EXPOSURE DRAFT

TECHNICAL GUIDE ON REVENUE RECOGNITION FOR TELECOMMUNICATION OPERATORS

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Research Committee
The Institute of Chartered Accountants of India
NEW DELHI

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The following is the Exposure Draft of the Technical Guide on Revenue Recognition For Telecommunication Operators, issued by the Research Committee of the Institute of Chartered Accountants of India, for comments. The Committee invites comments on any aspect of this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than ***January 5, 2009****. Comments can also be sent by e-mail at research@icai.org*

DRAFT TECHNICAL GUIDE ON REVENUE RECOGNITION FOR TELECOMMUNICATION OPERATORS

Introduction

1. India, like many other countries of the world, has adopted a gradual approach to telecom sector reforms through selective privatization. Indian telecom sector has undergone a major process of transformation through significant policy reforms. The reforms began in 1980s with telecom equipment manufacturing being opened for private sector and were later followed by National Telecom Policy (NTP) in 1994 and NTP 1999.

2. Historically, the telecom network in India was owned and managed by the Government through the Department of Posts and Telegraphs of the Ministry of Communications. The Department provided all telecommunications services, both domestic and international. However, in 1990's, the telecom revolution in many other countries led Indian policy makers to initiate a change process finally resulting in opening up of telecom services sector for the private sector. Today, India is one of the fastest growing telecom markets in the world with a growth rate of over 20 % and addition of more than 10 million connections per month.

3. Telecom operators are often faced with complex accounting issues especially in the area of revenue recognition and therefore a need is being felt to issue guidance on the same to ensure uniformity of accounting practices by various operators within this sector.

Definitions

4. Terms used in the Technical Guide are defined hereunder:

Telecom Operator means any person who has been issued license(s) under section 4(ii) of the Indian Telegraph Act 1885 by the Department of Telecommunications ("DoT") to establish, install, maintain and operate cellular mobile telecommunications services and owns or has acquired or taken on lease certain telecommunications sites and other passive infranstructure.

Customer activation fees is the amount charged to customers (not usually significant) when they connect to operator networks.

Average customer relationship period (often known as 'Churn rate') is a period which is calculated by dividing disconnects by the net subscriber base on a reporting date. This term used to describe customer attrition or loss.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Indefeasible Rights of Use (IRU) means an exclusive, unrestricted, and indefeasible right to use the relevant capacity (including equipment, fibres or capacity) for any legal purpose.

Interconnect agreements are agreements that allow operators to transit the traffic on another operator's network. Telecom operators, on whose network the call finally ends (known as termination of call) do not recover any amount directly from the subscriber. The operator on whose network the call originates pays terminating charge to the terminating network.

Multiple deliverable arrangements are arrangements where several products and services are sold for a single price e.g. in the mobile sector packages offered to end users include any combination of provision of handsets either at a subsidized rate or free of cost, pre-paid minutes, free SMS, discounts, special offers and other incentives.

Specific objective evidence of fair value is (a) the price charged for a deliverable when it is sold separately or (b) for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace).

Postpaid plans are plans where the customer settles the amount billed to him at the end of the month/specified period. Postpaid plans have two components - a monthly/periodic rental and a usage charge.

Prepaid plans are plans where the customer pays in advance for services to be provided by the operator in future.

Main principles of revenue recognition

5. Accounting Standard (AS 9), *Revenue Recognition*, defines revenue as "the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest,

royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

6. AS 9 mainly deals with the timing of recognition of revenue and guidance is required for recognition of revenue in the case of complex arrangements which are prevalent in the telecom industry for the measurement of revenue. While each complex arrangement needs applications of the Accounting Standard in the context of commercial arrangements, the specific guidance is intended to provide a basis of accounting in the areas discussed herein below.

7. AS 9 sets out the following criteria for recognition of revenue for sale of goods and rendering of services:

Sale of goods

8. Revenue from the sale of goods should be recognised when all of the following conditions are satisfied:

- *Completion of performance,* i.e., the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer; and the seller retains no effective control of the goods transferred to a degree usually associated with ownership;

- *Measurability:* no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods; and

- *Collectibility:* at the time of sale it would not be unreasonable to expect ultimate collection.

[AS 9(9.1) & (11)]

Rendering of services

9. Revenue from rendering of services should be recognised when all of the following criteria are satisfied:

- Performance has been achieved

- Revenue is measurable, i.e., no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service; and

- It is not be unreasonable to expect the ultimate collection.

10. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

[AS 9(9.1) & (12)]

Revenue recognition by telecommunication operators

11. Within the broad framework of the recognition criteria laid down I AS 9, complexities in accounting arise in the recognition and measurement of revenue of telecom operators due to the fact that the application of criteria for recognition and measurement differ depending upon the nature of products and items of revenue.

12. Revenue streams commonly earned by telecom operators and their accounting treatment are discussed hereinafter:

Customer Activation Fees

13. Customer activation fees are charged when customers connect to operator networks. Although the amounts charged to customers are not usually significant, costs are incurred when connecting customers to a network. Where activation fees are charged, the following accounting issues arise:

- recognition of revenue for the service provided (i.e. connecting to the network) as a separate product or service;
- unbundling activation fees with handset revenue;
- recognition of the activation fee over the period of the service contract.

14. For accounting of activation feestransactions should be separated wherever required *'to reflect the substance of the transaction'*. It is important to note that merely activating a service alone has no value to the customer unless the same is bundled with an instrument and/or an understanding to provide services on an

ongoing basis. One has to analyse each contract and determine the appropriate accounting treatment for the same.

15. Where the aggregate amount of the equipment fee together with the activation fee exceeds the fair value of the equipment then the substance of the arrangement is that the activation fee represents both a contribution towards the value of the equipment and a contribution towards the value of the ongoing phone service. The excess activation fee over the fair value of the equipment should therefore be deferred and recognized on a straight-line basis over the entity's average customer relationship period.

16. Activation fee received in arrangements where no new equipment is provided such as SIM-only activations should be deferred and recognized on a straight-line basis over the average customer relationship period as these are treated purely incidental charges and no separate service is rendered as discussed above.

Usage Revenues

17. Revenues earned from end customers can typically be classified as monthly rentals, airtime usage charges, domestic/international roaming services and other value added services. Cellular subscribers can choose from postpaid plans or prepaid plans. Each of these arrangements is discussed hereinbelow.

Prepaid plans

18. Since there is no on-going customer commitment under prepaid plans, these are significantly more popular in India where a majority of mobile customers opt for prepaid products. Customers usually pay for on-going services by purchasing scratch cards or vouchers that entitle them to a set amount of minutes. Online refills and direct refills through mobile phones using debit and credit cards are also gaining popularity.

19. Since under these plans the customer pays in advance for services to be provided by the operator in future, the timing of revenue recognition becomes critical. For prepaid plans, revenues should be recorded in the period in which the services are rendered, i.e., in the period in which calls are made. This will usually be different from the period in which cash is received.

20. Accounting for unused minutes needs careful consideration. In cases where there is a service expiry date on the prepaid card, revenue for unused minutes is recognized on such expiry date. If there is no expiry date on the card the operator never extinguishes its responsibility to deliver service. The revenue

relating to the unused minutes should not be recognized, even where the operator is able to demonstrate that it is unlikely that the card will be used again.

Example 1. Lifetime validity schemes

Telecom Company XYZ announced a lifetime validity plan in the market whereby the customers needed to pay Rs. 1,000 to stay connected for a lifetime provided the customer recharges at least once every six months with a minimum value coupon available in the market of Rs.100. How should revenue be recognized under this arrangement?

The lifetime validity plan essentially comprises access fee and talk time. Access fee pertaining to this transaction would constitute approximately Rs. 900 and the remaining amount would constitute the amount available for the talk time. Talk time revenues would be recognized by the telecom company based on usage. The access fee paid is nothing but revenue received from the customer the benefits of which are utilized over the period he is expected to remain connected to the same network. Hence, it is prudent to recognize and amortize the access fee over the customer relationship period using an appropriate churn rate.

21. Certain prepaid plans allow customers a fixed number of minutes or text messages each month for a fixed charge with an option to carry forward unused minutes or text messages to future periods. Again, from an accounting perspective, revenue recognition should be based on usage rather than billings. In respect of carried forward minutes, revenue recognition should be deferred and should only be recognized when the customer loses any entitlement to future use. Revenue should not be recognized until the entity has no further liability in respect of unused minutes which could only be the case when the right to use the minutes actually expires.

Example 2. Roll over minutes

(i) A tariff offers 1000 minutes for a fee of Rs. 500 per month with the option of rolling over any unused minutes. At the end of the first month, the customer uses 900 minutes and uses the remaining 100 minutes in the second month.

Revenue to the extent of Rs. 450 (90% x Rs. 500) should be recognised in the first month and Rs. 50 (10% x Rs. 500) is deferred until the second month when it should be recognised.

(ii) A tariff offers 1000 minutes for a fee of Rs. 500 per month with the option of rolling over any unused minutes into the following month. The minutes expire after 3 months.

At the end of the first month, the customer has used 800 minutes and therefore the service provider recognises revenue of Rs. 400 (80% x Rs. 500) and revenue of Rs. 100 is deferred.

The customer uses 100 of the rollover minutes in the second month and none in the third month. Revenue of Rs. 50 would be recognised in month two.

Even though the customer has used none of the rollover minutes in the third month, the customer's right to use them, i.e. liability of the Company to serve the customer has expired. Hence, the remaining Rs. 50 of revenue is recognised in the third month. Where rollover minutes have a longer expiry date, the recognition of this final 10% can only take place when the customer's ability to use them has expired.

Postpaid plans

22. There are two components in post paid plans: The first component is the monthly rent that the subscriber pays to the operator and the second component is the usage charges. Depending upon the kind of tariff plan that the subscriber selects, the usage charges vary. Revenue from the monthly rental is recognised on an accrual basis over the period to which the service relates. Unbilled rentals and usage revenue in the period between the billing cycle date and the end of each period are accrued.

Interconnect revenues

23. For most operators, interconnect charges represent the largest single operating cost and the second largest source of revenue. Mobile operators enter into a number of interconnect agreements with other operators. These agreements allow them to terminate a particular call or transit the traffic on another operator's network. This, essentially, uses network of contracting parties to facilitate and to provide the end-to-end connections required by customers of agreeing parties. In certain cases, the rates may be regulated (e.g., in India the rate is governed by the Interconnect Usage Charge Guidelines issued by Telecom Regulatory Authority of India). However, generally for international arrangements, companies are free to set and revise rates in accordance with market conditions.

24. Even though interconnect agreements usually allow operators to settle on a net basis, interconnect revenues are usually accounted for on a gross basis since the operators are exposed to the gross risks of the transactions. For example, an operator may bear the gross credit risk for non-payment and be obliged to make payments under interconnect arrangements, irrespective of the level of reciprocal revenues due. Each arrangement should therefore be evaluated on a case-to-case basis.

25. For interconnect arrangements it may be necessary to consider whether the transaction is a regular interconnect arrangement or an exchange transaction as the accounting treatment would depend on how the arrangement is classified.

26. As discussed above, interconnect arrangements are generally accounted for gross. However, the accounting on gross basis may not be appropriate where net settlement and the legal right of offset exists between operators or when operators enter into an agreement where the rates and amount of traffic to be carried by each operator are agreed upfront. Commercially, such arrangements are not much different from the interconnect arrangements which were typically accounted for on gross basis. However, in substance, these arrangements are similar to an exchange transaction. In exchange transactions where products are of similar nature no revenue is recognised if the quantity of the products is also same. However, if quantity exchanged is different revenue needs to be recognised as illustrated in the following example.

Example 3

Operator A agrees to send 10,000,000 minutes to Operator B in exchange for 10,000,000 minutes to be received from B over a period of 1 month. The agreed rates are as follows:

Up to 10,000,000 minutes:	Rs. 10
Above 10,000,000 minutes:	Rs. 0.50 for traffic generated from A
	Rs. 0.75 for traffic generated from B

A has sent 15,000,000 minutes to B and B has sent 11,000,000 minutes to A in 1 month. Both the service providers have met their volume commitments. The net settlement will happen as follows:

	Traffic sent	**Committed volume**	**Incremental traffic**	**Rate**	**Account balance**
A to pay	15,000,000	10,000,000	5,000,000	0.50	2,500,000

B to pay	11,000,000	10,000,000	1,000,000	0.75	750,000	
Net settlement					**1,750,000**	

As shown above, there is no exchange of cash for minutes up to 10,000,000 minutes. Only differential amounts will be settled and accounted for.

There is a predetermined volume of traffic to be terminated over a predetermined period at a fixed rate. There is an exchange of two similar services amongst the operators and hence this transaction does not generate revenue for either of the operator. Both the operators will account for the differential minutes only as exchange of similar goods does not result in generation of revenue.

Let us assume that in the above illustration, A has sent 15,000,000 minutes to B and B has sent 9,000,000 minutes to A.Operator A will have to pay Rs. 2,500,000 to B. B will not be required to pay to A.

Sale of handsets

27. Though uncommon for operators to sell handsets without a contract for ongoing services, where equipment is sold on a standalone basis, revenue for the same is measured by the charges made to customers for the handsets supplied to them. Where handsets are sold bundled with free texts or an airtime contract with inclusive voice minutes and texts, the arrangement should be divided into separate elements and revenue for each element should be recognised based on the fair value. Refer to paragraphs 42 to 55_for detailed guidance on accounting for bundled contracts.

Measurement of revenue – Other considerations

28. An area that requires considerable judgement in the accounting for revenue of telecom operators is measurement of revenue. Generally, multiple operators may be involved in providing end-to-end service to a customer, each earning a share of the revenues. An assessment is required to determine whether it is appropriate for all or only some of the operators involved in providing the service to record revenues.

Basis of accounting

29. Accounting for a transaction will depend on whether the operator is acting as a principal or as an agent. Such assessment may not always be simple and, therefore, it is pertinent that each operator should determine the appropriate treatment in respect of revenue recognition for the services that it provides. The following are examples of some products and/or services which often involve detailed considerations for measurement of revenue and associated costs.

- Premium rate line calls
- Ringtone, wallpaper, music, game downloads
- Goods purchased using mobile phone
- Directory enquiry services
- Location based services

30. As discussed in the preceding paragraphs, AS 9 defines, revenue as *'the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.'* Careful study of each arrangement is required to determine whether an operator is acting as a principal or as an agent in a transaction. However, the rule of thumb would be to determine with whom the risks and rewards vest. Where it can be demonstrated that the risks and rewards of the transaction effectively remain with the operator, revenue should be recognized on principal-to-principal basis. Conversely, if the risks and rewards do not vest in the operator and the operator recognises its own share of income, i.e. the amount billed to the customer less the amount paid to a content provider/third party (Hereinafter, the aforesaid situations are described as revenue recognized on 'gross basis' or 'net basis')

31. The following factors are relevant for analysing an arrangement whether these constitute a principal-to-principal arrangement or constitutes an agency relationship:

The operator is the primary obligor in the arrangement

32. One of the principal factors to be considered while assessing whether revenue should be accounted for on a gross or net basis, is the determination of whether a content provider/ third party or the operator is responsible for providing the product or service desired by the customer.

33. If the operator is responsible for fulfillment of the contract and retains an obligation for unsatisfactory performance not covered by normal warranty

provisions, there is a strong indication that the operator bears risks and rewards of a principal in the transaction and should record revenue gross on base is, i.e., based on the amount billed to the customer. If a content provider/ third party (and not the operator) is responsible for fulfillment of a contract, including the acceptability of the product or service ordered or purchased by a customer may indicate that the operator does not bear risks and rewards as principal in the transaction and should, therefore, record consideration in such an arrangement on a net basis(i.e. the amount billed to the customer less the amount paid to a content provider/third party).

34. The terms of the sales contract and representations made by the operator during marketing generally provide evidence as to whether the operator or the supplier is responsible for fulfilling the contract.

Ability to control the selling price

35. If an operator has control over establishing the price at which a product or service will be provided to a customer, may indicate that the operator bears risks and rewards of a principal in the transaction and should, therefore, record revenue on a gross basis. Even if the operator is able to control the sales price indirectly or is able to control the margins it receives, it could indicate that it bears the risks and rewards arising in the transaction.

Product or service specifications

36. If the nature, type, characteristics or design and specifications of a product or service ordered by the customer is determined by an operator it may indicate that the operator is working on principal-to-principal basis and is responsible for fulfillment of contract and, therefore, revenue should be recorded on a gross basis.

The operator changes the product or performs part of the service

37. If an operator physically changes the product (beyond its packaging) or performs part of the service ordered by a customer, such that the selling price of that product or service is greater as a result of an operator's physical change of the product or performance of the service, may indicate that the operator is primarily responsible for fulfillment, including the ultimate acceptability of the product component or portion of the total services furnished by the supplier, and that it should record revenue on gross basis, i.e., based on the amount billed to the customer.

Supplier selection

38. If there are multiple suppliers of a particular product or service in the market and the operator can determine which supplier will provide the product or service to the end-customer, it could be an indicator that the operator is primarily responsible for fulfillment of the contract and, therefore, revenue should be recorded on a gross basis.

Credit risk

39. Determining who retains the credit risk is a crucial factor that needs to be looked into and carefully considered when determining whether revenue should be recognised on gross or net basis. Credit risk exists when the operator is liable to pay the amount due to a supplier after the supplier performs the service irrespective of whether the operator has collected the sales price from the end-customer. If an operator assumes credit risk in a transaction, it may indicate that the operator bears risks and rewards as a principal in the transaction and, therefore revenue should be recognized on gross basis. However, if the credit risk is assumed by the content /intermediate product provider, it may indicate that an operator is an agent of the content provider and that revenue should be recognised on net basis by the operator,i.e, based on the amount retained.

Inventory risk

40. Inventory risk is a strong indicator that the operator bears risks and rewards as a principal in the transaction and, therefore, should recognise revenue on gross basis. An operator has inventory risk if:

- it has purchased or committed to purchase the product or service before firm orders have been received from the customer;
- if it is exposed to the risks of damage, slow movement or obsolescence of inventory; or
- it is liable if the customer returns the product where the buyer has the right to rescind the purchase.

Operator earns fixed income

41. If an operator earns a fixed amount or revenue per customer regardless of the amount billed to a customer or if it earns a stated percentage of the amount billed to a customer, it may indicate that the operator is an agent of the content provider in which case revenue should be recognised on net basis, i.e., the amount retained by the operator.

Examples on revenue recognition and measurement of revenue

Activation Revenue

Example 4.

A customer purchases a mobile phone with a contract for 1 year. He pays Rs. 2,000 for the handset, Rs. 500 for connection and a recurring monthly access fee of Rs. 200. The fair value of the handset is Rs. 2,800.

Since the fair value of the handset is greater than the consideration received, Rs. 2,500 received for the equipment and connection should be recognised immediately.

Example 5.

A customer purchases a mobile phone on a post pay contract for 1 year. He pays Rs. 2,500 for the handset, Rs. 500 for connection and a recurring monthly access fee of Rs. 200. The fair value of the handset is Rs. 2,800.

Since the fair value of the handset is greater than the consideration received, the handset revenue of Rs. 2,500 is recognised immediately. Further, since the total consideration received is greater than the fair value of the handset, the remaining fair value of the handset i.e. Rs. 300 is recognised immediately and the of Rs. 200 is deferred over the average customer relationship period.

Others

Example 6.

Operator F provides branded sports coverage via text message (SMS) as part of its service offering. A news agency provides the sports data to Operator F, which tailors the sports data for its sports coverage service. The content is branded by Operator F. Operator F determines the price to its customer and bears the credit risk from its customer.

Operator F bills the customer Rs. 5 for the service. The news agency receives 40% of the subscription price, Rs. 2, i.e., from Operator F for providing the raw data. Operator F keeps Rs. 3 for tailoring the content and for delivering the text messages to the customer. The news agency is guaranteed its Rs. 2 for each SMS.

Operator F is acting as a principal as it tailors the product that it receives from the news agency and the customer expects Operator F to provide the service. The operator also bears the credit risk. All these factors indicate that Operator F should recognise the gross proceeds of Rs. 5 as revenue. The payment to the news agency of Rs. 2 should be recorded as a cost of sale.

Example 7.

A customer in Mumbai makes a call to Delhi. Operator A hands the call over to Operator B in Ahmadabad which hands the call over to Operator C for termination. B receives Rs. 20 from A and pays Rs. 15 to C.

B has full discretion in determining the routing of the call. B establishes the price for terminating calls and bears the credit risk from A. B has determined that the least-cost route to Delhi was via C. The rates for termination are determined bilaterally between Operators A and B, and Operators B and C.

Operator B should recognize Rs.20 as revenue and Rs.15 as a cost of sale. B is acting as a principal. B controls the selection of the Operator to terminate Operator A's traffic. The rates for termination are negotiated bilaterally by Operators A and B and Operators B and C. B bears the credit risk and is obliged to pay C even if A defaults.

If the facts remain the same as stated above except that Operators A, B and C have entered into a tripartite agreement in which B agrees to terminate traffic originating from A's network via C. B does not control the routing of the traffic and must hand over the termination of A-originated traffic to C. B is also guaranteed payment from A.

In this case, B should recognise Rs. 5 as revenue (20 – 15). B is acting as an agent. The pricing for the calls is negotiated together by all parties. B does not bear credit risk and is guaranteed a fixed payment of Rs. 5 for each call. B cannot select a least-cost route to terminate A's traffic. B is obliged to hand over A's traffic to C, under the terms of the agreement.

Example 8.

A TV company is running a voting poll for its viewers. The TV company asks Operator G to provide two premium rate phone numbers on which its viewers can vote yes or no.

The TV company selects the type of premium rate phone number; hence the price that its viewers will pay and the revenue share with Operator G is decided by the TV channel. Also, the sharing of revenue is decided by the TV channel.

Operator G contracts with the TV company with respect to network capacity and reliability. Operator G also bills and collects Rs. 0.50 for each call made and pays Rs. 0.35 to the TV company. Operator G bears the credit risk.

How should the Operator recognise proceeds from the revenue share agreements?

Operator G is acting as an agent and should recognise his share of revenue of Rs. 0.15 (Rs. 0.50 – Rs. 0.35) i.e. for its own share of the amount paid to the content provider.

Operator G's customer is the TV company. The TV company selects the supplier (Operator G), sets the price to the viewer (its customer) and determines the specification of the service. Operator G has contracted for the provision of network capacity and connectivity to the TV company – that is, the network is a delivery mechanism for the viewers' votes. Operator G retains credit risk, but this alone does not make it the principal in the arrangement.

Multiple deliverable arrangements (Bundled transactions)

42. Stiff competition within the telecom industry has necessitated introduction of a range of innovative and complex products by the telecom operators. This is particularly true in the mobile sector where packages offered to endusers may include different combinations of provision of handsets either at a subsidized rate or free of cost, pre-paid minutes, free SMS, discounts, special offers and other incentives. Such products often present challenges in determining how to account for these elements . In such cases, accounting treatment is driven by substance of each case. Recognition criteria should usually be applied to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.Accordingly, assessment should first be made to determine if any of its components should be accounted for separately.

43. The decision to account for a transaction in its entirety or unbundle the product into its individual components can have a significant impact on an operator's financial statements. For instance, separating handset revenues or connection revenues from ongoing service may result in increased revenue upfront but there may also be instances where separating a contract into components may defer revenue recognition.

Identifying separate elements

44. Where a product includes more than one deliverable, such as the sale of a prepaid handset with free text messages or free talk time and text messages, the product should be divided into separate elements. A deliverable should only be considered as an element if it meets both of the following criteria:

- It has value to a customer on a standalone basis. Generally, value on a standalone basis exists if the equivalent item is sold separately, or the customer could resell the item on a standalone basis; and

- There is objective and reliable evidence of the fair value of the item.

45. All products within a bundle (including equipment, data cards and activation fees), including those provided for free or for a short period of time, should be considered in determining the separate units of accounting. As discussed earlier, activation has no standalone value without the provision of either equipment and/or ongoing phone service and, therefore, no allocation of fair value is made to this component within the bundle.

Determining fair values

46. The best evidence of fair value is the price of a similar product or similar service when it is regularly sold by the operator on a standalone basis to independent parties. Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value.

47. Fair value evidence should preferably be the operator-specific objective evidence of fair value being (a) the price charged for a deliverable when it is sold separately or (b), for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace).

48. It may be noted that for evidence of fair value to be established, substantial standalone sales must have been priced within a reasonably narrow price range. If an element is sold separately on a limited basis it may not be appropriate to consider that as evidence of operator-specific fair value.

Allocation of Revenue to various components in an arrangement

49. For the unbundling of various elements as discussed in paragraph 44 above, it is necessary to allocate the overall price to each component within the bundle. This is done on the basis of their relative fair values (the relative fair value method).

50. The amount allocable to a delivered item is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions. A common example of this is where a handset is given free at the inception of an airtime contract; it is prudent that no revenue be allocated to the handset as the realization of the revenue is dependent upon the future delivery of the airtime service.

Example 9.

A customer purchases an annual contract offering a free handset and 1,000 minutes (fair value is Rs. 1,500 per month) and 150 free texts (fair value is Rs. 300 per month), for a monthly fee of Rs. 1,500. The handset could be purchased separately for Rs. 15,000.

The allocation of revenue for the entire contract period should be as follows:

	Cash	***Total FV***	***Relative Fair Value***	***Fair Value restricted by contingent consideration***
Handset	*-*	*15,000*	*7,377*	*-*
Airtime	*18,000*			

contract:					
- Talk time		*18,000*	*8,852*	*15,000*	
- Text		*3,600*	*1,771*	*3,000*	
Total	***18,000***	***36,600***	***18,000***	***18,000***	

The relative fair value of the equipment is Rs. 7,377. However, the recognition of this amount should be limited to the amount which is not contingent upon the delivery of additional items (i.e. airtime contract). As a result, the relative fair value allocable to the equipment is reduced to Rs. nil, being the cash consideration, and the difference reallocated to the elements within the airtime contract.

51. Care should be taken to determine if the sale price of the bundled product exceed the total fair value of the elements. This may indicate existence of element(s) within the bundled product which have not been included in the assessment of fair value, such as customer activation. Although activation has no value on a standalone basis, assessment should be made to determine if the excess of sale price over fair value relates to activation. If the entity, or local competitors, regularly charge such fees, it should be presumed that the excess of the bundle relates to these types of fees, irrespective of the fact that they do not have standalone value. However, this presumption could be overcome if there are factors that clearly indicate the reason(s) for the premium pricing.

Timing of revenue recognition

52. For bundled products, revenue should be recognised based on usage of each separate element within the bundled product, unless there is an expectation or a history of non-delivery of products or non-performance of a service by an operator. If there is an expectation or history of non-delivery which results in discounts or credits provided to customers, the revenue recognised should be reduced by the expected discounts or credits.

53. Where a tariff plan offers the customer the ability to rollover unused bundled voice minutes or messaging from the month in which the customer is first entitled to the minutes/message to future periods, the revenue relating to the unused bundled voice minutes should be deferred until the earlier of when the minutes are used or expire.

Example 10.

A customer purchases a tariff offering 500 minutes of airtime for a fee of Rs. 750 per month and the option to rollover the unused minutes at the end of each month. The company also offers a standard tariff with no access charges for Rs. 250 per month.

At the end of the month, the customer has used 400 minutes.

The amount of revenue recognised is as follows:

Fair value of standard tariff	*Rs. 250*
Fair value of the airtime used (400/500 x (Rs. 750 – Rs. 250))	*Rs. 400*
Revenue recognised in month one	*Rs.* ***650***
Revenue deferred to next month (Rs. 750- Rs. 650)	*Rs. 100*

Note: often the customer may never use the rolled over minutes. When this occurs the related revenue should only be recognised when the minutes expire.

54. Certain services, e.g., unlimited cricket downloads, which meet the criteria of a separate element, cannot be easily measured by usage. Such elements should be recognized evenly over the period in which the service is provided.

55. In allocating revenue to delivered elements, the revenue should be limited to the amount that is not contingent upon the delivery of additional items. However, in determining the recognition of revenue within a unit of accounting, revenue should be determined by usage as long as the entity reasonably expects that the undelivered services within the unit of accounting will be delivered. For certain arrangements, this may result in revenue being recognised in advance of cash received, as shown in the example below.

Example 11.

A customer enters into a twelve-month tariff plan priced at Rs. 200 per month including 200 minutes of talk time per month (fair value is Rs. 200 per month) and 100 free texts for the first month (fair value is Rs. 100), plus receives a free handset (fair value of Rs. 3,000).

Relative fair values and revenue recognition:

	Cash	***Total FV***	***Relative FV(RFV)***	***RFV restricted by contingent revenue***
Equipment	*Nil*	*3,000*	*1,309*	-

Airtime contract:	*2,400*			
- Talk time		*2,400*	*1,047*	*2,304*
- Text		*100*	*44*	*96*
Total	***2,400***	***5,500***	***2,400***	***2,400***

The equipment has been provided for free and hence the revenue allocable to the equipment is restricted to Rs. nil. The revenue allocable to the talk time and texts increases to Rs. 2,400 and is split relative to their fair values and resulting in the following revenue:

Month	***Talk time#***	***Text***	***Total revenue***	***Cumulative revenue***	***Cumulative cash***
1	*192*	*96*	*288*	*288*	*200*
2	*192*	*Nil*	*192*	*480*	*400*
3	*192*	*Nil*	*192*	*672*	*600*
12	*192*	*Nil*	*192*	*2,400*	*2,400*
Total	***2,304***	***96***	***2,400***		

 # Rs. 2,304 spread over 12 months

This allocation of revenue results in revenue being recognized in advance of cash received. As the delivery of the talk time for the remainder of the contract term is reasonably assured, the difference between the cumulative revenue and cumulative cash will be accounted for as accrued income in the balance sheet.

Indefeasible Rights of Use (IRU)

56. Telecommunications industry is capital intensive and demands significant investment for setting up of network and other related infrastructure. Setting up a network also leads to unwarranted gestation leading to significant costs and delay in roll out of services. In addition to facilitating accelerated roll out of services, IRU and/or capacity arrangements help minimise/optimise the capital expenditure required for setting up of the networks.

57. IRU's are potentially effective tools for cost management as small number of operators can mobilise enough funds to set up a global network and achieve the desired geographic presence.

58. IRU means an exclusive, unrestricted, and indefeasible right to use the relevant capacity (including equipment, fibres or capacity) for any legal purpose. The purchase of an IRU gives the purchaser the right to use some capacity on a

telecommunications cable system, including the right to lease that capacity to someone else. However, with that right comes an obligation to pay a proportion of the operating cost and a similar proportion of the costs of maintaining and repairing the cable.The accounting treatment for IRUs is determined by the commercial substance of each individual arrangement. In determining appropriate accounting treatment, arrangements have to be assessed for specific facts and circumstances.

59. Generally, an IRU agreement has two parties,viz., the owner of the network of dark[1] or lit[2] fibre who becomes the grantor or the lessor and the purchasers known as the grantees or lessees. The grantor/lessor pays the fees associated with installing the pipe, the rights of way and other fees and incentives to jurisdictions through which the pipe will run. The grantor/lessor also pays for up-front labour costs of installing and testing and other costs for getting it into the ground. Once it is in the ground, the grantor/lessor tries to sign agreements with other long-haul fibre network owners, internet service providers and smaller telecom operators that need the pipe to get services to customers. As stated earlier, these leaseholders are known as grantees or lessees. In exchange for ownership of a portion of the network, the grantee/lessee pays the grantor a large up-front fee and also annual charges for maintenance and upkeep. If the grantee buys dark fibre, it may or may not be responsible for paying for the hardware and other network inventory necessary to light it. The grantee/lessee owns the right to pump the data, voice and video traffic it wants through the pipe and can set up its own IRUs with sub-carriers. In return, the grantor/lessor is responsible for maintenance and upkeep of the pipe. The contracts take many forms with the common arrangement being:

- Purchase or sale of specified network infrastructure,
- Purchase or sale of lit fibre capacity, and
- Exchange of network infrastructure or lit fibre capacity.

60. For the provider of the capacity, the fundamental accounting issue related to an IRU is when to recognize revenue. That determination can be quite complex but can be narrowed down to the following

- evaluating whether the IRU is a lease or a service contract; and
- if it is a lease, determining whether it is a finance lease or an operating lease.

[1] Dark fibre is optical fibre infrastructure that is currently in place but is not being used.
[2] Lit fibre is optical fiber that is regularly being used to transmit data

Determining whether the contract is a service contract or a lease

61. As stated earlier, the first step in determining when to recognize revenue is to evaluate whether the contract between the provider and purchaser of the capacity is an arrangement for the provision of a service or a lease. Although service contracts may have attributes similar to those embodied in leases, the accounting results may be considerably different for service transactions than for leases.

62. Revenues associated with long-term service contracts are generally recognised over time as performance occurs.

63. Accounting Standard (AS) 19, *Leases*, defines a lease "as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time." The standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, the standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

64. To the extent that a network capacity contract conveys to the purchaser the right to use specific identifiable assets for a period of time, it may be concluded that such a contract meets the definition of a lease. Accordingly, each contract should be evaluated and wherever the contract constitutes a lease the accounting needs to be driven by AS 19.If the network capacity contract does not convey to the purchaser the right to use specific identifiable assets, the contract would be viewed as an arrangement for the provision of services, and revenue would be recognised over the period of the contract as the services (the access to the network capacity) are provided.

Determination of the type of lease

65. For capacity contracts that meet the definition of a lease, the next significant accounting consideration is the determination of the appropriate lease classification. In a network capacity contract or arrangement that meets the definition of a lease, the capacity provider is the lessor, and the capacity purchaser is the lessee. There are two general types of leases: Finance leases and operating leases.

66. AS 19 states that a finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be transferred. AS 19 goes on to state that whether a lease is a finance lease or an

operating lease depends on the substance of the transaction rather than its form. It gives examples of situations which would normally lead to a lease being classified as a finance lease. Some of the examples relevant to to IRU capacity sales are:

- the lease term is for the major part of the economic life of the asset even if title is not transferred
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset

67. Most IRUs are for a period exceeding the major part of the economic life of the asset. Typically, the asset will have a negligible residual value at the end of the lease term. The amount paid upfront for the IRU will generally be representative of the fair value of the underlying asset.

68. If considered a finance lease,transaction should be recognised as per AS19, Leases.

Example 12.

Service provider X sold a 20 year IRU over three specified dark fibre pairs to Service provider Y. X classified the costs of the dark fibres as fixed assets. The dark fibres have a net book value of Rs. 300,000 on the date of the agreement. X received an up-front payment of Rs. 1 million in respect of the dark fibres. The fibres have a useful economic life of 25 years. Legal title to the fibres remained with X. Y has an exclusive and irrevocable right of use of the specified dark fibres and is also responsible for lighting the fibre pairs. Y is responsible for insuring the fibres. Y is also liable to reimburse X for any access costs and operation and maintenance costs that X incurs in respect of the specified fibre pairs. Y reimburses X on a “cost plus” basis for any cost it incurs with respect to the dark fibre.

This is a case of finance lease as per AS 19. Service Provider X has transferred substantially all of the risks and rewards of ownership, including managerial control of the dark fibre pairs to Service provider Y. X has received a one-off up-front payment for the grant of the IRU. There is no lease receivable and no finance income should be recognised. The carrying amount of the dark fibres should be deducted from fixed assets at the same point as the gain on the disposal is recognised. The receipts in respect of the operations and maintenance should be recognised on a straight-line basis over the term of the agreement.

69. In an operating lease arrangement, the leased capacity continues to appear in the financial statements of the lessor as a fixed asset net of depreciation. The minimum lease payments are recorded as rental revenue by the lessor over the lease term. Lease rentals are recognised as revenue over the period of lease usually on a straight line basis. Operating lease accounting is akin to service contract accounting.

Example 13.

Service provider Z has constructed a global fibre-optic backbone. Z sells a 20 year IRU over two STM-4s[3] from Mumbai to Sydney to Service provider A. Z is responsible for lighting the fibre and operating and maintaining the entire network. Z guarantees A network availability of 99.9% and commits to providing A with alternative wave lengths if there is a network outage. Z also controls the routing of A's traffic. Z is responsible for the technological obsolescence of the equipment that is lighting the fibre. A makes a one-off payment of Rs. 50 million for the right to use the STM-4s, and their operation and maintenance. A is also entitled to service credits if there is a network outage and A suffers financial loss.

Service provider Z should record the receipt of Rs. 50 million as deferred revenue. The revenue is recognized on a straight-line basis over a period of 20 years from the effective date of the IRU. Z has entered into a long-term supply contract with Service provider A. STM-4s are not specifically identifiable network assets. They are units of capacity or lit fibre. Z has granted a right to A to access and an obligation to pay for a certain amount of capacity from Mumbai to Sydney. Z continues to be responsible for the operation of the network assets over which the service is delivered. Z continues to retain substantially all of the risks and rewards incident to ownership, including controlling the routing of the traffic, the operation and maintenance of the network, technological obsolescence of the electronics and the obligation to compensate A for financial loss suffered from a network outage.

Arrangements involving exchange of capacities

70. Telecom service providers often exchange network assets or swap lit capacity with or without exchange payment resulting in negligible net impact. Commercial substance (of an exchange transaction) exists if there is a change in the cash flows of an entity subsequent to the transaction.

[3] STM (Synchronous Transport Modules) is the bandwidth throughput with varying bit rate. STM – 4s has a bit rate of 622.080 Mbit/s.

71. The main priniciples of accounting as given in paragraph 22 of Accounting Standard (AS) 10, *Accounting for Fixed Assets*, for exchange of such capacity are discussed below.

72. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes, fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. Fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Example 14.

Telecom operators V and R operate in different geographical areas in India. In order to expand its operations V acquired capacities (IRU) from R for 15 years (economic useful life of the asset) in North at an agreed price of Rs. 15 million. Further, R acquired similar capacities in South for a similar term from V, who had excess capacities in that region, for an agreed price of Rs. 15 million. Cash was mutually exchanged between V and R. How should revenue be recognized under this transaction? Would the answer be different if no cash was exchanged between V and R?

Operators V and R should not record revenue or costs in respect capacities exchanged. The operators have exchanged services that are similar in nature, duration and amount. The fair value of the services exchanged is similar. No revenue has been generated from this exchange. Answer would not be different if no cash was exchanged.