

Industry views

Telecommunications Industry Accounting Group

Making sense of a complex world

The future of leasing and the impact on the telecom industry



Introduction



Leasing is an essential commercial tool and is employed extensively by telecom operators, both as lessee and lessor. For many years, accounting standard setters and regulators have expressed concern that companies have taken advantage of weaknesses in existing GAAP to report leasing transactions in a way that does not reflect the underlying commercial substance. The most common criticism has been that it is relatively easy under

current GAAP to present a transaction whose primary purpose is to finance the purchase of an asset as a rental obligation instead.

The new joint IASB and FASB proposals will remove the historical distinction between finance (capital) leases and operating leases – all leased assets will be recorded on the balance sheet, together with the equivalent financing liability.

This paper describes the key elements of the exposure draft and the changes likely to be of most significance to the telecom industry. We hope you will find it useful and, as ever, will welcome your feedback.

A handwritten signature in white ink that reads "P. Barkus". The signature is written in a cursive, slightly stylized font.

Paul Barkus

Chairman
PwC Telecom Industry Accounting Group

The future of leasing

Impact on the telecom industry

On 17 August 2010, the IASB and the FASB ('the Boards') issued their exposure draft on leasing. They plan to require lessees to report all leases on balance sheet. The impact on lessee and lessor financial reporting, asset financing, IT, systems and controls could be substantial.

What would the change mean for telecom companies?

Lessees:

- The Boards appear ready to require all leases, not just finance leases, to appear on the balance sheet.
- Telecom companies will be affected, not only because of the magnitude of the impact on their financial statements, but also because of the impact on systems and processes given their numerous smaller leases.
- Balance sheets will grow, leverage ratios increase, and capital ratios decrease.
- There will be a change to both expense character (rent replaced with depreciation/amortisation and interest expense) and recognition pattern (significant acceleration of total expense recognition relative to the pattern under current rules). Performance measures such as EBIT and EBITDA will therefore change.
- 'Lease-buy' decisions may be affected. Telecom companies are not only affected as lessee, but may also be affected as lessor in their business transactions.
- Significant changes to internal controls and accounting/information systems are likely to be necessary.

Lessors:

- There are two different proposed models for lessors. Determining which should be applied will depend on a company's business model and on the extent of its exposure to the risks and benefits of the underlying asset.

Background

Leasing is an important and widely used source of financing. It enables companies, from start-ups to multinationals, to acquire the right to use property, plant and equipment without making large initial cash outlays.

Companies currently account for leases as either operating leases or finance leases. Lease classification is based on complex rules; where a lease is accounted for as an operating lease, neither the leased asset nor the obligation to pay for it are recorded on the balance sheet. Rather, rent expense is recorded on a straight-line basis throughout the lease term.

The Boards have been working to create a single, global leasing standard as part of their global convergence process. They issued a joint exposure draft in August 2010 and expect to release a final standard around a year later in mid-2011.

The proposed model - lessees

The key elements of the proposed lease accounting model and its effect on financial statements are as follows:

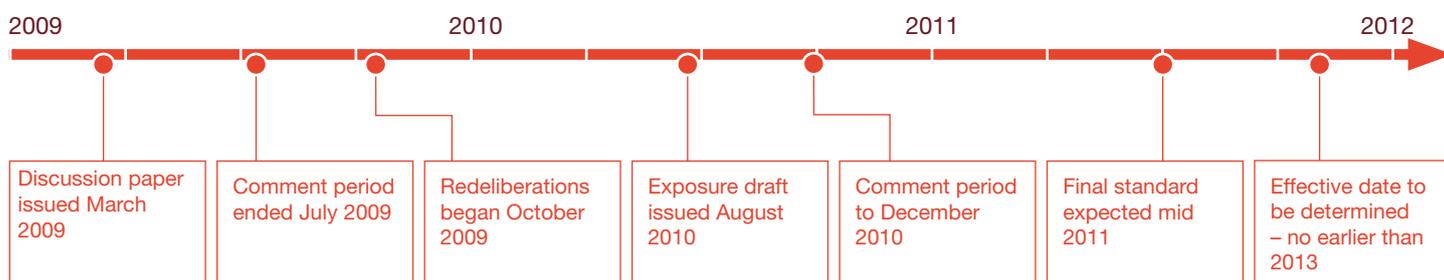
- A 'right of use' concept will replace the 'risks and rewards' concept. Companies will recognise an asset and liability at the start of a lease.
- The distinction between operating leases and finance leases will be eliminated.
- All lease liabilities will be measured with reference to an estimate of the lease term, which will include optional extension periods if they are more likely than not to occur.
- Contingent rentals and residual value obligations will have to be estimated and included in the measurement of the right of use asset and lease liability at the start of the lease.
- Lessees will be required to reassess the lease term, contingent rentals and residual value obligation if there is a change in facts or circumstances.

The proposed model - lessors

A lessor will recognise a right to receive lease payments and either:

- Derecognise the underlying asset (net of any residual asset value at the end of the lease) where the lessor no longer has exposure to the risks and benefits of the underlying asset; in essence treatment as a sales-type lease (referred to as the derecognition approach); or
- Recognise a right to receive lease payments and a lease liability while continuing to recognise the underlying asset (referred to as the performance obligation approach).

Timeline



The business impact

Businesses will need to undertake an in-depth review of the proposed changes in order to assess their impact on key financial performance ratios (including debt covenants).

The changes will require more information to be gathered and more judgements to be made on an annual basis. They will affect financial ratios and metrics, 'lease-buy' decisions, taxes, accounting processes and controls, IT and lease accounting systems.

Lessees and lessors may need to consider re-negotiating or restructuring existing and future leases. Business and legal structures supporting leases should also be reassessed to evaluate whether these continue to be effective (for example, joint ventures and special purpose entities).

The developments may also significantly impact lessors' business models. They will need to emphasise the continuing benefits of leasing, consider the implications for lessees and whether existing products need to be revised.

Impact on the telecom sector

Most telecom companies are both lessors and lessees. Typical agreements in which telecom companies act as a lessee include leases of land (including sites for mobile masts), buildings, equipment and vehicles. Other agreements that could qualify as leases include capacity contracts, wayleaves and rights of access, satellite broadcasting contracts and IT outsourcing agreements.

Telecom companies may also act as lessors of telecom equipment or may fall to be treated as lessors in network outsourcing agreements or data centre activities.

The magnitude of the impact of the proposed lease accounting model will depend on which of the above agreements fall within the scope of the new standard. Given the large number of (smaller) leases and options that are generally included in site leases and outsourcing agreements, implementation of the standard is likely to require significant resources and effort.

Response from the telecom sector

In March 2009, the Boards issued a joint discussion paper which set out preliminary proposals in respect of lessees. A number of telecom companies provided input to the Boards in the form of comment letters in response to the 2009 discussion paper. In this paper we have summarised their key comments and observations and how the Boards have responded in the recent exposure draft.

Overall, most telecom companies agreed with the general direction in which the Boards were heading. Although not all operators were convinced that the current model was significantly flawed, the proposed right of use model was considered a reasonable approach given some of the issues that users have with current accounting. Many operators however believed that the increased complexity and use of estimates would not add to the overall reliability and transparency of the financial statements. They raised concerns about whether the benefits outweigh the costs.

Scope of the project

Most respondents to the discussion paper argued that the Boards should work on a comprehensive lease standard, dealing with both lessee and lessor accounting (the discussion paper addressed only lessees). The exposure draft includes proposals in respect of lessor accounting, the main provisions of which are set out on the previous page.

Telecom companies also argued strongly that the new lease standard should be developed consistently with ongoing changes to the conceptual framework and other crucial standards such as revenue recognition and financial statement presentation.

Also on the subject of scope, telecom companies believed that the Boards should take the opportunity to reconsider the guidance regarding arrangements that contain a lease. The current guidance (IFRIC 4 'Determining whether an arrangement contains a lease') is generally considered by telecom companies to be difficult to apply in practice and can result in inconsistent conclusions about whether an arrangement contains a lease or not. The Boards have however incorporated the principles of IFRIC 4 into the exposure draft.

Short-term and non-core leases

Most telecom companies agreed with the Boards that no distinction should be made between leases of core and non-core assets. However, they believed that exclusion of certain short-term leases may be appropriate based on materiality. In the exposure draft the Boards have proposed that for leases with a maximum possible term (including all extension options) of less than 12 months, lessees can use a simplified form of accounting. No other exemptions have been proposed.

Contingent rentals and renewal options

Telecom companies generally disagreed with the proposed approach to contingent rentals and renewal options. Their principal argument was that recognition of a liability for payments that are avoidable is not consistent with the definition of a liability in the conceptual framework and other accounting standards. They also believed that a requirement to estimate whether renewal options will be exercised at specific points in the future contradicted the business reasons for seeking agreements with flexibility in the first place. Finally, they noted the significant administrative cost involved, volatility in the income statement and lack of reliability.

As an alternative, telecom companies proposed to limit measurement of the lease obligation to the unavoidable contractual payments to be made during the non-cancellable period, with enhanced disclosure about contingent rentals, renewal options and other uncertain elements.

The Boards believe the inclusion of contingent rentals and renewal options informs investors about expected cash flows and that the current requirements generally exclude these items making it more difficult for investors to estimate future cash flows. For this reason in the exposure draft the Boards continue to propose that contingent rentals and renewal options are included in the measurement of lease liabilities. They have changed their perspective as to how those amounts should be estimated, but this is unlikely to address the specific concerns of telecom companies.

Revision of estimates

The discussion paper proposed that estimates were to be revised at each balance sheet date. Most telecom companies believed that revision of estimates should be limited to specific circumstances because the administrative burden of continuous re-assessment would be too great. They also believed that lessees should not be required to revise the lease liability for changes in the incremental borrowing rate. The lease liability should however be re-assessed if new events indicated that there is a material change in the expected lease term or lease payments.

All responding telecom companies agreed that changes to the estimated lease obligation should be reflected in an adjustment to the right of use asset and not result in a gain or loss in the income statement.

In the exposure draft the Boards have proposed that a reassessment will only be required where there have been changes in facts and circumstances that indicate that there is a significant change in the liability to make lease payments or the right to receive lease payments.

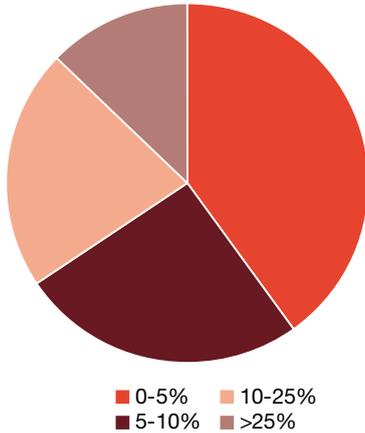
Where the change in estimate relates to prior periods it should be recorded in the income statement. Where it relates to future periods an adjustment should be made to the right to use or right to receive.

Presentation

Telecom companies had mixed views about whether the right of use assets and lease liabilities should be presented separately on the balance sheet or only in the notes. They generally agreed that the decrease in value of the right of use asset should be presented as depreciation or amortisation in the income statement. This is in line with the proposals in the exposure draft.

Practical considerations

Chart 1: Relative increase in EBITDA



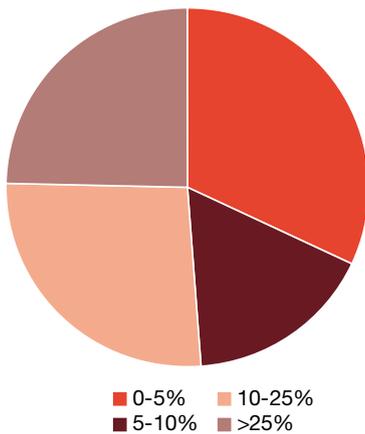
Financial ratios and metrics

The proposed model will change both balance sheet and income statement presentation. Leverage and capital ratios are likely to suffer from the gross-up of balance sheets. Rent expense will be replaced by depreciation and interest expense. In addition, the expense recognition pattern may change significantly. This will negatively impact some performance measures, such as interest cover, but improve others, such as EBIT or EBITDA, with no change in the underlying cash flows or business activity. In addition, periodic remeasurement is likely to increase volatility of key financial ratios.

Timely assessment of the proposals' impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies and other users of the company's financial data. Companies anticipating capital market transactions should consider the effects on their leverage ratios.

Agreements based on (company-specific) key performance indicators will require reassessment and potentially adjustment, for example, remuneration and bonus agreements.

Chart 2: Relative increase in debt/equity ratio



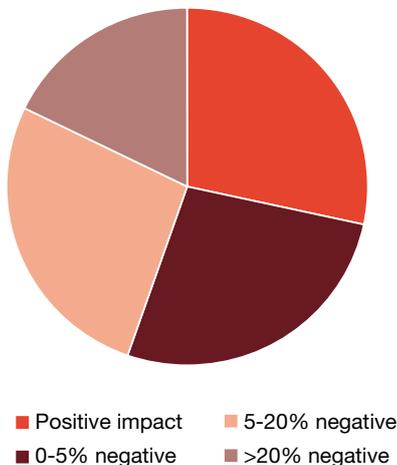
PwC has performed a benchmark study to assess the impact of the proposals on the financial statements and key financial ratios of a sample of 125 listed telecom companies from 32 countries.

The study identifies the minimum impact of capitalising the operating lease commitments disclosed in the published financial statements. In view of the proposed inclusion of likely lease renewals, contingent rentals and residual value obligations the eventual impact may be much greater and may also impact the amounts currently recognised for finance leases.

Furthermore, the study takes no account of any transitional reliefs that will be available on first-time adoption of the new standard. Nevertheless, it provides an indication of the impact that the proposed lease accounting model may have.

EBITDA is a key performance measure for almost all telecom companies. EBITDA will increase as a result of the replacement of operating lease expense by depreciation and interest expense. For 22% of the telecom companies, the increase in EBITDA is expected to be between 10% and 25%, for 13%, more than 25% (see Chart 1).

Chart 3: Impact on EBITDA/interest coverage



From a balance sheet perspective, the debt to equity ratio is an important ratio for many companies. Based on our study, we conclude that the ratio is expected to increase by more than 10% for more than 50% of the telecom companies and more than 25% for at least 25% of these companies (see Chart 2).

The combined effect of increasing debt and interest expenses, combined with an increase in EBITDA on a telecom company's EBITDA/interest ratio, is uncertain. For 28% of the companies in our study, the combined impact is positive. For 45%, however, the impact is more than 5% negative, for 18% of these the impact is more than 20% (see Chart 3).

IT and lease accounting systems

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept. They will need to be modified to the proposed right of use concept. Obviously, systems designed to meet the needs of this potential new standard have not yet been created and must be developed. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. Lessees will need to identify and implement IT and accounting solutions that meet their future needs.

Lessees may expect lessors to provide them with the necessary information to comply with the proposed standard. However, lessors may not have, or may be unwilling to provide, data required by lessees.

Consequently, lessees will need to capture such information themselves and may, therefore, need to modify their systems.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks.

Internal controls and processes

Many companies in the past have not needed robust processes and controls for leases. In addition to eliminating operating lease accounting, existing lessee accounting models (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The proposal that leases should be re-measured (for example, for changes in expected lease term) will require companies to (re)design processes and controls to ensure proper management and accounting of all lease agreements.

Initial recording on balance sheet and the reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more resources than current accounting.

Timely assessment and management of the impact on processes, controls and resource requirements will help control your business and reduce reporting risks.

Information gathering

The exposure draft proposes certain transitional provisions including setting the effective date as the beginning of the earliest comparative period as the date of application of the new standard. While this will assist with the adoption of the new standard, management will need to catalogue existing leases and gather data about lease term, renewal options and payments to measure the amounts to be included on balance sheet.

Gathering and analysing the information could take considerable time and effort, depending on the number of leases and the records available. Beginning the process early would ensure that implementation of a future standard is orderly and well controlled, and that data on new leases written before implementation of the changes is captured from the outset. In addition, it may allow companies to consider potential adoption strategies or to renegotiate agreements in order to reduce the impact of adoption.

Financial reporting

The financial statements will require restatement for the effect of the changes. The effects of the proposed lease accounting model should be clearly communicated to analysts and other stakeholders in advance.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognised on balance sheet; there is also likely to be a need for periodic reassessment of the lease term, contingent rentals, residual value obligations or the impact of purchase options.

The impact of change will not be restricted to external reporting; internal reporting information, including financial budgets and forecasts and the determination of profit-related employee benefits, will also be affected.

Tax impact

The proposed lease accounting model may have a broad impact on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalisation rules, percentage of EBITDA rules), existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Even where tax does not follow the proposed lease accounting model, management may see an increase in the challenges of managing and accounting for newly originated temporary differences in the financial statements.

Timely assessment and management of the potential tax impact will help optimise the tax position, by enabling companies to seek possible opportunities and/or reduce any tax exposures.

Questions and answers

Q: Is it possible that management will need to develop an entirely new system to track leases?

A: Many companies manage operating leases on spreadsheets or through their accounts payable system. The information needed to recognise and measure all leases on balance sheet at inception and then reassess expected lease terms and payments when there are changes in circumstances will require extensive data capture. Companies' information and systems needs will vary, but we expect most will need to modify their systems, processes and controls to comply with the proposed lessee accounting model.

Q: What if management cannot find the lease records of a lease entered into long ago?

A: The Boards recognise that management may not have some lease documents available when the standard becomes effective. Transitional provisions limit the retrospective application of the new standard to the beginning of the earliest comparative period presented on the year of adoption. For example, if the new standard was applicable for the year ending 31 December 2013 and the company presented two comparative periods, then lease accounting would be reset effective 1 January 2011.

Q: How would the proposal affect companies without many 'big-ticket' leases?

A: The proposed model will generally have a bigger impact on industries that lease high-value assets and real estate (including telecoms), but it will apply to all leases regardless of asset value or lease term (some very short-term leases will ultimately be treated differently). Moreover, businesses without many big-ticket leases may have large numbers of low-value leases, such as for vehicles and office equipment. The impact of the proposed model on large numbers of low-value leases could still be significant and is likely to give rise to a greater compliance burden. As a result, all companies are likely to need to evaluate the implications of the proposed model.

How PwC can help

PwC has multi-disciplinary teams of specialists in many countries who can assist you in assessing the impact of the proposed lease accounting model on your business.

Depending on your requirements, we can:

- perform an assessment of the likely impact of the proposals on your financial statements and key financial ratios;
- assess the impact on data collection, processes, controls and IT systems;
- provide project planning support, training and investor relations advice;
- assist in the identification, selection, (re)design and implementation of new processes, controls and IT systems;
- assist in updating accounting manuals and providing staff training;
- advise on the impact on your existing tax strategies and methods for reducing exposure and optimising your tax position under the new model; and
- benchmark the impact across peers and industry groups.

If you would like further information on the proposed lease accounting model or assistance in determining how it might affect your business, please speak to a member of the TIAG listed opposite or your regular PwC contact.

Telecommunications Industry Accounting Group (TIAG)

PwC's Telecommunications Industry Accounting Group (TIAG) brings together PwC telecom specialist knowledge worldwide to help our clients. Our role is to help operators interpret and implement new and complex standards that have a particular impact on our industry. Our TIAG Portal provides FREE online access to a wealth of industry-specific guidance and best practices on the application of GAAP within the Communications sector. Updated regularly by PwC's telecoms experts, the site provides:

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PwC has dedicated IFRS specialism in most territories. Should you wish to talk to a specialist in your country, please contact a member of the team who will be able to put you in touch with the most relevant person.

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