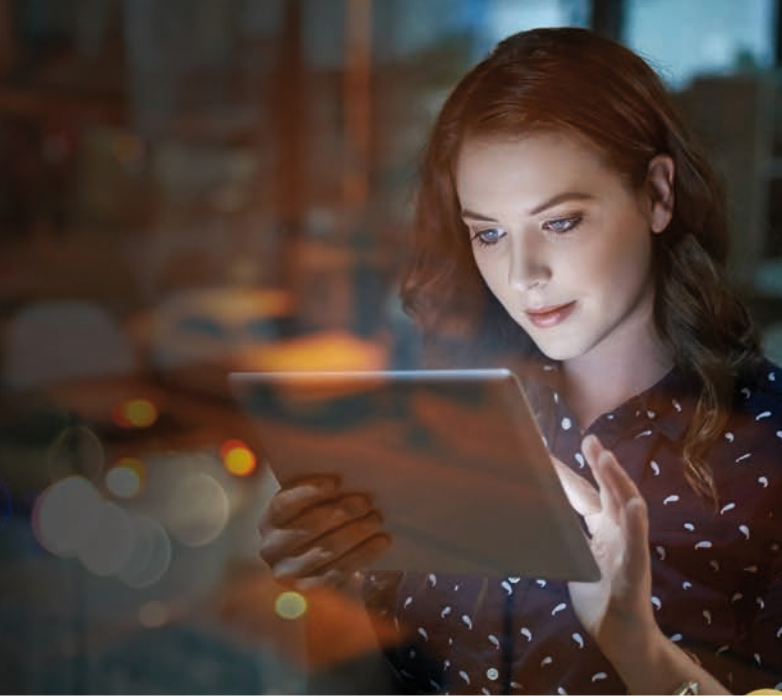
KPMG

Accounting for leases is changing



What's the impact on telecommunication companies?

November 2017

The new leases standard – IFRS 16 – will require companies to bring most leases on-balance sheet from 2019. For telcos, getting a complete list of leases will be a real challenge. But this is more than just an accounting change…

It could impact…

- debt, credit rating and covenants
- capital expenditure
- distributable reserves
- timing of revenue recognition
- IT systems and data availability and quality
- earnings
- processes and associated controls
- lease contract negotiations
- employee performance plans
- tax

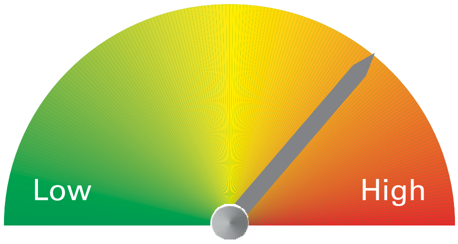
If you have…

- dedicated lines/links (e.g. copper, fibre, Ethernet, wavelength)
- other transmission assets (e.g. switch sites, data centres, poles, ducts, masts, satellites)
- customer premises equipment
- assets bundled with other goods and services
- assets in joint arrangements
- assets in back-to-back arrangements
- inter-company leases
- assets denominated in foreign currencies

… you need to start looking at your contracts now to assess how the new requirements will affect your business.

Engage with your stakeholders to manage expectations of how your KPIs or business practices may change.

Determining the impact



Dedicated lines/links

Potential impact

- If a telco has dedicated line agreements, a supplier may have substitution rights.
- Assessing whether substitution rights are substantive is highly judgemental. If the customer cannot determine whether the right is substantive, it must assume it isn't. This means that the contract will be a lease if the other lease definition criteria are met.

Actions to consider

- Review contractual terms to determine whether a supplier substitution right exists throughout the rental period.
- Assess if a supplier's right is substantive to determine whether a lease exists. A supplier's right is substantive if they have the practical ability to substitute the asset throughout the period of use and the economic benefits are expected to exceed the costs. This assessment will be unique to each arrangement, making it impossible for telcos to apply a 'one size fits all' approach.
- Identify key judgement points in your arrangements. Assess whether any common judgements can be applied across the business.

- Line arrangements manifest themselves in a variety of forms. Each type of arrangement will have unique 'how and for what purpose' decisions.
- If each line agreement structure is customised, then it may be challenging to determine who directs the asset's use and, consequently, whether a lease could exist.

Actions to consider:

- Consider the nature of existing line agreements and identify the key how and for what purpose decisions for each.
- Review contractual terms to determine whether the supplier or the customer has the right to make these decisions, and therefore who has control of the underlying transmission asset.

Other transmission assets

Potential impact

- A portion of a cable duct or a transmission pole's capacity can be a lease if it is physically distinct. It can also be a lease if it is not physically distinct as long as the customer has the right to receive 'substantially all' of the asset's capacity.
- Gathering the information to determine whether the agreement gives the right to substantially all of the asset's capacity may be challenging, particularly when the capacity portion is not physically distinct.

Actions to consider

- Operationalise the substantially all test to ensure it is applied on a consistent basis.
- When one component of a transmission asset is not physically distinct and the customer receives less than substantially all of its capacity, it is not a lease. Consider whether other components of the asset may meet the lease definition.

- If designated space on a mobile tower is shared with other providers, one component (e.g. the space on the tower) may meet the lease definition, but not another (e.g. a shared cabinet).
- The way in which lease components are separated will have a direct impact on KPIs and covenant metrics. For a lessee, electing to apply the practical expedient and record each lease component and associated non-lease components as a single lease component may result in an improved EBITDA figure, but also higher assets and more debt on the balance sheet. The practical expedient is not available to lessors.

Actions to consider:

- Identify which contracts are likely to have both lease and non-lease components.
- Quantify and evaluate the effects of componentisation, including whether to utilise the available practical expedient as a lessee.

- In tower share arrangements or line arrangements where the agreement term extends beyond the business' typical planning horizon, judgement will be needed to determine whether to include renewal and termination options in the lease term – i.e. whether they are 'reasonably certain' to be exercised.
- The lease term will affect the calculation of the discount rate and, ultimately, the lease liability.

Actions to consider:

- Identify lease agreements whose terms include renewal or termination options.
- Operationalise how to apply the reasonably certain test.

Customer premises equipment

Potential impact	Actions to consider
– Customer premises equipment (CPE) arrangements may involve a higher level of ongoing decision-making due to increased functionality. If the how and for what purpose decisions are made by the customer, then the customer has the right to direct the use of the asset and a lease exists if the other criteria are met.	– Identify the key how and for what purpose decisions for each asset. – Review contractual terms to determine whether the supplier or the customer has the right to make these decisions, and therefore who has control of the right to use the underlying asset.
– By contrast, arrangements that do not contain a lease – including some CPE arrangements – may fall entirely into the scope of IFRS 15 *Revenue from Contracts with Customers* for a supplier. – A mobile phone contract may contain a lease under IFRS 16 if the customer/telco has a significant economic incentive to return/repurchase the device.	– Identify arrangements where the business practice may be to fully transfer control of an asset to the customer, despite holding legal title to that asset. – Consider whether agreements that do not contain a lease fall in the scope of IFRS 15.

Assets bundled with other goods and services

Potential impact	Actions to consider
– Each lease component within a contract is accounted for as a lease, separately from non-lease components. – A lessee may elect, by class of underlying asset, not to separate a lease component from any associated non-lease components, and instead account for them as a single lease component. – The way in which lease components are separated will have a direct impact on KPIs and covenant metrics.	– Identify which contracts contain both lease and non-lease components. – Quantify and evaluate the effects of componentisation, including whether to utilise the available practical expedient as a lessee.
– Even when a lease component and associated non-lease components are combined into a single lease component, variable payments – such as usage-based utility charges – are excluded from the lease liability. – Contracts that include only variable rents as opposed to fixed payments will result in a lower right-of-use (ROU) asset and corresponding liability, despite the lease definition being met. However, this could result in lower EBITDA and greater volatility in profit or loss.	– Discuss potential contracting changes with your suppliers. – Model the impact of changing from fixed to variable payments, or vice versa.

Assets in joint arrangements

Potential impact

- Identifying the customer as either the joint arrangement (JA) itself or one of the parties in the joint arrangement is critical when determining whether a lease exists. This may impact:
  - the recognition of the liability and asset in the identified customer's books;
  - the evaluation of the discount rate, based on the identified customer's risk profile;
  - the existence of a sub-lease between the JA and the other parties in the JA; and
  - the accounting for transactions between the JA and the other parties to the arrangement.

Actions to consider

- Identify agreements that are signed by, or employed in, joint arrangements or strategic partnerships.
- Evaluate the terms of the agreement to identify the customer in each arrangement.
- Consider IFRS 16 policies and reporting requirements of other JA stakeholders and whether this impacts your reporting.

Assets in back-to-back arrangements

Potential impact

- An intermediate lessor accounts for the head lease and the sub-lease as separate contracts. Therefore, different accounting models may apply.
- Classification of the sub-lease as a finance or an operating lease is based on the ROU asset arising from the head lease. This may lead to more sub-leases being classified as finance leases in the future. For example, a telco sub-leases retail stores to a franchisee for the entire term of the head lease from the property owner.
- An intermediate lessor cannot apply the low-value lease exemption to an asset that it sub-leases, therefore those leases will be on-balance sheet.

Actions to consider

- Consider how the contractual terms of the sub-lease agreement may impact the lease term for the head lease – e.g. an option to extend the head lease when a sub-lease is for a period that reflects the option being exercised.
- Identify sub-lease contracts where the operating vs finance lease classification may change when applying IFRS 16.
- If you are an intermediate lessor, ensure that the low-value lease exemption is not applied.

Inter-company leases

Potential impact

- Inter-company lease arrangements that were previously classified as operating leases by both the lessee and the lessor may no longer attract equal and opposite accounting in each group entity's accounts – that is, the lessor will continue operating lease accounting but the lessee will recognise an ROU asset and a lease liability.
- This could significantly increase the complexity of internal reporting and consolidation systems and processes.

Actions to consider

- Evaluate whether the consolidation system is equipped to handle complex or high volume eliminations.
- Consider any statutory accounting implications – i.e. the inability to simplify the approach taken in group accounts, due to reporting and tax requirements.

Assets denominated in foreign currencies

Potential impact

- Leases of assets that are denominated in foreign currencies may increase volatility in profit or loss, as the lease liability is a monetary item that is translated at the closing exchange rate at each reporting date but the ROU asset is not.
- Foreign currency leased assets may also add complexity when determining the lease discount rate, accounting for lease modifications and preparing consolidated accounts.

Actions to consider

- Identify opportunities to hedge the foreign currency exposure to mitigate the volatility in profit or loss generated by the translation of the foreign currency monetary lease liability.
- Consider the lease's economic environment when determining the discount rate – i.e. the incremental borrowing rate as a lessee.

Transition options[1]

Potential impact

- IFRS 16 may be adopted either retrospectively, by restating comparatives and adjusting retained earnings at the beginning of the earliest comparative period; or using a modified retrospective approach, by adjusting retained earnings with the cumulative effect of initially applying the standard at the beginning of the first reporting year.
- When applying the modified retrospective approach, several options and practical expedients are available to provide some relief upon implementation.
- The selected transition approach will have a significant impact on the carrying amount of net assets, and trends in profit or loss in the post-transition years.

Actions to consider

- Perform detailed modelling of the opening balance sheet and future income statements and balance sheets for each transition method, including application of the practical expedients when using the modified retrospective approach.
- Assess the information that will be needed to comply with each method.
- If electing to apply practical expedients, consider any requirement to maintain multiple sets of records for trend analysis.
- Engage with stakeholders to determine the impact on tax, treasury, IT systems, strategy, legal, employee benefits, distributable reserves, investor relations, regulatory compliance and financial planning.

- On transition, companies can also make an accounting policy choice to either:
  - apply the new lease definition to all contracts; or
  - apply a practical expedient to grandfather the previous assessment of which existing contracts are, or contain, leases.
- When making this choice, consider for each arrangement whether:
  - the lease definition may differ under the new standard (e.g. power purchase arrangements); and
  - the quality of the existing analysis under IAS 17 *Leases* and IFRIC 4 *Determining Whether an Arrangement Contains a Lease* is sufficient.

- Evaluate the potential cost savings against the potential need to apply IFRS 16 to those arrangements that would not be a lease under the new definition.
- Review historical accounting assessments under IAS 17/IFRIC 4 to determine whether those conclusions continue to be appropriate at the date of transition.

Recognition exemptions[1]

Potential impact

- On transition and subsequently, a lessee can elect not to apply the lease accounting model to:
  - leases with a term of less than 12 months; and
  - leases of low-value items.
- This could offer significant cost savings for lessee telcos with large amounts of low-value assets – e.g. office equipment, mobile phones, low-value cables.
- The election for short-term leases is made by class of underlying asset, while the election for low-value leases is made on a lease-by-lease basis.

Actions to consider

- Evaluate the contract terms of leased assets (including cancellation clauses, and options to terminate early or renew) to identify those that are eligible for the short-term lease exemption.
- Perform cost benefit analysis to determine the potential cost savings that could arise from excluding low-value items from your transition analysis.
- Consider the impact across your business when determining whether to take the short-term exemption for an entire asset class.

1. You can find more detailed information about IFRS 16 in our publications *Lease Definition*, *Lease Payments*, *Lease Discount Rates*, and *Leases Transition Options*.

How KPMG can help

Assess the impacts → Design a tailored approach → Help implement a future state

A robust assessment phase is critical to laying the framework for a successful project, and it is important to start the assessment early to provide flexibility during the implementation phase. An assessment phase typically includes the following activities:

Activities	Actions	Deliverables
Transition option assessment	– Determine how each option may impact financials and business – Assess readiness to elect the retrospective or modified retrospective option	Transition option assessment report, using KPMG's IFRS 16 *Transition Impact Accelerator*
Accounting diagnostic	– Identify potential gaps to accounting policy and disclosures by reviewing current accounting policy and sample of contracts	Gap matrix, heat map and contract review summaries
Business impact assessment (including systems, processes and data)	– Assess existing system functionality and gaps – Identify data requirements and gaps – Determine new process and controls requirements – Assess other business impacts including tax, operations, financial planning and analysis, investor relations, regulation, contracting, HR, dividends and treasury	Business requirements document, process, technology and data gap analysis report, using KPMG's *Leases Diagnostic Accelerator*
Implementation plan	– Determine a robust implementation timeline and establish governance to achieve it	An IFRS 16 Programme Sponsor approved implementation plan

KPMG's Telecommunications practice

KPMG's Telecommunications practice is dedicated to supporting telecommunications carriers globally in understanding industry trends and business issues.

Member firms offer customised, sector-specific services that can add value to your most pressing business requirements.

At KPMG, our extensive network of professionals combines a global perspective with in-depth industry knowledge to help companies adjust to today's rapidly changing market.

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