Applying IFRS in Telecommunications

The new revenue recognition standard - telecommunications

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Building a better working world

Contents

What you need to know

- IFRS 15 creates a single source of revenue requirements for all entities in all industries. The new revenue standard is a significant change from current IFRS.
- The new standard applies to revenue from contracts with customers and replaces all of the revenue standards and interpretations in IFRS, including IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations.
- IFRS 15 is principles-based, consistent with current revenue requirements, but provides more application guidance. The additional application guidance will result in the need for increased judgement.
- Implementation will be challenging for many telecommunications (telecom) entities because of the variety of plans they offer and the frequency with which customers modify their plans.
- Most wireless telecommunications (wireless) entities will have to allocate more revenue than under current IFRS to subsidised handsets bundled with service contracts.
- Wireline telecommunications (wireline) entities may also have to change their accounting for certain enterprise contracts.
- IFRS 15 also specifies the accounting treatment for certain items not typically considered to be revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets.
- IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers, provided that fact is disclosed.

Overview

Telecom entities may need to change their revenue recognition policies and practices as a result of IFRS 15 *Revenue from Contracts with Customers,* a new standard issued by the International Accounting Standards Board (the IASB) jointly with the new standard issued by the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The new standards will supersede virtually all revenue recognition standards in IFRS and US GAAP, including any industry-specific requirements that telecom entities may use today under US GAAP.

Telecom entities are exploring whether using the portfolio approach will reduce some of the complexity of applying the new standard.

IFRS 15 specifies the accounting treatment for all revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS requirements, such as IAS 17 *Leases*). The standard also provides a model for the recognition and measurement of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment and intangible assets.

IFRS 15 will likely present implementation challenges for wireless entities, given the large number of possible handset/service plan options they offer, the frequency with which customers modify their plans, and the volume of contracts they have. The relative stand-alone selling price allocation could differ for each combination, depending on the size of the discount the entity provides on the handset and the expected revenue from providing future service. As a result, wireless entities will likely need to update their accounting and information systems to track individual transactions and allocate the consideration appropriately. The standard allows entities to group similar contracts in portfolios and account for them together, but the industry is still considering how this approach would work.

The wireless industry continues to evolve with frequent changes in product and service options, such as the recent introduction of handset instalment plans. Looking forward, wireless entities will need to continually evaluate their offerings to determine the accounting implications under IFRS 15.

Enterprise contracts will also be affected. If the terms are modified, telecom entities will have to determine whether the modified terms create a new contract or whether they should be considered part of the original contract. For some enterprise contracts, the pricing may be variable (e.g., the pricing is based on usage) and the entity will have to consider IFRS 15 requirements for variable consideration.

For contracts that are greater than a year, an entity may determine that there is a significant financing component.

This publication considers key implications of the new standard for telecom entities and highlights what is changing (or not changing) for the telecom industry. This publication supplements our *Applying IFRS, A closer look at the revenue recognition standard* June 2014)[1] (general publication) and should be read in conjunction with that publication.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and as entities begin to apply it and our views may evolve during that process.

[1] Available on www.ey.com/ifrs

1. Summary of the new standard

IFRS 15 specifies the requirements an entity must apply to measure and recognise revenue and the related cash flows. The core principle of the standard is that an entity will recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer.

The principles in IFRS 15 are applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract(s)
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when (or as) the entity satisfies each performance obligation

An entity will need to exercise judgement when considering the terms of the contract(s) and all of its facts and circumstances, including implied contract terms. An entity will also have to apply the requirements of IFRS 15 consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity will need to disclose more information than it does under current IFRS. Annual disclosures will include qualitative and quantitative information about the entity's contracts with customers, significant judgements made (and changes in those judgements) and contract cost assets.

Telecom entities also may wish to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on telecom issues. The Boards created the TRG to help them determine whether more application guidance or education is needed. The TRG will not make formal recommendations to the Boards or issue guidance. The AICPA's telecom industry task force is one of 16 industry task forces that it has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance provided by the AICPA are non-authoritative.

2. Effective date and transition

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers, provided that fact is disclosed, and for first-time adopters of IFRS.

The effective date of the standard for public entities applying US GAAP is 15 December 2016, which is essentially the same as for IFRS preparers. However, US public entities will not be permitted to early adopt the standard.[2]

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using IFRS 15, but prior periods would not be adjusted. Instead, an entity will recognise a cumulative catch-up adjustment to the opening retained earnings (or other appropriate component of equity) at the date of initial application for contracts that still require performance by the entity. In addition, an entity would disclose all line items in the year of adoption as if they were prepared under current IFRS (i.e., IAS 18, IAS 11 and related Interpretations).

For more information about the effective date and transition options, see Section 1 of our general publication.

3. Scope

IFRS 15 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts which are specifically excluded from the scope:

- Lease contracts within the scope of IAS 17 *Leases*
- Insurance contracts within the scope of IFRS 4 *Insurance Contracts*
- Financial instruments and other contractual rights or obligations within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

[2] US nonpublic entities will be required to apply the new standard to reporting periods beginning after 15 December 2017. Early adoption is permitted, but not prior to reporting periods beginning after 15 December 2016.

4. Identify the contract with the customer

The model in IFRS 15 applies to each contract with a customer. Contracts may be written, oral or implied by customary business practices, but must be enforceable and have commercial substance. An entity is required to combine two or more contracts that it enters into at, or near, the same time with the same customer and account for them as a single contract, if they meet specified criteria.

Before the model is applied to a contract, an entity must conclude that it is probable that it will collect the consideration to which it will be entitled. The Boards concluded that assessing a customer's credit risk is an important part of determining whether a contract, as defined by the standard, exists. The amount of consideration to which an entity expects to be entitled (i.e., the transaction price) may differ from the stated contract price (e.g., if the entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectability assessment to determine whether a contract exists, an entity should consider only the customer's ability and intention to pay the estimated transaction price and not the stated contract price.

Month-to-month contracts are common in the telecom industry. A month-to-month contract represents a series of renewal options because the same services continue to be provided until the customer or telecom entity cancels them. Most telecom entities have sufficient historical data to estimate the average customer life and may question whether they should consider the average customer life when applying the standard to month-to-month contracts. The standard is clear that revenue recognition is tied to the term of the contract when the parties have present enforceable rights and obligations. Therefore, we anticipate that a telecom entity will account for each month, in a month-to-month contract, as a separate contract unless the renewal options provide the customer with a material right (see Section 5).

Some wireless entities are offering arrangements that allow the customer some alternatives as to the term of the arrangement. For example, plans that allow a customer to pay the full retail price of the handset in monthly instalments as long as the customer is also purchasing monthly service. If the service is terminated, the remaining instalments on the handset become due. However, if the monthly service remains intact, after a certain number of months the customer has the option to trade in the financed handset (and all remaining payments are forgiven) and upgrade to a newer handset. In these situations, the wireless entity will need to determine the period over which there are enforceable rights and obligations with the customer.

4.1 Contract modifications

Entities may need to make changes to their accounting and IT systems to track contract modifications.

Telecom customers frequently make changes to their services. Wireless customers may: increase or decrease data in a wireless plan; add or remove lines from a shared data plan; or add or remove services. Enterprise customers also modify the terms of their contracts by adding or removing services.

The new standard requires certain modified contracts to be treated as entirely new contracts and others to be considered as part of the original arrangement. An entity must determine whether the modification creates a new contract or whether it will be accounted for as part of the existing contract. The determination of a new and separate contract is driven by whether the modification results in the addition of distinct goods or services and whether they are priced at their stand-alone selling prices (see Section 7). Contract modifications that meet these two criteria are treated as separate contracts. If these criteria are met, the accounting for the original contract is not affected by the modification and revenue recognition for the original contract is not adjusted. Contract modifications that may create separate new contracts include add-on services such as global voice and messaging plans. These plans will typically meet the standard's definition of 'distinct' and be treated as separate contracts because the monthly price for those services typically reflects the entity's stand-alone selling price.

Changes in the scope or amount of promised goods or services that do not create separate contracts have to be considered modifications of the original contract. However, if the goods and services to be provided after the contract modification are distinct from the goods and services provided on, or before, the modification, the entity accounts for the contract modification as a termination of the old contract and creation of a new contract. For these modifications, the revenue recognised to date on the original contract (i.e., the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining portion of the original contract and the modification are accounted for together on a prospective basis, by allocating the remaining consideration to the remaining performance obligations.

If a modification involves goods or services that are not distinct from the goods and services already provided, the entity will account for the contract modification as part of the original contract. The entity will adjust the revenue previously recognised to reflect the effect that the contract modification has on the transaction price and measure of progress (i.e., the revenue adjustment is made on a cumulative catch-up basis).

A change in a contract also may be treated as both a modification of an existing contract and the creation of a new contract. If that is the case, an entity would adjust revenue previously recognised to reflect the effect of the contract modification on the estimated transaction price allocated to the performance obligations that are not distinct from the modified portion of the contract and the measure of progress.

How we see it

Accounting for contract modifications has the potential to be a very complex issue for telecom entities. This is because customers frequently modify their contracts and can choose from a wide variety of offerings.

Most modifications to telecom agreements will be accounted for prospectively, as either a new contract or a termination of the old and creation of a new contract. However, telecom entities should carefully analyse contract modifications to appropriately account for them.

Entities that implement the standard on either a contract-by-contract basis or the portfolio approach will likely need to make changes to their accounting and IT systems to account for the effect of the modifications. For example, entities that implement the standard on a portfolio basis will need to determine how the modifications will affect the established portfolios. Accounting for modifications of contracts with millions of customers will likely be complex, regardless of the approach taken.

Illustration 4-1 – Wireless contract modification

On 1 January 20X1, Wireless Company enters into a two-year contract with a customer for a 2-gigabyte (GB) data plan with unlimited talk and text for CU60/month and a subsidised handset for which the customer pays CU200. The handset has a stand-alone selling price of CU600.

For purposes of this illustration, the time value of money has not been considered, the stand-alone selling price of the wireless plan is assumed to be the same as the contractual price and the effect of the constraint on variable consideration is not considered. Wireless Company allocates the transaction price, as follows:

	Consideration	Stand-alone selling price	Allocated transaction price
	CU	CU	CU
Handset	200	600	482
Wireless plan	1,440	1,440	1,158
Total consideration	1,640	2,040	1,640

The allocated transaction price for the handset (CU482) is recognised as revenue when the customer takes possession of the handset (at the time of sale). The CU1,158 service revenue is recognised over the two-year contract term (or CU48.25/month). A contract asset of CU282 is established at the time the handset revenue is recognised, representing the difference between the revenue recognised and the cash received. This asset is reduced each month by the portion of the monthly service fee that was allocated to the handset (CU11.75). For additional discussion on allocating the transaction price, refer to Section 7 below.

The following two scenarios address when a customer modifies the terms of their contract to decrease (Scenario 1) or increase (Scenario 2) their data service plan.

Scenario 1

On 1 July 20X1, the customer downgrades his wireless data plan from 2GB to the 1GB data plan for the remaining term of the contract (18 months). The 1GB plan is priced at CU50/month, which is the current price that is available to all customers.

Wireless Company determines that this modification does not create a separate contract because it does not add goods and services to the arrangement. However, to determine the appropriate accounting for the modification, Wireless Company assesses whether the remaining goods and services (18 months of service) are distinct from the goods and services already provided to the customer (handset and six months of service).

At contract inception, the entity had determined that each month of wireless data service was distinct. Therefore, at the date of the modification, Wireless Company determines that the remaining monthly services are distinct from the handset and services already provided to the customer. As a result, Wireless Company allocates the remaining consideration to be received to the remaining performance obligations (CU50 per month x 18 months remaining in contract), less the amount that has already been allocated to the delivered goods or services (i.e., the contract asset). In this fact pattern, the contract asset was initially CU282, but is reduced to CU211.50 at the date of the modification. As a result, the entity has CU688.50 to allocate to the remaining monthly service, or CU38.25 per month.

Illustration 4-1 — Wireless contract modification *(cont'd)*

Scenario 2

Assume the customer increases his data plan from 2GB to 3GB for the remaining term of the contract (18 months). The 3G plan is priced at CU70/month, which is the current price that is available to all customers.

This modification results in an additional 1GB of data for the remaining term of the contract and, therefore, represents the addition of goods and services. In narrow circumstances, such as this scenario, where the modified service will be delivered monthly over the remaining term of the contract with no other performance obligations added that have a different delivery of service, the distinction of whether the modification is treated as a separate contract or as the termination of an old contract and creation of a new contract has no effect on the accounting result, as illustrated below.

If Wireless Company determines that the additional 1GB of data is distinct[1] and the price of the contract has increased by the additional good or service's stand-alone selling price, the additional service would be treated as a separate contract. Wireless Company would recognise the CU10 each month over the remaining contract term in addition to the original amount of service revenue of CU48.25, resulting in a total amount of revenue of CU58.25 recognised each month.

Alternatively, Wireless Company may determine that the 1GB of data for CU10 is not at the wireless entity's stand-alone selling price. In this case, the modification cannot be treated as a separate contract. Instead, it is accounted for as a termination of the existing contract and the creation of a new contract. Wireless Company may also view the contract modification simply as a termination of the 2 GB data plan and the addition of a 3 GB data plan.

At contract inception, the entity had determined that each month of wireless data service was distinct.

Therefore, at the date of the modification, Wireless Company determines that the remaining monthly services are distinct from the handset and services already provided to the customer. As a result, Wireless Company allocates the consideration to be received to the new performance obligation (CU70 per month x 18 months remaining in contract), less the amount that has already been allocated to the delivered goods or services (i.e., the contract asset).[2] As a result, the entity has CU1,048.50 to allocate to the remaining monthly service (CU58.25 per month).

Notes:

1 The customer can benefit from the 1GB of data on its own or together with other resources and the promise to provide that data is separately identifiable from the other services in the contract.
2 In this fact pattern, the contract asset was initially CU282, but it has been reduced to CU211.50 at the date of the modification.

4.1.1 Family share plans

A potential complexity for telecom entities, as it relates to accounting for contract modifications, pertains to family share plans. Under those plans, telecom entities frequently allow their customers to modify their contractual obligations (i.e., the goods and services signed up for under the plan) at will and many customers have a history of making frequent modifications. This practice will likely result in telecom entities needing systems to track and adjust their accounting for frequent modifications.

For example, a common modification to a family share plan involves adding an additional handset, offered at a subsidised price, to the existing data plan. An access fee is charged for the new line each month and the shared data plan is extended to two years from the date of the modification (i.e., if the new handset is added three months into an existing 24-month data plan, the data plan is extended from 21 remaining months to 24 months).

The following illustration highlights the complexity of accounting for a modification to a family share plan.

Illustration 4-2 – Family share plan

In January 20X1, two individuals (Family A) enter into a wireless share plan with a two-year contract with Wireless Company. Family A agrees to pay CU150/month for a 4GB shared data plan (that includes unlimited talk and text), the same amount as the stand-alone selling price. Both individuals select the same smartphone at the subsidised price of CU200 (with a stand-alone selling price of CU600). For simplicity, assume that Wireless Company does not charge activation fees. Any data in excess of 4GB is rounded up to the next GB and priced at CU10 per extra GB. This is the standard pricing for all customers. There is a CU320 early termination penalty for cancelling the plan. This penalty decreases over the contract term.

For purposes of this example, there are no rebates, incentives or other discounts provided and the time value of money has not been considered. Furthermore, to simplify this example, there is no variable consideration, and we do not consider the effect of the constraint on variable consideration that we discuss in Section 6.1.

The following table illustrates, at contract inception, the allocation of the transaction price and revenue recognised under the new standard:

	Consideration	Stand-alone selling price	Allocated transaction price
	CU	CU	CU
Handset	400	1,200	1,000
Wireless plan	3,600	3,600	3,000
Total consideration	4,000	4,800	4,000

On day 1, the day the contract is signed and the handsets are activated and delivered to the individuals, Wireless Company will recognise the CU400 cash received from Family A; CU1,000 of revenue, which represents the allocated transaction price for the handset; and a contract asset of CU600, or the difference between the cash received and the revenue recognised. The amounts allocated to the service plan will be recognised over the two-year service term (or CU125 per month), and contract asset will be reduced over the same period (or CU25 per month).

On 1 April 20X1, Family A contacts Wireless Company and adds another smartphone to share in their existing data plan. Family A purchases a phone for CU200 (stand-alone selling price of CU600) and signs up for a two-year agreement; the 4GB data is not changed. The shared data plan will now be priced at CU190/month. Because the additional handset was sold at a subsidised price, the data plan is extended for three months to match the full 24-month period of the contract (required in order to receive a subsidised device). In addition, while not common in practice, assume for simplicity that all three lines in the example are required to stay for the full two-year term starting from the date of the modification.

Illustration 4-2 – Family share plan

Wireless Company must now determine whether this modification represents a change in the previously promised goods or services under the arrangement, the addition of distinct goods or services or a combination of the two. The addition of the handset for the third individual and the three additional months of the data plan are additions of distinct goods and services. However, the handset would not have been offered at a subsidised price without the previously contracted data plan. Therefore, the modification cannot be treated as a separate contract.

As a result, Wireless Company has to determine the remaining consideration associated with the contract and allocate it to the remaining performance obligations. This amount is calculated as CU200 (handset consideration) + CU4,560 (CU190 x 24 for the monthly service) – CU525 (remaining contract asset allocated to the handsets already delivered) = CU4,235. The allocation after the modification in this scenario would be the following:

	Stand-alone selling price	Allocated transaction price
	CU	CU
Handset	600	492
Wireless plan	4,560	3,743
Total consideration	5,160	4,235

On 1 April 20X1 (the day the contract is modified and the handset for the third individual is activated and delivered to the customer), Wireless Company will record the CU200 cash received from Family A for the handset and CU492 in revenue, which represents the allocated transaction price for the handset. A contract asset of CU292 is also recognised and represents the difference between the cash received and the revenue recorded.

At the end of April and going forward, Family A will pay the CU190 bill at the end of each month and the Wireless Company will recognise CU155.96 as service revenue with the remaining CU34.04 (composed of CU21.87 reduction from original contract asset and CU12.17 from modification) applied against the remaining contract asset.

Since there has been a change in the estimated useful life for the initial contract asset (because the first two lines were required to extend three additional months, as noted above) the remaining amount for the initial contract asset will be amortised over the modified contract period of 24 months. Therefore, the initial contract asset will be reduced by the same amount each month (CU21.87) through the end of the contract term, and the contract asset associated with the modification is reduced each month (CU12.17) over the contract term.

(Note: This illustration addressed a contract modification to a family share plan in which all of the lines are under a subsidised handset plan combined with a shared data service arrangement. Wireless entities that offer handset instalment plans for handsets will reach different conclusions based on the facts and circumstances of their handset instalment plans.)

5. Identify the performance obligations in the contract

Properly identifying performance obligations within a contract will be a critical step in applying IFRS 15.

Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify which promised goods or services (or bundles of promised goods or services) will be treated as separate performance obligations.

Promised goods and services represent separate performance obligations if the goods or services are:

- Distinct (by themselves or as part of a bundle of goods and services)

  Or

- Part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer

A good or service (or bundle) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources (i.e., capable of being distinct) and the good or service is separately identifiable from other promises in the contract (i.e., distinct in the context of the contract).

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Wireline entities frequently offer incentives, such as free products or services to attract new customers. For example, wireline entities frequently give new customers free tablets, TVs, a free month of service or a free premium channel, among other things, in order to entice them to sign up for services. These free services represent promised goods and services under the contract and need to be assessed to determine whether they represent separate performance obligations. If they represent separate performance obligations, a portion of the transaction price will be allocated to these items. Although the entity might consider the free goods or services to be marketing incentives or incidental goods or services, the Boards concluded that they are goods or services for which the customer pays and to which the entity needs to allocate consideration for the purpose of recognising revenue.

How we see it

During the deliberations, some wireless entities argued that handsets should not be considered separate performance obligations because wireless entities did not view themselves as being in the business of selling handsets. However, the Boards concluded that all goods or services promised to a customer in a contract give rise to performance obligations. As a result, the wireless handsets provided in most arrangements are promised goods within the arrangements. Furthermore, because handsets are capable of being distinct, and are distinct in the context of the contract for wireless service plans, they will be accounted for as separate performance obligations.

5.1 Set-top boxes

Telecom entities frequently provide their customers with set-top boxes as part of providing video services to the customer. Under IFRS 15, entities will have to determine if the set-top box is a revenue element or a leasing element (i.e., which standard applies). While the new leases standard is still under deliberation, the current leases proposal would require entities to separate the lease and non-lease components (e.g., services). However, based on the deliberations to date, if the customer does not have the right to control the use of an identified asset (e.g., a set-top box), the arrangement would not be a lease. In some cases, the customer may have no more control over a set-top box than it would over equipment located outside its premises that is used to deliver services to the customer. Therefore, pending final approval from the Boards on the definition of a lease and any related application guidance, it is possible that contracts for such assets would not meet the definition of a lease.

Assuming that such a set-top box does not meet the definition of a lease (and, therefore, is within the scope of IFRS 15), a telecom entity will need to determine whether the set-top boxes (as well as modems and routers) are separate performance obligations. If the assets identified and used to deliver services to the customer (e.g., set-top boxes, modems, routers) are determined not to be distinct, the telecom entity will identify only one performance obligation for the monthly service and recognise the amount of the transaction price allocated to this performance obligation monthly.

How we see it

As technology changes, telecom entities will have to evaluate all aspects of new products and/or service offerings to determine whether the assets used to deliver services (e.g., set-top boxes) should be accounted for under IFRS 15 or under another standard.

5.2 Options for additional goods or services and non-refundable upfront fees

Many telecom contracts give customers the option to purchase additional goods or services such as premium TV channels or international voice and data plans, the option to change wireless plans at any time or the option to access video on demand. These additional goods and services may be priced at their stand-alone selling price, at a discount or may be provided free of charge.

IFRS 15 states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right to the customer. For example, the right would be material if it results in a discount that the customer would not receive without entering into the contract (e.g., one that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the price in the option reflects the stand-alone selling price, the entity is deemed to have made a marketing offer, rather than having granted a material right.

Typically, options offered by telecom entities are priced at their stand-alone selling price and, therefore, will not be considered separate performance obligations. IFRS 15 includes the following telecom example that illustrates this point:

Extract from IFRS 15

Example 50 – Option that does not provide the customer with a material right (additional goods or services) (IFRS 15.IE254-IE256)

An entity in the telecommunications industry enters into a contract with a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their stand-alone selling prices.

The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 27(a) of IFRS 15. In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15).

The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph B41 of IFRS 15). This is because the prices of the additional call minutes and texts reflect the stand-alone selling prices for those services. Because the option for additional call minutes and texts does not grant the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional call minutes or texts. The entity will recognise revenue for additional call minutes or texts if and when the entity provides those services.

IFRS 15 also indicates that the existence of a non-refundable upfront fee may indicate that additional performance obligations exist within the arrangement. This is because the customer may have been provided with an option to purchase future goods or services at a discounted rate. For example, a telecom entity may charge an activation or installation fee at contract inception, but may waive the fee when the contract expires and reverts to a month-to-month contract. Alternatively, a telecom entity may only charge an activation fee associated with a month-to-month contract in the initial month. Generally, no performance obligations are associated with the activation or installation fee. The entity may determine that the ability to renew each subsequent month without having to pay an activation fee represents a material right. In this case, the material right (i.e., not to pay another upfront fee) is a separate performance obligation to which a portion of the transaction price is allocated. Revenue would be recognised when (or as) those goods and services are provided (i.e., over the customer relationship period in this example). Conversely, if the entity determines that the right is not material, the upfront fee is included in the total transaction price that is allocated to the separate performance obligations for the handset and the monthly service plan.

Variable consideration will need to be estimated and, after applying the constraint, included in the transaction price.

6. Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled. It includes an estimate of any variable consideration (after applying the constraint on variable consideration), the effect of the time value of money (if there is a financing component that is significant to the contract), the fair value of any non-cash consideration and the effect of any consideration paid or payable to the customer.

6.1 Variable consideration

The amount and timing of a portion of the transaction price could vary, due to discounts, rebates, refunds, credits, price concessions, incentives, bonuses, penalties or other similar items. Under IFRS 15, these variable amounts are estimated and included in the transaction price using either the expected value method or the most likely amount method, whichever better predicts the consideration to which the entity is entitled. The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at the end of each reporting period. Once a method is selected, the entity applies it consistently for similar types of contracts.

Under the expected value method, the entity identifies the possible outcomes of a contract and the probabilities of those outcomes. The Boards indicated that the expected value method may better predict expected consideration when an entity has a large number of contracts with similar characteristics. The Boards also clarified that an entity preparing an expected value calculation is not required to consider all possible outcomes. Instead, the Boards indicated in the Basis for Conclusions to IFRS 15 that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value.[3]

The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The Boards indicated that the most likely amount method may be the better predictor when the entity expects to be entitled to only one of two possible amounts.

IFRS 15 limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is highly probable that a subsequent change in estimated variable consideration will not result in a significant revenue reversal (i.e., the constraint on variable consideration). A significant reversal occurs when a change in the estimate results in a significant downward adjustment in the amount of cumulative revenue recognised.

For many common telecom arrangements, estimating variable consideration could be a challenge. IAS 18 currently permits recognition of variable consideration, but only if it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be reliably measured.[4] As a result, practice varies today in how telecom entities reflect terms such as tiered pricing/volume discounts, minimum contractual commitments and billing credits, depending on a telecom entity's ability to make a reliable estimate. Some entities have concluded there is sufficient uncertainty in their estimates that no revenue can be recognised until the amounts become known. IFRS 15 will require a telecom entity to make estimates for these amounts and apply the constraint to those estimates. The following example illustrates the application of IFRS 15 in an enterprise contract:

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3 IFRS 15.BC201
4 IAS 18.14 and IAS 18.18.

Illustration 6-1 – Determine transaction price

Telecom Inc. enters into a one-year enterprise contract with a business customer, Big Business Inc., to provide voice services. Under the terms of the contract, voice services are priced at CU0.020 per minute, but the rate will be reduced to CU0.015 per minute of use (applicable to all traffic) if Big Business Inc. uses at least 20,000 minutes during the contract period. Furthermore, the rate is reduced to CU0.014 per minute (applicable to all traffic) if Big Business Inc. uses at least 30,000 minutes during the contract period.

Analysis

Expected value

Based on its historical experience with Big Business Inc. and its expectations, Telecom Inc. anticipates that the likelihood that Big Business Inc. will exceed 20,000 minutes is 60%, but it is only 10% likely that Big Business Inc. will exceed 30,000 minutes. Telecom Inc. calculates the following price per minute under the expected value (probability-weighted) method:

Probability	Rate per minute	Estimated rate per minute
	CU	CU
30%	0.020	0.006
60%	0.015	0.009
10%	0.014	0.001
Weighted average rate		0.016

If Telecom Inc. determined that the expected value method was the better predictor, it would apply the CU0.016 estimated rate per minute of use to the actual traffic carried for Big Business Inc. during each month of the contract. At the end of each reporting period, Telecom Inc. will reassess these estimates and adjust the price accordingly.

Telecom Inc. would then apply the effects of the constraint on its estimate of variable consideration. In this illustration, the entity concludes it is approximately 90% likely that the entity will receive at least CU0.015 per minute (30% likelihood of CU0.020 per minute and 60% likelihood of CU0.015 per minute). However, because the calculated rate is higher than that amount, the entity will have to determine whether it is probable that using a rate of CU0.016 per minute would result in subsequent significant revenue reversal.

Most likely amount

Under a most likely amount method, using the same facts as above, Telecom Inc. would determine that the CU0.015 rate is the most likely amount (given its 60% probability) and would use that rate in estimating variable consideration.

Telecom Inc. would apply the constraint to its estimate of variable consideration. In this illustration, the entity concludes it is approximately 90% likely that the entity will receive at least CU0.015 per minute (30% likelihood of CU0.020 per minute and 60% likelihood of CU0.015 per minute). Therefore, the constraint would likely have no effect on the entity's calculated most likely amount.

IFRS 15 requires the entity to select the method that better predicts the amount of consideration the entity will be entitled to. Therefore, for the purposes of this illustration, because there are only a limited number of outcomes, Telecom Inc. may conclude that a probability-weighted estimate results in an amount that is not a potential outcome. Telecom Inc. would then determine that estimating the transaction price by identifying the most likely amount would be the better predictor.

IFRS 15 does not provide additional application guidance for how an entity would determine the most likely amount when there are more than two potential outcomes and none of the potential outcomes are significantly more likely than the others. For example, assume in Illustration 6-1 above that the probabilities are equal for all three rates. In this situation, because none of the rates are the 'most likely' amount, it is unclear which rate Telecom Inc. would choose.

6.2 Significant financing component

For certain transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). In these situations, the entity is required to consider the effects of the time value of money on the total transaction price.

An entity is required to assess whether the arrangement contains a significant financing component when the period between the customer's payment and the entity's transfer of goods or services is greater than one year. Furthermore, because the assessment of significance is done at the contract level, entities will not be required to adjust the transaction price for potential financing within the arrangement unless the financing component is considered significant to the contract. The Boards decided that it would be too burdensome to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract, but the combined effects of the financing components for a portfolio of similar contracts would be material to the entity as a whole.[5] This is an important point for telecom entities that plan to use the portfolio approach.

When an entity concludes that a financing component is significant to the contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. That is, the discount rate reflects the credit characteristics of the borrower in the arrangement. While this is not explicitly stated in IFRS 15, we anticipate an entity would have to consider the expected term of the financing arrangement in determining the discount rate.

There may be many arrangements where a significant financing component could be a factor in both wireline and wireless entities. For example, indefeasible right to use (IRU) agreements for the use of fibre lines are typically multi-year contracts that are either prepaid in full or include large upfront payments. For IRUs within the scope of IFRS 15, a telecom entity will need to evaluate whether there is a significant financing component; making this evaluation may be a significant change from current practice.

[5] IFRS 15.BC234

How we see it

Telecom entities will not have to consider whether their long-term contracts have a significant financing component when the services are provided and payments for those services are made on a monthly basis. However, when they offer arrangements in which a good or service is provided upfront, but paid for over time, telecom entities will need to consider whether there is a significant financing component in the arrangement. For example, wireless entities will need to evaluate whether there is a significant financing component to the arrangement when an entity offers subsidised handsets in conjunction with a two-year wireless services contract or when an entity offers the customer an instalment plan for the handset.

6.3 Consideration paid or payable to a customer

Consideration paid or payable to customers commonly takes the form of cash, credits, coupons, or vouchers that can be applied against amounts owed to the entity. For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the payment to the customer must be in exchange for a distinct good or service provided by the customer. This is generally consistent with current IFRS. However, the requirement to determine whether a good or service is distinct in order to treat the consideration payable to a customer as anything other than a reduction of revenue is new. While it is implied in many of the illustrative examples in IAS 18, it is not explicitly discussed in current IFRS. As such, some entities may need to reassess the treatment of consideration paid or payable to a customer.

7. Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, an entity is required to allocate the transaction price to each performance obligation on a relative stand-alone selling price basis.

Currently, IAS 18 notes that, in some instances, revenue is recognised for the separate elements identified so as to reflect the substance of a single transaction.[6] IAS 18 also specifically refers to situations in which the selling price of a product includes an identifiable amount for subsequent servicing, in which case, that amount is deferred and recognised as revenue over the period during which the service is performed.[7] IFRIC 13 *Customer Loyalty Programmes* provides some information as to possible methods of allocation. However, IFRIC 13 and IAS 18 are not prescriptive as to which allocation method should be used for multiple-element arrangements. Therefore, currently an entity must use judgement to select the most appropriate methodology, taking into consideration all relevant facts and circumstances and ensuring the resulting allocation is consistent with IAS 18's objective to measure revenue at the fair value of the consideration. Given the limited guidance in current IFRS on multiple-element arrangements, some entities have looked to US GAAP to develop their accounting policies.

[6] IAS 18.13
[7] IAS 18.IE11

Many wireless entities currently apply a form of 'residual method' to allocate the consideration between handset and telecom services. Under this method, the amount of revenue allocated for the sale of the handset is no more than the amount contractually receivable for it, which may be equivalent to the so-called 'cash cap' under US GAAP, ASC 605-25 *Revenue: Multiple- Element Arrangements.*[8] This is because the remaining transaction consideration is contingent upon the telecom entity providing the monthly telecom service and, therefore, cannot be allocated to the previously delivered item per US GAAP ASC 605-25.

Under IFRS 15, the total transaction consideration is allocated to the identified performance obligations (handset and monthly service) based on their relative stand-alone selling prices. Revenue is recognised when (or as) each performance obligation is satisfied. The result is that, under the new standard, wireless entities will likely allocate more transaction consideration to a subsidised handset than under their current accounting policies and will recognise that revenue before the consideration is actually charged to the customer.

The example below illustrates how a typical wireless contract with a subsidised phone would be accounted for, including the effect of eliminating the contingent revenue cap applied by some entities today:

Illustration 7-1 – Allocation of the transaction price

In January 20X1, Customers A and B enter into two-year contracts with Wireless Company. Wireless Company offers two handsets along with two-year service contracts. The first handset is a model that has been on the market for 18 months that the company is offering for free (the stand-alone selling price is CU350); the second handset is the newest version of the phone, which includes improved features and functionality, that the company is offering for CU160 (the stand-alone selling price is CU480). Both offers are under the traditional subsidy model, where the customer pays for a handset at a reduced price in return for agreeing to a two-year service contract. For simplicity, assume that Wireless Company does not charge activation fees.

Wireless Company offers a 1GB data plan with unlimited voice and text for CU40 per month over a two-year contract period. For the purposes of this example, assume the stand-alone selling price of the 1GB data plan (with unlimited voice and text) is CU40 per month. Any data usage in excess of 1GB is rounded up to the next GB and priced at CU10 per extra GB. This is the standard pricing for all customers. The service plan is cancellable. However, the customer is subject to a CU320 early-termination penalty that decreases pro rata over the contract term.

Customer A selects the older model phone, and Customer B selects the newer model. Both customers select the 1GB data plan (with unlimited voice and text). For purposes of this example, there are no rebates, incentives or other discounts provided and the time value of money has not been considered.

[8] ASC 605-25-30-5 states, “The amount allocable to a delivered item or items is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount).”

Illustration 7-1 — Allocation of the transaction price

The following table illustrates the differences in the allocation of the transaction price and revenue recognised between most wireless entities' current practiceand IFRS 15:

	Current practice		IFRS 15	
	Customer A	Customer B	Customer A	Customer B
	CU	CU	CU	CU
Handset revenue	0	160	256	373
Wireless service revenue	960	960	704	747
Total revenue	960	1,120	960	1,120

The calculations for the above amounts are, as follows:

- The CU0 and CU160 in handset revenue under current practice represent the amount of cash received when the handset is delivered.
- The CU256 of handset revenue under the new standard for Customer A is based on the proportionate share of the stand-alone selling price of the handset compared with the stand-alone selling prices of all of the elements in the arrangement. It is calculated as [CU350/(CU960 + CU350) x CU960].
- The CU373 of handset revenue under the new standard for Customer B is calculated as [CU480/(CU960 + CU480) x CU1,120].
- Wireless service revenue of CU960 under current practice for Customer A and Customer B is calculated as CU40 x 24 months.

Wireless service revenue of CU704 and CU747 under the new standard for Customers A and B, respectively, is calculated, as follows: CU704 = [CU960/(CU960 + CU350) x CU960], and CU747 = [CU960/(CU960 + CU480) x CU1,120].

When determining stand-alone selling prices, an entity is required to use observable information, if it is available. If stand-alone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Possible estimation approaches include an adjusted market assessment approach and an expected cost plus a margin approach.

While many telecom goods and services are sold separately, their prices may differ due to competition, state regulation or type of customer. Telecom entities will need to consider these factors when they determine the stand-alone selling prices of their goods and services. Selling prices also change frequently because of the introduction of new technologies and competitive market factors. The requirement to determine stand-alone selling prices on a regular basis will require entities to update their processes and systems. This will be a significant challenge for telecom entities.

How we see it

Many telecom entities offer customers a wide selection of handsets and wireless plan options. The requirement to allocate revenue on a relative stand-alone selling price basis may result in similar goods and services (e.g., a particular handset or a particular usage plan) being allocated different amounts of revenue depending on how the particular handset and service plan are bundled into the arrangement. This is shown in Illustration 7-1, in which a different amount of revenue is allocated to the 1GB wireless plan for Customer A and Customer B because the plan was bundled with different handsets.

Telecom entities will likely need to make significant investments in their information systems to be able to track multiple pricing points for a single product offering. IFRS 15 also requires entities to make updates to reflect new products and offerings, as well as changes in stand-alone selling prices to appropriately allocate consideration for new contracts. While IFRS 15 says an entity can use a portfolio approach to account for its transactions, tracking all of the necessary information may still be a monumental task for many entities.

8. Satisfaction of performance obligations

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer. Control may be transferred over time or at a point in time. IFRS 15 indicates that, at contract inception, an entity must determine whether it transfers control of a promised good or service over time.

While it may be relatively straight-forward for telecom entities to determine when goods or services transfer to the customer for many arrangements, there may be more complex arrangements for which it will not be as clear.

An entity satisfies a performance obligation over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for the performance completed to date.

An entity may use one of two types of methods to measure its progress towards completely satisfying a performance obligation over time: input methods and output methods. Telecom entities that use an output method can apply a practical expedient that the Boards provided to allow an entity to recognise revenue in the amount for which it has the right to invoice. This would be the case when an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance to date (e.g., overage charges associated with a service contract where an entity bills an amount each month for the overages incurred).

Illustration 8-1 — Enterprise contract

Telecom Inc. enters into an agreement to install telecom equipment in a 30-story office building and provide services under a three-year service agreement that begins when the installation is complete. The installation is expected to take 18 months.

During the installation phase, Telecom Inc. works extensively with the customer to configure the telecom equipment (purchased from an outside vendor) to the customer's specifications. Telecom Inc. then provides the installation services needed so that the equipment works properly in the office building. The equipment is being installed in the customer's building and the customer takes ownership and physical possession of the equipment as it is installed.

Telecom Inc. determines that it has two performance obligations: the configuration/installation of telecom equipment for the customer and the provision of three years of telecom services. Telecom entities will have to carefully consider their contracts to determine if the configuration and installation are separate performance obligations.

Because the customer controls the equipment as it is installed, Telecom Inc. determines that the configuration/installation of the telecom equipment is satisfied over time, rather than at a point in time.

9. Portfolio approach

IFRS 15 applies to individual contracts with customers. This can be complex for telecom entities, who may have millions of contracts with customers. The Boards recognised that there may be situations in which it may be more practical for an entity to combine contracts for the purposes of revenue recognition, rather than attempt to account for each contract separately. Specifically, IFRS 15 states that an entity can account for a portfolio of similar contracts together if the entity expects that the result will not be materially different from the result of applying IFRS 15 to the individual contracts.[9]

Many telecom entities are discussing whether using the portfolio approach for some or all of the steps of the model would be simpler than accounting for millions of contracts individually. In addition, entities are exploring whether it would be best to use the portfolio approach on certain aspects of IFRS 15, rather than in its entirety. However, the standard does not provide application guidance on how an entity would apply the portfolio approach.

We believe telecom entities will have to consider the following key questions:

- How will an entity apply the portfolio approach?
- How will an entity establish its portfolios?
- How does an entity determine that the effect of using the portfolio approach (for some or all aspects of the model) would not differ materially from applying the standard on an individual contract basis?

[9] IFRS 15.4

9.1 Applying the portfolio approach

The application of the portfolio approach will likely vary based on the facts and circumstances of each entity. For those entities that choose to implement using a portfolio approach, management will need to determine whether they will apply the portfolio approach to some or all of their business lines (e.g., wireless, wireline, enterprise).

In addition, an entity may choose to apply the portfolio approach to only certain aspects of IFRS 15. When an entity applies the portfolio approach to only certain aspects of the model, the first step will be to determine the parts of IFRS 15 to which the portfolio approach will be applied.

For example, assume a telecom entity has decided to use the portfolio approach to identify the costs to obtain and fulfil a contract and to account for the subsequent accounting for contract assets (i.e., the amortisation and impairment testing of contract assets). The telecom entity will need to determine how to establish portfolios for capitalised contract costs or contract assets that share similar characteristics. It will need to consider the factors that distinguish portfolios.

Entities that want to use the portfolio approach more broadly may wish to consider whether they need to implement certain steps of the model on a contract-by-contract basis. These decisions will likely be based on: the types of contracts typically entered into by an entity; the prevalence of contract modifications; and the IT and accounting system enhancements that an entity may need to perform in order to implement the standard on a contract-by-contract basis.

9.2 Establishing portfolios

Applying the portfolio approach will involve establishing portfolios of contracts with similar characteristics. The standard does not specify how the portfolios would be established or how many portfolios an entity would have. The Boards have acknowledged that entities will need to use judgement when establishing the size, composition and number of portfolios.[10] Factors telecom entities may wish to consider when establishing portfolios include:

- The type of customer (i.e., retail or business customer)
- The type of consumer (i.e., wireline, wireless or both)
- For wireless, whether the customer is obtained through a direct or indirect channel
- The type of plan (e.g., individual, family share, corporate)
- The duration of the contract (i.e., month-to-month or multi-year)
- The type of billing (i.e., monthly or based on usage)
- The number of goods or services in an arrangement (e.g., handset plus services, multiple service offerings such as triple or quadruple-play arrangements)
- The amount and types of discounts, rebates, price concessions, contract modifications, terminations and upgrades included in the arrangement

[10] IFRS 15.BC69

Telecom entities that use the portfolio approach will need to make estimates and assumptions to create portfolios. Management will need to document how it determines that the individual contracts within the portfolios are sufficiently similar such that the result will not be materially different if the entity had accounted for each contract individually. This may include the processes and procedures, including internal controls, telecom entities have to put in place to make these estimates and assumptions. Issues an entity should consider documenting when establishing portfolios include:

- Factors used to determine the assumptions are reasonable
- How management considered alternative assumptions or outcomes
- Controls over the processes established for determining the estimates used in the portfolios, e.g.:
  - Controls over the existence and completeness of the data used
  - Review and approval controls over assumptions for items such as the stand-alone selling price
  - Controls to ensure that changes in data, and resulting changes in portfolios, are identified in a timely manner

Telecom entities that choose to implement the portfolio approach more broadly will need to consider how contract modifications affect their portfolios. IFRS 15 includes explicit requirements for contract modifications. If a customer modifies a contract, and the modification does not create a separate contract, telecom entities will need to determine whether to leave the modified contract in the portfolio or move it to a separate portfolio of modified contracts. Both approaches may require accounting adjustments to the initial portfolio. See contract modifications discussed in section 4 above.

9.3 Materiality considerations under the portfolio approach

The Boards do not expect entities that use the portfolio approach to explicitly prove that the result of using the portfolio approach is not materially different from that of the contract-by-contract method. In their discussions, the Boards indicated that they did not intend that entities should quantitatively evaluate each outcome. Instead, the Boards noted that the entities should take a reasonable approach to determining their portfolios that would be appropriate for the entities' specific contracts.[11]

As a result, telecom entities will need to exercise significant judgement in developing a reasonable approach to evaluating whether the portfolio approach is materially consistent with a contract-by-contract approach. Questions telecom entities may face when evaluating the use of a portfolio approach include:

- How many outcomes need to be quantitatively evaluated? Do entities need to use a sampling technique? If so, which technique would be most appropriate?
- Can an entity perform a qualitative-only assessment?
- What level of materiality would the entity use in the analysis?
- What level of documentation will be necessary to support management's assumptions? How subjective are the assumptions, and how sensitive is the outcome to a change in the assumptions?

[11] IFRS 15.BC69

Management will need to document its evaluation of how it 'reasonably expects' the outcome of the portfolio approach not to be materially different from a contract-by-contract basis. Each entity's approach will be based on its specific facts and circumstances and may differ from the approach chosen by another entity.

We expect to update our views on the portfolio approach as the industry discusses the implementation issues we have raised here and others that may arise.

10. Indirect channel sales

Wireless entities frequently use indirect sales channels (i.e., dealers) to sell service contracts to customers. Under IFRS 15, a wireless entity will need to carefully evaluate all the facts and circumstances of an indirect channel arrangement to determine the appropriate accounting. We have identified three key points that wireless entities with indirect channel sales may wish to consider under the new standard:

- *Determining whether payments made to a dealer represent a commission on the sale of the service contract (i.e., costs to obtain a contract) or a handset subsidy (i.e., consideration paid or payable to a customer)*

  The terms and conditions of arrangements with dealers vary throughout the industry. Dealers purchase handsets from the manufacturer or from the wireless entity. The dealer then sells the handsets to the end-customer, who concurrently enters into a contract for a monthly service plan with the wireless entity. In return for the dealer identifying the end-customer, the wireless entity makes a payment to the dealer. Wireless entities will need to analyse their contracts with dealers under IFRS 15 to determine the appropriate accounting treatment for the payment made to the dealer.

- *Evaluating the accounting treatment for subsequent payments and adjustments (e.g., clawbacks) under dealer arrangements*

  Some contracts between dealers and wireless entities require additional payments or recoveries of previously paid amounts to the dealer (i.e., clawbacks). These are based on various factors, such as a customer terminating their service with a wireless entity prior to the completion of their contract term. Under IFRS 15, when a commission is paid to a dealer and capitalised by the wireless entity as a cost to obtain a contract, any amounts subject to clawbacks would likely be included in the initial capitalisation and reversed only once the clawback occurs.

- *Analysing the effects of variable consideration (i.e., when selling products through distributors or resellers)*

  IFRS 15 will change practice for some entities that sell their products through dealers. Because the sales price of the handset to the dealer may not be finalised until the handset is sold to the end-customer, under IAS 18, entities may wait until the product is sold to the end-customer to recognise revenue. Under IFRS 15, wireless entities are required to estimate any adjustments to the sales price that may be granted to the dealer, as well as the number of handsets that will be returned from the dealer as part of estimating the transaction price. That is, price concessions and returns cause consideration to be variable under IFRS 15.

11. Handset instalment plans

An evolving area in the market place is the use of handset instalment plans, in which wireless entities allow customers to pay full retail price for a handset in monthly instalments. In some arrangements, the customer also has the option to trade in the handset for credit toward a new handset after a certain point (e.g., once 50% of the handset has been paid for). Any remaining payments related to the original instalment sale are typically forgiven. The service portion of the arrangement (voice, text and data) may be offered at the stand-alone selling price under a separate month-to-month contract. In other cases, the handset instalment plan is offered in conjunction with a month-to-month service agreement. In these situations, the customer receives a discount on the service from the wireless entity in return for agreeing to the handset instalment pricing plan. Due to the competitive nature of the industry, these plans are subject to frequent changes and offerings vary by wireless entities.

Depending on the terms of each arrangement, the structure of the handset instalment plans will require entities to make several decisions under IFRS 15, including: (1) identifying the elements within the arrangement (promised goods and services, as well as any other elements, such as trade-in rights); (2) determining the appropriate accounting treatment for any trade-in right (e.g., whether the trade-in right is a guarantee); and (3) determining whether the contract is partially within the scope of any standard, other than IFRS 15.

How we see it

Due to the frequent changes in plan offerings and the complexity of the accounting treatment for handset instalment plans, entities will need to develop processes to monitor customer offerings in order to properly account for these plans.

12. Contract costs

IFRS 15 specifies the accounting treatment for certain costs an entity incurs in obtaining and fulfilling a contract.

12.1 Costs to obtain a contract

Under IFRS 15, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognised as an asset if the entity expects to recover them. Cost recovery may be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, IFRS 15 permits an entity to immediately recognise costs to obtain a contract as an expense when the asset that would have resulted from capitalising such costs would have been amortised in one year or less. While not explicitly stated, we believe entities are permitted to choose this approach as an accounting policy election and, if they do so, must apply it consistently.

IFRS 15 cites sales commission as an example of an incremental cost that may require capitalisation. However, commission programmes can vary widely among entities. For example, commissions may be paid to the parties directly involved with obtaining the contract and to additional parties (e.g., regional management). In addition, commission programmes may not be directly linked to any single or specific contract (e.g., commissions based on reaching a specified level of sales overall). It is likely that some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, earnings per share, performance evaluations) will not meet the criteria for capitalisation because they are not incremental costs of obtaining a contract. Telecom entities typically have both internal (employees) and external (third-party dealers) commission programmes that will be have to be analysed to determine whether they must be capitalised. IFRS 15 does not provide additional application guidance to assist an entity in determining whether costs are incremental costs of obtaining the contract. It is, therefore, unclear whether commissions paid to supervisors would be considered incremental costs of obtaining a contract. Determining which commission costs must be capitalised under the standard may require judgement.

How we see it

The requirement to capitalise incremental costs of obtaining a contract that telecom entities expect to recover may represent a significant change for entities that currently expense such costs.

12.2 Costs to fulfil a contract

An entity accounts for costs incurred to fulfil a contract with a customer that are within the scope of another IFRS (e.g., IAS 2 *Inventory*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets*) in accordance with that standard. If the costs are not subject to another IFRS, an entity capitalises the costs to fulfil a contract under IFRS 15, if *all* of the following criteria are met:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

IFRS 15 provides examples of costs that may meet the first criterion for capitalisation listed above (i.e., costs that relate directly to the contract), as follows:

- Direct labour (e.g., salaries and wages of employees who provide the promised services directly to the customer)
- Direct materials (e.g., supplies used in providing the promised services to a customer)
- An allocation of costs that directly relate to the contract or to contract activities (e.g., contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract)
- Costs that are explicitly chargeable to the customer under the contract
- Other costs that are incurred only because an entity entered into the contract (e.g., payments to sub-contractors)

Telecom entities typically incur significant costs related to the set-up, activation and installation of equipment for customer contracts. However, current IFRS provides limited application guidance on how to account for such costs. While there is some diversity in practice, many telecom entities capitalise activation and installation costs up to the amount of corresponding installation revenues deferred. However, under IFRS 15, the telecom entity would capitalise those costs that meet the criteria above, which may be more than is capitalised today.

IFRS 15 may also broaden the costs that are considered for capitalisation under current accounting practices. The list above also includes the allocation of costs such as management and supervision, insurance, and depreciation of the tools and equipment used to fulfil the contract. Entities may, therefore, need to exercise significant judgement to identify those other costs that should be capitalised (e.g., whether the depreciation on a vehicle that an employee drives to a customer's home in order to perform the set-up, activation and installation services is a cost that relates directly to the contract). IFRS 15 does not provide further application guidance to assist entities in determining which costs directly relate to fulfilling a contract.

In order for costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected in the pricing of the contract (and, therefore, recoverable through the margin). Costs are rarely explicitly reimbursable under many telecom contracts. Furthermore, it may be difficult for telecom entities to identify the information needed to demonstrate the costs are recoverable through the margin. As a result, judgement will likely be needed to make this assessment. IFRS 15 does not specify whether contract costs need to be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). However, since the standard clearly states that the amortisation period can exceed the contract period, it appears that entities may be able to use the same period in determining whether the deferred costs are recoverable. This is especially significant when a number of the arrangements are monthly contracts, but the expected term of the arrangement is longer. Telecom entities generally track customer terminations (i.e., churn) for their services and would, therefore, have the ability to demonstrate whether the average customer relationship lasts longer than the contractual period.

Illustration 12-1 – Telecom contract costs

A customer contracts with Telecom Inc. for a landline voice and internet bundle priced at CU55 per month, which is provided in a month-to-month contract that is cancellable at any time without penalty. Telecom Inc. has provided these services for many years and has accumulated history that indicates that customers (for this type of plan) stay with the plan for an average of three years. The cost of providing the monthly landline and internet services is expected to be CU30 per month.

Telecom Inc. sends a technician to the customer's home to set up the customer's internet and activate the landline. The technician spends four hours and his direct labour and material costs are CU500. Telecom Inc. charges the new customer a CU75 installation fee to recoup a portion of the direct costs incurred.

Under current IFRS, the CU75 installation fee is frequently deferred and CU75 of the direct labour and material costs are capitalised. The remaining costs of CU425 are expensed as incurred.

Assuming that, under IFRS 15, recoverability is determined using the expected customer life, Telecom Inc. capitalises the CU500 of contract fulfilment costs, because they are recoverable over the expected customer life. That is, Telecom Inc. expects to receive total consideration of CU2,055 [(CU55 per month x 36 months) + CU75 installation fee] over the expected customer life. This amount exceeds the cost of installation and providing the monthly landline and internet services of CU1,580 [(CU30 per month x 36 months) + CU500 installation costs] for the same period.

How we see it

Identifying costs to fulfil a specific contract will likely be a significant change in practice for telecom entities and may be difficult for them to do. For enterprise customers, telecom entities may spend up to a year performing set-up, activation and installation services before beginning to provide services. Telecom entities will first need to determine whether the installation meets the definition of a separate performance obligation. If so, under IFRS 15, the costs associated with the installation performance obligation would be expensed when the related performance obligation (i.e., the installation) is satisfied. Telecom entities may need to make updates to their accounting systems in order to track these costs at the contract level.

12.3 Amortisation and impairment

Any capitalised contract costs are amortised, with the expense recognised when (or as) the entity transfers the goods or services to the customer. An entity amortises capitalised costs on a systematic basis consistent with the pattern of transfer for which the service relates. Furthermore, entities can take into account any expected renewal periods in their assessment of the appropriate amortisation period. Telecom entities need to analyse their capitalised costs to determine the period to which they relate. Determining the period over which capitalised contract costs would be amortised may require judgement.

Any asset recorded by the entity is subject to an ongoing assessment of impairment. Costs that give rise to an asset must initially be recoverable to meet the criteria for capitalisation, but must also continue to be recoverable throughout the arrangement. An impairment exists if the carrying amount of any asset(s) exceeds the remaining amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those goods and services and that have not yet been recognised as expenses.

How we see it

Evaluating capitalised contract costs and contract assets for impairment will require telecom entities to make more estimates than they do today, regardless of whether they implement the standard on a contract-by-contract basis or by using the portfolio approach. Telecom entities may have a significant amount of capitalised contract costs and individual contract assets to evaluate for impairment. In order to do so, we believe a telecom entity may need to evaluate these assets using a portfolio approach.

13. Disclosures

IFRS 15 significantly increases the volume of disclosures required in entities' interim and annual financial statements. The expanded disclosures are in response to criticism that current revenue recognition disclosures are inadequate. The Boards sought to create a comprehensive and coherent set of disclosures. As a result, and to be consistent with other recent standards, IFRS 15 includes an overall objective for these disclosures, noted below:

Extract from IFRS 15

110. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

(a) its contracts with customers (see paragraphs 113–122);

(b) the significant judgements, and changes in the judgements, made in applying this Standard to those contracts (see paragraphs 123–126); and

(c) any assets recognised from the costs to obtain or fulfil a contract with a customer in accordance with paragraph 91 or 95 (see paragraphs 127–128).

Each of these required disclosures is discussed further in Section 9 of our general publication.

Telecom entities may need to expend extra effort when initially preparing the required disclosures for their interim and annual financial statements. For example, entities operating in multiple segments with many different product lines may find it challenging to gather the data needed to provide the disclosures. As a result, telecom entities will need to ensure that they have the appropriate systems, internal controls, policies and procedures in place to collect and make the required disclosures. In light of the expanded disclosure requirements and the potential need for new IT systems to capture the required data, telecom entities may wish to prioritise this portion of their implementation plan.

14. Next steps

Telecom entities should perform a preliminary assessment of how they will be affected as soon as possible so they can determine how to prepare to implement IFRS 15.

Telecom entities should consider whether they will need to make any changes in accounting policies, accounting systems or internal control over financial reporting. Regulatory requirements or laws that govern telecom contracts in specific jurisdictions may also need to be considered.

Telecom entities also may want to monitor the discussions of the Boards, the TRG and the telecommunications entities revenue recognition task force formed by the AICPA to discuss implementation issues and application of the new standard to common transactions.

Telecom entities also should consider how they communicate the changes with investors and other stakeholders, including their plan for disclosure of the effects of new accounting standards which are issued, but not yet effective, as required under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

We encourage telecom entities to gain an understanding of IFRS 15 and evaluate how it will affect their specific revenue recognition policies and practices.

EY hosted a telecom industry webcast to discuss implications of the revenue standard on 9 September 2014.[12]

[12] To access the archived webcast, please go to Thought center webcasts, EY Telecommunications webcast http://www.ey.com/GL/en/Issues/webcast_2014-09-09-1400_new-revenue-recognition-standards-for-telecommunications

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