

IFRS industry insights

Telecommunications implications of the revised leasing exposure draft

The bottom line

- A revised exposure draft on lease accounting has been published by the IASB with a comment deadline of 13 September 2013.
- The definition of leases will capture contracts conveying control of specific assets, rather than assets of a particular specification.
- Leases that could extend beyond 12 months will come on-balance sheet for lessees, potentially impacting key performance indicators, gearing and lending covenants.
- For lessees, most property leases will have an overall straight-line expense profile, whereas many other leases it will be front-loaded.

What's happened?

The IASB has published a revised exposure draft (the 'ED') on lease accounting with comments requested by 13 September 2013. Whilst a number of problems identified by respondents to the exposure draft published in 2010 (such as the definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities undoubtedly remain.

Implications for the telecommunications industry

This publication highlights three issues from the latest proposals that will be of particular interest to those in the telecommunications industry. Of course many more complexities exist and, as described below, Deloitte has produced further guidance, exploring these in greater detail.

Definition of a lease

A lease will exist where a contract conveys a right to control an identifiable asset. A physically distinct portion of an asset, such as a floor of a building, is an identifiable asset, but a capacity portion of an asset that is not physically distinct is not. An example of a capacity portion described in the ED is a share of fibre-optic cable which is less than substantially all of the capacity of the cable. The key judgement for many telecom operators will be whether the capacity they use (or sell) represents "substantially all" of the capacity.

Leases coming on balance sheet

Lessees would recognise an asset and corresponding liability on their balance sheets for their fixed future lease payments, similar to existing finance lease accounting. Aside from a few specific scope exclusions, the only other leases that could stay off-balance sheet would be those that have a maximum possible term of 12 months, including a presumption that extension options will be exercised. The result for telecom operators could be that arrangements for the use of equipment that have been treated as operating leases or service contracts will need to be reassessed. This balance-sheet gross-up, resulting from lease assets and liabilities being recognised, could be significant for assets such as property or leased circuits that run for several years. For telecom operators more than most, classifying leases may prove time consuming and will inevitably require judgements to be made. For example, multiple element contracts will need to be unbundled to separate lease components from service elements.

Capacity contracts between operators are common

Significant leases could include retail outlets and exchanges

Lessees recognise a straight-line expense for most property leases but front-loaded for others

Unless a property is leased for the "major" part of its remaining economic life or the lease payments are "substantially all" of its fair value, the subsequent measurement of the asset and liability would yield a straight-line single lease expense over the lease period. The same tests would be applied for assets other than property, such as equipment, but a lower threshold of "insignificant" would need to be met and the asset's total economic life considered. Otherwise, the expense profile would be front-loaded because the lease asset would be amortised on a straight-line basis, whilst the lease liability would be amortised using the effective interest rate method.

Areas impacted by the proposals

Banking covenants	Initial recognition of an asset and liability may not have an impact on a lessee's net assets, but it could affect key balance sheet ratios, particularly if the liability is treated as a financing item. For leases with front-loaded expense profiles, any interest expense beyond that on existing finance leases could impact covenants based on interest cover. Renegotiations could be required.
Key performance indicators	Key metrics of a business' performance could be impacted by the proposals. Depending on how they are calculated, measures such as return on capital may be affected or need redefining. For those operating lease expenses that would be replaced with a front-loaded interest and amortisation charge, adjusted measures of lessees' earnings which strip out the effect of interest, such as EBIT, may increase and those that strip out amortisation and depreciation as well, such as EBITDA, could increase by a greater amount.
Reporting systems	Systems would need to capture all information required by any new standard – the ED proposes extra disclosures beyond those currently required. Given the number of leases and capacity arrangements held by telecommunications businesses this could involve significant resource. Closer relationships between finance teams and the operations teams entering into leases may be advisable to avoid undesired accounting consequences.
Remuneration schemes	Performance related pay schemes could be impacted due to changes in key performance indicators. Again, renegotiating or redefining such schemes may be advisable.
Earnouts	Where acquisitions have included contingent consideration that is dependent on the acquiree's future performance the effects of any new lease accounting would need to be assessed carefully.
Tax	The potential impact of the proposed lease accounting changes on cash tax and deferred tax would need to be reviewed by reference to tax legislation in each relevant jurisdiction.

Resources

More detailed information on the revised ED can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. You can also register on IASPlus to receive newsletters that provide updates whenever the leasing project is discussed at IASB meetings. The revised exposure draft itself can be accessed on the on the IASB website at www.iasb.org.

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