case study 3.3

Telecom Assets Overvalued in First Report

Telecom, New Zealand’s biggest phone company, overvalued its fixed assets in its first regulatory report to the Commerce Commission.

The regulator says Telecom overstated the value of its fixed assets by $711 million using current cost accounting (CCA) methodology, which takes into account current values then depreciated, in the 12 months ended 30 June 2009.

The commission prefers use of historical cost accounting (HCA), which takes the value of an asset at the time of purchase before considering depreciation.

The majority of this so-called ‘uplift’ in value came in Telecom’s passive network, which is essential for all fixed-line services such as voice and broadband.

Under HCA, the passive network is worth $4.2 billion or 33 percent of the company’s total fixed assets, compared to $5.4 billion, or 62 percent of total assets, under CCA.

‘The valuation methodologies of Telecom’s network can have an impact on the estimated cost of providing access and backhaul services to other providers,’ the Commission said.

‘To the extent that the CCA statement of financial performance is impacted by the increase in the value of fixed assets through net revaluation gains and the resulting increase in depreciation expense, this will flow through to product statements in the 2010 financial year.’

Telecom is required to provide financial statements to the Commerce Commission under part 2B of the Telecommunications Act 2001, providing financial information about its network, wholesale and retail activities as though they operated as independent entities in what’s known as accounting separation.

Telecommunications Commission Ross Patterson said the first year of regulatory reporting was always a transition year.

It ‘has highlighted areas where a reworking of the reporting requirements, particularly in relation to the attribution of income and expenses and valuation of Telecom’s fixed assets, is likely to be necessary,’ he said in a statement.

The Commerce Commission report questioned the non-financial data used as the basis for attributing costs and assets as not being independently verified.

It also flagged the lack of transparency in Telecom’s internal transfer charges between services groups as a hindrance to its report.

The regulator is seeking submissions on a discussion document it’s released in response to Telecom’s first report until 28 April.

Shares of Telecom rose 0.5 percent to $2.25 on Thursday and have fallen 13 percent in the past three months.

SOURCE: ‘Telecom Assets Overvalued in First Report’, *Business Day*, 15 April 2010. Last accessed 05 September 2013: http://www.stuff.co.nz/business/industries/3585746/Telecom-assets-overvalued-in-first-report

Questions

1 Historical cost accounting is an asset measurement method, which underpins conventional accounting practice. Write a memo to Telecom’s senior management advising of three additional methods for reporting non-current assets, explaining each of your selected methods. Your memo needs to include an explanation as to why ‘historical cost’ accounting may be preferred by the Commerce Commission.

2 Differentiate between ‘current cost’ and ‘historical cost’ accounting.

3 Critically discuss what is meant by the following phrase:

‘To the extent that the CCA statement of financial performance is impacted by the increase in the value of fixed assets through net revaluation gains and the resulting increase in depreciation expense, this will flow through to product statements in the 2010 financial year.’

4 Describe what is meant by the term ‘accounting separation’.

5 Why would it be important to provide an independent verification of the non-financial data used as the basis for attributing Telecom costs and assets? How might this be achieved?

6 What is meant by the term ‘transfer charges’?

7 Why is transparency in financial reporting important?