Welcome to the first edition of EY's *Spotlight on Telecommunications Accounting*. With this new publication, we will address current industry practices and how they impact operators’ financial reporting. Your local EY partner and I are happy to discuss any of these issues in greater detail with you.

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Decommissioning liabilities

With the number of commercial long-term evolution (LTE) networks worldwide now past the 300 mark, industry players are already turning their attention to the potential for LTE – Advanced Technology, also known as LTE Release 10, which offers three times the spectral efficiency of LTE. According to the Global Mobile Suppliers Association (GSA), 318 operators have launched LTE networks as of July 2014, while 69 operators are deploying LTE – Advanced technologies. LTE technology-based infrastructure revenue will continue to grow over the coming years and is expected to reach US$20.5 billion in 2018. In this light, the move towards more sophisticated mobile network technologies involves the deployment of new equipment and the retirement of old infrastructure. As a result, telecoms operators will have to identify redundant sites that they expect to decommission, remove the equipment, terminate the underlying leases and settle the obligation related to the constructed assets as a consequence of having used the site.

In the construction of wireless and fixed line networks, telecoms operators often build on leased land. The terms and conditions of lease agreements usually require operators to dismantle and remove communications facilities (e.g., radios, back-up batteries, antennas, transmission lines and air conditioning equipment) and return the site to the landlord in the same condition that existed prior to entering into the lease agreement. If there are no obligations specified by law or contractual agreements, management will also need to consider constructive obligations arising from past practice or public statements. For example, operators may have an obligation in connection with decommissioning a coastal landing station connected to undersea cables.
These obligations are referred as decommissioning liabilities and are recognized and measured in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets. Accounting for decommissioning liabilities is often complex and requires the exercise of significant judgment and the use of estimates and assumptions. Key questions related to the application of IAS 37 include: (a) how should telecoms operators account for dismantling and removal costs? and (b) how should changes in the estimated obligation of an existing decommissioning liability be reflected?

Under IAS 37, decommissioning liabilities are recognised at the time the asset is constructed, because this is when the obligation to dismantle is created. The future site restoration costs are estimated and discounted to their present value to reflect the best estimate of the expenditures required to settle the present obligation as at the reporting date. The estimate should include attributable direct costs, such as labour, site cleaning, equipment uninstallation and demolition. Site restoration costs must be capitalised as part of the cost of the asset and depreciated over that asset’s useful life in accordance with IAS 16, Property, Plant and Equipment.

The following inputs should be considered in the initial estimate of decommissioning liabilities:

- The contractual period of the lease (although it may be longer or shorter in case of renewal options or early termination options).
- The discount rate shall be a pre-tax rate that reflects current market assessment of the time value of money and the risks specific to the liability. Risks can be reflected either by an increase in the estimated expenditures or a decrease in the discount rate. The starting point for this rate is a government bond rate of a similar currency and term as the obligation.
- The inflation rate, which will be reflected either by using current prices discounted at a real discount rate, or using expected future prices discounted at a nominal discount rate.

At the end of each reporting period, the amount of the decommissioning liability is reviewed and adjusted to reflect the unwinding of the discount and changes in the estimated timing or amount of outflows required to settle the obligation. IFRIC 1, Changes in Existing Decommissioning, Restoration and Similar Liabilities, contains guidance on how to account for the effect of these changes.

Changes in the estimated timing or amount of cash outflows may result from various factors such as:

- Changes in observable inputs from the market (e.g., increase in labour or material costs)
- Changes due to development of new technologies and/or practices that may make the decommissioning process more efficient
- Changes in legal or regulatory requirements that could impose new requirements and costs
- Changes in terms and conditions of the lease agreement (e.g., termination of a lease agreement)
- Macro-economic variables, such as inflation rates or government bond rates

If the asset is measured at cost, which is often the case, changes in the estimate of the decommissioning liabilities are added to or deducted from the carrying value of the related asset. However, the periodic unwinding of the discount is recognised in profit and loss as a finance cost as it occurs. Any amount deducted from the cost shall not exceed the asset’s carrying amount. If a decrease in the liability exceeds the carrying value of the asset, the excess shall be recognised immediately in profit or loss. If the adjustment results in an addition to the cost of an asset, the entity shall consider whether this gives rise to an indication of impairment of the asset. The adjusted carrying amount of the asset is depreciated prospectively over its remaining useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur.
Tower sale and leaseback transactions involve the sale of towers by a telecoms operator to an independent tower company (Towerco) and the immediate leaseback of space on the towers on which the operator’s active telecoms equipment are located. The transaction landscape saw a number of global deals struck as operators looked to divest of non-core assets and tower companies took advantage of favourable borrowing conditions. These transactions also allow operators to increase liquidity and reduce ongoing capital expenditure. It also results in industry-wide cost efficiencies and helps in the growth of telecoms services by avoiding duplication of infrastructure. These benefits have led to sale and leaseback transactions becoming increasingly popular with leading operators. For instance, in 2015, tower companies in Africa will own around 32% of all wireless towers compared to less than 5% in 2010.

Accounting for such transactions is often complex and requires the exercise of significant judgement and the use of estimates and assumptions. Following are some of the key accounting considerations and challenges relating to such transactions:

- When should towers be classified as held for sale and how they should be measured
- Whether the tower infrastructure being sold is a cash generating unit (CGU) or an operation within a CGU. In some cases, operators might have acquired the towers as part of an earlier business combination, so the question arises whether goodwill acquired in that business combination needs to be included in the carrying value of the CGU comprising towers
• Accurately recognising the gain realised on the portion of the tower sold and the portion leased back.

• Determining the type of lease involved, i.e., whether the leaseback is under a finance or an operating lease arrangement.

IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, addresses the accounting for assets held for sale and the presentation and disclosure of discontinued operations. IFRS 5 requires a non-current asset (or disposal group) to be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For an asset (or disposal group) to be classified as held for sale:

• It must be available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such assets (or disposal groups).

• Its sale must be highly probable.

Non-current assets that are to be abandoned shall not be classified as held for sale as their carrying amount will be recovered principally through continuing use.

IFRS 5 requires that non-current assets classified as held for sale be measured at the lower of carrying amount and fair value less costs to sell, with depreciation on them ceasing. They must be presented separately on the face of the statement of financial position. When in addition to the criteria as held for sale, also the criteria for classification as discontinued operations are met, the results from discontinued operations shall be presented separately on the face of the statement of comprehensive income.

A disposal group includes goodwill acquired in a business combination if the disposal group is a CGU to which goodwill has been allocated as per IAS 36, *Impairment of Assets*. Regular tower sale and leaseback transactions usually lead to classification of the towers as assets held for sale, whereas the classification as a separate CGU is rare.

Tower sale and leaseback transactions usually fall under the scope of IAS 17, *Leases*, as the arrangement provides a “right to use a specific tower.” Accordingly, the next step is to evaluate whether the lease is a finance lease or an operating lease, and it depends on the substance of the transaction rather than the form of the contract. Examples of situations which, either individually or in combination, would normally lead to a lease being classified as a finance lease are:

• The lease transfers ownership of the tower to the lessee by the end of the lease term.

• The lessee has an option to purchase the tower at a price that is expected to be sufficiently lower than the fair value to be reasonably certain, at the inception of the lease, that the option will be exercised.

• The lease term is for the major part of the economic life of the tower even if title is not transferred.

• At the inception of the lease the present value of the minimum lease payments amount to at least substantially all of the fair value of the leased tower.

• The leased tower is of such a specialised nature that only the lessee can use it without major modifications.

• If the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee.

• Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease).

• The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

When a lease includes land and building elements, an entity should separately assess the classification of each element as a finance or an operating lease.

Under IAS 17, if a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term. If a sale and leaseback transaction results in an operating lease, and it is clear that the sales price is at fair value, any profit or loss shall be recognised immediately. If the sale...
price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.

Tower lease agreements often involve various elements, including: (a) the right to use space on the tower, (b) a portion of the land on which the tower is located and (c) tower operation and maintenance services. The arrangement is sometimes referred to as a multiple-element arrangement. IAS 17 requires separate recognition of a lease that is embedded or contained within a multiple-element arrangement because it applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. In addition, the definition of minimum lease payments under IAS 17 clarifies that such payments exclude costs for services. Therefore, operators will need to split the lease charges and service charges on the basis of the relative fair values of the different elements.

In May 2013, the IASB and FASB issued a joint lease accounting proposal, which they are currently re-deliberating on key aspects. We will present the impact of the new lease standard on operators in a separate publication, once the standard is issued.
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EYG no. EF0149
CSG/GSC2015/1564051
ED None

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