

24 October 2007

Mr David Strang
Chief Financial Officer
Multinet Group Holdings Pty Ltd
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1 Ricketts Road
Mount Waverley VIC 3149

Dear David

Multinet Group Holdings Pty Ltd (“Multinet”) – Advice on treatment of meter refurbishment costs

This letter responds to your request for advice on whether Multinet should expense or capitalise meter refurbishment costs under Australian equivalents to International Financial Reporting Standards (“AIFRSs”).

Background and Issues

In preparing annual regulatory accounting statements, we understand that Multinet has historically expensed all meter refurbishment costs, but that other distributors have capitalised these costs into their Regulatory Asset Base (“RAB”).

We understand that, in its draft price review decision, the Essential Services Commission Victoria (“the Commission”) has requested that all distributors now follow the same accounting principles and capitalise these meter refurbishment costs into their RAB, as the Commission considers that capitalising meter refurbishment costs is consistent with the matching principles used in financial accounting.

You have requested financial accounting advice in relation to:

1. The basis on which an entity is required to capitalise or expense expenditure on refurbishments; and
2. Whether it is reasonable to continue to expense refurbishment costs within Multinet.

Facts

Following its draft price review decision, the Commission requested that all distributors now follow the same accounting principles and capitalise meter refurbishment costs into their RAB. Consequently, the Commission transferred \$4.4m per annum of Multinet operating costs to capital expenditure in its draft price review decision.

Since privatisation in 1999, however, Multinet has always treated the refurbishment cost of meters as an expense item (while the original meter cost continues to be depreciated over its useful life).

Refurbishment costs generally arise following an annual meter test under which Multinet is required to sample test meters each year to ensure they remain in good working condition. This typically involves testing ‘meter families’ once they are 15 years old (Multinet gives meters a useful life of 30 years).

In cases when a meter is faulty, Multinet either replaces the meter with a new meter (removing the old meter from the fixed asset register and recognising the new meter) or repairs the meter (by performing sufficient work to ensure its original useful life, ie 30 years, is maintained).

New meter costs are capitalised, while repair costs are expensed in accordance with AASB 116 ‘Property, Plant and Equipment’ para 7, which states that:

“The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if...it is probable that future economic benefits associated with the item will flow to the entity...and the cost of the item can be measured reliably.”

As the refurbishments are merely ensuring that the useful life of the meter is maintained at its original level, Multinet has determined that refurbishment costs do not enhance the future economic benefits from the meters and accordingly, are expensed for financial accounting purposes. We agree with this treatment.

Further, in relation to subsequent costs, AASB 116 para 12 states:

*“Under the recognition principle in paragraph 7, an entity **does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred.** Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the **‘repairs and maintenance’** of the item of property, plant and equipment.”*

Were the costs determined to have ‘improved’ the meter or extended its useful life beyond that originally anticipated then, assuming the other recognition criteria was met (ie that the costs could be reliably measured) these costs would be recognised as capital, rather than through the profit and loss account (Income Statement). However, given this is not the case, Multinet has expensed these costs.

The situation described in AASB 116 para 14 provides another example of where costs may be capitalised, although only if the recognition criteria in AASB 116 para 7 are met:

“A condition of continuing to operate an item of property, plant and equipment (eg an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied.”

It could be argued that Multinet has a requirement to perform ‘regular inspections for faults’ under its distribution licence and could therefore capitalise an element of these refurbishment costs. However, given that Multinet has already determined that there is no future economic benefit associated with the refurbishment (as stated above), again, we consider that expensing such costs is an appropriate treatment.

Conclusion

We consider the treatment of refurbishment costs by Multinet to be reasonable from the point of view of AASB 116 ‘Property, Plant and Equipment’, and consider that continuing to expense such refurbishment costs (which do not enhance the future economic benefits of the meters) is appropriate from a financial accounting perspective.

Limitations

The company’s management is responsible for the selection and application of accounting treatments in the preparation and presentation of the financial report in accordance with AIFRSs. The views we have expressed in this letter are given in the context of assisting the company in applying an accounting treatment in accordance with AIFRS.

The advice in this letter is based solely on the information presented to us as summarised in this letter. We have not performed audit or review procedures on the transactions or balances underlying the accounting treatment described in this letter. Our engagement was not intended to be an assurance engagement, and we are unable to and do not express an opinion or make a statement about the underlying transactions or balances. Had we performed additional procedures or had we performed an audit or review in accordance with Australian Auditing Standards, other matters might have come to our attention that would have been reported to you.

This letter has been prepared solely for the information and use of the company. It should not be used for any other purpose or provided to other parties. We disclaim any assumption of responsibility for any reliance on this letter to any persons other than company, or for any person other than that for which it was prepared.

This letter has been provided in accordance with our letter of engagement, and all of the terms set out in that letter of engagement also apply to this letter of advice.

Please contact Michael Perry on 03 8650 7622 or Kester Brown on 03 8650 7632 if you have any questions concerning the content of this letter.

Yours sincerely



Ernst & Young
Melbourne