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Investor Perspectives

Stephen Cooper: Revenue recognition and your mobile phone

The IASB and FASB will shortly issue an exposure draft of a revised standard for revenue recognition designed to provide what we believe will be significant improvements to financial reporting. Very briefly we propose that revenue be recognised when an entity satisfies a performance obligation to deliver a good or provide a service as part of a contract with a customer. Revenue is recognised at the value of the consideration receivable. If a contract involves the delivery of more than one good or service, each at a different time, then the total consideration is allocated between the respective performance obligations based upon the stand-alone selling prices of each item, estimated if necessary. More information about the approach can be found on the relevant project pages on the IASB web site.

For many companies the new approach will not change the amount or timing of revenue recognition. However, in some cases there could be a significant impact, an example of which is the supply of 'free' handsets bundled as part of a contract for the provision of mobile call services. We have been having extensive discussions about this and similar transactions with some of the telecoms companies who do not believe the proposals of the IASB represent an improvement. We would like to hear the views of more investors on this issue.

An example

Let's assume that a telecoms company supplies a 'free' smart phone handset if a customer signs up to a 24 month contract for the supply of a particular package of call and data services for CU35 per month.

Alternatively the same company supplies the handset without the monthly contract for CU330 and will provide the same call and data services for CU20pm if no handset is provided. You will notice that in this case the cost of the bundled offer of CU840 (CU35x24) is greater than the sum of the separate cost of each component of CU810 (CU330 + CU20x24). However, the present value of each set of cash flows is the same (CU770 when discounted at about 8%p.a). In practice the present value may not always be the same, but this added complication does not affect the accounting choices below.

Summary of transactions	Bundled contract	Separate contracts for the handset and call services
Initial purchase of the handset	Nil	330
Monthly cost for call services over 24 month contact	35	20
Aggregate cash paid	840	810
Present value of call services	770	440
Initial cost of handset	-	330
Aggregate present value	770	770

Current accounting

While there is limited guidance regarding these transactions in IAS 18, current accounting practice is fairly consistent. At present revenue of CU35 per month would be recognised for the bundled contract and revenue of CU330 on day 1 followed by CU20 per month for the two separate contracts. The cost of the handset would be expensed on day 1 in both cases. It should be noted that in many cases a (subsidized) payment is often made by the customer for the handset, in that case any payment received would be reported as day 1 revenue.

Accounting under the forthcoming exposure draft

The proposals in the exposure draft will not change the accounting where the contracts are separate. However, the bundled contract would be accounted for as two performance obligations, one of the delivery of the handset and one for the supply of call services. Also the time value of money would be taken into account (assuming the effect is judged to be material) in measuring the value of the consideration for the handset.

The allocation of the total consideration would reflect the relative stand alone selling price of each component (which in this case we know given the data for the two separate contracts). Therefore, day 1 revenue of CU330 would be recognised which is equal to the present value of the additional CU15 per month effectively being paid for the handset within the bundled price. Given no cash has actually been received on day 1 a receivable (strictly speaking a contract asset) of CU330 must be recognised. Subsequently the receivable is settled through the receipt of an additional CU15 each month such that only CU20 is booked as revenue in subsequent periods for the call services. In addition interest income is recognised on the receivable (remember the receivable is recognised at the present value of the deferred consideration).

Here is a summary of current and the proposed accounting for the bundled contract:

	Month 0	**Month 1**	**Month 2**		**Month 24**
Current accounting					
Revenue		35	35		35
Cost of sales (assumed cost of handset)	(200)				
Profit before other expenses	(200)	35	35		35
Proposed accounting					
Revenue – Handset	330				
Revenue – Call services		20.0	20.0	....	20.0
Revenue – Interest income		2.3	2.2		0.1
Cost of sales (assumed cost of handset)	(200)				
Profit before other expenses	130	22.3	22.2		20.1

Which approach provides the most relevant information for investors?

So which approach do you think provides the best reflection of the economics of this transaction and would be most useful to you as an investor? Below are some of the arguments put forward for each approach.

	Arguments for retaining the current accounting method	Arguments for the proposed performance obligation approach
Nature of the transaction / business model	The business model of telecoms companies is to supply call services and the cost of free or subsidized handsets is seen as a marketing expense.	Handsets are a material part of the transaction and a failure to recognise any revenue misstates revenue and profits each period. Total cash paid by the customer is for three goods or services (1) the handset, (2) interest on the credit being provided through deferred payment for the handset and (3) the call services.
Closeness to cash flows	Current accounting means revenue is essentially the same as cash flows.	The purpose of the income statement is not to report cash (for which we have the cash flow statement) but to report revenues earned and cost incurred through application of the accruals concept.
Cost of changing systems	Switching to the approach in the ED would require extensive changes to systems.	Billing systems would be unaffected. A separate system would be needed to record the receivable, which would need to be cross-referenced to the service contract details for impairment review. Ways of mitigating the cost of systems changes is something that we will explore in more detail during the comment period.
Dependence on the continued supply of call services	The receipt of any payment for the handset is dependent upon the telecoms company supplying the call services. If such services are not provided then there is no right to collect the 'receivable' for the handset.	The customer has taken ownership of the handset and it is appropriate for some revenue to be attributed to that part of the transaction. We don't account on the basis of there being a breach of contract or non-performance. We are accounting for the contract with customer – its breach is another issue. Also application of IFRS assumes the reporting entity is a going concern.
Prudence	The current approach back loads revenue and is therefore more prudent. Revenue is only recognised when actually received.	Current accounting artificially defers revenue and produces different revenue recognition for similar transactions. Collectability of the deferred payment for the handset is taken into account when measuring the value of the consideration.

This is just one very specific transaction the reporting of which would be impacted by our forthcoming proposals for revenue recognition. Nevertheless, it provides a good indication of the thinking behind the changes.

In summary we believe that the approach to revenue recognition that we have developed will provide a more consistent basis for reporting revenue and produce accounting that more closely matches the underlying economics of transactions. Full details about the proposed revenue recognition model will be given shortly when we publish the exposure draft. In the meantime we would be very interested to hear the views of investors about the specific transaction highlighted above.

Tell us what you think ….

Stephen Cooper is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.