New accounting standards will create major business impacts for telcos – meaning they must both understand their effects and also explain them to analysts

In our June 2016 Communications Review article we previewed the new IFRS 15 accounting standard on revenue recognition. As we highlighted then, most accounting changes never come to the attention of the CEOs or operational management. But this one is different, because it effectively puts an end to mobile operators’ practice of using service plan charges to subsidise handsets costs. Today, with IFRS 15 set to come fully into force from the end of 2017, and operators testing out its impacts, they’re about to encounter its first effects on their financial figures. And coming hard on its heels is IFRS 16, set to come into effect from the end to 2018, introducing major changes to how operators account for leases. Together, these two new accounting standards will drive major changes in operators’ reported financial figures, and investment analysts will be combing through the changes and expecting clear explanations. To satisfy these demands, operators will need both to understand the rules – and also to ensure their investor relations teams are fully briefed to explain their impacts.
In April 2008, Sir David Tweedie – then Chairman of the International Accounting Standards Board (IASB) – made a speech at the Empire Club of Canada in Toronto. During it, he commented light-heartedly: “One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet.”¹ Almost a decade later Sir David is long retired from the top job at the IASB. However, his vision of an aircraft that sits not just on a runway, but also on an airline’s balance sheet, is about to be realized from the beginning of 2018 in the shape of IFRS 16.

Inevitably, the effects of IFRS 16 on lease accounting will go far beyond airlines. And coming rapidly after are two other new accounting standards – IFRS 9 on accounting for financial instruments, and IFRS 15 on the recognition of revenue from contracts with customers – it promises to complete a triple-whammy of accounting changes taking place within a mere two years, and bringing major implications for telcos. What’s more, hardly any major players in the industry will be immune to their effects: having been promulgated by the Financial Accounting Standards Board (FASB) as well as the IASB, they’ll apply to virtually every company with a stock market listing anywhere in the world.

The reason the impacts of the new standards are so pervasive is that they remove previously differing requirements of IFRS and US GAAP. According to the two standards bodies, these formerly contrasting approaches of both standards often resulted in different accounting treatment being applied to transactions that were “economically similar”. To remove this inconsistency between the two standard boards the two bodies have worked together to develop new, fully converged requirements for areas like the recognition of revenue in both IFRS and US GAAP. By doing this, they have opened the way to what they’ve hailed as “substantial enhancements to the quality and consistency of how revenue is reported, while also improving comparability in the financial statements of companies reporting using IFRS and US GAAP.”
The impacts on financial reporting…

So, what will be the effects of the changes? In introducing the three new standards – IFRS 9, IFRS 15 and IFRS 16 –, the stated aim of the standards setters is to provide investors, analysts, and other users of financial statements with more useful information, while also making financial information more comparable across industries, entities and capital markets. These ambitious objectives mean the implementation of new standards will have major impacts on companies’ financial statements, key performance indicators (KPIs) and business models.

Crucially, market and industry analysts will use the financial information produced under the standards to assess a company’s financial position and performance. And while the telecoms industry will be materially affected by all three standard changes, little information has been produced to date on how analysts will assess and react to the resulting shifts in reported financial performance. However, in general investors and analysts appear to have welcomed the new standards. For example, press reports have quoted analysts as saying that the new IFRS 16 standard on lease accounting will bring offshore financing more into the open, make accounts more transparent and improve comparisons of returns on capital.

…will be felt across the P&L and balance sheet

Looking at the detailed impacts, let’s turn first to the IFRS 15 revenue recognition accounting standard. As we’ve already highlighted, this will affect a telco’s financial statements, KPIs and business models – and it will do this by requiring companies to align their revenues and performance, capitalise sales commissions, and recognise contract assets and contract liabilities in their balance sheets whenever revenue does not equal cash. These accounting requirements will lead to a shift of revenues between periods and affect significant KPI’s such as average revenue per user (ARPU) and EBITDA.

The precise scale and nature of these effects will clearly vary between different operators. But once the new IFRS 15 standard comes in from the start of 2018, it will result in all operators having to adjust their revenue line – which, as the largest figure on the profit & loss statement (P&L), is a key operational KPI. So, while accounting standards are often regarded as a technical matter for the finance function to deal with, this one – through its effect on revenue – directly involves and impacts the business’s operations and business models.

Effects of IFRS 15 on telcos’ revenues and business model

As we described in our previous article on IFRS 15 last year, a key effect of the new standard is that it outlaws the current handset subsidy approach taken by many mobile operators. This involves offering the customer a high-value smartphone handset for a nominal price of a few dollars or even free, and then recouping the cost over time – usually a two-year period – through a fixed-term service contract covering calls and data. Instead of applying this cross-subsidy, the new standard requires operators to carry out a “relative fair value” allocation between the handset and the service charge. This means shifting revenue away from the service element and reallocating it to the handset. So instead of recognising – for example – US$1 of revenue for the handset, the operator would have to recognise US$100, balanced by a corresponding and equal reduction in the total service charge the customer will make over the term of the contract. So while the revenue does not change in total, the timing of when it is recognised shifts from one period to another – creating a high degree of complexity when multiplied across all an operator’s customer contracts.
At the same time, the new revenue standard also involves the introduction of some new captions in the balance sheet, as mentioned above. One is the cost to obtain the contract, capitalising any sales commission paid to third-party retailers as well as internal directly attributable costs that will then be amortised over time. The other new captions are the contract assets and contract liabilities that are to be reported whenever cash doesn’t equal revenue. In combination, these requirements can create a variety of different impacts on important KPIs in different circumstances, as shown in Figure 1.

For most telcos, the effects will include a decline in reported ARPU, assuming it’s based on service revenue. Overall revenue could be effected and decrease, if Telcos assume to align the direct and indirect sales channel. And the treatment of amortisation of commissions will influence EBITDA. The overall impact is to intensify the focus on cash, and IFRS 15 could well result in the creation of a new KPI across the industry: cash revenue.

Lease accounting under IFRS 16: major impacts including higher EBITDA...

Turning to IFRS 16, the effects of the new lease accounting standard are equally significant (see Figure 2). The frustration voiced by David Tweedie about airlines reflected the fact that these businesses have traditionally taken great pains to keep the leases for their aircraft off their balance sheets – and indeed the leasing companies involved in the provision of the aircraft have done the same. The result even today is that there are very few airplanes that are on anybody’s balance sheet.

This anomaly has arisen not just in airlines, but also in other industries where companies lease equipment of a significant value, telecoms included. To address it, the new IFRS 16 standard requires that lessees must include all leases on the balance sheet. The only two exceptions from recognising assets and liabilities are for short-term leases (defined as leases of 12 months or less), and leases of low-value items such as personal computers. Under US GAAP only short-term leases are exempted.

In technical terms, the effect of implementing the new lease accounting standard is that telcos acting as a lessee will have to capitalise a right-of-use asset and a corresponding lease liability for all their lease commitments with a contract term longer than 12 months. Furthermore, they will have to split the rental expense into interest and depreciation expense in their P&L, which leads to an increase in EBIT and EBITDA. The fact that EBITDA rises under IFRS 16 has led some telcos to welcome it – though this comes at a cost.
...but also higher debt on the balance sheet

What cost? One downside is that the separate recognition of interest and depreciation can lead to further frontloading of expenses, though this effect is largely neutralised in a constantly evolving portfolio of lease contracts. However, more importantly, capitalising all lease agreements means the debt on a telco’s balance sheet – its leverage ratio – will increase, bringing potentially negative impact for its credit rating and possibly leading to higher borrowing costs.

Several other important KPIs are also negatively affected by IFRS 16, including the debt to EBITDA ratio, the return on capital employed (ROCE), and the equity ratio. The cash flow statement will also be impacted, as lease payments will relief the operating cash outflow and debit the financial cash outflow. The effect is to create a shift between cash outflow in operating to cash outflow in financing.

Another challenge will be the implementation of the ‘expected loss model’ introduced by IFRS 9, requiring companies to recognise their losses expected in the future immediately and not at the time when the loss actually occurs. For telcos, this will lead to a recognition of impairment losses in earlier periods than previously.

Timing of the impacts will differ...

Given the respective timelines that have been set for the introduction of IFRS 15 (revenue recognition) and IFRS 16 (lease accounting), the timing of the various impacts we’ve described will vary. While IFRS 15 is scheduled to come into force under the FASB from 15 December 2017 and the IASB from 1 January 2018, many telcos are applying the new accounting guidelines to their numbers earlier than this – and indeed are doing so already – to fit in with internal budgeting and reporting processes such as five-year planning. This means we could see the first real impact in their June 2017 numbers, generally published in July.

IFRS 16 will be officially introduced a year later than IFRS 15, from 15 December 2018 by the FASB and 1st January 2019 by the IASB – but again, many telecoms companies will look to apply the new standard early- if possible - to get up to speed in advance. While telcos will be less affected in terms of equipment leases than industries such as airlines and retail, it’s incredibly likely that telcos that have put leases for mobile towers off balance sheet may have to bring them back on.

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Figure 3: New IFRS and roadmap for application

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<th>Year</th>
<th>IFRS 15</th>
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- IFRS 15: First-time application
- IFRS 16: Early adoption permitted (if IFRS 15 has been adopted) and retrospective application
- IFRS 9: New standard
…with systems set to be a key issue

However, the biggest impact of IFRS 15 – and IFRS 16 – may be on telcos’ back-office and accounting systems. In terms of revenue recognition, operators’ existing business model is relatively easy to manage from an accounting perspective under current GAAP, because the systems currently in place simply recognise whatever the customer pays as revenue. Crucially, these systems were not designed to handle and automate a switch of revenue recognition from service to handset.

Operators with hundreds of millions of contracts will have to make this switch hundreds of millions of times. There are also challenges around capitalisation and amortisation of sales commissions over the lifetime of the customer under IFRS 15. For a large operator, these could add hundreds of millions of dollars to the assets on the balance sheet.

With IFRS 16, the basic accounting change of putting leases on the balance sheet is actually fairly straightforward. But where challenges are likely to arise is once again in handling the sheer volume of leasing contracts to be accounted for in this new way. It is not unrealistic to assume that operators have up to 500,000 leasing contracts across their business, meaning accounting for all of these under the new standard will involve a huge effort in terms of systems and processes.

While opinions on the new standards vary…

To date, it’s been interesting to note that the effects of these new accounting rules have been treated in very different way in the media. While the changes resulting from the new IFRS 15 revenue recognition standard have hardly been mentioned in the press, those required by the new IFRS 16 leasing standard have been the subject of much wider comments. And even though the IASB argues that the new revenue recognition standard will simplify the preparation of financial statements, opinions on this point differ between the preparers of financial reporting and the analysts who use it.

Meanwhile, the new leasing standard is generally being received positively by investors and analysts, who note that IFRS 16 will make accounts more transparent and provide analysts with better information for assessing a company’s exposure to lease arrangements. According to a member survey by the Chartered Financial Analyst (CFA) institute, investors’ overall expectations of the new accounting standards include better comparability of returns on capital, reduced analytical adjustments, and enhanced analytical accuracy.²

While the new standards have yet to be finally implemented, analysts have already started adjusting their valuation models, and the rating agency Moody’s has updated its methodology for capitalizing obligations under operating lease commitments. Also, most financial analysts already capitalise operating leases using specific multiples or disclosures in the notes.

…it’s time for telcos to understand the impacts – and explain them to the markets

As the “rubber hits the road” in terms of these new accounting standards, it’s vital that the leaders of telecoms companies don’t underestimate their importance or potential business impacts. Analysts are already adjusting their financial information accordingly. However, this is no reason to downplay their implications – especially since they will improve the quality and transparency of telcos’ reported financial information, and contribute to clearer comparability between companies by providing investors with a better starting-point.

With this in mind, telcos need to take three steps to prepare themselves fully for the introduction of the new standards. First, ensure that their accounting systems and processes are ready and able to handle the size and scope of the changes required – including the massive volumes of contracts and assets to be accounted for differently. Second, gain a deep understanding of the effects of the new standards on reported KPIs, ranging from revenues to EBITDA to ARPU to gearing. And third, ensure that the company’s investor relations professionals – and possibly senior executives – are sufficiently well informed about these impacts to explain them to analysts.

The changes about to be ushered in by IFRS 15 and IFRS 16 have been a long time coming, giving companies several years to prepare for them. Now’s the time for that preparation to be put into effect. Any telcos that’s caught off guard by the impacts of these new standards has only itself to blame.
New accounting standards
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**Endnote**