify the separate performance obligations in the contract;
- Step 3 – determine the transaction price;
- Step 4 – allocate the transaction price to the separate performance obligations in the contract; and
- Step 5 – recognise revenue when (or as) the entity satisfies each performance obligation.

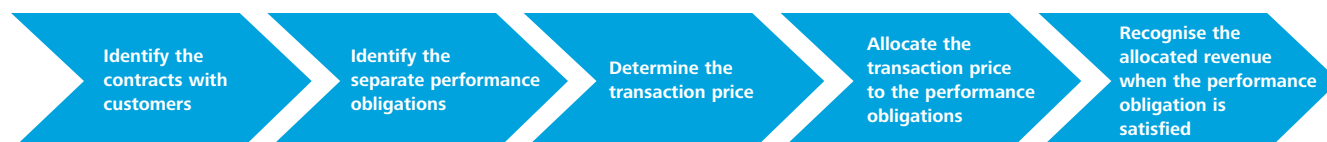
These steps are consistent with those identified in the original ED; however various changes have been proposed to their implementation as described below.

Step 1 – Identifying contracts with customers

In a manner consistent with the proposals in the original ED, the revised ED would apply to an entity's contracts with customers other than those within the scope of the leasing, insurance or financial instruments standards and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers other than the parties to the exchange. A contract must be with a customer, can be written, oral or implied and must create enforceable rights and obligations between two or more parties. The revised ED provides specific criteria for entities to consider in determining whether a contract exists. If all parties to a *wholly unperformed* contract can unilaterally terminate the contract without penalty, a contract would not be deemed to exist.

Step 2 – Identifying separate performance obligations

Both the original ED and the revised ED propose that a good or service would be accounted for as a separate performance obligation if it is deemed ‘distinct’. The original ED deemed an obligation to be distinct if the good or service is sold separately or could be sold separately because it has a distinct function and profit margin, raising concerns from many, particularly in the construction industry, that this could lead to identification of an unmanageably high number of performance obligations within a single contract. The revised ED responds to these concerns by refining the definition of ‘distinct’.





Per the revised ED and except as explained below, a good or service is distinct if either of the following criteria is met:

- (a) the entity regularly sells the good or service separately; or
- (b) the customer can benefit from the good or service either on its own or together with resources that are readily available to the customer.

Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct, and therefore the bundle of goods or services would be treated as a single performance obligation, if both of the following criteria are met:

- (a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- (b) the bundle of goods or services is significantly modified or customised in order to fulfil the contract.

The revised proposals note that, as a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer (e.g., if applying one method of measuring progress for the distinct goods or services would faithfully depict the transfer of those goods or services to the customer).

Step 3 – Determining the transaction price

The original ED proposed that if the transaction price is subject to variability, an entity would be required to use a probability weighted estimate of the transaction price if such an estimate can reasonably be made. The revised ED clarifies that “the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer”. The transaction price would include discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, concessions and other similar items. The estimation would reflect available historical, current and forecasted information and would be based on either the probability-weighted amount or the most likely amount (i.e., management’s best estimate), “depending on which method the entity expects to better predict the amount of consideration to which it will be entitled.”

One method would need to be applied consistently throughout the contract.

Step 4 – Allocating the transaction price to separate performance obligations

The original ED proposed that an entity should “allocate the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (i.e., on a relative standalone selling price basis).” The revised ED provides more flexibility in the estimation method used when the standalone selling price of a good or service is not directly observable. For example, a residual technique may be the most appropriate method for a performance obligation with a highly variable or uncertain standalone selling price. Discounts would generally be allocated to all separate performance obligations based on the relative standalone selling price unless each good or service is regularly sold separately and the observable selling price provides evidence of the performance obligation(s) to which the entire discount relates.

If the transaction price includes consideration that is contingent on a future event or circumstance, the entity would allocate that contingent amount and related subsequent changes entirely to one performance obligation (unlike the requirement proposed in the original ED to allocate subsequent changes in the transaction price to all performance obligations in the contract) when both of the following criteria are met:

- the contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or to a specific outcome from satisfying that separate performance obligation; and
- allocating the contingent amount entirely to that particular performance obligation is consistent with the ED's allocation principle, i.e., overall it reasonably reflects the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

All other subsequent changes in the transaction price would need to be allocated to the separate performance obligations on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation would be recognised as revenue, or as reduction of revenue, in the period in which the transaction price changes.

Step 5 – Recognising revenue as the performance obligations are satisfied

The original ED introduced the concept of 'control' in the determination of when a good or service transfers to a customer and, thus, when revenue is recognised, which may be at a point in time or over a period.

In producing the revised ED, the Boards decided to modify the proposed indicators of when a customer obtains control at a point in time and to provide additional guidance that an entity must consider in determining whether control transfers continuously over time (including clarifying how an entity should measure its progress towards completion of a performance obligation that is continuously satisfied).

Other key features of the revised ED

Constraining the cumulative amount of revenue recognised

For contracts with variable consideration, the revised ED imposes an additional constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which it is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
- the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

Onerous performance obligations

The revised ED retains the requirement of the original ED to assess for individual onerous performance obligations at inception of a contract, but limits that assessment to performance obligations that are satisfied over time and which are expected, at contract inception, to be satisfied over a period of greater than one year. The costs used in such a test and measurement of the onerous liability would be the lower of the direct costs to satisfy the performance obligation and the amount that the entity would have to pay to exit the performance obligation if the entity is permitted under the contract to do so other than by transferring the promised goods or services.

Costs of fulfilling or obtaining a contract

Costs of fulfilling a contract would be capitalised if "the costs relate directly to a contract (or a specific anticipated contract), the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and the costs are expected to be recovered." Examples of such costs might include direct labour and direct materials. However, general and administrative costs and costs of wasted materials would generally not be capitalised. The revised ED also clarifies that the costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract (i.e., pre-contract costs).

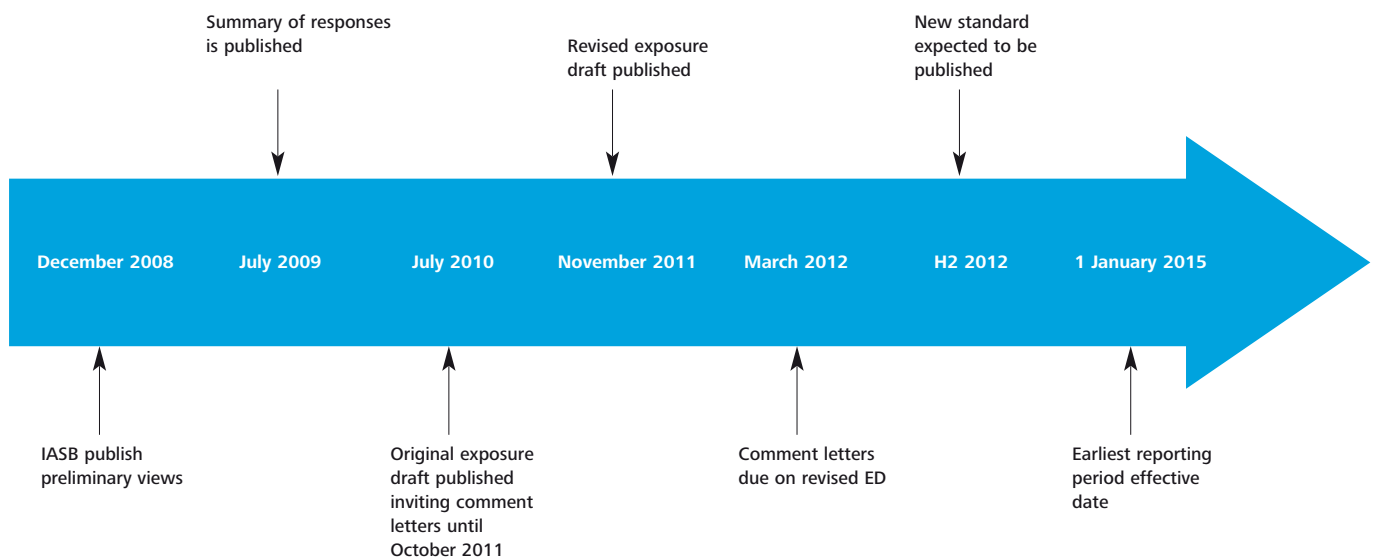
Whereas the original ED proposed that costs of obtaining a contract should be expensed, the revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs. Those incremental costs are the costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs that would have been incurred regardless of whether the contract was obtained should be recognised as an expense when incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained.

Annual disclosure and presentation requirements

The Boards determined that with the exception of minor amendments and clarifications, the guidance on presentation and disclosure in the original ED would be retained.

Effective date and early application

The Boards will not make a final decision on the effective date of the new standard until they complete their deliberations on the revised proposals in 2012. However, the Boards tentatively decided that the effective date of the proposed standard would not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early application. First-time adopters of IFRSs would also be permitted to apply the revenue recognition standard early.



Contract costs – the capitalisation of subscriber acquisition costs?

In some respects accounting for contract costs is currently as much an area of judgement for operators as revenue recognition. This is evidenced by the variety of accounting policies adopted globally, particularly in respect of the costs associated with obtaining contracts.

The original ED stated that the costs of obtaining a contract should be expensed as incurred. Current practice for accounting for these costs differs between operators and we estimate that over 80% of operators expense such costs.

Response to original proposals

Through their comment letters, some operators expressed a view that the proposed guidance for the costs of obtaining a contract should be the same as the costs of fulfilling a contract – that is, they should be capitalised if such costs relate directly to a contract, generate or enhance the resources of the entity that will be used in satisfying the performance obligation and are expected to be recovered. In the revised ED, the Boards have changed their view on the accounting for the costs of obtaining a contract and now propose that costs should be capitalised if they are incremental and recoverable. However, as a practical expedient, costs relating to short-term contracts (less than one year) may continue to be expensed as incurred. For example, commissions payable to retailers and merchants who sell top-ups for prepaid services would likely be eligible for the practical expedient because such top-ups are often utilised by customers within 12 months.

The costs of obtaining customer contracts are significant in the telecommunications industry and are commonly in the form of commissions paid to direct or indirect sales channels (referred to as Subscriber Acquisition Costs or “SACs”). As well as serving as a reward for the sales channels for acquiring customers, SACs may also serve to compensate for subsidised handsets delivered to the customer by an external channel. Furthermore, in an attempt to encourage their sales channels to acquire higher value customers, these SACs are often linked to future customer profitability and tenure.

A further point to note is that several of the comment letters received on the original ED expressed a view that a subsidised handset represents a cost to acquire a customer rather than a cost of fulfilling a contract as the handset is merely a marketing tool to attract customers. However, such a commercial view should not necessarily affect how operators account for such items.

Similar to the effect that the proposed accounting for multiple element deliverables will have, for the majority of operators the deferral of SACs will result in increased profits at the start of a customer’s life and a further disconnect between net income and cash flows.

Whilst the intention of this new guidance is to ensure consistent principles are used across all industries, and therefore amongst operators, and provide more clarity for investors, there are a number of judgements that many operators will need to consider in adopting these proposed requirements which are summarised below.

Treatment of hardware

The Basis of Conclusions of the revised ED indicates that the Boards consider the delivery of hardware to a customer (such as handsets, modems and set-top boxes) to be a separate performance obligation and therefore it may prove difficult for operators to demonstrate otherwise. There are differing accounting policies amongst those operators who currently capitalise SACs: some capitalise both the commissions and handset subsidies, while others only capitalise the sales commission element. Therefore, those operators who currently capitalise handset subsidies may find themselves recognising such costs upon delivery to the customer (i.e., at the same time as recognising handset revenues under the revised ED) rather than being recognised over a period of time.

Prepay services

Operators commonly use third party distributors to give away SIM cards or to sell pre-packaged services such as pre-pay handsets, netbooks or tablets with embedded SIMs where upon activation of the SIM by the customer the distributor is paid a commission. As such arrangements commonly do not have minimum revenue commitments or fixed contract periods with the end customer, it is questionable whether they would meet the definition of a contract. In particular, paragraph 14 of the revised ED states that it should only be applied to contracts if, amongst other criteria, “the entity can identify the payment terms for the goods or services to be transferred.” Operators therefore will need to consider carefully whether the costs incurred in obtaining pre-pay customers qualify for deferral.

Timing of asset recognition

Over recent years operators have been moving towards linking customer profitability to sales commission arrangements. Such arrangements typically pay commissions over the course of the customer's contract rather than up-front at the commencement of the contract. In these circumstances operators will need to identify the costs of obtaining the contract and whether a contract asset should be recognised for the estimated commission payable under the contract, together with a corresponding liability (which is also impacted by whether those receiving commissions are required to provide additional services to the acquired customer). We have observed different accounting practices between operators in this area including:

- full up-front recognition of commissions expected to be paid over the customer's life;
- up-front recognition of the commission cost which is not contingent on future customer performance (i.e., the contractual minimum commission payable); and
- no up-front recognition of commission but instead recognition by the operator as incurred.

The revised ED proposes circumstances where costs should be capitalised but does not explicitly discuss the timing of liability recognition for such costs. However, given the fundamental change in accounting for such costs we envisage that some operators may use this opportunity to reflect on their accounting policies in this judgemental area.

Multiple element costs

A further complexity is that commissions payable to indirect sales channels commonly include compensation for handset subsidies and ongoing services such as billing or customer services. The accounting for the handset subsidy as a cost of satisfying a performance obligation through the direct channel as opposed to a commission through the indirect channel could lead to a different accounting result from a sale being made through a direct channel compared to an indirect channel, as illustrated by Example 1.

Example 1

Operator A acquires two customers in different transactions that are, nevertheless, expected overall to have economically similar results:

- The first customer is acquired through Operator A's indirect distribution channel under a two-year contract that requires payments of CU 40 per month for a bundle of services which has a fair value of CU 60. The customer also receives a handset free of charge from the indirect sales channel which has a cost and standalone selling price of CU 250. Operator A paid a commission of CU 300 to the indirect sales channel. Operator A has not supplied the handset to the customer, and has no responsibilities to the customer in relation to the handset.
- The second customer is acquired through Operator A's own retail store. The customer acquired entered into a similar contract (CU 40 per month) and, like the first customer, was also given a free handset worth CU 250. In this case, Operator A has supplied the handset to the customer, and is responsible to the customer for the handset. A commission of CU 50 was paid to the sales assistant in the retail store who made the sale.

Operator A currently expenses commissions as incurred and anticipates that it will only provide services to the customers over the two-year term and therefore amortises the costs of obtaining the customer's contract over two years.

	Current practice				Future practice			
	Direct sales channel		Indirect sales channel		Direct sales channel		Indirect sales channel	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
Service revenue	480	480	480	480	409	409	409	409
Handset revenue	–	–	–	–	142	–	142	–
Total revenue	480	480	480	480	551	409	551	409
Sales commission	(50)	–	(300)	–	(25)	(25)	(150)	(150)
Handset costs	(250)	–	–	–	(250)	–	–	–
Total costs	(300)	–	(300)	–	(275)	(25)	(150)	(150)
Profit	180	480	180	480	276	384	401	259
Cash inflow	180	480	180	480	180	480	180	480

Example 1 illustrates how an operator could end up with a markedly different profile of profit for contracts that, although different, are expected overall to have economically similar results dependent on whether it sells through a direct or indirect sales channel caused by the payment made to the indirect channel being treated wholly as a sales commission. It also illustrates the significant increase in profit in year one through the combined effect of the change in handset revenue recognition and the deferral of costs.



This difference leads to the question of whether the costs associated with these arrangements should be analysed differently in the case of the indirect sales channel to reflect the performance obligation being undertaken by the indirect sales channel (it might be argued that part of the 'sales commission' is compensation to the indirect sales channel for supplying a handset at a loss, rather than a cost of acquiring the contract). If a different analysis is appropriate, it could lead to greater consistency of accounting between the direct and indirect channels.

But if operators determine that they should account differently for the separate components of a commission arrangement they will face further system issues on top of those relating to the unbundling of multiple element revenue arrangements. This is an issue that will require careful consideration by operators in light of the revised ED's proposals.

Asset amortisation

The revised ED states that the asset arising from the costs of obtaining a contract should be amortised "consistent with the pattern of transfer of the goods or services to which the asset relates". The ED also states that the asset recognised might relate to goods or services to be provided in future anticipated contracts (for example, if a customer chooses to renew an existing contract). Our research suggests that of those operators who currently capitalise SACs, the vast majority recognise the costs over the life of the initial customer contract.

The Illustrative Examples in the revised ED include an example of a service contract which is initially for a period of one year but may be renewed each year by the customer without extra charge. The example concludes that the costs incurred in fulfilling the contract would be capitalised and amortised over the period that the entity expects to provide services to the customer, which may be longer than the initial contract term.

Consequently, for contracts with a minimum term, open-ended contracts or contracts with renewal options, costs might be amortised over a relationship period that is longer than the contractual period.

It is likely that operators will use historical churn data to determine an appropriate amortisation period. However, a key consideration will be to what extent different customer segments should have different amortisation periods; for example, bespoke contracts with large corporate customers may have amortisation periods determined on a case by case basis whereas the amortisation period for consumer customers may be evaluated on a portfolio basis. Where a portfolio basis is used, the level of customer base disaggregation is also an important consideration as some operators may observe demographically driven behavioural differences within their customer bases.

Impairment

The revised ED would require that an impairment loss be recognised if the carrying amount of a contract asset (capitalised SACs) exceeds the remaining amount of consideration expected to be received under the contract. As described above, contract costs may be amortised over a period longer than the contractual period and therefore it will sometimes be very difficult for operators to make this assessment at a contract level. Paragraph 6 of the revised ED states that an entity may apply the ED's guidance to a portfolio of contracts with similar characteristics if the entity reasonably expects that the result of doing so would not differ materially from the result of applying the ED to individual contracts. Such a portfolio approach will clearly be beneficial to operators in undertaking such an impairment review if operators can justify such an approach.



Multiple element deliverables – handsets and headaches

It was evident from the comment letters submitted by operators on the original ED that this area was the most controversial proposal for the telecoms industry.

The revised ED retains the key principle from the original ED of recognising revenue when control of a good or service passes to the customer. As the revised ED requires identification of all separate performance obligations within a contract this will often result in the need for operators to attribute and recognise revenue for hardware such as set top boxes, handsets or modems which are delivered to a customer at the inception of a contract together with revenue attributed to on-going services.

Comments from operators

It was evident from the comment letters submitted by operators on the original ED that this area was the most controversial proposal for the telecoms industry. The vast majority of operators made specific comments about the proposals, and there was agreement amongst operators that, consistent with current US GAAP guidance, there should be a cap on the recognition of 'contingent revenues' and the option of applying the residual method for the purposes of revenue allocation.

The key concerns of the operators were in three areas. Firstly, concerns were of a commercial nature, principally around the impact this will have on external investors' assessment of the performance of the business. The level of complexity involved in the proposed accounting and the resulting movement away from the consistency often previously observed between revenue and cash generation is likely to make it harder for investors to understand results and put more pressure on the operators themselves to interpret and explain the results. Operators also expressed a view that handsets are viewed as an ancillary service and/or a marketing tool to attract customers to service plans and investors are really concerned about the average revenue per user ("ARPU") on the service element, and that the proposals in the original ED (which are essentially unchanged in the revised ED) would introduce fluctuations in this key industry metric.

Secondly, there were concerns around the technical application of the proposals. There were strong arguments amongst those who responded that economically similar transactions may result in differing revenue recognition treatments. For example, where a variety of different handsets may be offered with the same service plan, the proposals may result in operators attributing different amounts of revenue to the service element. Another common concern was that differences may arise depending on whether contracts are sold directly or through third party distributors. Operators also commented that accruing revenue on delivery of a handset will result in the recognition of a contract asset that may not be legally enforceable because it is only recoverable once the operator provides the related services to the customer.

Thirdly, respondents commented on the impact that the proposals will have on information technology systems. The customer base of a consumer-facing operator is characterised by millions of customers on thousands of different tariff and service plans. Operators felt that the costs of modifying systems will outweigh the benefits of implementing this proposed guidance.

Little change in the revised ED

The Boards met with representatives from the telecommunications industry after the publication of the original ED and, following that, discussed their specific concerns at the June 2011 joint meeting of the Boards. Notwithstanding the concerns of the industry participants, the Boards decided to retain the proposals of the original ED. Satisfaction of performance obligations remains the trigger for revenue recognition without a specific cap on contingent revenues. However, the use of the residual method would be permitted in determining the allocation of revenue to the respective performance obligations only if the selling price of a particular element is highly variable or uncertain. Variability is defined as something sold for a 'broad range of amounts' to different customers at or near the same time whereas 'uncertain' is where the good or service has previously not been sold.

The Basis of Conclusions to the revised ED provides the Boards' rationale for their decisions and explains that they did not adopt a contingent revenue cap primarily because they believed it would be tantamount to cash-basis accounting which would not fit with the core principles of the proposed standard and may result in recognising a loss for what is actually a profitable part of a contract. Furthermore, the Basis for Conclusions states that in the case of up-front provision of equipment to a customer an operator would have a contractual right to compensation, even if it does not have the present right to collect it, and therefore they consider this would represent a contract asset.

The Boards believe that there are scenarios in current practice where revenues are not strictly contingent. For example revenues may not be attributed to equipment provided up-front because a customer may not pay up-front in full for a handset or set-top box; however these may be part of a non-cancellable contract such that if the contract is terminated there is a clause to recoup the cost of the handset or set-top box.

The application of this guidance means that, in practice, where there is a performance obligation for which the selling price is highly variable or uncertain the difference between the total transaction price and the standalone value attributable to all the other performance obligations (where the standalone selling prices are observable) would be attributed to the performance obligation where the selling price meets the test of being highly variable or uncertain.

Operators often subsidise handsets to varying degrees dependent on the service plan that they are sold with; however, this doesn't necessarily mean that their selling price is 'highly variable'. The existence of cost data and the fact that handsets in particular are sold individually differentiates such third-party sourced equipment from items where the cost is not known (e.g. internally developed licenses). Even if operators were able to conclude that, in accordance with paragraph 73 of the revised ED, the standalone selling price was not directly observable they would be required to apply estimation techniques. These estimation techniques would include deriving a standalone selling price either from the selling prices (where sold separately) or on a cost plus margin basis in accordance with paragraph 73(b). Therefore, it does not appear likely that operators would be able to justify the use of the residual method in these circumstances.

Alternatively, there may be justification for the use of the residual method in respect of the variability in the pricing of service plans, especially when considering the extent of discounting applied by operators in the provision of bundled services both through comparison with different bundles and with the standalone pricing of each of the bundled components. However, the application of the residual method in this instance would result in more revenue allocated against the subsidised hardware and, therefore, a further move away from current accounting practice.



Deloitte insight

The resulting change in revenue recognition will impact operators' key financial metrics and therefore may result in investors and analysts needing to rebase their assessment of performance. Furthermore, operators are likely to consider the need to provide results under the current accounting methodology or move to using more cash-based metrics to provide continuity of information to the users of financial statements.

Systems – getting the response right

Many operators are heavily reliant on spreadsheets, databases and manual processes to meet existing revenue and cost reporting requirements but the revised ED's proposals may well mean that this will not be possible going forward.

Based on their responses to the original ED, it appears that the problems that operators will face in implementing the changes that the revised ED is proposing would be significant. Responding to the original ED, virtually all of the operators' comment letters expressed concerns about the complexities and costs associated with modifying their IT systems and business processes because of the new requirements. One large multinational operator commented that it would cost them "hundreds of millions of Euros" to implement the required changes where another operator described how the introduction of a new billing system took three years to complete and cost over \$80 million to implement.

Making changes to existing billing systems has always been a costly task for operators. Many operators are heavily reliant on spreadsheets, databases and manual processes to meet existing revenue and cost reporting requirements but the revised ED's proposals may well mean that this will not be possible going forward. The capabilities of existing billing systems and infrastructure are mostly limited to providing data on an "as-billed" basis and provide little capability for reporting data in any other way.

The changes to revenue accounting proposed in the revised ED mean that current ways of generating accounting entries must be updated. Whilst this may represent a significant undertaking it also presents an opportunity to build a flexible, transparent, auditable environment that will meet current and future regulation changes and improve the ability of Finance to serve the business.

In considering their response, operators may look to other industries such as the financial services sector where banks and financial institutions have significant experience in processing and accounting for large volumes of customer contracts which include multiple element arrangements.

Implementing change

Operators will need to choose between amending or re-engineering their billing infrastructure or inserting a software layer between the billing and accounting/finance systems.

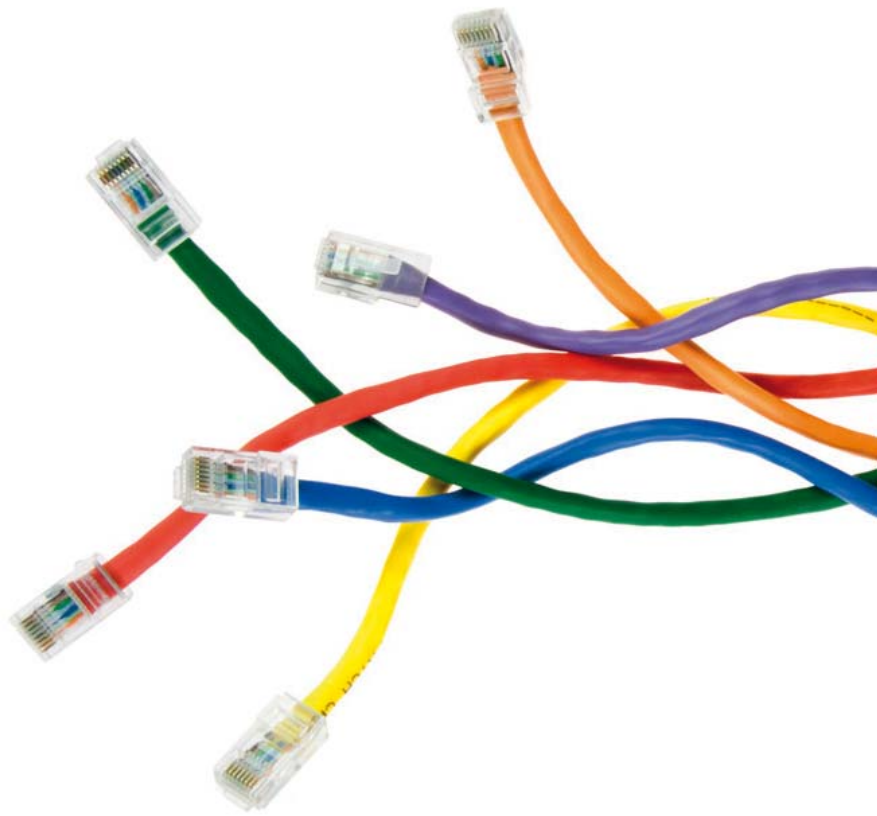
Having canvassed opinion from both software vendors and operators there appear to be several advantages of inserting a software layer over amending billing systems including:

- customer experience – there are inherent risks associated with making significant amendments to billing systems which may affect customer master data and customer billing;
- cost – the cost of inserting a software layer is likely to be lower than reconfiguring billing system infrastructure; and
- future proofing – specialised accounting software is likely to be more easily adaptable to future changes in accounting requirements or operator service offerings.

However, some operators' options may be constrained by their current infrastructure, particularly if they currently have heavily integrated end-to-end billing and finance systems.

Operators seeking to implement a software layer will require software that can cope with a high volume of transactions. Such software will need to be capable of receiving data from billing and other systems at the contract level and create accounting rules for bundled and unbundled products. Given the requirements of the revised ED, a number of other systems may also need to feed into such software including order fulfilment/ inventory-management systems, payroll systems (for internal commission payments) and external (indirect channel) sales commission systems.

An automated rules-based system may have an added benefit for multi-jurisdictional operators as consistent assumptions can be determined and applied centrally meaning that individual operating entities will be less exposed to differing judgements made by local finance personnel.



Deloitte insight

Operators seeking to better understand customer profitability and behaviour often have to combine unreconciled data from multiple systems. The amendments to billing infrastructure or the introduction of new software to address the proposals in the revised ED may also provide the opportunity for operators to unlock value hidden within these systems and within their customers' data. Such capability would also enable operators to simulate the financial implications of new tariff and promotional offerings, helping to ensure that finance isn't the bottleneck for responding to market changes but instead becomes a value-enhancing business partner.

Contract modifications – why goodwill isn't always good

The original ED provided guidance around contract modifications suggesting they should be accounted for together with the existing contract if the prices of the modification and the existing contract are interdependent.

In their comment letters, most telecoms operators who responded to the original ED expressed significant concern over the treatment of contract modifications as they believe that in the case of their typical contracts it may have unintended consequences. Within the telecoms industry, modifications are frequent and the number of permutations and combinations of tariffs are vast. This may result in the need to make hundreds of thousands or even millions of assessments on a contract by contract basis.

Some examples of the changes that might occur:

- a premium content television channel given for a period for free to a customer who has made a complaint to customer services;
- the amendment to the specification of an outsourced network roll-out contract;
- a customer who switches to higher speed broadband connecting resulting in an upgrade fee being charged; and
- a customer who extends the contract period in return for a reduction in monthly fees.

Operators have expressed concern that the guidance should take into account whether the modification is as a result of changes in facts and circumstances compared to when the original contract was agreed, and suggested that, if so, this should simply be accounted for as a separate contract. These concerns have been somewhat addressed by the guidance in the revised ED.

The other concern raised by operators is that there would be a significant change required in their IT systems to monitor and track the information necessary to evaluate and account for such contract modifications. The cost benefit argument is raised by many and the feasibility was also questioned by some.

Revised proposals

These revised proposals represent a shift away from the 'price interdependence' principle in the original ED. The Boards considered such a principle was insufficient for the determination of how to account for contract modifications.

The revised ED therefore seeks to better clarify the definition of what constitutes modification and how to account for it. It states that if a contract modification fits the definition of a contract for revenue recognition purposes then an assessment should be made as to whether it fits the requirement to be accounted for as a separate contract. This is considered to be the case if:

- there are additional promised goods or services that are distinct; and
- a right for the entity to receive an amount of consideration that reflects the entity's standalone selling price of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of that particular contract.

In all other cases the Boards decided that contract modifications should be accounted for as amendments to existing contracts. However, instead of proposing that such modifications should be accounted for on a retrospective or cumulative catch-up basis, the revised ED proposes that entities should account for the effects of such modifications on a prospective basis. Changes to a transaction price (i.e., in the absence of any other contract modifications) are not accounted for as contract modifications and are allocated to the separate performance obligations in the contract on a retrospective basis.

Therefore, a key judgement is whether goods or services are distinct. Amongst other criteria, the revised ED principally defines a good or service as distinct if:

- the entity regularly sells the good or service separately; or
- the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.

If a contract modification is not a separate contract, then the revised ED requires the remaining services or goods in the modified contract (i.e. those not transferred at the date of contract modification) to be accounted for in one of two ways, as summarised below (or a combination of these two methods). A third example is included below where the modification only relates to a change in the transaction price.

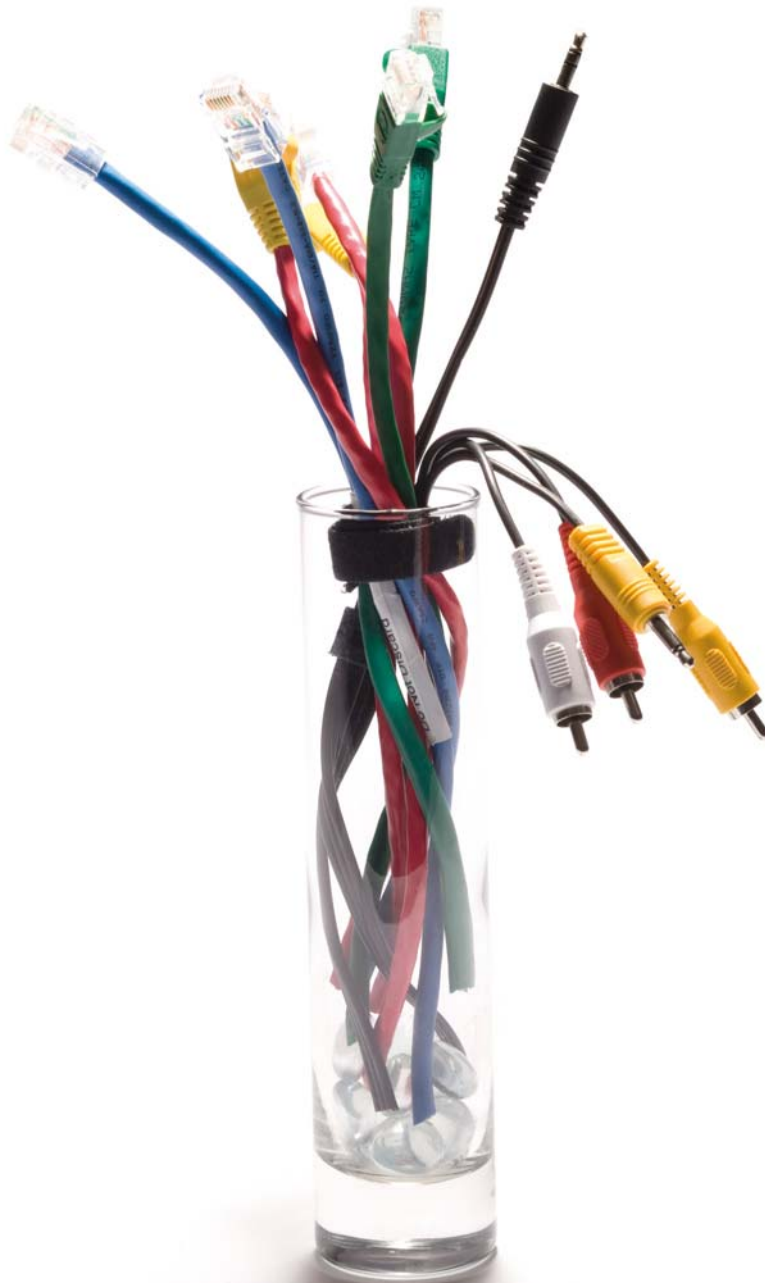
Circumstances	Requirement	Example
(a) Remaining goods and services are distinct from those transferred on or before the date of the modification.	<p>Allocate to the remaining obligations the amount of consideration received but not yet recognised and any remaining consideration that the customer has promised to pay.</p> <p>Equivalent to termination of the old contract, creation of a new one.</p>	<p>Provision of a premium sports channel for 3 months is given as a goodwill gesture to a cable television customer 12 months into an 18-month contract where a set-top box was provided to the customer at the outset. The premium sports channel is considered to be distinct and is frequently sold separately by the cable operator.</p> <p>In this scenario part of the obligations are ongoing – the monthly provision of television services – but the operator considers that the remaining 6 months of service would be considered distinct from the first 12 months. Therefore the revenue allocated to the first 12 months of cable provision would be considered a satisfied performance obligation. In addition there would also have been revenue recognised when a set-top box was provided. As the performance obligation to deliver the set-top box has been satisfied prior to the modification the consideration for that element is not reallocated.</p> <p>Therefore the consideration remaining would be allocated between the final 6 months of line rental and the 3 months relating to the ‘free’ sports channel, allocated on a prospective basis. This results in more revenue being recognised in months 13-15 than in the other months, and because this allocation is made on a prospective basis the revenue recognised in months 16-18 will be lower than in the first 12 months of the contract.</p>
(b) Remaining goods and services not distinct and part of a single performance obligation that is partly satisfied at the date of modification.	<p>Update the transaction price and the measure of progress towards completion.</p> <p>Then recognise the effect of the contract modification as revenue (or a reduction of revenue) on a cumulative catch up basis.</p> <p>Equivalent to accounting as if part of original contract.</p>	<p>A network equipment integrator enters into a contract to roll out an Ethernet network to a region over a 24-month period for a consideration of CU 100,000. 12 months into the contract (at which point the integrator has completed 50% of the work and recognised revenue of CU 50,000) a change request is granted which amends the technical specification of some elements of the equipment being installed which results in an increase to the total consideration receivable of CU 20,000 as well as an increase in the overall estimated costs to complete.</p> <p>The integrator considers that the remaining goods and services to be provided under the modified contract are not distinct as it provides a significant service of integrating the highly interrelated goods and services into the Ethernet network for which the customer has contracted. Therefore the entity revisits the overall assessment of percentage completion of the project and considers that after the 12 months it has completed 40% of the amended contract. Accordingly, it adjusts the revenue recognised to CU 48,000 resulting in the derecognition of CU 2,000 of revenue at that date.</p>
(c) Modification is only a change in transaction price.	<p>Where there are no changes in the goods or services, the change in transaction price is reallocated on the same basis as at contract inception.</p> <p>Equivalent to reallocation at inception.</p>	<p>A goodwill credit of CU 63 is given to a customer at the end of month 12 of a 24-month satellite television subscription where the customer was also provided a set-top box at the outset. Based on the original transaction price of CU 630, CU 30 was recognised on delivery of the set-top box and CU 25 per month for the on-going satellite television services.</p> <p>The CU 63 reduction in the transaction price would be allocated proportionally resulting in a reduction to the set-top box revenue of CU 3 and a reduction to the overall service revenue of CU 60 to be split CU 30 in year 1 and CU 30 in year 2. This would result in a reduction to previously recognised revenue of CU 33 at the end of month 12.</p>

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Operators will need to consider the impact of the discounts, goodwill credits and add-ons given to both new and existing customers. Additionally, customer service agents and sales personnel may need to better understand the repercussions of offering goodwill credits, free services or price reductions to their customers.

As with other elements of the revised ED there are significant system implications for operators resulting from these proposed requirements.

Where the modification situation results in a combination of (a) and (b) (i.e., there are distinct performance obligations combined with a part-satisfied performance obligation) the entity would allocate to the unsatisfied performance obligations the amount of consideration received from the customer but not yet recognised as revenue, plus any remaining consideration that the customer has promised to pay. If it was an obligation satisfied over time the entity would update the transaction price and the measure of progress. There would be no reallocation of consideration to adjust the amount of revenue recognised for separate obligations satisfied at the date of the modification.



Adjusting consideration – credit risk and the time value of money

The overarching message highlighted by these comments was that the level of judgement would increase as a result of the more manual processes involved, and in turn comparability between operators' reported revenue would decrease.

The original ED included two proposals which would directly affect the amount of revenue recognised – credit risk and the time value of money.

Credit risk

The original ED proposed that revenue recognised should be adjusted for credit risk using a probability weighted method.

A key concern raised by operators in their comment letters related to the feasibility of quantifying the level of credit risk for new customers given the likely limited information available on that customer and their credit history. Furthermore, the operators highlighted that they trade with millions of small, individual customers and therefore it is exceptionally difficult to make an assessment of who will default and by how much. The operators suggested they would prefer to adopt a portfolio approach based on customer demographics.

Another issue which was highlighted by operators in their comment letters is that under the original ED, companies will ultimately end up with a revenue figure which doesn't necessarily correspond to the economic substance of the transaction undertaken. Allocating an amount of credit risk to a contract asset ignores the actual value of the contract and immediately both assumes an inability of the customer to pay (and the entity to collect payment) and assigns a level of judgement to whoever calculates the value of the credit risk.

The overarching message highlighted by these comments was that the level of judgement would increase as a result of the more manual processes involved, and in turn comparability between operators' reported revenue would decrease.

The revised ED removes the requirement to record a credit risk adjustment directly against the revenue line, but it still requires entities to account for the effects of customer credit risk (i.e. collectability) at the inception of a new contract. The revised ED would require entities to account for credit risk in the carrying value of the financial asset (i.e. a receivable) at the start of the contract, with the effects of credit risk being shown directly adjacent to revenue in the income statement. In other words any difference between the measurement of the receivable and the corresponding amount of revenue recognised would be presented as a separate line item on the face of the income statement. Subsequent impairment of the receivable or changes to the measurement of impairment would also be presented in this line item.

These changes to the original ED should reduce the level of concern expressed by operators in their comment letters in relation to the difference between the economic substance of a transaction being reflected in the accounts as a result of the readjustment of the credit risk amounts to accommodate changes in amounts provided and amounts received. However the revised ED does not address the concerns raised in relation to the judgements required, the system implications and the risk of reduced comparability between operators.

The time value of money

The original ED proposed that the effects of the time value of money should be accounted for as a deduction from revenue where a contract includes a material financing component. A number of operators agreed with the proposal but called for clarification over what constitutes to be 'material'. The revised ED provides more guidance in this area and states that where the time difference between the delivery of goods or services and the receipt of payment is less than one year, then an entity need not adjust for the effects of financing. This proposal may require operators that provide subsidised hardware such as handsets, set-top boxes or modems to customers on contracts in excess of 12 months in duration to consider the effects of the time value of money.

A number of operators also commented that implementing the capability to adjust at the performance obligation level would be extremely costly and time consuming, with one operator commenting that it would require a "complete systems overhaul".

The revised guidance states that in considering whether a financing component is significant to a contract three factors should be considered:

- the length of time between transferring the goods or services and when the customer pays for them;
- whether the consideration would differ substantially if the customer paid up-front; and
- the interest rate in the contract and prevailing interest rates in the relevant market.

Given these criteria, operators may consider the first criteria the most relevant since generally the payment for services tends to be recovered in line with the delivery of the services. However, consideration would need to be given where the overall price of the contract includes consideration for subsidised hardware often delivered at the commencement of a contract but paid for by the customer over a period of more than 12 months.

The original ED stated that the discount rate used to reflect the time value of money should include an amount to reflect credit risk. One operator suggested that a risk free rate should be used for the discount rate, since using a credit risk adjusted rate builds in the assumption that collectability risk would diminish over the course of the contract and would lead to accounting treatment that is inconsistent with the economic substance of the transaction. Although the revised guidance continues to require the credit characteristics of the customer to be considered when determining the discount rate, we note that in the Basis for Conclusions the Boards state that "an entity would typically not recognise a loss on initial recognition because the receivable normally would initially be measured at the original invoice amount" – except in the case where there is a significant financing component. This suggests that in practice the credit adjustment will not always pose as significant an issue as noted by operators; but it should be noted that contracts for periods in excess of 12 months may well include a significant financing component.

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It may not always be readily apparent to operators where this would apply. For example, where a customer is given a handset for 'free' and signs a 24-month service plan contract each monthly payment would effectively include an element of payment for the handset with the remainder relating to the service plan. In this case, the handset is arguably being paid for over 24 months.

Disclosures – few changes, big challenges

The most significant addition to the disclosure requirements defined in the revised ED relates to the recognition of assets from the costs to obtain or fulfil a contract with a customer.

Full year disclosures

The key themes from the original ED are around the following areas:

- Inclusion of information about contracts with customers, such as:
 - a disaggregation of revenue for the period;
 - a reconciliation from the opening to closing aggregate balance of contract assets and liabilities; and
 - information about the entity's performance obligations including in respect of any onerous performance obligations.
- Information relating to performance obligations relating to:
 - when the performance obligations are satisfied;
 - the significant payment terms;
 - the goods or services the entity has promised to transfer;
 - obligations for refunds/returns; and
 - types of warranties and related obligations.

The revised ED substantially retains the disclosure requirements in these key areas. The fact that these disclosures have substantially remained will disappoint a number of telecoms operators, who expressed their concerns in their comment letters on the original ED. Several operators questioned the incremental benefit of the proposed additional disclosures, especially in light of the level of additional costs necessary to employ new systems and controls in order to account for the volume of contracts that they hold.

There has been a minor change in the guidance for contracts with an expected duration of more than one year. Disclosure of the amount of the transaction price allocated to remaining performance obligations and an expectation of when an entity expects to recognise that revenue are still required. However, whereas the original ED specified strict disclosure of the time bands for this information, the revised ED would provide operators a choice between either disclosing the information in a quantitative form or a qualitative form.

The most significant addition to the disclosure requirements defined in the revised ED relates to the recognition of assets from the costs to obtain or fulfil a contract with a customer. Entities will now be required to disclose a reconciliation of the opening and closing assets recognised from the costs incurred to obtain or fulfil a contract by main category of asset (e.g. sales commissions). Where applicable an entity should include amounts related to each of the following:

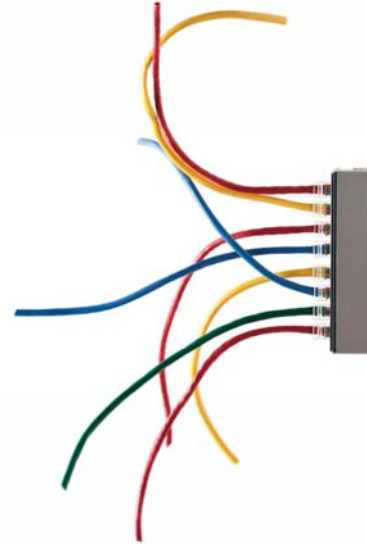
- additions;
- amortisation;
- impairment losses;
- reversal of impairment losses; and
- any additional line items that may be needed to understand the change in the reporting period.

The method used to amortise the costs should also be disclosed.

Interim disclosures

The ED proposes that an entity should provide specific revenue recognition disclosures in interim financial statements. The Boards decided to require disclosure of the following information in interim financial statements:

- a disaggregation of revenue;
- a tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period;
- an analysis of remaining performance obligations;
- information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period; and
- a tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer.



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