

The impact of IFRS on Regulatory Reporting in the telecommunications sector*



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1. Introduction

As of January 1, 2005, International Financial Reporting Standards (IFRS) will be the mandatory basis for financial reporting by companies that are listed on a stock exchange in the European Union ("EU"). This requirement is also applicable for listed telecommunications operators. Many of these operators are also required to report to the local regulator on the cost orientation of and returns on regulated telecommunications services by means of regulatory accounts. It is therefore important - for both operators and regulators - to understand the principles and requirements under IFRS as the implementation of IFRS may have an impact on the regulatory accounts, the return earned on assets and the apparent profitability of regulated services.

2. Summary and recommendations

As many regulators request and most operators use the statutory financial statements as a starting point for cost allocation and regulatory reporting, operators and regulators cannot ignore IFRS and should be aware of the possible impact of the implementation of IFRS on their regulatory accounts, the return earned on assets and the apparent profitability of regulated services. It is therefore a challenge for both operators and regulators to fully understand the impact of IFRS implementation decisions on future regulatory reporting and related interventions such as pricing decisions and price-cap reviews. The impact of the differences depends on the nature and magnitude of the differences between current local accounting principles, IFRS and regulatory accounting principles. Commonly recognized differences that most likely have a material impact on the regulatory accounts and the return measures included in those accounts relate to revenue recognition and the recognition and valuation of tangible fixed assets.

Although many companies see the implementation of IFRS as an additional administrative burden, most have not considered the potential additional burden of the implementation of IFRS on regulatory reporting or the potential opportunity to consider upfront the regulatory implications of accounting policy implementation decisions. We therefore recommend that the impact of the implementation of IFRS on regulatory reporting will be considered as part of IFRS conversion projects.

In a broader perspective, the implementation of IFRS could also be seen as an opportunity to harmonize the regulatory accounting principles across the EU taking the IFRS statutory accounts as a basis. The advantages would include:

- Consistent application of accounting principles in the regulatory accounts and therefore better comparability of the regulatory accounts, the return earned on assets and the apparent profitability of regulated services across the different territories; and
- Consistent proportionate reporting burden for the operators.

3. Background on regulatory reporting

In the late 80's and early 90's many of the state owned telecommunications companies were privatized and competition was introduced as a means of creating an efficient telecommunications market. To encourage and manage this process within the EU, the Open Network Provisions have been implemented in the EU and

local law and regulation. The Open Network Provisions provide a framework of conditions that need to be met by operators with significant market power. These conditions relate mainly to cost orientation and nondiscrimination.

Cost orientation is linked to the return that operators make on their regulated telecommunications services, often measured as Return on Assets (ROA) and Return on Capital Employed (ROCE). Key drivers for calculating these return measures are:

- Result - being the difference between revenues from regulated telecommunications services and its related costs. A major part of these costs relate to depreciation of the investments in telecommunications networks;
- Assets – being the (average) net asset base used for providing the aforementioned regulated telecommunications services. Depending on the return measure used, all or a subset of assets is used to calculate the return.

The return measures relating to regulated telecommunication services as presented in regulatory accounts is affected by:

- Allocation principles
- Valuation principles
- Accounting principles

Accounting and valuation principles have an impact on the underlying level of costs and assets to be allocated. Allocation principles determine how these amounts are allocated to the different regulated and non-regulated services. We will focus on the accounting and valuation principles, as these principles will be impacted by the introduction of IFRS.

It should be noted that in many regulatory accounts a separate set of accounting and valuation principles is applied, such as current cost accounting and long run incremental costing (LRIC). The precise nature of these requirements differs from country to country but in principle where Current Cost or Long Run Incremental Cost reporting is required by regulators the underlying value of assets and associated depreciation is recalculated for regulatory purposes and as a result certain aspects of IFRS discussed below may be less significant for the regulatory financial statements. However, any other change to fixed asset accounting, such as measurement of useful economic life or other changes to the basis of calculating depreciation, would flow directly through into the regulatory accounts, as would changes in areas other than fixed assets (e.g. revenue recognition).

A summary of approach to regulatory reporting by country is attached in appendix 1.

4. International Financial Reporting Standards

As of January 1, 2005, International Financial Reporting Standards (IFRS) will be the primary basis for financial reporting by companies that are listed on a stock exchange in the European Union ("EU"). Many of these companies are now in the process of converting their accounting principles from local accounting principles to IFRS. As part of this process, these companies should also consider the possible consequences of IFRS on their regulatory accounts.

Currently, within the telecommunications industry, different accounting methods are frequently seen for similar accounting issues. This happens not only because accounting standards differ from one territory to another, but also because operators have different interpretations and applications of these industry specific accounting issues. The introduction of a common set of accounting standards across the EU and many other countries will enable greater comparability of accounting and bring greater transparency to the treatment of many industry specific issues.

For a detailed discussion on applying IFRS to the telecommunications sector, we refer to our separate publication "Applying IFRS InfoComm Solutions".



5. Overview of areas for attention

5.1. First time application of IFRS

IFRS 1 ('First time adoption') provides in a limited number of transitional provisions for certain accounting areas. The objective of these provisions is to facilitate a smooth IFRS transition for companies, that otherwise would have to restate their reported figures under local GAAP for a large number of years.

IFRS 1 allows companies to value their Property, Plant & Equipment, or only certain categories of assets, at fair value at the date of transition whilst maintaining the historical cost convention as the primary reporting basis for PP&E in future years.

5.2. IFRS accounting standards to be applied on an ongoing basis

Although many differences might exist between current local accounting principles and IFRS (both explicit in the accounting standards and in the application of such standards), we have identified below the following commonly recognized differences that most likely have a material impact on the regulatory accounts and the return measures included in those accounts.

5.2.1. Revenue

IAS 18 on Revenue provides guidance on the accounting treatment for revenue arising from the sale of goods and provision of services in the ordinary course of the operator's activities. However, IAS 18 provides limited specific guidance on revenue recognition for more complex arrangements including principal/agency relationships and multiple element agreements. Revenue recognition is on the IASB's agenda and there is an expectation that additional guidance on revenue recognition will be issued in 2004. This guidance is expected to converge with US GAAP in a number of areas. Key issues include:

Service arrangements

The majority of operator's revenues are earned from the provision of telecommunications services. With the increase in competition it is now usual for operators to offer rollover minutes, free minutes and other similar offers to customers. It is therefore becoming increasingly important to recognize revenue when the service is rendered (deferral of revenues). The deferral of these revenues can only be released from the balance sheet when the obligation is effectively extinguished - that is, when the obligation specified in the contract is discharged, cancelled, or expires. Generally this will reduce revenue and margins and therefore the return measures on the services reported in the regulatory accounts.

Multiple elements arrangements

Technological advancements have enabled the provision of increasingly complex services and arrangements. Further, competition has also increased the complexity of solutions offered to customers. In the fixed line arena operators have moved to position themselves as the “one stop shop” for all IT and tailored communication solutions by offering to acquire equipment, install, operate and maintain it as a single service offering. The complexity of these bundled arrangements presents a challenge to operators converting to IFRS. Currently IFRS provides little guidance on the accounting for multiple element arrangements, but it is expected that this area will be included in the IASB’s revenue project and that IAS 18 may be interpreted in line with the US approach.

One-off up front connection and installation fees

Operators often charge one-off upfront connection fees. It is currently established industry practice to recognize revenue from connection fees at the outset where all of the following conditions have been met:

- the connection fee received is not refundable;
- revenue for future periods has not been bundled in the pricing for connection;
- there is no enforced contract period over which to defer the revenues; and
- there are incremental costs associated with the connection which have been charged to the income statement as incurred.

It is argued in the US (and increasingly elsewhere) that the customer perceives value in the ongoing provision of service and not in the initial connection per se. Hence if the operator cannot provide the service without the connection or the connection without ongoing service then the two elements are not separable and should be accounted for as a single transaction. While the broad principles of IAS 18 could be interpreted to support immediate recognition, it is expected that this area will be included in the IASB’s revenue project and that IAS 18 may be interpreted in line with the US approach of deferring connection fees.

Although the exact impact on the regulatory accounts is very hard to predict, the general trend will be that revenue (and its related direct costs and margin) are recognized later in time therefore reducing return measures. Another aspect that needs consideration is the fact that the accounting for certain products might change under IAS 18. The IFRS grouping of products together in one unit of accounting might not match the product definition under regulatory reporting. This might also have an impact on the allocation of fair values (including discounts) to the different products.

Principal versus agents (gross versus net revenue reporting)

While convergence has been a “buzz word” in the sector for some time, operators realize that nobody can do it all. Operators are therefore increasingly entering into alliances and revenue share arrangements with third parties for content and other services. Determining whether the operator is acting as a principal or an agent in the delivery of service and content to end-users is a matter of judgment and will depend on the facts and circumstances of each case. If a bigger part of current income from regulatory products and services is earned as an agent, revenue will decrease. However, as the costs will decrease with the same amount, the reported margins and return measures in the regulatory accounts will not be impacted.

5.2.2. Property Plant & Equipment

The costs involved in constructing a mobile or fixed network are substantial. The cost of network assets is usually one of the biggest items on a mobile or fixed operator’s balance sheet. Costs range from the fees payable to third party engineers to the internal costs of planning and financing the construction process. These costs must be incurred before any revenues can be generated. Further expenditure is then required to expand capacity to manage customer growth and improve the network in the light of technological changes.

Initial recognition

IAS 16 – “Property, plant and equipment” provides that an asset should be recognized when it is probable that future economic benefits associated with the asset will flow to the enterprise; and the cost of the asset to the enterprise can be measured reliably.

An asset should initially be recognized at cost. The cost of an item of property, plant and equipment comprises its purchase price and any directly attributable costs of bringing the asset to working condition for its intended use. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Any internal profits are eliminated in arriving at such costs.

Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in the production of a self-constructed asset should not be included in the cost of the asset.

According to IAS 16 standard examples of directly attributable costs of bringing an asset to working condition for its intended use are:

- The cost of site preparation,
- Initial delivery and handling costs,
- Installation costs,
- Professional fees such as for architects and engineers.

The impact of IAS 16 on the return measures in the regulatory accounts cannot be predicted as the impact is very much depending on the current accounting policies and the differences with IFRS.

Subsequent expenditure

Subsequent expenditure should only be capitalized where it demonstrably enhances the original asset such as by increasing capacity and/or functionality or by allowing for a substantial reduction of overhead costs. The costs of merely restoring the functions that have diminished through normal wear and tear should be treated as a repair cost and expensed as incurred. Higher current costs (offset by lower long term depreciation charges) and a lower asset base will reduce reported margins and return measures in the regulatory accounts.

Indirect costs

The significant amount of time and cost which is involved in constructing a network has led the majority of operators to capitalize some element of their internal costs. Such a treatment is reasonable so long as the cost can be viewed as being directly attributable to bringing the asset into its working condition.

Direct labour/indirect labour

Personnel costs should only be capitalized if they are incremental to normal operations. Where such costs are being capitalized, it is important to identify accurately the percentage of man-hours spent by each department on the construction of the network. Ideally this should be done by reviewing timesheets of the individuals, or based on a job cost system in the relevant department. In the early stages of development this may include the costs of the management, finance and administration departments although as the marketing and sales activities of the organization develop, the percentages attributed to these departments should reduce dramatically. The percentages identified should be reviewed on a regular basis.

Fair value

Under IFRS it is possible to apply fair value accounting to all or part of the fixed assets. This could either be applied by revaluing the existing asset base and continue depreciating based on this new value or by applying fair value on a continuous basis. The fair value of the assets should be determined based on external valuation reports (preferred) or by applying the deemed cost concept (e.g. revaluing existing assets based on current price levels). The impact on the regulatory accounts cannot be estimated, as the application of the fair value concept can have a positive and negative impact on the book value and depreciation of the fixed assets.

Depreciation methodology

Network assets are often one of the most significant items on an operator's balance sheet. The method used to determine depreciation costs of network assets is also likely to be significant to the income statement of operators.

The depreciable amount of an item of property, plant and equipment should be allocated on a systematic basis over its useful life. Furthermore, it should be decided which depreciation would be appropriate for network assets:

- Usage or subscriber basis?
- Straight-line basis from commencement?
- Usage basis during the start-up phase and then move to straight line?

The impact on the regulatory accounts cannot be estimated, however a depreciation method based on usage during the start-up phase and then move to straight line compared to a depreciation method applying straight line only will probably increase return measures in the start-up phase (lower depreciation costs, higher margins).

5.2.3. Other differences

There are also more common (cross industry) accounting principles under IFRS that need to be considered (e.g. pension accounting, share based compensation and financial instruments). As these accounting principles are not specific to the telecommunications industry, these are not discussed in this paper.

For more information please contact the PricewaterhouseCoopers InfoComm Advisory Group (Sander Kranenburg on +31 653 864 871 or Mark Allsop on +44 207 213 4892)

Warning: when applying individual accounting frameworks, readers must consult all the relevant accounting standards and, where applicable, their national law. Listed companies must also follow relevant securities regulations, for example the US Securities and Exchange Commission requirements and local Stock Exchange listing rules.

Appendix 1 - Summary of approach to regulatory reporting by country

	Cost accounting system actually in place for interconnection by SMP operators		Cost accounting system actually in place for unbundling by SMP operators		Deadline for implementation of a system based on current costs
	Cost base	Cost standard	Cost base	Cost standard	
Belgium	Historic/Current	1.1.1.3 FDC	Historic	Retail minus for full unbundling	Implemented for network assets
Denmark	Historic and best practice	FDC	Historic and best practice	FDC	LRAIC planned for 31.12.2002
Germany	Forward-looking costs	LRAIC	Forward-looking costs	LRAIC	Implemented
Greece	Current	LRAIC	Current	LRAIC	Ongoing implementation
Spain	Multistandard	Multistandard	Regulator Determined		Implemented
France	Current	LRIC + mark-up for common costs + specific costs	Current	LRIC + mark-up for common costs + specific costs	Work on LRIC completed; official decision to move to LRIC to be taken for the 2003 offer
Ireland	LRAIC	LRIC	Historic	FDC	LRIC planned for 1.4.03
Italy	Current	FDC	Historic	FDC	Implemented
Luxembourg	Historic	FDC			LRIC in principle for the RIO 2001 and 2002
Netherlands	Current	EDC for originating i/c Bottom-up LRIC for terminating i/c	Current	EDC	Implemented
Austria	Current	FDC	Current	FDC	Implemented
Portugal	Historic, forward-looking and current	FDC	Regulator determined		No deadline fixed
Finland	Historic/Current	Company specific	Historic/Current	Company specific	Ongoing implementation
Sweden	Historic	FDC	Historic	FDC	Planned for January 2004
UK	BT: Forward looking/current Concert: Forward looking/current Kingston ommunications: Forward looking/current	BT: LRIC + FDC Concert: LRIC + FDC Kingston Communications: CCA (Current Cost Accounting) + FDC	BT: Forward looking/current Concert: N/A Kingston ommunications: Forward looking/current	BT: LRIC + FDC Concert: N/A Kingston Communications: CCA + FDC	BT: Implemented Concert: Implemented Kingston Communications: Implemented for interconnection. For unbundling, to be implemented within the next 18 months

Legend:

LRIC: long-run incremental costs

FDC: fully distributed costs

LRAIC: long-run average incremental costs

EDC: embedded direct costs

