PwC TIAG perspectives on IFRS 15

IFRS 15 – Significant financing components

Introduction
IFRS 15, Revenue from Contracts with Customers (the Standard), will have a profound impact on the way in which the Communications industry measures and reports revenue. The industry is currently assessing the impact of the Standard on its current revenue recognition policies. Operators also have major change and implementation programmes in progress reflective of the impact this Standard will have on accounting, systems and processes.

Both the FASB and IASB have confirmed a one year deferral of implementation of the Standard. However rather than pause its implementation efforts, the industry has used this additional time to allow more time to better implement the changes.

In this series of papers we will set out some of the aspects of the Standard that require consideration by Communications businesses, including practical implementation considerations.

This fourth instalment of the series considers whether a contract contains a significant financing element.

Overview of the change
At times, payment by a customer may occur either significantly before or significantly after performance. Such timing differences can benefit either the customer, if the entity is financing the customer’s purchase of good and services, or the entity, if the customer finances the entity’s activities by making payments in advance of performance. If a financing component is considered significant, IFRS 15 requires an operator to reflect the effects of this when accounting for the goods and services transferred to the customer.

There are several arrangements in the Communications sector which may be affected by this change. Common examples include:

- Instalment payment plans for handsets or other devices.
- Sale of subsidised handsets where the cost is recovered over the contract term.
- Equipment provided as part of a managed service contract.
- Discounts offered for up-front payment of line rental.

Determining whether a financing component is significant will require judgement, and will depend on the individual facts and circumstances of the transaction. However the Standard does provide guidance on factors which indicate a timing difference is not a significant financing component, and also provides a practical expedient for short term contracts. These, and other considerations, are further discussed below.
Defining ‘significant’ will require judgement

When a financing component is identified, operators will need to determine whether that financing component is significant to the contract. A significant difference between the amount of contract consideration and the amount that would otherwise be paid in cash at the time of performance indicates that an implicit financing component exists.

Likewise, the longer the period between when a performance obligation is satisfied and when cash is paid for that performance obligation, the more likely it is that a significant financing component exists, especially in markets where prevailing interest rates are higher.

The IASB notes in IFRS 15’s ‘Basis for Conclusions’ (paragraph BC234) that the assessment of significance should be made at the contract level. The result is that the effects of financing can be disregarded if they are not significant at the contract level, even if the combined effect for a portfolio of contracts would be material to the operator as a whole.

Operators will have to develop policies or guidelines to determine what is considered significant to a contract and apply this consistently to all contracts. Thresholds or rules of thumb, such as the percentage a financing component represents of the consideration as a whole, may be useful in helping to establish consistency while performing this assessment.

The financing component can be ignored for certain short term contracts

The Standard includes a practical expedient that the financing component can be ignored for arrangements where the time difference between when the goods or services are provided and when payment is made is one year or less. This should provide significant relief for many operators. It is important to note that as the practical expedient focuses on the timing difference and not simply on the length of the contract, it might therefore be applicable to some longer contracts.

An operator that chooses to apply the practical expedient should apply it consistently to similar contracts in similar circumstances and must also disclose its use.

Determining an appropriate discount rate could prove challenging

If a significant financing component is identified, operators are required to adjust the contract consideration using a discount rate that reflects the rate that would be used in a separate financing transaction between the operator and its customer. As a result, operators will have to consider not just the risk free rate, but also the credit risk of their customers to determine an appropriate discount rate. This will likely prove burdensome, due to the large and often diverse customer base of most operators. It will also likely require operators to make assumptions regarding financing arrangements which they might not enter into on a regular basis.

A significant financing component can exist even where there is no explicit financing referred to in the contract. Some contracts, such as handset installment plans, may identify an explicit financing element. However, before using a specified rate operators should first consider whether this represents a market rate, or whether they are offering below market rates as an incentive to the customer. Use of below market rates for accounting purposes would not be appropriate.

Should the financing component be reflected as revenue or finance income?

Any consideration which represents a significant financing benefit to the customer must be presented separately from revenue from contracts with customers in the statement of comprehensive income. Operators will need to determine whether, in the context of their business, this is most appropriately presented separately within revenue or as finance income, thus reducing both revenue and EBITDA compared with current practice.

Analyst perspective

Operators with significant financing arrangements might see shifts in the timing and possibly the amount of their revenue.

For arrangements in which a financing benefit is provided to customers, revenue representing this benefit (i.e. the time value of money) could be recognised as interest rather than revenue from contracts with customers. For operators which derive a sizable amount of revenue from long term contracts, this change could significantly change the presentation of revenue, with amounts separately presented in the income statement as finance revenue or excluded from revenue altogether. As interest income is generally excluded from EBITDA, this could decrease in operator’s EBITDA metrics upon adoption of the Standard.

In addition, any consideration allocated to the financing element will be recognised over the financing period which could significantly change the timing for recognising revenue.

If material, operators will want to be transparent regarding how financing arrangements have affected their reported results.

Implementation considerations include:

- Identification of customer arrangements where the timing between payment and provision of goods and services exceeds one year.
- Establishing policies and guidelines to determine when a financing component is considered ‘significant’.
- Collection of credit risk and other information which can be used to/estimate market discount rates for significant financing components.

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A practical example

TimeValue Telecom, a mobile telecom provider, offers its customers a 24 month mobile contract which includes a discounted handset. The key terms of the arrangement include:

- Sale of the handset for €50, representing a discount of €650 from the standalone selling price
- The customer will pay €45 per month during the contract
- A similar SIM only plan would cost €20 per month
- The discount rate applied to similar customers in a financing arrangement is 10% per annum

As the discount on the handset will be recovered over a 24 month period, TimeValue believes there is an inherent financing component in the transaction. The Standard is not clear about how a significant financing component is identified and measured in a multiple element arrangement. Accordingly, TimeValue will need to apply judgement in selecting a method that meets IFRS 15’s overall objective (to recognise revenue in an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods or services) and is most appropriate for its circumstances. In this case, TimeValue chose to assess the significance of the financing element by comparing it to the total transaction price as follows:

<table>
<thead>
<tr>
<th>Standalone selling price (€)</th>
<th>Revenue allocation (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobile service</td>
<td>480</td>
</tr>
<tr>
<td>Handset</td>
<td>700</td>
</tr>
<tr>
<td>Total SASP</td>
<td>1,180</td>
</tr>
<tr>
<td>Transaction price</td>
<td>1,130</td>
</tr>
</tbody>
</table>

A – Calculated as €20 per month for 24 months
B – Calculated as €45 per month for 24 months plus €50 for the handset

The share of the transaction price allocated to the handset above includes the financing component, which, calculated at 10% per annum on the net financed amount of €620, and taking into account monthly payments, would be approximately €64. This represents approximately 6% of the total contract price. TimeValue will need to consider whether this is ‘significant’ in the context of the contract as a whole. If not considered significant, TimeValue will ignore the financing element and proceed to allocate the total transaction price of €1,130 as set out above. Alternatively, if TimeValue considers this amount significant, the amount recognised at delivery of the handset should be discounted and interest income recognised over the 24 month period.

There may be other acceptable means of identifying and measuring a significant financing component. For example, the standalone selling price of a handset sold for cash today could be adjusted to determine the standalone selling price of a handset sold on credit. Alternatively, iterative calculations and mathematical formulae could be used to determine how much of the total transaction price relates specifically to finance on the handset. Ultimately, TimeValue will need to apply judgement in selecting a method that is most appropriate for its circumstances.
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About TIAG

The PwC Telecom Industry Accounting Group provides a forum for discussion and develops in conjunction with the industry, solutions to emerging industry accounting issues. I thank the TIAG for its contributions to this paper and in particular Mark Allsop and Eric Gillman.

To have a deeper conversation about how the proposed changes to accounting for revenue may affect your business, please contact:

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