Impact of the Proposed Revenue Recognition Model on the Telecommunications Industry

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Introduction.

The purpose of this presentation is to highlight the concerns with the proposed revenue recognition model as it impacts telecommunications financial statements' preparers and users.

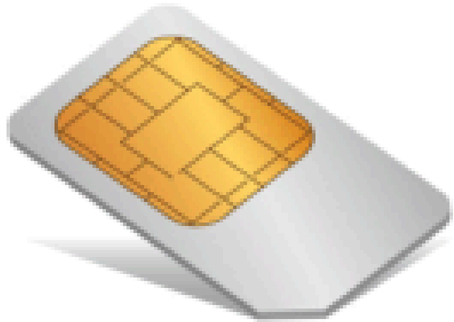
Reduction of decision usefulness of information and high complexity of implementation.

- Divergence from current revenue recognition model, which is well understood by users and provides relevant and reliable information.
- Reduced comparability within the industry - especially with respect to industry key performance indicators.
- Complexity of implementation.
- Significant cost of implementation.

Proposal for changes to the ED to address the concerns of the telecommunications industry.
Recommendation to re-expose the proposed standard.

What is telecommunication business all about?

"Selling handsets is not a line of business but a means to attract customers to networks."



"Telecommunication business is about providing access to networks."

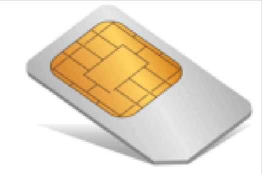
How does telecommunications business model work?

- We are practicing a **mass-market business model** with millions of customers and thousands of **customer-specific agreements** which can change every day.
- To provide comparability between telecoms, **industry-specific KPIs** have been successfully established.
- Customers usually receive subsidised handsets when entering into minimum-term service agreements.
- From customer's perspective the subsidised handset represents an incentive for (re-)entering into the agreement.
- In our business model handset subsidies are viewed as costs of acquiring the customer (**SAC***).
- **ARPU**** is applied by users to compare the performance of telecoms regarding the provision of telecommunications services.

Customer agreement (24 months)

Contractual price for the handset e.g. 50 €

bundled with

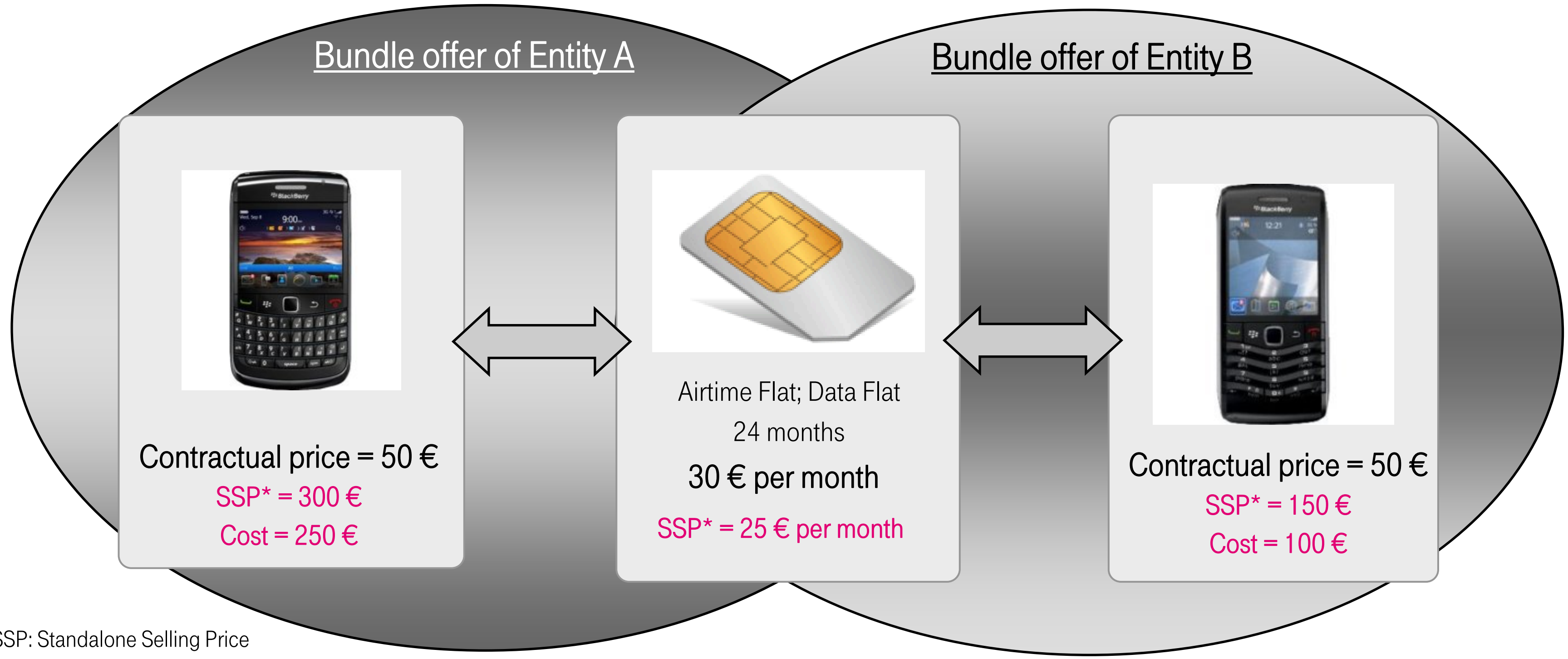


Contractual price for the service e.g. 30 € per month

*SAC: Subscriber Acquisition Cost

**ARPU: Average (Monthly) Revenue per User

Similar offerings do not automatically mean similar economic positions.



*SSP: Standalone Selling Price

Which information is useful for users?

From an economic perspective, Entity A needs to incur higher costs of acquiring the customer (by offering a more valuable handset for the same price) to receive the same cash flows / ARPU as Entity B.

Current accounting model including contingent revenue cap.

Current accounting model: direct distribution channel.

Reported figures of Entity A

	t_0	t_1	t_2
Handset revenues	50		
Service revenues		360	360
Cost of handset	250		
Income*	-200	360	360
Cash flow	-200	360	360
SAC	-200		

Reported figures of Entity B

	t_0	t_1	t_2
Handset revenues	50		
Service revenues		360	360
Cost of handset	100		
Income*	-50	360	360
Cash flow	-50	360	360
SAC	-50		

Information usefulness

Current accounting model provides information using the cost perspective.

Direct and comprehensive connection between income, cash flows, ARPU and costs of acquiring the customer (SAC) provides useful information to users.

*Service costs are not considered in this example.

Proposed accounting model.

Proposed accounting model: direct distribution channel.

Reported figures of Entity A

	t_0	t_1	t_2
Handset revenues	256		
Service revenues		257	257
Cost of handset	250		
Income*	6	257	257
Cash flow	-200	360	360

Reported figures of Entity B

	t_0	t_1	t_2
Handset revenues	154		
Service revenues		308	308
Cost of handset	100		
Income*	54	308	308
Cash flow	-50	360	360

Information usefulness

Proposed accounting model provides information using the revenue perspective.
Revenue in t_0 indicates better performance of Entity A: No predictive value for future periods.
Front-loading of revenues and income for entities incurring higher costs of acquiring customers to achieve the same cash flow stream.

*Service costs are not considered in this example.

Identical service contracts sold using different distribution channels.

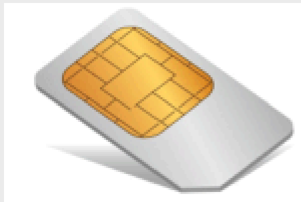
Bundle offer of Entity B

Direct distribution channel

Contractual price = 50 €

SSP* = 150 €

Cost** = 100 €



Airtime Flat; Data Flat

24 months

30 € per month

SSP* = 25 € per month

Entity B & Retailer

Indirect distribution channel

Handset provided by retailer

Contractual price = 50 €

Sales Commission = 50 €

*SSP: Standalone Selling Price

**Cost of handset include 10 € internal sales commission.

Which information is useful for users?

The offerings of Entity B and the Retailer are identical from customer‘s perspective.

Entity B has sold two identical service contracts.

Impact on service revenues depending on sales channel.

Current accounting model

Entity B: direct distribution channel

	t_0	t_1	t_2
Handset revenues	50		
Service revenues		360	360
Cost of handset	90		
Sales commission	10		
Income	-50	360	360

Service revenues are equal for identical contracts sold using different channels.

Entity B: indirect distribution channel

	t_0	t_1	t_2
Handset revenues	0		
Service revenues		360	360
Cost of handset	0		
Sales commission	50		
Income	-50	360	360

Proposed accounting model

Entity B: direct distribution channel

	t_0	t_1	t_2
Handset revenues	154		
Service revenues		308	308
Cost of handset	90		
Sales commission	10		
Income	54	308	308

Service revenues are higher for contracts sold using the indirect channel.

Entity B: indirect distribution channel

	t_0	t_1	t_2
Handset revenues	0		
Service revenues		360	360
Cost of handset	0		
Sales commission	0	25	25
Income	0	335	335

Proposal to introduce the contingent revenue cap.

We propose to introduce the <u>contingent revenue cap</u> to avoid the negative implications of the proposed accounting model.

The allocation of the transaction price to a satisfied performance obligation should not exceed the amount receivable without satisfying future separate performance obligations.

Contingent revenue cap leads to provision of useful information.

Relevance

- Revenue reflects management and investor view of substance of the transaction and is indicative of recurring cash flows/ARPU.
- Reflects the underlying commercial reality that handset discounts are acquisition cost.

Comparability

- Revenue is indicative of an entity's performance and competitive position.
- Service revenues are unaffected by sales channel and the amount of handset subsidy.
- Low impact of management estimation.

Contingent revenue cap

Faithful representation

- Revenues and receivables reflect the amount that operators have the right to receive, irrespective of fulfilling future performance obligations.
- IT capability to provide reliable data; few adjustments between billing and revenues.
- Lower risk of error given impact of assumptions, uncertain customer behaviour, system complexity.

Understandability

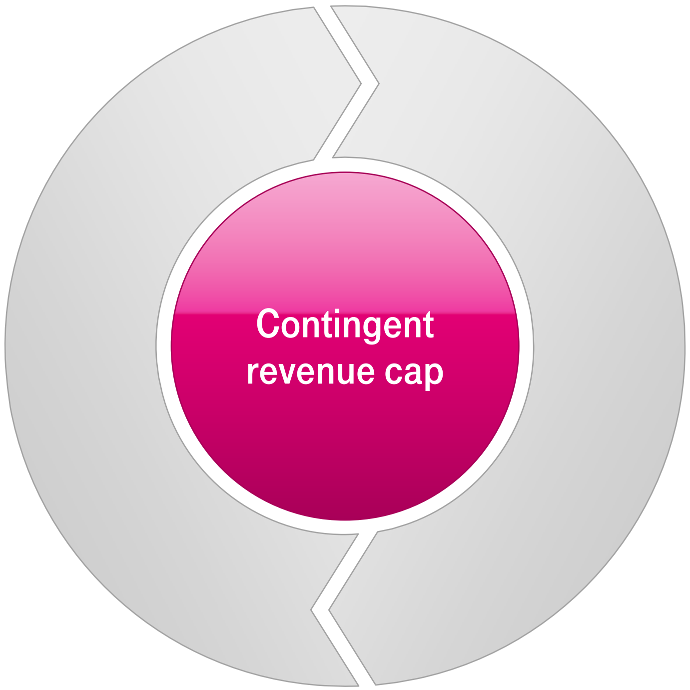
- Only one set of records (IFRS) for management / investors.
- Revenue closely aligned with cash flow.
- KPIs (like ARPU) are not distorted by front-loading of revenue.
- SAC can be derived from financial statements.

Possible limitations of applying the contingent revenue cap.

Application of contingent revenue cap could be limited to certain conditions:

Option 1	Option 2	Option 3	Option 4
▪ The legal or practical ability of management to enforce performance (payment) by the customer for future deliverables is uncertain.	▪ Applying the cap better achieves the qualitative objectives of the IFRS framework.	▪ Applying the standalone price allocation method cannot be achieved without unreasonable effort.	▪ Additional disclosures are provided.

Is the contingent revenue cap consistent with core principles in new accounting models?



New revenue model

- Contract asset definition:

*„An entity's **right to consideration** from a customer in exchange for goods and services transferred to the customer."*

- A right to consideration is a legal concept and, if applied to a single performance obligation, should not be contingent on the fulfilment of other future performance obligations.

New lease model

- No inconsistency with up-front revenue recognition under derecognition approach for lessor accounting.
- „Right to receive lease payments" asset results from a single performance obligation satisfied over time and is therefore not contingent on additional future performance obligations.

Cost of implementing the proposed model are not justified by increase in information usefulnes.

- Disconnect between cash flows and revenues: New IT systems for revenue recognition purposes needs to be implemented.

- Ongoing cost of systems and processes. Additional measures and checks needed to mitigate the increased risk of error.

Implementing costs amounting to at least hundreds of millions of Euros for each group.

- Monitoring of tens of millions of customer-specific contracts.
  - ▷ Accounting on individual contract basis not possible.
  - ▷ Retrospective application not feasible.

- Cost of compliance, auditing.
- Tax impact of front-loading revenue/profit depending on jurisdiction.

Thank you for your attention!

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