case study 3.3 solution

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.

**Memo**

Date: 14 March 2014

To: Telecom Senior Management

Re: Telecom Corporation of New Zealand Ltd Asset Valuation Update

From: Accounting 101 Student

CC: Accounting Lecturer

NZ Framework, discusses the measurement basis of non-current assets. NZ Framework states that the measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and statement of comprehensive income.

NZ Framework outlines different bases of measurement.

Historical cost – assets are recorded at the amount of cash or cash equivalents paid, or the fair value of the consideration given to acquire them at the time of the acquisition.

Current cost – assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or equivalent asset was acquired currently.

Realisable (settlement) value – assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.

Present value – assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

‘Historical cost’ accounting may be preferred by the Commerce Commission as it may be seen as a more reliable means of asset valuation, in that very little assumption and professional judgement needs to be made when using the historical value of an asset, as it is objective in that cash exchanged hands in a business transaction for the stated amount and a receipt is obtained as proof. This, however, needs to be balanced by the fact that the use of historical data may not prove relevant in that the information may be out of date and no longer relevant to today’s market value of assets.

There is a growing tendency for many non-current assets to be valued on the basis of market values in order to provide more-relevant information. Examples of such valuations are:

* Property, plant and equipment can be revalued to ‘fair value’, which is commonly defined as an exchange price between an independent, knowledgeable, and willing buyer and seller.
* Assets of a life insurer (for example, investments) must be measured at net market value, which is the amount that could be expected to be received from disposal after deducting the expected costs of disposal.
* Leased assets and other assets subject to deferred settlement should be valued on the basis of the present value of expected future settlement payments, using an appropriate discount rate.
* Biological assets are to be recorded at fair value.

These bases of measurement are permitted by either the NZ Framework or specific accounting standards, such as NZ IAS 16, ‘Property, Plant and Equipment’. This is a much contested area of accounting judgement and consensus has not yet been achievable – illustrated at a global level where professional accounting bodies from various jurisdictions fail to agree on this issue.

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

Current cost accounting (CCA) attempts to provide more realistic book values by valuing assets at current replacement cost, rather than the amount actually paid for them. The current cost is usually calculated by adjusting the historical cost for inflation, in addition to the usual adjustments such as depreciation.

CCA is more complex than historical cost accounting (HCA), and attempts to implement it tend to create controversy over what adjustments are appropriate (requires the use of professional judgement).

HCA is an approach to accounting using asset values based on the actual amount on money paid for assets with no inflation adjustment.

Although the use of HCA excludes routine adjustments for inflation, the cost still needs several adjustments when calculating the book value. The most important of these are depreciation, depletion (depreciation for assets that are used up in a directly measurable way), and impairment. (Impairment is when the value of an asset, as shown in the balance sheet, exceeds its actual value to a company, which means the amount shown in the balance sheet needs to be reduced. This reduction is shown as a cost in the statement of comprehensive income.)

In addition, although current accounting standards are largely based on HCA, there are exceptions such as the use of fair value, net realisable value and other revaluations.

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

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.’

Telecom has reported using current cost accounting, which means their non-current assets have been overvalued by $1.2 billion. This increase in assets would lead to an increase in the assets revaluation reserve and the asset increase itself as reported in the balance sheet. This increase in assets would also have the effect of increasing the depreciation amount charged in the statement of comprehensive income, resulting in a lower net profit and therefore a reduction in tax expense.

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

Accounting separation requires a de-consolidation of a holding company’s financial statements so that the costs and revenues associated with each subsidiary or unit can be individually identified and allocated.

In this case, Telecom would provide information under its different entities including network, wholesale, and retail activities as though they operated as independent entities.

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?

Often when measuring assets and determining their value for inclusion in the balance sheet, professional judgement is required from senior management, accountants, and so on.

Management will often make decisions based on information collated, both of a financial and non-financial nature. An independent verification may often be required as non-financial information, by its very nature, is often subjective, suitable only for a certain specific situation and less reliable than financial information.

This might be achieved through:

• the use of an independent valuation company and their expert advice

• consultancy advice from an accounting firm

• official statistics

• competitor analysis

• statistics provided from Inland Revenue Department.

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

Transfer charges refer to transfer pricing, which is a price charged by individual entities for goods or services supplied to one another in multi-department, multi-office or multinational firms. Tax authorities usually insist that each internal part of the firm deals with the other on ‘arm’s length’ (market price) basis.

7 Why is transparency in financial reporting important?

Transparency in financial reporting is important, as the financial statements prepared by the accountant are often the main form of communication between Telecom’s directors (senior management) and the shareholders.

A heightened level of disclosure in the financial statements will lead to increased transparency so that shareholders are able to see exactly what has occurred in terms of financial performance and position for that year.

This maximum degree of disclosure to which agreements, dealings, practices and transactions are open to all for verification, enables an increased degree of collaboration, cooperation and collective decision making among interested parties.