Working Draft:

Telecommunications Revenue Recognition Implementation Issue

Issue #15-5– Considering the effect of the time value of money

Expected Overall Level of Impact to Industry Accounting:
Moderate

Wording to be Included in the Revenue Recognition Guide:

Time Value of Money

1. FASB ASC 606-10-32-15 indicates that if a contract provides the customer or the entity with a significant benefit of financing the transfer of goods or services, the contract has a significant financing component, and the promised consideration should be adjusted to reflect the effect of the time value of money.

2. As discussed in FASB ASC 606-10-32-16, the objective when adjusting the promised consideration for a significant financing component is for an entity to recognize revenue at an amount that a customer would have paid for the promised good or service if the customer had paid for those goods and services when delivered (i.e. the cash selling price). In making the determination as to whether a significant financing component exists *all relevant facts and circumstances should be considered*, including the following factors:
    a. Whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred.
    b. The combined effect of both of the following:
        (1) The expected length of time between the transfer of the promised goods or services to the customer and the customer's payment; and
        (2) The prevailing interest rates in the relevant market.

3. FASB ASC 606-10-32-17 further states that an arrangement would not have a significant financing component if any of the following factors exist:
    a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity.
c. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

4. FASB ASC 606-10-32-18 explains that, as a practical expedient, the amount of promised consideration need not be adjusted if the entity expects, at contract inception, that the period of time between when the entity transfers goods or services and the time when the customer pays for the goods or services is less than one year.

5. BC231 of FASB ASU 2014-09 provides clarification that the guidance on identifying a financing component should not be based only on whether the payment is due either significantly before, or significantly after, the transfer of goods or services to the customer. As such, FASB ASC 606-10-32-15 explains that an entity should only adjust for financing if the timing of payments provides either the customer or the entity with a significant benefit of financing.

6. If a Company determines there is a financing component, the Company would then determine if the financing component is significant. As noted in paragraph BC234 of FASB ASU 2014-09, entities should consider the significance of a financing component at a contract level rather than considering whether the financing is material at a portfolio level or at an individual performance obligation level.

7. However, FASB ASC 606 and the Basis for Conclusions of ASU 2014-09 do not provide a definition for "significant" nor do they provide any bright-lines or safe harbors. Consequently, as discussed in FASB ASC 606-10-32-16, the determination will depend on the relevant facts and circumstances of the arrangements, and will require judgment. The determination of whether a significant financing component exists in a contract may differ between type of contracts, segments and companies based on the facts and circumstances pertaining to the contract.

8. Entities should consistently evaluate the quantitative and qualitative factors of each of their arrangements as they are entered into to determine whether there are financing components, and if so, whether those financing components are significant. The evaluation might include the following:
   a. the length of the contract;
   b. the intent of their marketing and promotional offers; and
   c. the reason for differences in timing between the delivery of goods and services and payment for those goods and services.
9. As discussed in FASB ASC 606-10-32-16, the objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the cash selling price. BC239 of FASB ASU 2014-09 indicates that the discount rate to be used when adjusting consideration for a financing component would not simply be a risk-free rate. BC239 also explains that the Board noted it would not be appropriate to simply use a rate explicitly specified in the contract as an entity may use "cheap" or below-market financing as an incentive. Therefore, the rate to be used, as discussed in BC239, is the discount rate that would be reflected in a separate financing transaction between the entity and its customer at the inception of the contract.

10. Many telecommunication entities may not enter into lending-only contracts with their customers. As such, the entity may need to consider other information such as the rates other consumer lending entities are charging customers, the differences in the credit quality of customers, and the rate implicit in the contract among other data points. If the use of a rate commensurate with lending-only transactions would result in an amount of revenue being recognized that is different than the cash selling price, FinREC believes that further consideration will likely be necessary in order to determine if an agreement contains a significant financing component.

11. While the objective indicates that the intent is for an entity to recognize revenue at an amount that reflects the cash selling price, a comparison of the cash selling price to the contract price is not the sole determination of whether a contract contains a financing component. A contract does not necessarily contain a significant financing component in every situation where the cash selling price does not equal the promised consideration and, conversely, an entity should not conclude in every situation where the cash selling price is equal to the promised consideration that there is no financing component. At its March 2015 meeting, the FASB/IASB Joint Transition Resource Group for Revenue Recognition (TRG) discussed how to determine when the difference between promised consideration and cash selling price is not related to a significant financing component. TRG members agreed that there is no presumption in the standard that a significant financing component exists or does not exist when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid, or when there is a zero interest rate such that the cash price equals the total consideration to be received over the period of the arrangement, and an entity will need to apply judgment to determine whether the payment terms are providing financing or are for another reason[1].

12. FASB ASC 606-10-32-20 states that the effects of a financing should be presented separately from revenue from contracts with customers in the statement of comprehensive income. However, as stated in BC247 of FASB ASU 2014-09, the standard does not preclude an entity from presenting interest as a type of revenue if the interest represents income from the entity's ordinary activities. BC247 indicates that banks and other entities with similar types of operations are examples of entities for which interest income may be included as a type of revenue.

13. If the provision of financing to customers is common and part of a telecommunication entity's ordinary activities, a Company may determine that interest income could be presented with other revenues (for example, as "interest revenue"); however, this assessment would depend on the facts and circumstances pertaining to the entity.

14. The standard does not provide explicit guidance regarding how to apply the significant financing component guidance when there are multiple performance obligations, including how to calculate the financing component and how to allocate. Due to the lack of explicit guidance, questions regarding the allocation were raised for discussion at the March 2015 TRG meeting. In TRG Agenda Ref 30, *Significant Financing Components*, Question 6, the FASB staff explains that, in Step 3 of the revenue model, the transaction price should be adjusted for the effect of financing, since the financing component is in exchange for financing rather than in exchange for promised goods or services. After determining the transaction price, adjusted for any financing components, an entity would allocate the transaction price to the performance obligations in Step 4 of the revenue model. For example, if the total consideration in a contract is $700 and an entity determines the interest component is $65, then the transaction price to be allocated to the performance obligations is $635.

15. As noted in paragraph 38 of TRG Agenda Ref 34, *March 2015 Meeting – Summary of Issues Discussed and Next Steps*:

> As it relates to Issue 6, the standard is clear that when determining the transaction price, the effect of financing is excluded from the transaction price prior to the allocation of the transaction price to performance obligations. TRG members agreed with the staff view that it may be reasonable in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. Some TRG members agreed that, practically, this might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount.

16. If there are multiple performance obligations in a contract with a significant financing component and certain criteria are met in FASB ASC 606-10-32-37 and ASC 606-10-32-40, an entity may then be able to allocate this significant financing component to one or more performance obligations as opposed to all performance obligations.

17. Although there is also no specific guidance relating to the calculation of the financing components when there are multiple performance obligations, the TRG has not addressed this question. As such there may be more than one allowable method.

[1] See paragraph 34 of in TRG Agenda Memo No. 34, *March 2015 Meeting – Summary of Issues Discussed and Next Steps*.

18. While significance should be determined at an individual contract level, an entity may consider using a portfolio approach when accounting for significant financing components as long as the entity reasonably expects that the effects on the financial statements would not differ materially from applying the guidance to the individual contracts within that portfolio as further discussed in Issue 15-1, *Portfolio Accounting*.

19. The following examples are meant to be illustrative, and the actual determination of the existence of a significant financing component in the contract should be based on the relevant facts and circumstances of an entity's specific situation as noted in FASB ASC 606-10-32-16.

20. **Example 1:** The purpose of this example is to illustrate a situation where the cash selling price is lower than the price paid over time and how the determination of whether the financing component is significant may be performed.

    A customer enters into a contract for wireless service and purchases a device. The customer has the option to pay $600 upfront and sign a month-to-month service contract for $60 a month, or remit $0 upfront and sign a two-year installment note for $710 and a month-to-month service contract for $60 a month. In both cases, the customer will pay an activation fee of $50. There are no stated interest rates or separate interest charges.

    Does this arrangement contain a significant financing component?

    The entity should consider all relevant facts and circumstances of this arrangement to determine whether the contract has a significant financing component, including but not limited to:

    - Whether the amount of consideration would be different if the customer paid cash when the goods or services were transferred.

      In this example, the customer would either pay a total of $2,090 ($600 + 24*$60 + $50) if they elected to pay $600 upfront or $2,200 ($0 +$710+$60*24 + $50). In this case, the customer is paying $110 more if they pay for the device over the two year term as opposed to upfront.

    - The combined effect of:
      - o The expected length of time between the transfer of the promised goods or services to the customer and the customer's payment:

        The customer has the option to remit payment for the device upfront or over 24 months. As the length of time between transfer of goods and payment (customer received device at initial transaction) is greater than one year, the practical expedient for contracts of duration of less than one year is not applicable.

      - o The prevailing interest rates in the relevant market.

        Although there is no stated interest rate, the Service Provider considers what the prevailing interest rates would be in the relevant market, which may include, but not limited to, consideration of the duration of the contract, the geographic market, the total amounts and the credit quality of the customer. For example, a Service Provider may consider that other institutions are lending to prime customers in their geographic market with rates of 10% for consumer purchases of less than $10,000.

    - Other factors - Additional factors to consider may include the following and other:
      - o Those factors included in FASB ASC 606-10-32-17, listed below, which if present indicate that there is not a significant financing component according to the standard:

    - The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
    - A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).
    - The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.
  - Whether there is a discount in one or both of the payment options available to the customer; or
  - Whether the payment options are typical within the industry or jurisdiction and have a primary purpose other than financing, such that the primary purpose of the payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, as described in paragraph BC 233(c) of FASB ASU 2014-09.

As the customer is able to pay for their device over time and there is no difference in the timing of the transfer of the goods and services between the payment options (upfront or over time), the Service Provider would likely conclude that financing has been provided to the customer. If so, the Service Provider would need to determine if the financing is a significant component in the contract. In order to determine the significance, the Service Provider would consider the differences in pricing, whether there is any variable consideration, and if there are any other reasons for the difference in pricing. Additionally, the Service Provider should consider the cash selling price, the rate implicit in the contract and prevailing interest rates with customers of similar credit quality to determine an appropriate discount rate in order to calculate the amount of consideration adjusted for the financing. There is not a description in the standard or the Basis for Conclusions of FASB ASU 2014-09 of what is meant by relevant market. Therefore, FinREC believes that the Service Provider may consider the rate implicit in the arrangement (which would result in revenue being recognized in an amount equal to the cash selling price consistent with the standard's objective as stated in ASC 606-10-32-19), as a potential way to determine the discount rate if it is consistent with a lending-only rate; however, as noted above, in situations where the implicit rate is not commensurate with lending only rates, the Servicer Provider may need to consider adjustments to the implicit rate or other available information. The Service Provider may conclude that $110 represents the financing component of the contract, noting that adjusting the transaction price by this amount will meet the objective of recognizing revenue at an amount equal to the cash selling price.

The Service Provider would then need to determine if the financing component was significant to the individual contract. In the scenario above, if the Service Provider determined that the difference was only due to financing, the financing benefit of $110 compared to the total expected proceeds of $2,200 would equate to 5%, which after considering all quantitative and qualitative factors may or may not be significant to the individual contract.

If the financing component of $110 is deemed to be significant, the Service Provider would adjust the total transaction price by the $110. If there are multiple performance obligations in a contract and certain criteria are met in paragraphs FASB ASC 606-10-32-37 and ASC 606-10-32-40, an entity may be able to allocate this significant financing component to one or more performance obligations as opposed to all performance obligations.

21. **Example 2:** The purpose of this example is to illustrate the evaluation of a situation where the cash selling price is equal to the price paid over time.

A customer may purchase the device upfront for $600 and will then be eligible to purchase service for $50 each month under a month-to-month service contract. If, instead, the customer decides to pay $0 for their device on day one, they have the option of signing a two year contract and paying $75 a month for the device and service.

Competitors and other retailers of consumer products within the market offer similar arrangements to their customers.

Does this arrangement contain a significant financing component?

The entity should consider all relevant facts and circumstances around this arrangement in determining whether the contract has a significant financing component, including:

- Whether the amount of consideration would be different if the customer paid cash when the goods or services were transferred.

  In this example, there is no difference between the price the customer would pay if they paid upfront when the device was delivered or if they remit payment for the device over a period of 24 months.

- The combined effect of both of the following:
  - The expected length of time between the transfer of the promised goods or services to the customer and the customer's payment.

    In this example, the customer has received the device but has not made an initial payment. The customer will be able to pay for the device over a 24 month period of time. Consistent with the previous example, the Company may not apply the practical expedient as the payment term is greater than 1 year.

  - The prevailing interest rates in the relevant market.

  There is no stated interest rate in the agreement. When considering the financing component, the Company would not merely consider the stated interest rate but also assess what the prevailing interest rates are in the relevant market, which may include consideration of the duration of the contract, the total amounts and the credit quality of the customer.

- Other factors, such as those listed above found in FASB ASC 606-10-32-17.

Consistent with FASB ASC 606-10-32-16, BC230 of FASB ASU 2014-09 states that the objective of adjusting the promised amount of consideration for the effects of a significant financing component is to reflect, in the amount of revenue recognized, the 'cash selling price'[2] of the underlying good or service at the time the good or service is transferred.

Further, BC231 of FASB ASU 2014-09 notes that the Boards had considered whether the guidance should be based only on whether payment is due either significantly before, or significantly after, the transfer of goods or service; instead they agreed with respondents that this should not require entities to adjust for the time value of money when the parties did not contemplate a financing arrangement as part of the negotiated terms of the contract and the timing between the transfer of the goods or services and the payment is not due to a financing arrangement. The Board concluded that an entity should adjust for financing <u>only</u> if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing (emphasis added).

In this example, the "cash selling price" is the same as the amount of cash that would be remitted over the 24 month period. However, at the March 2015 TRG meeting, TRG members agreed that the guidance does not allow entities to assume that there is no financing component if the total amount of consideration to be received over the arrangement period is equal to the upfront cash selling price. All relevant facts and circumstances should be evaluated, including assessing whether the "cash selling price" truly reflects the price that would be paid absent the financing.

[2] The cash selling price as defined in paragraph ASC 606-10-32-16 is the price that the customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer).

After consideration of all relevant factors including, but not limited to, the fact that the imputation of interest would reduce the amount of revenue recognized to an amount below the cash selling price, the Service Provider may conclude that there is not a significant financing component in the agreement with the customer.

Alternatively, the Service Provider may conclude that there is a significant financing element in this arrangement irrespective of the fact that the cash selling price is the same as the price paid by the customer over time as the cash selling price alone is not a determinative factor. This may be due to the economic or competitive environment at the time the transaction was entered into (such as the absence of like offers in the market or notably higher rates being charged in lending only transactions with consumers), a view that the pricing structure provides a discount for committing to a 2-year service contract (vs. a month-to-month arrangement), or a conclusion that the customer considers the payment of the device over their two year service contract period with no interest to be a significant benefit.

Comments should be received by July 3, 2017, and sent by electronic mail to Desiré Carroll at desire.carroll@aicpa-cima.com, or you can send them by mail to Desiré Carroll, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.