

## You Said: Revenue recognition for telecoms



In June 2010 the IASB<sup>1</sup> and the FASB<sup>2</sup> published an exposure draft on revenue from contracts with customers<sup>3</sup>, which comprises proposals to replace existing guidance under both IFRSs and US GAAP.

The ED proposes a single principles-based model under which an entity would recognise revenue as it satisfies the performance obligations in contracts with customers. A performance obligation would be satisfied when control of the promised goods or services is transferred to the customer.

An in-depth discussion of the proposals is included in our IFRS publication *New on the Horizon: Revenue recognition for telecoms*<sup>4</sup>.

The comment period on the ED has now closed, and 20 companies in the telecoms sector had responded to the proposals as of 5 November 2010.

We wanted to know what you said about the proposals: Are you supportive? Are consistent themes emerging from the sector? In this newsletter we have analysed your responses in the comment letters submitted to the IASB and/or the FASB.

The majority of respondents follow IFRSs as their reporting framework.

In general respondents were supportive of a single revenue recognition model that could be applied across industries.

Respondents had concerns in the following areas:

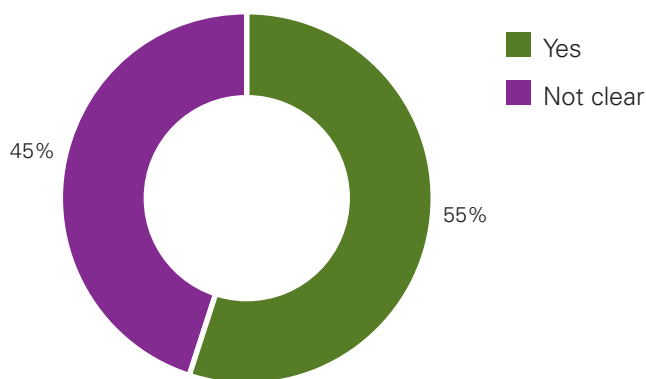
- Some of the proposals are not considered appropriate, e.g. expensing costs of obtaining a contract, and including credit risk in the measure of revenue.
- Some of the proposals would be difficult to apply in practice, e.g. applying the proposals to individual customer contracts.
- There is a lack of explicit accounting guidance for telecoms, e.g. contingent fees.
- There is a lack of application guidance in some cases, e.g. in assessing the transfer of control for service contracts.

Half of respondents disagreed with fully retrospective application of the final standard.

## Overall

Were you supportive of the proposals in the Revenue ED?

### Analysis



### Key proposal

The ED proposes a single principles-based model under which an entity would recognise revenue as it satisfies the performance obligations in contracts with customers. A performance obligation would be satisfied when control of the promised goods or services is transferred to the customer.

The final standard would replace all existing guidance under IFRSs and US GAAP, including all industry-specific guidance.

### Key messages/observations

The majority of respondents were supportive of a single revenue recognition model that could be applied across industries.

However, several respondents noted a lack of practical guidance for the telecoms sector that is characterised by large volumes of transactions with numerous customers involving small amounts. These respondents noted that implementation of the proposals would involve significant investment in existing IT<sup>5</sup> systems. Further, there were several areas of application guidance that respondents felt were inconsistent with the substance of their business practices. These areas are discussed in the rest of this newsletter.

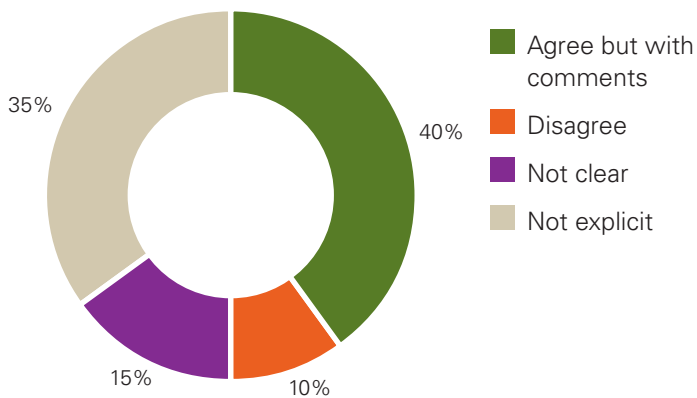
**Not clear** = Response included a discussion but it was not clear whether the respondents agreed with or supported the proposal.

## Step 1

# Identify the contract with the customer

The principle of “price interdependency” should be considered in determining whether: (1) two or more contracts should be combined and accounted for as a single contract; (2) a single contract should be segmented and accounted for as two or more contracts; or (3) a contract modification should be accounted for separately or as part of the original contract.

### Analysis



### Key proposal

The proposed model focuses on price interdependency: an entity could be required to combine two or more contracts when prices are interdependent; or segment a single contract if products or services are priced independently.

Additionally, a contract modification would be accounted for separately if the original contract and the modification are priced independently; otherwise, they would be accounted for together.

The proposals include several indicators for entities to consider when making these assessments.

### Key messages/observations

40 percent of respondents agreed with the Boards' proposal; only two companies disagreed explicitly.

Some of the concerns raised by those disagreeing with the proposal related to:

- a lack of additional guidance and clarity on the principle of “price interdependency”;
- a lack of clarity when determining whether the cancellation of one type of service plan and simultaneously signing a new service plan would be accounted for as a new contract or as a modification to the original contract; and
- practical difficulty in applying the principle using existing IT systems when customers frequently change tariff plans.

A few respondents suggested modifying the ED in order to allow the use of the portfolio approach when applying the proposal.

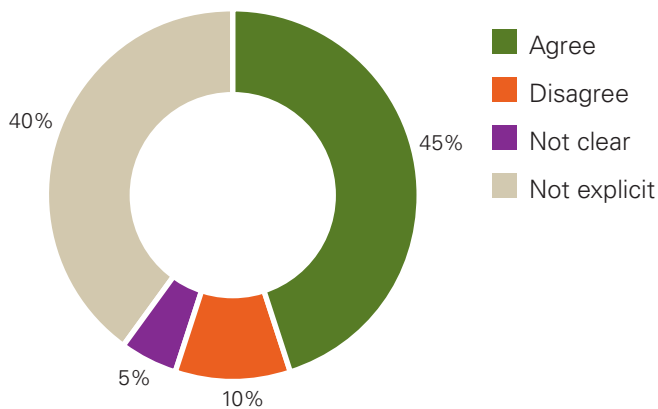
**Not explicit** = Response did not address the proposal explicitly.

## Step 2

# Identify the separate performance obligations in the contract

The identification of separate performance obligations in a contract should be on the basis that the promised goods or services are distinct.

### Analysis



### Key proposal

An entity would determine whether the promised goods or services are *distinct* before identifying them as separate performance obligations. A good or service would be considered distinct if either:

- the entity or another entity sells an identical or similar good or service separately; or
- the entity could sell the good or service separately because it has a distinct function and a distinct margin.

### Key messages/observations

45 percent of respondents agreed with the proposal; a further 40 percent did not state an explicit response to the question.

Some of the concerns related to:

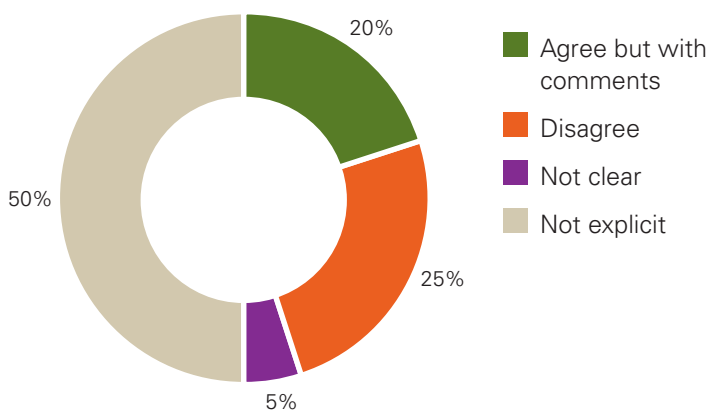
- a lack of clarity on the definition of distinct; and
- the presumption that the principles in the ED could be applied to all situations without regard to the entity's own business model.

## Step 3

# Determine the transaction price

Revenue related to a satisfied performance obligation should be recognised based on the principle of “estimated transaction price”, including when the consideration is variable.

### Analysis



### Key proposal

A transaction price in a contract involving variable consideration would be measured based on a probability-weighted average estimate. Under this approach, an entity would be required to estimate the possible outcomes of a contract for a reasonable number of possible outcomes and the probabilities of those outcomes when estimating the transaction price. The transaction price and revenue recognised would include only amounts that can be reasonably estimated.

### Key messages/observations

50 percent of respondents did not state an explicit response to the question; and a further 45 percent of respondents with a clear view were fairly evenly divided on the issue.

Some of the concerns raised by those disagreeing with the proposal related to:

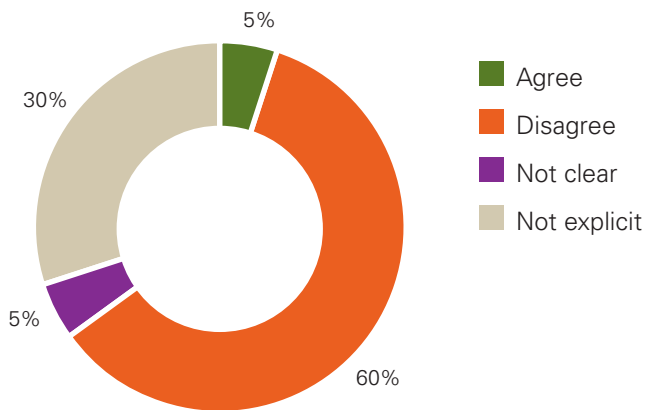
- using probability-weighted amounts in determining the transaction price, which does not reflect business reality and would require management to make significant estimates;
- the practical difficulty in estimating contingent revenue for multi-year contracts in a high volume environment;
- assigning probability weights to transaction prices using existing IT systems, which are incapable of accommodating the requirements of the proposal; and
- assuming that past events are indicative of future events, thereby ignoring the business risk involved.

## Step 3

# Determine the transaction price

The customer's credit risk should affect the amount of revenue to be recognised (i.e. how much) rather than whether revenue should be recognised.

### Analysis



### Key proposal

An entity would be required to assess collectibility, i.e. the customer's ability to pay the promised consideration, when determining the transaction price. An entity would adjust the consideration to a probability-weighted expected amount. Any effects of subsequent changes in the customer's credit risk would be recognised separately from revenue.

### Key messages/observations

60 percent of respondents disagreed that a customer's credit risk should affect the amount of revenue recognised.

The primary and the most common reason cited by respondents for rejecting this proposal related to the Boards' approach of considering customer credit risk as a measure of revenue rather than as an indicator of payment.

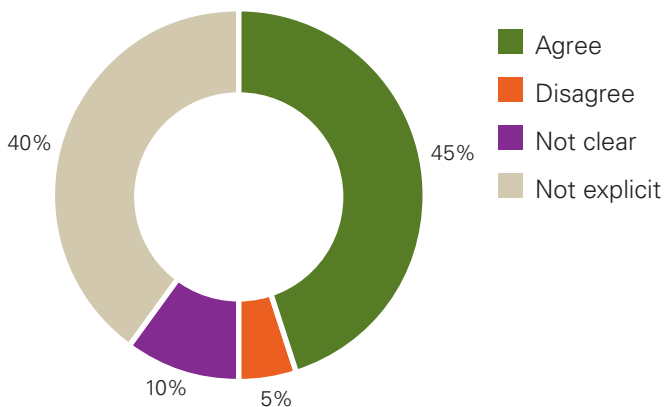
Some respondents suggested retaining the existing guidance on accounting for impairment losses due to customer credit risk on receivables.

## Step 3

# Determine the transaction price

The transaction price should be adjusted to reflect the time value of money if the contract includes a material financing component.

### Analysis



### Key proposal

An entity would adjust the amount of consideration to reflect the time value of money if the contract includes a material financing component. This could be the case if the entity receives payment significantly before or after transferring the goods or services.

### Key messages/observations

45 percent of respondents agreed with the proposal; a further 40 percent did not state an explicit response to the question; and only one company disagreed explicitly. This partly may be due to the nature of telecoms business in which the time lag between billings and collection generally is very short.

Some of the suggestions made to improve the proposal were:

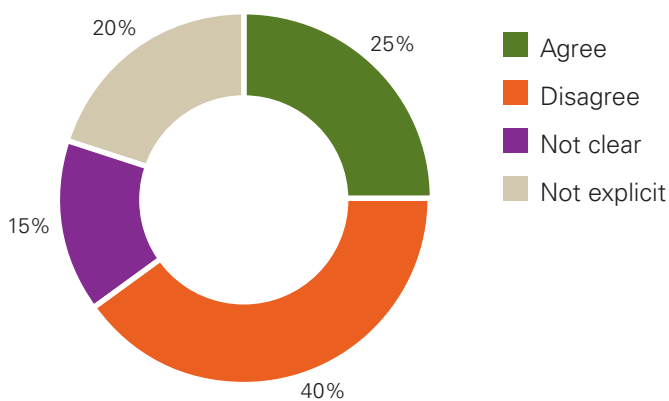
- clarifying the criteria to consider when determining whether a contract includes a material financing component; and
- restricting the proposal to contracts with payment terms in excess of one year.

## Step 4

# Allocate the transaction price to separate performance obligations

The transaction price should be allocated to all separate performance obligations in a contract in proportion to the stand-alone selling prices of the goods or services underlying each of the performance obligations.

### Analysis



### Key proposal

An entity would allocate the transaction price to separate performance obligations in proportion to their relative stand-alone selling prices, i.e. the price at which the entity would sell a good or service on a stand-alone basis at contract inception.

When available, the observable prices of a good or service sold separately would provide the best evidence of stand-alone selling prices. In the absence of such information, an entity would use approaches such as the “expected cost plus a margin approach” or the “adjusted market assessment approach”.

The residual method would no longer be considered an acceptable method of allocating the transaction price to the performance obligations in a contract.

### Key messages/observations

Views on this issue were diverse.

Some of the reasons for disagreeing with the proposal related to:

- allowing upfront recognition of contingent revenue in a bundled arrangement involving the sale of handsets and ongoing services would result in the recognition of inflated assets;
- the proposal would shift revenue to a separate category, i.e. equipment revenue, which is not the underlying business objective of telecoms;
- the proposal would lead to a disconnect between revenue and cash flows; and
- the proposal not being reflective of management’s intentions.

Some of the suggestions made to improve the proposal included:

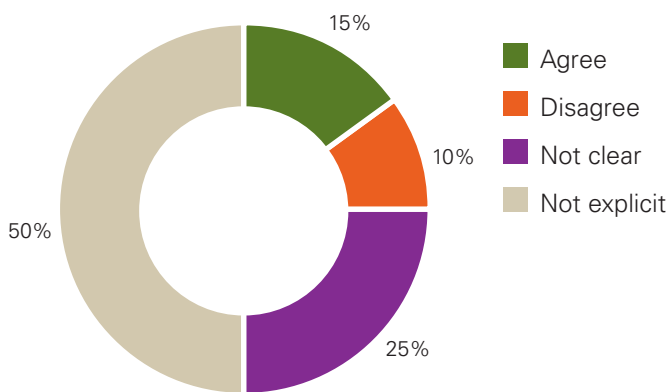
- retaining existing guidance on the use of the residual method; and
- allowing entities to use a portfolio approach for allocating transaction price to the various performance obligations in a contract.

## Step 5

# Recognise revenue when each performance obligation is satisfied

The guidance in the ED is sufficient for determining when control of a promised good or service is transferred to the customer.

### Analysis



### Key proposal

An entity would recognise revenue when a performance obligation is satisfied. This would occur when the underlying goods or services are transferred to the customer.

A transfer would occur when the customer obtains control, i.e. has the ability to direct the use of and receive benefit, of the good or service. Control also includes the ability to prevent other parties from controlling the asset. The ED proposes an indicator approach to determining when the customer has obtained control of the good or service.

If an entity assesses that the customer obtains control of the good or service continuously, then it would apply the revenue recognition method that best depicts the transfer of control of the good or service; typically a stage/percentage of completion method.

### Key messages/observations

50 percent of respondents did not state an explicit response to the question.

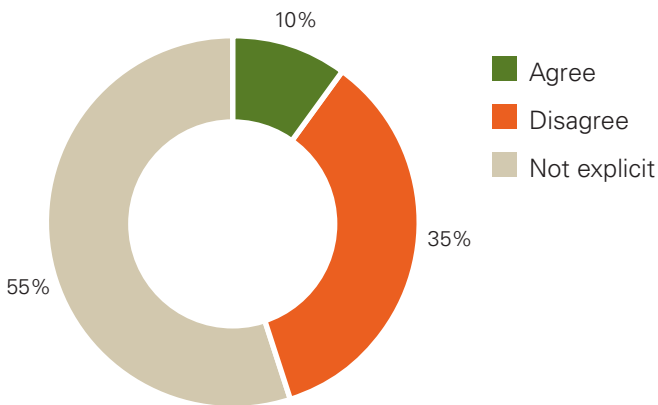
One of the common themes in the majority of comment letters related to a perceived lack of sufficient guidance on the transfer of control with respect to service contracts.

Some respondents requested retaining the existing principle of risks and rewards, which they felt is more focused on the economic substance of the transaction than the transfer of control.

## Contract costs: cost of obtaining the contract

The costs of obtaining a contract should be expensed when incurred.

### Analysis



### Key proposal

If the costs of fulfilling a contract are not eligible for capitalisation under other IFRSs, then a separate asset would be recognised under the proposal only if the costs relate directly to future performance under a contract and are expected to be recovered. Otherwise these costs would be expensed when incurred.

The ED also proposes that costs eligible for capitalisation should generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. As a result, and as stated explicitly in the ED, the costs of obtaining a contract would be recognised as an expense when incurred.

### Key messages/observations

35 percent of respondents disagreed with the Boards' proposal; only two companies agreed explicitly. However, the majority of respondents did not comment on the issue.

Some of the reasons for disagreeing were:

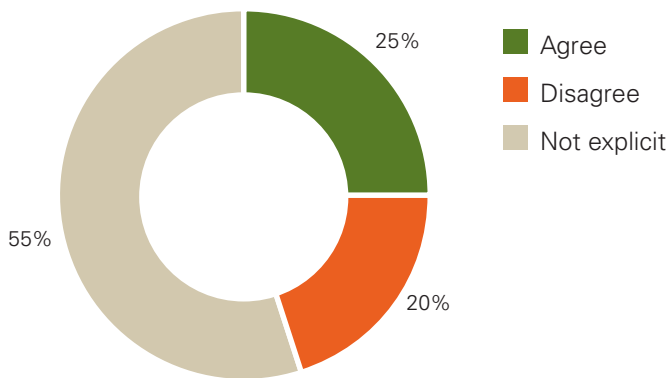
- these costs, i.e. subscriber acquisition costs, are direct and incremental to obtaining a contract and should be accounted for as part of the contract;
- the proposal is inconsistent with the current guidance in IAS 38 *Intangible Assets*, the joint IASB-FASB exposure draft on leases, and the IASB's exposure draft on insurance contracts.

Some respondents argued that the requirements related to asset recognition and contract costs should be dealt with in other accounting standards rather than in the revenue recognition standard.

## Specific application issues: product warranties

The proposal distinguishes between types of product warranties: (1) warranties for latent defects; and (2) coverage for faults after the product is transferred to the customer.

### Analysis



### Key proposal

The ED distinguishes between two types of product warranties: cover for latent defects (i.e. defects that exist when the product is transferred to the customer but not apparent); and cover for faults that arise after the product is transferred.

Latent defects would result in deferral of a portion of revenue allocated to the product based on an expectation of defects included in the products sold.

Cover for post-delivery faults would represent a separate performance obligation and a portion of the transaction price would be allocated and deferred in all cases.

### Key messages/observations

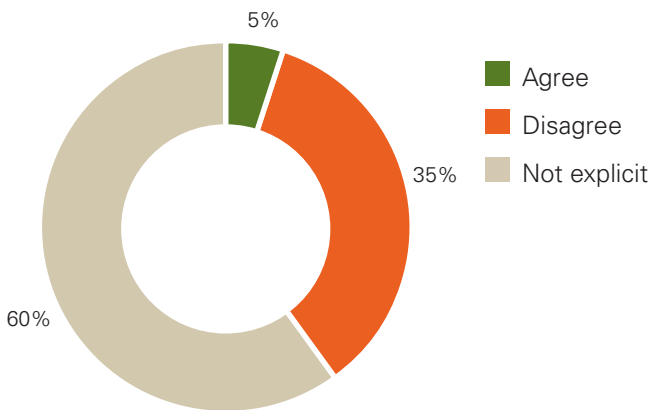
55 percent of respondents did not state an explicit response to the question. This partly may be due to the fact that most telecoms do not sell or generate significant revenue from the sale of handsets.

One of the primary reasons cited by respondents who disagreed with the proposal related to the difficulty in distinguishing between the two types of warranties.

## Specific application issues: licensing and right of use

The pattern of revenue recognition should depend on whether or not a licence is exclusive.

### Analysis



### Key proposal

The proposals include specific guidance on arrangements in which an entity grants a customer the right to use, but not own, IP<sup>6</sup>.

If a customer obtains control of substantially all of the rights associated with the entity's IP, then the contract would be considered a sale. If not, then revenue would be recognised over the period of the licence (for exclusive rights) or when the customer is able to use and benefit from the rights (for non-exclusive rights).

Rights could be exclusive during a period of time, or in a specified geographical area or distribution channel.

### Key messages/observations

60 percent of respondents did not state an explicit response to the question.

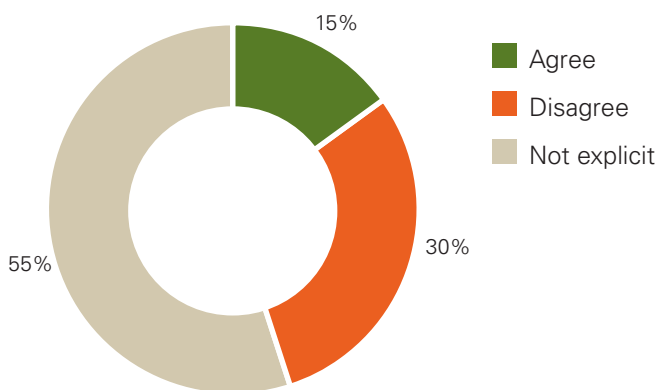
Respondents disagreeing with the proposal noted that exclusivity should not be the criterion to be considered when determining the pattern for recognising revenue. They felt that exclusivity should drive the value of the contract rather than determine the pattern of revenue recognition.

Some respondents suggested that other factors such as renewals, cancellation clauses, and other terms of the contract should be considered when making the assessment.

## Specific application issues: onerous performance obligations

The assessment of onerous provision should be performed at the performance obligation level.

### Analysis



### Key proposal

An entity would recognise a liability and a corresponding expense if a performance obligation within a contract is onerous.

A performance obligation would be onerous if the present value of the probability-weighted direct costs of satisfying it exceeds its allocated transaction price.

Any subsequent change in the measurement of the liability would be recognised as an expense or a reduction of expense, rather than as an adjustment to revenue.

### Key messages/observations

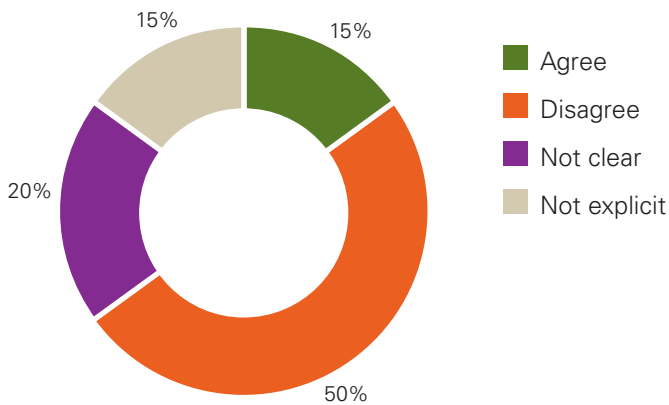
30 percent of respondents disagreed explicitly with the proposal, and a further 55 percent did not comment on the issue.

All respondents that disagreed with the proposal requested retaining the existing accounting guidance of assessing an onerous provision at the overall contract level.

## Effective date and transition

The final standard should be applied retrospectively.

### Analysis



### Key proposal

The proposals did not include a suggested effective date. In October 2010 the IASB and the FASB issued a “request for views” on the effective date of this and other new standards; comments are due by 31 January 2011.

The ED proposes application of the final standard on a retrospective basis.

### Key messages/observations

50 percent of respondents disagreed explicitly with the proposal and requested relief from fully retrospective application.

Almost all of these respondents suggested that the proposals should provide alternative options for adoption. Some of the suggestions were:

- allowing entities the choice of applying the final standard either prospectively or retrospectively;
- delaying the adoption date of the proposals by several years in order to allow entities to make the necessary changes to systems as well as to gather the necessary data; and
- limiting retrospective application to only one year of presentation.

## Next steps

The Boards have held several public roundtable discussions with industry participants with the aim of further understanding and discussing some of the key concerns with the ED. A final standard is scheduled for the second quarter of 2011.

### Key Dates

22 October 2010	Comment letter period closed
4 November 2010	Roundtable meeting in Norwalk, Connecticut, US
8 November 2010	Roundtable meeting in Kuala Lumpur, Malaysia
10 November 2010	Roundtable meeting in London, UK
23 November 2010	Roundtable meeting in Stanford, California, US
2011	Final standard

1 International Accounting Standards Board

2 US Financial Accounting Standards Board

3 IASB: ED 2010/6 *Revenue from Contracts with Customers*. FASB: Proposed Accounting Standards Update, *Revenue Recognition (Topic 605) – Revenue from Contracts with Customers*

4 Available at [www.kpmg.com/ifrs](http://www.kpmg.com/ifrs)

5 Information Technology

6 Intellectual property

## Contact us

We hope that readers have found the contents of this newsletter informative and thought provoking. Though the views on the ED are diverse, there are some common themes and messages that are consistent across the telecoms sector. We welcome hearing your feedback and discussing and debating them with you.

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