IFRS 16 applied to BT

3 July 2019

Introduction to IFRS 16

What is it?	• IFRS 16 is the new accounting standard for leases, replacing IAS 17 and IFRIC 4
What are the main changes?	• New lease definition: arrangements not previously classified as leases could be in scope of IFRS 16 • New lease accounting for **lessees**: operating/finance lease classification replaced with single accounting model, all leases on-balance sheet subject to certain exemptions • No change to lease accounting for **lessors** (however, different arrangement may be captured due to new lease definition)
When and how will we be adopting the standard?	• We applied the standard for the first time on 1 April 2019, taking the modified retrospective transition approach • We will not be restating prior year results, but instead recognise the cumulative impact of initial application on day one • We have published pro forma financial information showing the impact on EBITDA had the standard been adopted in 2018/19

Which of BT’s arrangements meet the IFRS 16 lease definition?

- Identified asset ✓
- Lessee obtains the economic benefits from use of the asset ✓
- Lessee directs the use of the asset ✓

IFRS 16 lease definition met

All existing operating lease commitments and finance leases

- Property
- Vehicles
- Cell sites

Some arrangements previously accounted for as service contracts

- Dark fibre
- Data centres
- Last mile*
- Ethernet*

* BT as lessor

What are the key impacts for BT?

Lessee accounting – operating lease commitments and some service contracts

IAS 17

Operating lease and service contract commitments are not recognised on the balance sheet. Operating lease and service contract expenses are recognised within operating costs.

IFRS 16

Any arrangements that meet the IFRS 16 lease definition are brought onto the balance sheet. A lease liability is recognised based on discounted future lease payments across the anticipated lease term, and a corresponding asset representing the right to use the asset is recognised. Interest expense and depreciation replaces lease expense within operating costs.

This is the most material impact for BT: we expect to recognise a lease liability of between £5.6bn and £6.6bn. EBITDA will increase as lease expenses no longer sit within EBITDA operating costs.

Lessor accounting – connection fees

IAS 17

Openreach copper and fibre access ('last mile') products and Ethernet arrangements are accounted for as service contracts under IFRS 15. Connection fees are recognised over the contract term governed by Ofcom, typically 1 month or less for last mile arrangements.

IFRS 16

'Last mile' arrangements meet the IFRS 16 lease definition. Connection fees will now be deferred over the contract term plus the renewal period which is reasonably certain: this is generally 6 months. This is not anticipated to have a material impact on profit and loss and therefore has not been included in our pro forma financial information. Ethernet arrangements also meet the IFRS 16 lease definition, however there is no change to the period over which connection fees are deferred.

Deferred income will be recorded on the balance sheet when connection fees are invoiced and unwound over the deferral period. An adjustment to retained earnings will be made on transition in respect of fees recognised in 2018/19 that now need to be recognised over deferral periods that run into 2019/20. **The day one balance sheet impact is expected to be less than £100m.**

Key accounting judgments, exemptions and practical expedients

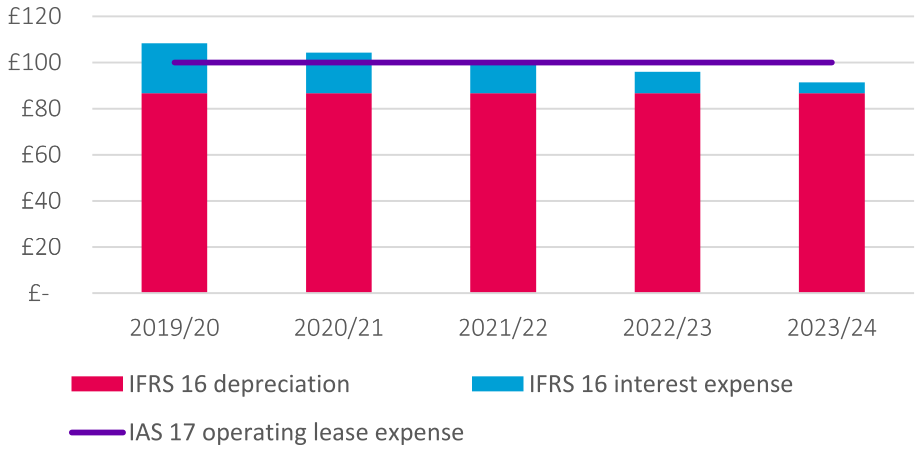
In adopting IFRS 16, we have made certain judgements, and taken advantage of a number of exemptions and practical expedients:

Lease term	• IFRS 16 defines the lease term as the period that we are ‘reasonably certain’ we will lease an asset for. Significant judgement has been exercised to establish this period for longer term leases such as our property estate and cell sites • For our shorter term leases, unless we have specific evidence for an individual lease, we have made the assumption that we are only reasonably certain that we will use the related asset for our medium-term planning period
Recognition exemptions	• We will not apply the IFRS 16 lease accounting model to short-term leases (lease term under 12 months) or low value leases (value of asset under £5k)
Scope exemptions	• Leases of intangible assets e.g. software will not be accounted for under IFRS 16
Non-lease components	• For certain classes of asset, we will not separate non-lease components (e.g. power) i.e. they will be accounted for as part of the related lease component
Discount rates	• To determine the lease liability, we will discount payments using the incremental borrowing rate – the rate we would have to pay for a loan of a similar term, and with similar security, to obtain an asset of similar value in a similar economic environment

Impact on income statement metrics and related KPIs

The total income statement charge will be higher than under IAS 17 in the early years of a lease, as interest is calculated on a larger lease liability. Over the course of a lease the income statement charge will reduce and will fall below the IAS 17 lease expense, as the lease liability is reduced by lease payments.

Example:
The following chart shows an example lease. The P&L charge is initially higher than the IAS 17 lease expense but lower later on.
Lease life: 5 years from 1 April 2019
Value: £100 pa
NPV on day 1: £433
Interest rate: 5% (indicative)



EBITDA	↑	Our definition of EBITDA will not change. Therefore, EBITDA will be higher as lease expense is replaced with depreciation (D) and interest expense (I)
Operating profit	↑	Higher as interest expense not included
Profit before / after tax	↓	Decrease (in early years) as interest expense is front-loaded. Flat in the long-term
EPS	↓	Decrease (in early years) as based on profit after tax. Flat in the long-term
Interest cover	↓	Decrease (in early years) due to front-loaded interest expense – subsequently improves
Net debt to EBITDA	↑	Expected to increase due to higher debt, despite improved EBITDA
ROCE	↓	Decrease due to increase in non-current assets

Impact on cash flow statement

	IAS 17	IFRS 16
Cash flow from operating activities		
Operating profit	✖	
Interest on leases		✖
Cash generated from operations		↑
Cash flow from financing activities		
Repayment of lease liabilities		✖
Net cash from financing activities		↓
Net change in cash and cash equivalents		↔

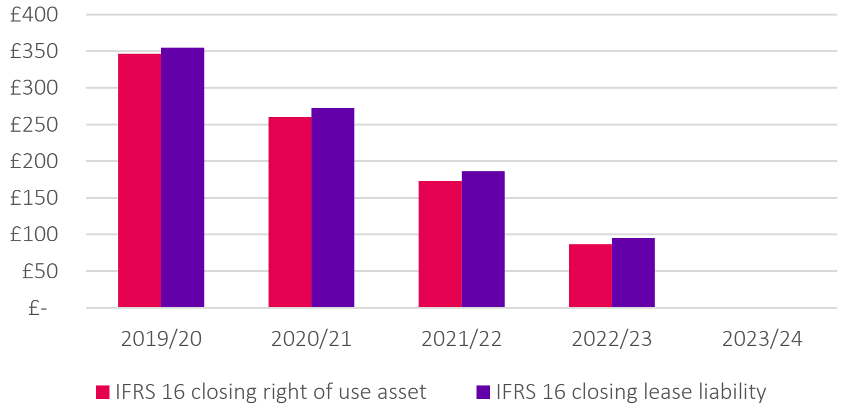
Cash flow statement	↔	Net impact nil. Lease payments previously included within operating profit will now be split into interest element and principal element: - Cash generated from operations will increase as removal of lease payments from operating profit more than offsets the inclusion of interest element - Cash flow from financing activities will decrease due to inclusion of principal element
Normalised free cash flow	↔	Unchanged, as we will now present this measure after cash lease payments

Impact on balance sheet metrics and related KPIs

Under the modified retrospective transition approach, we will recognise a lease liability based on payments due across the remaining lease term, and an equivalent right-of-use asset (adjusted for any prepaid/accrued rent and onerous lease provisions).

The rate of depreciation on the right-of-use asset is expected to be higher than amortisation of the lease liability, as lease payments applied against the lease liability are offset by interest expense.

Example:
The following chart shows the same lease presented on the income statement slide. The lease liability reduces to zero over the life of the lease.
Lease life: 5 years from 1 April 2019
Value: £100 pa
NPV on day 1: £433
Interest rate: 5% (indicative)



Total assets	↑	Increase due to recognition of right-of-use asset
Total liabilities	↑	Increase due to recognition of lease liability
Leverage	↑	Increase due to increase in debt
Net debt	↑	Will include lease liability
Capex	↔	Unchanged: will not include additions to right-of-use assets

IFRS 16 communication schedule

9 May 2019

- Published our results for 2018/19 under IAS 17
- We disclosed that we expect to recognise lease liabilities of between £5.6bn - £6.6bn

3 July 2019

- Released unaudited pro forma information showing 2018/19 EBITDA by quarter under IFRS 16

2 August 2019

- Q1 2019/20 trading statement
- Results will be reported under IFRS 16. Comparatives for business unit EBITDA results will be presented on a pro forma basis, all other comparatives remain under IAS 17

31 October 2019

- H1 2019/20 results
- Results will be reported under IFRS 16. Comparatives for business unit EBITDA results will be presented on a pro forma basis, all other comparatives remain under IAS 17
- We will disclose the finalised lease liability and right-of-use asset, and adjustment to our opening balance of retained earnings at 1 April 2019

May 2020

- Full year 2019/20 results
- Results will be presented under IFRS 16 and will be audited. Comparatives remain under IAS 17
- A one-off disclosure will be presented reconciling operating lease commitments disclosed as at 31 March 2019 to the opening IFRS 16 lease liability recognised at 1 April 2019
- Other new disclosures include a dedicated leasing note