

# Technical Line

FASB – final guidance

## How the revenue standard affects telecommunications entities

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### What you need to know

- ▶ Telecommunications entities need to apply judgment and make estimates, including estimating standalone selling prices and determining how to account for contracts with variable consideration, options for additional goods or services and contract costs.
- ▶ Telecommunications entities need to determine whether nonrefundable up-front activation or installation fees represent a material right.
- ▶ Identifying costs to obtain and/or fulfill a contract may be challenging, and determining the period over which those costs should be amortized requires judgment.

### Overview

When applying the revenue recognition standard,<sup>1</sup> entities in the telecommunications (telecom) industry need to make judgments and estimates, such as estimating standalone selling prices for handsets and free goods or services and determining how to account for contracts with variable consideration, options for additional goods or services and contract costs (i.e., whether to capitalize them and, if so, determine the appropriate period to amortize them).

This publication, which contains a summary of the standard in the appendix, highlights key aspects of applying the standard to a telecom entity's contracts with its customers. It supplements our Financial reporting developments (FRD) publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it.

## Contract duration

Telecom entities have to determine the duration of the contract (i.e., the period in which parties to the contract have present enforceable rights and obligations) to apply certain aspects of the revenue model (e.g., identifying performance obligations, determining the transaction price). The contract duration may be affected by termination provisions in the contract.

A substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty.<sup>2</sup> Determining whether a termination penalty is substantive, and what the enforceable rights and obligations are under a contract, requires judgment and consideration of the facts and circumstances.

Telecom entities typically include early termination penalties in fixed-term contracts. To assess whether an early termination penalty is substantive, a telecom entity should consider quantitative and qualitative factors such as the amount, nature and purpose of the penalty, the number of customers that terminate their contracts early and the entity's historical collection rate for the penalties.

For example, the entity would determine that it has a month-to-month contract rather than a two-year contract if it allows customers to terminate their contracts without paying the penalty and that practice limits the parties' enforceable rights and obligations in the contract (this is a legal judgment that may vary by jurisdiction). If the entity's practice of not enforcing its rights to a penalty does not change the parties' legally enforceable rights and obligations, the contract duration should equal the period through which a substantive termination penalty would be due (generally the telecom contract's stated contractual term).

These qualitative and quantitative factors are also relevant when determining the duration of an installment arrangement for the purchase of a handset. In an installment arrangement, a customer pays the full retail price for a handset in monthly installments and typically has a month-to-month service contract rather than a service contract with a fixed term (e.g., two years).

It is possible that payments that effectively act as a termination penalty and create or negate enforceable rights and obligations may not be labeled as such in an installment contract. While a customer may cancel the service plan at any time without penalty, the customer may be required to pay the unpaid balance for the handset upon termination of the service contract. The telecom entity may need to consider whether the handset payment acceleration clause in this type of contract is similar to a termination penalty in a longer-term service contract and whether this "penalty" is substantive (e.g., the amount owed upon cancellation may be greater than the present value of the installment receivable).

Consider another example in which a telecom entity offers a \$600 credit to a new installment arrangement customer. Under the terms of the arrangement, the credit is payable over 24 months and the customer forfeits any credit not yet received if the customer fails to renew the service contract. In this example, the telecom entity needs to consider whether the penalty (i.e., forgoing of the credit) is substantive and evidence of enforceable rights and obligations over a period longer than the month-to-month service contract.

### Month-to-month contracts

Month-to-month contracts that allow customers to cancel service without penalty at any time are common in the telecom industry. As discussed above, a contract with a longer stated contractual term is also considered month-to-month if enforceable rights and obligations do not exist throughout the entire term stated in the contract (e.g., if there are no contractual penalties or non-substantive penalties for termination). That's the case even though many telecom entities have

sufficient historical data to estimate the average customer life. As a result, the standard requires the performance obligations and the transaction price to be determined only for the month-long contract duration over which the parties have present enforceable rights and obligations.

## Identifying performance obligations in telecom contracts

Telecom entities need to evaluate their contract terms and customary business practices to identify all promised goods or services within their contracts and determine which of those promised goods or services (or bundled goods and services) should be accounted for as separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). Properly identifying performance obligations is a critical step in the revenue model because revenue allocated to each performance obligation is recognized as the performance obligation is satisfied.

Telecom entities often sell bundled products and services (e.g., wireless service and handsets, wireline triple-play packages). Further, telecom services may comprise several services such as voice, text and data services in wireless plans, or television, internet and landline telephone services in wireline triple-play packages.

Generally, promised goods and services in the telecom industry are capable of being distinct. Judgment is required to determine which telecom services are distinct within the context of the contract (i.e., separately identifiable). A telecom entity may need to consider (1) whether the customer's ability to derive the intended benefit from the contract significantly depends on the entity transferring all of the promised goods or services and (2) whether the promised goods or services are highly interdependent or highly interrelated (i.e., whether there is a significant two-way dependency between the promised goods or services). Some questions a telecom entity may need to consider include:

- ▶ What is the nature of the entity's promise to the customer?
  - ▶ Has the entity promised to provide a bundle of telecom services (e.g., voice, text and data in a wireless plan, or a wireline triple-play package), or has it promised to provide each of the individual services in those bundles?
  - ▶ Has the entity promised to provide telecom services to a bundle of lines (e.g., a family or multi-line plan), or has it promised to provide individual lines?
- ▶ Are any of the promised services in a wireless multi-line plan (e.g., voice, text and data) shared between lines?
- ▶ Do the individual services (e.g., voice, text and data) in the bundle have the same pattern of transfer to the customer? If so, the accounting outcome may be the same regardless of whether the bundle or individual services are determined to be the performance obligation(s).

For example, in a wireless service and handset bundle where the wireless service is shared among all four lines in a plan, the wireless service and handset are capable of being distinct and are separately identifiable. That's because the wireless service and handset do not significantly modify or customize one another, the telecom entity is not providing a significant service of integrating the wireless service and handset into a combined output and the wireless service and handset are not highly interdependent or interrelated. Therefore, the handset and wireless service are separate performance obligations. When evaluating whether each of the four wireless lines is a separate performance obligation, the telecom entity determines that each line is capable of being distinct but is not separately identifiable because the wireless service is shared among all lines. That is, the usage of wireless service per line may significantly affect the service available for the other lines. Therefore, the telecom entity determines the wireless service is a single performance obligation.

Telecom services generally meet the requirements to apply the series guidance (see Step 2 in the appendix) if the nature of the telecom entity's promise is to provide monthly telecom services, rather than individual units of data, text or minutes. The amount of telecom services consumed by the customer could vary throughout the day and from month to month, but that should not prevent an entity from concluding that the monthly telecom services are distinct, substantially the same and have the same pattern of transfer and should therefore be accounted for under the series guidance. This determination is important because it affects the accounting for contract modifications, the allocation of the transaction price and disclosures.

## Contracts with varying levels of service

Telecom entities often provide customers the ability to select services from a variety of offers ranging from a base level of service to an unlimited level of service. Customers select a service level at contract inception with an option to change the service level at any time. Depending on the telecom entity's assessment of the present enforceable rights and obligations in the contract, the telecom entity may determine that the nature of its promise to the customer is to provide the base service level and therefore would account for any additional services in excess of the base service level as an option to acquire additional services. Alternatively, the telecom entity may determine that the nature of its promise to the customer is to provide the contracted service level and therefore would account for subsequent changes in the service level as a contract modification. Telecom entities need to apply judgment when evaluating these contracts in order to appropriately identify the enforceable rights and obligations, identify the performance obligations and determine the transaction price.

Activation or installation fees may represent material rights.

## Material rights

Many telecom contracts give customers the option to purchase additional goods or services, such as premium TV channels, international voice and data plans, or minutes or data in excess of plan limits. Telecom entities have to determine whether any of these options provide a material right to the customer and therefore are separate performance obligations.

Options offered by telecom entities that are priced at their standalone selling price are not considered material rights (and are therefore not considered separate performance obligations). Example 50 in the standard<sup>3</sup> illustrates this point.

Renewal options and customer cancellation rights are another form of an option to purchase additional goods or services. This type of option could be described as a renewal option within a relatively short contract (e.g., a one-month contract with an option to renew at the end of each month) or a cancellation option within a longer contract (e.g., a three-year contract that allows the customer to discontinue the contract at the end of each year). Telecom entities need to determine whether these renewal or cancellation rights give rise to a performance obligation (e.g., there is a discount for goods or services provided during the cancelable period that provides the customer with a material right).

## Nonrefundable up-front fees

Telecom entities often charge nonrefundable up-front activation or installation fees at contract inception. These fees generally do not relate to the transfer of a good or service to the customer. However, in a month-to-month telecom contract, the customer's ability to renew each subsequent month without having to pay the activation or installation fee again may represent a material right, which gives rise to a separate performance obligation. A telecom entity should allocate a portion of the transaction price to the material right (which may differ from the activation or installation fee charged to the customer) and recognize that amount over the period of benefit of the activation or installation fee, which may be the estimated customer life in some situations.

To allocate the transaction price between the promised goods and services and the option (i.e., the material right that is a performance obligation), telecom entities need to determine the option's standalone selling price. The standard provides an alternative to estimating the standalone selling price of an option. Under this alternative, a portion of the transaction price is allocated to the option by reference to the total goods or services expected to be provided to the customer (including expected renewals) and the corresponding expected consideration. The standard indicates that this alternative generally applies to options for contract renewals.

The following illustration depicts the use of the alternative approach and the accounting for a nonrefundable up-front activation fee determined to be a material right:

#### **Illustration 1 – Nonrefundable up-front fees**

A customer brings his own device and signs a month-to-month wireless contract with a telecom entity and is required to pay both a nonrefundable up-front activation fee of \$50 and a monthly service fee of \$40. At the end of each month, the customer can renew the contract for an additional month without paying an additional activation fee. The monthly service fee upon renewal is \$40. For purposes of this illustration, assume this is the current market rate and it does not change during the period for which the customer retains service. The telecom entity's activity of setting up the customer account does not transfer any service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the up-front activation fee again at renewal, the telecom entity is effectively providing a discounted renewal rate to the customer.

The telecom entity determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged for new customers, and therefore, it is a separate performance obligation. Based on its experience, the telecom entity determines that its customers, on average, renew their initial one-month contracts for 35 more months before terminating their service. As a result, the telecom entity determines that the option provides the customer with the right to 35 monthly renewals at a discounted price.

The telecom entity may allocate the transaction price between the initial month of service and the renewal option by "looking through" to the optional goods and services using the practical alternative provided in Accounting Standards Codification (ASC) 606-10-55-45. The telecom entity would determine that the total hypothetical transaction price (solely for the purpose of allocating the transaction price to the option) is the sum of the up-front fee plus three years of service fees (i.e., \$50 + \$1,440) and would allocate that amount to all of the services expected to be delivered, or 36 months of service (or \$41.39 per month). Therefore, the total consideration in the contract of \$90 would be allocated to the one month of service (\$41.39) with the remaining amount being allocated to the renewal option (i.e.,  $\$90 - \$41.39 = \$48.61$ ). The amount allocated to the renewal option (\$48.61) would be recognized as each of the 35 renewal periods is either exercised or forfeited.

It is important to note that the calculation of total expected consideration (i.e., the hypothetical transaction price), including consideration related to expected renewals, is only performed for purposes of allocating a portion of the hypothetical transaction price to the option at contract inception. It does not change the enforceable rights or obligations in the contract. It also does not affect the actual transaction price for the wireless services that the telecom entity is presently obligated to transfer to the customer (which would not include expected renewals).

In a longer, fixed-term contract, the activation fee may be insignificant compared with the total transaction price. In these cases, based on quantitative and qualitative considerations, it may be less likely that a telecom entity will determine there is a material right. Regardless of whether there is a material right in the contract, the activation or installation fee is included in the total transaction price that is allocated to the performance obligations in the contract.

## Contract modifications

A contract modification is a change in the scope and/or price of a contract. Individual and enterprise telecom customers frequently add or remove services. For example, wireless customers may add or remove lines from a shared plan or add or remove services. The standard requires certain modified contracts to be treated as entirely new contracts (either a separate standalone contract or termination of the existing contract and the creation of a new contract) and others to be considered as part of the original contract. The accounting depends on whether the modification results in the addition of distinct goods or services and whether the amount of consideration expected for those goods or services reflects their standalone selling price.

The standard indicates that an entity may have to account for a contract modification before the parties sign a final modification agreement. For example, a telecom entity may verbally agree to modify a contract with an enterprise customer and begin providing the services under the modified terms but may not sign a final agreement (due to negotiations on pricing) for several months. The standard focuses on the enforceability of the changes to the rights and obligations in the contract instead of on the finalization of a modified agreement. Once the entity determines that the revised rights and obligations are enforceable, the entity should account for the contract modification.

### How we see it

Accounting for contract modifications is a significant issue for telecom entities. That's because customers frequently modify their contracts and can choose from a wide variety of product and service offerings.

Many modifications to telecom agreements are accounted for prospectively as either a new contract or a termination of the existing contract and the creation of a new contract because they will likely result in the addition of distinct goods and/or services. However, telecom entities should carefully analyze contract modifications to appropriately account for them.

### Effect on contract assets

Telecom entities may question how to account for contract assets (resulting from the transfer of a subsidized handset in advance of having an unconditional right to consideration from the customer for the service contract) when a contract is modified. When the modification is treated as the termination of an existing contract and the creation of a new contract, we believe it is appropriate to carry forward the related contract asset because the asset relates to a right to consideration for goods and services that have already been transferred and are distinct from those to be transferred in the future.<sup>4</sup> As such, the revenue recognized to date should not be reversed, and the contract asset should continue to be realized as amounts become due from the customer and are presented as a receivable. The contract asset that remains on the entity's balance sheet at the date of modification would continue to be subject to evaluation for impairment in accordance with ASC 310 or ASC 326 (if adopted).

We believe a similar conclusion would be appropriate when accounting for an asset created under ASC 340-40,<sup>5</sup> such as a capitalized commission, which exists immediately before a contract modification that is treated as if it were a termination of the existing contract and creation of a new contract. Refer to the *Contract costs* section below for additional discussion about capitalized contract costs.

### Estimating the standalone selling price of goods and services

Telecom entities often sell bundled products and services (e.g., wireless service and handsets, wireline triple-play packages, enterprise solutions). They need to estimate the standalone selling prices of the goods and services to allocate the transaction price to each performance obligation. While many telecom goods and services are sold separately, their prices may differ due to competition, state regulation, distribution methods (e.g., selling to resellers or dealers

versus directly to the end customer) or class of customer. Selling prices also change frequently because of the introduction of new technologies and competitive market factors. Telecom entities need to consider these factors, as well as other market and entity-specific factors, when determining the standalone selling prices of their goods and services.

The selling price of telecom bundled goods and services is often less than the sum of the standalone selling prices of the individual components. Telecom entities should assess whether the discount inherent in the bundle is promotional in nature (e.g., introductory pricing for the first three months). If the discount is promotional in nature, the discount would be allocated proportionately to all of the separate performance obligations in the bundle.

While this is not explicit in the standard, we anticipate that a single good or service could have more than one standalone selling price. That is, the telecom entity may sell goods or services at different prices to different customers. Depending on the facts and circumstances, a telecom entity may need to stratify its analysis to determine the standalone selling price for each class of customer (e.g., customers by wireless plan), geography and/or market.

In addition, we believe it is reasonable for a telecom entity to use a range of prices to estimate the standalone selling price of a good or service. That is, we do not believe that an entity would be required to determine a point estimate for each estimated standalone selling price if a range is a more practical means of estimating the standalone selling price for a good or service. While the standard doesn't address ranges of estimates, using a range of prices would not be inconsistent with the objective of the standard, which is to allocate the transaction price to each performance obligation in "an amount that depicts the amount of consideration for which the entity expects to be entitled in exchange for transferring the promised good or service to the customer."<sup>6</sup> The only requirements in the standard are that an entity maximize its use of observable inputs and apply the estimation approaches consistently. The use of a range would be consistent with these principles as well.

If the telecom entity has established a reasonable range for the estimated standalone selling prices and the stated contractual price fell within that range, it may be appropriate to use the stated contractual price as the standalone selling price in the allocation calculation. However, if the stated contractual price was outside of the range, the standalone selling price would need to be adjusted to a point within the established range in order to allocate the transaction price on a relative standalone selling price basis. In these situations, the entity would need to determine which point in the range is most appropriate to use (e.g., the midpoint of the range or the outer limit nearest to the stated contractual price) when performing the allocation calculation. We believe entities should establish a policy regarding the point in the range that will be used (e.g., low point, midpoint) and apply that policy consistently.

While the use of a range may be appropriate for estimating the standalone selling price, we believe that some approaches to identifying this range do not meet the requirements of the guidance. For example, it wouldn't be appropriate for an entity to determine a range by estimating a single price point for the standalone selling price and then adding an arbitrary range on either side of that point estimate or by taking the historical prices and expanding the range around the midpoint until a significant portion of the historical transactions falls within that band.

## **Variable consideration and options for additional goods or services**

Telecom network backhaul and enterprise service contracts often contain usage-based fees (e.g., price per gigabyte of data used). Telecom entities need to exercise judgment in distinguishing between contracts that contain an option to purchase additional goods or services and contracts that include variable consideration based on a variable quantity. This determination is important because it affects the accounting for the contract at inception and throughout the life of the contract, as well as disclosures.

Telecom entities have found it challenging to distinguish between a contract that includes customer options to purchase additional goods and services and one that includes variable consideration based on a variable quantity (e.g., a usage-based fee) because, under both types of contracts, the ultimate quantity of goods or services to be transferred to the customer is often unknown at contract inception.

While the standard does not explicitly address how entities should distinguish between contracts with optional purchases and contracts with variable consideration, entities should first identify the nature of the promises in the contract as well as the rights and obligations of the parties.<sup>7</sup> If the telecom entity concludes the variable quantity of services provided (e.g., gigabytes of data) represents customer options, the telecom entity would not be obligated to provide the additional goods and services until the customer makes a separate purchasing decision (i.e., exercises the option). If that option is not a material right, there is no accounting for the option and no accounting for the underlying goods or services until those subsequent purchases occur.

In contrast, if the telecom entity concludes the usage-based fee represents variable consideration, the telecom entity would be presently obligated to transfer all the goods and services requested by the customer. Therefore, an entity would have to estimate at contract inception the variable consideration expected over the life of the contract and update that estimate each reporting period. Refer to the *Contract duration* section above for additional discussion of determining the appropriate contract duration under the standard.

Certain telecom contracts may include volume discounts or rebates that are offered to customers based on a variable quantity (e.g., the use of data). Telecom entities may question whether a volume rebate or discount represents an optional purchase or variable consideration. Generally, if a volume rebate or discount is applied prospectively, we believe the rebate or discount would be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate program affect the price of future purchases. Telecom entities need to evaluate whether the volume rebate or discount provides the customer with an option to purchase goods or services in the future at a discount that represents a material right (and is therefore accounted for as a performance obligation).

However, we believe a volume rebate or discount that is applied retrospectively should be accounted for as variable consideration. This is because the final price of each good or service sold depends on the customer's total purchases subject to the rebate program. That is, the consideration is contingent upon the occurrence or nonoccurrence of future events. This view is consistent with Example 24 in the standard.<sup>8</sup>

## Contract costs

### Costs to obtain a contract

ASC 340-40 cites sales commissions as a type of incremental cost to obtain a contract that may require capitalization. For example, commissions that are related to sales from contracts signed during the period may represent incremental costs that require capitalization. The standard does not explicitly address considerations for different types of commission programs, so telecom entities have to exercise judgment to determine whether sales commissions are incremental costs and, if so, the point in time when the costs should be capitalized. For example, variable commissions, commissions paid for contract renewals or modifications, commissions paid to supervisors and commissions not directly linked to any single contract (e.g., commissions based on reaching a specified level of sales overall) may require additional analysis.

Neither ASC 340-40 nor the standard amended US GAAP liability guidance.<sup>9</sup> Therefore, telecom entities should first refer to the applicable liability standard to determine when they are required to accrue for certain costs. Entities would then use the guidance in ASC 340-40

Judgment is required to distinguish between optional purchases and variable consideration.



to determine whether the related costs need to be capitalized. Certain aspects of the cost guidance require entities to apply significant judgment to analyze the facts and circumstances and to determine the appropriate accounting.

### **Costs to fulfill a contract**

Telecom entities typically incur significant costs related to the setup, installation and activation of equipment for customer contracts. These entities need to first determine whether the installation activity is eligible for capitalization under other US GAAP (e.g., property, plant and equipment, intangibles). If it is not eligible for capitalization under other US GAAP, entities need to determine if the activity meets the definition of a separate performance obligation, in which case, the costs associated with the installation performance obligation likely are expensed as incurred because those costs likely do not generate or enhance resources of the entity that will be used in satisfying a performance obligation in the future.

If the setup, installation or activation activities do not transfer a good or service to the customer, telecom entities need to evaluate whether the costs to fulfill the contract are required to be capitalized. In addition to direct labor and material costs, examples of capitalized costs in ASC 340-40 also include the allocation of costs such as management and supervision, insurance and depreciation of the tools and equipment used to fulfill the contract. Telecom entities therefore have to exercise significant judgment to identify all of the costs that should be capitalized and determine whether they meet the criteria for capitalization, including whether the costs generate or enhance resources of the entity that will be used in satisfying future performance obligations. Costs that give rise to an asset must continue to be recoverable throughout the contract period (or period of benefit, if longer) to meet the criteria for capitalization, and therefore, any assets recorded by telecom entities are subject to an impairment assessment at the end of each reporting period.

### **Amortization of capitalized costs**

The standard requires that any capitalized contract costs be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. In doing this, a telecom entity must determine whether the capitalized contract costs relate only to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract. For example, if a telecom entity pays a commission based only on the initial contract and doesn't expect a renewal (e.g., based on its past experience or other relevant information), amortizing the asset over the initial term would be appropriate.

The amortization period could also extend beyond the initial contract term if the capitalized costs relate to a specific anticipated contract, such as when the customer is expected to renew its current telecom services contract for another term. In this situation, the capitalized costs should be amortized over the period that is consistent with the transfer of goods or services to which the asset relates.

Telecom entities need to apply judgment to determine the amortization period for capitalized contract costs. While a telecom entity might reasonably conclude that its average customer life is the best estimate of the amortization period consistent with the transfer of services to which the asset relates (e.g., if the service does not change over time), this approach is not required, and entities should not default to it.<sup>10</sup> When determining the amortization period, telecom entities should consider their current practice for estimating the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination), customer "stickiness" and how quickly their products and services change.

Telecom entities need to apply judgment to determine the amortization period for capitalized contract costs.

### ***Sales commissions for contract renewals***

When evaluating whether the amortization period for a sales commission extends beyond the contract period, a telecom entity should also evaluate whether an additional commission is paid for subsequent renewals. Amortizing the asset over a longer period than the initial contract would not be appropriate if a telecom entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. Alternatively, if the telecom entity's past experience indicates that a contract renewal is likely, the amortization period would be longer than the initial term if the renewal commission is not commensurate with the initial commission. Commissions should be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate.<sup>11</sup>

#### **How we see it**

An entity that pays smaller commissions to employees for renewals than for initial contracts is likely to amortize the initial contract's capitalized costs over a period longer than the initial contract term.

Telecom entities need to make sure they have appropriate systems, policies and procedures, and internal controls in place to identify, collect and amortize these costs and test any resulting assets for impairment at each reporting period.

## **Other considerations for telecom arrangements**

### **Payments made to dealers**

Wireless entities frequently sell service contracts to customers through the indirect sales channel (i.e., dealers). Generally, wireless entities make payments to the dealers when they sign up a new customer. There is no one-size-fits-all approach to accounting for these dealer payments. It depends on the nature of the dealer payment and terms of the arrangement. For example, if the dealer is not the customer in the arrangement (e.g., dealer purchases handsets from the original equipment manufacturer), the dealer payment may represent a commission that is capitalized as a cost to obtain a contract. If the dealer is a customer in the arrangement (e.g., the dealer purchases handsets from the wireless entity), the entity needs to carefully evaluate the terms of the dealer payment to determine whether some or all of the payment represents consideration payable to a customer. In this case, the wireless entity needs to determine whether the consideration payable to a customer (e.g., the dealer) is a reduction of the transaction price of the handset or a payment for a distinct good or service. Judgment likely is needed to perform this evaluation.

#### **How we see it**

Under the revenue standard, wireless entities should carefully evaluate all of the facts and circumstances of an indirect channel arrangement to determine the appropriate accounting for payments made to dealers. Generally, indirect channel arrangements vary by entity and across geographies. As a result, wireless entities may account for payments made to dealers in a different manner based on the terms and conditions of the indirect channel arrangement.

### **Customer premise equipment**

Telecom entities often provide customer premise equipment (CPE) such as set-top boxes and gateways (e.g., modems, routers) in conjunction with telecom services. Entities first have to determine whether the right to use the CPE is a lease. If CPE that is used to provide telecom services to a customer does not meet the definition of a lease, then the arrangement is

accounted for under the revenue standard. A telecom entity then needs to determine whether the CPE is distinct from the other promised goods and services in the telecom contract and, therefore, a separate performance obligation. If the CPE is not distinct, the telecom entity should combine the CPE with the other promised goods or services (e.g., monthly telecom services) in the arrangement.

A contract that contains a lease of CPE might still be accounted for under the revenue standard if a telecom entity meets the criteria for and elects the lessor practical expedient to not separate lease and non-lease components under ASC 842, *Leases*, and concludes the non-lease component (i.e., the telecom services) is the predominant component.<sup>12</sup> In this case, the telecom entity is required to account for the combined component (i.e., the CPE and telecom services) as a single performance obligation under the revenue standard.<sup>13</sup> Refer to our Technical Line, [How the new leases standard affects telecom and media and entertainment entities](#), for further information.

### Free goods or services

Telecom entities frequently offer free goods and services as an inducement for customers to enter into contracts (e.g., free tablets or TVs, free months of service, free subscriptions). Although an entity might not consider those goods or services to be the main items the customer contracts to receive, the Financial Accounting Standards Board (FASB) concluded that they are goods or services the customer pays for, and the entity should evaluate whether they are separate performance obligations.

The standard allows entities to disregard promises that are deemed to be immaterial in the context of the contract. When evaluating whether a promised good or service is immaterial, an entity should consider the relative significance or importance of the good or service in the context of a contract as a whole. In doing so, entities need to consider both quantitative and qualitative factors, just as they do when considering materiality in other areas of GAAP. If an entity determines that multiple goods or services are individually immaterial in the context of a contract, it has to further assess the collective significance of those goods or services before concluding it is appropriate to consider them all immaterial in the context of the contract. This is because those individual immaterial items may be material in the aggregate to the contract.

Sometimes another party is involved in providing the free goods or services. When a telecom entity concludes these free goods or services are separate performance obligations (i.e., they are not immaterial in the context of the contract), it then needs to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services. Significant judgment may be required to make this assessment. Some questions a telecom entity may consider when making this judgment about free goods or services that involve another party could include:

- ▶ Who will the customer hold responsible for the acceptability of the good or service (e.g., handling of complaints)?
- ▶ Who has discretion in establishing the price for the good or service (e.g., setting the floor or ceiling)?
- ▶ Who has title to the goods, if applicable? Does the telecom entity purchase the goods or services in advance? Is the telecom entity otherwise committed to purchase a minimum amount of goods or services?

Telecom entities are required to disclose significant judgments in the application of the standard.

## Presentation and disclosures

### Presentation of contract assets and contract liabilities

Telecom entities record contract assets and liabilities depending on their customary business practices (e.g., handsets sold at subsidized prices, advanced billings, bill cycles off month-end). The standard requires that an entity present contract assets and liabilities in the statement of financial position. Contract assets and liabilities should be determined at the contract level and not at the performance obligation level.<sup>14</sup> That is, an entity would not separately recognize an asset or liability for each performance obligation within a contract but would aggregate them into a single contract asset or liability.

Under the standard, entities are not required to use the terms “contract asset” or “contract liability” but must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (e.g., receivables) and conditional rights to receive consideration (e.g., contract assets, unbilled receivables). Telecom entities need to provide information regarding contracts that typically generate a contract asset (e.g., when an entity sells a subsidized phone with a two-year service agreement) or a contract liability (e.g., customer prepayments for wireless or wireline services).

### Disclosure requirements

Telecom entities are required to provide a comprehensive and coherent set of disclosures about revenue from contracts with customers. For public entities, these disclosures include disaggregated revenues and qualitative and quantitative information about contracts with customers, significant judgments made in the application of the standard and costs to obtain or fulfill a contract. Nonpublic entities can choose to provide all of the disclosures required for public entities or to provide reduced disclosures.

Disaggregated revenue disclosures should reflect categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. When determining how to disaggregate revenue, a telecom entity should consider how information is presented for other purposes, including information presented outside the financial statements (e.g., investor presentations), information reviewed by the chief operating decision-maker to evaluate operating segments and other similar information used to evaluate the entity’s financial performance. This information may include type of services, type of customer (e.g., prepaid, postpaid, residential, enterprise), type of contract (e.g., month-to-month, fixed-term) and geographical location.

The standard clarifies that an entity does not have to duplicate disclosures required by another standard. For example, a telecom entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers are affected by economic factors and are presented on a basis consistent with US GAAP.

However, segment revenue disclosures may not always provide users of financial statements with enough information to help them understand the composition of revenue recognized in the period.<sup>15</sup> Under ASC 606-10-50-6, an entity is required to explain the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. Entities can provide this information in a tabular or a narrative form.

Qualitative and quantitative disclosures include information about performance obligations (e.g., handsets, services, CPE), contract assets and contract liabilities (e.g., a reconciliation of contract balances) and costs to obtain or fulfill contracts.

The standard also requires disclosure of significant judgments and changes in judgments made in applying the revenue standard that significantly affect the amount and timing of revenue recognition. In particular, entities are required to disclose judgments and changes in judgments made in determining the transaction price, amounts allocated to performance obligations and the timing of satisfaction of performance obligations. For telecom entities, this may include information about estimating the standalone selling price of promised goods or services, estimating variable consideration, including application of the constraint, determining whether a customer option gives rise to a material right and allocating discounts to a specific part of a contract (e.g., allocating a discount to a discrete performance obligation within bundled arrangements).

The standard also expands disclosure requirements for interim financial statements.

### Endnotes:

- <sup>1</sup> ASC 606, *Revenue from Contracts with Customers*.
- <sup>2</sup> 9 November 2015 Transition Resource Group (TRG) meeting; agenda paper no. 48.
- <sup>3</sup> ASC 606-10-55-340 through 55-342, *Example 50 – Option That Does Not Provide the Customer with a Material Right (Additional Goods or Services)*.
- <sup>4</sup> 18 April 2016 FASB TRG meeting; agenda paper no. 51.
- <sup>5</sup> ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.
- <sup>6</sup> ASC 606-10-32-28, *Allocating the Transaction Price to Performance Obligations*
- <sup>7</sup> 9 November 2015 TRG meeting; agenda paper no. 48.
- <sup>8</sup> ASC 606-10-55-216 through 55-220, *Example 24 – Volume Discount Incentive*.
- <sup>9</sup> 26 January 2015 TRG meeting; agenda paper no. 23.
- <sup>10</sup> 7 November 2016 FASB TRG meeting; agenda paper no. 57.
- <sup>11</sup> 7 November 2016 FASB TRG meeting; agenda paper no. 57.
- <sup>12</sup> ASC 842-10-15-42A through 15-42B.
- <sup>13</sup> ASC 842-10-15-42B.
- <sup>14</sup> 31 October 2014 TRG meeting; agenda paper no. 7.
- <sup>15</sup> Paragraph BC340 of Accounting Standards Update 2014-09, *Revenue from Contracts with Customers*.

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## Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

<b>Step 1: Identify the contract(s) with the customer</b>
<p><b><i>Definition of a contract</i></b></p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> <li>▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations</li> <li>▶ The entity can identify each party's rights regarding the goods or services to be transferred</li> <li>▶ The entity can identify the payment terms for the goods or services to be transferred</li> <li>▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract)</li> <li>▶ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer</li> </ul> <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p><b><i>Contract combination</i></b></p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> <li>▶ The contracts are negotiated as a package with a single commercial objective</li> <li>▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract</li> <li>▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation</li> </ul> <p><b><i>Contract modifications</i></b></p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> <li>▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract</li> <li>▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract</li> <li>▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services</li> </ul>

**Step 2: Identify the performance obligation(s) in the contract**

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- ▶ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- ▶ The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

***Series guidance***

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

***Customer options for additional goods or services***

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

***Principal versus agent considerations***

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its

role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- ▶ The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- ▶ The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- ▶ The entity has discretion in establishing the price for the specified good or service

### Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

#### ***Variable consideration***

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

#### ***Significant financing component***

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

#### ***Noncash consideration***

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

#### ***Consideration paid or payable to the customer***

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity or equity instruments granted in conjunction with selling goods or services. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.



**Step 4: Allocate the transaction price to the performance obligations in the contract**

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

**Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation**

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

### Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ **Functional:** This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. However, we expect licenses of functional IP to meet the criteria to be recognized over time infrequently, if at all.
- ▶ **Symbolic:** This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

### Contract costs

ASC 340-40 specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. ASC 340-40 cites commissions as a type of incremental costs that may require capitalization. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
- ▶ The costs are expected to be recovered

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.