STAFF PAPER

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Project	**Revenue recognition**		
Paper topic	Effect of the revenue recognition model on some bundled arrangements		
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Purpose of this paper

1. This paper considers whether to amend the 2011 Exposure Draft *Revenue from Contracts with Customers* ('2011 ED') to address concerns raised by some respondents about how the proposals would apply to bundled arrangements under which the entity promises to transfer services to the customer together with a distinct good that relates to the provision of those services.

2. Those concerns were raised by entities in the telecommunications and cable or satellite television industries. The staff note that several entities in other industries commonly enter into bundled arrangements with customers (eg equipment bundled with maintenance services). Those entities did not raise concerns similar to the concerns raised by telecommunications companies ('telcos') and cable or satellite television providers.

3. The Boards previously discussed the application of the revenue model to the telcos and other similar entities at the June 2011 joint Board meeting (refer to Agenda Paper 4B/147B). At that meeting, the Boards tentatively decided not to modify the proposals. The staff have conducted significant outreach with telcos and users of their financial statements since the issuance of the 2011 ED. The staff have brought the topic back for redeliberations because those respondents

continue to disagree with the outcomes that result from applying the revenue recognition proposals to their contracts.

Summary of staff recommendation

4. The staff recommend that the Boards retain the proposals for allocating the transaction price in the 2011 ED and include in the implementation guidance an acknowledgement that those proposals could be applied using information that the staff think would be readily available to the entity. The staff also recommend that the Boards include in the implementation guidance a basic illustration of how the entity might think through such an approach, acknowledging that the entity would be expected to additionally apply all other provisions of the 2011 ED (eg time value of money).

5. The staff also recommend that the Boards affirm their tentative decision about contract costs from Agenda Paper 7B/165B as that decision would apply to the types of contracts discussed in this paper.

Structure of this paper

6. The remainder of this paper is structured as follows:

    (a) Background information (paragraphs 7 – 13)

    (b) History of this topic (paragraphs 14 – 17)

    (c) Summary of recent outreach activities and feedback received (paragraphs 18 – 27)

    (d) The path forward (paragraphs 28 – 47)

    (e) Aligning the direct and indirect channels (paragraphs 48 – 55)

    (f) Application of the proposals in a less costly manner (paragraphs 56 – 61)

    (g) Staff recommendation (paragraphs 62 – 66)

(h) Appendix A- Excerpt from the Basis for Conclusions in the 2011 ED

Background information

Bundled arrangements

7. Many telcos offer bundled arrangements to customers in which they promise to provide a good (ie handset) at contract inception together with the provision of network services to the customer over the term of the contract. In many of those arrangements, the telco provides the handset to the customer for 'free' or at a significant discount (hereafter referred to interchangeably as the 'upfront loss' or 'handset subsidy'). Importantly, the characterization of handset discounts as upfront losses refers only to the fact that the cost of the derecognized handset inventory generally exceeds the cash collected (and consequently the revenue recognized under current practice) when the customer obtains control of the handset. Those arrangements are generally expected to be profitable over the life of the contract.

8. Under current U.S. GAAP, telcos account for their contracts in accordance with the 'contingent cap' from Topic 605-25, *Revenue Recognition- Multiple-Element Arrangements*. The effect of that guidance is that the amount of consideration allocable to a satisfied performance obligation is limited to the amount that is not contingent upon satisfaction of an unsatisfied performance obligation. As it applies to telco contracts, this means that revenue from the sale of a handset is limited to the amount of cash received from the customer at contract inception. There is no equivalent guidance under IAS 18 *Revenue*; however, in practice many telcos applying IFRSs have an accounting policy that is consistent with the 'contingent cap' in U.S. GAAP.

9. Under the revenue recognition proposals, the entity would be required to allocate a portion of the transaction price to the sale of the handset (ie a separate performance obligation) using a relative standalone selling price method. The impact would be as follows:

(a) Neither handset revenue nor service revenue would equal the amount of cash contractually due from the customer in exchange for those goods and/or services.

(b) Handset revenue would increase and service revenue would decrease to reflect the allocation of a portion of the service charges to the sale of the handset.

10. The following example illustrates the effect of the allocation proposals on a typical bundled arrangement for a handset with network services:

An entity enters into a contract with a customer for a handset and twelve months of network services. The customer pays CU100 at the time of delivery of the handset and CU20 per month for twelve months.

The handset is sold on a standalone basis (i.e. without a customer's commitment to purchase a network service) for CU250. The entity sells one month of network services on a standalone basis (i.e. a prepaid month-to-month service) for CU20 per month.

The accounting under current practice is as follows:

	T_0	T_{1-12}	Total
Handset	100	0	100
Network service	0	240	240
Total revenue	100	240	340

The accounting under the proposed model would be as follows:

	T_0	T_{1-12}	Total
Handset	173 [a]	0	173
Network service	0	167 [b]	167
Total revenue	173	167	340

[a] CU173 = 250 selling price of handset / (250 + 240 selling price of network services) * 340 transaction price

[b] CU167 = 240 selling price of network services / (240 + 250 selling price of handset) * 340 transaction price

Direct versus indirect sales channel

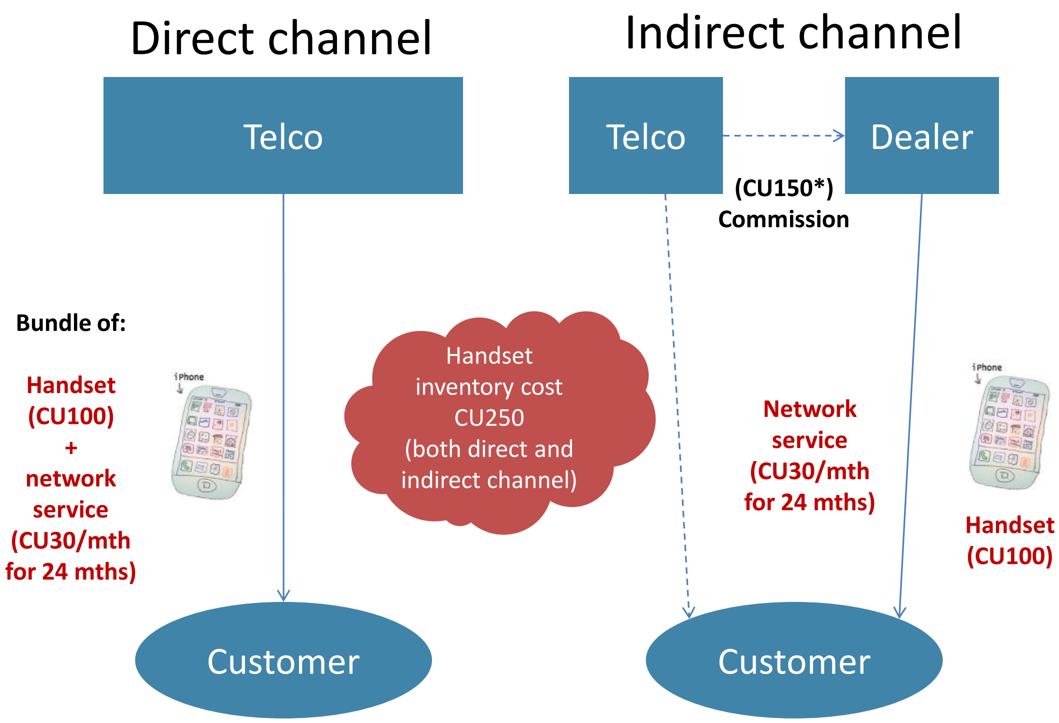
11. Telcos sell to customers through separate sales channels (refer to illustration below) that they refer to as ‘direct’ and ‘indirect’. In the direct sales channel, the telco provides (as part of a bundle of goods and services) a handset directly to the customer either for free or at a discounted price when the customer commits to a multi-year service agreement. In the example below in paragraph 13, the net result in the direct channel upon transfer of the handset is a loss of CU150 (CU150 = CU100 cash collected less CU250 inventory cost derecognized). Generally, the telco recognizes the upfront loss at inception in exchange for a commitment from the customer (ie under the same bundled arrangement) to purchase ongoing services.

12. In the indirect channel, telcos pay a third party vendor a commission as compensation for helping the telco secure a contract with the customer for network services. In effect, the role of the third party vendor in the indirect channel is to act as:

    (a) principal in the sale of the handset (ie because the vendor previously acquired the handset as inventory); and

    (b) agent for the telco in the sale of the network service contract.

13. The third party vendor in the indirect channel often uses a portion of its sales commission from the telco to enable it to provide the handset to the customer at a discount. Many telcos view the commissions paid to the third party vendor in the indirect channel as being economically similar to the upfront loss they recognize on transfer of the handset in the direct channel.



*For illustrative purposes the amount of the commission in the indirect channel equals the amount of the upfront loss on the sale of handset in the direct channel. (CU250 less cash received from customer of CU100)

History of this topic

14. Almost all respondents from the telecommunications industry (including users of the financial statements of those entities) opposed the proposals for allocating the transaction price in the 2010 Exposure Draft, *Revenue from Contracts with Customers* ('2010 ED'). Those respondents noted that:

(a) the cost of applying the proposals would be significant; while

(b) the usefulness of the financial statements would be diminished because many key metrics (eg average revenue per user) would be affected in a manner that they view to be artificial (ie because some of the transaction price would be allocated to the handset, the amount of the transaction price allocable to the service component would be reduced).

Those respondents suggested that their concerns could be addressed by modifying the proposals in the 2010 ED for allocating the transaction price to introduce the 'contingent cap' from U.S. GAAP (refer to Appendix A).

15. In June 2011, the Boards considered whether telcos could use a residual approach to estimate the standalone selling price of the handset. During redeliberations of the allocation proposals in the 2010 ED, the Boards decided to specify in the proposed standard that the entity could use a residual approach to estimate the standalone selling price for those promised goods or services for which the standalone selling price is highly variable or uncertain (previously, the residual approach was merely acknowledged in the Basis for Conclusions). Because the standalone selling price of the handset is generally not highly variable or uncertain), telcos would be unable to utilize the residual approach.

16. Telco preparers in the U.S. supported use of a residual approach because the standalone service pricing in the U.S. is generally the same as the service pricing in a bundled arrangement in which the customer was given a handset subsidy (ie which some think is evidence that any discount in a bundled arrangement is attributable to the handset). Telcos in other jurisdictions did not support this approach as a way to address their concerns because their standalone service pricing often varies depending on whether the customer purchases those services together with a handset (ie which some think indicates that the telco recovers the upfront loss on the handset through higher monthly prices for similar services).

17. After considering the feedback from respondents, the Boards decided not to modify the proposals on the basis that:

    (a) the proposals would most faithfully depict the economics of those arrangements because the pattern of revenue recognition would take into account the effect of any upfront discounts and/or commissions (refer to Appendix A); and

    (b) modifying the proposals would set a precedent that the required allocation methodology (ie relative standalone selling price allocation) need not be applied in all circumstances.

Summary of recent outreach activities and feedback received

18. Generally, telcos and users of their financial statements have not changed their opinions about the allocation proposals since the 2010 ED. Since the issuance of the 2011 ED, the Boards and the staff have obtained feedback from the telecommunications industry through comment letters, industry roundtables, workshops and constituent meetings. During the outreach period, some Board members and the staff met with preparers from the telecommunications industry in various jurisdictions and their financial statement users and auditors. The focus of the outreach for the 2011 ED has been on identifying alternatives that would address the concerns of respondents without compromising the core principle of the 2011 ED. Those concerns relate primarily to the effect of the allocation proposals on:

   (a) the usefulness of the information that would result from applying the proposals to bundled sales arrangements in the telco industry;

   (b) the resulting disparate accounting for sales through the direct and indirect channels; and

   (c) the cost of applying the proposals.

Bundled arrangements

19. The feedback about the allocation proposals in the 2011 ED was largely similar to the feedback about the previous proposals. Most telcos and users of their financial statements continue to believe that those proposals are onerous in that they would be costly (refer to paragraphs 25 - 27) and the resulting information would be less informative than what they currently provide. Those respondents think that the current accounting using the 'contingent cap' (refer to Appendix A) yields information that is reflective of the economics of their arrangements and is important to financial statement users. One respondent commented as follows:

> Under our current accounting model, wireless handset revenue is recognized at the time of sale, based on the subsidized price, and

> service revenue is recognized each month as the service charges are billed to the customer and earned. We believe this accounting accurately reflects the true nature and substance of the transactions with our customers. The sale of handsets to customers at unsubsidized prices, by us or by anyone else, is rare in the U.S. Even in these rare cases, sales are typically at cost, with little or no profit margin... We do not believe that an acceleration and allocation of service revenue to handset revenue is consistent with the core intent of the proposal. The acceleration and allocation limits, rather than enhances the usefulness of our financial results. (CL 119- Verizon)

20. Many respondents from the telecommunications industry suggested the Boards modify specific provisions in the 2011 ED to better align the outcome of applying the proposals with how they view of the economics of their arrangements. Those respondents suggested modifying the proposals for allocating the transaction price (assuming the Boards affirm their previous tentative decision not to introduce the 'contingent cap' concept from U.S. GAAP) as follows:

    (a) expand the use of the residual approach for estimating the standalone selling price of a good or service (paragraph 73(c) of the 2011 ED); or

    (b) allow an entity greater freedom to allocate a discount entirely to one performance obligation if they have evidence about where it belongs (paragraph 75 of the 2011 ED).

21. The staff has analyzed the viability of those recommendations as part of our description of Alternative B in paragraphs 32 - 47. Respondents from various other industries also commented that the criteria in paragraph 75 of the 2011 ED are too restrictive. That topic is discussed in Agenda Paper 7A/165A.

Misalignment of direct and indirect sales channels

22. Respondents note the following similarities between the direct and indirect channels as accounted for under current practice (refer to paragraphs 11 - 13):

    (a) In both the direct and indirect channels, some telcos currently recognize an upfront loss at contract inception to secure a stream of future service revenue (the staff understands that telcos may capitalize sales commissions in some jurisdictions). In the example below, this loss is equal to CU150 in both the direct and indirect channels.

(b) Service revenue recognized over the term of the contract is the same regardless of whether the contract was sold in the direct or indirect channel. In the example below, total service revenue is equal to CU720 in both channels.

	Direct Channel			Indirect Channel		
	T0	T1 - T24	Total	T0	T1 - T24	Total
Revenue	100	720	820	-	720	720
Expense	(250)	XX	XX	(150)	XX	XX
Profit/(loss)	(150)	720	570	(150)	720	570

23. Additionally, respondents note the 2011 ED revenue proposals impact (a) revenue recognition in the direct channel and (b) expense recognition in the indirect channel. Specifically:

(a) ***Revenue recognition*** – In the direct channel, due to the allocation proposals attributing greater revenue to the handset than cash collected at contact inception, revenue recognized at inception of the contract (transfer of the handset) will be greater than under current practice and therefore less revenue will be allocated to the on-going service. In contrast, the indirect channel revenue will remain unchanged as there is only one performance obligation in the contract between the entity and the customer.

(b) ***Expense recognition*** – In the indirect channel the commission paid to the third-party vendor is capitalized at contract inception in accordance with the cost proposals in paragraphs 94 - 97 of the 2011 ED and amortized over the contract term. Whereas, in the direct channel, consistent with current practice, any net loss recognized as the result of derecognition of the handset inventory not offset by the allocated transaction price is not capitalized at contract inception.

24. Many telcos argue that under the proposals in the 2011 ED, many of the metrics on which users of their financial statements rely would be lost or skewed. Users of telco financial statements confirmed this view in our outreach activities. Users indicated that one of the metrics that is most important to them in analyzing telcos is average revenue per user (ARPU). That metric would be affected by the misalignment of the direct and indirect sales channels caused by the proposals in the 2011 ED.

> These issues will significantly reduce investors' ability to make investment decisions, and analysts' ability to predict future results. For example, the widely-watched metric "average service revenue per user" (ARPU) will vary among entities depending on the relative mix of sales channels utilized, and not because the underlying economics of the transactions differ as discussed in the previous section. We would externally report different ARPU amounts for customers who acquire the same service plan and are paying the same monthly rate. (CL 73- Sprint)

Cost of applying the proposals

25. To apply the allocation proposals, many telcos note that they would have to build and/or modify systems so that they could account for each of their contracts with customers separately. Those entities think the cost of the necessary systems modifications would outweigh the conceptual benefits of the proposals described by the Boards in paragraph BC196 of the 2011 ED.

> …the model, as proposed, would require us to account separately for tens of millions of contracts. This would require telecom operators to implement new IT systems, solely for the purpose of revenue recognition, with an estimated implementation cost amounting to at least hundreds of millions of Euros for each company. (CL 215- Deutsche Telekom AG)

26. Typically, a telco's population of contracts with customers comprises a large number of low-dollar contracts which might share some common characteristics (eg the type of goods or services promised, the contract term and the class of customer). Those characteristics might typically lend themselves to the use of a portfolio approach. However, most telcos note that the relief afforded them by the allowance of a portfolio approach would be minimal. Generally, those

respondents question whether they could realistically apply a portfolio approach because their populations of contracts are so diverse. Consequently, those entities do not think that they could aggregate contracts into portfolios in a reliable and sustainable manner.

> Accounting on a portfolio basis would reduce data volumes but is likely to require a very large number of portfolios to achieve sufficient accuracy – for example, separate portfolios per tariff type, per start month and per handset supplied. This may result in thousands of separately accounted portfolios.
>
> We also believe that it may be difficult to demonstrate that portfolio accounting will result in materially the same results as a per contract basis, that recorded revenue will be even more dependent on management assumptions and that the link between revenue recognised on a portfolio basis and actual customer billings and cash receipts will be very marginal, potentially inhibiting the ability to reconcile movements in contract balances. (CL 273- Vodafone)

27. Some telcos note that the cost of preparing their financial statements would increase as a result of the allocation proposals. Those respondents note that they would continue to supply their financial statement users with many of the same metrics the users rely on under current guidance. Based on the results of an analyst survey conducted by a group of U.S. and European telcos, those entities think that their users would request financial data prepared using current guidance even if that data would be considered 'non-GAAP' information.

> Users of our financial statements have constantly expressed that the proposed requirements result in less useful information compared with current requirements and that they will require us to continue providing them with the existing information, i.e. forcing operators to produce non GAAP measures.
>
> As one of them stated, "I do see merit in the arguments presented in the ED. However it is not clear whether this is the BEST reflection of economic reality. Indeed, the accounting outcome appears to be awkward, and inconsistent with the rather predictable monthly cash flows generated." (CL 95- Orange)

The path forward

28. Many respondents from the telecommunications industry (including users of financial statements) have said that they prefer the current accounting for telcos compared with the proposals in the 2011 ED. Those respondents have requested the Boards to reconsider whether to modify the proposals to address their concerns. The staff thinks the Boards should consider the following alternatives:

Alternative A- Retain the proposals in the 2011 ED

29. Under the proposals in the 2011 ED, telcos would be required to allocate the transaction price to separate performance obligations based on the relative standalone selling price of the promised good or service.

30. The staff think that the benefits of this alternative are as follows:

    (a) Revenue would be recognized when the handset is transferred to the customer in an amount that reflects the entity's performance (as is consistent with the core principle of the 2011 ED), acknowledging that some of that amount might be recovered in the future through service and/or contract termination fees.

    (b) This alternative would result in a faithful depiction of the economic consequences of the bundled arrangement. In those arrangements, telcos recover the upfront loss over the life of the contract through monthly service fees and/or by charging the customer a fee if the customer terminates their contract early. Because the upfront loss is recognized entirely at inception under current guidance, the resulting financial information can appear confusing (ie an increase in customers leads to an immediate worsening of the entity's financial performance). Consider the following excerpt from the Sprint Nextel Corp. Q4 2011 earnings release:

    > **"**Sprint Nextel Corp. (NYSE: S) today reported Adjusted OIBDA***** of $842 million for the fourth quarter and nearly $5.1 billion for the

full year 2011. **Wireless service revenues for the fourth quarter increased more than 7 percent year-over-year**, driven by Sprint platform postpaid ARPU growth of $3.69 – the largest year-over-year increase on record across the U.S. wireless industry. **Strong revenue growth and cost management partially offset the impact of increased equipment net subsidies and sales expense** associated with the successful launch of the iPhone®… Additionally, **the company reported a net loss of $1.3 billion** and a diluted loss of $.43 per share for the quarter…" (Emphasis added)

(c) This alternative would highlight the effect on revenue of the entity's decision about whether and by how much to discount a handset (ie to provide a distinct good at a loss) to obtain the promise of a future stream of revenue.

31. The staff think that the disadvantages of this alternative are as follows:

(a) Implementation of the proposals in the 2011 ED would be costly for telcos and other similar companies. Those companies enter into a large number of contracts and they note that many of those contracts are modified during the contract terms, sometimes frequently. Respondents from those industries suggest that they would be unable to develop systems capable of tracking revenue data at the contract level.

(b) Users of the financial statements of telcos note that they conduct their analyses primarily on the basis of expected future service revenue. Under current accounting, service revenue is fairly predictable from period to period. Many users acknowledge the theoretical merit to the proposals in the 2011 ED; however, those respondents suggest that the resulting information would be less predictive and therefore less useful in analyzing the entity's future prospects.

(c) Sales through the direct and indirect channels would be accounted for differently from one another. Some view those transactions as economically similar. Users of the financial statements of telcos note that this would confuse their analyses of those companies.

Alternative B- Modify the proposals for populations of contracts that meet specified criteria

32. In outreach meetings, respondents from the telecommunications industry have suggested several modifications to the 2011 ED that would alleviate their concerns about the allocation proposals. During outreach, the staff could not identify, nor were we made aware of, an alternative that would fit within the revenue recognition model developed by the Boards and which could be applied equally to all revenue transactions. As a result, the staff do not think the allocation proposals should be modified for the broad population of entities. The options discussed below would modify how the proposals would apply to contracts with customers that meet specified criteria.

33. For Alternative B to be viable, the Boards would have to develop qualifying criteria that would not compromise the core principle of the 2011 ED or allow for other types of entities to adopt the guidance by analogy. The staff think that a contract that is the subject of this paper is one with the following characteristics:

    (a) The contract is one contract in a population that comprises a large number of individually insignificant contracts;

    (b) the contract includes more than one separate performance obligation, at least one of which is a good and the other a service for which revenue is recognized over time in accordance with the criteria in paragraph 35; and

    (c) the unsatisfied performance obligation in the contract is for a service with a standalone selling price that does not vary significantly over time when the entity sells the same service to other customers.

34. The proposed criteria are designed to capture only those contracts with characteristics (ie distinct goods and services sold together routinely to large numbers of customers) that in the view of respondents warrant differential accounting.

35. Under Alternative B, should a contract satisfy the proposed criteria, the entity could account for the contract in a manner other than that required by the 2011 ED. The staff think the options identified below are viable should the Boards choose this alternative. Each of those options would be less costly for preparers to implement than the 2011 ED and, as noted below may yield an outcome similar to current practice. Consequently, the resulting modifications to the proposals would be most responsive to user feedback in that they would be least disruptive to their current analyses. However, the staff note that introduction into the proposals of any permutation of Alternative B might be viewed as an exception for the telecommunications industry. Additionally, there are potential unintended consequences (eg the criteria could capture a broader population of contracts than the staff intend as business practices change in various industries). The staff note also that the introduction of any of the options under Alternative B would increase the complexity of the revenue recognition model.

Expanded use of the residual approach

36. The 2011 ED proposed that an entity could estimate the standalone selling price of goods or services using a residual approach, when the standalone selling price of those goods or services is highly variable or uncertain. Some respondents suggested that the use of the residual approach should be expanded from that in the 2011 ED, so that a residual approach could be used to estimate the standalone selling price of the handset.

37. Expanding the use of the residual approach to estimate the standalone selling price of the handset would result in the allocation of the entire discount in the arrangement to the handset. Respondents thought that this approach would be appropriate because typically, the price of a handset varies over time and is not necessarily easily observable. This is because telcos do not regularly sell handset to customers on a standalone basis, but rather those standalone sales generally occur when the customer requires a replacement handset for one previously included in a bundled arrangement that was lost or damaged. Furthermore, those

respondents explain that the price of standalone network services (referred to internationally as the 'SIM-only' price) is observable and does not typically vary significantly over time. For instance, one respondent commented that:

> In order to reflect the true nature of transactions with our customers and achieve the ASU's core intent, we believe that the Boards should broaden the residual approach described in paragraph 73 of the proposal to enable us to fully consider the fixed nature of our service pricing model, rather than the variability of our handset revenues. This is consistent with theory expressed in Basis of Conclusion paragraph 181, which indicates that a residual or reverse residual approach might be appropriate when there is a directly observable price of one performance obligation (monthly service revenue) and not the other (handset revenue). (CL 119- Verizon)

38. To apply the residual approach to estimate the standalone selling price of the handset, the entity would need to determine the standalone selling price of the network services (ie the non-residual item). The staff notes that availability and pricing of standalone network services can vary by jurisdiction due to differences between domestic telecommunications markets. Therefore, the application of the residual approach might result in different accounting outcomes in different jurisdictions. However, respondents have suggested two approaches that an entity may use to determine the standalone selling price of the network service. Those are:

    (a) SIM-only pricing; and

    (b) sales of network services in the indirect channel.

SIM-only pricing

39. Paragraph 72 of the 2011 ED states that the best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. In many jurisdictions, entities sell network services on a standalone basis (ie SIM-only deals) and thus they have suggested that the SIM-only price could be used to determine the standalone selling price of the network service in the application of

the residual approach. The main advantages of applying the residual approach using the SIM-only pricing would be as follows:

(a) less judgment is required to estimate the standalone selling price of the handset; and

(b) an entity would recognize revenue for the network service at the standalone selling price of that service. In other words, the revenue is recognized at an amount that reflects an observable price for that service.

40. However, as mentioned earlier, the availability and prevalence of those SIM-only sales and the pricing of standalone network services varies by jurisdiction. For instance:

(a) In the U.S., the pricing of standalone service (ie internationally, a SIM-only deal) is the same as the contractual pricing of the service component in a bundled arrangement (eg CU30 per month). Consequently, the staff understand that SIM-only deals are less common in the U.S. market.

(b) In Europe and other jurisdictions, the pricing of a SIM-only deal is typically less than the pricing of a comparable network service that is provided as part of a bundled arrangement. The staff note that the differences between those network services may include the contract term (SIM-only deals typically have a shorter duration, such as a month-to-month contract) and the quantity of call minutes and data allowance that the customer is entitled to use each month.

41. Therefore, a consequence of using the SIM-only pricing of the network service to estimate the standalone selling price of the handset is that a U.S. telco would recognize revenue consistently with current practice whereas telcos in other jurisdictions would allocate more of the transaction price to the handset compared to their current practice. This consequence is also one of the main disadvantages of using a SIM-only price in a residual approach (ie comparability between those telcos that operate in the U.S. and those that operate in other jurisdictions would

be reduced even though the contracts in those jurisdictions may be economically similar).

Pricing of network services sold in the indirect channel

42. As another alternative for determining the standalone selling price of the network service, other respondents have suggested that an entity could use the network service that is sold through the indirect channel (ie through third party dealers – CU30 in the example in paragraph 13). Those respondents have explained that this approach would be appropriate because the third party dealer acts as agent of the telco when they sell the network service to a retail consumer and thus the separate network service sold through the indirect channel is typically equivalent to the network service sold in a bundled arrangement in the direct channel, in terms of price, contract duration and the included call minutes and data allowance.

43. The staff notes that using the price of the network service in the indirect channel as evidence of the standalone selling price of the network service would result in the estimate of the standalone selling price of the handset under the residual approach as being the amount that the customer pays for the handset at contract inception. Accordingly, this approach would preserve the accounting outcome that is achieved under the 'contingent cap' in current practice.

Allocation of handset discount entirely to one performance obligation

44. Many of the respondents that support expanding use of the residual approach would support this option for similar reasons (ie because their service pricing does not vary over time). Some respondents have requested that the Boards clarify in paragraph 75 of the 2011 ED that a discount can be allocated entirely to one performance obligation when the price of the other performance obligation is the same when sold individually as the price when sold as part of a bundled arrangement. Those respondents generally note that they should be able to allocate the discount on a handset entirely to the related performance obligation

since they believe they can demonstrate price independence as described in BC191.

45. Paragraph BC191 states that unless the price of some promised goods or services in the contract is largely independent of the price of other promised goods or services, any discount in the contract would be attributable to the contract as a whole and should be allocated proportionally to all the separate performance obligations in the contract.

> We believe that a business can demonstrate independent pricing if it can show a performance obligation is not discounted on a standalone basis. For example, we have various services that are the same price whether you buy them on a month to month basis or in contracts of various lengths which is clear evidence that there is price independence for those services. (CL 71- AT&T)

46. Those respondents have suggested rewording paragraph 75 of the 2011 ED as follows (added text in **bold**, deleted text is ~~struck~~):

> An entity shall allocate a discount entirely to one (or some) separate performance obligation(s) in the contract if both of the following criteria are met:
>
> (a) The entity regularly sells ~~each~~ **one or more** goods or services (or ~~each~~ **one or more** bundles of goods or services) in the contract on a standalone basis.
>
> (b) The observable selling prices from those standalone sales provide evidence of the performance obligation(s) to which the entire discount in the contract belongs.

47. Respondents in most jurisdictions believe that the changes proposed under this option would be responsive to their feedback; however, it might still prove difficult for entities to satisfy criterion 75(b) (ie so that those entities could achieve a revenue recognition pattern that is consistent with current practice under the 'contingent cap') even if those entities sell services for different prices depending on whether those services are bundled with a handset. Additionally, the staff observe that this option might compromise the discipline that was built into the proposed allocation methodology in the 2011 ED, which could lead to

unintended consequences (eg entities analogizing to such guidance in accounting for other types of contracts).

Aligning the direct and indirect channels

48. In the indirect channel, telcos promise only to provide the customer with network services (ie as opposed to the bundled arrangements sold in the direct channel). Consequently, under the 2011 ED revenue would be recognised over the contract term at the monthly amount (CU30). Under the contract costs guidance proposed in paragraph 94 in the 2011 ED, the telco would capitalize any sales commissions paid to the third party dealer and amortize the expense over the contract term.

49. Under the 2011 ED, the accounting would differ for sales in the direct channel. The effect of the allocation proposals would be that the amount of the transaction price allocated to the handset would likely exceed the carrying amount of the derecognized handset inventory. Consequently, there would generally not be a loss at the time the handset transfers to the customer; instead, the amount of the transaction price allocated to the network services would be reduced.

50. If the Boards agreed to either of the options under Alternative B, the effect would be that in the indirect channel the transaction price allocated to the handset would likely be limited to the amount of cash received form the customer (ie similar to the 'contingent cap' under current practice). In that case, the telco would recognize an upfront loss when the handset transfers to the customer. However, service revenue in both channels would approximate the amount of the service fees stated in the contract with the customer.

51. Many telcos have stated that they view the economics of their sales in each channel to be similar. To achieve an outcome that reflects the view of those respondents (ie to align the cost accounting between the direct and indirect channels), some respondents request that the boards consider:

    (a) Allowing them to capitalize the amount of the upfront loss (ie handset subsidy); or

(b) Permitting them to expense contract acquisition costs (ie sales commissions)

Capitalize the amount of the upfront loss

52. As described above, some respondents from the telecommunications industry suggested that the Boards should allow them to capitalize the loss recognized on the sale of a handset as a contract acquisition cost under paragraph 94 of the 2011 ED. Those entities note that users of their financial statements analyze their businesses in this manner, and that the loss recognized on the sale of the handset is considered to be a necessary cost of doing business.

> Our main concern relates to the proposed transaction price allocation method, that would result in a shift from ongoing service revenue to the devices we provide to customers to allow them to access our services. We use the devices as marketing tools in order to attract new customers. This does not mean that we do not give any value to the handsets; in fact, because we know that customers give so much value to the devices, we try to sell them at important discounts so that customers are willing to join our company rather than one of our competitors. Almost all telecom companies do the same. For our business what is most relevant is the service we provide, as it is our primary activity and the means we have to recover our investment in the network. (CL 159-Telefonica)

53. Under this option, the entity would capitalize the upfront loss (eg subsidy, discount, etc...) recognized in providing a handset to the customer and recognize the loss as an expense over the expected life of the contract. For example, if a telco company paid CU250 to acquire a handset and sold it to the customer for CU100, the entity would record the following:

Description	**Debit**	**Credit**
Cash	100	
Handset revenue		100
Customer acquisition costs (asset)*	150	
Cost of goods sold	100	
Handset inventory		250

*This asset would be amortized as expense over the term of the contract.

54. The outcome of this option for telcos would differ from current practice for most entities; however, those entities would not be required to modify their systems to the extent they would if they were required to adopt the relative standalone selling price method under the 2011 ED. Additionally, under this option the costs recognized under the direct and indirect sales channels would be aligned (ie assuming the Boards retain the proposals for contract acquisition costs in paragraphs 94 – 96 of the 2011 ED). Introduction of this guidance would result in the most significant change to the proposals of the options under Alternative B. This option would be responsive to the concerns of respondents from the telecommunications industry; however, it would set a precedent for companies to capitalize upfront losses in loss-leader arrangements.

Expense contract acquisition costs

55. Another way to align the costs between the direct and indirect channels would be to permit the entity to expense contract acquisition costs. This topic is discussed more generally in Agenda Paper 7B/165B. In that paper, the staff recommend the Boards retain the requirement for the entity to capitalize contract acquisition costs but expand the scope of the practical expedient to allow for the entity to expense those costs regardless of the expected duration of the amortization period. If the Boards agree with that recommendation, telcos would be permitted to expense sales commissions in the indirect channel, which would align the cost accounting in the indirect and direct channels (ie in the indirect channel the entity would recognize the upfront loss at inception under the 2011 ED).

Application of the proposals in a less costly manner

56. The staff think that the Boards did not necessarily intend that the entity would be expected to track and account for each of its contracts individually in order to apply the revenue proposals. To address the concerns of respondents from the telecommunications industry about the anticipated costs of applying the proposals, the staff have considered whether those entities could apply the proposals using an

approach that would require only readily available data (ie thereby minimizing the need for systems modifications). The goal of any such approach would be for the entity to convey substantially the same result under a 'simplified' approach as it would if it applied the proposals at the individual contract level.

57. Under the ED, the entity is required to allocate consideration to each separate performance obligation in a contract. After applying the allocation proposals, the effect of this determination is that the entity would recognize more revenue from the sale of handset than the cash received for the handset and correspondingly less service revenue than the monthly service charges. To replicate this outcome using a simplified application approach, the entity could:

    (a) recognize revenue at inception equal to cost of the handset to the entity (CU250 in the example below); and

    (b) recognize a contract asset (CU150) equal to the amount of the difference between the cash received for the handset (CU100) and the cost of the handset to the entity (CU250); and

    (c) recognize the amortization of the contract asset over the term of the contract as a reduction of (ie offsetting amount to) the revenue recognized from the monthly service charges.

58. The following illustration using the example in paragraph 13 depicts the envisioned accounting under the simplified implementation approach; however, this simplified approach assumes that the entity sells the handset at cost (ie no margin is recognized):

	Current Accounting			Simplified Implementation (No Margin)		
Contract inception	Cost of goods sold	250		Cost of goods sold	250	
	Inventory		250	Inventory		250
	Cash	100		Contract asset	150	
	Revenue		100	Cash	100	
				Revenue		250
	Profit (loss) at inception		(150)	Profit (loss) at inception		0
Month 1	Cash	30		Cash	30	
	Revenue		30	Revenue		24
				Contract asset		6
	Total service revenue		720	Total service revenue		570
	Total handset revenue		100	Total handset revenue		250
	Total revenue		820	Total revenue		820

59. The entity could presumably apply this approach without significantly modifying its systems; however, the staff note that the approach might be considerably more difficult to apply when taking into account other requirements of the proposal. In the basic illustration above, the entity has not attributed any margin to its sale of the handset. Many telcos would support this assumption (ie that the handset is sold at cost) because they note that it is consistent with how they price the handsets in bundled arrangements (ie at a low or nominal margin). However, the standalone selling price of those handsets (ie absent a service contract) often is higher, meaning that such an approach would be inconsistent with the relative standalone selling price methodology required by the allocation proposals. To comply with the proposed standard the entity would be required to estimate and account for a realistic margin on the sale of the handset (ie at standalone selling price), introducing additional complexity into the approach.

60. Importantly, the staff note that under the simplified implementation approach the entity would not be exempted from any of the other provisions of the proposed revenue recognition model. The staff think the entity would have to determine how to adapt the methodology to account for the following other aspects of the 2011 ED:

(a) Time value of money would likely have to be accounted for given the standard 24-month contract term and lag between the transfer of the good and receipt of cash in the full amount of the revenue recognized.

(b) The entity would have to estimate the expected contract term over which it would amortize the recorded contract asset.

(c) The entity would have to test the recognized contract asset for impairment.

(d) The entity would have to consider the effect of changes to its contracts in the context of the proposed guidance for contract modifications.

61. Paragraph 6 of the 2011 ED explicitly allows for the entity to apply the proposals at a higher level than the individual contract (ie portfolio-level) if it expects the results of doing so would not differ materially. The staff think the entity could utilize a portfolio approach so that it could account for those aspects of the proposal for which it could not readily obtain data from its existing systems. Many telcos think that they would be unable to reliably identify separate portfolios because of the large number of permutations of their contracts. The staff acknowledge that with any portfolio approach comes a level of aggregation risk; however, we maintain that there are a sufficient number of characteristics that could be used to differentiate between the various types and permutations of customer contracts so that the risk associated with aggregating those contracts does not rise to a level of significance.

Staff recommendation

62. The staff acknowledge the validity of the concerns raised by respondents from the telecommunications industry about the allocation proposals in the 2011 ED. Feedback from users of the financial statements of telcos has indicated limited support for the allocation proposals in the 2011 ED. Consequently, preparers expect they would still have to provide their users with data that they prepare under current guidance (ie in what would be a non-GAAP measure). Additionally, those preparers expect application to be costly and complex.

63. However, the staff continue to think the accounting under the proposals would portray the economics of bundled telco arrangements better than under current practice because:

    (a) Revenue in a given period would reflect the value of the goods and services provided to customers (ie as opposed to the cash collected by the entity during the period).

    (b) In some arrangements, the entity transfers a good to the customer at a loss to the entity at inception of the contract. Under the proposals, the entity would allocate and recognize revenue at inception in proportion to the standalone selling price of the transferred good relative to total contract price. The staff think this portrayal is faithful to the core principle of the model in that it would recognize revenue in a manner that depicts that the entity has transferred a good to the customer and that it is entitled to recover at least a portion (and in some cases the full amount) of the standalone selling price (either through recurring service revenues or contract termination fees).

64. Additionally, the staff note that each of the options under Alternative B would constitute an exception to the model. In this regard, those options would stray from the core principle in the 2011 ED and the viability of the guidance would be dependent on preparers maintaining their current business models and/or practices into the future. Furthermore, the staff have significant concerns about the risk that preparers that offer similar bundled arrangements would analogize to the guidance that would result if the Boards were to decide to modify the proposals. On balance then, the staff recommend that the Boards do not modify the proposals for allocating the transaction price in the 2011 ED.

65. The staff think that the Boards should specify that a simplified implementation approach (that would still require the entity to apply all provisions of the model) might be an acceptable manner by which the entity could apply the ED. This guidance would alleviate the cost-benefit concerns of some entities without compromising the core principle of the 2011 ED despite the fact that significant

complexities would remain even when applying the simplified implementation approach. The staff recommend that the Boards should:

(a) specify in the implementation guidance that such an approach would be acceptable in some cases by stating specifically that the revenue recognition standard need not be applied at the contract-level; and

(b) include an illustration of a simplified implementation approach (as described in paragraphs 56 – 61 of this paper) as an example of a potentially acceptable method of applying the revenue recognition standard, acknowledging that the entity would still have to adapt the approach to account for all other provisions of model.

66. The staff also recommend that the Boards affirm their tentative decision about contract costs from Agenda Paper 7B/165B as that decision would apply to the types of contracts discussed in this paper.

Questions 1 - 3 for the Boards: application of the revenue recognition model to some bundled arrangements

1- Do the Boards agree that the proposals for allocating the transaction price in the 2011 ED should be retained for all types of contracts with customers (ie Alternative A)?

If not, which option under Alternative B do the Boards prefer?

2- Do the Boards agree that the implementation guidance should include an illustration of how the entity might apply the standard to bundled arrangements in a simplified manner?

3- Do the Boards agree that contract costs should be accounted for in accordance with the Boards' tentative decision in Agenda Paper 7B/165B for all types of contracts with customers?

Appendix A- Excerpt from the Basis for Conclusions in the 2011 ED

Contingent revenue cap

BC193. Some respondents to the 2010 proposed Update disagreed with the Boards' proposal that the transaction price should be allocated on a relative standalone selling price basis. Those respondents (primarily from the telecommunications and cable television industry) requested that, instead, the Boards carry forward the contingent revenue allocation guidance from Subtopic 605-25 (often described as the contingent revenue cap). (There is no equivalent guidance in IAS 18, although in practice the Boards understand that most telecommunications entities that apply IFRSs account for their contracts in a similar manner as entities that apply U.S. GAAP.)

BC194. The contingent revenue cap limits the amount of consideration allocated to a satisfied performance obligation to the amount that is not contingent on the satisfaction of performance obligations in the future (or meeting other specified performance conditions). For example, under that guidance, the amount of consideration that a telecommunications entity can allocate to a handset that is bundled with network services is limited to the amount that is not contingent on the delivery of network services in the future. Hence, when the handset is transferred to the customer, revenue is recognized at the amount that the customer paid for the handset at contract inception. The remaining contractual payments are recognized subsequently as revenue as the entity provides network services to the customer.

BC195. Respondents from the telecommunications industry observed that without a contingent revenue cap, revenue would be recognized for delivering a handset in an amount that exceeds the amount of consideration paid for the handset. These respondents do not think this is appropriate because they would be entitled to collect the excess only when they provide the network services. Therefore, they reasoned that the contract asset that results from recognizing revenue for delivery of the handset does not meet the definition of an asset. Additionally, they suggested that without a contingent revenue cap, the proposed model would be complex and costly to apply because of the high volume of contracts that they have to manage and the various potential configurations of handsets and network service plans.

BC196. However, the Boards affirmed their proposal in the 2010 proposed Update not to carry forward the contingent revenue cap for the following reasons:

> (a) Limiting the amount of consideration that can be allocated to a satisfied separate performance obligation is tantamount to cash basis accounting and does not meet the core principle of the proposed guidance. That is because revenue recognized would not depict the amount of consideration to which the entity expects to be entitled for the delivered good or service. Consequently, the contingent revenue cap could result in economically similar contracts being accounted for differently.
>
> (b) The contingent revenue cap can result in the recognition of losses when the contract is profitable. That would occur when the amount allocated to a satisfied performance obligation is constrained (potentially to zero) to an amount that is less than the expenses recognized for the costs of providing the good or service

(unless those costs are deferred). However, costs relating to a good or service already transferred to the customer would not give rise to an asset.

(c) Recognizing a contract asset in the situation described in paragraph BC195 is appropriate because the entity clearly has a valuable contractual right as a result of satisfying a performance obligation and that right meets the definition of an asset. That right exists even if the entity does not have the present right to collect consideration from the customer. This is evidenced by the fact that if the entity were to transfer the remaining rights and performance obligations in the contract to a third party after it had delivered a handset, it would expect to be compensated for that past performance.

(d) Applying the contingent cap more broadly than it is applied in existing standards could have far-reaching consequences. For example, in many services contracts (including construction contracts), it is appropriate to recognize revenue when services are provided even though the amount of consideration is contingent on the entity's future performance. Otherwise, the entity would not recognize any revenue until reaching a contract milestone or potentially until completion of the contract (which would not depict the transfer of goods or services to the customer).

(e) Although the consequences on construction and other service contracts could be reduced by limiting the amount allocated to satisfied separate performance obligations (rather than limiting the amount allocated to a satisfied portion of a single performance obligation), the Boards decided that this would create an arbitrary distinction and put additional pressure on the criteria for identifying separate performance obligations.

(f) For many contracts that currently are accounted for under the contingent revenue cap, the amount of consideration allocated to delivered items is not contingent because even if the customer cancels the contract, it would be obliged to pay for the delivered item(s). For example, in some contracts for the sale of a handset and network services, the contract either is not cancellable or, if it is, the customer is obliged to pay a termination fee that corresponds with the value of the handset delivered upfront (even if the entity chooses not to enforce payment of that fee).

BC197. Additionally, the Boards decided not to introduce an exception to the revenue model for telecommunications and similar contracts because they do not view those contracts to be unique. Furthermore, the Boards decided that the proposed guidance would provide a more consistent basis for recognizing revenue and would produce results in accounting that more closely match the underlying economics of transactions.