DURBAN – New gTLD Financials
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ICANN – Durban, South Africa

CHAIR: Thank you. Good afternoon, or good morning, good evening, depending on where you are. We have a number of people on the Adobe room. There are a lot of seats available at the front for those of you in the back; for those that are interested. Thank you Sebastian. Otherwise I'm going to have to go walking up there, which I will do.

So thank you for coming. We would like to suggest that we go through the entire presentation. It's not necessarily very long. Then we can give the sufficient time for your questions as well as remote participants' questions towards the end of this session, and we'll try to make sure we have – even though we started late – ample time for questions during that session.

So let's start. We are going to first review – and we'll try to be simple about it – revenue and expense recognition policy. It's all about accounting principles, which is why I want to make sure it's short and as simple as possible because we're not trying to make you accountants. But we would like to have a few words about it that you understand better what we're going to look after regarding the financial impacts of the program.

Then we'll go into these financials and provide a bit of an update versus the information that was presented in the budget presentation submitted to public comments on May 10th. The format of the information that we are providing today is the same or very similar to that one that was presented and published on their website for public comment. I don't know if you've seen it but if you haven't then you'll see it today.

We will also give an overview of the public comments that have been provided as part of the FY 14 budget public comment process. We extracted a few comments that we think are relevant to discuss a little further and that we expect would be of interest for some of you. And that's also leading us to the Q & A session.

So, accounting principles. There is extensive accounting principles relative to revenue recognition, which is really about how do you account for revenues and expenses in any business. As it relates to the New gTLD Program, the main issue is that there is a timing difference between when we collected the fees, which is all in the first half of the 2012 calendar year, and the timing of when we effectively recognize revenues into the financial statements of ICANN, which is all along the program.

So there is a difference between cash collection and revenue recognition throughout the program. And that's the first element that we can speak about; the fact that there is that timing difference, which is very significant. As you remember, we collected approximately 360 million of application fees between January 12th and Mat 31st 2012. This is not when we recognized the revenues. We did not recognize any revenue then because we did not start any work on the actual evaluation process.

The accounting principles require us to recognize the revenue and the related expenses simultaneously to the extent possible. So when we have an expense we recognize revenue. It's also very logical from the perspective of being a cost recovery program it is logical to recognize a revenue when you recognize an expense, because you offset it.

The methodology to determine this recognition is to use the progress on the evaluation to determine the amount of revenues to be recognized – the progress on the evaluation process. How do we measure the progress on the evaluation process? We measure it with costs having been incurred. So the work that's being done, the cost is evaluated with the invoices from the vendors, with the work of the Staff and is being recognized.

This is the indicator that is being used to determine the amount of revenue that we're going to recognize. We have had a number of accounting firms reviewing this approach. There are not a lot of industries that have similar types of projects like this program that we have. There is not specific accounting guidance about it and we had to use the help of accounting firms to formulate this guidance.

One of the three firms is our auditors, who have reviewed this policy last year and are further reviewing it this year. Next slide? So, as I was just saying, the expenses are recognized as incurred. This is regardless of when they are effectively paid. Incurred really means that when the work is done we recognize an expense. If we have a bill from the vendor already to help us understand what the expense was, great, that's what we're going to use. If we don't have it we will estimate the cost to recognize it in the period when the work has been done.

Revenues are recognized proportionally to the amount of costs incurred. So when we look at the amount of costs incurred in the program on a given date we determine a percentage corresponding to the cumulative amount of costs incurred divided by the total amount of costs for the program, and that gives us the progress percentage of the program.

We then apply that percentage to the total amount of revenue for the program. And that's how we get the cumulative amount of revenue to be recognized at that time for the program. That's the very basic calculation.

The historical development costs that are repaid to the ICANN operations from the program are calculated in the exact same fashion – proportionally to the evaluation costs. The recognition of revenues in of historical costs is limited to the amount of non-refundable fees. You all know that the application fees are potentially refundable if or/and when, an application withdraws.

But there are thresholds of refundability. So until the end of initial evaluation, 70% of the application fee can be refunded. So we always have to make sure that the amount of revenue in costs recognized never exceeds the amount of non-refundable application fees. This graph is trying to show that. I don't know if it appears as gray or beige on the graph but the area that you can see as a staircase on the graph, that's more or less gray, is showing the various steps of non-refundable fees.

So the red line on this graph is showing you the cumulative amount of revenues for the program. The axis, the horizontal axis of this graph, really is tied, at the end of day, with the first phase of initial evaluation, second phase of extended evaluation and then contracting.

And the gray area represents the amount of non-refundable application fees. The line in blue is reflecting the progress of costs. And the line in red would normally exactly reflect the line in blue. Would it not be for these steps into the non-refundable part of the fee that prevent us from recognizing the revenue in exactly the same rhythm as the expenses?

Let's move on. We published, on the 10th of May, the presentation for FY 14, which also included all the financials relative to the program that we're going to look at today – relative to the entire program. So what you're looking at here are numbers that correspond to the entire program across all the year; not just FY 14.

At a high level the net application fees – net being net of refunds – is estimated to be $311 million. I'm looking at the left column of this slide. It corresponds to the fees collected less the estimation of the refunds that have been and will be processed as per the refundability milestones that we've just discussed. The total amount of operating expenses – so evaluation costs, administration costs, overheads of the entire program – totals up at $172 million approximately.

The historical development costs of the program represent $32 million for a total of expense of $204 million. This leaves us with a remaining balance of $107 million. The element of costs that are not represented there are those costs difficult to predict that have been the rationale for including in the fee a risk component – an additional fee determined and designed to cover for these hard to predict costs.

We will talk more about that component later. I'm moving on but I'm expecting that during the Q & A session we can come back to this slide if necessary. This is a breakdown of the full program, multi-year costs by the type of expenses and the phases. On the left there we have initial evaluation, extended evaluation, quality control, string contention, objections, pre-delegation, administration and below that, gTLD Teams, ICANN Staff allocations and other overheads.

The total corresponds to the $172 million that we saw a little earlier. The initial evaluation, as you probably would expect, represents the bulk of the evaluation costs. Another significant element of the cost is the pre-delegation phase, which includes the testing but also the contracting and a number of other parts of that phase. The top-left of this slide is difficult to miss – we're talking about 1,930 applications, which is the number of valid applications received for the total program, by the end of May last year.

And this is the amount of applications that have been dealt with, even though of course we have today, from memory… Christine, 97 refunds? And that's to-date. Let's move on. This is another view… Sorry for the small numbers and the big table. This is another view of the program where you can see here the breakdown of the same figure that we looked at earlier by year. From '12 to '15. This is really covering the period of evaluation and the breakdown of the costs in revenues by period.

There was very little, from an evaluation standpoint, that had been done by the end of FY 12, which finished at the end of June 2012. So if you're a Member the strings were revealed on June 13th 2012. The evaluations costs work that had been done then was very minimal. The bulk of the activity, as you know from an evaluation standpoint, has happened in FY 13, which closed two weeks ago.

From a financial standpoint that shows you the amount of work that Christine's team and everybody else has done, along with all you guys. In 2014 you see a decreasing amount of costs reflecting that the program moves largely into the phase of extended evaluation and pre-delegation work. And from an evaluation standpoint the program decreases again in 2015 to approximately $24 million of expenses then. Next slide?

I mentioned the risk component earlier. I'm referencing here a document that is available on the website that was produced for the first time in October 2008 and has been updated in October 2009 – and I am referencing the version of 2009 there. This document helps explain the program's costs and notably the notion of risk. The notion of risk was defined as the costs that are most uncertain and harder to predict.

Examples were provided relative to potential inaccuracies in the evaluation cost estimates. Five years ago when the program was designed did we evaluate correctly that it would take this much money for initial evaluations, for example, or something else. So inaccuracy in the evaluation of processing costs is one of the potential risks. Another risk is, did we not anticipate that a phase, an evaluation or some work needed to be done, and that we would know better today that it needs to be done but it was not planned for? That's another risk.

Were the support costs adequately dimensioned five years ago when we designed the program? This is particularly difficult to do so far in advance, especially when we don't know what the size of the program is. So obviously today we have a much more comprehensive understanding of that in a very different [home? 20:45] than this.

Of course, what could possibly be the need for defense costs, litigation potentially, as part of the program? That's entirely impossible to predict. So these elements are those that a few years ago justified the risk component of the application fee. Those risks had been evaluated at the time at $30 million. This is the result of an exercise conducted in coordination with our insurance company at the time; Willis, who has a consulting arm that helped us formulate what the risks of the program could be, associate ranges of probability and ranges of financial impact.

Through a lot of modeling – through those interested, a Monte Carlo model type – the evaluation of $30 million was conducted. That was under the assumption that the program would be 500 applications. Again, to remind everyone, we're talking about five years ago when the program was being designed. Based on $30 million of risks, 500 applications, that's how the amount of $60,000 per application was determined in order to determine the fee.

So the forecast that we showed you a bit earlier in the presentation was referring to an amount that's resulted from taking the $60,000. Multiply that by the number of applications and that's how you arrive at $115 million. So far few costs have currently been applied against that risk docket – [the glitch? 023:04], a couple of legal analysis and pre-litigation work. And at this stage no difference in estimates have been applied against the risk component, as of yet.

We are going to continue forecasting the costs and looking at the costs before defining whether or not any should be applied against that risk component. Next slide? Public comments: we're just taking here a couple of comments extracted from the public comments that have been provided. It's a lot of information to read but we'll just get in the gist of these comments.

There is a historical development comment relative to when the historical development costs are being recovered by the ICANN operation. Where are they going? Are they going in the reserved fund? And is there an estimation of what the reserved fund total amount will be, or what is the target of the reserved fund? And that's a separate subject but obviously related.

So the historical repayment cost is, as you've seen in the previous documents, being made progressively along the program and to be completed no later than at the end of the evaluation phases. It is retroceded basically back to the ICANN operations and therefore increasing the operating fund of ICANN. And the normal process then is that the Finance Committee and then the Board determines how much of that operating fund gets allocated to the reserve fund.

And this is determined on an annual basis. There was also a comment on the Staff allocations. So we have two different sets of resources being charged to the program: we have the direct resources that are basically represented by Christine's New gTLD Team that are directly charged to the program. And then we have a lot more than just Christine's team that work on the program, from the ICANN operations. Let's take an example; the Legal Team.

In my team, in Finance, there is one person whose role is dedicated to controlling the cost of the program. That's all she does. So there is another person who is also not part of Christine's team but whose focus is on the program. I spend a certain amount of my time as well on the program, but not all of it. So therefore we determine allocations of those Staff that are not in the New gTLD Team but contribute to it nonetheless.

And on the basis of those estimates, those people charge the program's costs. The comment here is relative to why has it increased and the… You've heard me talking about the fact that we have completed most of the initial evaluation in FY 2013. This was not anticipated at the time of the design of the program and at the time of the design of the estimates.

If you remember, we had planned to do batches for approximately 500 for the evaluation. Instead, as you remember, last year the evaluation process changed to conduct all the initial evaluation of all the applications in one phase, rather than in four phases. So regrouping that work in a simultaneous fashion, rather than in a split fashion over time, has created a need for resources completely different than what was originally anticipated.

One second we were talking about inaccurate estimates at the time of the design of the program, and certainly the estimations made five years ago of the amount of resources needed to manage the program were vastly underestimated. And I think without having a detailed understanding of the time of the amount of work would be a required one-second. Considering that the project quadrupled in terms of size, things aren't necessarily proportional – when you think you need ten people to do something for 500 units, it's not just necessarily just four times as much for 2,000 units.

So that's one of the elements that has impacted this allocation number to change. Let me move on to questions. There is a mic here. I'll pull back so that people can come down. I can also walk around with a mic. One question coming through. Okay, more questions coming through. Good.

JIM PRENDERGAST: How are you doing? Jim Prendergast. I have a couple of questions if we could just go back on the slides? There was a mention of litigation cost – was that related to the image online and the something-space case? Was that…?

CHAIR: There were two cases that each of these… I mentioned a legal cost. It's two cases. I wanted to check with the Legal Team as they can provide more precisions on that. There is, on .list… I have the…

JIM PRENDERGAST: It's Name.Space and then Image Online Design. Are those the only two legal actions in there?

CHAIR: I think that's right. I would need to re-verify that but I think that's right.

JIM PRENDERGAST: And then the slide before that where it's just the total aggregate? Yeah. Initial evaluation costs there of $70,400,000? The application fee budgeted $100,000 per application for initial evaluation and if you divide that number up it comes out to, like $36,000 per application.

CHAIR: It was not $100,000 for initial evaluation. It was $100,000 for all the evaluation; the entire program. So let me break it down. $185,000 total. Out of the $185,000, $60,000 we have seen for risk. Originally $25,000 per application was designed to be a repayment of the historical development costs, leaving $100,000 for the entire evaluation. Not just initial evaluation but all the evaluation costs; all the panels, all the processes and all the administration and overheads of it.

So you should compare that to the $172,000 at the bottom of this slide.

JIM PRENDERGAST: Okay. So do you know off the top of your head what the cost is per application versus what the…?

CHAIR: It's about $85,000. If you divide that $170,000 by a bit less than 2,000 it's about $85,000.

JIM PRENDERGAST: Okay. And the extended evaluation – $6.8 million. How are you projecting that and is that going to be a moving number based upon actual extended evaluations?

CHAIR: It will be a moving number, yes, on the basis of that and on the basis for the amount of costs to be incurred per application, which depends upon each application.

JIM PRENDERGAST: Okay so right now I don't know how many are eligible for extended – it's only, what? 14, 15? Yeah? So that's $600,000 apiece… I don't…

CHAIR: Yes. So at the time we had this number I think we had more like 30 applications into extended evaluation, and that number has been revised. And I think there is another piece of cost… Well, I think there is a cost in the extended evaluation, which we've left there for an estimate standpoint. It's not necessarily proportional to the… And Christine can help us.

CHRISTINE WILLETT: Hi Jim. So extended evaluation isn't just… There is the Financial Technical panel, there's the Registry Services panel and there isalso the Geographic Names panel, which is not a secondary evaluation on the

Geographic Names panel, it's an extension that's possible and is offered by the AGB to applicants for an additional incremental 90 days for evaluation.

So that is an estimate based on the best information we had about the total potential number of applications going through each of the different panels, and the cost to sustain all of the panel forums required during the extended evaluation period.

JIM PRENDERGAST: Okay. So then I guess my next question would be if that $171,000 is paid for my the $100,000 per application and we've got $6.8 million set aside for extended evaluation, doesn't extended evaluation incur additional fees? Has everybody already paid for an extended evaluation out of their $100,000 and then when it comes time to go through it you've got to pay again?

CHAIR: No. Yes, yes. No, you don't have to pay again, the extended evaluation phase is covered by the $100,000. It's covered by the initial application fees.

CHRISTINE WILLETT: There is a cost for the RSTEP – the one-person versus three-person panel –, there is a cost for community priority evaluation for that, but the $100,000 per application is intended to be all of the evaluation costs, all of the program costs, to support the objection process to handle pre-delegation. So that $100,000 per application is everything except the risk and the repayment.

JIM PRENDERGAST: So aside from the technical re-evaluation and extended evaluation there wouldn't be any additional fees for extended evaluation?

CHAIR: No. Thank you. Chris?

CHRIS JAPLO: Thank you. Chris [Japlo? 35:25]. Can you go back to the risk slide? I'm just curious about something. Because you were saying the risk was calculated at $30 million based on the 500 applications at the time, which is $60,000 per application. So now we've got 1,900 or 1,800 applications, so has the risk been recalculated at $115 million, which comes back to the same $60,000?

CHAIR: Correct.

CHRIS JAPLO: It's almost like it's just been proportionalized, or have you done a re-evaluation properly to work out…?

CHAIR: Absolutely. You're correct. It's been arithmetically taken the $60,000 times the… So it's really how much fees have been collected relative to the risk bucket through the $185,000 that this $115 million represents, rather than, what is the risk of the program now that it is 2,000 applications.

CHRIS JAPLO: So at some point in the future that risk will have to be re-evaluated? And you'll move the balance into a different bucket or…?

CHAIR: Correct. Thank you. We're going to take one… Sorry, do we have questions online? No questions online, okay. We have two minutes so we're going to be very short. Yes, Raimundo?

RAIMUNDO BECA: As you know, I have been in several meetings making some comments on the historical costs. There are two issues I'm making. One is the amount of the total and the other one is the recognition; what time do we recognize it? Regarding the amount, I think that this morning we came to a fair solution to that and that's to ask the external auditors to fix this.

Because in the financial statements every year since the program started it's clearly indicated how much was spent in this program. So it's not a very difficult exercise to make and I think that that would be transparent for everybody. So I will not comment more on that because if you announce that you are going to do that then… Hmm?

On the recognition, well, the accounting principles are not universal. So this is probably the accountant's solution for in the US, but it's not a universal... And in the particular case is that I would like to see it because it was promised to us in Prague that the paper on the accounting principle would be made public – and it has not been made public.

But I have it [seized? 38:50] up about that. And mainly because the current principles are correct; you can pick up the revenue because you make the expense, but the expense has not made [inaudible 39:05] because in this case of historical costs, the historical costs were made beforehand. So you have the right to recognize all these historical costs.

And I would ask you to review this interpretation because you cannot say that because we have 2,000 applications so the historical cost per application gets lower. It was never calculated in that way. There doesn't have to be a percentage of every application. The recognition of the expense is the total and not [peripication? 39:59]. It's the case of the evaluation – the evaluation is the cost per application but the historical cost is not the cost per application. Okay.

CHAIR: Thank you. So we need to finish because we're two minutes late. With respect to Raimundo's comment I will say that the accounting principle that we're applying is an internationally compliant accounting principle.

So for those interested it's in the US GAP and in IFRS, which are the international accounting principles. So it would be accounted for in the same fashion anywhere and everywhere. And I will take the time to go back with Raimundo on the rest of his comments as he and I have already discussed on the audit side and on the timing of recognition.

Thank you very much for attending this session. We'll do more of these in the future. Thank you for your questions and have a good day.

[END OF AUDIO]