



IFRS industry insights: Telecommunications sector

Implications of the new leasing standard

Headlines

- IFRS 16 *Leases* has been published and is effective for periods beginning on or after 1 January 2019.
- For lessees with operating leases a right-of-use asset will come on balance sheet together with a lease liability.
- Determining whether a contract gives control of a specific asset may require a significant level of judgement for contracts such as network services.
- Leases with a term of 12 months or less and containing no purchase options, and those for low value assets may be accounted for as services.
- Previous high level analysis of current disclosures indicates a possible average increase in EBITDA margin of 2.5 percentage points.
- Previous research of the world's largest 50 telecoms operators suggests as much as \$125 billion right-of-use assets will be added to balance sheets, and the level of gross debt increase by between 15-20%.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard IFRS 16 *Leases*. For a customer (lessee) the new standard introduces a single accounting treatment, recognition of a right-of-use asset and a lease liability. For lessors the finance and operating lease distinction and accounting remains largely unchanged. The new Standard supersedes the previous standard and related interpretations and brings in a new definition of a lease that will be used to identify whether a contract is, or contains, a lease.

IFRS 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted if IFRS 15 *Revenue from Contracts with Customers* has also been applied.

What does it mean for the telecommunications industry?

The new Standard, in addition to bringing substantial new assets and liabilities onto a lessee's balance sheet, will have an impact on reported profit and performance measures such as EBITDA. It is likely that with the changed definition of a lease there will be some additional contracts within the scope of the new Standard, which need to be considered by lessors as well as lessees, although lessees may be able to use the limited exemptions which may permit some to remain accounted for as services. Some of the issues are considered below, but the impact on individual entities will vary according to their particular circumstances.

Companies in the telecoms sector will need to undertake an early assessment of the

impact on their results, and if possible on that of their peers, and to develop a plan for explaining this to their shareholders and other stakeholders.

What will this do to KPIs?

The KPIs most frequently used by analysts for telecoms companies are EBIT, EBITDA and capital expenditure.

The recognition of a right-of-use asset and lease liability will lead to depreciation, generally on a straight line basis, and interest expense, which will be front-loaded rather than the straight line operating expense at present. This will result in an increased EBIT and even more so EBITDA. Our high level analysis of operating lease disclosures by telecoms companies indicated that the removal of lease costs from operating expenses could result in EBITDA margin increasing by an average of 2.5 percentage points.

EBITDA less capital expenditure has historically been a good proxy for cash flow and often used as a basis of valuation for telecoms businesses. Given the requirement of IFRS 16 for lessees to capitalise right-of-use assets, consideration will need to be given to how to define capital expenditure, for example, defined as additions to the carrying amount of PPE including rights-of-use of PPE, or by investing cashflows in PPE. Entities will need to determine how their KPIs are impacted and ensure such KPIs are well defined,

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and remain relevant and comparable. Our previous research (based on current operating lease commitment disclosure) suggests that the world's largest 50 telecoms operators may add as much as \$125 billion to their balance sheets in respect of right-of-use assets.

Companies will also need to focus on whether the addition of lease liabilities will be taken into account when considering their level of indebtedness. The extent to which companies in the telecoms sector build their own networks and acquire their own infrastructure compared to leasing is varied within the sector so it is likely that change in the levels of liabilities will vary significantly between companies. Based on our previous research of the world's largest 50 telecoms operators, we estimate that their level of gross debt will increase by between 15-20% with the addition of existing operating lease liabilities to the balance sheet resulting in an eight-fold increase in lease liabilities recognised.

Applying the changed definition of a lease

A contract will be a lease if it enables an entity to control the use of an identified asset, by directing the use and obtaining substantially all the economic benefit for a period of time.

Within telecoms the judgements will focus on whether an asset is identified. An asset might appear to be explicitly or implicitly specified by being made available, but it will be necessary to establish whether the supplier has the ability to substitute an alternative asset during the period of the contract. If the supplier can practically substitute another asset (excluding any obligation to replace a defective asset) and there is a clear economic benefit for the supplier to do so it will not be considered specified and therefore the contract would not be considered a lease.

Delivery of some services requires the installation of equipment, such as IT equipment or set top boxes or satellite dishes. Since some of these assets are installed on the customer premises they might be implicitly specified. Practically such assets might be easily substituted with other assets able to deliver the service so it will be necessary, at the time the contract is agreed, to consider whether substitution would be economically beneficial to the supplier.

A physically distinct capacity portion of an asset such as specified dark fibres in a fibre optic cable can be an identified asset, but a portion of such capacity, e.g., 30% of the capacity of a fibre-optic cable, is not an identified asset since it does not give the right to substantially all of an identified cable. Other contracts which will require consideration of whether the asset is physically distinct include network tower space agreements and rights to use a certain wavelength of a fibre.

The scope of the Standard specifically excludes some intangible assets, in particular licensing agreements within the scope of IAS 38, such as spectrum licences, and entities are not required to, but permitted to, apply the lease standard to rights of use of other intangible assets.

Are there any recognition exemptions?

The Standard permits lessees two exemptions from the recognition requirements which may well be relevant to the industry, leases with a lease term of 12 months or less and containing no purchase options, and leases of underlying assets which have a low value when new (for example, personal computers and small office furniture). In the telecoms industry, assets such as mobile phones and set-top boxes would generally be considered of low value. For leases of low value assets the election to simply recognise the payments as a service expense may be taken on a lease-by-lease basis.

Are there reliefs at the date of adoption?

As noted above one of the particular areas of judgement in the telecoms industry is whether a contract is in scope. On adoption

an entity is not required to reassess whether existing contracts contain a lease, but can choose to carry forward the assessments under IFRIC 4 and IAS 17, and apply the definition of a lease only to new contracts entered into after the date of initial application. On transition an entity will have the option to apply the Standard fully retrospectively, restating prior year figures, or taking some transitional relief, leaving the prior year figures unchanged, and measuring the liability and asset at the incremental borrowing rate at the date of initial application with an initial cumulative adjustment to the opening balance of retained earnings.

Where can I go for more information?

This publication highlights just some of the issues that will be of particular interest to telecoms companies. More detailed information on the new Standard can be found in Deloitte's IFRS in Focus publication, available at www.iasplus.com.

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