Welcome to the second edition of EY’s Spotlight on Telecommunications Accounting. With this new publication, we will address current industry practices and their impact on telecom network 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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Global bandwidth demand measured 138 tbps in 2014, a 4.5-fold increase since 2009, while bandwidth prices are continuing to decline in nearly all markets worldwide. Sub-Saharan Africa remains the leader of activated broadband capacity along major undersea routes, although there has been a surge in cable projects in Latin America during the past year. Indeed, major global sporting events, such as the 2014 Football World Cup in South Africa and the 2016 Olympic Games in Brazil, are stimulating a wave of new investments.

In this context, telecom companies will continue to seek ways to reduce the upfront costs of undersea cables and long-distance telecommunications lines by selling excess network capacity to other telecom companies. This type of transaction is commonly referred to as an indefeasible right of use (IRU) arrangement. An IRU is a contractual agreement that confers an indefeasible and exclusive right of access to equipment, fibers or network capacity on a telecommunications system to another telecom operator for an agreed-upon period in return for upfront or recurring payments. An IRU agreement is usually for a longer term (e.g., 10-20 years).

Accounting for IRUs can be complex and requires a detailed analysis of the terms and substance of the arrangement. The key accounting decisions that will impact the balance sheet and income statement presentation of IRU arrangements relate to (a) determining whether the IRU arrangement is a lease or a service contract or a combination of both, and
(b) if the arrangement is or contains a lease, determining whether the lease is an operating lease or a finance lease. The accounting treatment applied will also impact key performance indicators, such as EBITDA, and may have an impact on the entity’s covenants.

The accounting guidance on evaluating whether an arrangement is or contains a lease is included in IFRIC 4 “Determining whether an Arrangement Contains a Lease.” For an arrangement to be considered as a lease, IFRIC 4 requires that it meet both of the following conditions:

- Fulfillment of the arrangement is dependent on the use of one or more specific assets.
- The arrangement conveys a right to use the specific assets.

IFRIC 4 specifies that if the entity has the right and ability to provide services using other assets not specified in the arrangement, the fulfillment of the arrangement is not dependent on the specified asset and therefore the arrangement does not contain a lease. In that case, the IRU agreement is accounted for as a service agreement.

Illustration 1:

Telecom Company A (seller) owns a large fiber network and enters into an agreement with Company B (purchaser). The agreement specifies that fiber strands four, five and six will be used to carry the traffic of Telecom B’s customer for a 10-year period. Telecom Company A cannot substitute other fiber strands to fulfill the agreement.

In this scenario, the agreement involves the use of explicitly identified PPE (i.e., fiber strands four, five and six). To determine whether the agreement is a lease, the entities would need to assess whether the agreement conveys the right to use the PPE to Telecom customer B.

The right to use the asset is conveyed if any one of the following conditions is met:

- The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset. For instance, the seller is prohibited from using the fiber strands identified in the arrangement for the traffic of other carriers – the purchaser solely decides the traffic to be transmitted on the specified fiber strands.
- The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or utility of the asset. The condition is not likely to be relevant as the purchaser will certainly not be able to control the access to the capacity when fiber strands are located in the seller’s facilities along with other assets of the seller.

It is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or utility that will be produced or generated by the asset during the term of the arrangement and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of the delivery of the output. Commonly, the purchaser of an IRU will pay a contractually fixed price over the term of the arrangement.
Illustration 2:

Assume the same facts as in illustration 1. In addition, Telecom Company A retains physical control over the PPE and the ability to operate the PPE (i.e., it will “light the fiber”). However, Telecom Company B will obtain substantially all of the output and utility of the specified (i.e., no other customers will be able to use the specified fibers). The price of the agreement is fixed, regardless of how much Telecom Company B uses the fiber. Considering the likelihood that one or more parties other than Telecom Company B will take more than an insignificant amount of the output or utility is remote, and the price it will pay is neither fixed per unit of output nor equal to the market price per unit, the contract meets the definition of a lease.

In a service agreement, the seller continues to recognize the asset on its balance sheet and the asset continues to be depreciated over its useful life. The seller recognizes revenue for the services provided. Similarly, the purchaser recognizes expenses for the services received.

To the extent the IRU is or contains a lease, the arrangement should be accounted for in accordance with IAS 17 “Leases,” which will require an evaluation to determine whether the arrangement is a finance lease or an operating lease. Lease classification should be based on an overall assessment of whether substantially all the risks and rewards of ownership have been transferred. The following considerations are used to determine if an arrangement is a finance lease:

- The lease transfers ownership of the specified asset(s) to the lessee by the end of the lease term.
- The lease includes a bargain purchase option.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the asset.
- The asset is of such a specialized 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.
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

If the arrangement does not meet the criteria for a finance lease, it will be classified as an operating lease. As such, the accounting...
treatment will be similar to a service contract. If the arrangement meets the criteria of a finance lease, the lessor records the transaction as a sale and recognizes revenue upon inception of the lease. If the lessor receives some portion of the total consideration upfront and the remaining portion over a period of time, then the lessor should discount the portion of the consideration expected to be received subsequently and recognize finance income over the period until payment is due. The lessee will recognize the assets and liabilities on its balance sheet at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments. A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period.

Because IRU arrangements in the telecom industry typically do not grant the purchaser the right to use specific identifiable assets or do not allow the purchaser to control the asset, these arrangements usually fail to meet the conditions for being treated as leases and, instead, are considered service contracts. However, if they do, the arrangement may also include operating and maintenance costs, which are included in the overall contract. In that case, IAS 17 applies only to the lease element of the arrangement. Other elements should be accounted for in accordance with other standards. Accordingly, payments have to be separated at contract inception.

As the IASB and FASB are continuing to re-deliberate their 2013 lease accounting proposal, including the definition of a lease, the new standard may affect the accounting for IRU arrangements. We will present the impact of the new lease standard on operators in a separate publication, once the final leases standard is issued.
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