Velocity cellular revenue case

Case 09-1: Velocity Cellular Page 1 D I S C U SS I O N M A T E R I A L S O b j e c t i v es o f t h e C a se This case gives students the opportunity to use accounting and auditing literature and professional judgment to research complex accounting issues effectively and efficiently. Specifically, students will be able to: Understand the application of the guidance in ASC 605-25, as amended by ASU 2009-13, to complex multiple-deliverable arrangements. Understand the application of the guidance in SAB Topic 13.

A p p l i c a b l e P r of essi on a l P r onou n c e m e n ts ASC 605-25, Revenue Re cogni t ion : Mul t ipl e- E l ement A r r angements (ASC 605-25) (formerly EITF Issue No. 00-21, Revenue Arrangements With Multiple Deliverables (Issue 00-21)), as amended by ASU 2009-13, Revenue Re cogni t ion (Topi c 605) : Mul t ipl e- D e l ive r abl e Revenue A r r angements (ASU 2009-13) (formerly EITF Issue No. 08(Issue 08-1)) SEC Staff Accounting Bulletin Topic 13, Revenue Recognition (SAB Topic 13) P rof essor N ot e : Thiscase studyrequires students to recognize an arrangement comprising multiple deliverables.

The case study essentially focuses on determining whether the activation card represents a separate arrangement deliverable and, if so, whether this deliverable represents a separate unit of accounting. In other types of arrangements, a company may provide additional deliverables, such as hardware (cellular phone), minutes, and additional services (e. g. , Web browsing, mail). Each multipledeliverable arrangement should be analyzed to determine the number of deliverables and units of accounting before determining the appropriate revenue recognition model.

Given the multitude of possible combinations of alternatives, this case study focuses on the activation card to simplify the analysis that is required in analyzing a multiple-deliverable arrangement. D isc uss ion Refer to current, relevant accounting guidance to determine and support the appropriate method for recognizing revenue for the Power Starterpack. To determine the appropriate revenue recognition model, students must first determine whether the Power Starterpack comprises multiple deliverables or is a single deliverable.

The prepaid voucher will probably be readily identifiable as a deliverable and a separate unit of accounting because it is sold separately, but the activation card will probably not be. Accordingly, the discussion that follows focuses on the need to determine whether the a c t i v a t ion c a r d is a separate unit of accounting. Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 2 A c co u n t i n g A l t e r n a t i v es A l t e r n a t i ve 1 The a c t iva t ion c a rd is not a sepa r a t e de l ive r abl e and not a sepa r a t e uni t of a c count ing in a c cordanc e wi th AS C 605-25.

Proponents of A l t e rna t ive 1 believe that subscribers do not ascribe value to the activation card separately from the prepaid voucher because they chose to purchase the Power Starterpack that includes both the prepaid minutes and the activation card. A l t e rna t i ve 1 proponents contend that subscribers have the option to purchase the activation card on a standalone basis but elected to purchase the Power Starterpack. Regarding review of the arrangement to determine separate deliverables, ASC 605-2525-4 states: A vendor shall evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting.

That evaluation shall be performed at the inception of the arrangement and as each item in the arrangement is delivered. Although there is no authoritative guidance defining proponents of A l t e rna t ive 1 believe that the perspective of the customer should be considered. The SEC staff has the deliverables. However, no clear consensus or group view delineates the criteria that should be used to determine separate elements or deliverables in a service arrangement. A l t e rna t ive 1 proponents believe that the a ccess to the network and, therefore, payment for the activation card should be viewed as an activation fee. Although the additional functionalities (the Bluetooth-enabledtechnology, international calling capabilities, and additional memory capacity) significantly enhance the existing cellular phones of subscribers, these existing subscribers believe that they are paying for a service and the extra charge for the activation card represents an activation fee that must be incurred in obtaining the prepaid minutes.

Proponents of A l t e rna t ive 1 further believe that the activation card is of no value without activation card . A l t e r n a t i ve 1 proponents therefore conclude that the activation card is not a separate deliverable and, accordingly, it cannot be a separate unit of accounting. To determine the appropriate revenue recognition model, the reviewer must combine the activation card with the prepaid phone service voucher. A l t e r n a t i ve 2 The a c t iva t ion c a rd is a sepa r a t e de l ive r abl e and a sepa r a t e uni t of a c count ing in a c cordanc e wi th AS C 605-25.

Proponents of A l t e rna t ive 2 believe that subscribers clearly ascribe value to the activation card separately from the prepaid voucher because subscribers are willing to replace their existing activation cards with new activation cards. Subscribers are willing to replace their existing activation cards because the additional functionalities of the new activation cards provide subscribers the ability to use new features on their existing cellular phones.

Accordingly, the activation card should first be considered a separate deliverable. Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 3 Regarding review of the arrangement to determine separate deliverables, ASC 605-2525-4 states: A vendor shall evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation shall be performed at the inception of the arrangement and as each item in the arrangement is delivered.

Although there is no authoritative guidance defining a deliverable, proponents of A l t e rna t ive 2 believe that the perspective of the customer should be considered, as described in A l t e rna t ive 1 above. No clear consensus or group view delineates the criteria that should be used to determine separate deliverables in a service arrangement. Other considerations that may be useful when determining whether an item is a deliverable in a contractual arrangement include (1) the fair value of the item, (2) whether the item is essential to the functionality of other products or services included in the arrangement, (3) eceiving a full or partial refund, and (4) whetherfailureto deliver the item causes a vendor to incur a significant contractual penalty. In the current fact pattern, the subscribers who obtain new activation cards also obtain additional functionalities. The additional functionalities (the Bluetooth-enabled technology, international calling capabilities, and additional memory capacity) significantly enhance the subscribers existing cellular phones.

These existing subscribers do not believe that they are paying for a service or paying an additional activation fee; rather, they ascribe a value to the additional functionalities of the new activation card. Since Velocity Cellular Services (Velocity) subscribers believe that they are paying for additional hardware that provides additional functionalities, the activation card should be viewed as a separate deliverable.

Proponents of A l t e rna t ive 2 acknowledge the view that the a purpose is to provide access to the network; therefore, payment for the activation card could be viewed as an activation fee. However, although the activation card does provide for network access and could be viewed as an in-substance activation fee, A l t e rna t i ve 2 proponents believe that the predominant feature of the activation card is to provide additional functionalities for subscribers existing cellular phones.

If this were not the case, subscribers would not purchase new activation cards on a standalone basis because the subscribers already have access to the network via their existing activation cards. After determining that the activation card represents a separate customer deliverable, proponents of A l t e rna t ive 2 also believe that this deliverable, which would be provided to the customer before any future activation services or airtime rights, should be considered a separate unit of accounting in a multiple-element arrangement if the appropriate criteria in ASC 605-25 are met.

ASC 605-25 describes the appropriate model for separation of arrangement deliverables and allocation of arrangement consideration. However, ASC

605-25 does not describe appropriate separation, attribution, and recognition models for deliverables that are within the scope of other relevant accounting literature. Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 4

Thus, the first step in determining whether the activation card deliverable should be separated and accounted for on a standalone basis would be to establish whether the deliverable is subject to accounting literature outside the scope of ASC 605-25 and, if so, whether this guidance provides a model for separation, allocation of arrangement consideration, and recognition. Proponents of A l t e rna t ive 2 believe that the deliverables under this arrangement (the activation card and the prepaid voucher) are subject to the accounting guidance in SAB Topic 13 (e. g. , revenue recognition guidance outside the scope of ASC 605-25).

ASC 605-25-15-3 and 15-3A, as amended by ASU 2009-13, state: A multiple-deliverable arrangement may be within the scope of another Codification Topic. Those Topics include all of the following: a. For leases, see Topic 840. b. For franchisors, see Topic 952. c. For property, plant, and equipment, see Topic 360; specifically, Subtopic 360-20. d. For guarantees, see Topic 460. e . F o r r e v e n u e r e cogn i t ion , se e T op i c 605 ; sp e c i f i c a l l y , Su b top i cs 605-20 a n d 605-35. f. For software, see Topic 985; specifically, Subtopic 985-605. g. For entertainment films, see Topic 926; specifically, Subtopic 926-605.

T hose T op i cs m a y p r ov i d e gu i d a n c e w i t h r esp e c t t o w h e t h e r a n d how to a l l oc a t e co ns i d e r a t i o n o f a m u l t i p l e- d e l i v e r a b l e a r r a n ge m e n t . W h e t h e r d e l i v e r a b l es a r e w i t h i n t h e scop e of t hose ot h e r T op i cs is d e t e r m i n e d b y t h e scop e p r ov isions of t hose T op i cs, w i t hou t r ega r d t o t h e o r d e r of d e l i v e r y of t h a t i t e m i n t h e a r r a nge m e n t . The following describes the three categories into which the other Codification Topics fall and the application f this Subtopic or the other Topics in determining separate units of accounting and allocating arrangement consideration: a. Other Topics address both separation and allocation. If another Topic provides guidance regarding the determination of separate units of accounting and how to allocate arrangement consideration to those separate units of accounting, the arrangement or the deliverables in the arrangement that is within the scope of that Topic shall be accounted for in accordance with the relevant provisions of that Topic rather than the guidance in this Subtopic. b. Other Topics address separation, but not allocation.

If another Topic provides guidance requiring separation of deliverables within the scope of that Topic from deliverables not within the scope of that Topic, but does not specify how Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 5 to allocate arrangement consideration to each separate unit of accounting, such allocation shall be based on the relative selling price of the deliverables within the scope of that Topic and the deliverables not within the scope of that Topic. For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30.

See paragraph 605-2555-3. (For purposes of the allocation between deliverables within the scope of another Topic and deliverables not within the scope of that other Topic, the selling price shall be determined using the guidance as discussed in paragraphs 605-25-30-6A through 30-6B.) Subsequent identification of separate units of accounting and allocation of arrangement consideration to the deliverables not subject to that other Topic would be governed by the provisions of this Subtopic. c. Other Topics address neither separation nor allocation.

If another Topic provides no guidance regarding the separation of the deliverables within the scope of that Topic from those deliverables that are not or the allocation of arrangement consideration to deliverables within the scope of that Topic and to those that are not , then the guidance in this Subtopic shall be followed for purposes of such separation and allocation . For example, Subtopic 605-35 provides separation and allocation guidance [segmentation provisions] for deliverables within its scope. However, that Subtopic does not provide separation and allocation guidance for deliverables within its scope and deliverables not within its scope.) In such circumstances, it is possible that a deliverable subject to the guidance of another Topic does not meet the criteria in paragraph 605-25-25-5 to be considered a separate unit of accounting.

In that event, the arrangement consideration allocable to such deliverable shall be combined with the amount allocable to the other applicable undelivered items within the arrangement. The appropriate recognition of revenue then shall be determined for those combined deliverables as a single unit of accounting. [Emphasis added] Proponents of Alternative 2 note that SAB Topic 13 does not provide guidance on separating elements in an arrangement into units of accounting; instead, it refers to ASC 605-25.

SAB Topic 13 is focused solely on recognition of revenue for specific revenue deliverables. Accordingly, proponents of A l t e rna t ive 2 believe that a determination of whether the activation card deliverable in this arrangement represents a separate unit of accounting should be made solely in accordance with ASC 605-25-25-5, which states, in part: In an arrangement with multiple deliverables, the delivered item or items shall be considered a separate unit of accounting if both of the following criteria are met: a.

The delivered item or items have value to the customer on a standalone basis. The item or items have value on a standalone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basi s ability to resell the delivered Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 6 item(s), [the Task Force observed that] this criterion does not require the existence of an observable market for the deliverable(s).

Under ACS 605-25-25-5(a), the activation card, or the delivered item in Velocity multiple-element arrangements, the same activation card model that is sold to existing customers (with the same additional functionalities) in the Power Starterpack is also sold by Velocity and other wireless retailers on a standalone basis. The second condition that must be met for Velocity to consider the activation card a separate unit of accounting relates to whether a general right of return exists. ACS 60525-25-5(c) states: c.

If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item or items is considered probable and substantially in the control of the vendor. Since there is no general right of return, the second condition is not applicable. Therefore, proponents of A l t e rna t i ve 2 believe that since both relevant conditions in ASC 605-25-25-5 are met, the activation card has standalone value and should be accounted for as a separate unit of accounting.

A l t e r n a t i ve 3 The a c t iva t ion c a rd is a sepa r a t e de l ive r abl e but not a sepa r a t e uni t of a c count ing in a c cordanc e wi th AS C 605-25. In a manner consistent with that of proponents of A l t e rna t i ve 2, proponents of A l t e rna t ive 3 perform a similar analysis and believe that the activation card should be considered a separate deliverable.

However, A l t e rna t ive 3 proponents question whether the criterion in ASC 605-25-25-5(a) is met because, as stated in the accounting memo, Standalone transactions for new activation cards are i n f r e q u e n t Proponents of A l t e rna t i ve 3 believe that if the standalone transactions are infrequent, there may not be enough evidence to conclude that the activation cards have standalone value per the requirement of ASC 605-25-25-5(a).

Without additional information, proponents of A l t e rna t ive 3 believe it is not possible to conclude that the activation card is a separate unit of accounting, citing the requirements of ASC 605-25-25-6: A delivered item or items that do not qualify as a separate unit of accounting within the arrangement shall be combined with the other applicable undelivered item(s) within the arrangement.

The allocation of arrangement consideration and the recognition of revenue then shall be determined for those combined deliverables as a single unit of accounting. Sol u t i on A l t e rna t ive 1 was rejected because the facts establish stronger support that the activation card is a deliverable on a standalone basis. In this fact pattern, the additional functionalities of the new activation card are the predominant reasons for subscribers to Copyright 2009 Deloitte Development LLC

All Rights Reserved. Case 09-1: Velocity Cellular Page 7 purchase the prepaid phone service plan because existing customers are willing to replace their old activation cards to add additional functionalities to their existing cellular phones. If the additional functionalities were not available in the new activation cards, existing customers would have continued to use their old activation cards, which already allowed them access to the network.

This is further evidenced by the fact that vendors outside of Velocity also sell the same model activation card on a standalone basis. -making process, the price the customer is willing to pay for the Power Starterpack with the additional functionalities of the new activation card indicates strongly that the activation card is valuable to the customer without the prepaid voucher (which can be purchased separately for $50) and represents a deliverable in the arrangement.

An analysis of the activation card under ASC 605-25 indicates that both criteria in ASC 605-25-25-5 are met and, therefore, the activation card is considered a separate unit of accounting. A l t e rna t ive 2 was determined to be the preferred alternative. T h e a c t i v a t ion c a r d is a se p a r a t e d e l i v e r a b l e a n d a se p a r a t e u n i t o f a c co u n t i n g. A l t e rna t ive 3 represents a legitimate question that should be evaluated in more detail according to specific facts and circumstances.

Generally, in situations in which a vendor sells an element, even infrequently, the criterion in ASC 605-25-25-5(a) will be met because the element is sold separately. A ddendum J u n e 2010 In September 2009, the EITF reached a consensus on Issue 08-1, which has been codified in ASC 605-25 and amended by ASU 2009-13. ASU 2009-13 requires the use of the relative selling price method to allocate arrangement consideration to the separate units of account and eliminates the use of the residual method.

When applying the relative selling price method, an entity should determine the selling price for each deliverable using vendor-specific objective evidence (VSOE) of selling price, if it exists; otherwise, thirdparty evidence of selling price is to be used. If neither VSOE nor third-party evidence of selling price exists for a deliverable, the vendor should use its best estimate of the selling price for that deliverable when applying the relative selling price method.

This revenue accounting model differs significantly from the previous model in Issue 00-21: the previous Issue 00-21 requirements for determining whether a deliverable in a multipleelement arrangement represented a standalone unit of accounting were based not only on the standalone value and general right of return requirements retained in Issue 08-1, but also on whether objective and reliable evidence of the fair value of any undelivered items was present.

The model presented in Issue 08-1 is thought to be less punitive to the revenue recognition process because it eliminated the requirement to have evidence of fair value of undelivered items on a standalone basis. The case and solution have been updated to reflect the adoption of ASU 2009-13. On

June 24, 2010, the FASB issued an exposure draft (ED) on a proposed ASU, Revenue Re cogni t ion : Revenue F rom C ont r a c ts Wi th C ustome rs, which was the result of a joint project between the FASB and IASB (the boards) to clarify the principles for recognizing revenue and to develop a common revenue standard for U.

S. GAAP and Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 8 IFRSs. The core principle in the proposed ASU would require an entity to recognize revenue to depict the completion of its separate performance obligations pertaining to the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services. The proposed ASU includes a model for entities to apply the core principle and includes guidance that pecifies the accounting for some arrangement costs. The boards received nearly 1, 000 comment letters in response to the ED and began their redeliberations of the proposals in January 2011, considering the feedback received on the ED. They have reached decisions on various aspects of the model and will continue developing the model with the goal of issuing a final standard in 2011. Certain significant provisions pertaining to the accounting model for multiple-element arrangements that have been contemplated in the redeliberation process are as follows:

I de n t i f y i n g Sep a r a t e P e r f o r m a n c e O b l i g a t i o n s The boards have noted that in some cases, an entity promises to provide a bundle of goods or services that the entity should account for as a single performance obligation because the risks to the entity of providing the goods or services are inseparable. That would be the case if the goods or services are highly interrelated and providing them requires the entity to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted.

That service typically results in significant modification of the goods in the contract. In all other cases, the boards decided an entity should account for a promised good or service as a separate performance obligation only if both of the following conditions are met: a. The good or service is distinct. A good or service is distinct if either: 1. The entity regularly sells the good or service separately, or 2. The customer can use the good or service either on its own or together with resources that are readily available to the customer.

Readily available resources include goods or services that are sold separately (whether by the entity or another entity), or resources that the customer has obtained from previous transactions or events. b. The pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract. This recognition model is similar to the model in Issue 08-1. However, there are some slight differences in comparison to ASC 605-25-5, discussed above.

A l l oc a t i o n o f t h e T r a n s a c t i o n P r i c e to t h e Se p a r a t e P e r f o r m a n c e O b l i g a t i o n s The boards have preliminarily determined: Copyright 2009 Deloitte Development LLC All Rights Reserved. Case 09-1: Velocity Cellular Page 9 An entity should allocate to each separate performance obligation the amount of consideration the entity expects to receive in exchange for satisfying that performance obligation.

To apply that principle, an entity should allocate the transaction price (or change in the transaction price) on a relative standalone selling price basis.

If the standalone selling price of a good or service is highly variable, the most appropriate technique to estimate a standalone selling price may be a residual technique. Using a residual technique, an entity would determine a standalone selling price by reference to the total transaction price less the standalone selling prices of other goods or services in the contract.

An entity should allocate a portion of (or a change in) the transaction price entirely to one (or more) performance obligation if both of the following conditions are met: a. The contingent payment terms of the contract relate specifically to the from satisfying that separate performance obligation; and b. The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

The model presented above for the allocation of consideration to a multiple-element revenue arrangement is relatively consistent with the model provided in ASC 605-25. However, there are some slight differences noted, primarily in that the ED would allow for use of a residual method of consideration allocation, whereas this method is explicitly prohibited in ASC 605-25 (this provision was removed in Issue 08-1).