EFRAG

European Financial Reporting Advisory Group

EUROPEAN FIELD-TEST OF THE IASB'S EXPOSURE DRAFT REVENUE FROM CONTRACTS WITH CUSTOMERS

TELECOMMUNICATION COMPANIES

.

Preparation of the feedback statement

Summary of the input received from telecommunication companies

This note summarises the input received from European telecommunication companies' field-tests of the IASB's Exposure Draft *Revenue from Contracts with Customers* ('the ED'), published in November 2011.

This feedback statement has been prepared for the convenience of European constituents by EFRAG's secretariat. It has been reviewed by participants in the field-test.

About the field-test

Focus on application issues, the effects on financial statements and cost of applying the proposal

The purpose of the European field-test of the ED was to:

- identify potential implementation and application difficulties;
- assess the potential effects of the proposals on financial statements;
- estimate the effort required to implement and apply the proposals.

The field-test did not assess whether the requirements proposed in the ED represented an improvement to current accounting practice. The field-test only provides input for such an assessment.

The participants in the field-test were asked to select some of their contracts, apply the requirements proposed in the ED on these contracts, and report their findings at workshops.

All European entities expressing a wish to participate in the field-test were invited to participate. The entities participating in the field-test therefore do not constitute a representative sample of the entities that will be affected by the proposals. Similarly, the assessed directions and changes in elements of financial position and performance only reflect the outcome of the selected contracts based on the accounting practice currently chosen for those contracts.

Participating companies

Nine companies participated in the field-test

The following companies participated in the field-test:

- BT

- Deutsche Telekom
- KPN
- Orange
- Telecom Italia
- Telefonica
- Telekomunikacja Polska
- Vivendi
- Vodafone

The results of each company's tests were presented at a workshop on 9 March 2012 in Brussels.

Results of the field-test – implementation and application

Members of the IASB staff were present at the workshop and provided explanations on many of the issues raised by participants. The issues listed below reflect implementation and application problems that were identified by participants before the additional explanations were provided.

Contract term

Participants were unsure about what should be considered as the contract period

Paragraph 13 of the ED defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. Paragraph 14 of the ED states that an entity should only apply the ED to a contract with a customer if all of the following criteria are met:

- the contract has commercial substance;
- the parties to the contract have approved the contract;
- the entity can identify each party's rights regarding the goods or services to be transferred; and
- the entity can identify the payment terms for the goods or services to be transferred.

Participants found it unclear how long the contract period should be considered to be in cases where, for example, a two-year contract had been entered into with the customer, but national law would allow the customer to cancel the contract after one year by paying a termination fee to the entity. In addition, participants were unsure whether the period as specified in the contract or the period which, based on the entities experience, would be the de facto duration of the contract, should be considered as the contract period in relation to the proposals.

Scope

Participants were uncertain about what should be considered to be a 'customer'

According to paragraph 10 of the ED, a customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. For some contracts, the counterparty to a contract might not be a customer but rather a collaborator or a partner that shares with the entity the risks and benefits of developing a product to be marketed. Such contracts are not in the scope of the ED.

One participant was uncertain about whether an agreement with another telecommunication operator would be within the scope of the standard. The agreement was for the operation, design, development, and maintenance of a telecommunication network and for the exchange of services rendered by the networks of both operators. If the agreement was not a contract with a customer, the participant was unsure about how to account for the contract.

Another participant offered a third party discount on mobile telephones if the third party within 180 days sold the handset to a final customer together with a contract for the use of the participant's network. If the handset was not sold within 180 days, the third party would not receive the discount, but was then allowed to do whatever it wanted with the handset. The participant assessed that the third party acted as a principal in relation to the final customer. However, the participant was unsure about whether it should consider the third party as a customer or as a collaborator.

Applying the proposals to a portfolio of contracts

A participant was uncertain about when the proposals could be applied to a portfolio of contracts

According to paragraph 6 of the ED, an entity may, as a practical expedient, apply the proposals to a portfolio of contracts (or performance obligations) with similar characteristics if the entity could reasonably expect that the result of doing so would not differ materially from the result of applying the proposals to individual contracts (or performance obligations).

A participant was unsure about when contracts would have ‘similar characteristics’ and thought that in the case of contracts of telecommunication operators, it would be impractical to assess given the contract volume and the large variety of different kinds of offers.

Identifying separate performance obligations

Participants found it unclear how many performance obligations that were included in a contract for a network connection

Paragraph 28 of the ED states that except as specified in paragraph 29 of the ED, a good or service is distinct if either of the following criteria is met:

- the entity regularly sells the good or service separately; or
- the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.

Paragraph 30 of the ED states that as a practical expedient, an entity may account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

- Participants found it unclear whether a contract for the use of network services for two years would consist of numerous short-term performance obligations (for example, each minute of network service could be regarded as a separate performance obligation) or one performance obligation that would be satisfied over two years.

In addition, one participant was unsure on how to account for ‘call time’ offered with no extra charges in a lease contract for a handset

- A participant leased handsets to its customers for a monthly fee. When leasing a handset the customer would also receive 30 minutes of call time per month without paying any additional amount. The participant was uncertain about whether the minutes of call time should be considered as an onerous performance obligation or a revenue generating activity.

Allocation of the transaction price to separate performance obligations

Participants were uncertain about whether the detailed requirements of paragraphs 71 to 76 of the ED should be applied when it would result in

For a contract that has more than one separate performance obligation, paragraph 70 of the ED requires an entity to allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate *an outcome that was considered not to be in accordance with paragraph 70 of the ED*

performance obligation.

Paragraphs 71 to 76 provide more detailed guidance on how the transaction prices should be allocated to each separate performance obligation.

Paragraph 72 specifies that to allocate an appropriate amount of consideration to each separate performance obligation, an entity shall determine the stand-alone selling price at contract inception of the good or service underlying each separate performance obligation and allocate the transaction price on a relative stand-alone selling price basis.

Paragraph B30 of the ED explains that in many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, the upfront fee is an advance payment for future goods or services and, hence, would be recognised as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right.

Paragraph IE15 provides an example where an entity charges the customer a non-refundable upfront fee in part as compensation for the initial activities of setting up the customer on the entity's systems and processes. The entity's set-up activities do not transfer any service to the customer and the entity should therefore recognise as revenue the initial fee over the period that it expects to provide service to the customer.

Participants were uncertain about whether the detailed guidance included in paragraphs 71 to 76 of the ED should be applied when it was not considered to result in an allocation of the transaction price that would be in accordance with paragraph 70 of the ED (that is an allocation of the transaction price to each separate performance obligation in an amount that would depict the amount of consideration to which the entity expected to be entitled in exchange for satisfying each separate performance obligation).

If it should, participants found it difficult to estimate stand-alone selling prices

If the guidance included in paragraphs 71 to 76 should be applied, participants found it difficult to estimate the stand-alone selling prices as required by paragraph 72 of the ED for many goods and services underlying separate performance obligations. The difficulties arose as different types of customers were offered different prices for the goods and services. The different prices were offered as it was considered to be a key success factor for an entity in the industry to offer the right customer the right price. For example, a mobile telephone operator, who provided customers with a subsidised handset, could have different prices on the airtime and the handset in different contracts.

In addition, participants were unsure about how to allocate an upfront connection fee to an ongoing connection service when the duration of the service could not be estimated reliably

Participants were uncertain about whether a connection fee would relate to a service that could be considered as a separate performance obligation. If not, participants were unsure about how to allocate an upfront connection fee. For example, in relation to a participant's fixed-line telecommunication services, the customer could cancel the contract within a month although the entity was responsible for providing the customer with a connection to a fixed-line telephone network for an indefinite time period. However, customers did normally not cancel the agreement within a month. Participants were unsure about whether a connection fee should be recognised over the legal enforceable contract period or over the period under which the customer would, based on the entity's experience, benefit from the network connection in its relationship with the operator. For fixed-line telecommunication services, a participant assessed that it would be difficult to provide a reasonable estimate on the time period a customer would benefit from the connection in its relationship with the operator. Another participant thought it was difficult to determine whether the customer's option to renew the contract provided the customer with a material right in accordance with paragraph B30 of the ED.

One participant was unsure about how to allocate discounts within a group

In addition, a participant was unsure about how to account for discounts offered by different companies within a group. For example, a mobile telecommunication company within a group offered a discount to customers that used the fixed-line services provided by another company within the same group and vice versa. The participant was uncertain about whether the ED would require the discount to be allocated differently between the mobile and fixed-line services for the purpose of the financial statements for each company within the group and for the purpose of the group accounts. For example, if in practice most customers were first using the fixed-line services, the discount offered would be deducted from the revenue from the mobile service in the financial statements of the mobile company. However, if the ED was applied on higher group level financial statements, the requirements could result in more of the discount being allocated to the fixed-line services.

Time value of money

Participants were unsure about when revenue should be adjusted to reflect the time value of money

According to paragraph 58 of the ED, the transaction price shall be adjusted to reflect the time value of money if a contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognise revenue at an amount that reflects what the cash selling price would have been at the date control is transferred.

Paragraph BC143 of the Basis for Conclusions states that some contracts with customers include a financing component. The financing component may be explicitly identified in the contract or may be implied by the payment terms of the contract.

Paragraph BC147 of the Basis for Conclusions states that the length of time between performance and payment should not necessarily be the only factor that determines whether a contract includes a financing component that is significant. It is noted, that the typical credit term in an industry and jurisdiction should also be considered, because 'in some circumstances, a payment in advance or in arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing. For example, a customer may retain or withhold an amount of consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. The purpose of such payment terms may be primarily to provide the customer with assurance that the entity will satisfactorily complete their obligations under the contract, rather than to provide financing to the customer. Consequently, the effects of the time value of money may not be significant in those circumstances.

To adjust the promised amount of consideration to reflect the time value of money, paragraph 61 of the ED states that an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer. The rate should reflect the credit characteristics of the party receiving financing in the contract as well as any collateral or security provided by the customer or the entity.

Participants were unsure about when the transaction price should be adjusted to reflect the time value of money. The ED could be interpreted as requiring the transaction price to be adjusted whenever a calculated financing effect resulting from differences between the timing of revenue recognition and cash-inflows would be significant for the contract. On the other hand, participants also thought that the ED, including the Basis for Conclusions, could be interpreted as only requiring the transaction price to be adjusted when the parties to the contract intended that the contract should include a financing component.

A participant thought that if the transaction price should reflect the time value of money, it would be difficult to determine the appropriate interest rate as the band of observable consumer finance interest rates was very broad.

Contract modifications

Participants considered it unclear how to account for contract modifications

Paragraph 21 of the ED specifies that an entity shall account for a contract modification as a separate contract if the contract modification results in the addition to the contract of both of the following:

- promised goods or services that are distinct; and
- an entity's right to receive an amount of consideration that reflects the entity's stand-alone selling price of the promised good(s) or service(s) and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

Paragraph 22 of the ED specifies how to account for contract modifications that shall not be accounted for as a separate contract.

Participants were unsure about whether accounting for contract modifications would depend on how the use of network services for a given (longer) period was considered. Participants thought that the use could be considered both as a bundle of many short-term performance obligations and as only one performance obligation. If the connection was considered as one performance obligation, it was thought that the ED could be interpreted as requiring the transaction price and the measure of progress towards complete satisfaction of the performance obligation to be updated following a contract modification. On the other hand, the ED could be interpreted as requiring the contract modification to be accounted for as a new contract, if the contract was considered to include a bundle of short-term performance obligations.

Participants were also uncertain on whether paragraph 21 of the

ED would be operational in the telecommunication sector. The paragraph required the price of the contract modification to be compared with the entity's stand-alone selling price of the promised good(s) or service(s). However, participants found it difficult to assess what the stand-alone selling price would be for the good(s) or service(s) (handsets and airtime) as all of the following factors were present: there were many different handsets, the technical obsolescence of handsets was high (the price changed fast), there were many different customer classes, and the customers in different classes were offered different prices.

Incremental costs of obtaining a contract

Participants were uncertain about what costs should be considered as incremental costs of obtaining a contract and the order by which assets should be impaired

According to paragraph 94 of the ED, an entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

Participants were uncertain about whether bonuses to employees from contracts signed, bid team costs, advisors fees, and labour costs related to discussing the terms of the contract should be capitalised.

A participant was also unsure about whether the intention of paragraph 102 of the ED was that an impairment loss for tangible assets, for example inventory, should be recognised before recognising impairment losses on the capitalised contract acquisition costs.

Presentation of income and expenses from financing activity

Participants were uncertain about whether income and expenses from reflecting financing components should be presented as separate line items

Paragraph 62 of the ED states that an entity shall present the effects of financing separately from revenue (as an interest expense or interest income) in the statement of comprehensive income.

Participants found it unclear whether separate line items termed 'interest expense' and 'interest income' should be presented in the statement of comprehensive income, or the intention of paragraph 62 was just to state that income and expenses from financing should not be reflected in the revenue line.

Presentation of the effect of a customer's credit risk

Participants were uncertain about what was meant by 'adjacent to the revenue line'

Paragraph 69 of the ED requires an entity to present the effects of customer credit risk in the profit or loss as a separate line item *and how to account for losses arising from fraud*

adjacent to the revenue line item.

Participants were uncertain about whether the ED required a revenue-net-of-credit-risk figure to be presented on the face of the statement of comprehensive income.

Participants were also uncertain about whether losses occurred because of fraud should be reported as a credit loss, or no revenue should be reported from these contracts. For example, telecommunication operators experienced that:

- customers provided a fictitious name and/or address when entering into a contract; or
- customers would enter into a contract without having the intention to fulfil their obligations under the contract.

Application

Participants thought it would be problematic to apply the proposals retrospectively

According to paragraph C2 of the ED, an entity shall apply the requirements of the ED retrospectively.

Participants doubted that it would be possible to apply the proposals retrospectively given the volume of data to be processed and because some data would not be available.

Participants' estimates of when it would be possible to apply the standard ranged from five to nine years after finalisation/ endorsement of the standard.

One participant explained that contract terms were often 24 months. As the necessary information to comply with the proposals might currently not be collected, 24 months would be needed to prepare an opening balance sheet in accordance with the proposals. The participant was required to report two comparative years in the financial statements. Therefore, if the necessary systems were in place, the effective date should be at least four years after endorsement of the standard. However, the necessary systems would first have to be developed and implemented which, the participant assessed, would take two additional years.

Results of the field-test – impact on financial statements

The test identified the following potential impact on the financial statements:

The ED would result in revenue being recognised when the customer receives a subsidised handset

- Participants currently only recognised as revenue the amount receivable for the handset under the contract terms when a subsidised handset was transferred to a customer under a post-paid contract. This is less than the amount of revenue that would be allocated to the transfer of the handset according to the ED. One participant estimated that the earlier recognised revenue would equal 6% of the yearly revenue, 20% of EBIDTA, and 11% of the net equity of the entity.

The ED would result in deferral of revenue related to activation/connection fees

- Currently, some participants recognised revenue from non-refundable upfront connection fees received as compensation for initial activities of connecting a customer to its network. In cases where this activity will not result in the transfer of a promised good or service to the customer, the ED will result in revenue being deferred until goods or services are transferred to the customer.

The ED would result differences between telecommunication operators using their own sales channels and operators using third party distribution networks

- Currently some participants did not capitalise incremental costs of obtaining a contract. The ED requires such costs to be capitalised (when the amortisation period is more than one year). The participants that did not capitalise incremental costs, assessed that incremental costs of obtaining a contract would mainly arise when third party distributors were used. Accordingly, financial statements of telecommunication operators using a third party distribution network would be different from financial statements of telecommunication operators selling their services through their own sales channels.

The ED could result in more impairment losses if more expenses are capitalised

- Due to the up-front recognition of accrued handset revenue and the capitalisation of incremental contract acquisition costs of some participants, more impairment losses will be recognised when a customer defaults. In addition, a participant assessed that the capitalisation of incremental contract acquisition costs may result in the carrying amount of cash generating units, to which the resulting asset belongs, to increase without any increases in the recoverable amount. This could result in more impairment losses related to the cash-generating unit.

The ED would result in revenue recognition when handsets are sold to distributors that are not acting as agents

- One participant sold handsets to distributors, which ultimately would sell the handset to the final customer. The handset could only be used when the SIM-card provided had been activated. Currently the participant did not recognise any revenue on the sale of the handset until the SIM-card was activated by the final customer. It was assessed that the ED would require revenue to be recognised on the transfer of the handset to the distributor, when the distributor would not be acting as an agent.

The ED would result in discounts being allocated to distinct goods and services differently than under current practice of some participants

- One participant only allocated discounts in major contract to the different goods and services provided in the contract based on the stand-alone selling prices of these distinct goods and services. Discounts in other contracts were allocated on a different basis. Other participants allocated the discount based on the contracted prices of the distinct goods and services in the contract. The ED requires that discounts are allocated to the distinct goods and services included in a contract based on the stand-alone selling prices, unless specific criteria are met. This results in a different allocation of discounts to separate performance obligations and hence a different pattern of revenue.

The ED would result in separate presentation of bad debt expenses on the face of the statement of comprehensive income

- Participants did not disclose bad debt expenses as a separate line item in the statement of comprehensive income but in a note to the statement. The ED requires bad debt expenses to be presented as a separate item adjacent to revenue.

Results of the field-test – Costs

Participants considered application of the proposal costly

Generally participants considered the ED very costly to apply, although it was considered not to be meaningful to determine the costs more accurately before a final standard would be issued.

Participants also considered that there would be no benefits of applying the proposals. Some of the participants had performed a survey and had received feedback from 22 telco investors. 90% of the sampled investors disagreed with the proposed revenue accounting changes of the ED. Participants therefore considered that they would still have to report revenue figures under the current applied accounting practice as non-GAAP measures, in addition to the proposed requirements, for communicating financial information internally to management and externally to users of financial statements. This would result in additional costs.

Much of the data required to comply with the proposals would require implementation of new IT systems and control environments.

The new IT system would have to be enhanced to include:

- information about point of sales that would have to be tracked from the sales management IT systems to the accounting IT systems;

- information about what handset a particular customer was offered at contract inception and at contract modification dates;

- information about stand-alone selling prices for all distinct goods and services at any given date;

- a module for the allocation of the transaction price to the various distinct goods and services provided under the contract;

- records of contract assets and performance obligations. The system should also be able to distinguish between contract assets and receivables;

- records of capitalised costs related to a particular contract and any impairment of this asset.

When designing the IT system, the many different types of contracts would have to be taken into consideration.

Some participants, who had experience with implementing new billing IT systems and data warehouses, said that the costs amounted to around €100 million per country.

On an ongoing basis, participants mentioned that it would be costly to:

- assess for every contract the amount to which the entity would be reasonably assured (in cases of variable consideration following for example volume rebates);

- allocate discounts (for the purpose of separate financial statements) provided to customers when these used more of the group's services (e.g. discount provided when a customer had both a contract with the subsidiary providing fixed line services and the mobile telephone subsidiary within the same group);

- assess the amortisation period and impairment for each contract for capitalised incremental costs of obtaining the contract;

- estimate (which would depend on the specific agreement with the customer) and update the database of stand-alone selling prices of the goods and services provided, in order to be able to allocate the transaction price at contract inception (considered the most expensive part by some participants);

- recognise revenue separately for the separate performance obligations within each contract (as some of the performance obligations would have a different pattern of transfer, e.g. value added services would often have a different pattern than the core service);

- reconcile reported figures under IFRS 8 (where current 'contingent revenue capped' revenue figures would be reported as these would be the figures that would be used for decision making purposes by the entity) with the revenue figures resulting from the ED;

- account for the time value of money (because of the number of (different) contracts and because the interest rates should reflect a separate financing transaction between the entity and the customer at contract inception). (As noted above, some participants did not consider the contracts to include a financing component and would thus not account for the time value of money);

- account for contract modifications which would often have to be accounted for as a new contact; and

- provide the disclosures required by the ED (particularly the reconciliation of contract balances, the analysis of remaining performance obligations and the reconciliation of any assets recognised from the costs to obtain or fulfil a contract with a customer were considered challenging).

Participants also assessed that costs would arise as the control environment had to be upgraded due to judgements and simplifications needed to measure revenue. One participant assessed that 15 additional employees in one country would have to be hired to deal with internal control issues (currently the company had 14 employees in the county dealing with revenue in the internal control department and the company employed 24 thousand persons in total).

It was questionned whether the option provided in paragraph 6 of the ED to apply the requirements to a portfolio of contracts (or performance obligations) would reduce the costs of applying the standard.

Participants considered that it would not be easier to account for contracts on a portfolio level as:

- many entities had many different types of offers, and therefore many different portfolios of contracts (one participant had in relation to the field-test counted around 2,000 different portfolios within its selected subsidiary which operated in only one country);
- some types of contracts (one participant mentioned contracts with large enterprises) was individually negotiated; and
- it could be difficult to demonstrate initially, and on an ongoing basis, that portfolio accounting would result in materially the same results as a per contract basis (which is the requirement of paragraph 6 of the ED for the use of a portfolio approach).