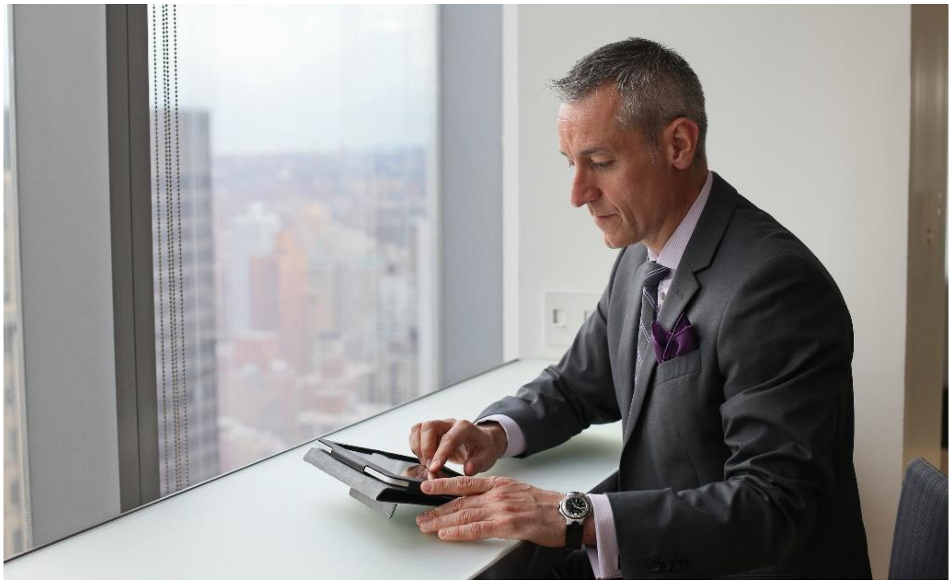
PwC TIAG perspectives

Accounting for customer premises equipment under IFRS 15 and IFRS 16



Background

Within the communications sector, it is common for service arrangements to be dependent on the use of equipment, for example:

- Routers and modems
- Handsets and other mobile devices
- Set-top boxes and other decoders
- Satellite receivers
- Servers and other IT equipment
- Cables and other network equipment

Where an arrangement involves both the delivery of services and the use of equipment, several accounting questions arise. These have been brought into sharp focus as operators face the challenge of adopting IFRS 15, *Revenue from contracts with customers, and IFRS 16, Leases.*

This paper examines two particular questions; how should an operator determine whether equipment is 'distinct' for the purpose of IFRS 15 and whether arrangements involving equipment contain a lease for the purpose of IFRS 16?

Considering whether equipment is 'distinct' for the purposes of IFRS 15

A fundamental principle of IFRS 15 is that revenue recognition is considered at the level of the specific deliverable, or 'performance obligation', within an arrangement. Where arrangements involve multiple deliverables, the standard provides guidance on identifying those that are 'distinct' and therefore to be accounted for separately. It states that a good or service is distinct if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other readily available resources (that is, the good or service is capable of being distinct). For example, the fact that many operators regularly sell handsets and other mobile equipment separately would indicate that those items are capable of being distinct.
- The supplier's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract). The objective here is to determine whether the nature of the promise is to deliver a number of goods or services individually or, instead, to transfer a combined item to which the promised goods or services are inputs. Factors that indicate the latter include the following:
  - The supplier provides a significant service of integrating the goods or services into a combined output.
  - One or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, other goods or services promised in the contract.
  - The goods or services are highly interdependent or highly interrelated.

An operator needs to apply the above criteria in considering whether equipment is distinct and is therefore accounted for as a separate performance obligation. If so, the operator would allocate part of the transaction price to the equipment and recognise revenue when it is transferred to the customer. If the equipment is not distinct (not a separate performance obligation), any amounts received in its respect would be allocated amongst the other performance obligations in the arrangement.

There are a number of factors that management should consider in making this judgment, which in our view include but are not limited to the following.

Whether there is a secondary market which allows the customer to benefit from the equipment independently from the service

Equipment can sometimes be sold in a secondary market. For example, a handset or set-top box might be sold on an online auction site. The frequency and price of transactions that are undertaken on the secondary market should be considered. The closer the price on the secondary market is to scrap value, the more likely that the secondary market is not substantive or determinative for the purposes of deciding whether the equipment is distinct.

Whether the equipment is sold separately

Equipment is often sold separately by the operator providing the service. This might be because the customer might want an 'extra', for example, a set-top box to access the service on a different television or an additional router to boost the signal within the home. However, this might not always mean that the servicing equipment is distinct because the additional sale of the equipment could be seen as merely an extension to the existing service.

The operator might also sell equipment to retailers who purchase it like any other item of inventory for sale to end consumers. A substantive volume of sales to customers (retailers/end consumers) independent of a contract for services might indicate that the equipment is capable of being distinct. However, the customer might be required to sign up for the service at the same time as purchasing the equipment from the retailer. This might indicate that the equipment is not, in substance, sold separately.

Whether the customer can benefit from the equipment through 'use' without the service

Equipment is often designed to deliver a particular service. However, there is often additional functionality available to the customer. For example, a set top box might allow the customer to access the content of other service providers or the internet and a satellite dish might also serve as an antenna to pick up freely available channels. The more substantive the additional features (in addition to providing the service), the more this indicates that the equipment is capable of being distinct.

Whether the customer perceives the equipment as an input that is being used to provide the service

In many cases, although an item of equipment might be capable of being distinct, when viewed from the perspective of the customer it is not distinct within the context of the contract. This will be the case when the equipment is merely an input that is being used to produce the output for which the customer actually contracted. When the equipment and the service are required to continually interact in order to fulfil the promise to the customer, the two goods/services are highly interdependent/interrelated. In other words, the equipment and the service are significantly affected by each other because the supplier would not be able to fulfil its promise by transferring each of these goods independently.

A consequence is that, depending on the distribution channel, an operator might reach different conclusions about whether the equipment is distinct. For example, if the operator sells equipment to a retailer that is a customer, there is no other good/service to consider in the context of that contract. However, when the operator sells similar equipment directly to an end consumer alongside other goods and services, the operator would need to consider whether the equipment and other goods and services represent a single performance obligation in the context of the specific contract with the end consumer.

The circumstances described above are different from an arrangement in which an entity provides equipment and consumables (such as printer ink or pods for a coffee machine). This is because, in the cases described above, the entity provides a service that needs to continually interact with the equipment in order to satisfy the promise to the customer. With consumables, the entity can satisfy its promise related to the equipment regardless of whether the customer requests the consumables at a later point in time.

Considering whether an arrangement contains a lease for the purposes of IFRS 16

Sometimes, an operator will provide equipment to a customer solely for the duration of their contractual relationship. As a right to use an asset for a period of time meets the definition of a lease, it is necessary to consider whether such arrangements are within the scope of IFRS 16.

Identifying a lease within an arrangement requires the exercise of judgement. IFRS 16 provides that an arrangement contains a lease where there is an identified asset and the customer has both of the following rights:

- to obtain substantially all of the economic benefits from use of the asset; and
- to direct the use of the asset. This might be because the customer has the right to direct how and for what purpose the asset is used or because relevant operating decisions are predetermined but the customer operates the asset or designed it in a way that dictates how and for what purpose the asset is used.

An asset might be identified explicitly in a contract, or it might be implicitly identified because the supplier can fulfil the contract only by the use of a particular asset. In either case, the arrangement might still not fall within IFRS 16's scope where the supplier has substantive rights to substitute the asset. Such rights exist where the supplier has a practical ability to substitute alternate assets and it would benefit economically from exercising that right. IFRS 16 makes clear that rights or obligations to substitute assets for repair and maintenance are not taken into account. In addition, the standard provides that substitution rights based on the introduction of new technology that is not substantially developed at contract inception are also ignored.

The following examples illustrate the above considerations -

Example 1

An operator enters into a contract with a customer to provide network services. To supply the services, the operator installs equipment at the customer's premises. The operator can reconfigure or replace the equipment, when needed, to continuously provide the network services; the customer does not operate the equipment, nor does it make any significant decisions about its use. The operator determines the speed and the quality of the network and how to best deploy the equipment to achieve that.

The operator has the right to control the use of the equipment because it makes all the relevant decisions about its use. It decides how the network operates, whether to reconfigure the equipment and whether to use it for another purpose. The customer only decides about the level of network services (that is, the output) before the period of use. This arrangement does not contain a lease. Instead, it is a service contract in which the operator uses the equipment to provide the level of network services determined by the customer.

Example 2

A contract for cable television services requires a set-top box to be placed in the customer's premises. The operator offers different kinds of set-top boxes.

At one end of the spectrum, the equipment has no use to the customer other than to receive the requested television services. The operator has pre-programmed it to deliver the specified services and controls what content is delivered. The set-top box has no additional functionality and the customer cannot use it to receive any other services from any other service provider.

Other set-top boxes have additional features. The most sophisticated offer a wide range of functionality, including the ability to access content and services provided by third parties.

For the purpose of this example it is assumed that each set-top box meets the definition of an identified asset. It is also assumed that as the set-top boxes are located in the customers' homes and are used exclusively to deliver the requested TV services, it is the customer who obtains substantially all of the economic benefits from their use. But whether or not the customer also directs how and for what purpose the equipment is used depends on its functionality.

For simple set-top boxes, with no functionality for the customer other than to receive the requested services, it can be argued that the customer does not direct how and for what purpose they are used. The customer has no more control over the set-top box than it would over similar equipment located elsewhere, including at the operator's premises. But it could also be argued that the customer has the right to direct the use of the equipment because its use is predetermined and the customer switches it on or off and can choose which programmes to watch. This is where the operator will need to apply judgement in weighing up the various factors and selecting an appropriate accounting policy.

The more functionality the set-top box has for the customer, the more likely it is that the customer has the right to direct its use and the more likely the arrangement contains a lease. There is however no 'bright-line' and judgement will need to be applied in determining the point at which the customer is considered to direct how and for what purpose the equipment is used.

Considering whether a lease component should be separated from other lease components in an arrangement

We have described above the approach to be taken in determining whether equipment is distinct for the purpose of IFRS 15. Similar principles apply where an arrangement contains a lease of equipment instead of outright sale.

IFRS 16 provides that a right to use equipment is treated as a separate lease component from other lease components if both of the following criteria are met:

- The customer can benefit from use of the equipment either on its own or together with other resources that are readily available.
- The equipment is neither highly dependent on, nor highly interrelated with, other assets in the contract.

These criteria are applied in determining whether an arrangement includes one or multiple lease components. They are similar to IFRS 15's concepts of 'capable of being distinct' and 'distinct within the context of the contract'; a point acknowledged by the IASB in IFRS 16's basis for conclusions. So they are useful in considering how many elements are to be accounted for separately in an arrangement. That said, it is likely that once an operator has identified the existence of a lease within a service arrangement, so the customer is directing the use of the leased equipment, that lease will be considered a 'distinct' element to be accounted for separately.

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

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