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International Financial Reporting Standards (IFRS 16) in the Telecommunications Industry

Overview

The International Accounting Standards Board (IASB or the Board) issued a guidance in 2016 on accounting for leases IFRS 16. IFRS 16 replaces the earlier standard IAS 17 on lease accounting. The new standard impacts industries with assets under leases as part of their long-term business models, such as telecommunications, aviation, and construction industries.

The new standard requires leases to be accounted in the balance sheet on a 'right-to-use model. It further categorizes leases as short-term and long-term leases, unlike IAS 17, categorized into operating and finance leases.

There is no significant change in lessor accounting in the new standard from IAS 17. Lessors will continue to classify all leases using the same classification principle between operating and finance leases.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019, with early application permitted.

Impact on Telecommunications Industry

The telecommunications industry is a capital-intensive industry, involving large CAPEX spends as part of its business. The telecom industry is dependent heavily on lease contracts to run its business. Lease transactions in the telecom industry relate to leases on store rentals, cell sites, among others. In the past, accounting for rental expenses had a significant impact on the income statement of telecommunications entities, impacting their EBITDA numbers.

The new standard states most leases need to be recorded on the balance sheet and lease expenses (interest and depreciation) to be recorded below EBIDTA (similar to Finance Lease in IAS 17) for lessees. This will help entities improve EBIDTA and strengthen their balances by an increase in net worth.

Books of Lessee

	Balance Sheet (BS)			
	Old Standard		New Standard	
	IAS 17		IFRS 16	Impact
Presentation	Finance Lease	Operating Lease	Most of the leases	
Asset	Plants & Equipment	N/A	Right-Of-Use (ROU)	Strengthen the Balance Sheet
Liability	Lease Liability	N/A	Lease Liability	

	Income Statement			
	Old Standard		New Standard	
	IAS 17		IFRS 16	Impact
Presentation	Finance Lease	Operating Lease	Most of the leases	
Expense-Operating	-	Lease Payments	-	Increase In EBITDA
EBITDA	-	-	-	
Depreciation	Depreciation	-	Depreciation	
EBITA	-	-	-	
Interest	Interest	-	Interest	

Key areas where changes are required as part of the transition in adopting the new standards.

Key Areas	Impact
Statutory	Change in recognition criteria of leases in financial statements. The lessee should bring most leases on the balance sheet and expenses below EBITDA. Financial disclosures for listed companies.
Finance Operations	Industry to enhance and revisit processes and internal controls to incorporate new lease requirements. Most of the leases will for part of the balance sheet as right-of-use asset and a lease liability for lessees. P&L recognition below EBIDTA.
Finance Planning	The new recognition criteria will attract changes in key financial ratios like leverage ratio, interest cover ratio, net worth, etc.
Treasury	The new standard helps the treasury function to leverage the operating cash flow. Bringing leases to the balance sheet will increase the company's net worth, which helps companies for asset financing.
Information Technology	Investment in additional ERP and IT systems to incorporate the new accounting standard requirements.

Illustration on the new standard IFRS 16

Company X is a telecom company that enters into a three-year lease of store rental starting from June 2020 and ending on June 2022. Lease agreements state annual payments at the end of each year of CU 16,000 (Year 1), CU 18,000 (Year 2), and CU 20,000 (Year 3). The initial measurement of the right-of-use (RoU) asset and lease liability is CU 48,000 (present value of lease payments using a discount rate of approximately 5.9%). Company X follows a straight-line basis for calculating depreciation. Considering the rate of 5.9% interest accrues for Year 1 is CU 2,832 and Year 2 is CU 2,055. ROU amortization expense every year is CU 16,000.

Impact on financial statements is as follows:

ROU Asset

		Currency Unit					Initial Recognition	
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Debit	Credit
Balance Sheet		Right-of-use asset	48,000	32,000	16,000	0	BS-RoU Asset	BS-RoU Liability
	Less:	Accumulated Depreciation	-16,000	-16,000	-16,000	0		
		Net Book Value	32,000	16,000	0	0		
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Debit	Credit
Income Statement		Depreciation	16,000	16,000	16,000	0	P&L- Depreciation Expense	BS-Accumulated Depreciation

ROU Liability

		Currency Unit					Initial Recognition	
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Debit	Credit
Balance Sheet	Opening	Lease Liability	-48,000	-34,832	-18,887	0	BS-RoU Asset	BS-RoU Liability
		Net liability movement	13,168	15,945	18,887	0		
	Closing	Lease Liability	-34,832	-18,887	0	0		
		Currency Unit					Debit	Credit
		Cash Payment - Lease	16,000	18,000	20,000	0	BS-Lease Liability	BS-Bank
Income Statement		Interest Exp @5.9%	-2,832	-2,055	-1,113	0	P&L -Interest Expense	BS-Lease Liability
		Net liability movement	13,168	15,945	18,887	0		

Currency Unit

Balance Sheet (Amount in USD)	Jun 2020	Jun 2021	Jun 2022	Jun 2023		Debit	Credit
Right-of-use asset	48,000	32,000	16,000	0		BS- RoU Asset	BS- RoU Liability
Lease liability	-48,000	-34,832	-18,887	0			
Cash Payment - Lease	-16,000	-18,000	-20,000	0	-54,000	BS- RoU Liability	BS-Bank

Currency Unit

P&L	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Total	Debit	Credit
Depreciation	16,000	16,000	16,000	0	48,000	P&L- Depreciation Expense	BS- RoU Asset
Interest Exp @5.9%	2,832	2,055	1,113	0	6,000	P&L -Interest Expense	BS- RoU Liability
Expense for the period	18,832	18,055	17,113	0			

COVID-19 pandemic and its impact on leases

The pandemic has caused a sizeable impact on world economies. Organizations have been required to do paradigm shifts in their business models and take steps to enhance their cash flows and their overall financial position by revising forecasts and reassessing business plans. The business world adapts to a new, more virtual way of doing business.

As a welcome move, governments worldwide have introduced financial stimulus packages and announced moratoria and waivers on rentals.

Businesses, however, are in a fix due to various ongoing uncertainties, including;

- Time for which the pandemic is expected to continue
- The extent of the damage expected to business due to the pandemic
- Business changes to be carried out to continue as a going concern

A critical factor in this business shift is the impact on leased assets held by organizations and operating leases. Organizations in the service industry, such as hospitality, aviation, telecommunications, and retail, heavily dependent on leased assets or establishments such as leased buildings and shops, leased aircraft, shops, and kiosks, will require to reassess their leases and readjust their financial disclosures.

Need for amendment

Finance functions across organizations have to review their leases due to;

- Rent moratoria and concessions provided by government authorities and owners
- Probable impact on rental payments in future
- Adjustments in lease durations through arrangements with the lessor

The IASB, on 28 May 2020, issued an amendment to the IFRS 16 provisions to provide lessees with relief during the pandemic situation.

These amendments apply to rental concessions cases as a direct consequence of the COVID-19 pandemic, only if all the following criteria are met:

- There are rental concessions as a direct consequence of COVID-19 to be applied
- The concession results in revised consideration that is substantially the same, or less than, the consideration for the lease immediately preceding the change
- Affects lease payment originally due on or before 30 June 2021
- There is no substantive change to other terms and conditions of the lease

An entity that applies the practical expedient requires the following disclosures to be made as part of the financial statements:

a) Listing and information on contracts against which such practical expedient has been applied

b) Amount recognized in the profit and loss account in the reporting period to consider changes arising from such concessions

An organization in the telecom industry hands multiple lease contracts – relating to cell sites and shops. These lease contracts are bound to be impacted by the amendments to this standard.

Example of the impact of the amendment:

In the above example, amid crises of COVID-19 lessor agrees to let pass 100% of store rental for year one and 50% for year two with no future payment schedule changes.

ROU Asset									
		Currency Unit						Initial Recognition	
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023		Debit	Credit
Balance Sheet		Right-of-use asset	48,000	32,000	16,000	0		BS-RoU Asset	BS-RoU Liability
	Less:	Accumulated Depreciation	-16,000	-16,000	-16,000	0			
		Net Book Value	32,000	16,000	0	0			
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023		Debit	Credit
Income Statement		Depreciation	16,000	16,000	16,000	0		P&L- Depreciation Expense	BS-Accumulated Depreciation

ROU Liability								
		Currency Unit					Initial Recognition	
		Description	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Debit	Credit
Balance Sheet	Opening	Lease Liability	-48,000	-34,832	-18,887	0	BS-RoU Asset	BS-RoU Liability
		Net liability movement	13,168	15,945	18,887	0		
	Closing	Lease Liability	-34,832	-18,887	0	0		
		Currency Unit					Debit	Credit
		Cash Payment - Lease	0	9,000	20,000	0	BS-Lease Liability	BS-Bank
Income Statement		Practical Expedient Benefit	16,000	9,000	0	0	BS-Lease Liability	Practical Expedient Benefit
		Interest Exp @5.9%	-2,832	-2,055	-1,113	0	P&L -Interest Expense	BS-Lease Liability
		Net liability movement	13,168	15,945	18,887	0		

Currency Unit

Balance Sheet	Jun 2020	Jun 2021	Jun 2022	Jun 2023		Debit	Credit
Right-of-use asset	48,000	32,000	16,000	0		BS- RoU Asset	BS- RoU Liability
Lease liability	-48,000	-34,832	-18,887	0		BS- RoU Liability	Practical Expedient Benefit
Cash Payment - Lease	0	9,000	20,000	0	29,000	BS- RoU Liability	BS-Bank

Currency Unit

P&L	Jun 2020	Jun 2021	Jun 2022	Jun 2023	Total	Debit	Credit
Depreciation	16,000	16,000	16,000	0	48,000	P&L- Depreciation Expense	BS- RoU Asset
Interest Exp @5.9%	2,832	2,055	1,113	0	6,000	P&L -Interest Expense	BS- RoU Liability
Offsetting Adjustment	-16,000	-9,000		0	-25,000	BS- RoU Liability	Practical Expedient Benefit
Expense for the period	-2,832	-9,055	-17,113	0			

This amendment is a welcome relief in the challenging pandemic situation. Lessees can apply amendments for annual reporting periods beginning on or after June 2020.

At the same time, it also provides disclosure requirements to the reader of Financial Statements. The lessee needs to disclose that it has applied practical expedient for rent concession. The amount of impact on income and expense statement for the reporting period for leases on which practical expedient has been applied.

How can we help

Protiviti's financial reporting consultants help companies on various financial reporting matters.

As Protiviti, we have assisted clients in transitioning to the new standard requirements, including performing impact assessment, coordination on ensuring changes in the ERP, changes to disclosure requirements, and accounting operations.

Analyze

a) Establish a steering committee

b) Determine available transition methods and evaluate various transition-related choices available

c) Perform gap analysis (both accounting and non-accounting impact) and establish an execution framework

d) Assess reporting system capabilities- to capture new data elements for recognition, measurement, and disclosures

e) Prepare detailed roadmap along with timelines

Design

a) Prepare proforma financial statements

b) Develop the new accounting policies

c) Discuss and determine efforts required for system changes (including the chart of accounts)

Implement

a) Update critical accounting policies and materiality thresholds for lease accounting

b) Update financial reporting controls

c) Update financial statements and disclosure requirements along with other reports

d) Training and workshop for employees

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independent and locally owned Member Firms provide clients with consulting and managed solutions in finance, technology, operations, data, analytics, governance, risk and internal audit through our network of more than 85 offices in over 25 countries.

Named to the 2020 Fortune 100 Best Companies to Work For® list, Protiviti has served more than 60 percent of Fortune 1000 and 35 percent of Fortune Global 500 companies. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

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