**PUBLIC VERSION**

This paper is prepared as part of the response by Telecom (NZ) Ltd to the draft report of the Commerce Commission investigation into regulation of mobile termination, dated 18 October 2004.

# COMMENT ON THE FINANCIAL STATEMENTS PREPARED BY THE WIRELESS DIVISION OF TELECOM (NZ) LTD

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30 November, 2004

This paper has been prepared for inclusion with the response by Telecom (NZ) Ltd to the draft report of the Commerce Commission investigation into regulation of mobile termination. A summary of my credentials and work experience are in an attachment to this paper. Apart from this assignment, I have no association with Telecom (NZ) Ltd, and I have no association with Stern Stewart and Co, the proprietors of the EVA trademark. I provide my comments from an independent standpoint.

## The financial statements of the Wireless Division

As part of its response to the draft report, Telecom has prepared summary financial statements for a ***[ ]TCNZRI*** year period for the company's Wireless Division. This information is attached to Telecom's submission as Annex E. The information is in columnar form with a column for each of the years commencing ***[ ]TCNZRI***.

## The purpose of this paper

The summary financial statements have been prepared on an "EVA" basis. The purpose of this paper is to explain the EVA approach, and to provide assurance to the Commerce Commission that the presentation on the EVA basis is a credible portrayal of the net assets and results of operations of the Wireless Division of Telecom for the ***[ ]TCNZRI*** year period.

**The meaning of EVA**

"EVA" means "Economic Value Added". The terms "EVA" and "Economic Value Added" are registered trade marks of Stern Stewart & Co, an international financial organization with headquarters in New York. Telecom, along with many other companies, use the EVA basis for presentation of financial information for internal reporting to management and the board. It is used as the basis for setting targets and for measuring performance, and for setting the "at risk" component of remuneration for company executives.

I am advised that the Wireless Division EVA model was first established by Telecom at the time Telecom was considering the divestiture of Telecom Mobile as a separate entity.

Financial information prepared on an EVA basis is not significantly different from the information found in financial statements prepared in the conventional manner. Telecom uses a "simplified" (but wholly acceptable) form of EVA measurement. The figures in the Telecom EVA presentation can be easily reconciled with a conventional presentation, as follows:

The Net Profit

Net profit on the EVA basis is the same as conventional net profit after tax, except that there is the add back of the cost of interest on borrowings and the add back of the amortisation of goodwill. In addition, abnormal revenues and expenses are excluded from the profit calculation.

The Net Capital Employed

Net Capital on the EVA basis is the same as the conventional calculation (i.e. assets less liabilities) except that interest bearing liabilities are excluded and regarded as part of the net capital. Goodwill and Brand Names (which are purchased assets for this company and not internally generated assets) are included in total assets at their cost. This is consistent with the amortisation of goodwill being excluded from the net profit calculation, and closer to the practice that will be adopted by all New Zealand companies when there is compliance with International Financial Reporting Standards commencing from 2005.

Added Value

A capital charge is applied to the EVA net capital – being the weighted cost of capital for borrowings and equity employed in the company. This capital charge is deducted from the EVA net profit. If there is a surplus after the deduction of the capital charge, then this is a true surplus that is added value to the business. This is described as Economic Value Added.

The goal of a company using the EVA approach is to ensure that there is some Economic Value Added from the profit calculation. This is designed to overcome misleading signals from the conventional profit calculation. The company may show a surplus on the conventional basis, and pay taxation on the surplus, but the total wealth of the company is eroded (and the company is worse off rather than better off) if that surplus does not cover the cost of all the capital employed, including the equity of the shareholders.

**A review of the EVA financial statements**

I have the following comments on the EVA financial statements that are attached:

The capital charge is calculated at ***[ ]TCNZRI***. ***[***

***]COI***

**My conclusions on the reliability of the financial statements for the Division**

As mentioned earlier, these accounts have been used within the business as the basis for setting targets and measuring performance, and for establishing the remuneration for senior executives. The Wireless Division EVA model was first established when Telecom Mobile was potentially being considered for divestiture as a separate entity. When it is known that such reliance is placed on the information by executives within the organization, there can be some assurance that the figures fairly represent the capital base and the results of operations of the Division.

There is no doubting that the EVA approach to presentation of results is sound in principle, and most useful to management and the board when making decisions on the administration of a business. The approach is now widely adopted by major corporations throughout the world.

Based on my enquiries, and review of the schedule that is attached, in my opinion the principles of the EVA approach have been properly applied when preparing the schedule, and the resulting information is appropriate for fairly reflecting the net assets and results of operations of the Wireless Division of Telecom for the ***[ ] TCNZRI*** year period.

Don G. Trow
30 November 2004