



Accounting in the
Telecommunications
industry
*A new view of
revenue emerges*



Introduction

The IASB and the U.S. FASB are undertaking a joint project to develop a single standard for revenue recognition.

The objectives of the project are to provide a model for revenue recognition which can be applied to a range of industries. By providing a single model, the IASB and FASB hope to eliminate the acknowledged weaknesses and inconsistencies within existing concepts and standards. This project is a key part of convergence between IFRS and U.S. GAAP.

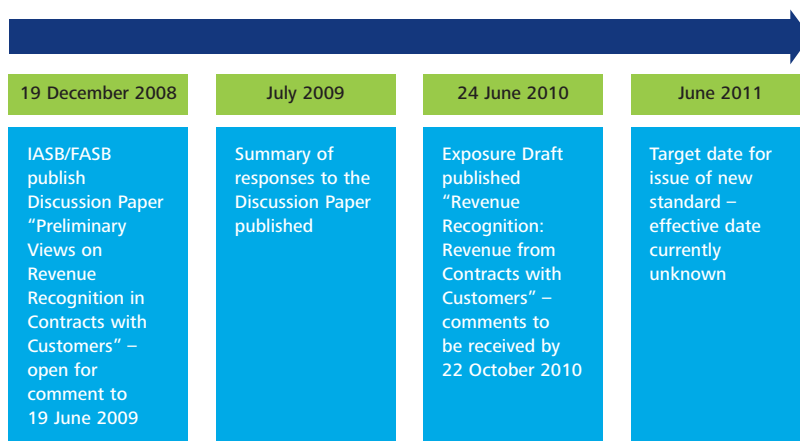
The new standard will replace the existing standards on revenue recognition: IAS 11 *Construction Contracts* and IAS 18 *Revenue* in IFRS and the extensive U.S. GAAP guidance including EITF 00-21 *Revenue Arrangements with Multiple Deliverables*.

In December 2008 a Discussion Paper was issued by the IASB and FASB. The Boards received over 200 comment letters, including letters from a number of the world's largest fixed line and mobile operators. It was clear from these comment letters that many of the concepts and proposals in the Discussion Paper would have a significant effect on financial reporting and on underlying systems and processes in the telecommunications industry and that there is divided opinion on many aspects of the proposals.

The Exposure Draft *Revenue Recognition – Revenue from Contracts with Customers* was issued on 24 June 2010 and requests comments by 22 October 2010.

This publication highlights the key proposals in the Exposure Draft in light of the areas of concern identified in the comment letters on the Discussion Paper and provides insights on how the proposals could affect the telecommunications industry.

Project timeline



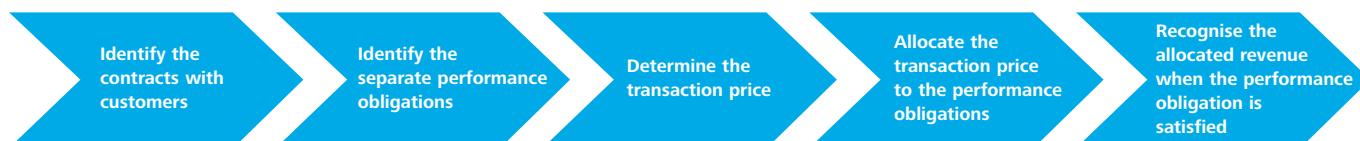
Overview

At the heart of the Exposure Draft are five-stages that entities should apply in determining revenue recognition. The guidance provided by the Exposure Draft in relation to these five stages is summarised below.

Stage 1 – Identify the contracts with customers

There may be situations when an entity would combine two or more contracts as a single contract. According to the Exposure Draft, combining of contracts would be appropriate if the prices of those contracts are interdependent. Conversely, an entity may treat a single contract with a customer as two or more contracts if elements within the contract are priced independently of other elements.

Overview



Stage 2 – Identify the separate performance obligations

Under the Exposure Draft, an entity evaluates all goods and/or services promised in the contract to determine whether there are separate performance obligations. The proposals would require an entity to account separately for a good or service if it is distinct, meaning that the good or service either is sold separately in the customer's market or could be sold separately because it would be useful in itself or in conjunction with another product that is available separately.

Stage 3 – Determine the transaction price

Time value of money

The time value of money should be considered when its effect is material. The adjustment for the time value of money would be applicable when a payment is due significantly before or after the transfer of goods and/or services. Therefore, it may become more common to adjust revenues for the time value of money when a prepayment is made by a customer or a credit period is granted to a customer.

Variable consideration

When an entity has delivered goods or services, sometimes the amounts it will receive in the future are not fixed. Under the proposals, future variable consideration would be recognised using an 'expected value' approach, but only where that expected value can be measured reliably. Such an approach requires management to develop probabilities for each possible scenario based on the relevant past experience and assess whether it believes circumstances will change significantly.

Credit risk of the customer

Under the proposals, the customer's credit risk affects how much revenue is recognised rather than whether revenue is recognised. An entity would adjust the transaction price to reflect the customer's credit risk using a probability-weighted approach.

Stage 4 – Allocate the transaction price to performance obligations

The Exposure Draft requires the transaction price to be allocated between distinct elements in proportion to the standalone selling price of each element. The best evidence of a standalone selling price is the observable price of a good or service that is sold separately. However, in situations where goods or services are not sold separately, the Exposure Draft would require an entity to develop an estimate based on a reasonable approach. Any discount to the aggregate of standalone selling prices is allocated strictly in proportion to the standalone selling price of each distinct good or service.

Stage 5 – Recognise allocated revenue when the performance obligation is satisfied

Revenue would be recognised when the customer obtains control of the goods or services. This aspect of the proposals is of fundamental importance to many, but it is also one that is likely to require the most judgement. The principle outlined is that "a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service". A customer has obtained control if it has the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities, together with the present right to obtain substantially all of the potential cash flows from that asset. The transfer of control of a product or service can be at a point in time or continuous. The Exposure Draft provides a number of indicators for determining whether control has passed to the customer as well as suggesting methods of recognising revenue for the continuous transfer of goods or services.

Key industry concerns

A key feature of the Discussion Paper was the proposal to introduce a single revenue recognition principle based on the increase in an entity's net contractual position with a customer.

Whilst the proposal to have a single, principles based standard was welcomed by the majority of the telecommunications industry, those who responded provided differing opinion as to whether recognition based on net contractual position with a customer is the most appropriate principle and whether the implementation of such a standard is practicable.

The key themes cited by the majority of those respondents from the telecommunications industry were:

- **Capability of existing IT infrastructure** – the impracticability of adopting the proposed standard was a view shared by all the respondents due to the system requirements of measuring the net contractual position with millions of customers who are contracted under thousands of different tariff plans, with some operators offering the view that a “portfolio” approach may be better.
- **Fear of inconsistency in practice** – it is clear that the respondents believe there is currently good consistency of revenue recognition policy amongst telecommunication operators despite the absence of prescriptive guidance, particularly under IFRS.

- **Inconsistency between revenue and cash** – a potential consequence of adopting the proposals of the Exposure Draft is that the recognition of revenue may deviate significantly from the cash flows derived from those transactions. This may make it more difficult for analysts and investors to understand the link between revenue and cash. The respondents argued that this could result in reported financial information becoming a less useful decision making tool for its users.

Other comments in response to the Discussion Paper considered the definition of performance obligations to be too vague and called for more guidance, concerned that a broad definition could result in a different interpretation between industry participants whilst others were satisfied that the definition was fit for purpose. There was also split opinion on how to separate performance obligations and what constitutes a performance obligation.

We have reviewed the responses from operators in relation to the questions posed in the Discussion Paper. We have identified 10 key areas that we believe may result in changing accounting practice within the industry, which we summarise overleaf.

Issue 1 – Free handsets generate revenue?

Example

A customer enters into a 24-month mobile phone contract to receive a bundle of voice, SMS and data services for CU30 per month (CU720 in total over the contract). On entering into the contract the customer receives a handset for free which has a standalone selling value of CU378 (the cost of the handset is CU350). The standalone selling price of the voice, data and SMS services without the free handset (sold on a SIM-only deal) is CU22 per month. For the purposes of this example, the time value of money and customer credit risk are ignored.

- Standalone selling price for everything except the phone = $CU22 \times 24 \text{ months} = CU528$
- Standalone selling price for the phone = CU378
- Total = CU906
- Actually charged = $CU30 \times 24 \text{ months} = CU720$
- Therefore, allocate to handset revenue $720/906 \times CU378 = CU300$
- Allocate to service revenue $720/906 \times CU528 = CU420$
- Amount per year for service revenue = CU210

The profile of recognition under the Exposure Draft compared to current industry practice would therefore be as follows:

	Proposal per Exposure Draft		Typical current industry practice	
	Year 1	Year 2	Year 1	Year 2
Service revenue	210	210	360	360
Handset revenue	300	–	–	–
Total revenue	510	210	360	360
Cost of sales	(350)	–	(350)	–
Net income	160	210	10	360
Net cash flow	10	360	10	360

Whilst the effect of the revised accounting smoothes profits, the impact of the proposed Exposure Draft results in a mismatch between reported net income and net cash flow.

One of the most contentious issues amongst the respondents to the Discussion Paper was the suggestion that the new guidance may result in a change in the way that mobile operators recognise revenue relating to subsidised handsets. At present, the majority of operators restrict revenue recognised on the sale of handsets to the amount which is not contingent on the delivery of future services – that is, the cash received for the handset. It is commonplace in a number of markets for handsets to be heavily subsidised resulting in the recognition of the cost of the handset with little or no corresponding revenue being recognised on acquisition of a customer.

One of the core concepts of the Exposure Draft is that revenue is recognised when an entity transfers control of a good or service to a customer and in doing so satisfies its performance obligations. Therefore, consistent with the Discussion Paper, it would seem logical that this would result in revenue being recognised upon the delivery of a handset to a customer.

The Exposure Draft does not restrict revenue that can be recognised to the amount which is not contingent on the delivery of other items but instead would require an entity to recognise revenue using a transaction price which can be reasonably estimated based on its experience (or the experience of other entities) with similar transactions. For a mobile operator this means that revenue may be recognised in relation to the subsidised handset, although the amount recognised would need to take account of the likely collectability at the outset. The requirement to incorporate collectability into the transaction price may also lead to a small reduction in revenue for operators who recognise bad debt costs within operating costs.

The Exposure Draft requires that the transaction price is allocated to all separate performance obligations in proportion to the standalone selling price of each performance obligation. The requirement to use standalone values as the basis of allocation involves little judgement to be exercised in the allocation process.

Deloitte insight

Accounting for 'contingent' revenue would represent a fundamental shift from existing industry practice. The implementation of such accounting is likely to be difficult given that operators have typically accounted for the handset cost separately through another management information system rather than within revenue. The vast array of possible permutations of handsets and tariff plans as well as accounting for sales through both direct and indirect sales channels may require operators to invest in the enhancement of their finance systems, at a time when cost reduction programmes are commonplace within the industry.

Issue 2 – Modifying revenue

Contract modifications (changes in the scope, price or duration of a contract) are commonplace in the telecommunications industry, particularly for providers of managed services or network solutions. In addition, mobile and fixed line operators who sell to the enterprise and corporate markets frequently experience modifications to the multi-year contracts and master service agreements they have with those customers.

At present there is little definitive guidance on how to account for contract modifications. Telecoms industry participants typically apply a range of accounting policies: either accounting for modifications prospectively, retrospectively or somewhere in between.

While the Discussion Paper included little on this topic the Exposure Draft states that contract modifications should be accounted for together with the existing contract if the prices of the modification and the existing contract are interdependent. In such a scenario the cumulative effective of a modification would be recognised in the period in which the modification occurs. In the scenario where the prices of the contract modification and the existing contract are deemed not to be interdependent, the contract modification would be accounted for as a separate contract.

In assessing whether a contract modification is interdependent the Exposure Draft provides indicators, such as the contracts being entered into at a similar time, with a single commercial objective and being performed concurrently or consecutively. The Implementation Guidance in the Exposure Draft clarifies that a key factor in assessing whether a modification to a contract is interdependent to an existing contract is the comparison of the standalone price of a good or service available in the market at that time compared to that being given in the modification. This assessment may be complex particularly where there may be a wide range of prices offered to differing groups of customers.

The Exposure Draft specifically notes that the price of a contract is not interdependent with another contract solely because a discount is given as a result of an existing customer relationship.

Example

Operator A enters into a five-year contract on 1 January 2009 (year 1) to provide fixed line services to Customer B for CU100 per annum. Half-way through year 4 Operator A agrees a two-year extension to the contract with a 20% discount, effective from 1 July 2012. At this time, the stand-alone price of the services being offered by Operator A to other customers is CU90 per annum. The modification results in a total contract value of CU630 over the seven-year contract period.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Contracts are not interdependent	100	100	100	90	80	80	80
Contracts are interdependent	100	100	100	60	90	90	90

In this example, if the contracts were not interdependent (e.g. if the revised price of CU80 was a market price), the accounting would reflect the billing profile. The effect of accounting for the contracts as interdependent (because the contract extension was offered at below market price) would lead to a reduction in revenue in year 4 to result in CU360 being recognised by the end of that year. This is because revenue in this scenario is determined on a cumulative basis, and the cumulative revenue at the end of year 4 needs to be 4/7 of CU630, i.e. CU360.

Deloitte insight

For the companies where this would represent a change in accounting, the complicated nature of contract amendments in the telecoms industry is likely to result in the need for more technical accounting resource – working with both the sales and legal teams during contract negotiations as well as advising revenue accountants. In particular, assessing the correct standalone value following a modification is likely to be a key judgement and operators should consider whether a basis allowing for more judgement in that area would be more appropriate.

Issue 3 – Accounting for cash or equipment incentives

Cash payments to customers are becoming increasingly common in the industry both in the form of 'cashback' offers paid to consumers (either on entering into a contract or based on the satisfaction of certain requirements) or as a rebate in consideration for the extension of an existing contract.

In response to the Discussion Paper opinion was split between the respondents within the telecoms industry on the subject of whether sales incentives give rise to performance obligations. Some operators argued that sales incentives are not performance obligations as they are typically dependent on the future actions of a customer or such incentives are incidental to the main goods or services.

The Exposure Draft provides guidance on accounting for consideration paid to a customer, which is broadly consistent with existing guidance in U.S. GAAP (*EITF 01-09 Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*). This guidance states that where cash is given to a customer and does not represent consideration for goods or services then it should be accounted for as a reduction in revenue and recognised at the later of when the entity transfers its goods or services and when it incurs the obligation.

Accounting for such cash incentives under the Exposure Draft poses several questions:

- When does an entity 'incur the obligation' to pay consideration to the customer?
- Does the payment of the cash incentive represent a modification of an existing contract that should therefore be accounted for retrospectively?
- If the cash incentive is only offered for existing customers does it imply that the goods and services have already been delivered to the customer and the cost should be recognised immediately?

Such considerations may also need to be made in light of the guidance on contract modifications (per Issue 2). If a customer was given a cash payment on renewal of a contract, consideration should be given as to whether this represents an interdependent pricing change or not and whether such a payment represents a rebate in relation to past performance or an upfront discount.

Similar considerations would apply when, for example, corporate customers are provided with an allowance to spend on equipment or handsets over the period of a contract. Under the Exposure Draft the customer's option to receive additional goods for no further consideration would represent a separate performance obligation to which part of the transaction price would be allocable.



Deloitte insight

Judgement will need to be applied in determining whether cash incentives payable on upgrade or contract extension reflect a discount in relation to a new contract or a retrospective rebate for services already delivered – as these two scenarios may result in differing revenue recognition profiles.

Issue 4 – Activating revenue?

Activation, connection or set-up fees are commonly charged by mobile and fixed line operators, particularly for the connection of consumer and residential customers. From a survey of the accounting policies of 25 operators (reporting under IFRS or U.S. GAAP), five disclosed that activation/connection fees were recognised on connection of a customer, eighteen spread such fees over the expected average customer life and the remaining two spread over the contract period. This demonstrates that whilst there is a majority view on how to account for such revenues, there is still differing practice.

The implementation guidance in the Exposure Draft includes a section on the recognition of non-refundable upfront fees and cites telecommunication contracts as a common source of such fees. Consistent with the general guidance in the Exposure Draft, the focus is on whether connection fees relate to a separate performance obligation – i.e. whether the activation of a customer's SIM and set up on the operator's systems constitutes the transfer of a service to the customer. If the connection of a customer does not represent a separate performance obligation, the revenue arising from the connection fee would be allocated across the other performance obligations.

Issue 5 – Agent vs. principal – a new angle?

The Exposure Draft specifically considers the assessment of whether an entity is acting as an agent (net revenue presentation) or principal (gross presentation) in a contract. In making the assessment of whether an entity is acting as an agent or principal the Exposure Draft focuses heavily on who controls the delivery of goods or services to a customer. Further guidance is provided in the form of a series of indicators which are similar to those included in existing guidance under IFRS and U.S. GAAP. This apparently moves away from the notion of whether an entity possesses 'risks and rewards' associated with the delivery of goods or services towards the concept of controlling the delivery.

In the case where a product or service is sold by an entity to a customer, but it is provided by a third party with the entity not performing any significant part of the process, it is possible that a differing treatment to current practice may arise. Take the example of third party content provided by a mobile operator to its customer – at present some operators may consider it appropriate for revenue to be recognised on a gross basis if they consider that they possess the risks and rewards associated with delivery of the content, e.g. branding of content and credit risk. In this scenario, the guidance in the Exposure Draft may result in mobile operators re-assessing their presentation of revenue if they do not control the delivery of such content.

Deloitte insight

Whilst not representing a fundamental shift to guidance, the Exposure Draft's basis for establishing principal vs. agent is focussed more on the delivery of goods or services rather than an evaluation of a number of equally-weighted considerations. Whether this will result in a differing treatment in practice is unknown, however it will certainly fuel the debate about where Telcos sit in the value chain versus content creators and providers.

Issue 6 – Contract costs

The Discussion Paper provided limited guidance on accounting for contract costs. The response from the operators was varied with some calling for more guidance on the treatment of contract acquisition costs and others stating that they were satisfied that other standards provide sufficient guidance in relation to cost recognition.

The Exposure Draft has included specific guidance which states that unless contract costs are eligible for capitalisation in accordance with existing accounting standards, an asset should only be recognised if the costs:

- relate directly to a contract;
- generate or enhance resources of the entity that will be used in satisfying performance obligations; and
- are probable of recovery.

This guidance is likely to have little impact on accounting for items of inventory delivered as part of contracts (such as handsets and routers) as practice is currently to recognise as an expense the cost of such assets at the time of delivery.

However, one of the areas where industry practice is most diverse surrounds accounting for sales commissions, which are typically a significant acquisition cost for operators in certain markets. The Exposure Draft states that the costs of obtaining a contract should be expensed as incurred; therefore whilst consideration should be given to sales commissions and whether such costs “generate or enhance resources of the entity” and therefore could be recognised as a contract asset, the Exposure Draft makes it clear that sales commissions should be expensed as incurred. Other areas of costs may be more judgemental in determining whether they are eligible for capitalisation.

Deloitte insight

Whilst there is broad consistency in accounting for costs within the industry the Exposure Draft provides prescriptive guidance in certain areas which may result in a change to current practice for certain entities, and should reduce the divergence of practice across the industry in accounting for the ever-increasing complexity of sales commission arrangements.



Issue 7 – Losing control on long term contracts

A number of the industry participants who responded raised concerns over the application of the concepts in the Discussion Paper to long-term contracts, which is of particular relevance to those entities that supply network solutions or managed services. Their concerns were that the application of the guidance could result in a pattern of revenue recognition which is not a reflection of an entity's performance over the period of a contract.

The Exposure Draft, consistent with the Discussion Paper, focuses on the customer's ability to control the goods or services delivered through an entity satisfying its performance obligations as the basis of when revenue is recognised. This is a different approach from that in IAS 11 *Construction Contracts*, under which revenue is recognised by reference to the stage of completion of the contract. As a result, revenue may be recognised at a later stage under the Exposure Draft.

In making the judgement about whether a customer has obtained control of a good or service the Exposure Draft provides a number of indicators of the passing of control.

Where an entity supplies a customer-specific good or service (i.e. a good or service where the customer specifies the design or function) this is one of the indicators that control may pass to the customer as the product is created. However, the Exposure Draft also states that none of the indicators is individually determinative, which suggests that a good or service being customer-specific is not, in itself, necessarily sufficient to demonstrate that control is with the customer. Accordingly, this is an area that may require careful judgement.

Where goods or services are transferred continuously, the Exposure Draft allows revenue to be recognised by reference to the stage of completion. Three methods are described which are deemed to be acceptable in measuring the extent to which those goods or services have been transferred at any point in time.

Given that this proposed guidance will need to be applied on a contract by contract basis, it is unclear whether it will result in significant differences in revenue recognition within the industry and such judgement may result in differing application amongst industry peers.

Issue 8 – Installing consistent practice?

One of the key judgements that operators will need to make relates to the identification of separate performance obligations. The Exposure Draft states that a good or service is distinct if either the entity sells identical or similar products in the market or if it could sell such goods or services separately because they have a distinct function and a distinct profit margin.

Existing guidance on this subject has led to differing practice within the industry – a good example being the recognition of installation fees typically earned by fixed line operators through the deployment of customer premises equipment within long term managed service contracts – generally with corporate customers. Some operators recognise such fees on installation while others recognise the fees over the life of the contract to which they relate.

Given that operators typically don't sell installation services separately and typically installation has a distinct profit margin (either because it is provided by a third party or costed based on internal resource metrics) the judgement that needs to be made is whether installation services have a distinct function – i.e. installation provides utility either on its own or together with other goods or services separately available in the marketplace.

Deloitte insight

In determining the appropriate treatment of installation fees, consideration should be given as to whether the fees charged are in relation to the physical installation of equipment or merely the activation of services, which may result in a different outcome (see Issue 4 above).

The Exposure Draft's guidance requires less interpretation on this subject than existing guidance, which may yield more consistent accounting across the industry.

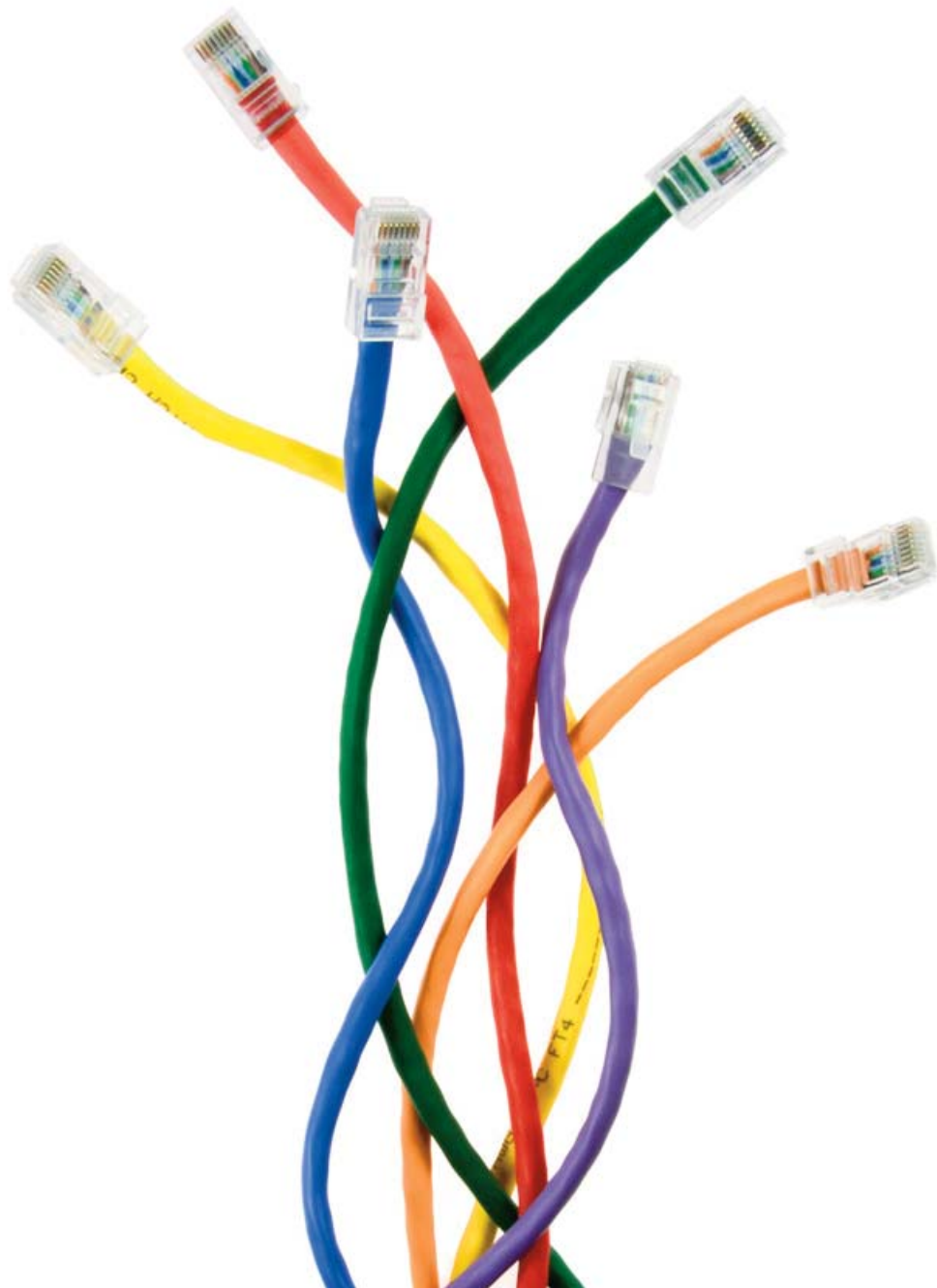
Issue 9 – Exclusive and non-exclusive licences

The Exposure Draft sets out specific treatment for the provision of licences. This may have implications for entities that provide software to customers, typically as part of managed service or network solutions.

Under current practice, revenue relating to licences delivered as part of a long term contract is commonly recognised on delivery of that licence to the customer. Under the Exposure Draft if a licence granted is exclusive and not for the entire useful life of the licenced intellectual property, then control is deemed to pass over a period of time with the implication that revenues associated with such a licence would be spread over the period of the licence.

Conversely, where a licence granted is non-exclusive, control would be deemed to pass immediately and therefore revenues would typically be recognised on delivery.

This guidance may result in some entities deferring revenue relating to the sale of licences. An example of an exclusive licence would be where a customer is granted exclusive rights to an entity's intellectual property for a specified period of time whereas a non-exclusive licence would be an off-the-shelf software product where similar rights are granted to many customers under the same terms.



Issue 10 – Disclosure

A summary of the disclosure requirements set out in the Exposure Draft is summarised below

Exposure Draft disclosure requirements

Revenue disaggregated into categories which best depict how the amount and timing of revenue and cash flows are affected by economic characteristics. Examples include the type of good or service, geographical market, the market or type of customer and the type of contract.

Reconciliation of opening to closing aggregate balance of contract assets and contract liabilities. Reconciliation should include:

- amount of revenue, interest income/expense and foreign exchange gains and losses recognised in the statement of comprehensive income;
- unconditional rights transferred to receivables;
- cash consideration received other than for amounts transferred to receivables;
- non-cash consideration received; and
- contracts acquired in business combinations and contracts disposed.

Description of performance obligations including:

- goods and services that the entity has promised to provide, highlighting those where the entity is acting as an agent;
- when the entity typically satisfies its performance obligations;
- the significant payment terms; and
- obligations for returns, refunds, warranties and other similar obligations.

The amount of the transaction price allocated to performance obligations remaining at the end of the reporting period that are expected to be satisfied in less than one year, between one and two years, between two and three years and after three years.

The amount of liability recognised for onerous performance obligations including a description of the nature and amount of the performance obligation, why those performance obligations have become onerous and the period during which the entity expects to satisfy the liability.

A reconciliation of the opening and closing liability relating to onerous performance obligations including new and ceased onerous performance obligations, the amount of liability satisfied during the period, the effect of the time value of money and any changes in estimates.

For performance obligations satisfied continuously, the judgements used in determining the methods used to recognise revenue and an explanation of why such methods are a faithful depiction of the transfer of goods or services.

A description of the methods, inputs and assumptions used to estimate variable consideration/measure non-cash consideration in the amount of revenue recognised, estimate standalone selling prices, measure obligations for returns, refunds, warranties and similar obligations and measure the liability for onerous performance obligations.

Deloitte insight

Disclosure of the proposed information would represent a considerable challenge to most companies in the telecoms sector and is likely to require system changes to extract the relevant data.

The requirement to present disaggregated revenue is likely to lead to divergence in practice across industry participants in both the level of disaggregation and its categorisation e.g. products vs. geographies.

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