

Telecommunications Spotlight

Lease Accounting Model to Be Reexposed

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The Bottom Line

- In the August 2010 exposure draft (ED), the FASB and IASB (the “boards”) proposed dramatic changes to current lease accounting. The boards received over 750 comment letters in response and started redeliberating the proposal in January 2011.
- Telecommunications (telecom) companies provided the boards with feedback on the conceptual merits of the proposal. However, they also requested clarifying guidance on the definition of a lease and expressed concerns about the subjectivity, operational complexity, and administrative burden of the proposal.
- Although many substantive adjustments were made to the ED’s original proposals during redeliberations, current practice is still expected to change significantly. Telecom companies will need considerable time and resources to implement the final standard, particularly given the extent of leasing activities within the industry.
- The proposed provisions may significantly increase the lease-related assets and liabilities on the balance sheet and will most likely affect recognition (both timing and classification) of lease-related income and expense in the income statement.
- Companies are starting to prepare now by performing preliminary assessments of the potential impact on key financial measures and the related implications; companies are also beginning to identify the data, systems, and processes that will be essential to supporting a successful implementation.
- The proposal will be reexposed for comment, most likely before the end of 2011, and its effective date is not likely to be earlier than 2015. A form of retrospective application would be required for companies that present comparative financial statements.

Implementation and ongoing compliance will involve detailed analysis of all lease contracts and may require data, systems, processes, and controls that do not currently exist.

Beyond the Bottom Line

Telecom companies should continue to monitor the boards' tentative decisions and prepare to comment on the reexposed ED. In addition, to effectively plan for the significant changes ahead, telecom companies should evaluate the significance of the industry-specific challenges to their businesses and assess the requirements of an eventual implementation. The discussion below provides insight into these and other important considerations related to the proposed changes in lease accounting for telecom companies.

Proposed Changes in Lease Accounting

Since the issuance of the original proposal, several telecom companies have provided feedback to the boards through comment letters and participation in roundtable meetings. On the basis of feedback received from companies in many industries, the boards are now considering significant adjustments to the proposed model. Key tentative decisions the boards have made to date are outlined below.

Recognition of Lease Assets and Liabilities

The cornerstone of the proposed lease accounting model is the objective of developing a consistent, cohesive reflection of all leasing activities in the financial statements. Specifically, a lessee would recognize a right-to-use asset and a liability to make lease payments, while a lessor would potentially recognize a lease on the balance sheet by using one of several proposed models. For lessees and lessors alike, the definition of a lease and the short-term lease exception will be critical to determining whether a contract requires balance sheet recognition as a lease.

Definition of a Lease

The ED proposed that a contract be considered a lease if fulfillment of the contract depends on the use of a specified asset and the contract conveys the right to control the use of that asset. During redeliberations, the boards have tentatively decided to largely retain the current definition of a specified asset but will attempt to align the right-to-control concept with the revenue recognition project.

- *Specified asset* — A specified asset would be an identifiable asset that is explicitly (e.g., by serial number) or implicitly identified in the contract. The underlying asset can be a physically distinct portion of a larger asset (e.g., a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (e.g., 50 percent capacity of a pipeline) is not a specified asset. An asset would be implicitly identified if it would not be practical and economically feasible for the owner to substitute alternative assets in place of the underlying asset during the lease term. Conversely, a contract would not be a lease if it would be practical and economically feasible for the owner of the asset to substitute the underlying asset and substitution could occur at any time without the customer's consent.
- *Right to control* — A contract would convey the right to control the use of the underlying asset if the customer has the ability to **direct the use**, and **receive the benefit** from use, of a specified asset throughout the lease term. The ability to direct the use of a specified asset would include determining how, when, and in what manner the specified asset is used and determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer. If a customer can specify the output or benefit from use of the asset but is unable to make decisions about the input or process that results in that output, the ability to specify the output would not, in and of itself, indicate that the customer has the ability to direct the use of the asset. In circumstances in which the supplier directs the use of the asset used to perform services requested by the customer, the supplier and customer would be required to assess whether use of the asset is separable or inseparable from those services

Accounting for all leases on the balance sheet will be a major change that may affect key financial ratios and metrics.

The boards' decision on the definition of a lease is a critical issue for many telecom companies.

(if inseparable, the entire contract would be accounted for as a service contract because the customer has not obtained the right to control the use of the asset). A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term. The economic benefits would include those that arise directly from the use of the asset (e.g., renewable energy credits or secondary physical output) but would exclude income tax benefits.

The boards have not indicated whether the grandfathering provisions of Issue 01-8¹ (i.e., for contracts entered into or acquired before May 2003) would be carried forward.

The significance of whether an arrangement is treated as a lease or service contract is greater than ever because of the proposal that all leases generally be reflected on the balance sheet. In their redeliberations of the definition of a lease, the boards have included in their discussions telecom-specific arrangements, such as the delivery of consumer or business services involving integral hardware (e.g., servers, switches, modems, cable boxes), but have not discussed other telecom-specific arrangements, such as rights of way and easements. Telecom companies will need to remain attentive to what is expected to be more detailed guidance in the reexposed standard. Even with further guidance, the determination of whether some arrangements are, or contain, a lease may require significant judgment.

Short-Term Lease Exception

The ED proposed simplified lessee and lessor accounting for short-term leases, defined as leases with a maximum possible term of 12 months or less (including renewal periods). The boards' redeliberations indicated that this simplified accounting would not require any form of balance sheet recognition for both lessees and lessors. The boards have tentatively decided that an entity would apply the short-term lease guidance as an accounting policy election on the basis of asset class.

Although balance sheet recognition may not be required, companies may still need to perform detailed tracking of short-term leases to comply with potential disclosure requirements, if material.

Measurement of Lease Assets and Liabilities

Critical to both lessee and lessor measurement of lease balances will be the evaluation of lease term, variable lease payments, and nonlease components.

Lease Term

The ED proposed that the lease term be the "longest possible term that is more likely than not to occur." The boards' redeliberations have resulted in a change to this proposal, and their most recent tentative decisions have clarified that in evaluating lease term, lessees and lessors will be required to assess whether there is a "significant economic incentive" for exercising renewal options and, in both the initial and subsequent evaluation, to consider contract-based factors, asset-based factors, and entity-specific factors as follows:

- Contract-based factors are terms that are written into the lease contract that could create a significant economic incentive to exercise an option (e.g., nonrenewal penalties, bargain renewals).
- Asset-based factors are related to the characteristics of the underlying leased asset that could create a significant economic incentive to exercise an option (e.g., loss of leasehold improvements).
- Entity-specific factors include historical practice of the entity, management intent, and common industry practice.

Note that market-based factors, such as rental markets or asset values, would only be considered during the initial evaluation.

¹ EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

The proposed lessee and lessor models would change both the timing and characterization of lease-related income and expense for leases currently treated as operating.

The tentative decisions regarding the application of lease term, though notably different from the ED's proposals, may result in the inclusion of more renewal options in the recorded lease balances of lessees and lessors, particularly if intent and past practice are factors.

Variable Lease Payments

The ED proposed that an expected outcome approach be used to measure lease payments, including contingent rentals. However, the boards have tentatively decided that variable lease payments should only be included in the measurement of a recorded lease balance if they are (1) based on an index or rate, (2) deemed an in-substance minimum lease payment (i.e., the variability lacks substance), or (3) a portion of a residual value guarantee expected to be paid.

The general exclusion of variable lease payments from the recorded balances will notably decrease the subjectivity and complexity of the proposed rules.

Nonlease Components

The ED proposed that lease accounting not apply to "distinct" service components of a contract. However, the boards have tentatively decided to eliminate this threshold and to require that all nonlease components generally be separately accounted for; thus, payments would typically be allocated between lease components and nonlease components on the basis of their relative stand-alone purchase prices. For a lessee, if stand-alone prices are not available for at least one of the components, the entire contract would be accounted for as a lease.

Cost pass-through items (e.g., insurance, tax, and maintenance) in real estate leases will most likely be considered nonlease components, requiring separation from gross lease payments.

Recognition of Lease Income and Expense

The proposed changes to create uniform accounting for leasing in the income statement would affect lessees and lessors differently.

Lessees

The ED proposed a single lessee model that would apply to all leases. Under this model, the lessee's right-to-use asset would be amortized systematically (ordinarily straight-line) and entities would use the interest method to allocate lease payments between interest expense and a reduction of lease liability, which would result in higher interest expense in earlier periods. In their initial redeliberations, the boards considered whether there should be two types of leases for income statement recognition. However, the boards' recent tentative decisions indicate support for only one type of lease for lessees, which is consistent with the ED.

A single lessee model will result in accelerated recognition of lease costs and characterization of those costs as amortization and interest expense for all leases.

Lessors

The ED proposed two accounting models for lessors — the performance obligation approach and the derecognition approach. However, the boards have since tentatively decided that a single lessor accounting model, generally consistent with the partial derecognition approach, should apply to all leases. Under the model now contemplated, a lessor will derecognize an underlying asset and recognize (1) a lease receivable measured as the present value of the lease payments and (2) a residual asset measured on an allocated-cost basis. Day-one profit would be recognized if it is reasonably assured.

The elimination of operating lease accounting for lessors, aside from an exception for short-term leases, will be important to telecom companies that are providers in arrangements that potentially either meet the definition of a lease in their entirety (e.g., towers) or contain an embedded lease (e.g., equipment in managed services), since the accounting for these arrangements is likely to become significantly more complex than it is under current practice.

Challenges for Telecom Companies

In addition to the proposed rule's technical requirements, many of its broader implications may present significant challenges to telecom companies. Such challenges include business implications related to:

- *Data* — For telecom companies to implement the anticipated financial reporting changes, they will need to summarize, validate, and analyze contract terms — on a lease-by-lease basis — to assess the proper accounting treatment. The preliminary experience of companies that have started planning indicates that tracking down lease information on an entity-wide basis can be challenging, especially if lease contracts and data have not been centrally managed. Many companies have discovered that their current systems do not capture all of the data elements they need to perform the requisite calculations under the proposed model.
- *Technology* — Telecom companies will need to consider whether their current systems allow them to store the key data, perform the necessary calculations, and provide accounting entries on an ongoing basis. The automation of this process will be imperative for effective and efficient financial reporting.
- *Debt covenants* — The ability of telecom companies to comply with leverage-based covenants in debt arrangements may be jeopardized by the recording of substantial lease liabilities. Furthermore, the replacement of rent expense with depreciation and interest affects EBITDA calculations. Many companies are already starting to assess the ED's impact on covenants by creating pro forma financial statements.
- *Taxes* — The tax departments of telecom companies will need to determine how the final standard will affect the overall tax analysis, including possible changes in cash taxes paid (financial statement changes may affect transfer pricing, state apportionment, or non-U.S. taxes) as well as changes in deferred tax positions related to book/tax differences in accounting for leases.
- *Investor education* — Investors will need to understand the impact on the key performance indicators. Telecom companies should (1) consider providing additional disclosures to explain the changes to the balance sheet and income statement and (2) assess the impact on comparability to competitors.

Thinking Ahead

The boards have not discussed the timing of the proposed lease model reexposure, but it will most likely be before the end of 2011. Telecom companies should continue to provide feedback to the boards during this reexposure process. While the boards have still not voted on an effective date, a final standard may be effective as soon as January 1, 2015, in which case the new rules would be applied, upon adoption, to all leases outstanding as of January 1, 2013, for companies that present comparative financial statements.

While the exact details of the proposed rules will be subject to ongoing refinement, the broad requirements of lease accounting have become more defined — and there are many things telecom companies can do to begin preparing. Specifically, they can start to identify and evaluate the challenges introduced by the proposed rules, both in terms of adoption demands and broader business impacts. By planning early, telecom companies can more effectively manage what promises to be, for many, a complex and resource-intensive implementation.

Tracking down individual lease contracts for leases that were previously accounted for as operating leases may be a major challenge.

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