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*No. US2017-14*
*July 27, 2017*

*What's inside:*



# *New revenue guidance*
# Implementation in the communications industry

## At a glance

Public companies must adopt the new revenue guidance in 2018. Almost all companies will be affected to some extent by the new guidance, though the effect will vary depending on industry and current accounting practices. Although originally issued as a converged standard under US GAAP and IFRS, the FASB and IASB have made slightly different amendments so the ultimate application of the guidance could differ under US GAAP and IFRS.

The Revenue Recognition Transition Resource Group (TRG) and the AICPA's Telecommunications Entities Revenue Recognition Task Force has discussed various implementation issues impacting companies across many industries. These discussions may provide helpful insight into application of the guidance, and the SEC expects registrants to consider these discussions in applying the new guidance.

This publication has been updated to reflect the implementation developments over the past two years and to highlight certain challenges specific to companies in the communications industry. The content in this publication should be considered together with our Revenue guide, available at CFOdirect.com.

## Overview

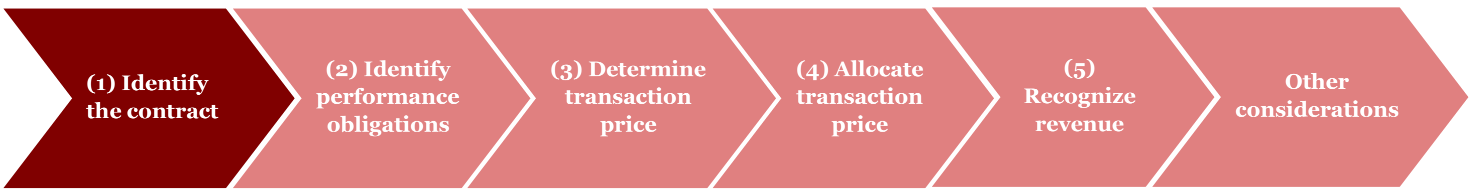
The communications industry comprises several subsectors, including wireless, fixed line, and cable/satellite television (TV). These companies generate revenue through many different service offerings that include access to, and usage of, network and facilities for the provision of voice, data, internet, and television services. These services generate revenues through subscription fees or usage charges. Some communications companies also sell or lease equipment such as handsets, modems, dongles (a wireless broadband service connector), customer premises equipment (CPE), and a variety of accessories.

Offerings in the communications industry have evolved as a result of consolidation, technology changes and innovation. Examples include installment sales of wireless devices; multi-line plans, in which customers attach more than one device to a service; and bundled plans, with core video service, including voice and internet services, combined with other offerings, such as home security services. Also, companies may provide services that expand beyond traditional core offerings, including cloud and machine-to-machine services.

The revenue standards (ASC 606 and IFRS 15, *Revenue from Contracts with Customers*) will impact each of these businesses. Certain changes having the potential for the greatest impact include:

- Additional revenue may need to be allocated to discounted or free products provided at the beginning of a service period due to the elimination of the "contingent revenue cap," and changes to and restrictions in the use of the "residual method" currently applied by some communications companies.
- The accounting treatment of activation fees, customer acquisition costs, and certain contract fulfillment costs may change.
- The guidance may be applied to a portfolio of contracts or performance obligations in some circumstances, although this approach may create additional implementation challenges and complexities.
- Free goods or services previously considered to be marketing offers may qualify under the revenue standards as distinct goods or services.

Communications companies are continually evaluating their business models and providing new device and service plans to customers. Assessing the accounting impact of these new services can be challenging. During the transition to the revenue standards, management will need to consider the impact that these new offerings have under both the old and new guidance, adding complexity to their growing list of challenges.




## 1. Identify the contract

A contract can be written, oral, or implied by a company's customary business practices. Generally, any agreement with a customer that creates legally-enforceable rights and obligations meets the definition of a contract under the new guidance. Legal enforceability depends on the interpretation of the law and could vary across legal jurisdictions where the rights of the parties are not enforced in the same way.

As part of identifying the contract, companies are required to assess whether collection of the consideration is probable, which is generally interpreted as a 75-80% likelihood in US GAAP and a greater than 50% likelihood in IFRS. This assessment is made after considering any price concessions expected to be provided to the customer. In other words, price concessions are variable consideration (which affects the transaction price), rather than a factor to consider in assessing collectibility. Further, the FASB clarified in an amendment of ASC 606 that companies should consider, as part of the collectibility assessment, their ability to mitigate their exposure to credit risk, for example by ceasing to provide goods or services in the event of nonpayment. The IASB did not amend IFRS 15 on this point, but did include additional discussion regarding credit risk in the Basis for Conclusions of their amendments to IFRS 15.

The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collection is not reasonably assured (US GAAP) or probable (IFRS). Companies that conclude collection is not probable under the new guidance cannot recognize revenue for cash received if (1) they have not collected substantially all of the consideration and (2) continue to transfer goods or services to the customer.

### *Contract term*

Determining the contract term is important as it impacts the determination and allocation of the transaction price and recognition of revenue. Termination clauses should be considered when assessing contract duration – the period over which the parties have enforceable rights and obligations. If a contract can be terminated at any time for no compensation, the parties do not have enforceable rights and obligations, regardless of the stated term. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term equal to the stated term. This is because enforceable rights and obligations exist throughout the stated contract period. Judgment should be applied in determining whether a termination penalty is substantive. There are no "bright lines" for making this assessment.

### *Contract modifications*

Customers of communications companies often request changes to their service plans. For example, wireless telecom customers might change their existing service plans to upgrade or replace a device; include additional wireless minutes; increase data usage; add incremental, or remove, existing services; or terminate service altogether. Modifications also occur in multi-line plans when the customer adds or removes a device and/or changes the size of the data plan being shared across devices. Companies will need to account for the changes as modifications to the contracts when devices or services not covered under the original contract are added or removed.

Contract modifications exist when the parties to the contract approve a modification that creates or changes the enforceable rights and obligations of the parties to the contract. A modification is accounted for as either a separate contract or as part of the existing contract (either prospectively or through a cumulative catch-up adjustment). This assessment is driven by whether (1) the modification adds distinct goods and services and (2) the distinct goods and services are priced at their standalone selling prices. Companies will need to apply judgment in evaluating whether goods or services in the modification are distinct. This may be particularly challenging when there are multiple performance obligations in a contract.

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| A contract modification is treated as a separate contract only if it results in the addition of a distinct performance obligation and the price reflects the standalone selling price of that performance obligation. Otherwise, the modification is accounted for as an adjustment to the original contract.<br><br>A company will account for a modification prospectively if the goods or services in the modification are distinct from those transferred before the modification. A company will account for a modification through a cumulative catch-up adjustment if the goods or services in the modification are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified.<br><br>A contract modification that only affects the transaction price should be treated as part of the existing contract. | Modifications to add or remove goods or services in telecom arrangements are typically viewed as new arrangements with changes accounted for prospectively. | Modifications to add or remove goods or services in telecom arrangements are typically viewed as new arrangements with changes accounted for prospectively. |

### Potential impact - both US GAAP and IFRS

Historically, modifications to communications contracts have typically been treated as new agreements with changes accounted for prospectively. Going forward, companies will need to evaluate modifications under the new guidance to determine whether they are accounted for prospectively or require a cumulative catch up adjustment. The analysis will need to consider modifications in new types of service plans, such as multi-line plans, in which it may be more difficult to determine whether the modification adds distinct goods or services, or modifies existing goods or services being provided under the contract.

### *Contract modifications for a series*

The revenue standards state that a company will account for a series of distinct goods or services that are substantially the same as a single performance obligation if each distinct good or service meets the criteria for over-time recognition and the same method would be used to measure progress for each distinct good or service. This approach will likely be used by communications companies for contracts that provide the customer with a consistent level of services on a monthly basis over a contract period, rather than treating each month or each day of service as a separate performance obligation.

Companies that account for a series of distinct goods or services in this manner at inception of the arrangement must consider the distinct goods or services in the contract (not the performance obligation) for purposes of applying the guidance on contract modifications. Therefore, when the remaining goods or services in the modified contract are distinct from goods or services that have already been transferred to the customer, these modifications will be accounted for prospectively.

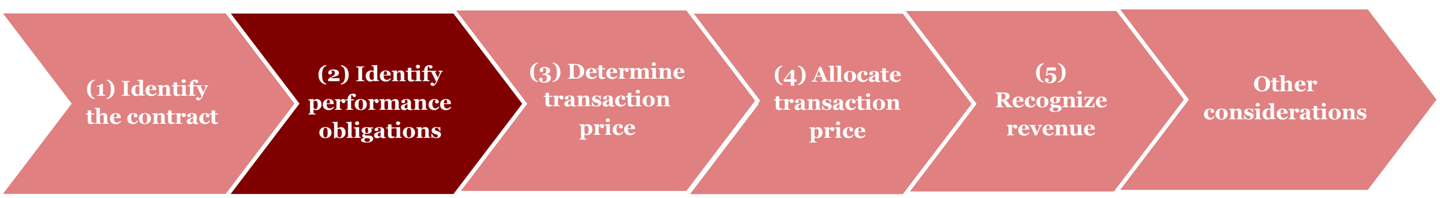
### *Example 1-1 – Contract modification*

*Facts:* A fixed-line communications company enters into a contract with a customer to provide voice and data services for 24 months at a fixed charge of $50 per month. After six months, the customer decides to add TV services for an incremental fee of $50 per month over the same term. This price is slightly lower than the price charged to customers who just purchase the TV service without voice and data services, which reflects the fact that the customer acquired the TV service as part of a bundle. In this scenario, assume there are no other fees or deliverables.

How should the company account for this modification?

*Analysis:* The TV services added by the customer are a distinct performance obligation. These services are being charged at relative standalone selling price (when adjusted for the selling costs avoided by transacting with an existing customer). The TV services are a new contractual arrangement, and there is no impact to the accounting for the existing data and voice services.

While this example is fairly simple, further complexities could arise with contract modifications. For example, the modification could provide the customer with a discount on new or existing services, the contract period could be extended for all services, or additional deliverables (such as equipment) could be introduced. Communications companies will have to assess the facts and circumstances in these more complex situations.




## 2. Identify performance obligations

A performance obligation is a promise to transfer a distinct good or service to a customer. Identifying the separate performance obligations within a contract affects both when and how much revenue is recognized. Companies will need to determine whether performance obligations within customer contracts should be accounted for separately or bundled together. A promised good or service might be explicit in a contract, or implicit, arising from customary business practices. Applying the separation principle might be challenging when there are multiple offerings in bundled packages.

Communications companies regularly bundle the sale of services and equipment (e.g., handsets, modems, accessories) and might also charge for activation or set up. Wireless companies give free or discounted equipment or promotional rates to customers as incentives to enter into contracts.

Equipment (including handsets) transferred to customers is a separate performance obligation in most cases if the company separately sells equipment or the customer can benefit from the handset together with other resources (for example, the handset could operate on another communications company's network). This is true regardless of whether the equipment is given at no cost or at a significantly discounted price. Other obligations, such as promises of future discounted services or other material rights, will also need to be evaluated to determine if they qualify as separate performance obligations.

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| **Performance obligations**<br><br>The revenue standards require companies to identify all promised goods or services in a contract and determine whether to account for each promised good or service as a separate performance obligation.<br><br>A performance obligation is a promise in a contract to transfer a distinct good or service to a customer.<br><br>A good or service is distinct and is separated from other obligations in the contract if:<br>• the customer can benefit from the good or service separately or together with other resources, and<br>• the good or service is separately identifiable from other goods or services in the contract.<br><br>The FASB clarified that companies are not required to identify promised goods or services that are immaterial in the context of the contract. The IASB did not incorporate similar wording; however, IFRS reporters should consider materiality concepts when identifying performance obligations.<br><br>A series of distinct goods or services that are substantially the same are accounted for as a single performance obligation if:<br>• each would be a performance obligation satisfied over time; and<br>• the same method would be used to measure the company's progress toward satisfaction.<br><br>Examples of this could include network access or call center services provided continuously over a period of time. | The following criteria are considered to determine whether elements included in a multiple-element arrangement are accounted for separately:<br>• The delivered item has value to the customer on a standalone basis.<br>• If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor. | The revenue recognition criteria are usually applied separately to each transaction. In certain circumstances, it might be necessary to separate a transaction into identifiable components to reflect the substance of the transaction. Separation is appropriate when identifiable components have standalone value and their fair value can be measured reliably.<br><br>Two or more transactions might need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. |

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| **Options to acquire additional goods or services** | | |
| A company might grant a customer the option to acquire additional goods or services free of charge or at a discount. These options might include customer award credits or other sales incentives and discounts. An option gives rise to a separate performance obligation if it provides a material right that the customer would not receive without entering into the contract. The company should recognize revenue allocated to the option when the option expires or when the additional goods or services are transferred to the customer.<br><br>An option to acquire an additional good or service at a price that is within the range of prices typically charged for those goods or services does not provide a material right, even if the option can be exercised only because of entering into the previous contract. | When an option is determined to be substantive, a company evaluates whether that option has been offered at a significant incremental discount. If the discount in an arrangement is significant, a presumption is created that an additional deliverable is being offered in the arrangement, requiring a portion of the arrangement consideration to be deferred at inception. | The recognition criteria are usually applied separately to each transaction (i.e., the original purchase and the separate purchase associated with the option). However, in certain circumstances, it is necessary to apply the recognition criteria to the separately-identifiable components as a single transaction to reflect the substance of the transaction.<br><br>If a company grants to its customers, as part of a sales transaction, an option to receive a discounted good or service in the future, the company accounts for that option as a separate component of the arrangement and therefore allocates consideration between the initial good or service provided and the option. |
| **Non-refundable upfront fees** | | |
| Some companies charge a customer a nonrefundable upfront fee at or near contract inception. Companies will need to determine whether the nonrefundable upfront fee relates to the transfer of a good or service to a customer.<br><br>The standards state that activation services are an example of nonrefundable upfront fees that do not result in the transfer of a good or service to the customer. The payment for the activation service is an advance payment for future communications services. | An upfront fee should be deferred and recognized systematically over periods in which it is earned unless it is in exchange for products delivered or services performed that represent the culmination of an earnings process.<br><br>When an upfront fee is not related to specific products or services, it should be excluded from the consideration allocated to the deliverables and recognized over the longer of (1) the initial contractual term of the arrangement or (2) the estimated period over which the customer is expected to benefit from the payment of the upfront fee (i.e., the customer benefit period).<br><br>When all or a portion of an upfront fee is related to a specific deliverable(s) within the arrangement, the upfront fee, or a portion of it, should be included in the consideration allocated to the deliverables using the relative selling price method. | Recognition of revenue from an upfront fee depends on the nature of the services provided. A company must determine whether an upfront fee related to installation or activation is a separate component of the transaction.<br><br>Generally, an activation fee for communications services is not a separate component, and the activation fee is recognized over the period that the communications services are provided to the customer. |

### Potential impact - both US GAAP and IFRS

Companies will need financial processes and systems that identify the different performance obligations in each of their contracts and pinpoint when and how the obligations are fulfilled. Traditionally, wireless communications companies have identified the device and service as separate units of accounting under existing guidance, but they will need to consider whether additional performance obligations exist under the new model. This assessment will need to extend to all obligations under a contract, even items that are not regularly sold by the company, or that have previously been viewed as marketing expenses (e.g., free products not related to the provision of communications services).

Companies will also need to consider separation when multiple services are provided in an arrangement, as this may affect the allocation of the transaction price to separate performance obligations that have different patterns of transfer. When multiple services (e.g., voice services, data services, television services) or multiple access points are being provided that the customer can benefit from either on its own or together with readily available resources (i.e., the services are capable of being distinct), companies will need to evaluate whether the promise to transfer the goods or services is separately identifiable from other promises in the contract (i.e., they are distinct in the context of the contract) or whether some or all of the goods or services should be combined into one performance obligation. For instance, if multiple services have the same pattern of transfer to the customer, the company may, as a practical matter, account for the services as a single performance obligation.

Communications companies will have to consider outsourcing and network IT contracts, various types of activation/connection services, and other upfront services (e.g., connecting customers to their networks or laying physical line to the customers' premises) to determine if these services meet the definition of a separate performance obligation and if a good or service is transferred to the customer. The timing of revenue recognition for communications companies that currently do not account for equipment separately from the telecom services will be significantly affected if the components of their bundled offerings are separate performance obligations under the revenue standards.

Many companies charge activation fees at the inception of a contract. The activation services are typically not a separate performance obligation. Activation fees are typically advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided. The recognition period could extend beyond the initial contractual term if (1) the customer has the option to renew and (2) that option provides the customer with a material right (e.g., an option to renew without requiring the customer to pay an additional activation fee). Companies should consider the impact of options on all contracts, including month-to-month service arrangements. This may result in a different pattern of revenue recognition from today's accounting models under which activation fees are often recognized over the contract period.

Further, communications companies increasingly sell multi-line plans and will need to determine whether the option to add additional lines is a material right that is a separate performance obligation.

## *Example 2-1 – Identifying performance obligations*

*Facts:* A communications company enters into a contract with a customer to provide wireless telecom services for $50 per month and a handset for $100. It also charges an activation fee of $30. The communications company sells handsets separately (for example, when a customer's handset is lost, stolen, or damaged).

How many separate performance obligations are in the contract?

*Analysis:* At least two separate performance obligations exist in this arrangement: telecom services and the handset. The handset is a separate performance obligation because the company sells the handset separately.

The handset would be a separate performance obligation even if the company did not sell the handset separately if the customer could use the handset to receive telecom services from another company.

Activation/connection fees are not separate performance obligations, but are considered upfront payments for the handset and future telecom services.

Depending on the facts and circumstances, the company may need to further assess the nature of the telecom services to determine whether the individual services should be considered separate performance obligations. For example, if the services consist of bundled voice, text, and data, and the customer has the right to roll over some or all of the unused services (e.g., unused data) to the next month, the individual services may not have the same pattern of transfer. As a result, the company would not be able, as a practical matter, to bundle all services into a single performance obligation as different measures of progress would be applied to them.

### *Example 2-2 – Options that do not provide a material right*

*Facts:* A communications company enters into a two-year contract with a customer to provide wireless telecom services for $50 per month. The contract requires the communications company to provide the customer with 800 voice minutes and 100 text messages per month. The contract specifies the customer may purchase additional voice services for $0.10 per minute and text services for $0.20 per message during the contract. These prices are typically charged for those services regardless of the type of contract, and therefore, they reflect the standalone selling price of those services.

Is the customer's option to purchase additional voice minutes and text messages a separate performance obligation?

*Analysis:* No. The option provided in the contract is not a performance obligation because it does not provide a material right to the customer. The customer pays the same price, or price within a range, for voice minutes and text messages as other customers. The company will recognize revenue for the additional voice minutes and text messages if and when the customer receives those additional services.

### *Example 2-3 – Multi-line "family" plans*

*Facts:* A communications company enters into a contract to provide unlimited telecom services under a multi-line "family" plan on a monthly basis. The customer has the option to add additional lines to the plan each month for a package price that reflects a decrease in the monthly service fee per line as additional lines are added.

Does the option to add an additional line to the plan provide the customer with a material right?

*Analysis:* No. The option to add additional lines to a family plan in a future month does not provide the customer with a material right. Even though a customer may add or subtract lines within the plan, which may be capable of being distinct, the context of the contract provides for a plan that shares the same telecom services as a bundle. Further, when customers add or subtract lines from the plan, they are making a decision on a month-to-month basis regarding which family plan to purchase that month (e.g., a three line plan vs. a four line plan). The pricing for the family plan is based on the number of lines purchased that month and is consistent across customers, regardless of the plan a customer purchased in prior months. The customer is not receiving a discount based on its prior purchases.

### *Example 2-4 – Installation services*

*Facts:* A communications company enters into a contract to provide cable services (television, internet, voice, etc.) on a monthly basis, with no contract end date. The company charges an upfront, nonrefundable installation fee of $50 to recover the cost of laying physical line to the customer's premises. This line can be used by other communications companies if the customer later changes service providers.

Is the installation service a separate performance obligation?

*Analysis:* It depends. The company will need to determine whether laying the physical line is a distinct good or service. In this example, other communications companies can provide services on the same physical line, so the line is separately identifiable and can be used by the customer without the company subsequently providing cable services. Therefore, laying the physical line is a distinct performance obligation.

### *Example 2-5 – Cable company, activation services*

*Facts:* A cable entity enters into a contract to provide cable services (television, internet, voice, etc.) on a monthly basis, with an initial contract period of 12 months. The company charges an upfront, nonrefundable fee of $50 to recover the cost of sending a technician to activate the service on the customer's premises.

Is the activation service a separate performance obligation?

*Analysis:* It depends. The company will need to determine whether the activation is a distinct service. In this example, the activation service is not distinct from the provision of the cable services because the customer cannot benefit separately from the activation service. The activation fee should be deferred and recognized over at least the contract period.

Companies will need to determine if the activation fee relates to the services that extend beyond the initial contract period, and should be recognized over that longer period. This could be the case if the customer has a material right to extend the contract without paying an additional activation fee.

## 3. Determine transaction price

The transaction price is the amount of consideration a company is entitled to receive in exchange for transferring goods or services to customers. Determining the transaction price is more straightforward when the contract price is fixed; it becomes more complex when it is not fixed. Discounts, rebates, refunds, credits, incentives, performance bonuses, and price concessions could cause the amount of consideration to be variable. Because variable consideration is required to be estimated and included in the transaction price subject to a constraint, communications companies may recognize revenue earlier under the new revenue guidance.

| Final guidance | Current US GAAP | Current IFRS |
| --- | --- | --- |
| **Variable consideration** | | |
| The transaction price might include an element of consideration that is variable or contingent upon the outcome of future events, such as discounts, rebates, refunds, credits, incentives, etc. A company should use the expected value or most likely outcome approach to estimate variable consideration, depending on which is the most predictive.<br><br>Variable consideration included in the transaction price is subject to a constraint. The objective of the constraint is that a company should recognize revenue as performance obligations are satisfied to the extent it is probable (US GAAP) or highly probable (IFRS) that a significant reversal will not occur in future periods. Although the terminology differs, "highly probable" under IFRS means the same as "probable" under US GAAP. Management should update the assessment at each reporting period.<br><br>If a company receives consideration from a customer and expects to refund some or all of that consideration to the customer, it recognizes a refund liability for an amount it expects to refund.<br><br>Customers might not exercise all of their contractual rights related to a contract, such as mail-in rebates and | The seller's price must be fixed or determinable for revenue to be recognized.<br><br>Revenue related to variable consideration generally is not recognized until the uncertainty is resolved. It is not appropriate to recognize revenue based on the probability of an uncertainty being achieved.<br><br>Certain sales incentives entitle the customer to receive a cash refund (e.g., a rebate) for some of the price charged for a product or service. The company recognizes a liability for those sales incentives based on the estimated refunds or rebates that will be claimed by customers.<br><br>The company also recognizes a liability (or deferred revenue) for the maximum potential amount of the refund or rebate (i.e., no reduction is made for expected breakage) if future refunds or rebates cannot be reasonably and reliably estimated. | Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset or liability could be exchanged or settled between knowledgeable, willing parties in an arm's length transaction.<br><br>Trade discounts, volume rebates, and other incentives (such as cash settlement discounts) are taken into account in measuring the fair value of the consideration to be received.<br><br>Revenue related to variable consideration is recognized when (1) it is probable that the economic benefits will flow to the company and (2) the amount is reliably measurable, assuming all other revenue recognition criteria are met.<br><br>The company recognizes a liability based on the expected levels of rebates and other incentives that will be claimed. The liability should reflect the maximum potential amount if no reliable estimate can be made. |

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| other incentive offers. Companies will need to continually update their estimates to adjust for changes in expectations. The revenue guidance explains several factors that companies should consider in assessing the amount of consideration to which a company expects to be entitled. | | |

### *Significant financing component*

The revenue guidance requires companies to adjust the promised amount of consideration to reflect the time value of money if the contract has a significant financing component. Factors to consider when determining whether a contract has a significant financing component include, but are not limited to: (1) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services, (2) whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction, and (3) the interest rate in the contract and prevailing interest rates in the relevant market (i.e., interest rates offered by financing institutions in the same market or geography).

A significant financing component would not exist when: (1) the customer paid for the goods or services in advance and transfer is at the discretion of the customer, (2) a substantial amount of the promised consideration is variable and the amount or timing of consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the company, or (3) the difference between the cash selling price and promised consideration is for a reason other than providing financing and the difference is proportional to that reason.

### Potential impact - both US GAAP and IFRS

Some companies will recognize revenue earlier under the revenue guidance because variable consideration is included in the transaction price prior to the date on which all contingencies are resolved. For example, a network provider might offer a communications company (its customer) a volume discount on usage rates (voice and data access) to access its network as part of a minimum purchase commitment arrangement. The network provider charges penalties or the customer loses the volume discount if the customer does not meet specified usage volumes. Network providers that offer such discounts under minimum purchase commitment arrangements and determine it is probable (US GAAP) or highly probable (IFRS) that they will receive penalties or additional payments because customers fail to meet the specified usage volumes could recognize revenue earlier than under current guidance.

Companies will also have to estimate amounts related to incentives and consider the guidance for variable consideration to determine the amounts to which they expect to be entitled, considering their experience with existing incentives, discounts, take-rates, and other external factors.

Communications companies should consider whether the transfer of a handset to a customer at the initiation of the contract and collecting monthly payment for the handset over the contract period provides the customer with significant financing, which would result in an adjustment to the transaction price to reflect the financing component. A significant financing component may exist even though a contract has an interest rate of zero.

Communications companies may offer incentives to customers to purchase handsets with payments made over an extended period of time. The company needs to determine whether it offered a discount equal to the financing charge that would have otherwise been charged to the customer. If a financing component exists, the company needs to evaluate whether the financing is significant.

## *Example 3-1 – Discount program, revenue is not constrained*

*Facts:* A communications company enters into contracts with its customers to provide telecom services for $50 per month and provides Equipment X for $200. The customers will receive a discount of $100 related to the purchase of Equipment X if they submit a proper form and proof of purchase via mail (also known as a mail-in-rebate). The company has predictive experience from providing similar discounts to a range of customers (refund amounts for similar equipment with similar sales prices).

Historically, 75% of the company's customers took advantage of the rebate and the company concludes that there are no external economic factors that affect historical trends.

How should the company estimate the transaction price?

*Analysis:* The company should estimate the transaction price based on the amounts to which it expects to be entitled using the most recent history for similar discount programs (refund amounts for similar equipment with similar sales prices). It estimates the refund liability for each transaction using the following probabilities representing the pattern of similar rebates.

| Amount | Probability | Probability-weighted amount |
|---|---|---|
| $ 0 | 25% | $ 0 |
| 100 | 75% | 75 |
| | | $ 75 |

The company concludes it is probable (US GAAP)/highly probable (IFRS) that variable consideration of $25 will not be subject to significant reversal. The company records a refund liability of $75 and reduces the transaction price by $75. The company will update the estimated liability at each reporting period, with any adjustments recorded to revenue.

### *Example 3-2 – Discount program, revenue is constrained*

*Facts:* A communications company is launching its service in a new country; it enters into contracts with its customers to provide telecom services for $50 per month and Equipment Y for $350. The customers receive a discount of $100 related to the purchase of the equipment if they submit a proper form and proof of purchase via mail. The company does not have predictive experience providing similar discounts (refund amounts for similar equipment with similar sales prices) in this country and concludes that there is no amount of the variable consideration (the potential discount) that is probable (US GAAP)/highly probable (IFRS) of not being subject to a significant reversal.

How should the company determine the transaction price?

*Analysis:* The company records a full refund liability of $100 and reduces the transaction price by $100 as there is no amount of the potential discount that is probable (US GAAP)/highly probable (IFRS) of not being subject to a significant reversal.

The company will adjust the liability and recognize revenue as soon as management is able to conclude it is probable (US GAAP)/highly probable (IFRS) that (1) there will be no significant reversal for some part of the consideration or (2) the right to the discount expires. The company will update the estimated liability at each reporting period, with any adjustments recorded to revenue.

### *Example 3-3 – Minimum purchase contract*

*Facts:* A network provider enters into a contract with a communications company (its customer) to provide access to its network over a one-year period. The contract offers a discounted usage rate of $0.05 per voice minute. The discounted rate is contingent on the customer's minimum monthly purchase commitment of 25 million minutes of network voice usage. If the customer is unable to meet the volume commitments, the usage rate increases to $0.08 per voice minute, applied retroactively.

How should the network provider determine the transaction price?

*Discussion:* The network provider should estimate the variable consideration to determine the transaction price. The network provider determines, based on its facts and circumstances, including the customer's usage history, that there is an 85% probability that the customer *will* meet the minimum monthly volume commitments for the contract period and a 15% probability the customer *will not* meet the minimum commitments. The network provider uses the most likely outcome method as it concludes it is the best prediction of the amount it expects to receive. It also determines that there is no amount in excess of $0.05 per minute that is probable (US GAAP)/highly probable (IFRS) of not being reversed. Therefore, the network provider will recognize revenue based on a transaction price of $0.05 per voice minute.

## 4. Allocate transaction price

Communications companies often provide multiple products and services to their customers as part of a bundled offering. These arrangements usually consist of the sale of telecom services and the sale of equipment (wireless handset, modem, etc.). Some communications companies also charge customers upfront activation fees. Under current US GAAP, communications companies are required to apply a contingent revenue cap, while most communications companies reporting under IFRS use either a residual method or apply a contingent revenue cap. The contingent revenue cap limits the amount of consideration allocated to the delivered item (e.g., a handset) to the amount that is not contingent on the delivery of additional items (e.g., the telecom services).

Under the new guidance, the transaction price in an arrangement must be allocated to each separate performance obligation based on the relative standalone selling prices (SSP) of the goods or services being provided to the customer. The allocation could be affected by variable consideration or discounts.

The best evidence of SSP is the price a company charges for that good or service when the company sells it separately in similar circumstances to similar customers. However, goods or services are not always sold separately. The SSP needs to be estimated or derived by other means if the good or service is not sold separately.

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| The transaction price is allocated to separate performance obligations in a contract based on relative standalone selling prices, as determined at contract inception.<br><br>Companies will need to estimate the selling price if a standalone selling price is not observable. In doing so, it should maximize the use of observable inputs.<br><br>Possible estimation methods include:<br>• Expected cost plus reasonable margin<br>• Assessment of market price for similar goods or services<br>• Residual approach (if certain criteria are met)<br><br>A residual approach may be used to estimate the standalone selling price when the selling price of a good or service is highly variable or uncertain. A selling price is highly variable when a company sells the same good or service to different customers (at or near the same time) for a broad range of amounts. | Arrangement consideration is allocated to each unit of accounting based on the relative selling price.<br><br>Third-party evidence (TPE) of fair value is used to separate deliverables when vendor specific objective evidence (VSOE) of fair value is not available. Best estimate of selling price is used if neither VSOE nor TPE exist. The term "selling price" indicates that the allocation of revenue is based on entity-specific assumptions, rather than assumptions of a marketplace participant. The residual or reverse residual methods are not allowed.<br><br>When performing the allocation using the relative selling price method, the amount of consideration allocated to a delivered item is limited to the consideration received that is not contingent upon the delivery of additional goods or services. This limitation is known as the "contingent revenue cap."<br><br>Communications companies typically account for the sale of the equipment and telecom services in a bundled offering as separate units of account, with telecom services collectively accounted for as a single unit of account, as they are generally delivered at the same time. | Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset or liability could be exchanged or settled, between knowledgeable, willing parties in an arm's length transaction.<br><br>IFRS does not mandate how consideration is allocated and permits the use of the residual method, in which the consideration for the undelivered element of the arrangement (normally service or tariff) is deferred until the service is provided, when this reflects the economics of the transaction. Any revenue allocated to the delivered items is recognized at the point of sale. |

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| A selling price is uncertain when a company has not yet established a price for a good or service and the good or service has not previously been sold. | The arrangement consideration that can be allocated to the equipment is generally limited to cash received because future cash receipts are contingent upon the company providing telecom services. Therefore, when the handset is transferred, revenue is recognized at the amount that the customer paid for the handset at contract inception. The remaining contractual payments are recognized subsequently as the company provides network services to the customer. | |

### Potential impact - both US GAAP and IFRS

The revenue guidance's allocation requirements will have significant implications to the telecom industry. It requires the transaction price be allocated to each separate performance obligation in proportion to the standalone selling price of the good or service. It therefore eliminates the contingent revenue cap. The revenue guidance also substantially reduces the circumstances when a residual approach can be applied under IFRS and permits it in certain circumstances under US GAAP. The residual approach is different from the residual method that is used today. Applying today's residual method results in the entire discount in an arrangement being allocated to the first item delivered under the contract. This will not be the case under the new guidance.

Judgment will be needed to determine the standalone selling price for each separate performance obligation (e.g., services, equipment, and material rights) in a customer contract. There is good visibility into the pricing of communications equipment and the associated telecom service in some markets. However, in many markets, communications companies charge customers little, if anything, for the equipment, and only sell equipment bundled with the telecom services. If communications companies do not separately sell equipment, management may have to use various estimation methods, including, but not limited to a market assessment approach or a cost plus margin approach.

Determining the standalone selling price of certain services may also present challenges. Historically, there was a reasonable level of consistency in the amounts charged for bundled services within operators and between operators. Today, there is increasing variability in the amounts charged for equivalent bundles of services. For example, the amount charged for services can vary depending on the number and mix of devices chosen by the customer, including "SIM-only" deals in which the monthly price for service is less when the customer does not take a subsidized device, or multi-line plans.

The revenue guidance will likely require companies to allocate more of the transaction price to the equipment than under the current guidance, and therefore, result in earlier recognition of revenue. Recognizing more revenue than consideration received also results in the recognition of a contract asset, which will need to be monitored for impairment. See chapter 4 of PwC's Revenue guide for more information.

Companies will face practical challenges in allocating the transaction price for a large volume of customer contracts with varying configurations of equipment and service plans. The revenue guidance permits a company to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics if it reasonably expects that the effects on the company's financial statements of doing so would not differ materially from the results of applying the guidance to individual contracts (or performance obligations). The boards acknowledged in their Bases for Conclusions that this approach may be particularly useful to companies in the telecommunications industry. The boards also noted that companies should be able to take a "reasonable approach" to identify portfolios for applying this guidance, as opposed to a quantitative evaluation. Companies choosing to apply a portfolio approach should consider the extent of variability in characteristics of portfolio groupings not only upon adoption, but also on an ongoing basis. Companies should consider whether they need to modify existing systems or develop new systems to gather information on customer contracts and to perform the required allocations of the transaction price between separate performance obligations.

### *Example 4-1 – Allocating the transaction price*

*Facts:* A wireless company enters into sales arrangements with two different customers: Customer A and Customer B. Each customer purchases or receives the same handset and selects the same monthly service plan. The standalone selling price for the handset is $300 (it is purchased wholesale by the wireless company for $290) and the standalone selling price of the telecom service plan is $40 per month.

Customer A purchases the handset for $300 and enters into a cancelable contract to receive telecom services for $40 per month.

Customer B enters into a 24-month service contract for $40 per month and receives a discounted handset for $50.

| In summary: | Customer A | Customer B |
|---|---|---|
| Standalone selling price of handset | $ 300 | $ 300 |
| Standalone selling price of services | 40 | 960 ($40 x 24 months) |
| Total | $ 340 | $1,260 |
| Cost of equipment | $ 290 | $ 290 |

| | |
|---|---|
| Customer A transaction price | $ 340 ($300 handset + $40 for one month of service) |
| Customer B transaction price | $ 1,010 ($960 services + $50 for handset) |

How should the transaction price be allocated to the performance obligations in the contracts with Customer A and B?

*Analysis:* The company needs to identify the separate performance obligations within the customer contracts. In this example, the sales of telecom services and handsets are separate performance obligations because they are distinct goods and services. Revenue is recognized when a promised good or service is transferred to the customer and the customer obtains control of that good or service. Revenue is recognized for the sale of the handset at delivery, when the communications company transfers control of the handset to the customer. Service revenue is recognized over the contract service period.

For simplicity, the example assumes the potential financing impact of transferring the handset to the customer at the initiation of the contract and collecting the customer's monthly payment over the 24-month contract period is insignificant.

The tables below compare the effect of applying the allocation guidance in the revenue guidance with that of the current guidance.

### *Current guidance—existing US GAAP guidance (contingent revenue cap)*

| Customer | Day 1 | Month 1 | Month 2 | Month 3 |
|---|---|---|---|---|
| Customer A | $300[(a)] | $40[(a)] | $40 | $40 |
| Customer B | $50[(b)] | $40 | $40 | $40 |
| Total | $350 | $80 | $80 | $80 |

(a) Recognize revenue for the sale of the handset ($300) and service ($40) based on the relative standalone selling prices.
(b) Recognize revenue for the amount of consideration received ($50) that is not contingent upon the delivery of additional items (telecom services).

### *Current guidance—existing IFRS guidance (residual method)*

| Customer | Day 1 | Month 1 | Month 2 | Month 3 |
|---|---|---|---|---|
| Customer A | $300[(a)] | $40 | $40 | $40 |
| Customer B | $50[(b)] | $40 | $40 | $40 |
| Total | $350 | $80 | $80 | $80 |

(a) Under the residual method, the amount of consideration allocated to the delivered item ($300) equals the total arrangement consideration ($340) less the aggregate fair value of the undelivered item(s) ($40).
(b) Under the residual method, the amount of consideration allocated to the delivered item ($50) equals the total arrangement consideration ($1,010) less the aggregate fair value of the undelivered item(s) ($960).

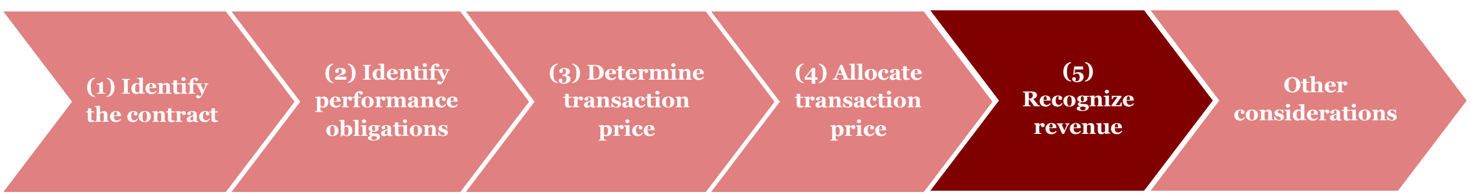
### *New guidance—revenue recognized*

| Customer | Day 1 | Month 1 | Month 2 | Month 3 |
|---|---|---|---|---|
| **Customer A** | **$300**[a] | **$40**[a] | **$40** | **$40** |
| **Customer B** | **$240**[b] | **$32**[c] | **$32**[c] | **$32**[c] |
| **Total** | **$540** | **$72** | **$72** | **$72** |

(a) Handset: $300 = ($300 / $340) x $340; One month of service $40 = ($40 / $340) x $340.
(b) Handset: $240 = ($300 / $1,260) x $1,010.
(c) Monthly service revenue: $32 = ($960 / $1,260) x $1,010 = $770 / 24 months.

In this example, the communications company recognizes $190 more in equipment revenue compared to current US GAAP and IFRS. The communications company will also recognize a net contract asset of $190 under the revenue guidance ($540 less $350 cash received), which should be amortized over the period that the related goods and services are transferred to the customers. Management needs to monitor the contract asset for impairment each reporting period. For example, the communications company may have to impair the asset if Customer B terminates the contract before the end of two years, and it is unable to collect an early termination fee in excess of the contract asset balance.

This simple example does not address other complexities that companies will have to consider. For example, the company may charge an activation fee. The guidance states that activation services are an example of nonrefundable upfront fees that do not result in the transfer of a good or service to the customer. Rather, the activation fee is an advance payment for future communications services. Additionally, if the company grants the customer an option to renew that provides a material right (e.g., an option to renew without requiring the customer to pay an additional activation fee), the amount allocated to the material right would likely be recognized over the customer relationship period.




## 5. Recognize revenue

A performance obligation is satisfied and revenue is recognized when control of the promised good or service is transferred to the customer. A customer obtains control of a good or service if it has the ability to (1) direct its use and (2) obtain substantially all of the remaining benefits from it. Directing the use of an asset refers to a customer's right to deploy the asset, allow another entity to deploy it, or restrict another company from using it.

Management should evaluate transfer of control primarily from the customer's perspective, which reduces the risk that revenue is recognized for activities that do not transfer control of a good or service to the customer.

(1) Identify the contract | (2) Identify performance obligations | (3) Determine transaction price | (4) Allocate transaction price | (5) Recognize revenue | Other considerations

## Other considerations

### *Costs to obtain a contract*

Communications companies often pay commissions to internal sales agents and third-party dealers for connecting new customers to their networks. Commissions paid for connecting new customers can vary depending on the length of the service contract and the type of service plan, including any enhanced services sold. The longer the service contract and the greater the monthly proceeds (e.g., service plans with relatively high or unlimited minutes of use), the greater the commission costs.

Some companies that report under IFRS capitalize customer acquisition costs as an intangible asset, while other communications companies, including most US communications companies, expense these costs as incurred. The new guidance requires communications companies to capitalize incremental costs of obtaining a contract if the costs are expected to be recovered. As a practical expedient, companies are permitted to expense these costs when incurred if the amortization period would be less than one year.

Some wireless companies also provide free or heavily-discounted handsets to attract customers. Incentive programs will not be accounted for as costs to obtain a contract under the revenue guidance. A handset is a separate performance obligation, and the cost of the handset is recognized as an expense when the performance obligation is satisfied (i.e., when the handset is delivered to the customer). Communications companies offer a wide range of discounts and subsidies, using both their own and third-party dealer networks, and will have to assess the accounting for each different type of arrangement.

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| Companies recognize as an asset the incremental costs of obtaining a contract with a customer if they expect to recover them.<br><br>The incremental costs of obtaining a contract are those costs that a company would not have incurred if the contract had not been obtained. All other costs incurred regardless of whether a contract was obtained are recognized as an expense.<br><br>The revenue standards permit companies to expense incremental costs of obtaining a contract when incurred if the amortization period would be one year or less, as a practical expedient.<br><br>Contract costs recognized as an asset are amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates. In some cases, the asset might relate to goods or services to be provided in future | US GAAP allows incremental direct acquisition costs to be deferred and charged to expense in proportion to the revenue recognized. Other costs—such as advertising expenses and costs associated with the negotiation of a contract that is not consummated—are charged to expense as incurred. | Given the lack of definitive guidance under current IFRS, costs of acquiring customer contracts are capitalized by some communications companies as intangible assets and amortized over the customer contract period, while other communications companies expense the costs when incurred. |

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| anticipated contracts (e.g., service to be provided to a customer in the future if the customer chooses to renew an existing contract).<br><br>An impairment loss is recognized if the carrying amount of an asset exceeds:<br><br>1) the amount of consideration to which a company expects to be entitled in exchange for the goods or services; less<br>2) the remaining costs that relate directly to providing those goods or services.<br><br>Under IFRS, companies may reverse impairments when costs become recoverable; however, the reversal is limited to an amount that does not result in the carrying amount of the capitalized acquisition cost exceeding the depreciated historical cost. Companies are not permitted to reverse impairments under US GAAP. | | |

### Potential impact - both US GAAP and IFRS

The revenue standards will have a significant impact on companies that do not currently capitalize costs to obtain contracts. Companies will likely have to develop systems, processes, and controls to identify and track incremental contract acquisition costs and to subsequently monitor the capitalized costs for impairment.

A communications company will capitalize costs to obtain a contract as an asset if they are recoverable, and amortize them consistent with the pattern of when goods or services to which the asset relates are transferred to the customer. Companies will need to use judgment to determine the amortization period as the revenue standards require companies to consider periods beyond the initial contract period (e.g., the renewal of existing contracts and anticipated contracts). Therefore, the asset recognized from the cost to obtain the initial contract may be amortized over a period longer than the initial contract term, such as over the average customer life, which is based on the period of expected future cash flows to be received from the customer. However, there may be circumstances when the asset should be amortized over a period shorter than the average customer life, such as when the lifecycle of the goods or services to which the asset relates is shorter than the average customer life.

Amortizing an asset over a longer period than the initial contract would not be appropriate when a company pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. The FASB staff clarified that the level of effort to obtain a contract or renewal should not be a factor in determining whether the commission paid on a contract renewal is commensurate with the initial commission. However, it may be reasonable for a company to conclude that a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract value.

A company also has to develop a systematic approach, considering the number of customers and contract offerings, to test assets relating to contract acquisition costs for impairment (e.g., a portfolio approach) when the estimated amount of consideration to be received from customers might be less than the outstanding contract asset.

Spreading these costs over the amortization period could significantly affect operating margins compared to the current accounting model. Wireless companies, for example, often incur significant contract acquisition costs during the holiday seasons as they sign up customers through significant promotional offers.

### *Example 6-1 – Contract acquisition costs, practical expedient*

*Facts:* A communications company enters into a contract with a customer to provide telecom services. The transaction does not include the sale of a device. The company pays a third-party dealer a commission to connect the customer to its network. The customer signs an enforceable contract to receive telecom services for one year.

How should the communications company account for the third-party dealer commission?

*Analysis:* The company identifies incremental contract acquisition costs and capitalize those costs that are recoverable.

The communications company may use the practical expedient and expense contract acquisition costs when incurred if the amortization period would be one year or less. In this case, the company determines that the amortization period is one year because no renewal is expected.

### *Example 6-2 – Contract acquisition costs, identifying incremental costs*

*Facts:* A communications company sells wireless telecom service subscriptions (service plans) from a retail store in a shopping mall. Sales agents employed at the retail store sign 120 customers to two-year telecom service contracts in a particular month. The monthly rent for the store is $5,000. The communications company pays the sales agents' commissions for the sale of telecom service contracts, in addition to their normal wages. Wages paid to the sales agents during the month are $12,000 and commissions are $24,000.

The communications company also offers customers free, or significantly subsidized, handsets to create an incentive for them to enter into two-year contracts. The net subsidy (loss) on handsets sold to the 120 customers is $36,000 (measured on the basis of the cost of the handset compared to advertised price, and not as specified in the revenue standards). The retail store also incurs $2,000 in costs during the month to advertise in the local journals.

How much should the communications company recognize as a contract acquisition asset?

*Analysis:* The communications company is required to capitalize incremental costs to acquire contracts, which are those costs it would not have incurred unless it acquired the contracts. The practical expedient is not available as the amortization period is greater than a year. In this example, the only costs that qualify as incremental contract acquisition costs are the $24,000 commissions paid to the sales agents.

All other costs are expensed when incurred. The store rent of $5,000, the sales agents' wages of $12,000, and advertising expenses of $2,000 are all expenses the communications company would have incurred regardless of acquiring the customer contracts.

Although the company might internally regard the handset losses as marketing incentives or incidental goods or services, the sale of the handsets are performance obligations, and the costs of the handsets are recognized (as cost of goods sold) as the goods are delivered.

Companies should be aware that subtle differences in arrangements could have a substantial impact on the accounting for subsidies and discounts under the revenue guidance. For example, another communications company might pay third- party dealers greater commissions to allow those dealers to offer similar incentives (i.e., offer significantly-discounted handsets at a dealer's discretion). Payments to dealers that are in-substance commissions should be treated as contract acquisition costs.

### *Example 6-3 – Contract acquisition costs, amortization period for prepaid services*

*Facts:* A communications company sells wireless services to a customer under a prepaid, unlimited monthly plan. The communications company pays commissions to sales agents when they activate a customer on a prepaid wireless service plan. While the stated contract term is one month, the communications company expects the customer, based on the customer's demographics (e.g., geography, type of plan, and age), to renew for six additional months.

What period should the communications company use to amortize the contract acquisition costs (i.e., the commission costs)?

*Analysis:* The company could use the practical expedient to expense the costs as incurred. If the company chooses to capitalize the costs, it will use judgment to determine an amortization period that represents the period during which the company transfers the telecom services. In this example, the company determines an amortization period of seven months based on anticipated renewals.

### *Fulfillment costs*

Some communications companies defer the cost of activating customers to the network (i.e., labor and equipment cost) under US GAAP. These costs can be material and are typically deferred up to the amount of related activation revenue and amortized on a straight-line basis consistent with the related revenues.

Under IFRS, companies that provide long-term network outsourcing services sometimes defer set-up costs because they are necessary investments to support the ongoing delivery of the contract.

Costs to fulfill contracts are capitalized in accordance with other standards (e.g., inventory, property, plant and equipment, or intangible assets) or, if not within the scope of other guidance and they meet specific requirements, are capitalized under the revenue guidance. Companies need to review their cost capitalization policies to understand the potential effect of these changes.

| Final guidance | Current US GAAP | Current IFRS |
|---|---|---|
| Direct costs incurred to fulfill a contract are first assessed to determine if they are within the scope of other standards, in which case the company accounts for them in accordance with those standards.<br><br>Costs that are not in the scope of another standard are evaluated under the revenue guidance. A company recognizes an asset only if the costs:<br>• relate directly to a contract;<br>• generate or enhance resources that will be used in satisfying future performance obligations (i.e., they relate to future performance); and<br>• are expected to be recovered.<br><br>These costs are then amortized as control of the goods or services to which the asset relates is transferred to the customer. | Costs incurred to install services at the origination of a customer contract are either expensed as incurred or deferred and charged to expense in proportion to the revenue recognized.<br><br>In particular, direct, incremental, set-up costs on long term network outsourcing contracts may be deferred by reference to the FASB Conceptual Framework and analogy to ASC 310-20 and ASC 605-20-25-4.<br><br>In addition, many of the costs of connecting customers form part of the operator's network, and the costs are capitalized as property, plant and equipment. | Costs incurred to install services at the origination of a customer contract are either expensed as incurred or recognized as an asset and charged to expense in proportion to the revenue recognized, depending on the nature of the costs.<br><br>In particular, direct, incremental, set-up costs on long term network outsourcing contracts may be deferred if they are "costs that relate to future activity on the contract."<br><br>In addition, many of the costs of connecting customers form part of the operator's network, and the costs are capitalized as property, plant and equipment. |

#### Potential impact - both US GAAP and IFRS

Communications companies that currently expense all contract fulfillment costs as incurred might be affected by the revenue standards since costs are required to be capitalized when the criteria are met. Fulfillment costs that are likely to be in the scope of this guidance include, among others, set-up costs for service providers.

## *About PwC's Technology, Media, and Telecommunications (TMT) practice:*

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