In depth
A look at current financial reporting issues

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Revenue from contracts with customers
The standard is final – A comprehensive look at the new revenue model

Communications industry supplement

What's inside:

At a glance

On 28 May 2014, the IASB and FASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

This supplement highlights some of the areas that could create the most significant challenges for entities in the communications industry as they transition to the new standard.

Overview

The communications industry comprises several subsectors, including wireless, fixed line, and cable/satellite television (TV). These entities generate revenue through many different service offerings that include access to, and usage of, network and facilities for the provision of voice, data, internet, and television services. These services generate revenues through subscription fees or usage charges. Some communications entities also sell or lease equipment such as handsets, modems, dongles (a wireless broadband service connector), customer premises equipment (CPE), and a variety of accessories.

Newer offerings are also emerging such as instalment sales of wireless devices; multi-line plans, where customers attach more than one device to a service; and bundled plans, with core video service, including voice and internet services, combined with newer offerings like home security services. Cloud services and machine-to-machine services are also a growth area.

The revenue standard will impact each of these businesses with certain changes having the potential for the greatest impact:

- Additional revenue may need to be allocated to discounted or 'free' products provided at the beginning of a service period due to the elimination of the 'contingent revenue cap', and changes to and restrictions in the use of the 'residual method' currently applied by some communications entities.

- The revenue standard could affect the accounting treatment of activation fees, customer acquisition costs, and certain contract fulfilment costs.

- The guidance may be applied to a portfolio of contracts or performance obligations in some circumstances, although this approach may create additional implementation challenges and complexities.

Communications entities are continually evaluating their business models and providing new device and service plans to customers. Assessing the accounting impact of these new services can be challenging. During the transition to the revenue standard, management will need to consider the impact these new offerings have under both the old and new guidance, adding complexity to their growing list of challenges.

Identifying performance obligations

A performance obligation is a promise to transfer a distinct good or service to a customer. Identifying the separate performance obligations within a contract affects both when and how much revenue is recognised. Entities will need to determine whether performance obligations within customer contracts should be accounted for separately or bundled together. A performance obligation might be explicit in a contract, or implicit, arising from customary business practices. Applying the separation principle might be challenging where there are multiple offerings in bundled packages.

Communications entities regularly bundle the sale of telecom services and equipment (for example, handsets, modems, accessories, etc.) and might also include a charge for activation or set up. Wireless entities give free or significantly discounted handsets to customers in some countries as an incentive to enter long-term telecom service contracts (for example, one- and two-year contracts).

Equipment (including handsets) transferred to customers is a separate performance obligation in most cases if the entity separately sells equipment or the customer can benefit from the handset together with other resources (for example, the handset could operate on another communications entity's network). This is true regardless of whether the equipment is given at no cost or at a significantly discounted price. Other obligations such as promises of future discounted services or other material rights will also need to be evaluated to determine if they qualify as separate performance obligations.

Final standard	Current US GAAP	Current IFRS
Performance obligations The revenue standard requires entities to identify all promised goods or services in a contract and determine whether to account for each promised good or service as a separate performance obligation. A performance obligation is a promise in a contract to transfer a distinct good or service to a customer. A good or service is distinct and is separated from other obligations in the contract if: • the customer can benefit from the good or service separately or together with other resources; and	The following criteria are considered to determine whether elements included in a multiple-element arrangement are accounted for separately: • The delivered item has value to the customer on a stand-alone basis. • If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.	The revenue recognition criteria are usually applied separately to each transaction. It might be necessary to separate a transaction into identifiable components to reflect the substance of the transaction in certain circumstances. Separation is appropriate when identifiable components have stand-alone value and their fair value can be measured reliably. Two or more transactions might need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

Final standard	Current US GAAP	Current IFRS
• the good or service is separately identifiable from other goods or services in the contract. A series of distinct goods or services that are substantially the same are accounted for as a single performance obligation if: • each would be a performance obligation satisfied over time; and • the same method would be used to measure the entity's progress toward satisfaction. Examples of this could include network access or call centre services provided continuously over a period of time.		
Options to acquire additional goods or services An entity might grant a customer the option to acquire additional goods or services free of charge or at a discount. These options might include customer award credits or other sales incentives and discounts. An option gives rise to a separate performance obligation if it provides a material right that the customer would not receive without entering into the contract. The entity should recognise revenue allocated to the option when the option expires or when the additional goods or services are transferred to the customer. An option to acquire an additional good or service at a price that is within the range of prices typically charged for those goods or services does not provide a material right, even if the option can be exercised only because of entering into the previous contract.	When an option is determined to be substantive, an entity evaluates whether that option has been offered at a significant incremental discount. If the discount in an arrangement is significant, a presumption is created that an additional deliverable is being offered in the arrangement requiring a portion of the arrangement consideration to be deferred at inception.	The recognition criteria are usually applied separately to each transaction (that is, the original purchase and the separate purchase associated with the option). However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components as a single transaction in order to reflect the substance of the transaction. If an entity grants to its customers, as part of a sales transaction, an option to receive a discounted good or service in the future, the entity accounts for that option as a separate component of the arrangement and therefore allocates consideration between the initial good or service provided and the option.
Non-refundable upfront fees Some entities charge a customer a non-refundable upfront fee at or near contract inception. Entities will need to determine whether the non-refundable upfront fee relates to the transfer of a good or service to a customer.	Unless an upfront fee is in exchange for products delivered or services performed that represent the culmination of an earnings process, an upfront fee should be deferred and recognised systematically over periods that the fees are earned	Recognition of revenue from an upfront fee depends on the nature of the services provided. An entity must determine whether an upfront fee related to installation or activation is a separate component of the transaction.

Final standard	Current US GAAP	Current IFRS
The standard states that activation services are an example of non-refundable upfront fees that do not result in the transfer of a good or service to the customer. The payment for the activation service is an advance payment for future communications services.	In cases in which an upfront fee is not related to specific products or services, the fee should be excluded from the consideration that is allocated to the deliverables and recognised over the longer of the initial contractual term of the arrangement or the estimated period the customer is expected to benefit from the payment of the upfront fee (that is, the customer benefit period). When all or a portion of an upfront fee is related to a specific deliverable(s) within the arrangement, the upfront fee, or a portion thereof, should be included within the consideration that is allocated to the deliverables using the relative selling price method.	Generally, activation fees for communications services are not a separate component of the transaction. The activation fees are generally recognised over the period the communications services are provided to the customer.

Potential impact - both IFRS and US GAAP

Entities will need financial processes that identify the different performance obligations in each contract and pinpoint when and how those obligations are fulfilled. Traditionally, wireless communications entities have identified the device and service as separate units of accounting under existing guidance, but they will need to consider whether additional performance obligations exist under the new model. This assessment will need to extend to all obligations under a contract, even items that are not regularly sold by the entity, or that have previously been viewed as marketing expenses (for example, provision of 'free' products not related to the provision of communications services).

Communications entities will have to carefully consider outsourcing and network IT contracts, various types of activation/connection services, and other upfront services (for example, connecting customers to their network or laying physical line to the customers' premises) to determine if these services meet the definition of a separate performance obligation and if a good or service is transferred to the customer. The timing of revenue recognition for communications entities that currently do not account for equipment (for example, handsets) separately from the telecom services will be significantly affected if the components of their bundled offerings are separate performance obligations under the revenue standard.

Many entities charge activation fees at the inception of a contract. The activation services are typically not a separate performance obligation. Activation fees are advance payment for future goods or services and, therefore, would be recognised as revenue when those future goods or services are provided. The recognition period could extend beyond the initial contractual term if the customer has the option to renew and that option provides the customer with a material right (for example, an option to renew without requiring the customer to pay an additional activation fee). Entities should carefully consider the impact of options on all contracts, including month-to-month service arrangements. This may result in a different pattern of revenue recognition from today's accounting models under which activation fees are often recognised over the contract period.

Communications entities increasingly sell multi-line plans and will need to determine whether the option to add additional lines is a material right that is a separate performance obligation.

Example 1 – Identifying performance obligations

Question: A communications entity enters into a contract with a customer to provide wireless telecom services (voice, data, etc.) for C50 per month and a handset for C100. It also charges an activation fee of C30. The communications entity sells handsets separately (for example, when a customer's handset is lost, stolen, or damaged).

How many separate performance obligations are in this contract?

Discussion: Two separate performance obligations exist in this arrangement: wireless telecom services and the handset. The handset is a separate performance obligation because the entity sells the handset separately. The handset is a separate performance obligation even if the entity does not sell the handset separately, if the customer could use the handset to receive telecom services from another entity (that is, there are no technological or legal barriers that prevent customers from using the equipment on another entity's network). Activation/connection fees are not separate performance obligations, but are considered upfront payments for the handset and future telecom services.

Example 2 – Options that do not provide a material right

Question: A communications entity enters into a two-year contract with a customer to provide wireless telecom services (voice, data, etc.) for C50 per month. The contract requires the communications entity to provide the customer with 800 voice minutes and 100 text messages per month. The contract specifies the customer may purchase additional voice services for C0.10 per minute and text services for C0.20 per message during the contract. These prices are typically charged for those services regardless of the type of contract and therefore reflect the stand-alone selling price of those services.

Is the customer's option to purchase additional voice minutes and text messages a separate performance obligation?

Discussion: The option provided in the contract is not a performance obligation because it does not provide a material right to the customer. The customer pays the same price, or price within a range, for voice minutes and text messages as other customers. The entity will recognise revenue for the additional voice minutes and text messages if and when the customer receives those additional services.

Example 3 – Installation services

Question: A communications entity enters into a contract to provide telecom services (voice, data, etc.) on a monthly basis, with no contract end date. An upfront, non-refundable installation fee of C50 is charged to recover the cost of laying physical line to the customer's premises. This line can be used by other communications entities if the customer later changes service providers.

Is the installation service a separate performance obligation?

Discussion: The entity will need to determine whether laying the physical line is a distinct good or service. In this example, other communications entities can provide services on the same physical line, so the line is separately identifiable and can be used by the customer without the entity subsequently providing telecom services. Laying the physical line is therefore a distinct performance obligation.

Example 4 – Cable entity, activation services

Question: A cable entity enters into a contract to provide services (voice, television, internet, etc.) on a monthly basis, with an initial contract period of 12 months. An upfront, non-refundable fee of C50 is charged to recover the cost of sending a technician to activate the service for the customer's premises.

Is the activation service a separate performance obligation?

Discussion: The entity will need to determine whether the activation is a distinct service. In this example, the activation services are not distinct from the provision of the voice and data services because the customer cannot benefit separately from the activation service. The activation fee should be deferred and recognised over at least the contract period. Entities will need to determine if the activation fee relates to the provision of services that extend beyond the initial contract period, and should be recognised over that longer period. This could be the case if the customer has a material right to extend the contract without paying an additional activation fee.

Determining the transaction price

The transaction price is the amount of consideration an entity is entitled to receive in exchange for transferring goods or services to customers. Determining the transaction price is straightforward when the contract price is fixed; it becomes more complex when it is not fixed. Discounts, rebates, refunds, credits, incentives, performance bonuses, and price concessions could cause the amount of consideration to be variable. The guidance on variable consideration might require communications entities to recognise revenue earlier than current practice.

Final standard	Current US GAAP	Current IFRS
Variable consideration The transaction price might include an element of consideration that is variable or contingent upon the outcome of future events, such as discounts, rebates, refunds, credits, incentives, etc. An entity should use the expected value or most likely outcome approach to estimate variable consideration, depending on which is the most predictive. An estimate of variable consideration is included in the transaction price to the extent it is highly probable (IFRS) or probable (US GAAP) that a significant reversal will not occur in future periods. Highly probable under IFRS means the same as probable under US GAAP. The estimate should be updated at each reporting period. If an entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, the entity recognises a refund liability for an amount the entity expects to refund. Customers might not exercise all of their contractual rights related to a contract, such as mail-in rebates and other incentive offers. Entities will need to continually update their estimates to adjust for changes in expectations. The revenue standard explains several factors entities should consider in making this assessment to determine the amount of consideration to which an entity expects to be entitled.	The seller's price must be fixed or determinable in order for revenue to be recognised. Revenue related to variable consideration generally is not recognised until the uncertainty is resolved. It is not appropriate to recognise revenue based on the probability of an uncertainty being achieved. Certain sales incentives entitle the customer to receive a cash refund (for example, a rebate) for some of the price charged for a product or service. The vendor recognises a liability for those sales incentives based on the estimated refunds or rebates that will be claimed by customers. A liability (or deferred revenue) is recognised for the maximum potential amount of the refund or rebate (that is, no reduction is made for expected breakage) if future refunds or rebates cannot be reasonably and reliably estimated.	Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset or liability could be exchanged or settled between knowledgeable, willing parties in an arm's length transaction. Trade discounts, volume rebates, and other incentives (such as cash settlement discounts) are taken into account in measuring the fair value of the consideration to be received. Revenue related to variable consideration is recognised when it is probable that the economic benefits will flow to the entity and the amount is reliably measurable, assuming all other revenue recognition criteria are met. A liability is recognised based on the expected levels of rebates and other incentives that will be claimed. The liability should reflect the maximum potential amount if no reliable estimate can be made.

Potential impact - both IFRS and US GAAP

Some entities will recognise revenue earlier under the revenue standard because variable consideration is included in the transaction price prior to the date on which all contingencies are resolved. For example, a network provider might offer other communications entities (customers) volume discounts on usage rates (voice and data access) to access its network as part of a minimum purchase commitment arrangement. The network provider charges penalties or the customers lose the volume discounts if the customers do not meet specified usage volumes. Communications entities that offer such discounts under minimum purchase commitment arrangements, and determine it is highly probable (IFRS) or probable (US GAAP) they will receive penalties or additional payments because customers fail to meet the specified usage volumes, could recognise revenue earlier than under current guidance.

Entities will also have to estimate amounts related to incentives and consider the guidance for variable consideration to determine the amounts they expect to be entitled to, considering their experience with existing incentives, discounts, take-rates, and other external factors.

The revenue standard requires entities to adjust the promised amount of consideration to reflect the time value of money if the contract has a significant financing component. Factors to consider when determining whether a contract has a significant financing component include, but are not limited to: (a) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services, (b) whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction, and (c) the interest rate in the contract and prevailing interest rates in the relevant market.

Communications entities should consider whether the transfer of a handset to a customer at the initiation of the contract and collecting monthly payment for the handset over the contract period provides the customer with a significant financing benefit, which would result in an adjustment to the transaction price to reflect the financing component.

Example 5 – Discount program, revenue is not constrained

Question: A communications entity enters into contracts with its customers to provide telecom services (voice, data, etc.) for C50 per month and Equipment X for C200. The customers will receive a discount of C100 related to the purchase of Equipment X, if they submit a properly completed form and proof of purchase via mail (also known as a mail-in-rebate). The entity has predictive experience from providing similar discounts to a range of customers (that is, refund amounts for similar equipment with similar sales prices). The entity concludes there are no external economic factors that affect historical trends, and that historically approximately 75% of customers take advantage of the rebate.

How should the entity account for this transaction?

Discussion: The entity should estimate the transaction price based on the amounts it expects to be entitled to.

The most recent history for similar discount programs (that is, refund amounts for similar equipment with similar sales prices) is used to estimate the amount to which the entity expects to be entitled. The refund liability for each transaction is estimated using the following probabilities representing the pattern of similar rebates.

Amount	**Probability**	**Probability-weighted amount**
C 0	25%	C 0
100	75%	75
		C 75

The entity concludes it is highly probable (IFRS) or probable (US GAAP) that variable consideration of C25 will not be subject to significant reversal. The entity will record a refund liability of C75 and reduce the transaction price by C75. The entity will update the estimated liability at each reporting period, with any adjustments recorded to revenue.

Example 6 – Discount program, revenue is constrained

Question: A communications entity is launching its service in a certain country for the first time and enters into contracts with its customers to provide telecom services (voice, data, etc.) for C50 per month and Equipment Y for C350. The customers receive a discount of C100 related to the purchase of the equipment if they submit a proper form and proof of purchase via mail. The entity does not have predictive experience providing similar discounts (that is, refund amounts for similar equipment with similar sales prices) in this country and concludes that there is no amount of the variable consideration (the potential discount) that is highly probable (IFRS) or probable (US GAAP) of not being subject to a significant reversal.

How should the entity account for this transaction?

Discussion: The entity will record a full refund liability of C100 and reduce the transaction price by C100 as there is no amount of the potential discount that is highly probable (IFRS) or probable (US GAAP) of not being subject to a significant reversal. The liability will be recognised as revenue as soon as management is able to conclude it is highly probable (IFRS) or probable (US GAAP) that there will be no reversal for some part of the consideration or the right to the discount expires. The entity will update the estimated liability at each reporting period, with any adjustments recorded to revenue.

Example 7 – Minimum purchase contract

Question: A communications entity enters into a contract with another communications entity (customer) to provide access to its network over a one-year period. The contract offers a discounted usage rate of C0.05 per voice minute. The discounted rate is contingent upon the customer's minimum monthly purchase commitment of 25 million minutes of network voice usage. If the customer is unable to meet the volume commitments, the usage rate increases to C0.08 per voice minute, applied retroactively.

How should the communications entity providing network access account for this transaction?

Discussion: The entity should estimate the variable consideration to determine the transaction price. The entity determines, based on its facts and circumstance, including the customer's usage history, that there is an 85% probability the customer *will* meet the minimum monthly volume commitments for the contract period and a 15% probability the customer will not meet the minimum commitments. The entity determines to use the 'most likely outcome' method as it is the best prediction of the amount it expects to receive. It also determines that there is no amount in excess of C0.05 per minute that is highly probable (IFRS) or probable (US GAAP) of not being reversed. Therefore, the entity will recognise revenue based on a transaction price of C0.05 per voice minute.

Allocating the transaction price

Communications entities, as previously discussed, often provide multiple products and services to their customers as part of a bundled offering. These arrangements usually consist of the sale of telecom services and the sale of equipment (wireless handset, modem, etc.). Some communications entities also charge customers an upfront activation fee. Under current guidance, communications entities reporting under US GAAP are required to apply a contingent revenue cap, while most communications entities reporting under IFRS use either a residual method or apply a contingent revenue cap. The contingent revenue cap limits the amount of consideration allocated to the delivered item (for example, a handset) to the amount that is not contingent on the delivery of additional items (for example, the telecom services).

Final standard	Current US GAAP	Current IFRS
The transaction price is allocated to separate performance obligations in a contract based on relative stand-alone selling prices. The stand-alone selling price is the price at which the entity would sell a good or service separately to the customer. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately. Entities will need to estimate the selling price if a stand-alone selling price is not observable. In doing so, the use of observable inputs is maximised. Possible estimation methods include: • Expected cost plus reasonable margin. • Assessment of market price for similar goods or services. • Residual approach, in limited circumstances. A residual approach may be used to estimate the stand-alone selling price when the selling price of a good or service is highly variable or uncertain. A selling price is highly variable when an entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts. A selling price is uncertain when an entity has not yet established a price for a good or service and the good or service has not previously been sold.	Arrangement consideration is allocated to each unit of accounting based on the relative selling price. Third-party evidence (TPE) of fair value is used to separate deliverables when vendor-specific objective evidence (VSOE) of fair value is not available. Best estimate of selling price is used if neither VSOE nor TPE exist. The term 'selling price' indicates that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. The residual or reverse residual methods are not allowed. When performing the allocation using the relative selling price method, the amount of consideration allocated to a delivered item is limited to the consideration received that is not contingent upon the delivery of additional goods or services. This limitation is known as the 'contingent revenue cap'. Communications entities typically account for the sale of the equipment and telecom services in a bundled offering as separate units of accounting, with telecom services collectively accounted for as a single unit of account, as they are generally delivered at the same time. The arrangement consideration that can be allocated to the equipment is generally limited to cash received because future cash receipts are contingent upon the entity providing telecom services. Therefore, when the handset is transferred, revenue is recognised at the amount that the customer paid for the handset at contract inception. The remaining contractual payments are recognised subsequently as the entity provides network services to the customer.	Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset or liability could be exchanged or settled, between knowledgeable, willing parties in an arm's length transaction. IFRS does not mandate how consideration is allocated and permits the use of the residual method, where the consideration for the undelivered element of the arrangement (normally service or tariff) is deferred until the service is provided, when this reflects the economics of the transaction. Any revenue allocated to the delivered items is recognised at the point of sale.

Potential impact - both IFRS and US GAAP

The revenue standard's allocation requirements will have significant implications to the telecom industry. It requires the transaction price be allocated to each separate performance obligation in proportion to the stand-alone selling price of the good or service. It therefore eliminates the contingent revenue cap. The revenue standard also substantially reduces the circumstances in which a residual approach can be applied. The residual approach is different from the residual method that is used today. Applying today's residual method results in the entire discount in an arrangement being allocated to the first item delivered under the contract. This will not be the case under the revenue standard.

Judgement will be needed to determine the stand-alone selling price for each separate performance obligation in a customer contract (the telecom services and equipment). There is good visibility into the pricing of communications equipment and the associated telecom service in some markets. However, in many markets, communications entities charge customers little, if anything, for the equipment and only sell equipment bundled with the telecom services. If communications entities do not separately sell equipment, management may have to use various estimation methods, including, but not limited to a market assessment approach or a cost plus margin approach.

Determining the stand-alone selling price of certain services may also present challenges. Historically, there was a reasonable level of consistency in the amounts charged for bundled services within operators and between operators. Today, there is increasing variability in the amounts charged for equivalent bundles of services. For example, the amount charged for services can vary depending on the number and mix of devices chosen by the customer, including 'SIM-only' deals, where the monthly price for service is less when the customer does not take a subsidised device, or multi-line plans.

The revenue standard will likely require entities to allocate more of the transaction price to the equipment than under the current guidance, and result in earlier recognition of revenue. Recognising more revenue than consideration received also results in the recognition of a contract asset, which will need to be monitored for impairment.

Entities will face practical challenges in allocating the transaction price for a large volume of customer contracts with varying configurations of equipment and service plans. The revenue standard permits an entity to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the entity's financial statements of doing so would not differ materially from the results of applying the guidance to individual contracts (or performance obligations). The boards acknowledged in their basis for conclusions that this approach may be particularly useful to entities in the telecommunications industry. The boards also noted that entities should be able to take a 'reasonable approach' to identify portfolios for applying this guidance, as opposed to a quantitative evaluation.

Entities should consider whether they need to modify existing systems or develop new systems to gather information on customer contracts and to perform the required allocations of the transaction price between separate performance obligations.

Example 8 – Allocating the transaction price

Question: A wireless entity enters into sales arrangements with two different customers: Customer A and Customer B. Each customer purchases or receives the same handset and selects the same monthly service plan. The stand-alone selling price for the handset is C300 (it is purchased wholesale by the wireless entity for C290) and the stand-alone selling price of the telecom service plan is C40 per month.

Customer A purchases the handset for C300 and enters into a cancellable contract to receive the telecom services (voice and data) for C40 per month.

Customer B enters into a 24-month service contract for C40 per month and receives a discounted handset for C50.

In summary:	Customer A	Customer B
Stand-alone selling price of handset	C 300	C 300
Stand-alone selling price of services	40	960 (C40 x 24 months)
Total	C 340	C1,260 C
Cost of equipment	290	C 290

Customer A transaction price C 340 (C300 handset + C40 for one month of service)
Customer B transaction price C 1,010 (C960 services + C50 for handset)

How should the transaction price be allocated to the performance obligations in the contracts with Customer A and B?

Discussion: The entity needs to identify the separate performance obligations within customer contracts. The sales of telecom services and handsets are typically separate performance obligations given they are distinct goods and services.

Revenue is recognised when a promised good or service is transferred to the customer and the customer obtains control of that good or service. Revenue is recognised for the sale of the handset at delivery, when the communications entity transfers control of the handset to the customer. Service revenue is recognised over the contract service period.

For simplicity, the example assumes the potential financing impact of transferring the handset to the customer at the initiation of the contract and collecting the customer's monthly payment over the 24-month contract period is insignificant.

The tables below compare the effect of applying the allocation guidance in the revenue standard with that of the current guidance.

Current guidance—existing U.S. GAAP guidance (contingent revenue cap)

Customer	Day 1	Month 1	Month 2	Month 3
Customer A	\$300[(a)]	\$40[(a)]	\$40	\$40
Customer B	\$50[(b)]	\$40	\$40	\$40
Total	\$350	\$80	\$80	\$80

(a) Recognise revenue for the sale of the handset (C300) and service (C40) based on the relative stand-alone selling prices.
(b) Recognise revenue for the amount of consideration received (C50) that is not contingent upon the delivery of additional items (telecom services).

Current guidance—existing IFRS guidance (residual method)

Customer	Day 1	Month 1	Month 2	Month 3
Customer A	\$300[(a)]	\$40	\$40	\$40
Customer B	\$50[(b)]	\$40	\$40	\$40
Total	\$350	\$80	\$80	\$80

(a) Under the residual method, the amount of consideration allocated to the delivered item (C300) equals the total arrangement consideration (C340) less the aggregate fair value of the undelivered item(s) (C40).
(b) Under the residual method, the amount of consideration allocated to the delivered item (C50) equals the total arrangement consideration (C1,010) less the aggregate fair value of the undelivered item(s) (C960).

New guidance:Revenue recognised

(a) Handset: C300 = (C300 / C340) x C340; One month of service C40 = (C40 / C340) x C340.
(b) Handset: C240 = (C300 / C1,260) x C1,010. (c) Monthly service revenue: C32 = (C960 / C1,260) x C1,010 = C770 / 24 months.

In this example, the communications entity will recognise C190 more in equipment revenue compared to current IFRS and US GAAP. The communications entity will also recognise a net contract asset of C190 under the revenue standard (C540 less C350 cash received). This asset will have to be monitored for impairment each reporting period. For example, the communications entity may have to impair the asset if Customer B terminates the contract before the end of two years and it is unable to collect an early termination fee in excess of the contract asset balance.

The simple example above does not address other complexities that entities will have to consider. An entity that charges an activation fee to customers will need to determine whether activation represents a separate performance obligation, or if it relates to the provision of future goods or services. If activation is not a separate performance obligation, and the entity grants the customer an option to renew that provides a material right (for example, an option to renew without requiring the customer to pay an additional activation fee), the activation fee would likely be recognised over the customer relationship period.

Contract acquisition costs

Telecom

Communications entities often pay commissions to internal sales agents and third-party dealers for connecting new customers to their networks. Commissions paid for connecting new customers can vary depending on the length of the service contract and the type of service plan, including any enhanced services sold. The longer the service contract and the greater the monthly proceeds (for example, service plans with relatively high or unlimited minutes of use), the greater the commission costs.

Some entities that report under IFRS capitalise customer acquisition costs as an intangible asset, while other communications entities, including most US communications entities, expense these costs as incurred. The standard will require communications entities to capitalise incremental costs of obtaining a contract if the costs are expected to be recovered. As a practical expedient, entities are permitted to expense these costs when incurred if the amortisation period would be less than one year.

Some wireless entities also provide free or heavily discounted handsets to attract customers. Incentive programs will not be accounted for as 'customer acquisition costs' under the revenue standard. A handset is a separate performance obligation and the cost of the handset is recognised as an expense when the performance obligation is satisfied (that is, when the handset is delivered to the customer). Communications entities offer a wide range of discounts and subsidies, using both their own and third-party dealer networks, and will have to assess the accounting for each different type of arrangement.

Cable

Cable television companies often incur costs to obtain and retain subscribers. Entities will need to consider the guidance on acquisition costs in determining whether they should be expensed, or capitalised and amortised over a specified period.

Final standard	Current US GAAP	Current IFRS
Entities will recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity would not have incurred if the contract had not been obtained. All other contract acquisition costs incurred regardless of whether a contract was obtained are recognised as an expense. The revenue standard permits entities to expense incremental costs of obtaining a contract when incurred if the amortisation period would be one year or less, as a practical expedient. Contract costs recognised as an asset are amortised on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates. In some cases, the asset might relate to goods or services to be provided in future anticipated contracts (for example, service to be provided to a customer in the future if the customer chooses to renew an existing contract). An impairment loss is recognised to the extent that the carrying amount of an asset exceeds: (a) the amount of consideration to which an entity expects to be entitled in exchange for the goods or services to which the asset relates; less (b) the remaining costs that relate directly to providing those goods or services. Entities may reverse impairments, under IFRS, when costs become recoverable; however, the reversal is limited to an amount that does not result in the carrying amount of the capitalised acquisition cost exceeding the depreciated historical cost. Entities are not permitted to reverse impairments under US GAAP.	US GAAP allows costs that are directly related to the acquisition of a contract that would not have been incurred but for the acquisition of that contract (incremental direct acquisition costs) to be deferred and charged to expense in proportion to the revenue recognised. Other costs— such as advertising expenses and costs associated with the negotiation of a contract that is not consummated —are charged to expense as incurred.	Given the lack of definitive guidance under current IFRS, costs of acquiring customer contracts have been capitalised by some communications entities as intangible assets and amortised over the customer contract period, while other communications entities expense the costs when incurred.

Potential impact - both IFRS and US GAAP

The revenue standard will have a significant impact on entities that do not currently capitalise contract acquisition costs. Entities will likely have to develop systems, processes, and controls to identify and track incremental contract acquisition costs and to subsequently monitor the capitalised costs for impairment.

Communications entities will capitalise these contract acquisition costs as an asset if they are recoverable and amortise them consistent with the pattern of when goods or services to which the asset relates are transferred to the customer. Entities will need to use judgement to determine the amortisation period as the revenue standard requires entities to consider periods beyond the initial contract period; for example, the renewal of existing contracts and anticipated contracts. Entities should carefully consider potential renewals in assessing the amortisation period for contract acquisition costs, including month-to-month service arrangements.

While the revenue standard moves closer to aligning the recognition of costs with the associated revenue, differences may still exist. For example, upfront fees (such as activation fees, discussed briefly in Example 8 above) are deferred if they do not relate to a transfer of a promised good or service that represents a separate performance obligation. These fees could represent advance payments for goods and services provided under the contract, or they might provide the customer with a 'material right' in the form of renewal option that extends beyond the initial contract period.
Judgement will need to be exercised in determining the period over which the related revenue is recognised. As there is a practical expedient that allows contract acquisition costs to be recognised immediately if the deferral period is less than one year, the revenue recognition period will not necessarily correspond with the period over which contract acquisition costs are amortised.

Entities will also have to develop a systematic approach, considering the number of customers and contract offerings, to test assets relating to contract acquisition costs for impairment (for example, a portfolio approach) when the estimated amount of consideration to be received from customers might be less than the outstanding contract asset.

Spreading these costs over the amortisation period could significantly affect operating margins compared to the current accounting model. Wireless entities, for example, often incur significant contract acquisition costs during the holiday seasons as they sign up customers through significant promotional offers.

Example 9 – Contract acquisition costs, practical expedient

Question: A communications entity enters into a contract with a customer to provide telecom services. The entity pays a third-party dealer a commission to connect customers to its network. The customer signs an enforceable contract to receive telecom services for one year.

How should the communications entity account for the third-party dealer commission?

Discussion: The entity will identify incremental contract acquisition costs and capitalise those costs that are recoverable. The communications entity may use the practical expedient and expense contract acquisition costs when incurred if the amortisation period would be one year or less. The entity determines the amortisation period is one year in this case after considering expected renewals. The communications entity may use the practical expedient and expense these costs when incurred.

Example 10 – Contract acquisition costs, identifying incremental costs

Question: A communications entity sells wireless telecom service subscriptions (service plans) from a retail store in a shopping mall. Sales agents employed at the retail store sign 120 customers to two-year telecom service contracts in a particular month. The monthly rent for the store is C5,000. The communications entity pays the sales agents' commissions for the sale of telecom service contracts, in addition to their normal wages. Wages paid to the sales agents during the month are C12,000 and commissions are C24,000.

The communications entity also offers customers free, or significantly subsidised, handsets to create an incentive for them to enter into two-year contracts. The net subsidy (loss) on handsets sold to the 120 customers is C36,000 (measured simply on the basis of the cost of the handset compared to advertised price, and not as specified in the revenue standard). The retail store also incurs C2,000 in costs during the month to advertise in the local journals.

How much should the communications entity recognise as a contract acquisition asset?

Discussion: The communications entity is required to capitalise incremental costs to acquire contracts, which are those costs the entity would not have incurred unless it acquired the contracts. The practical expedient is not available as the amortisation period is greater than a year. In this example, the only costs that qualify as incremental contract acquisition costs are the C24,000 commissions paid to the sales agents.

All other costs are charged to expenses when incurred. The store rent of C5,000, the sales agents' wages of C12,000, and advertising expenses of C2,000 are all expenses the communications entity would have incurred regardless of acquiring the customer contracts and should be expensed as incurred. The entity might internally regard the handset losses as marketing incentives or incidental goods or services, but the sale of the handsets are performance obligations, and the costs of the handsets are recognised (as cost of goods sold) as the goods are delivered.

Entities should be aware that subtle differences in arrangements could have a substantial impact on the accounting for subsidies and discounts under the revenue standard. For example, another communications entity might pay third-party dealers greater commissions to allow those dealers to offer similar incentives (that is, offer significantly discounted handsets at a dealer's discretion). Payments to dealers that are in-substance commissions should be treated as contract acquisition costs.

Example 11 – Contract acquisition costs, amortisation period for prepaid services

Question: A communications entity sells wireless services to a customer under a prepaid, unlimited monthly plan. The communications entity pays commissions to sales agents when they activate a customer on a prepaid wireless service plan. While the stated contract term is one month, the communications entity expects the customer, based on the customer's demographics (for example, geography, type of plan, and age), to renew for six additional months.

What period should the communications entity use to amortise the contract acquisition costs (that is, the commission costs)?

Discussion: The entity could use the practical expedient to expense the costs as incurred. If the entity chooses to capitalise the costs, it will use judgement to determine an amortisation period that represents the period during which the entity transfers the telecom services. In this example, the entity determines an amortisation period of seven months based on anticipated renewals.

Fulfilment costs

Some communications entities defer the cost of activating customers to the network (that is, labour and equipment cost) under US GAAP. These costs can be material and are typically deferred up to the amount of related activation revenue and amortised on a straight-line basis consistent with the related revenues. Entities that provide long-term network outsourcing services sometimes defer set-up costs under IFRS because they are necessary investments to support the ongoing delivery of the contract.

Costs to fulfil contracts are capitalised under the scope of other standards (for example, inventory, property, plant and equipment, or intangible assets) or if they meet specific requirements under the revenue standard. Entities will need to carefully review its cost capitalisation policies to understand the potential effect of these changes.

Final standard	Current US GAAP	Current IFRS
Direct costs incurred to fulfil a contract are first assessed to determine if they are within the scope of other standards, in which case the entity accounts for such costs in accordance with those standards. Costs that are not in the scope of another standard are evaluated under the revenue standard. An entity recognises an asset only if the costs: • relate directly to a contract; • generate or enhance resources that will be used in satisfying future performance obligations (that is, they relate to future performance); and are expected to be recovered. These costs are then amortised as control of the goods or services to which the asset relates is transferred to the customer.	Costs incurred to install services at the origination of a customer contract may be either expensed as incurred, or deferred and charged to expense in proportion to the revenue recognised. In particular, direct, incremental, set up costs on long-term network outsourcing contracts may be deferred by reference to the FASB Conceptual Framework and analogy to ASC 310-20 and ASC 605-20-25-4. In addition, many of the costs of connecting customers form part of the operator's network and the costs are capitalised as property, plant and equipment.	Costs incurred to install services at the origination of a customer contract are either expensed as incurred or they are recognised as an asset and charged to expense in proportion to the revenue recognised, depending on the nature of the costs. In particular, direct, incremental, set up costs on long-term network outsourcing contracts may be deferred if they are 'costs that relate to future activity on the contract'. Many of the costs of connecting customers form part of the operator's network and the costs are capitalised as property, plant and equipment.

Potential impact - both IFRS and US GAAP

Communications entities that currently expense all contract fulfilment costs as incurred might be affected by the revenue standard since costs are required to be capitalised when the criteria are met. Fulfilment costs that are likely to be in the scope of this guidance include, among others, set-up costs for service providers.

Contract modifications

Customers of communications entities often request changes to their service plans. For example, wireless telecom customers might change their existing service plans to upgrade or replace a device; include additional wireless minutes; increase data usage; add incremental, or remove, existing services; or terminate service altogether. Modifications also occur in multi-line plans when the customer adds, or removes a device and/or changes the size of the data plan being shared across devices. Entities will need to account for the changes as a modification to the contract as devices or services not covered under the original contract are added or removed.

Contract modifications exist when the parties to the contract approve a modification that creates or changes the enforceable rights and obligations of the parties to the contract. Entities will need to apply judgement in evaluating whether goods or services in the modification are distinct to determine whether a contract modification should be accounted for prospectively or as a cumulative catch-up adjustment. This may be particularly challenging in situations where there are multiple performance obligations in a contract.

Final standard	Current US GAAP	Current IFRS
A contract modification is treated as a separate contract only if it results in the addition of a distinct performance obligation and the price reflects the stand-alone selling price of that performance obligation. Otherwise, the modification is accounted for as an adjustment to the original contract. An entity will account for a modification prospectively if the goods or services in the modification are distinct from those transferred before the modification. An entity will account for a modification through a cumulative catch-up adjustment if the goods or services in the modification are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified. A contract modification that only affects the transaction price should be treated like any other contract modification.	Modifications to add or remove goods or services in telecom arrangements are typically viewed as new arrangements with changes accounted for prospectively.	Modifications to add or remove goods or services in telecom arrangements are typically viewed as new arrangements with changes accounted for prospectively.

Potential impact - both IFRS and US GAAP

Historically, modifications to communications contracts have typically been treated as a new agreement with changes accounted for prospectively. Going forward, entities will need to evaluate modifications under the new guidance to determine whether they are accounted for prospectively, or require a cumulative catch up adjustment. The analysis will need to consider modifications on new types of service plans, such as multi-line plans, where it may be more difficult to determine whether the modification adds distinct goods or services, or modifies existing goods or services being provided under the contract.

The revenue standard states that an entity will account for a series of distinct goods or services that are substantially the same as a single performance obligation if certain criteria are met. This approach will likely be used by communications entities in applying the guidance to contracts that provide the customer with a consistent level of services on a monthly basis over a contract period, rather than to treating each month or each day of service as a separate performance obligation. Entities that account for a series of distinct goods or services in this manner at inception of the arrangement must consider the distinct goods or services in the contract (not the performance obligation) for purposes of applying the guidance on contraction modifications. Therefore, contracts where the remaining goods are services in the modified contract are distinct from goods or services that have already been transferred to the customer will be accounted for prospectively.

Example 12 – Contract modification

Question: A fixed-line communications entity enters into a contract with a customer to provide voice and data services for 24 months at a fixed charge of C50 per month. After six months, the customer decides to add TV services for an incremental fee of C50 per month over the same term. This price is slightly lower than the price charged to customers who just purchase the TV service without voice and data services, which reflects the fact that the customer acquired the TV service as part of a bundle. In this scenario, assume there are no other fees or deliverables.

How should the entity account for this modification?

Discussion: The TV services added by the customer are a distinct performance obligation. These services are being charged at relative stand-alone selling price (as adjusted for the selling costs avoided by transacting with an existing customer). The TV services are a new contractual arrangement, and there is no impact to the accounting for the existing data and voice services.

While this example is fairly simple, further complexities could arise with contract modifications. For example, the modification could provide the customer with a discount on new or existing services, the contract period could be extended for all services, or additional deliverables (such as equipment) could be introduced. Entities will have to carefully assess the facts and circumstances to ensure the guidance is appropriately applied to these complex situations.

Contact us

Questions?

To have a deeper discussion, please contact:

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