



Franchise Fee Accounting Procedures

Relating to

Comcast and AT&T

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Fall 2002

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INTRODUCTION

The Emerging Issues Task Force (EITF) recently ruled that franchise fees should be reported as part of gross revenue. Prior to this ruling, companies had the discretion to report franchise fees as part of gross revenue or as an offset against operating earnings. Comcast currently reports franchise fees as an offset against operating earnings, and opposes the new EITF ruling. The timeliness of clarification for this ruling is paramount to Comcast for two reasons. The first is because it is about to issue its 10-K report and a change in accounting procedures will inaccurately inflate their gross revenue totals. The second reason is that Comcast and AT&T Broadband account for franchise fees differently and clarification on this issue needs to be resolved prior to their pending merger by the end of 2002.

There are many recommendations and issued statements as to the accounting of franchise fees. Due to widely varying industries, business agreements and regulations, the issue is not very clear. To determine the proper accounting procedure one must examine the individual situation or industry. Further, one must recognize the importance of proper accounting procedures and their effect on company financial statements and how they are to be used by the industry.

ISSUE ANALYSIS

Our group has elected to oppose the recent EITF ruling with regards to franchise fees for the following reasons:

Whether or not franchise fees are recognized as gross revenue or netted against operating expenses, the end effect on net income is the same. However, this difference has far-reaching effects for companies where hundreds of millions of dollars in franchise fees are assessed each year, like those in the cable communications industry. For example, a common basis of comparison of cable communications companies customarily involves the "average revenue per subscriber". Lets

assume that two cable companies each charge \$50 per month with an additional \$5 for franchise fees, if both used different accounting policies, one would report average revenue per subscriber as \$50 and the other as \$55, for a difference of approximately 10%. Unless an investor makes the necessary adjustments, that investor will not be able to adequately compare the operating efficiency of these two companies.

In addition, Section 622c1 and 622e of The Communication Act of 1934 and its addendums allows cable operators to charge franchise fees by passing them through directly to subscribers. In doing so, the cable operator has the option to add this charge as a line item to the subscriber's bill. Comcast follows this ruling by billing its franchise fees as a pass through item. Comcast does not have any influence over the existence or the amount of the franchise fee and uses the pass through mechanism to inform the customer how much of their bill goes directly to the local municipality. Since the entire fee collected is passed from the customer to the municipality as a zero margin item, the fee should be offset against earnings on the income statement. By presenting the fee as a line item on a subscriber's bill, it is clear from the revenue collection aspect that the cable operator has no management control over the fee. Therefore, it should be stated separately to avoid the possible misinterpretation on the income statement.

Another issue has arisen regarding the pass through of franchise fees. Cable operators often have revenue from sources other than subscribers, which is also subject to the franchise fees. The City of Pasadena, California requested clarification from the FCC regarding this matter. The FCC responded that it is allowable for a cable operator to charge 100% of its franchise fee directly to subscribers, even when some of their revenue comes from non-subscriber services¹. However, the FCC Local and State Government Committee published their Advisory Recommendation No. 21, which states that cable operators should not charge

100% of the franchise fee to only one of several sources of revenue.² Another factor complicating the issue of franchise fees is the wide variance in opinions throughout industry. No real consensus exists because, given the freedom to do so, each company will adjust its financials to best suit its needs.

While neither of the two EITF documents addresses franchise fees directly, the documents do give some situations to determine if net or gross revenues should be used.

The majority of the examples given are centered on products that a company is selling to its customers. Whether or not these companies produce the product or resell it, the company takes physical ownership or title. As this is common practice to buy products and resell them, the conclusions were to report these earnings as a part of gross revenue. Other examples addressed the issues of service commissions. Companies reselling products or offering services where title is not obtained can use the net method because the company does not offer any fulfillment or customer service role in the delivery of the product.

Franchise fees, as stated are very similar to a line charge or tax. The company is not marketing its franchise fee and according to EITF 01-14, the franchise fee is similar to a pass-through cost, which has a zero margin and the cable company has no latitude in determining the pricing of the franchise fee. Until the SEC makes a clear determination of the treatment of franchise fees, ambiguity will continue to taint financial statements of these companies.

Presentation of the franchise fee is not the central issue. Comcast will have to pay the fee whether or not it presents it to the customer. Furthermore, the FCC authorizes Comcast to charge its customers the fee with zero margin; thus, making it a pass-thru cost. This fee is a little different than sales tax, as tax is a variable that increases or decreases with dollar sales volume. The fee is a

¹ <http://www.fcc.gov/statelocal/recommendation21.html>

² <http://www.naco.org/leg/platform/teletech/cablefran03.cfm>

fixed charge per customer no matter how many services Comcast provides. Franchise fees do not necessarily have to be included on each subscriber's bill to be a valid pass-thru cost.

Another factor complicating the issue of franchise fees is the wide variance in opinions throughout industry. Robert Herdman of Comcast states, "...diversity in practice has and continues to exist within the cable communications industry."³ No generally accepted consensus exists because, given the freedom to do so, each company will adjust its financials to best suit its needs.

It is useful to examine the reporting of several different companies and see if any generalizations can be made. As shown in exhibit 1, AOL Time Warner states that historically, franchise fees have been treated as an offset against operating earnings. By applying the guidelines of Topic D-103, revenues will increase by approximately \$300 million for 2002.

Another cable industry company, Cox Communications, also treats the fees as a pass through item, whereas Charter Communications reports them as part of gross revenue. This is shown in Exhibits 2 and 3.

The main argument against counting the fees as revenue is that it seems relatively deceptive given that the money is not exchanged for any type of goods or service. It is interesting then to compare the stock performance of companies who utilize each reporting style. While the whole sector experienced a large decrease in market cap, the firm that relied on the fees for revenues performed notably worse. As shown in Exhibits 4 through 7, the decrease in stock price from January 1, 2002 to September 9, 2000 for AOL Time Warner, Comcast, and Cox Communications was 63%, 43%, and 48% respectively. Charter Communications had a decrease of 87%. It is reasonable to assume that the motivation for including the fees was to try to improve the appearance of poor company performance.

³ Herdman, Robert K. *Income Statement Presentation of Franchise Fees*. 07 Mar 2002.

An analogous topic is “out-of-pocket” expenses, also covered by Topic D-103. Recently, most IT service firms were found to report these expenses on a net basis.⁴ This reinforces the idea that most mainstream companies tend to use this type of reporting. There is still a diversity in practice, however, where some weaker companies like to report these expenses as revenue.

SUMMARY

To adequately determine the issue of accounting for franchise fees, the issue of why we have financial reporting and standards must be examined. Financial reporting was created to allow investors both current and potential the access to the health of a company to determine whether to invest, divest, value the company or effectiveness of management. Without this insight, outside investments in a company would be impossible. However, until standards were implemented, it was impossible to compare the success of a company with another due to inconsistencies in the way different corporations accounted for different income and expense items. Thus the FASB and accounting standards were created. Now investors had the access and consistency they needed to make informed investment decisions. The issue before us has to deal with both consistency and adequately representing the real revenue generated by a company and the control over which management has control over those revenues. It is recommended that the EITF make a final ruling for consistency sake. It is also recommended that the EITF rule that franchise fees be accounted as a pass through expense due management’s lack of control over these fees and that by including these fees as gross revenue would misrepresent the real revenue generated by the company.

⁴ Casco Jr., Edward S. and Fendley, Clinton D. *Account Change to Affect Margin Presentation*. 15 Jan, 2002

EXHIBIT 1: NOTES FROM AOL/TIME WARNER

AOL TIME WARNER INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

D-103"). Topic D-103 requires that reimbursements received for out-of-pocket expenses be classified as revenue on the income statement and will be effective for AOL Time Warner in the first quarter of 2002. As a result of this classification change, AOL Time Warner will present cable franchise taxes collected from subscribers as revenues. As a result of applying the guidance of Topic D-103, AOL Time Warner management believes that the Company's revenues and costs will be increased by an equal amount of approximately \$280-\$320 million, having no impact on operating income or EBITDA. Once adopted, the new guidance requires retroactive restatement of all periods presented to reflect the new accounting provisions.

AOL Time Warner 2001 Annual Report, P43

EXHIBIT 2: NOTES FROM CHARTER COMMUNICATIONS

Overview of Operations

Approximately 85% of our revenues for the year ended December 31, 2001 are attributable to monthly subscription fees charged to customers for our basic, expanded basic, premium and digital cable television programming services, Internet access through television-based service, dial-up telephone modems and high-speed cable modem service, equipment rental and ancillary services provided by our cable systems. The remaining 15% of revenue is derived primarily from installation and reconnection fees charged to customers to commence or reinstate service, pay-per-view programming, advertising revenues, commissions related to the sale of merchandise by home shopping services and franchise fees. We have generated increased revenues in each of the past three years, primarily through customer growth from acquisitions, internal customer growth, basic and expanded tier price increases and revenues from new services and products.

Charter Communications 2001 Annual Report, P16

EXHIBIT 3: NOTES FROM COX COMMUNICATIONS

2. Summary of Significant Accounting Policies and Other Items (Continued)

At the November 2001 meeting of the Emerging Issues Task Force, or EITF, the FASB staff announced their position regarding the classification of reimbursements for out-of-pocket expenses. The FASB staff believes that these reimbursements should be classified as revenue in the statements of operations. The staff announcement, which will be codified in EITF Topic No. 01-14, is effective for fiscal years beginning after December 15, 2001 and will require comparative financial statements for prior periods to be reclassified. Cox is currently assessing the impact of this announcement, which will be adopted in the first quarter of 2002, on its consolidated financial statements.

Reclassifications

Certain amounts in the 2000 and 1999 consolidated financial statements have been reclassified for comparative purposes with 2001.

Cox Communications 2001 Annual Report, P52

Exhibit 4: AOL TIME WARNER STOCK PERFORMANCE

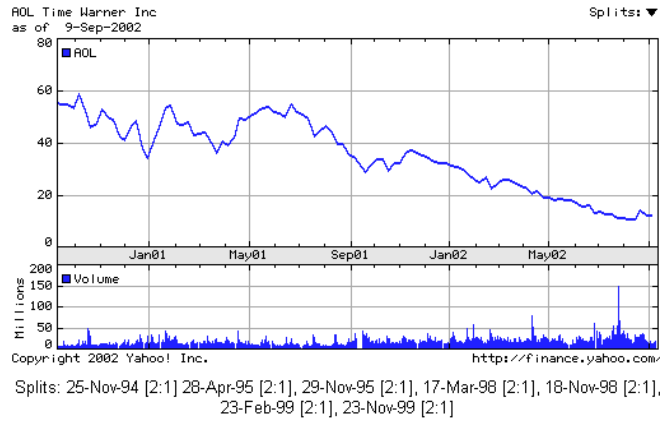


Exhibit 5: CHARTER COMMUNICATIONS STOCK PERFORMANCE

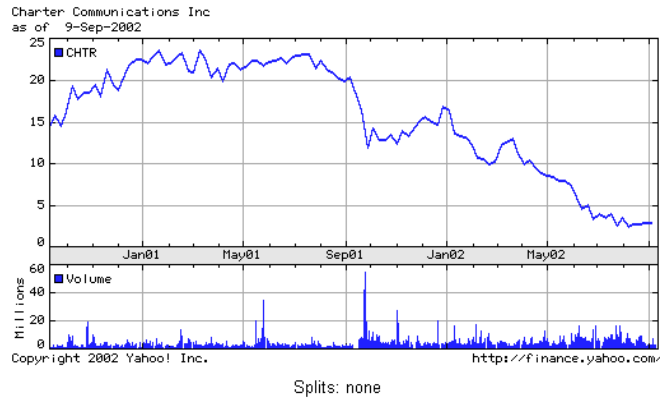


Exhibit 6: COMCAST CORPORATION STOCK PERFORMANCE

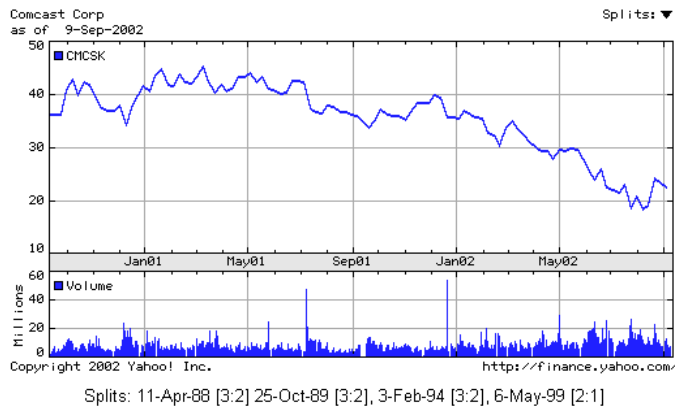
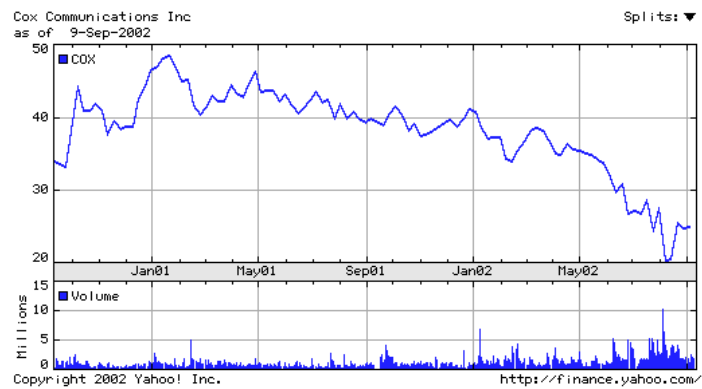


Exhibit 7: COX COMMUNICATIONS STOCK PERFORMANCE



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