

Urgent Issues Group

Interpretation 1042

December 2004

Subscriber Acquisition Costs in the Telecommunications Industry



Australian Government

**Australian Accounting
Standards Board**

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PREFACE

Main Features of UIG Interpretation 1042

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. Early adoption of this Interpretation is not permitted. Application of this Interpretation will begin in the context of adopting all Australian equivalents to International Financial Reporting Standards. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

The Interpretation requires direct subscriber acquisition costs to be capitalised, and subsequently amortised, when they meet the asset definition and recognition criteria. Direct subscriber acquisition costs are directly attributable to establishing specific subscriber contracts, and would not have been incurred had those contracts not been entered into. The type of subscriber contract may affect the degree to which the asset recognition criteria are satisfied. The provision of telephones to subscribers, whether or not discounted, is treated as a sale transaction separate from the acquisition of the subscriber contract.

Comparison with Superseded Requirements

UIG Interpretation 1042 supersedes Abstract 42 *Subscriber Acquisition Costs in the Telecommunications Industry*. Although the requirements have many similarities, there are two principal differences between the pronouncements arising from the requirements of Australian equivalents to IFRSs. First, Abstract 42 included the subsidised provision of telephones as a subscriber acquisition cost whereas this Interpretation treats the provision of telephones as a separate sale transaction. Secondly, Abstract 42 required amortisation of the subscriber acquisition costs asset over the period during which the future economic benefits are expected to be obtained. This Interpretation limits that amortisation period to the period of the subscriber contract.

URGENT ISSUES GROUP
INTERPRETATION 1042
***SUBSCRIBER ACQUISITION COSTS IN THE
TELECOMMUNICATIONS INDUSTRY***

Interpretation 1042 is set out in paragraphs 1 to 29.

ISSUE

1. Entities in the telecommunications industry incur significant expenditures in setting up and establishing business operations that result in the acquisition of various intangible rights rather than tangible assets. Specifically, the expenditures often include subscriber acquisition costs. The entities incur substantial costs in acquiring new customers, including costs relating to advertising, the employment of sales staff, the payment of commissions and the subsidised provision of telephones.
2. Accounting Standards in Australia do not specifically address the accounting for customer acquisition costs in the telecommunications industry. Concern has been expressed that, in the absence of authoritative guidance, diverse or unacceptable accounting practices may occur or develop and that this will undermine the relevance and reliability of general purpose financial reports.
3. The issues are:
 - (a) Should subscriber acquisition costs incurred by entities in the telecommunications industry be capitalised, that is, recognised as an asset?
 - (b) If so, what costs should be recognised as part of the cost of the asset?
 - (c) If subscriber acquisition costs are capitalised, should they be amortised and, if so, on what basis?

CONSENSUS

4. For the purposes of this Interpretation, subscriber acquisition costs are costs incurred in obtaining and recording telecommunications service contracts with subscribers. Direct subscriber acquisition costs are those incremental subscriber acquisition costs that are directly attributable to establishing specific subscriber contracts and would not have been incurred had those contracts not been entered into. Those costs do not include the cost of telephones provided to subscribers.
5. Direct subscriber acquisition costs shall be recognised as expenses as incurred, except that they shall be recognised as an asset when, and only when, the costs can be identified separately and:
 - (a) the entity controls future economic benefits as a result of the costs incurred;
 - (b) it is probable that those future economic benefits will flow to the entity; and
 - (c) the costs can be measured reliably.
6. Subscriber acquisition costs other than those dealt with in paragraph 5 shall be recognised as expenses as incurred.
7. Subscriber acquisition costs recognised as an asset in accordance with paragraph 5 shall be amortised from the inception of the contract over the lesser of:
 - (a) the stated period of the contract; and
 - (b) the period during which the future economic benefits are expected to be obtained.

Application

8. This Interpretation applies to:
 - (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001* and that is a reporting entity;
 - (b) general purpose financial reports of each other reporting entity; and

- (c) **financial reports that are, or are held out to be, general purpose financial reports.**
9. **This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.**
10. **This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.**
11. **The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**
12. **When applicable, this Interpretation supersedes Abstract 42 *Subscriber Acquisition Costs in the Telecommunications Industry*, as issued in October 2001.**
13. **Abstract 42 remains applicable until superseded by this Interpretation.**

DISCUSSION

14. Accounting Standard AASB 138 *Intangible Assets* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. AASB 138 also specifies that an intangible asset should be recognised in the balance sheet only when it is probable that the future economic benefits attributable to the asset will flow to the entity and the asset possesses a cost that can be measured reliably. The Standard defines an intangible asset as an identifiable non-monetary asset without physical substance. The identifiability criterion is satisfied when the asset is separable from the entity or arises from contractual or other legal rights. Subscriber contracts clearly meet this criterion, and are distinguished from internally generated intangible assets such as customer lists since the subscriber contracts involve transactions with external parties.
15. Example 14(b)(iii) in the Appendix to AASB 118 *Revenue* illustrates the recognition of an investment management contract as an asset, distinguishing the costs of securing a contract from those relating to providing ongoing services under the contract. Similarly, where an entity has incurred costs to obtain and record telecommunication contracts with subscribers, the characteristics of an asset (and therefore the condition in paragraph 5(a) of this Interpretation) and the asset recognition criteria (paragraphs 5(b) and 5(c)) may or may not be met. Whether these conditions are met in relation to subscriber acquisition

costs is considered in the context of the nature of the costs incurred and the types of subscriber contracts, as discussed below.

Nature of Subscriber Acquisition Costs

16. The criteria for the recognition of assets set out in paragraphs 5(b) and (c) are likely to be satisfied only in relation to a limited range of costs incurred in obtaining subscribers. For example, the requirement that it is probable that the costs incurred will result in future economic benefits for the entity is likely to be met only for costs that can be shown to be directly attributable to the obtaining of subscribers to the entity's services and that would not otherwise have been incurred by the entity. These incremental costs can be specifically identified in relation to particular contracts, rather than merely to subscriber contracts in general. Directly attributable costs may include costs incurred prior to the contracts being entered into. Directly attributable costs include costs such as commissions paid for obtaining subscriber contracts, and costs of recording subscriber and contract information in relation to contracts entered into.
17. It is difficult to show a reliable relationship between the incurrence of other costs and the obtaining of subscriber contracts, so that the asset definition or recognition criteria are unlikely to be satisfied in relation to such costs. For example, it may be difficult to reliably measure the portion of the costs related to unsuccessful contract origination efforts or idle time. These costs include wages, salaries and other employee entitlements of the sales force (excluding commissions paid for obtaining subscriber contracts), costs of establishing subscriber credit and operating policies, advertising costs, and other administrative and overhead costs (such as directors' and executives' salaries, rent, depreciation and all other occupancy and equipment costs).
18. An entity may offer prospective subscribers the opportunity to purchase a telephone on a subsidised basis, that is for a discounted amount or for instalment payments over a specified period. The provision of a telephone to subscribers is accounted for as a sale under AASB 118 *Revenue*, as a separately identifiable component of the transaction. Where the payments under a subscriber contract cover both the initial supply of a telephone and the supply of subsequent services, the entity recognises revenue on a basis that reflects the purpose for which the payments are required.

Subscriber Contracts

19. In order for any subscriber acquisition costs to be recognised as assets, it is necessary for the entity incurring the costs to control future

economic benefits as a result of the costs incurred. The entity may incur costs in the expectation that they will lead to future revenue streams, however where the expenditure does not give rise to subscriber contracts there is little basis for concluding that future economic benefits are controlled by the entity. Therefore, this Interpretation is based on the view that the characteristics of an asset can be satisfied in relation to subscriber acquisition costs only where subscriber contracts are obtained.

20. There are various types of contracts between subscribers and telecommunications service providers (or carriers). At one end of the spectrum, contracts may commit the subscriber to minimum levels of service or fees. At the other end of the spectrum are “dial around” facilities, which are contracts that allow the subscriber to dial a special code or prefix to re-route a particular call from the preferred carrier to a second carrier, with whom the subscriber has a contract to pay for the services utilised. In between these types, there are “exclusive carrier” contracts and “preferred carrier” contracts. Exclusive-carrier contracts commit the subscriber to use the services of a specific carrier for all or some types of calls for a period of time, to the exclusion of other carriers. Preferred-carrier contracts route calls through the pre-selected carrier, unless a dial-around facility is invoked for a particular call.
21. The type of subscriber contract may affect the degree to which the asset recognition criteria in paragraphs 5(b) and (c) are satisfied. For example, under a minimum service or fee contract it normally would be probable that future economic benefits would eventuate, since at least the minimum revenue would be determinable, especially where the carrier has a policy of enforcing such contracts throughout their term. Where such contracts are not enforced for their full term, an entity may have sufficient historical data on lapse rates that would still enable it to reliably measure the future economic benefits expected to eventuate.
22. This approach does not mean, however, that subscriber acquisition costs should be recognised as an asset only up to the amount of the minimum revenues committed under contract to be paid by subscribers. The recognition criteria refer to the future economic benefits that are probable, which includes the revenues expected from current contracts on the basis of subscriber usage and lapse-rate data. However, the future economic benefits assessed relate to the contract period, and do not include any anticipated subscriber usage beyond the minimum contract period, since the subscriber acquisition costs are recognised as assets (if appropriate) for no longer than the contract period.

23. Similar considerations apply to the other types of subscriber contracts described in paragraph 20. However, it may be more and more difficult to show the probability of future economic benefits arising and to reliably measure them as the type of contract changes from exclusive-carrier contracts through preferred-carrier contracts to dial-around contracts. In each case it would be necessary to have reliable data for the entity on subscriber usage and lapse rates. For example, under a dial-around contract the revenues from future call charges may reflect the entity's future selling activities. As a result, it would be rare for the recognition criteria to be satisfied for dial-around contracts.

Accounting Requirements Subsequent to Initial Recognition

24. AASB 138 requires the depreciable amount of an intangible asset with a finite useful life to be allocated on a systematic basis over its useful life from the time when the asset is available for use. That Standard also requires the amortisation method applied to an asset to reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. This Interpretation reflects the view that subscriber acquisition costs recognised as assets are depreciable assets. As such, this Interpretation requires subscriber acquisition costs recognised as an asset to be amortised from the date of inception of the subscriber contract.
25. The period during which subscriber acquisition costs recognised as assets can be expected to provide future economic benefits to the entity is normally limited, particularly since subscribers may be committed to using the entity's services only for a specified period. Furthermore, subscribers are able to establish relationships with other telecommunications suppliers during or after the period of a non-exclusive contract. Where a subscriber contract terminates at the end of a specified period, the amortisation period is limited to that period. This is consistent with AASB 138 specifying that the useful life of intangible assets that arise from contractual or other legal rights shall not exceed the period of those rights.
26. Where a subscriber contract specifies a minimum contract period, any subscriber acquisition costs recognised as assets are amortised over that period, without extension for any expected continued usage by subscribers beyond that period. This approach is consistent with the requirements in AASB 138 concerning the useful life of intangible assets that arise from contractual or other legal rights: if those rights are conveyed for a limited term that can be renewed, the useful life includes the renewal period(s) only if the term can be renewed by the entity without significant cost. In the case of subscriber contracts, it is

the subscriber that may have the option to renew the contract or to continue using the entity's services beyond the minimum period.

27. However, if the period during which future economic benefits are expected to be obtained by the entity is less than the contract period, the subscriber acquisition costs are amortised over that lesser period. The amortisation period therefore is required to reflect expected cancellations of contracts, provided that the terms of the contracts are not enforced by the entity.
28. Where an asset is recognised in accordance with this Interpretation, and measured on the cost basis, it is written down to recoverable amount when its carrying amount is greater than the recoverable amount, in accordance with AASB 136 *Impairment of Assets*. For example, if contracts are terminated during the contract period, unamortised subscriber acquisition costs attributable to terminations in excess of estimated levels already reflected in the amortisation of acquisition costs are written off as an expense.
29. Subsequent costs incurred in relation to subscriber contracts are likely to relate to either the regular servicing of subscribers' requirements or to achieving contract renewals. Servicing costs are expensed as incurred, and costs incurred in relation to contract renewals are expensed unless the criteria specified in paragraph 5 are satisfied.

REFERENCES

Australia

The Urgent Issues Group discussed Issues Paper 04/3 “Revision of Various UIG Abstracts for 2005” in relation to this Interpretation at meetings on 22 July, 26 August, 5 October and 25 November 2004. In developing the superseded Abstract, the UIG discussed Issue Summary 01/2 “Subscriber Acquisition Costs in the Telecommunications Industry” or a draft Abstract at meetings on 8 February, 15 March, 27 April, 14 June, 26 July, 6 September and 18 October 2001.

Accounting Standard AASB 118 *Revenue*

Accounting Standard AASB 136 *Impairment of Assets*

Accounting Standard AASB 138 *Intangible Assets*

Canada

CICA Accounting Guideline AcG-3 *Financial Reporting by Property and Casualty Insurance Companies*

International Accounting Standards Board

International Accounting Standard IAS 18 *Revenue*

International Accounting Standard IAS 36 *Impairment of Assets*

International Accounting Standard IAS 38 *Intangible Assets*

United Kingdom

Financial Reporting Standard FRS 10 *Goodwill and Intangible Assets*

United States of America

Statement of Financial Accounting Standards SFAS 60 *Accounting and Reporting by Insurance Enterprises*

Statement of Financial Accounting Standards SFAS 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

FASB Technical Bulletin FTB 90-1 *Accounting for Separately Priced
Extended Warranty and Product Maintenance Contracts*

AICPA Statement of Position SOP 93-7 *Reporting on Advertising Costs*