Impact of the Proposed Revenue Recognition Model on the Telecommunications Industry

Joint meeting – FASB/IASB

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Disclaimer

The views and opinions expressed in this presentation do not necessarily reflect our individual interpretations with respect to the application of the proposed guidance. The examples contained within this presentation are for illustrative purposes only and do not intend to represent a final consensus of the implementation of the proposed exposure draft. We request the Boards to reconsider the detailed considerations included in our individual comment letters in which we have highlighted our individual viewpoints with respect to the interpretation and application of the proposed guidance.

U.S. Industry Statistics

Wireless Subscribers as of March 31, 2011 (AT&T, Sprint, Verizon)	
Postpaid	185 million
Prepaid	24 million
Other	43 million
Total subscribers	**252 million**

Executive Summary

The purpose of this presentation is to broadly discuss the telecommunications industry, its existing revenue recognition accounting practices, identify areas of concern with the proposed revenue recognition standard and discuss considerations for alternative solutions.

- Benefits of existing telecommunication revenue recognition model
  - Generally consistent application globally
  - Provides decision useful information
- Areas of concern with proposed model
  - Reduced comparability for key metrics within industry - arising from:
    - Sales channel distribution (direct versus indirect)
    - Assumptions required for application to identical transactions
    - Contract aggregation
  - Reduction in decision usefulness (both from a management approach and for users)
  - Complexity and cost of implementation
- Consideration of residual value approach to address concerns
- Recommendation for telecom specific staff analysis and re-exposure prior to finalization

Industry Background

- Principal objectives of the telecommunications business model
  - Provide differentiated telecommunications services
  - Recover our primary investment (Network and maintenance)
  - Ancillary products such as handsets are commonly offered at discounted prices in order to attract customers
- Customer base
  - Customer base in the hundreds of millions
  - Requires significant ongoing retention and acquisition strategies:
    - Incentives such as subsidized handsets and equipment
    - Bundling of equipment and service
    - Products and services with significant pricing flexibility
- Contracts
  - Frequent upgrades, renewals or modification of contracts at various points during the contract term
- User community focuses on key metrics that provide predictive value

Reduced Comparability

- Varying assumptions may be applied to identical transactions
  - Stand-alone selling price (“SSP”)
  - Aggregation
- Sales channel (direct vs. indirect) affects assessment of interdependence
- Consider an identical transaction entered into by Entities A, B and C (device sold for CU 50 bundled with a 24-month service contract for CU 30 per month) with the following variations*:
  - Entity A executes the transaction through an indirect sales channel (Entities B and C use a direct sales channel).
  - Entity C assumes a lower SSP on service (Entities A & B assume identical SSP on service).

	Entity A		Entity B		Entity C	
Period	t_0	t_1/t_2	t_0	t_1/t_2	t_0	t_1/t_2
ARPU	-	360	-	286	-	272
Service Margin	-	180	-	106	-	92
OIBDA	-	75	(52)	101	(24)	87
OIBDA Margin	N/A	21%	N/A	35%	N/A	32%

* Refer to Appendix for definitions and more detailed version of example

Reduction in Decision Usefulness

"improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets"

Exposure Draft, paragraph IN2(c)

- Service revenue dependent upon handset combination (bundled transactions) and not reflective of the underlying economics of the transaction
- Key telecommunication metrics lose significance:
  - Average service revenue per user (ARPU)
  - Service Margin
  - OIBDA/EBITDA
  - OIBDA/EBITDA Margin
- Significant difference in service revenue recognized based on channel mix (direct vs. indirect)
- Recent discussions with industry analysts
  - Equity analysts have indicated this will significantly diminish predictive value
  - Current revenue recognition is generally consistent and comparable across industry, even beyond geographic boundaries

Complexity of Implementation

“simplify the preparation of financial statements by reducing the number of requirements to which entities must refer”

Exposure Draft, paragraph IN2(d)

- Device/service combinations are extensive within the industry
- Identical devices will derive non-identical equipment revenue if paired with varied service plans
- Modifications to service plans within the initial contract period are frequent
- Existing billing systems tied to accounting systems at an aggregate level not at contract level
- Contract population will require aggregation (which will also diminish comparability)

Alternative Considerations

- Consideration of the residual method to potentially approximate current revenue recognition
  - Service plan: non-variable
  - Handset price: variable

- Consideration for limiting revenue to the extent of cash consideration for ancillary equipment such as handsets

- Consideration of equipment loss as customer acquisition cost

Conclusion

- We appreciate the opportunity to discuss the important project in relation to our industry.
- We fully support the effort for convergence, consistency and simplification for revenue recognition.
- We believe the Boards objectives are not achieved as it relates to the Telecommunications Industry.
  - Proposed model accounting is not reflective of commercial substance of the arrangements
  - Does not meet the primary objective of the proposal which is to drive comparability across companies
  - Does not meet the Boards’ objective of simplifying revenue recognition for financial statement preparers
- We request re-deliberation of telecommunications issues at the next joint Board meeting, including a staff paper outlining key issues with associated staff recommendations, as well as re-exposure of the Exposure Draft.
- We recommend field testing prior to final issuance.

Appendix

Illustrative Example and Definitions

Illustrative Example

This example illustrates that varying assumptions (required by each entity) and sales channels applied to identical transactions will result in significantly different results and metrics.

- Consider the following <u>identical transaction</u> entered into by Entities A, B and C:
  - Customer purchases a device for CU 50 and enters into a 24-month service contract for CU 30 per month. The following facts and assumptions are applied by each Entity:

	Entity A	Entity B	Entity C
Sales channel	Indirect	Direct	Direct
Device contractual price	250	50	50
Device Cost	250	250	250
Device SSP	250	250	250
Commission	210	10	10
Service contractual price	720	720	720
Service Cost	360	360	360
Estimated Service SSP	720	720	600

Illustrative Example (CURRENT MODEL)

Entity A	t_0	t_1/t_2
Device revenue	250	-
Service revenue	-	360
COGS	250	-
COS	-	180
Commission	210	-
Service margin	-	180
OIBDA	(210)	180
Cash Flow	40	360
ARPU	-	360
OIBDA margin	N/A	50%

Entity B	t_0	t_1/t_2
Device revenue	50	-
Service revenue	-	360
COGS	250	-
COS	-	180
Commission	10	-
Service margin	-	180
OIBDA	(210)	180
Cash Flow	40	360
ARPU	-	360
OIBDA margin	N/A	50%

Entity C	t_0	t_1/t_2
Device revenue	50	-
Service revenue	-	360
COGS	250	-
COS	-	180
Commission	10	-
Service margin	-	180
OIBDA	(210)	180
Cash Flow	40	360
ARPU	-	360
OIBDA margin	N/A	50%

Illustrative Example (PROPOSED MODEL)

Entity A		
	t_0	t_1/t_2
Device revenue	250	-
Service revenue	-	360
COGS	250	-
COS	-	180
Commission	-	105
Service margin	-	180
OIBDA	-	75
Cash Flow	40	360
ARPU	-	360
OIBDA margin	N/A	21%

Entity B		
	t_0	t_1/t_2
Device revenue	198	-
Service revenue	-	286
COGS	250	-
COS	-	180
Commission	-	5
Service margin	-	106
OIBDA	(52)	101
Cash Flow	40	360
ARPU	-	286
OIBDA margin	N/A	35%

Entity C		
	t_0	t_1/t_2
Device revenue	226	-
Service revenue	-	272
COGS	250	-
COS	-	180
Commission	-	5
Service margin	-	92
OIBDA	(24)	87
Cash Flow	40	360
ARPU	-	272
OIBDA margin	N/A	32%

Note: Example considers indirect sales commission (Entity A) as customer acquisition cost and equipment subsidy (Entity B and C) as cost of fulfillment.

Definitions

- **ARPU:**

  Average service revenue per user. The metric is provided as an average monthly service revenue per user within the industry. Our examples provide this metric on annual basis for illustrative purposes.

- **Service Margin:**

  Service revenue less service cost of sales (COS).

- **OIBDA:**

  Operating income/(loss) before depreciation and amortization.

- **OIBDA Margin:**

  OIBDA divided by non-equipment net operating revenues for wireless.

- **Equipment Subsidy:**

  Equipment cost in excess of the revenue generated from equipment sales.