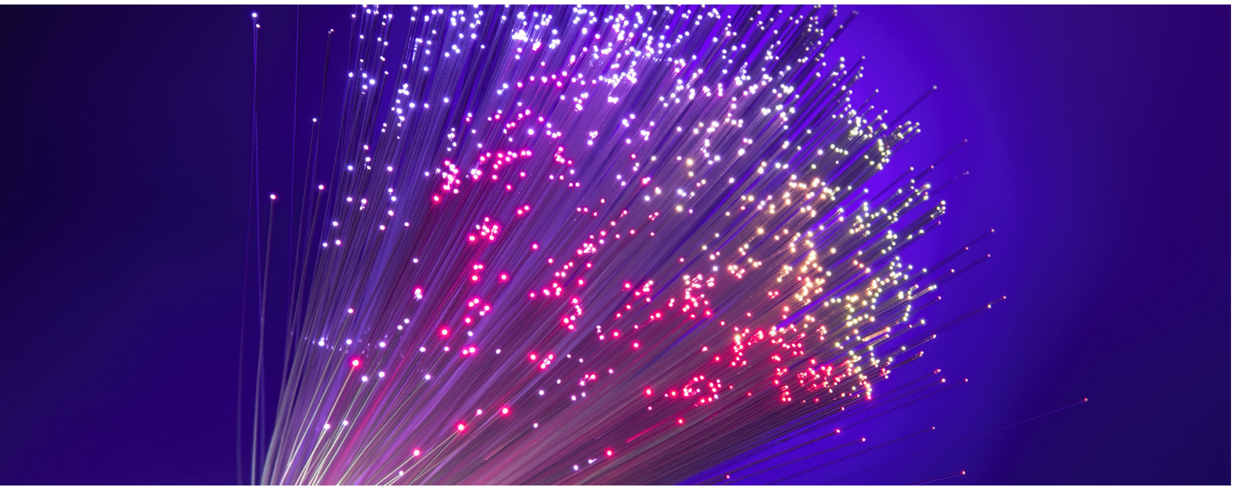
Point of View

Telecommunications – Implications of the new leasing standard



In a nutshell

- Australian Accounting Standard AASB 16, *Leases* (Standard or AASB 16), was issued in February 2016 and is effective for periods beginning on or after 1 January 2019, meaning that for many Australian entities the changes will be effective for 30 June 2020 year-ends.
- For lessees with operating leases, a right-of-use asset will now come onto the balance sheet together with a lease liability.
- For lessors, the finance and operating lease distinction remains largely unchanged.
- Previous high level analysis of current financial statement disclosures of telecom operators indicates a possible average increase in EBITDA margin of 2.5 percentage points.
- Previous research of the world's 50 largest telecom operators suggests as much as $125 billion in right-of-use assets will be added to the balance sheets and the level of gross debt will increase by 15-20%.
- The Standard has a far reaching impact on lessees' systems and controls. The elimination of nearly all 'off balance sheet' accounting for leases requires the capture of more data than under the previous Standard.
- Considering the significant number of lease arrangements entered into, telecom operators should assess the impact of the Standard and inform key stakeholders of any relevant changes at an early stage.

What's happened?

- The Australian Accounting Standards Board (AASB) issued AASB 16, *Leases* in February 2016. AASB 16 incorporates IFRS 16, *Leases,* issued by the International Accounting Standards Board (IASB) without modification.
- For a customer (lessee) the Standard introduces a single accounting treatment, that is, recognition of a right-of-use asset and a lease liability. For lessors the finance and operating lease distinction and the accounting for leases remain largely unchanged.
- The 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.
- AASB 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted only if AASB 15, *Revenue from Contracts with Customers* (AASB 15), has also been applied.

What will this do to KPIs of telecom operators?

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

Under the new guidance the recognition of a right-of-use asset and a lease liability will lead to depreciation and interest expense (which will be front loaded), rather than the current (straight-lined) operating lease expenses. This change will result in an increase in EBIT and even more so, in EBITDA.

'The new leasing standard could increase EBITDA margins of telecom operators by an average of 2.5 percentage points'

Our high level analysis of operating lease disclosures by telecom operators indicates that the removal of lease costs from operating expenses could result in EBITDA margins increasing by an average of 2.5 percentage points.

EBITDA, less capital expenditure, has historically been a good proxy for cash flow and is often used as a basis of valuation of telecom businesses. However, given the requirement of AASB 16 for lessees to capitalise right-of-use assets, consideration will be needed around how to define capital expenditure, for example, as an addition to the carrying amount of PPE (including rights-of-use PPE), or by the investing cash flows in PPE.

Previous research by Deloitte (based on current operating lease commitment disclosure) suggests that the world's 50 largest telecom operators may add as much as $125 billion to their balance sheets in respect of right-of-use assets.

Telecom companies will also need to consider whether the addition of lease liabilities should be taken into account when calculating their level of debt obligations, as bringing liabilities onto the balance sheet potentially (negatively) impacts leverage ratios and debt covenants.

'The new leasing standard potentially (negatively) impacts leverage ratios and debt covenants of telecom operators'

Based on our previous research of the world's 50 largest telecom operators, we estimate that the addition of existing operating lease liabilities to balance sheets increases their level of gross debt by 15-20%, resulting in an eightfold increase in lease liabilities recognised.

What will this do to systems and controls of telecom operators?

Given the new 'on balance sheet' accounting applying to almost all leases under the Standard, lessees will be required to capture more data. As a consequence, more sophisticated systems and more robust controls will be needed to track and report lease information in a timely manner.

'The availability of data around leases in existence at the date of transition should be considered as part of an early impact assessment'

The significant number of lease arrangements entered into by telecom operators also poses potential challenges with regard to the availability of existing lease data, if not stored and/or maintained centrally. The availability of data around leases in existence at the date of transition to the Standard should be considered as part of an early impact assessment.

Applying the changed definition of a lease

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

Within the telecoms industry the judgement will focus on whether an asset is specified. An asset might appear to be explicitly or implicitly specified by it being made available. However, it will be necessary to establish whether the supplier has the ability to substitute an alternative asset during the period of the contract (excluding any obligation to replace a defective asset) and if there is a clear economic benefit for the supplier to do so.

Telecom equipment

Delivery of some telecom services requires the installation of assets such as IT equipment, set top boxes or satellite dishes. Since some of these assets are installed on customer premises, they might be implicitly specified. Practically such assets might be easily substituted to deliver the same service. It will therefore be necessary, at the time the contract is entered into, to consider whether substitution would be economically beneficial to the supplier, in order to ascertain whether a contractual arrangement is considered a lease.

Capacity

A capacity portion of an asset can be an identified asset if it is physically distinct or if it represents substantially all of the capacity of the entire asset. For example, a specified dark fibre in a fibre optic cable can be an identified asset as it is physically distinct. However, a 30% portion of the capacity of a fibre-optic cable is not an identified asset since it does not give the right to substantially all of the identified cable. As such, this capacity portion would not meet the definition of a lease.

Other contracts that will require consideration as to whether the asset is physically distinct include network towers' space agreements and right-to-use of a certain wavelength of (lit) fibre.

The scope of the Standard specifically excludes some intangibles relevant to the telecom industry, in particular licensing arrangements (e.g. spectrum licenses) that fall within the scope of AASB 138, *Intangible Assets*. Entities are not required, but are permitted, to apply the Standard to rights-of-use of other intangible assets.

Are there any recognition exceptions?

The Standard permits lessees two exemptions from the recognition requirements which may be considered relevant to the telecom industry:

- Leases with a lease term of 12 months or less and containing no purchase options
- Leases of underlying assets which have a low value when new.

In the telecoms industry assets such as mobile phones and set top boxes would generally be considered low value. Lessees can elect to continue to apply existing operating lease accounting to such leases by expensing the rental cost on a straight-line basis.

Are there reliefs at the date of adoption?

As noted above, one of the areas of judgement in the telecoms industry is whether a contract is in scope. On adoption of the Standard, an entity is not required to reassess whether existing contracts contain a lease, but can choose to carry forward the existing assessment under AASB Interpretation 4, *Determining whether an Arrangement contains a Lease* (as amended) and AASB 117, *Leases*. This means that the Standard will only be applied to existing contracts that were previously identified as leases and new contracts entered into after the date of adoption of the Standard.

During transition an entity will have the option to apply the Standard retrospectively, but only if AASB 15 has also been applied. An entity will have the option to restate the previous year's figures, or can opt to take some relief by leaving the previous year's figures unchanged and measure the liability and assets at the incremental borrowing rate at the date of initial application, with an initial cumulative adjustment to the opening balance of retained earnings.

Why early preparation is critical to telecom operators?

As highlighted above, not only does the Standard impact KPIs and potentially debt covenants of telecom operators, the Standard significantly impacts lessees' systems and controls as more lease data will need to be tracked by bringing operating leases onto the balance sheet.

Because of this, together with the significant number of operating lease arrangements that telecom operators enter into, we strongly recommended that operators use the intervening period to analyse the new requirements, consider any wider implications and make any required changes to their systems, controls and processes. Early planning and establishment of implementation plans will be necessary to ensure the new requirements of the Standard are met in a timely and cost effective manner.

Where can I go for more information?

If you would like to discuss any aspects of this report, please contact one of the below at Deloitte Australia:

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