

Making sense of a complex world*

Revenue recognition in contracts with customers

The IASB/FASB discussion paper and its potential impact
on the telecoms industry



Introduction

On 19 December 2008, the IASB and FASB finally issued their long-awaited revenue discussion paper. It proposes some potentially significant changes to the revenue recognition guidance under both IFRS and US GAAP, and it is likely that companies reporting under the latter framework will experience a greater impact. Nevertheless, the proposals are important for IFRS reporters as the IASB is seeking to replace both IAS 18, 'Revenue' and IAS 11, 'Construction contracts'. Comments on the discussion paper are due by 19 June 2009. There is no proposed final release date for a standard, but it is not expected before 2011 with an effective date no earlier than 2012. Experience has shown that comments made by preparers and users of accounts at the discussion paper stage are more likely to result in modifications in areas of principle than comments made when the document is closer to final publication.

Summary of the proposals

The discussion paper covers many aspects of revenue recognition. The overall objective is to develop a single revenue recognition model using a recognition principle that can be applied consistently to various transactions. It starts from a premise that revenue arises when an entity satisfies an enforceable contractual obligation (which may be explicit or implicit) to transfer an asset to a customer. For a good, the obligation literally represents a promise to transfer an asset; for a service it is also a promise to transfer an asset, although that asset may be ‘consumed’ immediately as the customer receives the service. At the same time, the contract conveys to the entity a right to receive payment.

The combination of rights and obligations will result in a net contract asset (remaining rights exceed remaining obligations) or liability (remaining obligations exceed remaining rights). Hence, the discussion paper takes a balance sheet view of revenue and proposes that it represents either an increase in a net contract asset or a reduction in a net contract liability. It should be noted that revenue is not recognised until there has been a transfer of an asset, so accounting for long-term contracts under a ‘percentage of completion’ method would not be permissible unless there is a continuous transfer of assets to the customer as the contract progresses.

As far as measurement is concerned, the discussion paper proposes using actual or estimated stand-alone selling price to measure each performance obligation. It tentatively rejects the view that performance obligations should be measured at fair value, though there remains the possibility of using a fair value approach in some cases (such as certain insurance contracts). The discussion paper does not address the measurement of customer consideration. This is not an issue where consideration is in the form of a fixed amount of cash, but is relevant where there is any degree of contingency or potential adjustment for rebates and discounts.

Where contracts provide for the delivery of a combination of several goods and services, the discussion paper proposes that they should each be identified and separated. The total consideration should then be allocated to each performance obligation in proportion to the stand-alone actual or estimated selling prices of the individual goods and services. Alternative methods of allocating consideration between multiple deliverables which are currently in use, such as the ‘residual’ and ‘reverse residual’ methods, would be prohibited. It is acknowledged that this will involve a much greater degree of estimation (for example, cost-plus or market-based estimates), but the standard setters believe that the alternative (that is, not separating a particular element) “will result in an entity accounting for a satisfied performance obligation as if it was unsatisfied... which would impair the depiction of an entity’s financial position and performance in a contract with a customer”.

The discussion paper does not consider the treatment of costs and in fact proposes that no cost accounting guidance be included in the final standard. However, it does propose that **all** costs should be expensed as incurred, **unless** they are eligible for capitalisation in accordance with other accounting standards and highlights this as one of the areas where existing practice may be impacted.

Impact on the telecom industry

So what does this mean for a telecommunications operator? If the proposals were to be implemented as currently drafted, our initial view is that there are two areas which have the greatest potential for change:

1. Disaggregation of bundled transactions

It is common for operators to sell handsets in conjunction with a post-paid service contract and, in many markets, the cost of the handset to the customer is subsidised by the operator. Currently, there are two primary models in place for accounting for the provision of the handset. In the first model (which is more common in Western markets), the provision of the handset is treated as a sale at the inception of the contract and the cost of the handset expensed as a cost of sale at that point. Typically this results in a loss being recorded at inception. Ongoing service charges are currently recognised as they are charged to the customer, so the amount of revenue recorded for service equates to the customer's monthly bill.

In the second model (which is more common in Eastern markets), the provision of the handset is not regarded as a revenue-generating transaction but rather as consideration for acquiring the customer service contract. In this case, the cost of the handset (reduced by any cash received from the customer in respect of the handset) is recorded as a subscriber acquisition cost. Ongoing service charges are currently recognised exactly as in the first model, so revenue is again derived directly from the billing system.

If the proposals in the discussion paper were to be implemented as drafted, it is likely that both of the current treatments would have to change. The amount of revenue apportioned to the handset would be based on an estimated stand-alone selling price rather than the subsidised price when offered with a post-paid contract. In effect, a portion of each month's service charge during the contract period would be deemed to relate to the handset rather than service and be recognised on inception of the contract rather than over its life.

Example

Operator X sells the Lion handset for €60 if taken with a €20 per month, one year service contract on the Tiger tariff. The cost of the handset to Operator X is €120. Operator X sells the Lion for €140 on a SIM-free basis. The Tiger tariff is available at the same price to existing customers and those providing their own handset. X currently records the sale of the Lion to contract customers at the amount of cash received on inception of the contract.

The approach taken by the discussion paper is to consider the price the handset would or could be sold for on a stand-alone basis. The example assumes that the SIM free price is a reasonable estimate of the stand-alone value of the Lion. The total value of the deliverables under the contract is €380 (€140 for the handset and €240 for the service) and the prescribed accounting is to allocate the total consideration received (€300) to the two deliverables based on their relative fair values.

	Current treatment (€)	Potential treatment (€)
Handset revenue on inception	60	111
Service revenue/month	20	15.75
Total service revenue	240	189
Total consideration	300	300

2. Treatment of contract acquisition costs

The discussion paper requires that costs connected with securing a revenue contract must be expensed unless they qualify for capitalisation under another standard. This will directly impact those US reporters who defer costs to 'match' revenues, for example under FAS 51, 'Financial reporting by cable television companies' or SAB 104, 'Revenue recognition'. As currently worded, it could also affect the treatment adopted by some IFRS reporters for customer contract acquisition costs.

For many mobile operators, subscriber acquisition costs are material and their treatment is an area of keen interest to users of their financial statements. Those operators that currently treat subscriber acquisition costs as an intangible asset (the cost of acquiring the service contract) typically include dealer commissions in that calculation. The discussion paper does not include any discussion of whether such costs are expected to qualify as an intangible asset, although one of the illustrative examples includes a payment of sales commission that it is treated as an expense because it "does not give rise to an asset qualifying for recognition". The discussion paper does offer an alternative for debate, whereby the customer consideration allocated to individual performance obligations is net of the costs of obtaining the contract. This would result in a portion of revenue equal to the contract acquisition costs being recognised at contract inception. This may be worth further consideration if commission costs do not qualify for capitalisation.

Next steps for industry participants

We encourage those involved in the industry as operators, investors or advisers to review the discussion paper and consider the 13 questions posed by the Boards. As a reminder, the deadline for comments to be submitted is 19 June 2009.

If you would like to discuss the contents of this briefing or any matter relating to accounting and reporting in telecoms, please contact your local PwC service team or any member of the PwC Telecom Industry Accounting Group listed.

Contacts

PricewaterhouseCoopers has dedicated IFRS specialism in most territories. Should you wish to talk to a specialist in your local country, please contact a member of the team who will be able to put you in touch with the most relevant person.

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