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Dear Simon

Independent advice on the basis of accounting for disposals of assets in Telstra's regulatory asset base for fixed line services

1. Background

The Australian Competition and Consumer Commission (**ACCC)** published in June 2015 a "Further Draft Decision – Outstanding Issues", concerning its current public inquiry into final access determinations for fixed line services – primary price terms (the **Further Draft Decision**).

Section 4.4.3 of the Further Draft Decision sets out why the ACCC considers assets made redundant by NBN migration constitute asset disposals, consistent with Australian Accounting Standards (**Accounting Standards**) and Australian Accounting Standard AASB 116 "Property, plant and equipment" in particular. This matter is relevant to determining the inputs required by clause 6.7 "Roll-forward mechanism" of the ACCC's fixed principles provisions, to roll forward Telstra Corporation's regulatory asset base for fixed line services.

I have been asked by Gilbert + Tobin to advise on the Further Draft Decision's treatment of assets which are made redundant by NBN migration but which remain under Telstra's ownership and control. Specifically, I have been asked to advise on whether the treatment of these assets as "asset disposals" is consistent with Australian Accounting Standards.

2. Purpose

The sole purpose of this letter is to assist Gilbert & Tobin to provide advice to Telstra in relation to the ACCC's current Fixed Lines Services Final Access Determination Inquiry.

3. Scope

The findings in this letter are based on an independent review of the accounting basis for the ACCC's view set out on pages 74 and 75 of the Further Draft Decision that assets which become commercially obsolete or reach the end of their useful lives, are properly accounted for as disposals.

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The next section in this letter sets out the findings from this scope of work. Subsequent sections describe the bases of these findings and comprise:

- a comparison of statements set out in the Further Draft Decision, with relevant Accounting Standards and other relevant precedents; and
- commentary on the broader accounting implications of the ACCC's Further Draft Decision on the nature of asset disposals.

My training and experience are set out in the KPMG report to Gilbert and Tobin, *"The basis of accounting for disposals of assets in Telstra' regulatory asset base for fixed line services", April 2015* (**the KPMG April 2015 Report**)

I have read, understood and complied with Federal Court Practice Note CM7 (Expert witnesses in proceedings in the Federal Court of Australia) in preparing this letter.

4. Findings

At the head of page 75, the Further Draft Decision states that:

> *"The ACCC, having had regard to relevant cost accounting standards[1], and Telstra's confirmation of its compliance with such standards, is of the view that the removal of assets made redundant by NBN migration from the RAB by treating them as asset disposals is consistent with the fixed principles."*

The adoption of Accounting Standards as the relevant framework for determining accounting treatments is appropriate. Section 5.3 of the KPMG April 2015 Report explains the reasons for this view. These reasons include the authority and objectives for Australian Accounting Standards given by the *Corporations Act 2001* including Section 297 of the *Corporations Act 2001* which requires financial statements to give a true and fair view.

Further, the Australian Accounting Standards Board (**AASB**) Framework referred to in Section 5.3 of the KPMG April 2015 Report, emphasises the importance of neutrality in financial reports. For example, it states:

> *"To be reliable, the information contained in financial reports must be neutral, that is, free from bias. Financial reports are not neutral if, by the selection or presentation of information they influence the making of a decision or judgement in order to achieve a pre-determined outcome."[2]*

A purpose of Accounting Standards is to provide this neutrality.

However, the Further Draft Decision's treatment of assets which are made redundant by NBN migration but remain under Telstra's ownership and control, as disposals, is:

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[1] "Cost accounting standards" is not a recognised term in the Australian accounting framework. Presumably, the ACCC intended to refer to Australian Accounting Standards.

[2] AASB, Framework for the preparation and presentation of financial statements, July 2014, p. 19.

- inconsistent with Australian Accounting Standards;
- not advanced as part of a coherent principles based accounting framework that considers the consequential effects and requirements of the Further Draft Decision's treatment of disposals; and
- consequentially, is consistent with achieving a single purpose (of reducing Telstra's regulatory asset base) rather than a purpose of applying a bias free and outcome neutral, accounting framework.

4.1 Reasons

The principal reasons for these findings are that:

- The ACCC has incorrectly concluded on page 74 of the Further Draft Decision that under AASB 116, an asset is disposed of at the end of its useful life;
- The Further Draft Decision ascribes to 'disposal' a meaning that is inconsistent with:
  - precedents and guidance established by the AASB 's, "*Issues Paper Definition and application of residual value*, *AASB meeting 3-4 September 2014, Agenda Paper 17.2 (M140)* (**the AASB Issues paper**); and
  - the complementary requirements of AASB 116 Property, plant and equipment and AASB 118 'Revenue';
- The ACCC has considered "disposal" and "derecognition" to have the same meaning under Accounting Standards. It has not taken into account requirements of AASB 116:
  - to distinguish the derecognition of an asset's value arising from a disposal from that arising from reductions in future economic benefits; and
  - for disposals to only be accounted for when specific conditions are met, including both the transfer of significant risk and reward of ownership and the discontinuance of management involvement with an asset;
- The Further Draft Decision refers to an asset's 'useful life' in its interpretation and application of Accounting Standards. However, an asset's 'economic life' is the relevant test in the case of redundant assets. Australian Accounting Standards define and treat 'useful life' and 'economic life' differently;
- Page 75 of the Further Draft Decision also states:

  "The ACCC considers that whether or not an asset has been disposed of for the purpose of the building block approach in the fixed principle provisions should not be limited to a transaction whereby the asset has been sold, and should include circumstances in which an asset has ceased to be used."

  and

"As noted above, the ACCC considers that a relevant factor in determining whether an asset has been disposed of for the purposes of the building block model approach is whether it is commercially obsolescent – that is, if it is no longer required as a result of a change in market demand for the product or service output of the asset. Whether a disposal transaction occurs and the nature of such a transaction is incidental to this core factor."

Section 5.4 of the KPMG April 2015 Report describes how Australian access regulators including the ACCC, have since 1995, required businesses to report financial information under Accounting Standards for the purposes of regulators implementing building blocks regulation or monitoring prices using a building blocks approach. These examples include the ACCC and AER.

However, for the reasons given in this letter, the ACCC's view cited above that commercial obsolescence is a relevant factor in determining whether an asset has been disposed of, is inconsistent with Accounting Standards. Commercial obsolescence is relevant to the derecognition of value through impairment or depreciation, but it does not fall within the ambit of a disposal under Accounting Standards.

In particular, the view in the last sentence of the second extract from the Further Draft Decision cited above that a disposal transaction is incidental to determining whether an asset is disposed, contradicts Accounting Standards. A disposal transaction is necessary for a disposal; and

- Having postulated a definition of a disposal that is specific to Telstra's Fixed Line Services' regulatory asset base, the Further Draft Decision does not consider how the accounting framework will determine on a mutually consistent basis:
  - the other components including deprecation and capex, of the roll forward mechanism in fixed principle 6.7. For example if a loss arises on disposal, then consistent with paragraph 67 of AASB 116 and the AASB requirement for accounting neutrality referred to above, the resulting loss would be accounted for under fixed principle 6.7, as depreciation; and
  - broader accounting and reconciliation issues arise from Telstra being required to account for regulatory purposes, contrary to statutory obligations, disposals of assets over which it retains ownership and control.

5. Comparison of Further Draft Decision with Accounting Standards and other relevant precedents

On page 74 of the Further Draft Decision, the ACCC states that it has *"considered the Australian Accounting Standards Board's (AASB) approach to disposals*".

5.1 Definition of 'disposal'

On page 74 of the Further Draft Decision, the ACCC also:

- notes that the AASB has noted that the term 'disposal' is not defined in the Australian Accounting Standards and that the Board has referred to a common definition of that term

(Australian Accounting Standards Board, *Issues Paper Definition and application of residual value*, AASB meeting 3-4 September 2014, Agenda Paper 17.2 (M140), paragraph 6); and

- considers that 'disposals' has an 'ordinary meaning'.

While the Further Draft Decision does not provide a definition or expand on the 'ordinary meaning' of disposal, the AASB Issues Paper that the ACCC references, refers to various sources to describe the term 'disposal':

- paragraph 6 of the Issues Paper refers to Oxford Dictionaries http://www.oxforddictionaries.com/definition/english/disposal (accessed 14 August 2014) for the common definition of the term as '*the act or means of getting rid of something*';
- paragraph 7 states that the term 'disposal' is used throughout Australian Accounting Standards and cites as examples:
  - AASB 116 "Property, plant and equipment" paragraph 67. This example is specifically considered by this letter, below; and
  - AASB 5 which defines a 'disposal group' as being 'a group of assets to be disposed of, by sale or otherwise. . .'; and
- paragraph 8 observes that in the definition of residual value, and its use throughout Australian Accounting Standards, the requirement for disposal appears to limit the recognition of a residual value to circumstances when an entity relinquishes control of the asset to a third party. This paragraph of the Issues Paper cites paragraph 69 of AASB 116 as providing examples of disposal, being by sale, by entering into a finance lease or by donation.

5.2 The ACCC's interpretation of AASB 116

On page 74 of the Further Draft Decision, the ACCC states:

> *"Under the AASB Standard "Property, Plant and Equipment" (AASB 116) an asset is disposed at the end of its useful life."*

AASB 116 does not state this.

AASB 116 defines "useful life" as follows:

> *"Useful life is:*
>
> *(a) the period over which an asset is expected to be available for use by an entity; or*
>
> *(b) the number of production or similar units expected to be obtained from the asset by an entity."*[3]

[3] AASB 116, p12

Paragraph 57 of AASB 116 goes on to explain:

> *"The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets."*

Neither the definition nor the explanation in AASB 116 paragraph 57, require an asset to be accounted for as a disposal at the end of its useful life. To the extent that paragraph 57 envisages a disposal, it is in the context of a management decision on the method of recovery of asset value, not a mandatory accounting requirement.

Because AASB 116 simply does not require the disposal of an asset at the end of its useful life, the basis of the ACCC's assertion that this is a requirement of AASB 116, is a matter of speculation. It is possible that the ACCC may have interpreted a definition within AASB 116:

> *"Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability."*

as meaning that the end of a useful life necessitates a disposal. But:

- this does not follow from a reading of this definition;
- the disposal of an asset is not necessary to establish the present value of future cash flows arising from an asset; and
- in any event, it would be highly unusual for the AASB to bury what would be a core accounting requirement in a definition rather than to make it an explicit requirement within the body of the Accounting Standard.

The Further Draft Decision in stating that:

> *"…an asset **may** (KPMG emphasis) be disposed if it becomes commercially obsolescent"*

is correct in so far as obsolescence can normally be expected to result in the derecognition of asset value, and that derecognition does not necessitate disposal. As Section 5.3 of this letter explains, derecognition can arise from either the cessation of anticipated future economic benefits or from disposal. Obsolescence and disposal not necessarily related and are not synonymous.

The ACCC has formed a view that an asset is disposed of when its useful life has expired. It has not considered the economic life of an asset, which is distinguished from useful life by

Accounting Standards and specifically and separately defined in the AASB's Glossary of Defined Terms[4] as meaning:

> _Either:_
>
> _(a) the period over which an asset is expected to be economically usable by one or more users; or_
>
> _(b) the number of production or similar units expected to be obtained from the asset by one or more users._

An asset's useful life is not necessarily the same as its economic life as exemplified by paragraph 57 of AASB 116.

The ACCC has considered that an asset is disposed of when it:

> _"…..becomes commercially obsolete – that is, if it is no longer required as a result of a change in market demand for the product or service of the output of the asset."_

In these circumstances, it will have reached the end of its economic life as defined by Accounting Standards, but not its useful life if the asset remains available for use by the entity. Accordingly, even if the ACCC's view that the expiry of useful life constitutes a disposal under Accounting Standards were to be valid, this view would not be relevant. This is because it is the expiry of an asset's economic life not its useful life, that is relevant to the circumstances indicated by the ACCC in the above extract from the Further Draft Decision.

Nonetheless, for the avoidance of doubt and for the sake of completeness of explanation, AASB 116 also has no requirement for an asset to be accounted for as a disposal when its economic life expires.

5.3 Matters in AASB 116 and other relevant Accounting Standards that the Further Draft Decision does not consider

The Further Draft Decision does not recognise that Accounting Standards provide two alternative paths for an asset's value to be "derecognised" (i.e. value is no longer recognised in an entity's financial statements), namely disposal or devaluation. Section 6.1 of the KPMG April 2015 Report explains that paragraph 67 of AASB 116 states that:

> _The carrying amount of an item of property, plant and equipment shall be derecognised:_
>
> _(a) on disposal;_ **_or_** (KPMG's emphasis)
>
> _(b) when no future economic benefits are expected from its use or disposal._

Sub-paragraphs (a) and (b) represent distinctly separate conditions that are not synonymous. For example:

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[4] AASB , Glossary of Defined Terms, September 2012, p 17.

- an asset does not have to be disposed of in order for no future economic benefits to be expected from its use or disposal. An example would be where an entity retains ownership of an obsolete asset that has zero scrap value or may require net cost to be incurred to scrap the asset; and
- an asset may be disposed of for valuable consideration, in which case condition (a) would be fulfilled, but not condition (b).

Conditions (a) and (b) are not necessarily mutually exclusive, but both conditions would only be fulfilled when an entity relinquishes ownership with no sale proceeds.

To assess whether the conditions of sub-paragraph 67(a) of AASB 116 have been met, it is necessary to have a clear understanding of what constitutes a disposal. Section 3.1 describes how the ACCC considers how 'disposals' has an ordinary meaning and has referenced the AASB's sources for definitions of the term for the purpose of its "*Issue Paper Definition and application of residual value*".

Additionally, paragraph 69 of AASB 116 "Property, Plant and Equipment" states that:

> *"The disposal of an item of property, plant and equipment may occur in a variety of ways (e.g. by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an entity applies the criteria in AASB 118 for recognising revenue from the sale of goods."*

Because the date of a disposal cannot exist without the disposal itself occurring, the criteria of paragraph 14 of AASB 118 "Revenue" are used to recognise the disposal of an item of property, plant and equipment under AASB 116. Section 6.1 of the KPMG April 2015 Report also sets out these criteria:

> *"Revenue from the sale of goods shall be recognised when* ***all*** *(author's emphasis) the following conditions have been satisfied:*
>
> *a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*
>
> *b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*
>
> *c) the amount of revenue can be measured reliably;*
>
> *d) it is probable that the economic benefits associated with the transaction will flow to the entity; and*
>
> *e) the costs incurred or to be incurred in respect of the transaction can be measured reliably."*

To satisfy these conditions:

- it is not necessary for there to be revenue. Condition c) is met where an absence of consideration is reliably established; and

- it is not necessary for there to be economic benefits associated with the transactions (e.g. donations) but where they do exist, it is necessary that it is probable that they will flow to the entity making the disposal.

Paragraph 14 of AASB 118 indicates that each of its conditions is critical to the recognition of a disposal. With regard to sub-paragraph (a), Section 6.1 of the KPMG April 2015 Report also sets out the following additional guidance provided by paragraph 15 of AASB 118 on the transfer of risk and rewards of ownership:

> *"The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession."*

The conditions that have to be met for a disposal to be recognised require, as a minimum:

- the transfer of the risks and rewards of ownership; and
- the discontinuation of management involvement to the degree usually associated with ownership or effective control of an asset.

The expiry of an asset's useful or economic life does not meet these criteria and the Further Draft Decision is inconsistent with paragraph 15 of AASB 118 because it has not examined the circumstances of the transaction it considers to be a disposal to assess whether the conditions of paragraph 14 of AASB 118, necessary for a disposal to be recognised, have been fulfilled.

The situation where an asset that remains under an entity's ownership becomes commercially obsolete, envisaged by pages 74 and 75 of the Further Draft Decision, is consistent with Accounting Standards' requirements for the recognition of an impairment loss, not a disposal. This is because

- Paragraph 30 of AASB 116 requires that:

  "After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses."

- AASB 116[5] and AASB 136[6] Impairment Losses, define:

  "An impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount." and

- Paragraph 12 of AASB 136 also states that:

[5] AASB 116, p12
[6] AASB 136, p15

"In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:"

Paragraph 12 of AASB 136 provides 4 indications that include

(b) *"significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated;"*

6. The accounting implications of the recognition of asset disposals adopted by the Further Draft Decision

The ACCC's interpretation of Accounting Standards in the Further Draft Decision is that an entity is required to account for disposals of assets it may continue to own. This would be highly problematic, where continuing responsibility or liability for the asset attaches to the owner, or where the physical disposal or scrapping of the asset may involve the owner incurring cost.

Where a liability may arise or other costs are incurred, those costs need to be settled and accounted for. But the ACCC's interpretation of Accounting Standards, this would lead to a contradictory accounting position in these circumstances. The ACCC's interpretation would require an entity to continue to account for an asset and any future liabilities and costs that may accrue to it, after a disposal of the asset had been accounted for.

The ACCC's interpretation does not distinguish disposals of assets that an entity no longer owns from 'disposals' of assets (as interpreted by the ACCC) which an entity may continue to own. Such a distinction is necessary to distinguish requirements for an entity to account for the liabilities, costs and potential future benefits (such as increases in future value or revenues) that accrue to assets an entity owns from those that accrue to assets it does not own and should not account for.

For example if this distinction were not in place, an entity could account for revenues or valuation changes from assets it no longer owns and is responsible for. This would be both an economically irrational outcome and provide a true and fair view of the entity's financial performance.

The Further Draft Decision has not considered the interaction between disposals and residual asset values. Where an asset that is to be disposed has a residual value including a scrap value for example, that asset value needs to be recognised in an entity's fixed asset accounting records until the disposal value is realised by the asset being scrapped for example. The Further Draft Decision's interpretation of "disposal" has the effect of not recognising any asset value and hence is inconsistent with this accounting requirement.

The crux of the matter is that it is necessary for an accounting framework to associate asset ownership with the accrual of costs, risks and benefits that attach to assets. Accounting Standards including paragraph 67 of AASB 116 and paragraph 14 of AASB 118, do this. The interpretation and application of 'disposal' provided by the Further Draft Decision, does not.

7. Important notice

I have made all the inquiries that I believe are desirable and appropriate and that no matters of significance that I regard as relevant have, to my knowledge, been withheld from the Court.

The purpose of this letter is set out in Section 2 and it is not to be used for any other purpose without KPMG's prior written consent.

Accordingly, neither I nor KPMG accept responsibility in any way whatsoever for the use of this letter for any purpose other than that for which it has been prepared.

Nothing in this letter should be taken to imply that I have verified any information supplied to me, or have in any way carried out an audit of any information supplied to me other than as expressly stated in this letter.

The analysis in this letter is based on the information set out in this letter. I reserve the right to amend any conclusions, if necessary, should any further information become available.

Yours sincerely

Keith Lockey
Director