In the Spotlight
An industry focus on the impact of IFRS 16 – Communications

March 2016

IFRS 16, 'Leases'

The new lease accounting standard will fundamentally change the accounting for lease transactions and is likely to have significant business implications.

Almost all leases will be recognised on the balance sheet, with a right of use asset and financial liability that recognise more expenses in profit or loss during the earlier life of a lease.

This will have an associated impact on key accounting metrics, and clear communication will be required to explain the impact of changes to stakeholders.

Why the new standard matters to the industry

- Most Communications companies enter into lease agreements both as lessors and lessees. While lessor accounting remains largely unchanged under IFRS 16, leases in the industry are prevalent. The new standard is likely therefore to have a material impact for Communications companies.
- Typical areas where the standard will have a significant impact are
  - arrangements with other operators;
  - shared network assets arrangements;
  - arrangements where network equipment is embedded in the supply of communication services; and
  - leases of network sites and retail space.
- In respect of leases embedded within service arrangements the application of IFRIC 4 has historically been a judgmental area in the industry. For many, the embedded lease was generally viewed as an operating arrangement which typically did not impact the Income Statement profile. IFRS 16 brings in new conditions to be assessed in the determination of whether the agreement contains a lease which may impact current industry custom and practice.
- The PwC Global Lease Capitalisation study published in February 2016 indicated that there would be a median debt increase of 21% for Communications companies (due to the recognition of lease liabilities).

An In depth guide to the new standard and its effects

In depth INT 2016-01 provides a comprehensive analysis of the new standard.

This Spotlight summarises the main aspects of the standard, highlighting some key challenges and questions management should ask as they prepare for transition.

Although the new standard will not be effective until 2019, the extent of data-gathering and requirement to embed new processes for many entities means that, for many, preparations should begin now.

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The new standard on a page

When is the effective date?	The new leasing standard will become effective in 2019 and include pre-existing leases (however, there are some reliefs on transition).
What is the scope of the standard?	The standard covers every lease except for rights to explore non-regenerative resources, rights held under certain licensing agreements, leases of biological assets and service concession arrangements. For lessors, licences of intellectual property granted are excluded from IFRS 16.
Are there any exemptions?	A recognition and measurement exemption for *short term leases* and *leases of low value assets* is available as a policy choice. However, this is only available to the lessee.
What is the definition of a lease?	A lease is a contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an *identified asset* and it conveys the *right to control the use* of that identified asset throughout the period of use. Each *lease component* should be identified and accounted for separately.
What is an identified asset?	An asset can be identified explicitly or implicitly. A contract does not depend on an identified asset if the supplier has a substantial right to substitute the asset.
What is the "right to control the use" of an asset?	A customer has the right to control the use of an identified asset if they have the right to obtain *substantially all of the economic benefits* from the use of the asset and the *right to direct the use* of the asset, i.e. to decide how and for what purpose it is used.
When is an arrangement split into separate lease components?	A right to use an asset is a separate lease component if the lessee can benefit from the asset on its own (or together with readily available resources) and the asset is neither interdependent nor highly correlated with any other underlying asset in the contract.
What is recognised on the balance sheet?	*Lessees* will recognise almost all leases on the balance sheet (as a "right-of-use asset" and "lease liability"). *Lessors* will still distinguish between finance leases (recognise a lease receivable) and operating leases (continue to recognise the underlying asset).
How is a lease initially measured by lessees?	The lessee recognises: • a lease liability at the present value of future lease payments; and • a right-of-use asset to an equal amount plus initial direct costs.
What does a lessee recognise in profit or loss?	A lessee will recognise: • interest on the lease liability • depreciation of the right of use asset Variable lease payments not included in the lease liability are recognised in the period the obligation is incurred.
Is lessor accounting affected?	IFRS 16 does not change lessor accounting.

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Key questions for the industry

Q: What types of arrangements might meet the new definition of a lease?

A: Arrangements with other operators could include – Indefeasible Rights of Use, leased circuits, network purchase or leasing arrangements, the leasing of space or capacity in exchanges and at other network sites.

Arrangements involving shared assets could include tower site, co-location and radio access network sharing agreements.

Arrangements which may contain leases could include – customer contracts for using identified network or infrastructure equipment, equipment provided to customers through which the operator delivers communication services such as set top boxes and modems (particularly to larger corporate customers) and data centre services and other outsource arrangements. Most rental contracts for retail outlets whether for individual outlets, high-street locations or shop-in-shops in department stores are likely to qualify as leases.

Q: What might evidence a "right to control the use" of an asset?

A: Right to control the use may be evidenced by the right to obtain substantially all economic benefits – such as the exclusive use of specified dark fibres.

Q: What areas might affect the lease liabilities recognised?

A: Contingent rent, renewal/purchase options and other services received under the agreements might all affect the calculation of the lease liability.

Determination of the lease term might be a complex task; for example in case of cell site leases, which may be affected by the useful life of the mobile towers, technology changes or the term of the frequency licence will affect the lease term.

Due to the large number of the lease agreements and embedded extension options, measuring of lease liabilities may require significant effort.

Q: What will be the impact of implementation on key accounting metrics?

A: For lessees, the new accounting treatment will immediately affect a range of key metrics monitored by stakeholders, including:

- EBITDA (increases as rental expense replaced by interest, depreciation and amortisation)
- Operating free cash flow
- Net debt and gearing (increases as lease liability included in net debt)
- Net assets (decreases as the right of use asset amortises on a straight line basis while lease liability is unwound more slowly in early years)
- CAPEX (increases as right-of-use assets are recognised on the balance sheet)

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Q: What are the wider potential business impacts?

A: The new accounting treatment could affect a number of areas:

- Network development and network sharing agreements – agreements previously classified as operating leases may be renegotiated to minimize CAPEX and liabilities recognised.
- Communications companies have large asset bases and the resulting increase in assets may increase the impairment risk often inherent in this industry.
- Debt covenants – covenants might need to be renegotiated.
- Share-based payments– performance metrics might need renegotiation.
- Dividend policy – the revised profile of the profit or loss expense might affect the ability to pay dividends.
- Lease negotiations – although accounting should not be the key driver in commercial negotiations, market behavior might change towards shorter lease tenures to minimize lease liabilities.

Q: Will we need to develop an entirely new system to track and administer leases?

A: Many lessees currently manage operating leases on spreadsheets, through the accounts payable system or through the network services teams. Information needed to reassess lease terms and index-based payments at each reporting date will now need extensive data capture. Lessees might need to modify information systems, processes and internal controls to comply with the standard.

Q: How and when should I start a program to manage change and meet compliance?

A: Entities should take advantage of the long implementation period available. An initial assessment of people, processes, systems, data, governance and policy would be a good starting point.

Q: What other departments other than accounting might be impacted?

A: The tax department will need to assess how deferred tax liabilities might be affected. The human resources department should consider whether there are any effects on compensation metrics and policies.

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Contact us

Questions?

To have a deeper discussion, please contact:

Telecommunication Industry Accounting Group contacts			
Territory	Name	E-mail	Telephone
London	Fiona Dolan	fiona.mc.dolan@uk.pwc.com	+44 20 7213 4885
London	Peter Hogarth	peter.hogarth@uk.pwc.com	+44 20 7213 1654
London	Richard Veysey	richard.j.veysey@uk.pwc.com	+44 20 7212 1060
Paris	Matthieu Moussy	matthieu.moussy@fr.pwc.com	+33 15 657 8630
Frankfurt	Christoph Gruss	christoph.gruss@de.pwc.com	+49 699 585 3415
Düsseldorf	Thomas Tandetzki	thomas.tandetzki@de.pwc.com	+49 211 981 1105
Rotterdam	Jay Tahtah	jay.tahtah@nl.pwc.com	+31 88 792 39 45
Amsterdam	Arjan Brouwer	arjan.brouwer@nl.pwc.com	+31 0 88 792 4945
Milan	Francesco Ferrara	francesco.ferrara@it.pwc.com	+ 39 02 778 5525
Madrid	Vanesa Prieto	vanesa.gonzalez.prieto@es.pwc.com	+34 915 684 826
Budapest	Gabor Balazs	gabor.balazs@hu.pwc.com	+36 14 61 9534
Johannesburg	Helen Wise	helen.wise@za.pwc.com	+27 11 797 5293
Hong Kong	Sean Tuckfield	sean.tuckfield@hk.pwc.com	+852 2289 2368
India	Akhlesh Chowla	akhlesh.chowla@in.pwc.com	+ 91 22 6669 1216
Australia	Rosalie Wilkie	rosalie.wilkie@au.pwc.com	+61 2 8266 8381
Little Rock	Rob Glasgow	rob.glasgow@pwc.com	+1 973 236 4019
Toronto	Geoff Leverton	geoff.m.leverton@ca.pwc.com	+1 416 815 5053

Authored by:

Fiona Dolan
Phone: +44 207 213 4885
Email: fiona.mc.dolan@uk.pwc.com

Gabor Balazs
Phone: +36 14 61 9534
Email: gabor.balazs@hu.pwc.com

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