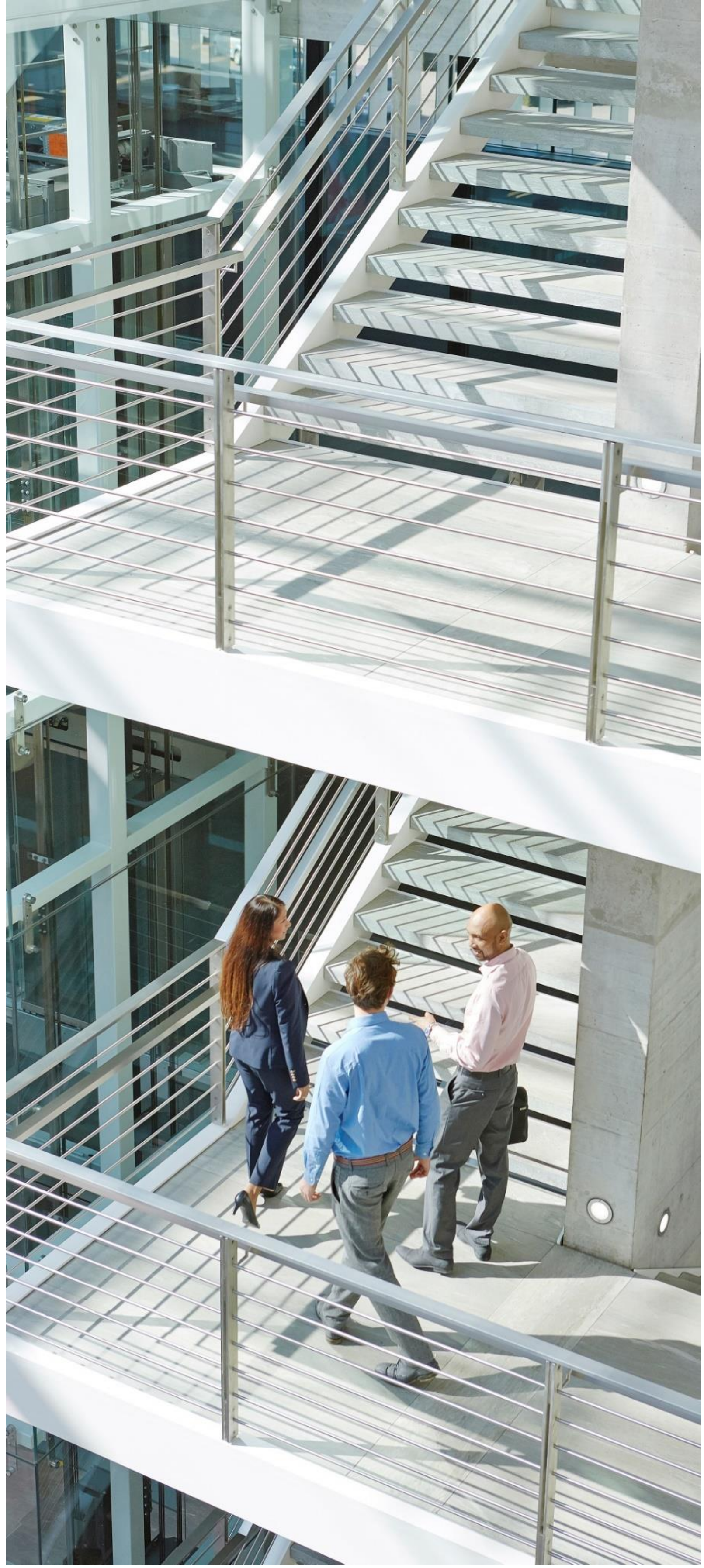
The impact of IFRS 16 on telecommunications accounting for long-term capacity arrangements



Background

Telecommunications entities have been grappling with the accounting for long-term capacity arrangements ever since International Financial Reporting Standards came into widespread use, and a new standard issued in 2016 (IFRS 16) will soon add another layer of complexity. Starting in 2019, entities will need to apply IFRS 16 accounting requirements for leases. This new standard is prompting many operators to reconsider, given the guidance the standard provides, whether their capacity arrangements contain leases.

This report applies IFRS 16 to a variety of common capacity arrangements to see if they contain leases, and it explores these arrangements' impact on accounting.

Determining whether an arrangement contains a lease

IFRS 16 defines a lease as a contract, or part of a contract, that conveys the right to control use of an identified asset for a period of time in exchange for consideration. At first sight, the definition looks straightforward. But in practice, it can be difficult to assess whether a contract conveys the right to use an asset or is instead a contract for a service that is provided using that asset. Breaking down the definition can help entities determine their accounting obligations.

What is an identified asset?

An asset can be identified either explicitly or implicitly. If identification is explicit, the asset is specified in the contract (for example, by a serial number or a similar identification marking); if implicit, the specific asset itself is not mentioned in the contract but the supplier can fulfil the contract only by using a particular asset. In both cases there might be an identified asset.

There is no identified asset if the supplier has a substantive right to substitute the asset. Substitution rights are considered substantive when the supplier has the practical ability to substitute an alternative asset and would also benefit economically from substitution.

The term 'benefit' is interpreted broadly. For example, the fact that the supplier could deploy a pool of assets more efficiently by substituting the leased asset from time to time might create a sufficient benefit, as long as there are no significant costs associated with the substitution. It is important to note that costs are considered 'significant' if they exceed the economic benefits of the substitution, regardless of whether the costs are low or not material to the supplying entity as a whole. Significant costs could occur, in particular, if the underlying asset is customized for the customer.

A right to substitute an asset if it is not operating properly, or if a technical update is required, is not regarded as substantive, which means the asset could still be considered identified. The same is true for a supplier's right or obligation to substitute an underlying asset for any reason on or after a particular date or on the occurrence of a specified event.

An identified asset can be a physically distinct portion of a larger asset. A capacity portion — a portion of a larger asset that is not physically distinct — is not considered an identified asset unless it represents substantially all of the capacity of the entire asset.

When does the customer have the right to control the use of an identified asset?

A contract conveys the right to control the use of an identified asset if the customer has both the right to obtain substantially all of the economic benefits from its use and the right to direct the use for a period of time.

Economic benefits can be obtained directly or indirectly (for example, by using, holding or subleasing the asset). Benefits include the primary output and any by-products (including potential cash flows derived from these items), as well as payments from third parties that relate to the use of the identified asset. However, economic benefits relating solely to the ownership of the asset (such as some tax credits or reliefs) are ignored.

When assessing who directs use of the asset, the key question is which party (customer or supplier) has the right to direct how and for what purpose the identified asset is used throughout the period of use.

IFRS 16 gives several examples of relevant decision-making rights:

- Right to change *what type* of output is produced.
- Right to change *when* the output is produced.
- Right to change *where* the output is produced.
- Right to change *how much* of the output is produced.

If both parties have decision-making rights, an entity would consider the rights that are most relevant to changing how and for what purpose the asset is used. However, there are several rights that are not taken into account:

- **Protective rights:** In many cases, a supplier might limit the customer's use of an asset in order to protect personnel or ensure compliance with relevant laws and regulations. These protective rights do not affect the assessment of which party has the right to direct the use of the identified asset.
- **Maintaining/operating the asset:** Being able to make decisions about maintaining and operating an asset does not grant the right to direct the use of the asset. These maintenance and operations rights are only taken into account if decisions about how and for what purpose the asset is used are predetermined (see below).
- **Decisions made before the period of use:** These sorts of decisions are not taken into account unless they are made in the context of the design of the asset by a customer (see below).

In some scenarios, decisions about how and for what purpose the underlying asset is used are predetermined before the inception of the lease. If this is the case, the customer has the right to direct the use of an asset if it either:

- has the right to operate the identified asset throughout the period of use without the supplier having the right to change those operating instructions, or
- has designed the identified asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Sometimes, an identified asset is incidental to a service but has no specific use to the customer by itself. This subject is considered further in our publication,

Accounting for customer premises equipment under IFRS 15 and IFRS 16.

Illustrative examples

1. Original investment via consortium agreement

A telecommunications operator (OrigCo) enters into a consortium agreement with three other parties for the construction of a subsea cable system between Australia and New Zealand. The consortium agreement does not involve the creation of any new legal entity, and the consortium members hold joint legal title over the assets.

Under the terms of the agreement, each party is responsible for 25% of the capital and operating costs of the cable system for the entirety of its life. The agreement stipulates which elements of development each party is responsible for delivering (e.g. cable laying or landing stations), with the 25% share of costs being subject to a true-up process. Decisions regarding the development and operation of the system require the unanimous agreement of all consortium members.

Each party is entitled to 25% of the planned capacity of the system, defined in terms of gigabits per second (Gbps). As planned upgrades to the transmission equipment are made over the life of the system, each consortium member will continue to be entitled to 25% of the increased system capacity. As Wave Division Multiplexing (WDM) equipment is installed, each consortium member's capacity share will be redefined in terms of wavelengths rather than Gbps.

There are no restrictions on how the consortium members use or resell the capacity on the system.

The use of WDM equipment on the system means that none of the consortium members controls the use of any individual fibre on the subsea cable, and the WDM transceivers also are a shared asset supporting the transmission of data for all consortium members. Consortium members' traffic is delivered to the cable system using multiple industry-standard transmission technologies (i.e., not necessarily at the wavelength over which they have contractual rights). One of a number of transponders that form part of the WDM terminal multiplexer converts the incoming signals to the separate wavelengths used in the WDM system.

Accounting analysis

Although the focus of this publication is on whether arrangements contain leases, this first example considers a different, but also common, issue, which is foundational for some of the lease examples that follow.

The consortium members, including OrigCo, have entered into an agreement that gives them joint control over a collection of assets that together constitute a subsea cable system. Decisions regarding the development and operation of the system require the unanimous agreement of all consortium members. Accordingly, this represents a joint arrangement within the scope of IFRS 11.

The arrangement does not involve creation of a separate legal entity, so it is treated as a joint operation. OrigCo will therefore account for its 25% share of the consortium's assets, liabilities, revenue and expenses.

2. Capacity purchased from consortium member (with capacity guarantee)

Another telecommunications operator (ShareCo) enters into an agreement with OrigCo for the use of half of the capacity that OrigCo owns through its membership in the consortium described in example 1. The agreement between ShareCo and OrigCo has a fixed term of 20 years, which is the expected service life of the cable system.

Under the terms of the agreement, ShareCo will be responsible for reimbursing OrigCo for 50% of the operating cost payments it makes to the consortium.

Decisions regarding the development and operation of the system continue to be made by the original consortium members, including OrigCo, and require the unanimous agreement of all members.

ShareCo is entitled to 12.5% of the planned capacity of the system (half of OrigCo's consortium rights). At the outset of the agreement, ShareCo's capacity is defined in Gbps, but this will be redefined in terms of wavelengths as WDM equipment is installed.

There are no restrictions on how ShareCo may use or resell its capacity.

Although the contract provides for penalties if service levels fall below specified limits, there is no provision for OrigCo to provide any resilience (alternative routing).

Accounting analysis

In contrast to example 1, ShareCo does not share control of the system, so is not a party to the joint operation. ShareCo's obligations are to make payments to OrigCo as a result of their agreement, and not to share in the assets or liabilities of the joint operation. The question is whether the arrangement gives ShareCo rights to control the use of any specific assets, which would indicate the existence of a lease.

ShareCo does not obtain the right to use any identified network assets. Instead, ShareCo is entitled to 12.5% of the planned capacity of the entire system, which represents 50% of OrigCo's consortium rights. Clearly, ShareCo's capacity portion does not represent substantially all of the capacity of the network or any component part. So, the arrangement does not contain a lease.

From the outset of the agreement, when ShareCo's capacity is defined in Gbps, the arrangement represents delivery of a service from OrigCo and not a lease (see also: example 5). As WDM equipment is installed, and ShareCo's capacity share is redefined in terms of wavelengths, it might be concluded that the substance of the arrangement changes. The treatment of rights to use specific wavelengths is considered further in example 4.

3. IRU – Dark fibre lease

A telecommunications operator (DarkCo) enters into an indefeasible rights of use (IRU) contract with NatCo (the incumbent telecommunications operator) for a dark fibre route between two cities. The agreement is for a term of 20 years, which is the expected service life of the cable.

The arrangement specifies exclusive use of a distinct fibre within the NatCo fibre cable, and DarkCo is responsible for the installation of transmission equipment in NatCo's buildings in order to light the fibre. NatCo has the right to swap DarkCo over to an alternative fibre, but only for reasons of repair, maintenance or malfunction, in which case it must compensate DarkCo for financial loss.

In addition to a single up-front payment, the contract provides for NatCo to charge DarkCo for a share of maintenance costs and for space, power and cooling within the NatCo buildings.

DarkCo is responsible for the installation and maintenance of its transmission equipment and is free to upgrade that equipment during the life of the contract.

There are no restrictions on how DarkCo may use or resell its capacity.

Accounting analysis

Unlike the previous examples, there is no consideration in this case of whether the entities have entered into a joint arrangement, because there is no sharing of decision making regarding the business or assets. Instead, the analysis is only concerned with whether the arrangement contains a lease.

A contract contains a lease where it conveys the right to control the use of an identified asset for a period of time. In this case, DarkCo obtains the right to use a distinct fibre for a period of 20 years. However, IFRS 16 requires a more detailed analysis, including consideration of the following questions:

- Does NatCo have a substantive right to substitute for another fibre such that there is no 'identified' asset according to IFRS 16? The answer is no. For a substitution right to be substantive, that right must be practicable throughout the term of the arrangement, and NatCo must benefit economically from its exercise. In this case, NatCo has a substitution right only for repair, maintenance or malfunction, and must pay compensation if it exercises that right. IFRS 16 is clear that a substitution right that exists only in the case of repair, maintenance or upgrade does not preclude the existence of a lease.
- Does DarkCo have the right to obtain substantially all of the economic benefits from use of the fibre? Yes, DarkCo has exclusive use of the fibre, and there are no restrictions on how it may use or resell the capacity.
- Does DarkCo have the right to direct the use of the fibre? IFRS 16 focuses on the ability to make decisions about how and for what purpose the fibre is used. So yes, it is clear from the fact pattern that DarkCo does have that ability.

Based on this analysis, the arrangement does contain a lease. The fact pattern resembles Illustrative Example 3A in IFRS 16, and the solution is the same.

Although it's irrelevant for DarkCo, NatCo must determine whether the lease is a finance lease or an operating lease. In this case, the arrangement is for 20 years, which is the expected service life of the cable in which DarkCo's fibre is encased. Determining whether a lease is a finance lease or an operating lease requires the exercise of judgment, but where the lease term is for a major part of the economic life of the leased asset, this normally indicates that the lease is a finance lease. Accordingly, the arrangement between NatCo and DarkCo likely contains a finance lease.

4. IRU – Wavelength

A telecommunications operator (WaveCo) enters into an agreement with OrigCo for the use of specified wavelengths that OrigCo controls through its membership in the consortium described in example 1. The agreement between WaveCo and OrigCo has a fixed term of 20 years, which is the expected service life of the cable system.

Under the terms of the agreement, WaveCo will be responsible for reimbursing OrigCo for a fixed percentage of the operating cost payments it makes to the consortium.

Decisions regarding the development and operation of the system continue to be made by the original consortium members and require the unanimous agreement of all the original members. WaveCo is not a member of the consortium, but OrigCo must consult with WaveCo regarding any decisions that could affect service continuity and quality (such as an equipment upgrade that would interrupt service for WaveCo), and will be subject to service credits if service levels fall below the minimum standards set out in the contract.

WaveCo is entitled to transmit traffic over a specific wavelength within the WDM system, which represents 5% of the planned capacity of the system (20% of OrigCo's consortium rights). The contract prevents OrigCo from allowing any other party to utilise this specific wavelength.

Although it might be technically possible for OrigCo to change the wavelengths used by WaveCo according to their agreement (through a change in port on the WDM transceivers) or the fibre on which WaveCo's traffic is carried, any such change would cause interruption to WaveCo's service, so this is not anticipated unless significant equipment upgrades or replacement is required.

There are no restrictions on how WaveCo may use or resell its capacity.

The contract provides for penalties if service levels fall below specified limits, but there is no provision for OrigCo to provide any resilience (alternative routing).

Accounting analysis

Similar to the analysis of ShareCo's rights in example 2, WaveCo does not have access to rights that give it joint control over the cable system, so the agreement does not constitute a joint operation.

Applying the principles set out in example 3, it is also clear that WaveCo does not have the right to control the use of any identified fibre or other physical asset. Nor does its capacity portion represent substantially all of the network capacity or any component part. It does, however, have the right to control the use of specific wavelengths. Would such an arrangement fall within IFRS 16's scope?

The wavelength of a beam of light, like its frequency, is a property of that light and not a physical attribute. It is therefore inappropriate to describe a wavelength as if it were a physical asset. An intangible asset is defined in International Accounting Standard 38 as an identifiable nonmonetary asset without physical substance. A right to use specific wavelengths could therefore meet the definition of an intangible asset, which is how spectrum licences are consistently treated by mobile operators.

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets (other than in a few specified cases). WaveCo might, therefore, take this approach and treat the arrangement as containing a lease of an intangible asset.

If WaveCo does not apply IFRS 16, it must determine whether the arrangement includes the acquisition of a licence (intangible asset) or constitutes solely a service from OrigCo. Where WaveCo attaches its own optronics and is responsible for transmission, the former might be appropriate, but if OrigCo is responsible for transmission, the latter is more likely to reflect the substance of the arrangement. The specific fact pattern presented here is less clear-cut. In practice today, it is more common to see these arrangements treated as a service.

OrigCo, as the supplier, would be expected to consider how many distinct performance obligations exist in its arrangement with WaveCo, and whether one of those comprises a licence to use a specific wavelength. Consistent with the previous paragraph, it is more common today to see the entire arrangement treated as a single service. Therefore, OrigCo would approach the arrangement from the perspective of IFRS 15, which is not the subject of this publication.

5. IRU – Capacity

All facts in this example are the same as in example 4, except that WaveCo's capacity is defined in Gbps and may be carried on *any* wavelength at the discretion of OrigCo.

Accounting analysis

This fact pattern is similar to Illustrative Example 3B in IFRS 16. As in that example, and in contrast to example 3, OrigCo makes all decisions about the transmission of WaveCo's data, which requires the use of only a portion of the capacity of the cable. The capacity portion that will be provided to WaveCo is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable. Consequently, WaveCo does not have the right to use an identified asset. Equally, there is no right to use a specific wavelength and so the considerations from example 4 are not relevant. This arrangement represents the delivery of a service from OrigCo to WaveCo from the perspective of IFRS 15, which is not the subject of this publication.

To have a deeper conversation about how the proposed changes to accounting for revenue may affect your business, please contact:

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