IFRS 16, *Leases*: Impact on media and entertainment sector

This article aims to:

- Discuss the key impacts of IFRS 16 on the entities engaged in the media and entertainment sector.

Background

Internationally, International Financial Reporting Standard (IFRS) 16, *Leases* was issued by the International Accounting Standards Board (IASB) in January 2016 and it replaces, International Accounting Standard (IAS) 17, Leases. IFRS 16 is effective from 1 January 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers* on or before the date of the initial application of IFRS 16.

IFRS 16 brings about a paramount shift in lessee accounting by bringing most of the off-balance sheet leases on the balance sheet. It practically eliminates the difference between a finance and an operating lease.

In July 2017, the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) had issued an Exposure Draft (ED) of Ind AS 116, *Leases* which is largely converged with IFRS 16. The ED is proposed to be effective for annual periods beginning on or after 1 April 2019. As per the IFRS convergence status issued by ICAI as on 19 December 2018, Ind AS 116 has been cleared by the National Advisory Committee on Accounting Standards (NACAS) and submitted to the Ministry of Corporate Affairs (MCA) for notification.

In this article, we aim to highlight the key changes in accounting introduced by IFRS 16 from the perspective of the lessee. Additionally, we will also discuss how such changes may impact a company's operations and financial reporting in the Media and Entertainment (M&E) sector.

Impact of IFRS 16 on M&E sector

The M&E sector is fairly diverse and entities in this sector, generally, use diverse range of products for delivering the final content which implies that a single contract may often contain multiple components. Also, the contracts at times may involve use of third party assets, such as online servers, satellites or physical advertising space. Therefore, it becomes necessary to identify the contracts that would qualify for recognition of a lease arrangement under the new standard.

- **Identification of a lease arrangement:** An entity is required to evaluate at the inception of the contract whether that contract is, or contains a lease. As per IFRS 16, a contract, is or contains, a lease if it **conveys the right to control the use of an identified asset** (i.e. the underlying asset) **for a period of time in exchange for consideration.** Therefore, for a contract to qualify as a lease, it should have the following pre-requisites:

  a. Identified asset: A contract contains a lease only if it relates to an identified asset. An identified asset could be either explicitly or implicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the lessee.

  Capacity portion

  A capacity portion of an asset that is not physically distinct is not an identified asset, unless it represents substantially all of the capacity of the asset and, therefore, provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion.

  Substantive substitution rights

  Even if an asset is specified, a lessee does not have the right to use an identified asset if the lessor has the substantive right to substitute the asset for an alternative asset during the lease term.

  A substitution right is substantive if the lessor:

  a. Has the practical ability to substitute the asset and

  b. Would benefit economically from exercising its right to substitute the asset.

  Therefore, an entity is required to evaluate at the inception of the contract whether substitution rights are substantive. A lessor's right or obligation to substitute an asset for repairs, maintenance, malfunction or technical upgrade does not constitute substantive substitution rights and therefore, would not preclude the lessee from having the right to use an identified asset.

b. Right to control use of an identified asset: After identification of an asset, the key step is to determine whether the entity has the right to control the use of an identified asset. IFRS 16 provides specific guidance for this purpose. According to it, a lessee would have the right to control the use of an asset, if throughout the period of use, it has the rights to:

i. Obtain substantially all of the economic benefits from the use of the identified asset and

ii. Direct the use of the identified asset.

The economic benefits from using an asset would include primary outputs in the form of goods or services, and ancillary benefits such as, rebates and duty credits. Such economic benefits can be obtained by a lessee directly or indirectly (e.g., by using, holding or subleasing the asset). However, economic benefits which arise from ownership of an identified asset such as, tax benefits do not relate to the use of an asset and therefore, would not be considered while assessing a lessee's right to obtain substantially all of the economic benefits.

Entities in the M&E sector would need to evaluate each and every arrangement entered into by it so as to determine whether a contract constitutes a lease under the new framework and would have to be recognised in the financial statements.

For instance, in an arrangement to hire sites for mounting an advertising billboard or to rent fiber optic cable for transmission, while evaluating which party has the right to direct the use of the underlying asset, the lessee would have to assess which party directs the use of a dedicated cable that is part of the larger network infrastructure. This is likely to involve considerable amount of judgement.

Example:

Right-to-use advertising billboards on a structure (e.g., a side of building, side of bus stop shelter, pillars of bridge and floor of a sporting arena) for advertising

A Ltd. (customer) is a television broadcasting network that enters into an arrangement with B Ltd. (supplier), an out-of-home advertising entity, to advertise its new television show on billboards located in metro and non-metro cities across India.

The arrangement for metro cities is for digital billboard and locations are pre-approved by the operations team of A Ltd. including its display, design and other features for each location.

In case of non-metro cities, the customer selects 15 locations in each city of which B Ltd. will put traditional billboards on five such locations throughout the term of the arrangement.

The duration of arrangement for metro and non-metro cities is three months and 16 months respectively. B Ltd. is responsible for the operation and maintenance of the billboard and requires a week's advance notice before the advertisement can be changed.

Analysis

In many instances, specific space on the side of the structure is an identified asset as it can specifically be used to mount an advertising billboard. Further, economic benefits can be derived not only from an asset's primary use (e.g. building) but also from ancillary use. Consequently, entities may reach different conclusions about whether there is an identified asset or not, depending on the facts and circumstances of each case.

In the given case, the arrangement for the traditional billboard would not be a lease if the supplier has substantive substitution rights i.e. if B Ltd. finds a higher bidder for a particular site in a non-metro city, it can relocate A Ltd.'s advertisement to one of the other approved sites within the city.

On the other hand, in case of the arrangement for digital billboard, it would be likely to be concluded that the arrangement contains a lease on account of the following reasons:

a. The customer will use digital billboard for advertising its television show and may direct to change or modify the advertisement

b. The supplier lacks control to substitute the digital billboards

c. The billboard is explicitly identified as stated in the arrangement and

d. Locations are pre-approved by the customer and the supplier does not have the contractual ability to substitute the locations.

Further, the customer has the right to control the use of the advertising billboard throughout the period as:

a. It has the right to obtain substantially all of the economic benefits from use of digital billboard over the period of use (i.e. the economic benefit obtained from displaying advertisement at the site) and

b. It makes the relevant decisions on 'how and for what purpose' the billboard space is to be used by determining what content has to be displayed, when it is to be displayed and how often it needs to be changed.

(Source: KPMG in India's analysis, 2019)

Example: Transmission service arrangement in a television industry

A Ltd. (customer) a multi-system operator, enters into a five-year contract with B Ltd., a satellite communications provider (supplier) to provide dedicated broadcast transmission capacity using five dedicated satellite transponders. B Ltd. is the owner of the satellite transponders and is responsible for its operation to enable transmission, including any required maintenance. Each transponder is capable of 35 to 54 channels. The arrangement specifies the transponder capacity of each transponder and provides the customer with the relevant technical details to access and operate its dedicated capacity (e.g., the microwave radio frequency range and specific orbital location to up-link customer's broadcast signal to the transponder). The capacity on the dedicated transponder is assigned to the customer who has exclusive use of that capacity and the customer can choose during which hours and/or which signals it wants to broadcast via that transponder. Further, the supplier cannot substitute the transponder except for maintenance or in the event of malfunction.

B Ltd. receives channel signals from C Ltd., a broadcasting network, from its up-linking location. The content/television feed is transmitted to the up-linking facility through fiber optic cable hired from various telecom operators. Telecom operators offer similar services to other broadcasters and operators.

The term of the arrangement with C Ltd. is five years and the telecom operators are the legal owners of the fiber cable.

Analysis

The arrangement between A Ltd. and B Ltd. contains a lease on account of the following reasons:

a. The transponder is physically distinct in nature and is dedicated for use by A Ltd., thus, it is an identified asset.

b. A Ltd. has the right to control the use of the transponder throughout the period of use because it has the right to:

   i. Obtain substantially all of the economic benefits from the use of the transponder as the identified transponder's capacity is dedicated to A Ltd. throughout the period of use and

   ii. Make relevant decisions about when and how much data is to be transmitted because A Ltd. can elect at its sole discretion to go-off or on-air at any time during the period of use.

The arrangement between B Ltd. and C Ltd. will not be classified as a lease as the capacity portion of fiber cable does not seem to qualify as an identified asset as it is not capable of being distinct. Further, since it is being shared by several customers, therefore, it neither provides substantially all economic benefits to B Ltd., nor B Ltd. can direct the use of the cable.

(Source: KPMG in India's analysis, 2019)

Example: Hire of projectors by exhibitors

DEF Ltd. (customer) is a film exhibitor having 300-plus cinema screens across locations. Out of these, 55 screens are exclusively used to exhibit technologically advanced 3D movies for which DEF Ltd. has installed high-end projectors specially designed for exhibition of such movies. Since, purchase of high-end projectors involve huge costs, DEF Ltd. has entered into an arrangement for hire of such projectors with STL Ltd. (supplier) for a period of five years in exchange for a consideration to be paid on a monthly basis. These projectors are physically distinct and explicitly specified in the contract. STL Ltd. is the legal owner of the projectors and performs regular maintenance services. Also, the projectors are annually verified by STL Ltd.

Analysis

The arrangement between ABC Ltd. and STL Ltd. contains a lease as it relates to an identified asset i.e. a projector which is physically distinct and explicitly specified in the contract. Since, the primary use of the projector is to exhibit movies on the defined screens of ABC Ltd., therefore, substantially all economic benefits from the use of the projectors by exhibition activity (for instance, sale of tickets, advertisement revenue, etc.) will flow to ABC Ltd. Please note that, though STL Ltd. may have legal right of substitution, this right would not be considered substantive in nature, if significant costs are involved in substituting the projectors.

Further, ABC Ltd. has the right to control the projectors in terms of exclusive access during the contract period and in terms of the content to be exhibited and its timing. Moreover, supplier's right for verification of projectors annually seems to be protective in nature.

(Source: KPMG in India's analysis, 2019)

- **Identifying components of a lease:** In the M&E sector, Multiple System Operators (MSOs) and Direct-To-Home (DTH) players (i.e. lessors) have arrangements with a lease and a non-lease component i.e. set-top box (lease) and television broadcasting service (non-lease). If a contract contains a lease component and one or more additional lease or non-lease components, then the lessee is required to allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of each lease component and the non-lease components.

- **Transition considerations:** Entities will need to decide upon the transition options available under the new standard i.e. whether to apply the standard retrospectively to all leases or to use a modified retrospective approach. The extent of information required will depend on the transition approach chosen. For instance, a modified retrospective approach could be applied using only current period information i.e. the lessee's incremental borrowing rate at the beginning of the current and lessee's remaining lease payments. On the other hand, an entity would require extensive information about its leasing transactions to apply the standard retrospectively. This will include historical information about lease payments and discount rates. The information will be required as at lease commencement and also as at each date on which an entity would have been required to recalculate lease assets and liabilities or modification of the lease.

Consider this...

The main impact of IFRS 16 will be to bring assets held under operating leases and the lease liabilities onto balance sheet of a lessee. Profitability and leverage ratios would also get affected.

In case of M&E sector, the key challenge will remain to identify whether the contract is, or contains, a lease and segregation of non-lease components in a lease. Some of the other key considerations for entities in the M&E sector are as follows:

- Accounting of contracts for partial use of assets (e.g. fibre optic cables) under the new standard given the requirements for an asset to be considered physically distinct
- Eligibility of an arrangement for use of third party assets (e.g. use of satellites or physical advertising space) to create/publish content to qualify as a lease arrangement
- Transition options and related information requirements.