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Ind AS Industry Insights- Telecommunications

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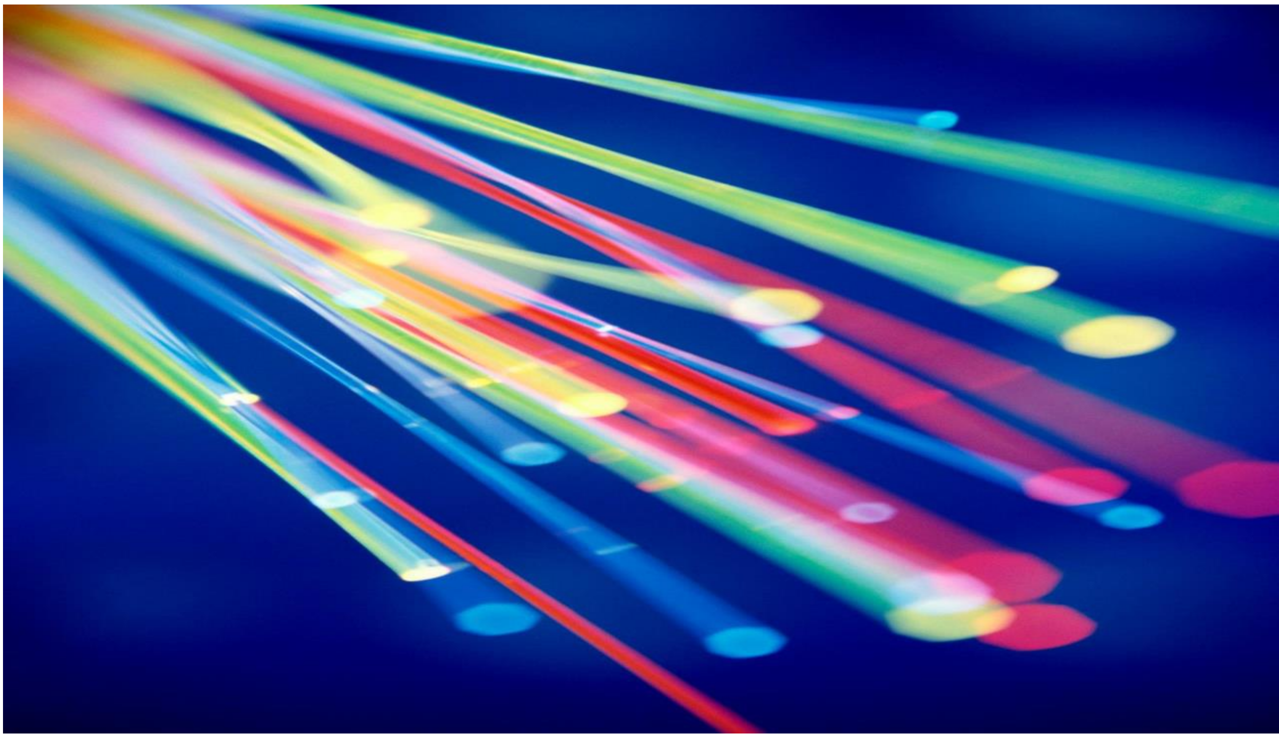

The bottom line

Ind AS represents a fundamental shift that will force many CFOs to play a larger role in setting standards for their organisations. Reporting under Ind AS will enhance the presentation of financial performance and balance sheet to investors and capital providers.

What's happened?

Ind AS are at par with global reporting standards and accordingly, the accounting principles adopted and the disclosures accompanying financial statements become even more important to investors, as they provide information about the decisions made regarding various accounting judgements made by the management in preparing financial statements. Needless to say, the impact of any fundamental change to an accounting framework has a much wider ramification on the company. Any transaction, from a routine sales transaction to corporate restructuring, needs to be narrated in an accounting language. So when that changes, the impact is pervasive.

Beyond the issue of rules versus principles, Ind AS also can pose particular technical accounting challenges to companies in the telecommunication industry. Some of the key areas impacting the telecommunication industry are highlighted below.

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A. REVENUE RECOGNITION

1) Streams of revenue for Telecom Company

i) Access charges and airtime usage charges- Revenue from post-paid service is recognized on an accrual basis over the period to which services relates. Unbilled revenue between the billing cycle and the end of each reporting date is accrued.

Revenue from prepaid service is recognized when the scratch card is used by the customer. Revenue from expired cards is recognized in the period of expiration. Generally where no expiry date exists, the revenue should continue to be deferred until the customer becomes inactive according to the prepaid agreement.

ii) Roaming revenue- A company recognizes roaming service revenue when the services are rendered. Revenues due from foreign carriers for international roaming calls on a company's network should be included in revenues in the period in which the call occurs.

iii) Interconnect fees- Interconnect fee is recognized in respect of call from abroad transitioning across the network of the company when the service is provided. The industry practice is to recognize revenues from interconnect arrangements on a gross basis despite the existence of net settlement arrangements and legal rights of offset. Care must be taken however to ensure that these specific contractual arrangements do not trigger revenue recognition on a net basis.

iv) Leased line revenue- Leased line revenue is generally recognized when the service is rendered. This is usually in accordance with a fixed contract and recognized on a monthly basis, net of discounts.

v) Connection fees- In determining the treatment of connection fees it is necessary to consider the type of contract entered into by the customer. Both pre pay and post-paid customers are considered connected to the network upon activation of the handset or SIM card.

It is generally not possible to demonstrate that the connection fee is in respect of a service which is operating independently from the service arrangement with the operator. Amount received will therefore need to be evaluated for contribution towards phone service and/ or equipment provided.

vi) Installation revenue- Revenue arising from the installation of network equipment is generally considered to be separable from service revenue and so recognized immediately on completion of the installation and after acceptance by the customer.

vii) Number portability- Where automated rerouting of ported numbers does not occur, any costs and revenues incurred in respect of number portability should be recognized net.

2) Multiple element arrangements/ bundled contract:

Many arrangements in a telecom industry involve multiple goods or services. A wireless operator typically sells a handset along with a wide range of wireless services or a managed services provider often sells equipment along with implementation, training, or maintenance services. These goods and services may be promised in a single contract or in separate contracts and may be explicitly stated in the contract or implied by a vendor's customary business practices or specific statements.

When an arrangement includes more than one component, it is necessary to account for the revenue attributable to each component separately. Ind AS provides guidance on evaluating the promised "goods or services" in a contract to determine each performance obligation.

a) Residual method can be used to allocate the consideration i.e. defer revenue for the fair value of all undelivered items and recognize the residual

b) Contractually stated prices should not be presumed to be representative of fair value.

An example relevant in this case is of sale of handset and wireless service, both of these represent separate performance obligations, since the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer. An entity should recognize the portion of the total contract consideration allocated to the handset when control of the handset is transferred to the customer on a relative standalone selling price basis.

3) Activation and SIM card fees

Initial fee in the form of Activation and SIM card fee, in substance, is wholly or partly an advance payment for future products or services. In this case, the upfront fee and the continuing performance obligation related to the services to be provided should be assessed on a combined basis.

In certain circumstances, upfront fees, even if non-refundable, may be 'earned' as the services are performed over the term of the arrangement, and may need to be deferred and recognized systematically over the periods that future services are performed.

4) Gross versus net accounting

An entity needs to consider legal form as well as substance of the transaction while presenting revenue and costs associated with the transaction.

In telecom sector, generally the company is just one of the parties involved in providing service to the end user. A telecom company having exposure to the significant risks and rewards of ownership associated with the sale of goods or rendering of services is acting as a principal and in the absence of such exposure, as an agent. Consideration received by telecom companies from customers relating to mobile content downloads and premium rate services generally can be recorded on a gross basis when the telecom company retains the risks and rewards associated with the content rights before it sells them to users. If the telecom company merely passes the consideration received to the content owner after taking its share, then it may be appropriate that the consideration received by the telecom company be recorded on a net basis representing only the gross margin on the transaction.

Indicators of gross revenue reporting

Strong Indicators	Questions to Ask
The company is the primary obligor in the arrangement	• Is the company responsible for the provision of service? • Is the customer contract with the company? • Is the company responsible for fulfilment?
The company has general inventory risk (before customer order is placed or upon customer return)	• Has the company purchased or committed to purchase the product or service before any customer orders have been taken? • Is the company exposed to the risks of damage, slow movement or obsolescence of inventory? • Is the company liable if the customer returns the product?
The company has latitude / freedom in establishing price	• Is the company able to determine the exact price at which the product or service is offered? • Is the company able to determine the pricing indirectly? • Is the company able to control the margins it receives?
The company has control over how the product or service is produced	• Does the company change the product or perform part of the service? • Does the company have discretion in supplier selection? • Is the company involved in the determination of product or service specifications? • Does the company have physical inventory risk?
The company has credit risk	• Is the company responsible for billing the customer, thus bearing the risk of customer default? • Does the supplier rely on the company's credit controls? • Does the company absorb the credit risk with no additional reward?
The company has reputation risk	• Is the product or service branded? • Can the customer look to the company for recourse for under-performance?

Following factors indicate that the entity may be acting as a principle in a transaction:

i. entity is primarily responsible for fulfilling the contract

ii. inventory risk is retained by the entity until the return of goods sold to the customer

iii. entity has a leeway in establishing prices for goods or services

iv. the entity is exposed to the credit risk for the amount receivable from the customer

To determine the appropriate accounting, telecom companies would need to consider the contractual terms of the arrangements as well as the entity's normal business practices.

5) Accounting for customer incentives

Telecom companies offer various incentives in the form of half price line rental, free initial period, and roll over minutes, additional services in the form of free minutes, etc.

If, in a contract, the company grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract. If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

In the initial period of customer relationship, half price line rental may be charged which is lesser than the fee which would normally be charged to the customer for the same service. In such case, total revenue for the reporting period is apportioned equally on a monthly basis and thus revenue recognition for an initial period of half price rental is more than the fees recovered from the customer for provision of service. A corresponding asset generally needs to be created for accrued income.

Revenue from roll over minutes is generally recognized as service is delivered and provision of service is not complete where minutes are carried over to the subsequent month. In this case revenue relating to unused minutes is normally deferred until following month.

6) Accounting for customer acquisition costs

As per Ind AS 38 *Intangible Assets,* for capitalization both definition as well as recognition criteria need to be met. Asset recognition is permitted when it is controlled by the entity and it is probable that there will be an inflow of future economic benefits attributable to the asset and that the cost of the asset is measurable reliably. The requirement that it is probable that the costs incurred will result in future economic benefits for the entity is likely to be met for costs that can be shown to be directly attributable to the obtaining of subscribers to the entity’s services and that would not otherwise have been incurred by the entity.

If the recognition criteria is met then the cost should be capitalized as an intangible asset and amortized over life of the customer. If these criteria are not met then the customer acquisition costs are more akin to marketing expense and should be expensed as incurred.

7) Indefeasible Right of Use (IRU) accounting

Indefeasible Rights of Use (IRU’s) are rights to use cables, fibres or capacity thereon; such rights are typically contractual and may take the form of capacity or service agreements or leases.

Certain points that may be considered in order to identify whether the IRU is a service contract or an operating lease would be:

1) What does the contract offer the acquirer?

2) Does the provider have to deliver a set amount of capacity, or does the provider deliver the network capability to obtain that capacity?

3) Is there a specified period in which the capacity is to be available?

4) Is the acquirer able to re-sell capacity for a charge or otherwise?

5) Who maintains the network and bears the risk of obsolescence?

6) Does the contract transfer legal ownership to the acquirer by the end of a specified term?

If the contract to sale IRU is identified to be a finance lease, revenue is recognized upfront. Revenue is deferred over a period of lease term and recognized on a straight-line method in case the contract is determined to be an operating lease or a service contract.

B. PROPERTY, PLANT AND EQUIPMENT

1) Costs incurred on testing of new network

Ind AS provides that administrative and general overheads cannot be capitalized and only costs that are directly attributable to bringing the item of Property, plant and equipment (PPE) in its working condition or location can be capitalized.

Generally network testing costs could be in the nature of cost directly attributable to bringing an asset to the present condition and location necessary for intended use and may be eligible for capitalization.

2) Componentization of assets- Determining what constitutes separate component

Ind AS requires that components, which are significant and have a significantly different useful life, should be depreciated separately.

Certain parts of an item of PPE of a telecom company may be individually significant and therefore depreciated separately from remainder of the item of equipment. Estimates of useful life and residual value and the method of depreciation are reviewed at least annually.

Following factors should be assessed at the minimum:

i) Comparison of the cost allocated to the item to the total cost of the aggregated PPE.

ii) Consideration of the potential impact of componentization on depreciation expense.

Following categories of assets can be considered for the purpose of determining components:

- Transmission Assets
  - Satellite
  - Fibre Optic
  - IP backbone
  - Cable Infrastructure
- Switching Assets
  - Time Division Multiplexing (TDM)
  - Next Generation Network (NGN)
- Network assets
  - Towers
  - Diesel generator set
  - Transmitters
  - Cablings and Circuits

3) Accounting for Asset Retirement Obligations (ARO)

Ind AS 37 provides that the provision for a liability should be the best estimate of the expenditure that would be required to settle the obligation as of the balance sheet date. This is the amount that an entity would pay to settle the obligation or to transfer the liability to a third party as of the balance sheet date. Although it will often be "impossible or prohibitively expensive" to transfer or settle the liability as of the balance sheet date, estimating that amount provides the best indicator of the expense required to settle the obligation at such time.

A telecom company should recognize ARO when an asset is initially installed. This is mainly relevant due to the significantly high amount of leasing contracts entered into by companies for network infrastructure site.

An ARO is the present value of the best estimate of future cost of dismantling/ removing the asset and is measured as the best estimate of the expenditure to settle the obligation or to transfer the obligation to a third party as of the balance sheet date. The provision is reviewed at each reporting date based on the best estimate of dismantling and asset removal cost.

The liability can be estimated using judgment supplemented by (1) a history of similar transactions, (2) information provided by third-party experts (in certain instances), and (3) additional information provided after the balance sheet date. When the time value of money would materially affect the outcome, Ind AS 37 provides that "the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation."

Changes in estimate may result from changes in amount or timing of outflows or changes in discount rate. The effect of changes in the existing provision, generally is added to or deducted from the cost of the asset and depreciated over the remaining useful life. Periodic unwinding of discount shall be recognized in profit and loss account as finance cost.

4) Towers and self-constructed assets

Ind AS 16 states that, if an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale, in accordance with the principles of Ind AS 2 Inventories.

However, if the entity does not construct similar assets for sale, only those elements of costs described in Ind AS 16 can be incorporated in the cost of a self-constructed asset. Accordingly, costs which can be included are direct materials, direct labour costs and unavoidable costs that are directly attributable to the construction activity.

This concept of ‘directly attributable’ costs is different from the concepts applied in the measurement of costs of conversion in Ind AS 2. The latter includes a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Such systematic allocation of fixed overheads is not appropriate under Ind AS 16, because Ind AS 16 looks to capitalize only directly attributable costs.

The Standard gives no further guidance on how to determine which costs should be viewed as ‘directly attributable’. Costs that are directly incremental as a result of the construction of a specific asset would generally be eligible if they relate to bringing the asset to working condition. When an entity regularly constructs assets, however, it is possible that some element of apparently 'fixed' costs may also be directly attributable. In such circumstances, an entity should consider which costs would have been avoided if none of those assets had been constructed.

Generally, site identification, planning and acquisition costs should only be capitalized for successful sites. Costs associated with abandoned sites must be expensed. Capitalization of costs must cease once site is ready for use as intended by the management.

5) Identification of Cash Generating Unit (CGU) for impairment analysis

Ind AS 36 defines a CGU as, the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

In identifying whether cash inflows from CGU are largely independent of the cash inflows from other CGU, various factors, including the manner in which management monitors operations and makes decisions about continuing or disposing of assets and/ or operations should be considered.

C. INTANGIBLE ASSETS

1) Method of amortization of intangible assets

Under Ind AS, the useful life of an intangible can be assessed as finite or indefinite. Where the useful life is assessed as finite, such useful life is determined based on management's estimate which is reviewed at least annually. An intangible can be assessed to have an indefinite useful life if there is no foreseeable limit over which it is expected to generate economic benefits for the company.

An intangible asset with an indefinite useful life would not be amortized, however, an entity is required to test an intangible asset with an indefinite useful life for impairment annually and whenever there is an indication that the intangible asset may be impaired.

When the churn rate of an acquired customer is significantly higher than the rate anticipated at the time of acquisition, and the current churn rate is expected to continue, then the carrying value of the customer related intangible asset may be written off over a shorter period than originally projected.

2) Accounting of spectrum cost /license fees and its period of amortization

Spectrum licenses can either be acquired through government auctions or as part of an acquisition of another telecom company. When purchased as a part of government auction includes purchase price and any directly attributable costs. The purchase cost of network licenses and spectrum allocation may be capitalized as intangible assets. Alternatively, when such licenses are acquired as part of acquisition, they are measured at fair value.

In case license and spectrum terms are renewed and the additional fee payable is significant compared with the future economic benefits expected to flow to the entity, the additional term of the license may be treated as a new intangible asset and same can be capitalized from the date of renewal.

In case license is renewed and the renewal fee is not significant when compared to the consequential future economic benefit, i.e. if the fee payable is nominal, then the useful economic life of the original asset can be extended instead of a separate capitalization.

For licenses and spectrum allocation purchased in relation to new networks, the amortization period should normally commence from the date of network acceptance. The date, commercial service commences, may be used as an approximation to the date of network acceptance provided there is no material difference between these dates.

The end of the useful life may be prior to the end of the license period, if company's opinion is that the use of the license or spectrum allocation will end before that date.

D. OTHER MATTERS

1) Accounting for Capacity swap agreement

Capacity swaps are the exchange of network capacity between telecom companies. A diligent analysis of the facts and circumstances of the specific transaction would have to be made, in order to record the same appropriately in the financial statements of both the parties to the transaction.

When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue.

In general, accounting for nonmonetary transactions should be based on the fair values of the assets (or services). Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.

2) Evaluation of contracts for embedded derivative

Telecom equipment are generally imported and the contracts may have embedded derivatives to hedge the pricing risk for the company.

These derivatives will have to be separately identified and accounted separately under the Ind AS regime. Unless these are designated as qualifying hedged instruments, these derivatives will result into volatility in the financial statements at each reporting period.

Future Developments

IFRS 15- Revenue from Contracts with Customers

IFRS 15 outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance including industry specific guidance. As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

For further information on how the new standard can impact telecom companies please refer our publication Telecommunications Spotlight: Navigating the New Revenue Standard.

IFRS 16- Leases

The new leasing standard introduced by IASB, IFRS 16 – Leases, is likely to impact certain business arrangements entered into by telecom companies. IFRS 16 eliminates the classification of leases as either operating lease or finance lease for lessees. The most significant effect of the new requirements will be an increase in right-of-use assets and financial liabilities which probably were off balance sheet so far.

Transactions like tower sharing and leasing, IRUs and similar off balance sheet transactions are likely to get covered under IFRS 16 and will have a significant impact on key financial metrics derived from the company’s reported assets and liabilities.