

Technical Line

FASB – proposed guidance

The revised revenue recognition proposal – telecommunications

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What you need to know

- ▶ The FASB and the IASB have issued a second exposure draft of their joint revenue model that is closer to current US GAAP than their 2010 proposal.
- ▶ The proposal would require wireless telecommunications companies to allocate more revenue than they currently do to handsets they sell to customers who also sign service contracts.
- ▶ Implementation would be challenging for many telecom companies. They would have to track and update pricing information as contracts are modified and as they offer new products and services.
- ▶ The proposed model would require telecom companies to capitalize incremental costs incurred in obtaining a contract.
- ▶ Comments are due by 13 March 2012.

Overview

The revised revenue recognition proposal issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) would result in significant changes in practice in the telecommunications industry.

The proposal would supersede all existing revenue guidance under US GAAP and IFRS, including guidance under which wireless companies currently cap the amount of revenue they recognize for handsets at the amount the customer pays for the handset. The proposed model would require wireless companies to allocate revenue based on the relative standalone selling price of the handset and the monthly

service plan, which in many cases would result in the company allocating some service revenue to the handset. In addition, this process could result in different revenue amounts being allocated to the same or similar monthly service plans.

Many telecom companies would likely find it challenging to implement the proposal. They would likely need to update their information systems to track all of the data they would be required to consider to allocate revenue to performance obligations. The task would be further complicated by new products and service plans that telecom companies frequently offer.

This publication supplements our Technical Line, *Double-exposure: The revised revenue recognition proposal* (SCORE No. BB2231) (general Technical Line), and should be read in conjunction with it. The discussions in this publication do not represent our final or formal views, because the proposal could change as the Boards deliberate further.

Background

The Boards issued their joint revenue recognition proposal for a second time because they made significant changes to their initial June 2010 proposal during redeliberations.

The principles in the November 2011 Exposure Draft (ED) would be applied using the same five steps the Boards initially proposed:

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

Under the proposal, companies would be required to exercise judgment when considering the terms of contracts and all of the facts and circumstances, including implied contract terms. Companies would also have to apply the requirements of the proposal consistently to contracts with similar characteristics and in similar circumstances. A complete discussion of the proposed guidance can be found in our general Technical Line.

The Boards are proposing that companies adopt the new guidance retrospectively for all periods presented in the period of adoption, although the guidance provides for limited relief from full retrospective adoption. The ED states that the effective date would be no earlier than fiscal years beginning on or after 1 January 2015. The Boards will determine the exact date during redeliberations.

Step 1: Identify the contract with the customer

To apply the proposal, an entity would have to first identify the contract, or contracts, to provide goods or services to customers. Contracts could be written, oral or implied by an entity's customary business practice.

Important changes have been made to the proposal that would affect telecom companies.

Most wireless contracts have terms of two years and include termination penalties if the contract is canceled before it expires. However, many wireline arrangements have monthly terms and are renewed each month (i.e., they are month-to-month contracts), either from inception or upon expiration of an initial contract term. A month-to-month contract represents a series of renewal options because the same services continue to be provided until the customer or telecom company cancels them. Most telecom companies have sufficient historical data to estimate the average customer life and may wonder whether they should consider the average customer life when applying the proposed model to month-to-month contracts. The proposal is clear that revenue recognition would be tied to the contract, and therefore we believe that a telecom company would account for each month as a separate contract.

Contract modifications

Customers frequently make changes to their telecom services, such as increasing or decreasing minutes in a wireless plan, moving from a rate-per-use plan to a flat-rate plan or adding or removing services. A contract modification exists when both parties to the contract approve a change in its scope or price (or both).

When a contract is modified, companies would have to determine whether the modification combined with any remaining performance obligations creates a new contract (separate from the original contract) or whether the contract modification should be accounted for as part of the existing contract. This determination would be driven by whether the modification results in the addition of goods or services that are distinct and whether the price of the additional good or service reflects the standalone selling price and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

Contract modifications that modify or remove previously agreed-to goods and services would not be treated as separate contracts. However, if the modifications are distinct from the goods and services provided before the modification, the entity would treat the contract modification as a termination of the old contract and the creation of a new contract.

When evaluating contract modifications, a telecom company would look at whether the good or service is regularly sold separately or whether the customer can benefit from the service with other resources readily available to the customer (i.e., it is distinct) and the price of the modification reflects the telecom company's current standalone selling price for that good or service. If the price of the modification reflects a material discount or premium from the current selling price, the modification could not be considered a separate contract and would need to be accounted for as part of the existing contract.

If a contract modification results only in a change to the transaction price, an entity would allocate the change in the price to the separate performance obligations in the contract in the same manner in which the transaction price was allocated at contract inception.

Illustration 1 – Wireless contract modification

On 1 January 20x1, Wireless Company enters into a two-year contract with a customer for a 600-minute wireless plan for \$60/month and a handset for which the customer pays \$100. Assume that the time value of money is not significant. In addition, to simplify this example, the standalone selling price of the wireless plan is the same as the contractual price. Wireless Company allocates the transaction price as follows:

	Consideration	Standalone selling price	Allocated transaction price
Handset	\$ 100	\$ 350	\$ 301
Wireless plan	1,440	1,440	1,239
Total consideration	\$ 1,540	\$ 1,790	\$ 1,540

The allocated transaction price for the handset (\$301) is recognized as revenue when the customer takes possession of the handset (at the time of sale). The \$1,239 service revenue is recognized over the two-year contract term (or \$51.63/month). A contract asset of \$201 is established at the time the handset revenue is recognized, representing the difference between the revenue recognized and the cash received.

Scenario 1

On 1 July 20x1, the customer realizes that he needs more minutes in his wireless plan and upgrades to the 800-minute plan for the remaining term of the contract (18 months). The 800-minute plan is priced at \$80/month, which is the current price for this plan that is available to all customers.

Because this modification represents a change in the previously promised goods or services under the arrangement (and is not the addition of incremental goods or services), this modification cannot be treated as a separate contract. However, to determine the appropriate accounting for the modification, the entity has to assess 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 services).

Because the entity frequently sells service plans on a standalone basis, it determines that the remaining monthly services are distinct from the goods and services already provided to the customer. As a result, Wireless Company allocates the remaining consideration to be received to the remaining performance obligations (\$80 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 \$201, but it has been reduced to \$150.75 at the date of the modification. As a result, the entity has \$1,289.25 to allocate to the remaining monthly service, or \$71.63 per month.

(Note: While the proposal does not explicitly address the treatment of contract assets when a contract is modified, it does address the treatment of a contract liability. This illustration applies that same principle to the contract asset, which we believe is the Boards' intent.)

Illustration 1 – Wireless contract modification (continued)

Scenario 2

On 1 July 20x1, the customer realizes that he needs a text messaging plan and adds an unlimited text messaging plan for the remaining term of the contract (18 months). The unlimited text messaging plan is priced at \$20 a month. This is the current pricing for this plan, available to all customers.

Wireless Company determines that the modification should be treated as a separate contract because the modification has resulted in the addition to the contract of goods or services that are distinct (the text messaging services), and the monthly price for those services is reflective of the entity's standalone selling price. As a result, Wireless Company would account for the text messaging plan separately from the previous contract, and each month would recognize \$20 in text messaging revenue (in addition to the revenue recognized each month related to the original contract).

Step 2: Identify the performance obligations

The goods or services promised in a customer contract (either explicitly stated in the contract or implied by customary business practice) are referred to as performance obligations in the proposed standard and are akin to deliverables under current US GAAP.

Goods and services would be accounted for as separate performance obligations when they are distinct, meaning they are sold separately or the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer. These resources can be offered by the entity or by another entity. If a good or service is not distinct, it would be combined with other goods or services until a distinct performance obligation is formed.

Further, an entity could choose to account for two or more distinct goods or services in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

Once an entity determines whether the individual goods and services would be distinct, the entity would have to consider the manner in which the goods and services have been bundled in an arrangement. Because of the manner in which they have been bundled, an entity may determine it is appropriate to account for otherwise distinct goods or services as a single performance obligation.

To account for a bundle of goods and services as one performance obligation, the goods and services must be highly interrelated, transferring them to the customer must require significant integration, and the bundle of goods and services must be significantly modified or customized to fulfill the contract.

Properly identifying performance obligations within a contract would be a critical component of the proposed revenue guidance.

How we see it

Based on the criteria provided by the Boards for determining separate performance obligations, we believe the wireless handsets provided in most arrangements would be considered separate performance obligations. This would require a change in mindset for telecom companies, which generally view handsets as part of their marketing strategy to attract customers and therefore, economically speaking, as a cost of doing business. Moreover, telecom companies do not think of themselves as being in the business of selling handsets – they view themselves as providers of telecom services. However, handsets are sold separately from wireless plans, in connection with prepaid plans and as replacement units or “early” upgrades, although this may occur less frequently than sales with a wireless plan. Because handsets are sold separately, they are distinct and therefore would be accounted for as separate performance obligations under the proposal.

Telecom companies typically offer free products or services, such as a free month of service, to entice new customers. These free goods or services represent promised goods and services under the contract and would be assessed to determine whether they represent separate performance obligations. If they represent separate performance obligations, a portion of the transaction price would have to be allocated to these items. This treatment would represent a change in practice for entities that currently treat free goods or services as a marketing cost of the arrangement rather than as a revenue element of the arrangement.

Some goods provided by telecom companies may not meet the definition of distinct. For example, a wireline company may determine that the set-top boxes used to provide video services are not distinct because they are rarely, if ever, sold separately. The customer also cannot use the set-top box with another company’s network.

It is unclear whether the provision of the set-top box to the customer would be considered a lease (the Boards have discussed this example, but they have not yet reached a definitive conclusion). Assuming that the set-top box is within the revenue guidance (and therefore, is not a lease), the telecom company would combine the monthly set-top box fee and monthly video service into one performance obligation and recognize the amount of the transaction price allocated to this performance obligation when the customer uses the video services and set-top box (i.e., monthly). If the customer pays for the set-top box in full at the inception of the contract, the cash received would be deferred and recognized when the services and set-top box are used.

Options for additional goods/services and nonrefundable up-front fees

Under the proposal, when an entity gives a customer the option to purchase additional goods and services as part of an arrangement, the entity would have to consider whether the option is an additional performance obligation. The proposed model states that the option would be considered a separate performance obligation if it provides a material right to the customer (e.g., it results in a discount that the customer would not otherwise receive). An option to acquire additional goods or services at a price that reflects the standalone selling price for that good or service would not provide the customer a material right.

Telecom companies frequently provide options to customers to acquire additional goods or services, including add-ons such as text messages, data downloads and video on demand. The proposal includes a telecom example that illustrates that the option to purchase minutes and text messages in excess of a flat-rate plan would not be a material right and, therefore, not a separate performance obligation because those excess minutes and text messages are priced at the standalone selling prices for those services (see Example 23 in the proposal).

However, the proposal also indicates that the existence of a nonrefundable up-front fee may indicate that additional performance obligations exist within the arrangement because the customer may have been provided with an option to purchase future telecom services at a discounted rate (the activation or installation fee is waived at renewal). For example, if the up-front fee is associated with a month-to-month arrangement, the company may determine that the ability to renew each subsequent month without having to pay an activation fee represents a material right. The up-front payment would be recognized over the period when those goods and services are provided (i.e., the customer relationship period in this case). Conversely, the company may determine that an activation fee associated with a two-year arrangement that switches to month-to-month at the end of the stated contractual term is not a material right, given the small dollar amount of the fee in relation to the total service fees, and therefore would not identify a discounted renewal option as an additional performance obligation in the arrangement. In this case, the activation fee would be included in the total transaction price that is allocated to the separate performance obligations (i.e., the handset and monthly service plan).

Telecom companies would have to evaluate the facts and circumstances to determine whether the option to renew without an activation or installation fee is a material right to the customer. If a telecom company determines that the option is a material right, it would allocate a portion of the transaction price to the renewal option performance obligation and recognize it as revenue when the renewal is exercised or forfeited.

Step 3: Determine the transaction price

The third and potentially most complex step in the proposal is to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., sales taxes). An entity does not consider collectibility when determining the transaction price. When determining the transaction price, the entity would consider the effects of the following:

- ▶ Variable consideration
- ▶ The time value of money
- ▶ Noncash consideration
- ▶ Consideration payable to a customer

Variable consideration

A portion of the transaction price could vary in amount and timing for such things as discounts, rebates, refunds, credits, incentives, bonuses, penalties, contingencies or concessions. Under the proposal, these variable amounts would be estimated and included in the transaction price using either the expected value approach or the most likely amount approach, whichever best predicts the consideration to which the entity will be entitled.

For telecom companies, the treatment of variable consideration under the proposal would represent a significant change from current practice in certain circumstances. Most current US GAAP limits the amount of revenue allocable to identified performance obligations to the amount that is not contingent on the future satisfaction of performance obligations. The proposal would allow variable consideration to be estimated, included in the total transaction price and allocated to performance obligations and would restrict only the recognition of variable amounts that are not “reasonably assured” of being received. This difference could have a significant effect on the timing of revenue recognition, as discussed below.

While estimating variable consideration would be challenging for many arrangements, there may not be a significant change in practice for month-to-month telecom contracts. Because each month represents a separate contract, any variable consideration included in the transaction price for that month will be included in the amount billed. This eliminates the need for estimating variable consideration for month-to-month arrangements.

For contracts longer than one month, the variable consideration requirement would be more significant. The following example illustrates how a telecom operator would estimate the expected consideration in a wholesale arrangement.

Variable consideration would be estimated in determining the transaction price.

Illustration 2 – Determine transaction price

Telecom Inc. enters into a one-year wholesale contract with a competitive local exchange carrier, CLEC Inc., to provide access to its network. Under the contract, access services are priced at \$.02 per minute of use, with the rate reduced to \$.015 per minute of use, applicable to all traffic, if CLEC Inc. uses at least 20,000 minutes.

Expected value approach

Based on its historical knowledge of CLEC Inc., Telecom Inc. anticipates that the credit (offered through the reduced rate per minute) will apply and that the amount charged will be either \$.02 or \$.015, depending on the usage. Telecom Inc. takes this into consideration when determining the transaction price at the beginning of the contract term. At contract inception, Telecom Inc. estimates that it is 80% likely that CLEC Inc. will exceed 20,000 minutes and calculates the following per minute price under the expected value (probability-weighted) approach:

Probability	Rate per minute of use	Estimated rate per minute of use
80%	\$.015	\$.012
20%	.02	.004
Weighted average rate		\$.016

Illustration 2 – Determine transaction price (continued)

Based on its probability-weighted average calculation, Telecom Inc. would apply the \$.016 estimated rate per minute of use to the actual traffic carried for CLEC Inc. during each month of the contract. As services are provided to the customer, Telecom Inc. would be required to reassess these estimates and adjust the price accordingly.

Most likely amount approach

Using the same facts as above, Telecom Inc. determines there are two possible scenarios (a rate of either \$.02 per minute or a rate of \$.015 per minute) and determines that the most likely approach best predicts the transaction price. At inception of the arrangement, Telecom Inc. would determine that the \$.015 rate is the most likely amount (given its 80% probability) and use that rate in recognizing revenue.

However, the proposal stipulates that an entity should apply the selected method consistently throughout the contract. It is unclear what an entity should do, then, in situations where the assessed likelihood has changed such that neither amount is more likely than the other. For example, assume that two months into this arrangement, CLEC Inc.'s usage is well below historical levels. As a result, Telecom Inc. now believes it is only 50% likely that CLEC Inc. will reach the needed volume to get to the reduced billing rate. In this scenario, since neither the \$.015 rate per minute nor the \$.02 rate per minute is the "most likely" amount, it is unclear which rate Telecom Inc. should choose.

Step 4: Allocate the transaction price

Once the performance obligations are identified and the transaction price has been determined, the proposal would require an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). Generally, any discount within the contract would be allocated proportionally to all of the separate performance obligations in the contract. While the notion of allocating revenue to the separate deliverables based on their proportionate value is not new (the current multiple-element arrangements guidance contains a similar requirement), including variable consideration in the allocation (as part of the total transaction price) would be a change from current practice.

The example below illustrates the effect of the proposed elimination of the contingent revenue cap (i.e., the cap on revenue recognized for handsets sold along with a monthly wireless service plan) on a typical wireless contract.

Illustration 3 – Allocation of the transaction price

In January 20X1, two customers, Customers A and B, enter into two-year contracts with Wireless Company. Wireless Company offers two handsets: a cell phone model that has been on the market for 18 months that the company is offering for free (the standalone selling price is \$350) and the newest version of the phone, which includes improved features and functionality, which the company is offering for \$160 (the standalone selling price is \$480). For simplicity, assume that Wireless Company does not charge activation fees.

Illustration 3 – Allocation of the transaction price (continued)

Wireless Company offers a 400-minute wireless plan for \$40 per month over a two-year contract period. For purposes of this example, assume the standalone selling price of the 400-minute wireless plan is \$40 per month. Any minutes in excess of 400 minutes are priced at \$0.05 per minute. This is the standard pricing for all customers. The voice plan is cancelable subject to a \$320 penalty that decreases pro rata over the contract term.

Customer A selects the older model cell phone, and Customer B selects the newer model. Both customers select the 400-minute wireless plan. For purposes of this example, there are no rebates, incentives or other discounts provided.

The following table illustrates the differences in the allocation of the transaction price and revenue recognized between current US GAAP and the proposal:

	Current US GAAP		Proposal	
	Customer A	Customer B	Customer A	Customer B
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 \$0 and \$160 in handset revenue under current US GAAP represents the amount of cash received.
- ▶ The \$256 of handset revenue under the proposal for Customer A is calculated as $[\$350/(\$960 + \$350) \times \$960]$
- ▶ The \$373 of handset revenue under the proposal for Customer B is calculated as $[\$480/(\$960 + \$480) \times \$1,120]$
- ▶ Wireless service revenue of \$960 under current US GAAP for Customer A and B is calculated as $[\$40 \times 24 \text{ months}]$
- ▶ Wireless service revenue of \$704 and \$747 under the proposal for Customer A and B, respectively, is calculated as follows: $\$704 = [\$960/(\$960 + \$350) \times \$960]$, $\$747 = [\$960/(\$960 + \$480) \times \$1,120]$

Under current US GAAP, the revenue that Wireless Company recognizes upon the delivery of the handset is limited to the amount of consideration received up front; that is, the discounted purchase price. This is because the remaining transaction consideration is contingent upon the telecom company providing the monthly wireless service and therefore cannot be allocated to the first delivered item. Conversely, under the proposal, the total transaction consideration would be allocated to the identified deliverables (handset and monthly service) based on their relative standalone selling prices, and revenue would be recognized as each performance obligation is satisfied. The result would be that under the proposal, Wireless Company would allocate more transaction consideration to the handset than under current US GAAP and recognize that revenue before the consideration is actually due from the customer.

How we see it

Eliminating the contingent revenue cap is likely the most significant operational issue telecom companies would face in applying the proposed standard. Many telecom companies offer customers a wide selection of handsets and wireless plan options. The proposed requirement to allocate revenue on a relative standalone selling price approach may result in similar goods and services (e.g., a particular handset and a particular usage plan) being allocated different amounts of revenue. This is shown in Illustration 3, in which a different amount of revenue is allocated to the 400-minute wireless plan for Customer A and Customer B because the plan was bundled with different handsets.

Telecom companies likely will need to make significant investments in their information systems to be able to process multiple pricing points for a single product offering. The proposal also would require constant revisions to reflect new products and offerings, as well as changes in standalone selling prices to appropriately allocate consideration for new contracts. While the proposal says an entity could use a portfolio approach in accounting for its transactions, and this could provide some relief, we believe this would still be a monumental task for many entities.

The standalone selling price would be the price at which an entity would sell a good or service on a standalone basis at contract inception. The proposal indicates the observable price, when available, of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In these situations, an entity would have to estimate the amount for which it would sell each good or service on a standalone basis.

While many wireline and wireless goods and services are sold separately, their prices may differ due to competition, state regulation, or type of customer. Telecom companies would need to consider these factors when they determine the standalone selling prices of their goods and services. Selling prices also change frequently because of competition and the introduction of new technologies. From discussions with companies within the industry, we understand that the requirement to determine standalone selling prices on a regular basis represents a significant challenge to the industry and may require updated systems or processes.

Some challenges a telecom company might face in applying the relative selling price method could be alleviated if performance obligations could be aggregated because the goods or services have the same pattern of transfer to the customer (as discussed above under Step 2: Identify performance obligations). However, it is unclear how much relief this would provide because of disaggregated disclosure requirements. Additionally, the proposed disclosure requirements may prevent a company from aggregating certain performance obligations. That is, to comply with disclosure requirements, a telecom company may have to separate performance obligations that otherwise could have been aggregated.

Step 5: Satisfy the performance obligation

Under the proposal, an entity would recognize revenue when each performance obligation is satisfied. This would occur when the goods or services are transferred to the customer and the customer obtains control. The proposal indicates that certain performance obligations are satisfied as of a point in time; therefore, revenue would be recognized at that point in time (e.g., the delivery of the handset to the customer). However, other performance obligations are satisfied over time, and therefore the associated revenue would be recognized over the period the performance obligation is satisfied (e.g., the monthly data and phone services).

While it would be relatively straightforward for telecom entities to determine when goods or services transfer to the customer for most arrangements, there may be more complex arrangements for which it would not be as clear. The Boards acknowledged that it may be difficult to determine whether goods and services transfer over time and provided guidance to assist in that determination. An entity would satisfy a performance obligation over time if at least one of the following two criteria is met:

- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is being created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity and at least one of the following is met:
 - ▶ The customer simultaneously receives and consumes the benefits
 - ▶ Another entity would not need to substantially re-perform the work to fulfill the obligation
 - ▶ The entity has a right to payment for performance completed to date, and it expects to fulfill the contract as promised.

Illustration 4 – Enterprise contract

Telecom Inc. enters into an agreement to provide the installation of telecom equipment in a 30-story office building along with a three-year service agreement that begins upon the completion of the installation. The installation phase is expected to last 18 months.

During the installation phase, Telecom Inc. works extensively with the customer to configure the telecom equipment to the customer's wishes. Telecom Inc. then manufactures or procures the needed equipment and provides the installation services needed to have the equipment work properly in the office building. The equipment is being installed in the customer's building; therefore, the customer takes physical possession of the equipment as it is installed.

In this scenario, Telecom Inc. determines it has two performance obligations, the first being the design/manufacture/installation of telecom equipment for the customer, and the second being the three years of telecom services.

Because the customer controls the equipment as it is installed, Telecom Inc. determines that the first performance obligation as it relates to the telecom equipment is satisfied over time rather than at a point in time. The customer reaches a similar conclusion regarding the telephone services that are to be provided over the three-year period.

Telecom companies would have to consider the facts and circumstances of each enterprise contract to determine when the performance obligations in a contract are satisfied.

Directory revenues are another area where the timing of revenue recognition could change significantly from current practice, as illustrated below.

Illustration 5 – Directories contract

Telecom Inc. is the dominant telephone company in a particular geographic area and is required by state law to print telephone directories annually and distribute them to customers free of charge. Telecom Inc. distributes a large number of newly printed directories and then distributes directories based on individual requests (e.g., for users who want additional copies or have moved). Fees are generated from advertising in these directories. Consequently, revenue is recognized based on Telecom Inc.'s contract with the advertiser, in which Telecom Inc.'s performance obligation is to print an advertisement in the directory, distribute the directory and make directories available for the entire advertising period.

Telecom Inc. considers the control indicators under the proposal to determine when control of the advertising services is transferred. The customer obtains control, meaning it has the ability to benefit from the advertising services, when the directory is delivered to Telecom Inc.'s end users. Because the majority of directories are distributed shortly after initial printing, Telecom Inc. would recognize the majority of revenue at the time of distribution. Under this approach, some revenue would be deferred and recognized as additional directories are distributed.

This would represent a significant change in the revenue recognition pattern for printed directories. Under current US GAAP, directory revenue is recognized on a straight-line basis over the life of the directory, generally one year (referred to as the amortization method).

Indirect channel sales

Wireless companies frequently use indirect sales channels (i.e., dealers) to sell contracts to customers. The terms and conditions of the arrangements with dealers vary throughout the industry. The key areas to consider in accounting for these arrangements include the recognition of revenue related to the initial sale of the handset to the dealer and the treatment of any subsequent payments to the dealer (e.g., commissions and handset subsidies). Under these arrangements, the wireless company typically transfers a handset to the dealer. The dealer then sells that handset to the end customer, who concurrently enters into a contract for a monthly service plan with the wireless company. In return for the dealer identifying the end customer, the wireless company makes a payment to the dealer. The contract with the dealer may specify whether the payment is meant to represent a commission, a subsidy on the handset or a combination of the two.

Because the terms of these arrangements are unique and frequently vary from dealer to dealer, there is currently diversity in the accounting for the sale/transfer of handsets to dealers and the related payments to dealers. Some wireless companies recognize revenue from the sale of handsets to a dealer on a gross basis when the handsets are transferred to the dealer. The related payments to the

dealers are reported in operating expenses when the dealer sells the handset to the end user. Other wireless companies report the sale of the handsets net of the dealer payments in operating revenues.

Under the proposal, the assessment of the appropriate accounting for these transactions would likely be similar to that made under current US GAAP. However, given the significant differences that exist within these arrangements, the accounting would likely continue to be diverse. To determine the appropriate accounting, wireless companies would need to thoroughly consider the contractual terms of the arrangements as well as the entity's normal business practice.

The following illustrations highlight some of the different arrangements a wireless company may enter into with a dealer and some of the factors the wireless company would have to consider to determine the appropriate accounting. Because the accounting for sales of handsets and monthly service contracts through indirect sales channels would require thorough analysis of all facts and circumstances, these examples are not intended to address all situations.

Illustration 6 – Indirect channel sales

Wireless Co enters into an arrangement with Dealer Co in which Dealer Co acquires handsets for \$400 each from Wireless Co and sells these handsets, along with two-year monthly service contracts, to end users. Dealer Co may also sell an end user a Wireless Co two-year service plan bundled with a handset acquired from another vendor (such as the original manufacturer).

Whenever Dealer Co gets an end user to sign up for a two-year service contract with Wireless Co, Wireless Co makes a payment to Dealer Co. The amount of the payment varies depending on the terms of the arrangement with the dealer.

Scenario 1

In this scenario, the handsets sold to the dealer are branded handsets, and, as such, can only be sold to end users who sign up for a service plan with Wireless Co (rather than another wireless company). However, when the handsets are sold to Dealer Co, Dealer Co obtains control of the handsets, assumes inventory risk, has only limited return rights, and determines the price charged to the end user. Wireless Co determines that the transfer of the handset to Dealer Co represents a sale transaction.

Under the terms of the contract with Dealer Co, when Dealer Co gets an end user to sign up for a two-year service contract with Wireless Co, Wireless Co makes a payment to Dealer Co. The amount of the payment depends on whether the handset sold to the end user was one Dealer Co originally obtained (\$550) from Wireless Co (as is the case in this scenario) or one it acquired from another vendor (\$300).

However, because the handset being sold to Dealer Co will ultimately be sold to an end user who also signs up for a service contract with Wireless Co, Wireless Co knows that it will have to make a \$550 payment to Dealer Co at some point in the future. Further, Wireless Co determines that of that payment, \$300 represents a commission related to the acquisition of a new customer (based on other transactions with Dealer Co that do not include handsets from Wireless Co). As a result, the remaining \$250 payment represents a rebate or reduction of the handset selling price.

Illustration 6 – Indirect channel sales (continued)

Therefore, at the point of sale of the handset to Dealer Co, Wireless Co recognizes \$150 in revenue (\$400 selling price less \$250 rebate to be made in the future). When Wireless Co makes the \$550 payment to Dealer Co in the future, Wireless Co treats only \$300 of that payment as a cost of obtaining a contract.

Scenario 2

The handsets sold to the dealer are not branded, meaning the handsets can be bundled by Dealer Co as part of any wireless service contract (not only wireless service contracts with Wireless Co). Also, similar to Scenario 1, when handsets are transferred to Dealer Co, Dealer Co obtains control of the handsets, assumes inventory risk, has only limited return rights and determines the price charged to the end user. Wireless Co determines that the transfer of the handset to Dealer Co represents a sale transaction.

Additionally, in this fact pattern the amount of the payment to Dealer Co does not depend on whether Dealer Co obtained the phone from Wireless Co or from another vendor. Instead, the payment to Dealer Co varies based on the length of the service contract and the type of services (voice and data versus just voice) the end user enters into with Wireless Co.

In this fact pattern, Wireless Co determines that because the amount of the subsequent payment to Dealer Co is not affected by the sale of the handset to the dealer, no portion of that payment represents a rebate or reduction on the sales price of the handset. Therefore, Wireless Co records the entire \$400 received from Dealer Co associated with the sale of the handset as revenue at the time the handset is transferred and recognizes the entire payment to Dealer Co as a cost of obtaining a contract.

Scenario 3

In this scenario, the handsets sold to the dealer are branded handsets, and, as such, can only be sold to end users who sign up for a service plan with Wireless Co (rather than some other wireless company). Further, while Dealer Co pays for the handsets obtained from Wireless Co, Dealer Co is allowed to return any unsold handsets within six months and receive a full refund. Additionally, Dealer Co agrees to sell the handsets at prices specified by Wireless Co, depending on the type and length of service plan the end user signs up for.

Based on this fact pattern, Wireless Co that determines Dealer Co is actually acting as an agent of Wireless Co for the purpose of obtaining new service contracts with end users. As a result, the transfer of the handset to Dealer Co does not represent a sale transaction. Therefore, Wireless Co does not record any of the consideration received from Dealer Co upon the transfer of the handset as revenue (such amount is instead recorded as a contract liability).

Once Dealer Co successfully gets an end user to purchase the phone and service plan bundle, Wireless Co would have to account for a revenue transaction with the end user. As Dealer Co was acting as an agent of Wireless Co, this arrangement with the end customer would be accounted for in the same manner as if the end customer had signed up directly with Wireless Co. Additionally, Wireless Co would have to make a payment to Dealer Co of \$550 for obtaining the new service contract. The net cash outflow to Dealer Co of \$150 would be considered the cost of obtaining a contract.

Contract costs

Costs of obtaining a contract

Under the proposal, incremental costs of obtaining a contract (i.e., costs that would not otherwise have been incurred if the contract were not obtained, such as sales commissions) should be recognized as an asset if the entity expects to recover those costs. As a practical expedient, the proposal would permit immediate expense recognition for contract acquisition costs related to contracts with a duration of one year or less. While this is not explicitly stated, we believe entities would be permitted to choose this approach as an accounting policy election and, if they did so, would have to apply it consistently to all short-term contract acquisition costs.

As described in the Indirect channel sales section above, wireless companies would need to thoroughly analyze amounts payable to third-party dealers. Telecom companies would need to evaluate the terms of their contracts with these dealers to determine how much of those payments represent commissions (versus subsidies on handsets) and, therefore, would be considered costs to obtain a contract. These costs would have to be capitalized if a company expects to recover them.

How we see it

The proposed requirement to capitalize expenses that telecom companies expect to recover would represent a significant change for companies that currently expense the costs of obtaining a contract.

Costs of fulfilling a contract

An entity would account for costs incurred in fulfilling a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment and software) in accordance with that guidance. Otherwise, an entity would capitalize the costs to fulfill a contract if all of the following criteria are met:

- ▶ The costs relate directly to the contract (or a specific anticipated contract).
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.
- ▶ The costs are expected to be recovered.

Telecom companies typically incur significant costs related to the setup, activation and installation of customer contracts, but there is little guidance under current US GAAP on how to account for these costs. While there is some diversity in practice, one generally accepted practice for wireline companies is to capitalize activation and installation costs up to the amount of corresponding revenues deferred, which is generally the installation fee received. However, under the proposal, the telecom company would capitalize costs that are expected to be recovered, which could be more than the amounts capitalized today.

The proposal does not specify whether contract costs should be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). However, because the proposal clearly states that the amortization period can exceed the contract period, we believe that companies would use the

same period in determining whether the deferred costs are recoverable. This is especially significant when a number of the arrangements are contractually on a month-to-month basis but the expected term of the arrangement is longer. Telecom companies track customer terminations (i.e., churn) for most of their services and have the ability to demonstrate that the average customer relationship lasts longer than the contractual period.

How we see it

We believe that telecom companies would need to use judgment and look to the expected period of benefit for the costs incurred to determine recoverability.

For example, wireline companies incur costs upon installation of a new customer, with no further costs expected (outside of monthly fulfillment costs). These entities may determine that the recoverability period for the installation costs is the customer relationship period. Therefore, even when customers are under month-to-month contracts, we believe that the customer relationship period would be the appropriate period to use for the assessment of recoverability for those costs (as long as the company has the ability to reasonably estimate the customer relationship period).

Illustration 7 – Telecom contract costs

A customer signs up with Telecom Inc. for a landline voice and internet bundle priced at \$55 per month, which is provided under a month-to-month contract that is cancelable at any time without penalty. Telecom Inc. has provided these services for many years and has accumulated history that shows 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 \$30 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 labor and material costs are \$500. Telecom Inc. charges the new customer a \$75 installation fee to recoup a portion of the direct costs incurred.

Under current US GAAP, the \$75 installation fee is deferred and \$75 of the direct labor and material costs would be capitalized. The remaining \$425 in costs would be expensed as incurred.

Assuming recoverability under the proposal is determined using the expected customer life (it is currently unclear whether this would be the case or only the contractual period would be considered), Telecom Inc. would capitalize the \$500 of contract fulfillment costs, because they would be recoverable over the expected customer life. That is, Telecom Inc. expects to receive total consideration of \$2,055 [(\$55 per month x 36 months) + \$75 installation fee] over the expected customer life, which exceeds the cost of installation and providing the monthly landline and internet services of \$1,580 [(\$30 per month x 36 months) + \$500 installation costs] for the same period.

Amortization

For both the incremental costs of obtaining a contract and costs to fulfill a contract that would be capitalized, an entity would amortize these assets on a systematic basis consistent with the pattern of transfer for which the service relates. Unlike the guidance on capitalization of costs, however, the proposal states clearly that entities could take into account the expected renewal period in their assessment of the appropriate amortization period.

Telecom companies would need to analyze their commission programs to determine the period to which they relate. For example, assume a telecom company's commission program allows a \$100 commission to be paid upon activation by the customer and an additional \$100 commission to be paid at the anniversary date if the customer is still active. Under this arrangement, the original \$100 commission and each additional \$100 commission would be amortized over one year because that is the period of benefit associated with the commission payments. Alternatively, if the telecom company's commission program provides a onetime \$150 commission to be paid upon activation, the commission would be amortized over the average customer life.

Disclosures

In response to criticism that the current revenue recognition disclosures are inadequate, the Boards tried to create a comprehensive and coherent set of disclosures. As a result, the proposal includes an overall objective that the revenue recognition disclosures should enable users of the financial statements to understand the "amount, timing and uncertainty of revenue and cash flows arising from contracts with customers." The proposed guidance says preparers would meet that objective by providing both qualitative and quantitative disclosures about:

- ▶ Contracts with customers – These disclosures would include disaggregation of revenue, reconciliation of contract asset and liability balances (including liabilities due to onerous performance obligations) and information about an entity's performance obligations.
- ▶ Significant judgments (including changes in those judgments) – This would include disclosures about judgments that significantly affect the determination of the transaction price, the allocation of the transaction price to performance obligations and the determination of the timing of revenue recognition.
- ▶ Assets recognized resulting from costs incurred to obtain or fulfill a contract.

In their revised proposal, the Boards have clarified that the disclosures they listed in the ED are not meant to be a checklist of minimum requirements. Instead, entities would have to determine which disclosures are relevant to them. Entities also would not have to disclose items that are not material.

Other implementation issues

System implications

For many telecom companies, multiple billing systems hold much of the detailed individual contract information. That information often is transferred to the accounting systems at an aggregated level. Consequently, many current accounting systems do not have the capability to account for millions of individual contracts and may not have been designed to handle this volume of data. Additionally, some

of the information required by the proposal is not tracked in current systems. For example, billing systems house recurring and nonrecurring charges for the services to which a customer subscribes. They do not track when a customer entered into a contract or when the contract expires and therefore are not capable of calculating the expected or remaining performance obligation. Instead, this information is housed in other systems that do not feed billing or accounting systems. They also do not currently hold information about standalone selling prices. To accurately account for individual contracts under the proposal, billing and accounting systems likely would require extensive and costly changes that likely would take a considerable period of time to implement.

Transaction taxes

Telecom goods and services are taxed in a variety of ways, and there is no uniformity among different states and jurisdictions. What is taxed, how much is taxed and the rate of tax varies; as a result, we expect that the proposal would add complexity in this area. Under current US GAAP, there is a high correlation between billings and revenue recognized. This would likely change under the proposal, but it is not clear what would happen when these amounts differ. For example, a telecom company would collect from the customer sales tax on a handset based on the amount charged at the point of sale, but the amount of revenue recognized for that handset under the proposal may be more than the cash collected. Taxing authorities could potentially require a telecom company to remit sales tax on the revenue recognized, which in many cases would be more than the cash collected from the customer.

Next steps

- ▶ Given the potential consequences, we encourage telecom companies to gain an understanding of the proposal, including how it may affect their particular facts and circumstances, and provide the Boards with feedback.
- ▶ We believe telecom companies would need to review all of the terms within their contracts with customers to ensure that the guidance in the proposed guidance is properly applied. Identifying the term of the contract and evaluating the termination clauses (for both the telecom company and customer) would be important in determining the amount and timing of revenue recognition. Regulatory requirements or laws that govern telecom contracts in specific jurisdictions also may need to be considered.
- ▶ Comments are due by 13 March 2012.

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