IFRS INDUSTRY ISSUES

TELECOMMUNICATIONS

IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS

The headlines

In May 2014, the International Accounting Standards Board published IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 contains comprehensive guidance for accounting for revenue and will replace existing requirements which are currently set out in a number of Standards and Interpretations.

IFRS 15 is fully converged with equivalent new US GAAP guidance (although, unlike IFRS, US GAAP does not permit adoption before 2017), and contains significantly more prescriptive and precise requirements in comparison with existing IFRS. This means that for many entities, the timing and profile of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning, including for commercial effects.

For entities in the telecommunications sector, BDO's initial analysis of IFRS 15 indicates that the following areas may be of particular significance:

- Will a contract need to be 'unbundled' into two or more components?
- How should contracts which include a right of return be dealt with?
- How should modifications to contracts be dealt with?
- Should costs associated with obtaining a contract be capitalised, or expensed immediately?
- What adjustments are required for the effects of the time value of money (a 'financing component')?

IFRS 15 also introduces significantly more disclosures about revenue recognition. It is possible that new and/or modified internal processes will be needed in order to obtain the necessary information.

IFRS 15 is applicable for annual periods beginning on or after 1 January 2017. Earlier application is permitted. For entities that report in accordance with EU-endorsed IFRS, endorsement is currently scheduled for quarter 2 of 2015.

EFFECTIVE DATE

Annual periods beginning on or after 1 January 2017. Earlier application permitted.

ACCOUNTING IMPACT

Wide and potentially very significant effects on the timing and profile of revenue and profit recognition in comparison with current guidance. Significant enhancements to disclosure requirements.

The commercial effects

The adoption of IFRS 15 may lead to significant changes in the pattern of revenue and profit recognition. Careful consideration and planning will be needed for a wide range of issues, including the effect on:

- Compliance with bank covenants
- Performance based compensation (including share-based payments)
- Internal budgeting processes
- Corporate tax obligations
- Market and investor communications, including compliance with regulatory requirements (which might arise from significant expected future changes to an entity's reported financial position or performance).

A review of the terms and conditions of existing contracts will be needed (in particular long term contracts which extend into periods covered by financial statements affected by the adoption of IFRS 15) as well as those which are to be entered into in future. In some cases, entities may wish to consider whether changes should be made to contracts.

It is also likely that sales departments will need to liaise more closely with the accounting department in future, in order that the effects of any proposed contractual terms on the related financial statements can be understood in advance.

Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?

Previously, IFRS had little guidance for 'unbundling' contracts into components. In contrast, IFRS 15 contains detailed guidance and it is likely that many entities will need to amend their current accounting policies and approaches. This may have a significant effect on the pattern of revenue and profit recognition. The changes for the telecommunications industry are likely to be particularly significant.

The lack of existing guidance in IFRSs has resulted in significant judgment being applied when considering how revenue should be allocated and recognised (for example, for contracts involving the supply of a free mobile phone handset that is combined – or bundled – with an allocation of permitted use in return for a monthly payment for a minimum period of time). Some entities have treated the cost of the handset as a marketing expense, while others have deferred the cost of the handset and amortised it over the minimum contract period. In other cases, entities have recognised revenue from the sale of the handset, but have limited this to its cost.

The application of IFRS 15 will result in the revenue to be derived from the contract to be allocated to each component (or 'performance obligation'). This means that at the start of each contract, entities will record revenue and profit that is attributable to the supply of the handset. In comparison with current practice, this will typically mean the recognition of more revenue and profit on inception of contracts, and less revenue and profit as the contract continues.

As with many other goods and services, telecommunication equipment is frequently sold with a warranty that it will operate satisfactorily for a specified period of time. The accounting treatment depends on

- whether customers have an option to purchase the warranty separately and,
- whether the warranty is part of the overall package of goods and services sold to the customer and, if so, whether the warranty simply provides assurance that the hardware and software is in compliance with the agreed upon specifications in the contract.

Agreed upon specifications often relate to an assurance that an item will function properly for a specified period, and may link to legal requirements in some jurisdictions.

If customers have an option to purchase a warranty separately from the telecommunications equipment itself, this is accounted for separately. If the warranty is part of the overall package, then if it simply provides an assurance of compliance with agreed upon specifications, it is not accounted for separately. If it goes beyond compliance with agreed upon specifications, then it is accounted for separately regardless of whether it is identified as a separate component of the sales transaction.

Standard telecommunications packages may be sold for a specified period (such as 12 months), with the customer being given the right to renew the contract on expiry (for example, for a further 12 months) at a discount from the standard selling price. In these cases, the consideration received for the first 12 month licence will typically be split between the initial 12 month contract and the renewal right, with revenue relating to that renewal right being deferred and recognised in a future period.

Consequently, we expect that almost every entity in the telecommunications sector will need to give careful consideration to how IFRS 15 will change their timing and profile of revenue recognition, and to the potentially very significant systems and process changes which will be required. This is particularly the case due to the very high volume of contracts, and the large number of options which are available to customers.

How should contracts which include a right of return be dealt with?

Telecommunications sales are often accompanied by the customer having a right of return under which the customer may be entitled to a refund (for example, in some jurisdictions there is a 'cooling off' period during which a customer can cancel a contract with no penalty), a credit that can be applied against another purchase, or another product in exchange.

To the extent that the vendor expects customers to exercise the right of return, revenue is not recognised for the related goods or services, even though these may already have been transferred to the customer. Instead, a refund liability is recognised together with an asset for the right to recover the original asset (depending on whether the item recovered would have any value).

How should modifications to contracts be dealt with?

Customers are frequently given the option to modify their existing contracts by adding (or in some cases reducing) the number of minutes of talk time included in a package, and by adding or deleting additional services.

IFRS 15 includes detailed guidance which, depending on the way in which a contract is modified, can result in it being accounted for retrospectively (with an immediate adjustment to revenue, which could be upwards or downwards), or being accounted for prospectively in which case the effect of the contract modification is recognised in future periods.

These new requirements may result in significant changes in practice, because existing IFRSs contained limited guidance and a variety of approaches have been followed in the past. There may be significant changes in the pattern of revenue and profit recognition.

Should costs associated with obtaining a contract be capitalised or expensed immediately?

In addition to the substantially more detailed guidance for revenue recognition, IFRS 15 contains prescriptive criteria to be applied when determining whether costs associated with the acquisition of a contract should be recognised as an asset, or expensed as incurred.

IFRS 15 is restrictive, in that it permits only incremental costs of obtaining a contract to be considered. Consequently, only those costs which would not have been incurred if the contract had not been obtained are eligible to be considered. An example is a sales commission which is only payable in the event that a customer completes a sale. In contrast, ongoing costs of running the business are not eligible to be considered because these costs would have been incurred regardless of whether a specific contract had been obtained. Although it might be argued that certain costs might be lower if an entity was not involved in obtaining sales contracts, IFRS 15 does not permit contracts to be analysed on a portfolio basis. Instead, the focus is on whether costs attributable to each individual contract are incremental.

Once incremental costs have been identified, these are required to be recognised as an asset if there is an expectation that they will be recovered, typically through profits to be generated from the related contract. This asset is then amortised on a basis that is consistent with the transfer of the goods or services specified in the contract. It will be necessary for judgement to be applied in determining an appropriate amortisation period and profile.

This may represent a significant change for some entities, because at present these costs may be accounted for differently. For example, many entities simply expense them as incurred and for them, IFRS 15 will bring the need to introduce systems and processes to identify eligible contract acquisition costs, capitalise them, and amortise them over an appropriate period.

What adjustments are required for the effects of the time value of money (a 'financing component')?

Contracts in the telecommunications industry can involve cash receipts from customers which do not correspond to the timing of the recognition of revenue. If a financing component is significant, IFRS 15 requires an adjustment to be made for the effect of implicit financing.

As a practical expedient, adjustments for a financing component are not required when there is a period of less than one year between the transfer of goods or services and the receipt of payment from a customer.

In a major change from existing practice, adjustments for a financing component are required for circumstances in which customers pay in advance, as well as in arrears. Payments in arrears will result in finance income and a reduction in revenue (because the vendor is providing finance to its customer), while payments in advance will result in a finance expense and an increase in (deferred) revenue (because the vendor is, in effect, borrowing funds from its customer).

The purpose of this approach is to reflect the 'cash selling price' of the underlying good or service at the point at which it is transferred to the customer. It also results in transactions which involve a significant financing component being split into two parts; one for the sale of the good or service and the other for the financing arrangement. However, the implications for the internal processes and systems that are needed in order to identify when a financing component is to be recognised, and to account for this, may be significant.

Disclosure requirements

Users of financial statements, and regulators, have criticised the existing disclosure requirements in IFRS as being inadequate and lacking cohesion with other disclosures made in financial statements. This has made it difficult to understand an entity's revenues, as well as the judgements and estimates that have been made in determining their recognition and measurement.

In consequence, comprehensive disclosure requirements have been included in IFRS 15. This means that, even if an entity concludes that the effect of the new standard on revenue recognition is not significant, changes to internal systems and processes may be required to enable the necessary information to be collected for disclosures.

In addition to the detailed guidance, an overall disclosure objective has been specified together with an explicit statement that immaterial information does not need to be disclosed and the disclosure requirements should not be used as a checklist. This is because some disclosures may be very relevant for certain entities or industries, but irrelevant for others. It is also intended to encourage entities to give careful consideration to the information that they will include in their financial statements in order to meet the disclosure objective. However, this again brings the need for careful planning, well in advance of adoption of the new requirements.

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders where you can find full lists of regional and country contacts.

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