Practical guide to IFRS

Joint arrangements: a significant issue for the telecommunications industry

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What is the issue?

The International Accounting Standards Board issued IFRS 11, 'Joint arrangements', in May 2011, which overhauls the existing accounting for joint arrangements.

IFRS 11 provides investors with greater clarity about an entity's involvement in joint arrangements by requiring entities to recognise the contractual rights and obligations arising from their joint arrangements. Parties to a joint arrangement should recognise on the balance sheet their rights and obligations arising from the arrangement as assets and liabilities.

More information on the detailed requirements of the standard is available in the *Practical guide to IFRS: Joint arrangements– a new approach to an age-old business issue,* which can be downloaded from www.pwc.com/ifrs.

This supplement considers the business and industry-specific issues associated with IFRS 11 that management should consider. For example, management will need to evaluate how the standard will affect the way they account for their existing or new joint arrangements; and how their current business activities may need to change beyond the accounting processes, such as key business metrics (for example, debt covenants), controls and processes, information-gathering and information technology requirements.

Growing use of joint arrangements in telecoms industry

Accounting issues in the telecoms sector regularly present management with challenges. Telecoms operators find themselves operating in increasingly complex business models. A range of industry-specific accounting challenges arises through the provision of 'standard' telecoms services (such as fixed and mobile services), as well as through the provision of additional services such as data and internet access.

Telecoms operators are moving from control and ownership of all assets and activities to sharing control through joint arrangements. Telco operators commonly enter into joint arrangements to build cable systems and mobile networks; to develop and market billing software; and to form consortia to acquire spectrum licences. A decade ago, this sort of arrangement was rare, but these arrangements are expected to continue to grow in popularity as the pace of change puts strain on capital budgets and capacity.

The joint arrangements standard will continue to be a significant accounting and business issue for the telecoms industry.

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Why is this issue significant for the telecoms industry?

The new standard will affect some entities and industries more than others, although all entities with joint arrangements should expect some level of change. Entities in the telecoms industry that are likely to be most significantly affected include those that:

- are active in emerging or developing economies with restrictive foreign ownership rules;
- enter into new joint arrangements;
- apply proportionate consolidation for joint venture entities;
- participate in a significant number of complex joint arrangements; and
- have former joint arrangements with limited documentation detailing the terms of the arrangement.

We expect IFRS 11 to affect a significant number of entities in the telecoms industry because joint arrangements are commonplace. They generally allow entities to share the risk and expense of projects; facilitate access to new geographies; provide benefits from new expertise; and often ensure the retention of tax benefits.

Many of these joint arrangements are established in a legal entity and take on significant amounts of debt, but all different types of joint arrangement can and do occur. IFRS 11 also introduces new financial statement presentation requirements. These will be particularly relevant for telecoms operators where identifying their share of revenue or expenses is important to stakeholders and/or where their gross balance sheet does not currently consider the specific rights and obligations associated with the joint arrangement.

Three key areas of focus under IFRS 11

1. Classification of a joint arrangement	
Key change (snapshot)	The standard requires entities to assess their rights and obligations under the joint arrangement in order to determine the appropriate classification as either a 'joint operation' or 'joint venture'. The accounting for a joint arrangement will no longer be driven solely by its legal form. Operators will account for their involvement in a joint arrangement in a manner that is consistent with their rights and obligations.
Impact on IFRS financial statements	A joint operation is a joint arrangement that gives parties to the arrangement direct rights to the assets and obligations for the liabilities. A joint operator will recognise its interest based on its involvement in the joint operation (that is, based on its direct rights and obligations) rather than on the participation interest it has in the joint arrangement. The balance sheet and income statement will be presented gross. A joint venture, in contrast, gives the parties rights to the net assets or outcome of the arrangement. A joint venturer does not have rights to individual assets or obligations for individual liabilities of the joint venture. Instead, joint venturers share in the net assets and the outcome (profit or loss) of the activity undertaken by the joint venture. Joint ventures are accounted for using the equity method in accordance with IAS 28, 'Investments in associates'. The net investment in the venture is a single line in the balance sheet, and the profit appears in a single line in the income statement.
Industry insight	Network or infrastructure share arrangements are common in the industry. Some take the form of contractual arrangements between the sharing parties; others operate through joint ownership of a separate entity that owns and/or operates the shared assets. Classification and the resulting accounting for each structure will differ based on the rights and obligations of the parties to the joint arrangement. For example, Telco A and Telco B enter into an agreement to share the costs of construction of an undersea cable. The arrangement is set up in an

	unincorporated entity over which Telco A and Telco B have joint control over decision-making. This is likely to result in the accounting as a joint operation as opposed to a joint venture, depending on the rights over the assets and obligations. Telco A and Telco B will account for their rights and obligations to assets, liabilities, revenue and expenses rather than their share of the net assets and net income.
2. No proportionate consolidation for joint ventures	
Key change (snapshot)	The standard requires joint ventures to be accounted for using the equity method. Previously, a venturer could choose to proportionately consolidate its ownership interest in the joint venture.
Impact on IFRS financial statement	Equity accounting will apply to all joint ventures. A single line item will be shown in the consolidated income statement to reflect the share of profit or loss in the joint venture, and a single line item will be shown in the consolidated balance sheet to reflect the share of net assets in a joint venture.
Industry insight	Proportionate consolidation is not widely used in the industry. However, some operators provide additional disclosure about revenues and customer numbers using their proportionate share of joint ventures; this practice of additional disclosure should be unaffected. Those operators that currently proportionately consolidate will no longer show their share of revenue in the income statement, which will impact key metrics such as revenue growth.
3. Transition	
Key change (snapshot)	Management should re-evaluate the terms of their existing contractual arrangement to ensure their involvement in joint arrangements are correctly accounted for under IFRS 11.
Impact on IFRS financial statement	Joint arrangements that were previously accounted for as joint operations may need to be treated as joint ventures or vice versa on transition to the standard. A change in the classification of a joint arrangement will require all parties to the joint arrangement to change the way they report their respective rights and obligations in their financial statements. When transitioning from the proportionate consolidation method to the equity method, management should recognise its initial investment in the joint venture as the aggregate of the carrying amounts that were previously proportionately consolidated. To transition from the equity method to accounting for a joint operation, management derecognises its investment in the joint arrangement, and recognises its rights and obligations to the assets and liabilities of the joint operation.
Industry insight	For example, Telcos T1 and T2 form a 50:50 joint venture to build a new cable system. Under their existing policies, T1 and T2 account for their proportionate ownership of the cable on balance sheet; the day-to-day operating costs will be shared equally. Under IFRS 11, T1 and T2 account for the joint arrangements based on their contractual rights and obligations. These may differ from a 50:50 sharing of each asset and liability. For example, if T1 is responsible for maintaining the cable network and T2 is responsible for marketing the cable service to potential customers, these respective rights and obligations would not necessarily result in a 50:50 share of the network assets.

Examples: illustration of key impacts in telecoms industry

Scenario 1

Operator A has obtained an investment in entity T in a relatively undeveloped telecoms environment. The in-country requirements for foreign ownership of T do not permit a local entity with a telecoms licence to be controlled by a foreign entity. Operator A therefore enters into a shareholders' agreement with a local investor B, whereby all decisions will be made jointly. Over the last couple of years, T has shown phenomenal growth, with net profit of C400 million and net assets in excess of C10 billion.

Current accounting. The investing parties have joint control of entity T; they account for their interests by using proportionate consolidation in their own financial statements. This is on the basis that there is joint ownership of the legal entity by two shareholders and that operator A has a policy to account for jointly controlled entities using the proportionate consolidation method.

New accounting. Under IFRS 11, operator A needs to consider the type of joint arrangement. On the basis of the contractual rights and obligations, the arrangement would be considered a joint venture, as A has a right to the net assets of T. IFRS 11 requires all joint ventures to use the equity accounting method outlined in IAS 28. Operator A replaces the line-by-line proportionate consolidation of entity T's statement of comprehensive income and balance sheet with a single net result and a single net investment balance.

Challenges in practice. This may have a fundamental impact on the landscape of each party's financial statements. The financial position and income statement line items would be reduced individually, which would directly impact return-on-asset calculations and average revenue per user (ARPU); it may even affect certain loan covenants, such as those based on asset ratios and earnings before interest, tax, depreciation and amortisation (EBITDA). Furthermore, many entities have concerns that the business may now be undervalued, as EBITDA valuations often do not include income that has been equity accounted.

Scenario 2

Two large telecoms operators enter into an arrangement in which they establish a Newco and transfer all tower equipment to the Newco. The purpose of the arrangement is to share tower-related costs. The operators have direct rights to the assets and obligations for the liabilities of the Newco based on their proportionate shareholding. All Newco's decisions need to be made unanimously between the operators.

Current accounting. The parties account for their involvement in the legal entity as a joint venture and equity-account their investment. This is on the basis that the parties have elected to equity account all joint ventures.

New accounting. The arrangement should be accounted for as a joint operation, based on the fact that the operators have direct rights to the assets and obligations for the liabilities. This requires the interest to be accounted for based on rights to the assets and obligations for the liabilities and not on a net basis as previously presented.

Challenges in practice. Understanding the respective rights and obligations may be challenging, and contracts need to be carefully considered. Management should consider the impact on covenants and financing agreements.

Scenario 3

Based on the same facts as Scenario 2; however, the telecoms operators do not have direct rights to the assets and obligations for the liabilities of the Newco based on their proportionate shareholding. In addition, the operators have agreed to ensure that the capacity of the network towers will be shared by the two operators only. The capacity fee charged for the network will be based on costs of the network towers.

Current accounting. The parties account for their involvement in the legal entity as

a joint venture and equity-account their investment. This is on the basis that the parties have elected to equity account all joint ventures.

New accounting. All of the network assets or costs are borne by the two parties, so the interest should be accounted for as a joint operation and not a joint venture. The network towers provide all economic benefits to the operators, and the network towers are dependent on the financing of the operators. This is because liabilities and costs will be settled through the purchase of capacity by the operators. The network entities will therefore recognise their share of the assets and liabilities based on ownership interest.

Challenges in practice. This is a crucial judgement and will have a significant impact on the financial statements. It will need to be carefully considered and properly disclosed. Leverage, capital ratios, covenants and financing agreements may be affected as a result of changes to the balance sheet, particularly when moving from equity accounting to the share of assets and liabilities approach.

Scenario 4

This scenario also considers a tower-sharing arrangement, except that the two telecoms operators involved do not form a separate legal entity. Instead, each operator retains ownership of its own network estate and grants a right of access to the other operator. Decisions concerning investment in new equipment and maintenance of existing equipment are made jointly, and tower-related costs are shared.

Current accounting. The parties treat the arrangement as jointly controlled assets; they account for their own network assets and obligations as well as their share of any joint obligations.

New accounting. The arrangement should be accounted for as a joint operation, which in practice would represent continuation of the previous accounting. Each operator will account for its own rights and obligations as well its share of any joint rights and obligations.

Challenges in practice. Understanding the respective rights and obligations may be challenging; contracts need to be carefully considered and scrutinised to ensure they have been correctly interpreted. There would be no change to the accounting in this scenario, but that should not be presumed to be the case for all arrangements.

What are the potential effects on the telecoms industry?

- Changes to the classification of joint arrangements may result in significant financial changes for telecoms operators. This could impact the recognised amounts in profit and loss (for example, revenues and expenses) as well as the balance sheet presentation. For example, leverage, capital ratios, management incentives, covenants and financing agreements may be affected as a result of changes to the balance sheet, particularly when moving from the equity-accounting approach to the share of assets and liabilities approach. Such impacts should be reviewed in advance to understand how an entity's balance sheet may be affected.
- Most operators focus on EBITDA and ARPU. The changes will impact both of these measures, and some operators may choose to adjust the figures they report.
- Management should consider how to communicate the impacts of the accounting changes to their shareholders and other stakeholders. There could be important changes to the manner in which the operator's interest in the joint arrangement is reported and understood by users of the financial statements.
- Future deal-structuring should be considered with the new rules in mind. For example, a joint arrangement in a corporate wrapper would not necessarily give rise to a joint venture, but the specific terms

of the arrangement would still need to be analysed in order to understand the operator's rights and obligations under the agreement.

- There are frequent instances in the industry of arrangements being characterised as 'revenue shares'. Some of these are, in reality, simple supply agreements; however, some involve sharing results and/or underlying assets. These will need to be assessed against the new framework to see whether their presentation needs to change.
- Operators may need to request more detailed financial reporting information from an operator of a joint operation if they move from equity-accounting to the share of assets and liabilities approach. Similarly, they may need to provide more detailed information to other parties if they are the operator of a joint operation. For example, an operator may need to provide information concerning the maturity profile of financial liabilities to allow appropriate classification on the balance sheet of the venturer or understand the assumptions utilised in measuring assets at fair value (such as investment property). Operators may also be required to provide this information at numerous points during a reporting cycle, as venturers may have different reporting dates, which could increase their reporting obligations.
- In some countries, non-domestic operators are obliged to have a local partner. It can be challenging to obtain detailed financial information on a timely basis from these businesses, and moving from equity accounting to share of assets and liabilities could be complex.
- Existing systems that integrate joint arrangement accounting may be in place. Any changes to the accounting should be understood to ensure the accounting application of any systems used can also be updated on a timely basis. Some operators in the telecoms industry may need to develop new systems.
- Initial transition requirements and annual reassessment of arrangement terms may require changes to existing processes and internal controls. Gathering and analysing the information could take considerable time and effort, depending on the number of arrangements in place, the inception dates and the records available. Where significant changes to financial results and financial position arise, management should communicate these effects to stakeholders as soon as possible. Timely assessment and management of all of the potential implementation and ongoing business impacts of IFRS 11 will help reduce unexpected business and reporting risks. Beginning this process early will allow management enough time to consider potential adoption strategies or to renegotiate agreements in order to reduce the impact of adoption and to achieve preferred classification outcomes for future arrangements.

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