هيئة الاتصالات وتقنية المعلومات
Communications and Information Technology Commission

ACCOUNTING SEPARATION POLICY

May 2004

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ACCOUNTING SEPARATION POLICY

1. Introduction

Along with the liberalization of telecommunications services in Saudi Arabia comes an obligation to ensure fair and effective competition. In order to meet this obligation the CITC is implementing an Accounting Separation policy to detect and prevent the occurrence of cross-subsidy.

Cross-subsidy is typically an issue when the dominant service provider operates in both monopoly and competitive markets. In such situations, accounting separation, which requires separate financial reports for the monopoly and individual competitive services, can help guard against anti-competitive practices such as cross-subsidy.

The accounting separation policy contained herein attempts to provide a balance between the detailed accounting separation required in some regulatory jurisdictions, and the situation actually faced by STC in the Kingdom.

2. Competition issues

The CITC is in the process of introducing competition in the telecommunications sector on a gradual basis, complying with relevant CITC statutes and the Council of Ministers' resolution No. 171 dated 2/7/1423H (10/9/2002G). competition in the telecommunications market is expected to increase with the liberalization of the mobile and data markets in 2004G and the landline telephony market after 2006. Other services such as Internet and VSAT have already been opened to competition.

As long as there remains one dominant operator, the CITC must ensure that competition is not impeded or adversely affected by anti-competitive behaviour. The benefits of competition must be allowed to reach all users. These benefits include the delivery of new and highly efficient telecommunications services with lower prices, higher telecom sector employment and increased investment.

The CITC must ensure the presence of an even playing field for both new and existing service providers. New entrants must be provided with a fair environment in which to compete. The dominant service provider must be provided with the opportunity to compete without unnecessary rules and regulations.

The incumbent has the economic incentive to use monopoly services to cross-subsidize competitive services. This can happen as long as the incumbent provides monopoly services (for example, fixed line services) and competitive services (for example, mobile) under the same corporate structure. The costs of services and the corresponding revenues must be determined for each of the competitive and monopoly segments. It is this determination that leads to a requirement for accounting separation.

3. Legal & regulatory issues-the Telecommunications Act and Bylaws

The experience of other regulators has shown that under conditions of emerging competition, regulation of the incumbent is necessary. The objective of the CITC as set out in the Telecommunications Act is to "ensure creation of [a] favorable atmosphere to promote and encourage fair competition in all fields of telecommunications. " In addition the Act states, "Any operator dominating a certain telecommunications market or part of it shall not undertake any activities or actions which are considered an abuse of his position."

The Telecommunications Bylaw provides that the CITC shall perform a number of functions designed to monitor and prevent abuses of a service provider's dominant position. This also includes attempting to detect an abuse of a dominant position such as cross-subsidy which negatively impacts competitors.

4. Objective of accounting separation

The objective of accounting separation is to provide separate financial statements for each business entity as if it were a stand-alone business. Separating the segments will provide the opportunity to judge whether there is a cross-subsidy flowing from the monopoly segment to competitive segments.

Accounting separation requires the preparation of separate accounts for each of the different businesses run by the same company, by identifying and allocating the costs and revenues associated with each business as well as the dealings between them.

The CITC is aware that a number of telecommunications regulators require that business operations be divided into separate retail and wholesale business, so that charges between the two segments may be explicitly observed. The CITC may consider such splits in the future, if they are required to ensure fair competition, however, retail and wholesale splits are not required at this time.

5. Accounting separation approach

The approach to be implemented by the dominant service provider will include the separation, on an accounting basis, of the Monopoly segment from various competitive segments. The CITC has determined that in order to achieve the objective stated above, the dominant service provider is required to create three segments in the competitive sector - Mobile, Data and Other. The general principle to be applied in categorizing services into each of these segments is as follows: The Mobile segment should include all GSM services offered by STC and any 3G services that may be offered when STC is licensed to provide such services. The Data segment should include all public data telecommunications services such as analogue and digital leased lines, VPN, ATM, IP, Frame Relay and international data services. The Other segment should include VSAT, Internet, and the remaining competitive services. The dominant service provider is to propose a detailed schedule of services for each of the four segments in its filing as per the schedule outlined in Section 11.

6. *Accounting principles to be used in accounting separation*

a. Cost causation

Revenues and costs should be allocated to the monopoly and competitive segments on the basis of causation. Costs and revenues should be allocated to those services or products that cause the revenue or cost to arise. For example, competitive costs must be causally related to the provision of a service in the relevant competitive segment, i.e., Mobile, Data or Other.

In principle, each cost or revenue item should be reviewed, and the driver, or the activity that caused the cost to be incurred or the revenue to be earned, should be identified. The cost or revenue item should then be attributed to the monopoly or competitive segment in which the activity is undertaken.

Asset and liability accounts must also be allocated between competitive and monopoly segments to allow for the calculation of rates of return on shareholders' equity for each of the four segments. These rates of return will permit an assessment of whether there is a cross-subsidy flowing from the monopoly segment to one of the competitive segments.

Cost causation will involve judgements on some matters, so it is important that the basis for these attribution methods be easily applied and transparent. In some cases causality can only be ascertained by examining historical data through a special study, using statistical analysis. In the event that costs can't be assigned to a specific competitive category they should be included as a common cost.

b. Cost basis

The Historical Cost Accounting (HCA) approach is to be used by the dominant service provider. The cost basis, as well as other accounting principles used in preparing the separated financial results for the monopoly and competitive segments, must be consistent and in conformity with Saudi Arabian Generally Accepted Accounting Principles (GAAP). These are the same principles used today by STC in preparing its audited financial statements.

c. Allocation methods

Allocation of costs, revenues, assets and liabilities must be on a clear, rational, and easily understandable basis. The methods of allocation and determination should be consistent over time. If changes in allocation are necessary, they should be identified to the CITC for approval. As well, costs and assets should be accumulated into groups or pools for allocation. These pools should be material in terms of financial magnitude.

To the extent possible, allocations should be made to the service generating the cost or generating the revenue. As well, the CITC believes it appropriate that where possible the allocations be based on resource usage, which drives costs and revenues. Allocations may be supported by special studies, historical data, or other methods.

These data, if supporting the allocation, may include non-financial information that should separately be disclosed to the CITC.

d. Common costs

Common costs are by definition, shared costs that can not be causally linked to individual services. In general, the percentage of common to total costs should be a small amount.

In the separated results common costs must first be individually identified then allocated to the monopoly and competitive segments using the most appropriate methodology.

7. Transfer pricing

The concept of transfer pricing applies to the cost of internal use of equipment, facilities or services provided from one the dominant service provider business operation to another. Transfer prices should be non-discriminatory, transparent and should be based on clear and supportable rationale. Accordingly, the dominant service provider must identify all services provided by one segment and used by another. The transfer price should be equivalent to the charge that would be obtained from the dominant service provider if such equipment, facilities or services were to be provided to other service providers. However, there may be economies of scope derived from the utilization of common resources, which may alter this equivalence. The CITC does not intend to eliminate these efficiencies, only to account for the use of common facilities on a fair and transparent basis.

8. Reporting requirements

a. Applicability

It is expected that STC will remain the dominant service provider for a period of time. As such, separated STC results will be required for the duration of such dominance. In the future it will be necessary to reconsider this matter in accordance with changes to the status of STC as a dominant service provider.

It should be noted that CITC will take action against new entrants if anti-competitive behaviour is detected.

b. Accounting Standards

Currently STC's audited financial statements are prepared in conformity with Saudi Arabian Generally Accepted Accounting Principles (GAAP). These standards are issued by the Saudi Organization for Certified Public Accountants (SOCPA), which functions under the supervision of the Ministry of Commerce and Industry. The CITC expects the same principles to apply to the separated financial results.

c. Auditing

The financial results prepared for accounting separation must be audited. The dominant service provider must also prepare a detailed accounting separation methodology specifically describing the allocation methodologies for revenues, expenses, assets and liabilities. As well, the allocation methodologies must define details of transfer pricing including the justification of transfer prices. Only when the methodology is fully documented and approved by the CITC can the accounting separation be properly audited. When separated results are added together, and inter-segment transfer pricing is accounted for, they should reconcile with the audited non-separated financial statements.

d. Frequency of reports

The dominant service provider is required to prepare and submit to the CITC separated financial statements on an annual basis The CITC may also require financial statements on a forecast (or budgeted) basis, and/or on a quarterly basis. In such circumstances the CITC will identify these requirements as they arise.

9. Financial statements to be prepared

a. Income statement, balance sheet and financial ratios

The publicly available audited financial statements include the statement of income, balance sheet, statement of changes in shareholder's equity and statement of cash flows. However, only the income statement and balance sheet will be required for accounting separation.

A prime measure of profitability is the rate of return on shareholders' equity. This profitability measure becomes one of the financial ratios that the CITC will use to assess whether there are cross-subsidies at work between the monopoly and competitive segments. As such, both the income statement and balance sheet will be required for accounting separation purposes.

b. Confidentiality

The separated financial statements prepared by the dominant service provider should be made public. However, the CITC recognizes, especially as competition evolves, that there may be reasons why select information may be considered confidential by the dominant service provider. Under the rules of procedure the dominant service provider has the right to claim confidentiality on select data. However, it remains up to STC to provide the necessary rationale for claiming confidentiality and demonstrating that the potential harm done to the dominant service provider by not making the selected information confidential, outweighs the benefit to the public, including the new operators, in making such information public. The final determination of confidentiality will be determined by CITC according to Article 11 of the CITC Rules of Procedure.

10. Other reports and information

The dominant service provider must provide a detailed description of all assumptions used for revenue, cost, asset and liability allocations. It is to be noted that STC may be requested to provide additional information and studies to support the allocation or estimation processes.

11. Regulatory Timing

STC is required to implement this policy in accordance with the guidelines outlined herein and the schedule provided below:

2Q 2004	CITC issues Final Accounting Separation Policy
3Q 2004	STC submits work plan, and draft methodology to implement accounting separation
3Q 2004	STC issues 2003 unaudited separated income statement, and unaudited separated balance sheet
1Q 2005	STC submits the final methodology for preparing separated results
2Q 2005	CITC approves methodology for preparing separated results
2Q 2005	STC issues 2004 audited financial results
2Q 2005	STC issues 2004 unaudited separated income statement, and unaudited separated balance sheet
2Q 2006	STC issues 2005 audited financial results
2Q 2006	STC issues 2005 audited separated income statement, and unaudited separated balance sheet
2Q 2007	STC issues 2006 audited financial results
2Q 2007	STC issues 2006 audited separated income statement, and audited separated balance sheet

12. Framework for STC to prepare separated results by segment

		Saudi Telecom Company (for the year ended December 31, 2002)	COMPETITIVE MOBILE	COMPETITIVE DATA	SEGMENT COMPETITIVE OTHER*	MONOPOLY FIXED	COMMON COSTS
Statement of Income (Saudi Riyals in thousands)							
Total operating revenues		23,547,065	[redacted]	[redacted]	[redacted]	[redacted]	
Services provided to other segments:			[redacted]	[redacted]	[redacted]	[redacted]	
To Data			[redacted]	[redacted]	[redacted]	[redacted]	
To Other			[redacted]	[redacted]	[redacted]	[redacted]	
To Fixed			[redacted]	[redacted]	[redacted]	[redacted]	
To Mobile			[redacted]	[redacted]	[redacted]	[redacted]	
Total operating revenues, including inter segment revenues			[redacted]	[redacted]	[redacted]	[redacted]	
Total operating expenses, before transfer pricing and allocation of common costs		-10,759,361	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Government charges		-6,299,389	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Access charges		-1,763,532	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Employee costs		-3,456,375	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Depreciation		-3,265,293	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
General and administrative expenses		-2,569,454	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Repairs and maintenance		-1,405,318	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Services acquired from other segments			[redacted]	[redacted]	[redacted]	[redacted]	
From Data			[redacted]	[redacted]	[redacted]	[redacted]	
From Other			[redacted]	[redacted]	[redacted]	[redacted]	
From Fixed			[redacted]	[redacted]	[redacted]	[redacted]	
From Mobile			[redacted]	[redacted]	[redacted]	[redacted]	
Total operating expenses, after transfer pricing, before allocation of common costs			[redacted]	[redacted]	[redacted]	[redacted]	
Common costs allocated to segments			[redacted]	[redacted]	[redacted]	[redacted]	TOTAL
Total operating expenses, including transfer pricing and allocation of common costs			[redacted]	[redacted]	[redacted]	[redacted]	
Operating Income		4,787,704	[redacted]	[redacted]	[redacted]	[redacted]	
Other income and expenses, net		-79,620	[redacted]	[redacted]	[redacted]	[redacted]	
Net Income before Non-recurring Items and Zakat		4,708,084	[redacted]	[redacted]	[redacted]	[redacted]	
Total non-recurring items		-1,070,000	[redacted]	[redacted]	[redacted]	[redacted]	
Net Income before Zakat		3,638,084	[redacted]	[redacted]	[redacted]	[redacted]	
Provision for Zakat		-92,250	[redacted]	[redacted]	[redacted]	[redacted]	
Net Income		3,545,834	[redacted]	[redacted]	[redacted]	[redacted]	
Net Investment (From Balance Sheet, Saudi Riyals in thousands)	As of December 31, 2001	As of December 31, 2002					
Total current assets	8,423,441	7,926,809	[redacted]	[redacted]	[redacted]	[redacted]	
Property, plant and equipment, net	29,870,474	32,018,244	[redacted]	[redacted]	[redacted]	[redacted]	
Investment in associates	667,151	769,634	[redacted]	[redacted]	[redacted]	[redacted]	
Other investments	136,565	112,090	[redacted]	[redacted]	[redacted]	[redacted]	
Other non-current assets	71,914	86,066	[redacted]	[redacted]	[redacted]	[redacted]	
Short-term borrowings	1,216,667	583,333	[redacted]	[redacted]	[redacted]	[redacted]	
Long-term borrowings	683,333	650,000	[redacted]	[redacted]	[redacted]	[redacted]	
Total liabilities	18,695,259	16,903,513	[redacted]	[redacted]	[redacted]	[redacted]	
Net Investment[1], equals Total Capitalization	22,374,286	25,242,663	[redacted]	[redacted]	[redacted]	[redacted]	
Capitalization Report							
Total shareholders' equity	20,474,286	24,009,330	[redacted]	[redacted]	[redacted]	[redacted]	
Short-term borrowings	1,216,667	583,333	[redacted]	[redacted]	[redacted]	[redacted]	
Long-term borrowings	683,333	650,000	[redacted]	[redacted]	[redacted]	[redacted]	
Total Capitalization, equals Net Investment	22,374,286	25,242,663	[redacted]	[redacted]	[redacted]	[redacted]	
Return on Average Common Equity							
Net Income		3,545,834	[redacted]	[redacted]	[redacted]	[redacted]	
Average common equity[2] (shareholders' equity)		22,241,808	[redacted]	[redacted]	[redacted]	[redacted]	
Rate of return on average common equity (%)		15.9%	[redacted]	[redacted]	[redacted]	[redacted]	

[1] Net Investment equals the sum of "Total current assets", "Property, plant and equipment", "Investment in associates", "Other investments", "Other non-current assets", "Short-term borrowings", and "Long-term borrowings", less "Total liabilities".
[2] Simple average of year end values.
* "Other" must include the VSAT segment and the Saudi Net segment.

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13. Glossary of terms

Accounting separation: the preparation of separate accounts for different businesses and parts of businesses run by the same company, so that the costs and revenues associated with each business (and transfers between them) can be separately identified and properly allocated.
Incumbent: Saudi Telecommunication Company
Cross-subsidization :to the extent it is not earning a profit within a corporate structure, that segment may be receiving financial support or a cross-subsidy from the profitable part of the same company. A segment of a firm may receive a benefit from not having appropriate costs allocated to it, or an over allocation of revenues to it such that it appears profitable when in fact it is not.
Common costs: costs that support a number of services or business segments of a company.
Retail: provision of goods and services to the final consumer, who does nothing more with the product but use or consume it.
Wholesale: provision of a service that is taken by the buyer and is added to in the way of additional features and value, and is then sold retail to the final consumer.
Cost Causation: means the attribution and allocation of cost (including transfer pricing), assets and liabilities to units in accordance with the activities, including revenue achievement, which cause the cost to be incurred and the assets to be acquired or liabilities to be incurred.
Transfer pricing: the price charged by a division of a firm (e.g. mobile) for services acquired from that division. The division that receives the service should report the amount as an expense (or capital) in the separated results for that division. The division that supplies the service should report offsetting revenue.
Economies of scope: cost savings that occur when two or more products are produced together, i.e. the provision of service B reduces the unit cost of supplying service A.
Historical cost accounting: (HCA)-a universally recognised accounting convention. Costs, revenues, assets and liabilities are generally recorded at the value when the transaction was incurred and where assets are valued and depreciated according to their cost at the time of purchase.