Regulatory financial reporting: a review

Consultation

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Section 1

Summary

The case for change

1.1 The current framework for BT’s regulatory financial reporting dates from 2004\(^1\). Since then, both technology and the use of financial data have evolved significantly. Fibre-based networks are being rolled out and there has been a large growth in data traffic and in IP networks. In regulation, there has been increased focus on detailed costing data for the development and scrutiny of charge controls and in resolving disputes.

1.2 At the same time, communication providers’ (CPs) confidence in the published financial statements has gradually been eroded. BT considers that it is required to publish unnecessary levels of detail, and we find that we have to make material adjustments to reported information in order to make regulatory decisions. Following publication of BT’s most recent financial statements for 2012 on 31 July, it is a good time for us to set out proposals for our review. We seek stakeholders’ views and suggestions as to how to make regulatory financial reporting better for the future.

The consultations

1.3 In November 2011, we published a Call for Inputs (CFI) seeking stakeholders’ views on both regulatory financial reporting and cost orientation\(^2\). This document is our first consultation on regulatory financial reporting and sets out our emerging thinking for improvement of the regulatory financial reporting framework. Informed by responses to this consultation, we plan to issue a second consultation, in early 2013, setting out more detailed proposals, together with draft legal instruments and other implementation details. The proposals set out in this consultation take into account the responses to the CFI, our own experience in using the accounts and the views that we have received from stakeholders since the current framework came into effect in 2004.

1.4 As anticipated in our CFI, we are also planning to publish a consultation on cost orientation. The implications of our review of cost orientation for regulatory reporting (if any) are therefore not dealt with further here. To the extent necessary, we will address this in our consultation on cost orientation and/or in our second consultation on regulatory financial reporting.

There is general agreement on the need for change

1.5 CPs and BT agree that the regulatory reporting framework needs to change, although the specifics of some of their concerns may differ. We also agree that changes are required to the current reporting framework.

1.6 CPs are concerned that BT has too much influence over how the accounts are prepared: the choice of principles, methodologies, and rules that are applied in deciding upon the treatment of costs and the valuation of assets in the Regulatory Financial Statements (RFS). They are also concerned by errors, restatements and changes in accounting treatment over recent years.

\(^{1}\) http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

\(^{2}\) http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/summary
1.7 BT is concerned about the complexity and level of detailed information that it is required to report and what it considers to be the unrealistic demands this places on its reporting systems. It also argues that some of this disclosure is commercially confidential information the disclosure of which could harm competition and that it reports more information than its counterparts in most other European countries.

1.8 We recognise both CPs' and BT's concerns. In addition, we believe that the published RFS need to align more closely with the regulatory decisions made by Ofcom.

1.9 At the same time, there is a need for pragmatism and proportionality. We recognise that running a fully allocated costing system, across a business with a market capitalisation in the tens of billions of pounds and reporting publicly, to a high degree of granularity, is a challenging task, both conceptually and practically. Similarly, current cost accounting (CCA) is a complex process requiring a degree of judgement.

Establishing confidence in the published financial statements

1.10 It is important to establish greater stakeholder confidence in the published financial statements. A series of restatements, errors and changes in treatment, in recent years, have led to a loss of confidence in the regulatory accounts. CPs do not appear to take much comfort from the review of the statements by BT's auditors or, indeed, by Ofcom. This has led to demands for greater detail to be reported, so that CPs can check the results for themselves. In this context, however, greater detail does not necessarily mean greater accuracy or that the resulting data are more robust. The solution, we believe, is to restore confidence by ensuring that the framework for regulatory financial reporting is relevant, reliable and robust. The requirements must also be proportionate to the benefits.

1.11 The focus of this, the first consultation, is on the published financial statements, within the context of the wider regulatory financial reporting framework. However, views are also invited on the scope of the confidential information provided to Ofcom.

1.12 In this document we consider:

- the purpose of reporting;
- the current reporting requirements; and
- how the current framework might be improved.

The purpose of regulatory financial reporting

1.13 The regulatory financial reporting obligations imposed on SMP providers should provide information which allows us effectively to monitor compliance with other SMP conditions (including cost orientation, non-discrimination and charge controls) and to enable our timely intervention to ensure that those other SMP obligations continue to effectively address the underlying competition problems identified in our market analyses. We also need reliable information to inform our regulatory decisions, the market reviews we undertake and the setting of SMP obligations. In developing our thinking and detailed proposals, we intend in particular to assess whether any changes to the reporting framework are appropriate, effective and necessary to achieve that aim.
1.14 We also consider that other parties have a legitimate interest in the financial regulatory statements, compliance monitoring and what, if anything, the statements may suggest regarding the need for regulatory intervention. Transparency and the requirement that the SMP provider makes available certain regulatory accounting information in public form are, therefore, important elements of the overall framework. However, we do not consider in principle that the published financial statements can or should provide CPs with all the information necessary for them to determine whether an SMP provider has complied with its obligations. Rather, our view is that the level of information published, taken in conjunction with the underlying processes, systems and assurance framework, should be such as to provide confidence to CPs that an SMP provider is complying with its regulatory obligations.

1.15 In section 3, we discuss these objectives and the attributes of effective regulatory financial reporting. We also set out the specific questions that we consider need to be addressed by the regulatory financial statements, in order to provide confidence to stakeholders that BT has complied with its obligations. For the purpose of this consultation we have focused on the reporting requirements as they apply to BT, but will consider the requirements for Kingston Communications plc (KCOM) as part of the second consultation.

The current reporting requirements

1.16 In section 4, we set out our views on how well the current framework for regulatory financial reporting meets the purposes and attributes described in section 3. We conclude that the financial reporting requirements appear to answer most of the relevant questions identified in section 3 but do not appear to deliver the appropriate level of confidence to stakeholders that BT has complied with its SMP obligations.

Proposals for improved reporting

1.17 It appears that, under the current regime, stakeholders derive little confidence from the way the data are prepared by BT or are reviewed by BT's auditors or by Ofcom. As a result, stakeholders rely on the publication of detailed financial information to inform their own review. BT considers that these publication requirements represent an onerous and, potentially harmful level of disclosure.

1.18 We consider that an effective regime should enable stakeholders to draw more confidence from the way the financial information is prepared and reviewed and therefore rely less on the publication of detailed financial data.

1.19 On this basis, we consider that, if BT can deliver a robust and transparent reporting system, supported by a strong review process, stakeholders will be less reliant on the publication of detailed financial information to derive the necessary level of confidence. Therefore, it is possible that there will be scope to reduce the level of published information in the longer term, subject to the effective implementation of improved accounting systems and review processes.

1.20 Additionally, we make a range of other proposals for the shorter term, aimed at increasing stakeholder confidence in the way the numbers are generated, and making the financial data easier to understand and use. As explained in section 5, these include increasing Ofcom involvement in setting the bases of preparation and improved transparency for stakeholders of the way the financial statements are prepared. We are keen to get stakeholder views on these proposals to inform our more detailed proposals to be set out in our second consultation.
Next steps

1.21 Success in improving regulatory financial reporting will depend critically upon the positive and pragmatic engagement of all stakeholders. We are therefore keen to get your comments and suggestions in response to our proposals.

1.22 Responses to this consultation are requested by 2 November 2012.
Section 2

Introduction

Summary

2.1 Since we established the current framework for regulatory financial reporting in 2004, a number of stakeholders have expressed dissatisfaction with the current regulatory reporting framework; there have been issues with the accuracy, timeliness and relevance of the numbers in BT’s regulatory financial statements. We share some of these concerns. We also accept BT’s view that any reporting requirements should be proportionate to the benefits.

2.2 The planned output for this project is an improved framework for regulatory financial reporting. At this stage we are inviting comment on whether we have identified the appropriate set of issues and how they might be addressed. Our detailed proposals will follow in a subsequent consultation, taking account of responses we receive to this consultation.

Introduction

2.3 We started this project in autumn 2011. Our first public step was to issue an early consultation document, or a ‘call for inputs’, in which we sought stakeholders’ opinions on the current cost orientation and regulatory financial reporting regimes.

2.4 We issued our call for inputs (CFI) on 8 November 2011; the consultation period closed on 6 December 2011. We received ten responses from stakeholders including BT, UKCTA and other fixed and mobile communication providers. We have published these on our website.

Cost orientation and regulatory financial reporting

2.5 When we issued our CFI last year, we were considering regulatory reporting alongside cost orientation, and were planning to issue a consultation addressing both at the same time. We have now split the two projects, and continue to consider cost orientation separately.

2.6 We are also planning to publish a consultation on cost orientation in the autumn. The implications of our review of cost orientation for regulatory reporting (if any) are therefore not dealt with further here. To the extent necessary, we will address this in our consultation on cost orientation and/or in our second regulatory financial reporting consultation.

Scope of this review

2.7 This review will cover the reporting of regulatory financial information provided by BT and KCOM, with a particular focus on the published financial information. Financial information which we may gather using our information-gathering powers are excluded from this review.

3 http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/
4 http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/?showResponses=true
2.8 For clarity, we set out below what we mean when we speak about the regulatory financial statements on the one hand, and the published financial statements on the other.

**Regulatory financial statements/regulatory financial reporting**

2.9 We use the term regulatory financial statements (RFS) to describe the annual regulatory financial statements, prepared according to a defined framework and methodology. We use the term in this document to refer to both the published and unpublished statements. The unpublished financial statements are submitted to Ofcom confidentially.

2.10 We use the term regulatory financial reporting to refer to the whole of the regulatory reporting methodology, systems and framework, as well as the RFS. Regulatory reporting is more than just the financial statements as it includes the principles and methodology, according to which the information has to be prepared.

2.11 The scope of this review therefore includes regulatory financial reporting and the principles and methodologies under which the accounts are prepared.

**Published financial statements**

2.12 The term published financial statements refers only to the subset of the regulatory financial statements that is published by the SMP provider.

2.13 In theory, the extent of information that BT could be required to publish could range widely between, on the one hand, publishing most of the information that Ofcom also receives confidentially or on the other hand, limiting this to, for example, the market summary statements

**KCOM**

2.14 The first consultation is focused on BT rather than KCOM. To a significant extent, this reflects the focus of responses to the Call for Inputs, which did not present a strong demand for significant changes to KCOM’s reporting requirements.

2.15 Where relevant, we will briefly refer to KCOM in this consultation. We will consider KCOM’s reporting further in our second consultation and will make specific proposals at that stage if needed.

**Planned output and timing of this project**

2.16 The planned output for this project is an improved framework for regulatory financial reporting. At this stage we are setting out our emerging thinking and overall proposals – our proposed steps to implement these overall proposals will follow in our second consultation, the precise content of which will depend on responses to the proposals set out in this document.

2.17 We welcome responses from stakeholders to the questions set out in the subsequent three sections, by 2 November 2012.

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5 For example, see 2012 RFS, “Market summary” at the top of page 36, Section 7.3, comprising two rows of data for 2012 and 2011. However, by market summary statement, we exclude “Detailed service analysis”, provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.).
Structure of the rest of this document

2.18 The rest of this document is set out as follows:

• Section 3: the purpose and attributes of regulatory financial reporting;

• Section 4: the current regulatory reporting framework and issues identified; and

• Section 5: proposals for improved regulatory financial reporting.
Section 3

Purpose and attributes of regulatory financial reporting

Summary

3.1 The regulatory financial reporting obligations imposed on SMP providers should provide information in order to allow Ofcom to monitor compliance with other SMP conditions (including cost orientation, non-discrimination and charge controls). They should enable timely intervention to ensure that those other SMP obligations continue to effectively address the underlying competition problems identified in our market analysis. They should also ensure Ofcom is provided with relevant and reliable information to support our regulatory decisions, such as the setting of charge controls. In developing our proposals, we will assess whether any changes to the reporting framework are appropriate, effective and necessary to achieve that aim.

3.2 We also consider that other parties have a legitimate interest in the financial regulatory statements, compliance monitoring and what, if anything, the statements may suggest regarding the need for regulatory intervention. Transparency and the requirement that the SMP provider makes available certain regulatory accounting information in public form are, therefore, important elements of the overall framework. However, we do not consider, in principle, that the published financial statements can or should be expected to provide CPs with all the information necessary for them to determine whether an SMP provider has complied with its obligations. Rather, our view is that the level of information to be published and the underlying methodological assurance procedures should be appropriate to provide confidence to CPs that an SMP provider is complying with its regulatory obligations.

3.3 We consider that effective regulatory financial reporting should reflect the following attributes:

- **Relevance.** The information needs to answer the right questions, in the right way and at the right time.

- **Reliability.** The underlying data must be reliable, suitable rules for treatment of those data must be chosen and those rules need to be followed.

- **Transparency.** The basis of preparation should be understood by the users of the reports.

- **Proportionality.** The reporting requirements should be proportionate to the benefits. In particular, we need to balance the benefits of publication versus the costs of disclosing potentially commercially sensitive information.

Introduction

3.4 In this section, we first consider the purposes of the RFS. We then consider the purposes of the published financial statements. We do this with reference to our legal framework. We then go on to consider what are the key attributes that make for an effective reporting regime.
3.5 In sections 4 and 5, we consider how well these purposes are met under the current regime and discuss proposals for improving the reporting regime in the future.

Legal framework

3.6 In order to address the purposes of the regulatory reporting framework, it is important to first set out the legal basis for that framework.

The Common Regulatory Framework

3.7 The current regulatory financial framework was established in 2004 in response to the (then) new framework harmonised across the European Union (“EU”) for the regulation of electronic communications by the Member States (known as the Common Regulatory Framework or the ‘CRF’). The applicable rules are contained in five Directives; the following are of particular importance here:


3.8 The CRF was implemented in the UK by the Communications Act 2003 (as amended) (“the Act”).

3.9 Under the CRF and the Act, Ofcom is obliged to conduct periodic market reviews in the telecommunications sector in order to identify undertakings with significant market power (i.e. dominance) in particular markets, and to impose appropriate ex ante obligations upon such undertakings. The CRF and the Act set out the remedies which can be imposed by Ofcom. They include, among others, access remedies, non-discrimination and price remedies (such as a charge control and cost orientation). They also include the following:

- **Wholesale accounting separation.** Under Article 11(1) of the Access Directive and Sections 87(7) and (8) of the Act, Ofcom may impose an obligation on the undertaking with SMP to maintain a separation for accounting purposes in relation to specified activities. Ofcom may also impose obligations in relation to the accounting methods to be used in maintaining the separation.

- **Wholesale cost accounting.** Under Article 13(1) and (4) of the Access Directive, and Section 87(9) of the Act, Ofcom may impose a cost accounting system. Where Ofcom imposes a cost accounting system, it also needs to impose a condition on the dominant provider to make a description of the cost accounting system available, including details of the main categories under which costs are grouped and the rules used for the allocation of costs. In addition, the Access Directive and the Act require that compliance with the cost accounting system is

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verified by a qualified independent body and that a statement concerning compliance is published annually.

- **Retail cost accounting.** In markets where retail price controls (or other matters to which costs are relevant) are implemented, Ofcom is required to also impose retail cost accounting, pursuant to Article 17(4) of the Universal Service Directive and Section 91(6) of the Act. Ofcom may specify the accounting methods and the format to be used. In addition, the Access Directive and the Act require that compliance with the cost accounting system is verified by a qualified independent body and that a statement concerning compliance shall be published annually.

- **Transparency.** Ofcom may require a dominant provider to make certain information public, in particular accounting information, pursuant to Article 9(1) of the Access Directive and Section 87(6)(b) of the Act.

3.10 The obligations concerning wholesale and retail cost accounting, accounting separation, and publication of accounting data constitute the basis for imposing regulatory financial reporting obligations.

**Limitations on imposing financial reporting obligations**

3.11 Ofcom’s powers to impose financial regulatory reporting obligations are subject to certain limitations. As SMP remedies, they can only be imposed on a provider where that provider has been identified as having SMP in the relevant market. SMP remedies cannot be imposed in a market which has been found to be effectively competitive.

3.12 When imposing SMP conditions, Ofcom needs to consider its general duties under Section 3 of the Act and the six European Community requirements for regulation under Section 4 of the Act.

3.13 In addition, any SMP obligation needs to satisfy the test that the obligation is: (a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates; (b) not such as to discriminate unduly against particular persons or against a particular description of persons; (c) proportionate to what the condition or modification is intended to achieve; and (d) in relation to what it is intended to achieve, transparent.\(^7\)

3.14 For certain SMP obligations, additional requirements need to be fulfilled. In particular, obligations imposed under Section 87(9) of the Act, including wholesale cost accounting, may only be imposed where it appears there is a relevant risk of adverse effects arising from price distortion; and it appears the conditions are appropriate for the purpose of promoting efficiency, sustainable competition and conferring the greatest possible benefits on the end-users of public electronic communications services.

**The 2004 regulatory financial reporting framework**

3.15 During the course of 2003 and 2004, and as a consequence of the entry into force of the CRF, Oftel (the legacy regulator for telecommunications) and Ofcom undertook a number of market reviews where cost accounting and/or accounting separation obligations where imposed on the dominant provider. However, those market reviews did not impose detailed rules for the application of such cost accounting/accounting

\(^7\) Section 47 of the Act.
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3.16 In the statement, Ofcom set out the detailed obligations imposed on BT and KCOM (then Kingston Communications) which implemented the cost accounting and/or accounting separation obligations previously applied. In particular, 34 conditions were imposed on BT (33 on KCOM) which set out the general requirements for the preparation of the regulatory financial statements (“RFS”)\(^\text{11}\). The conditions are grouped under the following headings:

- general requirements (including power to make directions);
- requirements relating to the preparation, audit, delivery and publication of the RFS;
- requirements relating to the audit of the RFS;
- requirements relating to the primary and secondary accounting documents;
- requirements relating to the up-dating of systems, accounting documents and form and content;
- requirements relating to deficiencies in the RFS and the accounting documents;
- requirements relating to the maintenance of sufficient accounting records;
- requirement to facilitate on-demand reporting;
- requirements relating to the preparation and maintenance of a Wholesale Catalogue;
- requirements relating to the preparation and maintenance of a Retail Catalogue;
- further accounting separation requirements; and
- requirements relating to the demonstration of non-discrimination.

3.17 In addition to the conditions, six directions were put in place which set out the detail of the RFS.

3.18 We amended and reviewed the framework established by the 2004 statement in subsequent years, albeit not fundamentally. First, the framework has been amended

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\(^11\) Not all accounting conditions are applicable in all SMP markets. In particular, some conditions are specific to retail or wholesale markets, and some conditions only apply where only one of cost accounting and accounting separation obligations have been imposed.
as part of the various market reviews which have taken place since 2004, to ensure the regulatory accounting conditions remain consistent with the SMP findings in the market reviews. Second, an annual “update” is published every year. In the course of this update, the directions are amended, for example to reflect changes in BT’s systems or to obtain more detailed accounts in certain areas. The conditions are not normally amended, except, occasionally, to ensure the regulatory accounting conditions reflect the SMP findings in the market reviews undertaken since 2004. Third, Ofcom carried out a limited review of some elements of reporting and audit requirements, resulting in a statement entitled “Changes to BT’s regulatory financial reporting and audit requirements”, published on 30th May, 2007.

3.19 Finally, it should be noted that BT has certain regulatory reporting obligations under the Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002. In particular, under paragraph 5.31 of the Undertakings, the Regulatory Financial Statements of BT should also separately present the financial results of Openreach.

EC Recommendation on cost accounting and accounting separation

3.20 In 2005, the EC Commission adopted a recommendation which addressed the implementation of a cost accounting and/or accounting separation system (further referred to as the “EC Recommendation”). The EC Recommendation sought to foster consistent application of accounting principles and methodologies at EU level, and improve the transparency of the accounting systems, the methodologies, the data, the auditing and the reporting process. This recommendation was adopted after the 2004 statement, but it constitutes a useful and relevant reference point in our current review.

3.21 Financial reporting has also been addressed by BEREC (the Body of European Regulators for Electronic Communications) and ERG (the European Regulators Group) before it. In particular, ERG Common Position (05) sets out guidelines for implementing the EC Recommendation. Since 2006, ERG/BEREC also publishes annual “Regulatory Accounting in Practice” reports, the most recent dating from 2011.

Purposes of regulatory reporting

The CRF and the Act

3.22 The Access Directive and the Act reveal that there is a close link between the accounting conditions (cost accounting, accounting separation and publication of accounting information) and other SMP conditions. In particular, cost accounting has

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15 In EU law, Recommendations have no binding legal force. However, they are not completely devoid of legal effect, in that they are a persuasive authority which would need to be considered by a national court (and by extension an NRA) where it is relevant to the matter before it.
17 BoR (11) 34, “BEREC Report Regulatory Accounting in Practice 2010”.

a particular role in supporting price regulation (including network charge controls and cost orientation obligations) and accounting separation is important for obligations of non-discrimination. Publication of accounting information aids transparency.

3.23 This is also addressed in the EC Recommendation, which states:

“The purpose of imposing an obligation to implement a cost accounting system is to ensure that fair, objective and transparent criteria are followed by notified operators in allocating their costs to services in situations where they are subject to obligations for price controls or cost-oriented prices.

The purpose of imposing an obligation regarding accounting separation is to provide a higher level of detail of information than that derived from the statutory financial statements of the notified operator, to reflect as closely as possible the performance of parts of the notified operator’s business as if they had operated as separate businesses, and in the case of vertically integrated undertakings, to prevent discrimination in favour of their own activities and to prevent unfair cross-subsidy.”

“The cost accounting and accounting separation systems of the notified operators need to be capable of reporting regulatory financial information to demonstrate full compliance with regulatory obligations.”

“It is recommended that NRAs make relevant accounting information from notified operators available on request to interested parties at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services internally (...).”

3.24 In a judgment of the Competition Appeal Tribunal (“CAT”) of 22 March 2011, the purpose of regulatory financial reporting, and the published accounts in particular, was also touched on. In relation to the regulatory reporting obligations imposed by Ofcom on BT and KCOM in 2004, the CAT found:

“That, after all, is one of the purposes of regulatory financial statements: to ensure that the appropriate data is published to enable compliance with SMP obligations to be monitored.”

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21 BT v Ofcom, Case 1146/3/3/09, Judgement of 22 March 2011. BT appealed our determination of 14 October 2009 in respect of certain disputes between BT and various other CPs in relation to BT’s charges for partial private circuits (PPCs). The CAT addressed, among others, questions relating to the data on which Ofcom relied. The judgement of the CAT was upheld by judgement of the Court of Appeal of 27 July 2012, Case C3/2011/1683
Responses to the call for inputs

3.25 In their response to the call for inputs, stakeholders addressed the purpose of regulatory financial reporting, including the published reports.

3.26 There was consensus that some form of regulatory reporting was necessary.

3.27 BT stated “we recognise the need for us to provide robust current cost information regarding regulated services and regulated markets and to provide assurance to stakeholders about our ongoing compliance”\(^{23}\).

3.28 UKCTA stated “A reliable and transparent accounting regime is a prerequisite for a robust and accountable regulatory regime which is able to effectively remedy instances of market failure and combat market power”\(^{24}\). It further stated “It is abundantly clear to us that detailed accurate and transparent regulatory accounting information is essential”\(^{25}\).

3.29 BT summarised its view on the purpose of regulatory reporting in three key purposes\(^{26}\):

- “To provide a reliable source of cost information to inform regulatory judgements”
- “To provide a satisfactory level of assurance around such cost information”
- “To provide assurance internally, to Ofcom and to other stakeholders (CPs) that we comply with the regulatory rules in place (charge controls, cost orientation, non discrimination)”.

3.30 BT questioned whether the demonstration of compliance with non-discrimination and cost orientation were appropriate purposes for the annual published information. With regard to non-discrimination, BT stated that it felt that in most cases Equality of Input (EOI) requirements addressed this concern. For non-EOI services BT felt that the level of assurance provided by the published financial statements could be provided in a simpler, more high-level way although it did not provide details\(^{27}\).

3.31 UKCTA’s response focused on the purposes of the published information. It believed that the purpose of the Regulatory Reporting Framework should be to provide information to enable CPs to\(^{28}\):

- Check compliance with regulatory obligations (cost orientation, non discrimination, financial aspects of equivalence and Equality of Inputs).
- Obtain a reference point against which charge control modelling can be reviewed.
- Inform CPs of the drivers of price and determine whether elements of the service might be provided more efficiently by themselves.

\(^{23}\) BT Call for Inputs Response page 3.
\(^{24}\) UKCTA Call for Inputs Response page 2.
\(^{25}\) UKCTA Call for Inputs Response page 25.
\(^{26}\) BT Call for Inputs Response page 6 and 9.
\(^{27}\) BT Call for Inputs response page 9.
\(^{28}\) UKCTA call for input response page 15.
• Identify and investigate margin squeeze and prevent exploitation of market power.

Ofcom’s views on the purpose of regulatory financial reporting

Financial reporting

3.32 We consider that a key aim for the regulatory financial reporting obligations should be to provide information in order to allow Ofcom to effectively monitor compliance with other SMP conditions (including cost orientation and non-discrimination) and to enable our timely intervention to ensure that those other SMP obligations continue to effectively address the underlying competition problems identified in our market analysis.

3.33 We also believe that regulatory financial reporting supports investigations of potential breaches of SMP obligations and anti-competitive practices generally and may be used in resolving disputes. Regulatory financial reporting also constitutes a useful source of information, for example to inform our market reviews and in setting charge controls, and functions as an anchor point to reconcile other data.

3.34 We recognise that in many cases these purposes will not be satisfied by the RFS alone. Often, we will require more detailed and additional information that we cannot and should not require as part of the RFS. Our information-gathering powers allow us to do so. As such, the SMP provider’s regular reporting obligations ensure that Ofcom obtains such information as is routinely required on an ongoing basis, while our information-gathering powers supplement the regulatory reporting requirements to ensure that Ofcom is able to obtain specific information where needed to investigate specific matters.

3.35 Nevertheless, there are at least two aspects that are better dealt with through regulatory financial reporting. Firstly, we cannot request from SMP operators information that does not exist. It is a feature of accounting that source data must be captured and recorded when the transaction takes place. For example, if all the details of a sale are not captured when it is made, it may be hard or impossible to go back two years later and seek those data. Secondly, there is a discipline and consistency maintained by a reporting framework that spans the whole of the SMP operator. Without this, for example, an SMP operator could load a large proportion or all of common costs into one market for the response to a first information request and load the same common costs into another market for the second information request. With no cross-check, there could be double-recovery of common costs.

Publication

3.36 Other interested parties have a role to play in assisting us to monitor compliance effectively and to intervene in a timely fashion. Therefore, wider transparency and the need to require the SMP provider to make certain regulatory accounting information public, form part of achieving the above-mentioned aim. Published information supports stakeholders’ contribution to an informed regulatory framework, as stakeholders (who may have a better understanding of the relevant activities and costs than Ofcom) can review and comment on the data that might otherwise only be seen by Ofcom. This is consistent with the guidance given in the EC Recommendation, which states that:

“Regulatory accounting information serves national regulatory authorities and other parties that may be affected by regulatory
decisions based on that information, such as competitors, investors and consumers. In this context, publication of information may contribute to an open and competitive market and also add credibility to the regulatory accounting system.”

3.37 As we commented in our 2007 review:

“Ofcom considers that a regulatory environment where stakeholders are simply informed that the regulator is satisfied that the obligations have been met is likely to be less effective than one where the industry is better informed. Specifically, Ofcom considers that relying solely on the regulator’s assessment of whether compliance has been demonstrated carries the risk that either:

- important issues that may have been identified by stakeholders will remain unnoticed; or
- Ofcom’s allocation of scarce resources to important issues will be reduced as it is obliged to consider an increased number of speculative complaints raised by less well informed stakeholders.”

3.38 However, we do not consider that the published financial statements can or should provide CPs with all the information necessary for them to determine whether an SMP provider has complied with its obligations. Rather, our view is that the level of information to be published should be appropriate to provide confidence to CPs that an SMP provider is complying with its regulatory obligations.

3.39 However, as explained in the following sections, the publication of data in the published financial statements is not the only means of providing stakeholders with confidence that BT has complied with its obligations. Specifically, an understanding of, and confidence in, the way the data are prepared and reviewed is also essential.

The attributes of an effective reporting regime

3.40 In response to the Call for Inputs, stakeholders proposed a range of attributes for an effective regulatory reporting regime. We have considered these attributes under four broad headings, as follows:

- relevance;
- reliability;
- transparency; and
- proportionality.


This is consistent with the EC Recommendation, which states that

“The cost accounting and accounting separation systems of the notified operators need to be capable of reporting regulatory financial information to demonstrate full compliance with regulatory obligations. It is recommended that this capability be measured against the qualitative criteria of relevance, reliability, comparability and materiality”.

We consider each of the criteria in turn below.

**Question 3.1 – Do you agree with the four attributes we have identified for BT’s regulatory financial reporting: relevance, reliability, transparency, and proportionality? Are there any further attributes you would consider?**

**Relevance**

For information to be relevant it needs to answer the right questions, in an appropriate way and at the appropriate time. We consider these issues in turn below.

**What questions need to be answered?**

Having indicated the broad purposes of the reporting framework, it is necessary to identify the questions that need to be answered by the regulatory reporting regime in order to meet those purposes.

As explained above, the SMP provider’s regular reporting obligations ensure that Ofcom obtains such information that is routinely required on an ongoing basis, but our information gathering powers supplement the regulatory reporting requirements to ensure that we are able to obtain specific information where needed to investigate specific matters. Therefore, for the purpose of this consultation we have focussed on the questions to be answered by the published financial statements, although some of our findings may have implications for the reporting regime more widely.

In our consultation of 10 May 2004 which preceded Ofcom’s July 2004 statement on regulatory financial reporting, we set out some reasons why publication is necessary. We repeat these below:

“.....publication of regulatory financial statements demonstrating compliance with price controls, cost-orientation and no undue discrimination obligations:

• provides assurance to other communications providers that the services they are buying from dominant providers are genuinely cost-oriented and non-discriminatory;
• provides assurance to other communications providers that Ofcom has sufficient information to monitor and – if necessary – enforce these obligations; and

• enables other communications providers to reach their own judgements on whether they are, for example, being discriminated against by a dominant provider, and if necessary provide them with information to make an evidence-based and well-argued complaint to Ofcom.”

3.47 UKCTA provided a list of examples of the sort of questions that regulatory financial reporting should be able to answer, which might be summarised as follows 33:

• “where a product is subject to a cost orientation obligation but not a price control, then stakeholders need the RFS to be able to judge whether or not we think the cost orientation obligation is being met” (“cost orientation”).

• “...where a product is also subject to a charge control we need to be able to judge whether we think the charge control modelling is being done in the most appropriate way and that no extra-ordinary events have affected the cost base during the charge control period” (“charge control modelling”).

• “...the RFS help stakeholders to understand what is driving the price that they pay for key wholesale inputs and whether there are any aspects that they could provide more efficiently themselves...This information acts as a substitute for the range of competitor pricing information that would be accessible in a competitive market” (“make or buy”).

• “The framework is a vital tool for both identifying and investigating margin squeeze... RFS detail is also vital if other stakeholders are to meet the complaint information criteria set out by Ofcom when referring any possible Margin Squeeze cases” (“investigating margin squeeze”).

• “it is crucial that BT is required to maintain and track the costs and returns on key regulated products”. (“tracking costs”) 

• “The Regulatory Framework is also a key tool for both Ofcom and industry to investigate issues around suspected discrimination or to assess differences in products supplied externally to those supplied internally” (“non-discrimination”).

• “The regulatory framework also helps to underpin the financial aspects of equivalence and Equality of Inputs, helping to ensure that the spirit of the undertakings ... being complied with”. (“EOI”)  

3.48 Just because a stakeholder might find certain information useful or interesting, it does not follow that BT should be required to publish that information in the published financial statements. It may be that the information sought does not link to a regulatory objective. We consider stakeholders’ suggested questions below. Even if there is a regulatory benefit, it does not necessarily follow that the information should be published; it is also necessary to consider whether there is an alternative and more appropriate mechanism by which the information could be obtained if

33 UKCTA Call for Inputs Response, question 17.
necessary, or whether the information should remain confidential. We consider the question of confidentiality later in this section.

Cost orientation

3.49 We believe that it is important for CPs to have public assurance of compliance with cost orientation obligations, where they apply. The recent disputes regarding cost orientation suggest that cost orientation is a key area of concern and it is appropriate that it is the subject of both our and CPs’ attention. We also agree with CPs that such published information was important in enabling them to bring recent disputes relating to cost orientation of partial private circuits (PPCs) and Ethernet services.

3.50 Monitoring compliance with cost orientation is, therefore, an important consideration. However, as explained above, we are planning to publish a separate consultation on cost orientation. We therefore do not comment further on cost orientation in this section. To the extent necessary, we will address the implications for reporting in our separate consultation on cost orientation and/or in our second regulatory financial reporting consultation.

Charge control modelling and review

3.51 As noted above, regulatory financial reporting is an important source of information when setting charge controls. We usually request much more granular information than that which is published in the published financial statements, but they are nevertheless used as a starting point in obtaining base year financial cost data.

3.52 While the published financial statements may contain helpful information for CPs, for example to participate in the development of charge controls and inform out-turn performance against charge controls, the information contained in the published financial statements can never be fully comprehensive. That information will typically be supplemented by information provided and disclosed, if appropriate, during the consultation process.

3.53 In respect of the publication of actual costs against costs forecast for the purposes of setting charge controls, such information would potentially allow stakeholders to see how BT was performing against the original assumptions of the price control.

3.54 We understand that routine reporting of price control out-turn costs and revenues against forecast assumptions is one of the main aspects of regulatory financial statements for other UK sectoral regulators, such as the Civil Aviation Authority (CAA) and Office of Rail Regulation (ORR), as well as for some European telecoms regulators. In the case of Ofgem, the regulator monitors performance in detail, via confidential returns from operators (rather than via the published regulatory financial statements) but publishes annually a high-level summary of its findings.

3.55 While reporting of out-turn costs and revenues against forecast assumptions may provide information of interest, we would not require additional information to support this where that information is not also required for other purposes.

Make or buy decisions

3.56 We recognise that the statements may, incidentally, contain some information to inform stakeholders’ make or buy decisions (by virtue of reporting requirements supporting existing regulatory obligations such as non-discrimination). However, we
would not require additional information to support this where that information is not also required for other purposes.

**Investigating margin squeeze**

3.57 We recognise that SMP obligations may, in some cases, seek to address the ability of an SMP provider to operate a margin squeeze. Where we have imposed such SMP obligations, the RFS, and the published financial statements in particular, will help Ofcom and stakeholders to monitor compliance with such SMP obligations.

3.58 In addition, the published financial statements will contain information which will allow some margins to be monitored. However, we do not believe that the published financial statements can ever include all necessary information to identify all possible potential cases of margin squeeze (for example, to allow CPs to monitor BT’s margins in some downstream markets, it may be necessary for BT to publish cost information for markets where there have been no findings of SMP) and we do not believe that the published financial statements should disclose additional information over and above that required for other purposes.

**Tracking costs**

3.59 We consider that this is addressed by our comments above in respect of cost orientation and price controls.

**Non-discrimination/EOI**

3.60 BT stated that it did not believe that the published financial statements should include assurance of compliance with non-discrimination, suggesting that EOI requirements should address the concern in most cases. EOI and non-discrimination exist as separate remedies and as such, compliance should be considered separately. In addition there are some services that fall outside EOI but nevertheless are still subject to non-discrimination. These would therefore not be captured by EOI reporting. We would be interested in stakeholders’ views as to what extent EOI requirements are sufficient in this respect.

3.61 The use of regulatory financial reporting to provide assurance regarding compliance with non-discrimination obligations is well established under Article 11(1) of the Access Directive. We believe that publication of such data (both volumes and prices), within the framework of an audited set of published financial statements provides further confidence to CPs. We therefore propose that providing assurance around compliance with non-discrimination should remain one of the purposes of the published financial statements.

**Other objectives**

3.62 We do not consider that the published financial statements should include as primary purposes, the need to provide assurance that BT has complied with its obligations to charge on a fair and reasonable basis. We consider that the need for financial information is fairly limited and to the extent that it exists would be covered by existing requirements around reporting relating to cost orientation, non discrimination or charge control obligations.

3.63 Many of the purposes of regulatory financial reporting included within UKCTA’s and other CPs’ responses are reflected in the broader regulatory objectives documented above. However, we do not agree that all of the purposes proposed, e.g. assess BT’s
efficiency, should be purposes of regulatory financial reporting. For example, in the case of assessing efficiency, this is something that Ofcom may choose to do as part of a consultation on setting a charge control, following a finding of SMP in a market. In that case, we may seek specific information from BT using our statutory information gathering powers and may publish some of this as part of our consultation, in order to give CPs the opportunity to comment upon it. Of course, we are not precluded from using information that already exists regarding efficiency and that has been reported in the published financial statements for other purposes.

**Is the information being provided in the right way?**

3.64 We consider that the published financial statements will be most useful if they provide data that (as far as possible) have been prepared on a basis that is consistent with the way Ofcom sets, or tests compliance with, the underlying obligations.

3.65 As explained in section 4, while currently the published financial statements are prepared on a basis that is broadly similar to that used by Ofcom when making regulatory decisions, they cannot be said to be entirely consistent with those decisions. The current approach means that reviewing reported results in the context of regulatory decisions is not always straightforward. If Ofcom and BT have different views on the key issues in the regulatory financial statements, this complicates any assessment of compliance, not only for BT but for all stakeholders.

**Is the information being provided at the appropriate time?**

3.66 The regulatory reporting regime supports the monitoring of compliance with obligations. Delays in the provision of the data or publication of the published financial statements could lead to market distortions through delays in identifying areas of non compliance. It is therefore important that compliance information is reported in a timely fashion. In terms of how to set timeframes for publication, we note here that we need to consider the uses of such information and how any delays would impact upon stakeholders using the information for such purposes.

*Question 3.2 – Have we identified the right questions which BT’s published financial statements should answer? What further questions do these statements need to answer?*

**Reliability**

3.67 In order to meet the regulatory objectives, the reported data must be reliable. Ensuring that the financial data are reliable, and can be seen to be reliable, is a key focus of this review.

3.68 We have considered the need for reliability in three parts, as follows: the reliability of the underlying data, the choice of suitable rules and the need for those rules to be followed.

**Are the underlying data reliable?**

3.69 The data that form the input to the cost allocation system need to be, as far as possible, free from error. For most data, that would mean that data should be, as a starting point, capable of reconciliation to the statutory accounts. The fact that the statutory accounts (and by implication the supporting systems) have been subject to statutory audit provides us with further confidence about the reliability of the
underlying data. (We discuss the regulatory audit further below, under the heading of “Are the rules followed?” as well as in Section 4 under the heading of “Control”).

Have suitable rules been chosen?

3.70 In deciding upon an accounting treatment, there may be a range of options to choose from and the selection will require some judgement. For the purpose of the RFS, these rules need to cover the way costs and revenues are identified, the way assets are valued, the way these assets are allocated to products and services and the way this information is presented. Our view is that the rules need to be chosen so as to align with the purposes of regulatory financial reporting and to support our regulatory objectives (we discuss this further in our proposal about consistency with regulatory decisions in Section 5).

3.71 One important aspect in such choices is objectivity. In the context of statutory accounting, the need for objectivity might be considered as a requirement for accounting entries to be based on fact rather than on personal opinion. We recognise that, for the purpose of regulatory accounting, and in particular in the context of allocating costs, there may be rather more scope for judgement (for example in interpreting the general principle of cost causation) where identifying a simple cost driver that would allow the costs to be allocated is not always easy. Nevertheless, we consider that it is important that the set of rules used to prepare the RFS is free (and is seen to be free) of any inherent bias that favours BT. As set out in section 4, recent changes to key assumptions have led to questions from some stakeholders around the apparent objectivity of the assumptions used by BT in preparing the RFS.

Are the rules followed? The regulatory financial audit

3.72 It is not enough to have an appropriate and objective set of rules, if those rules are not followed.

3.73 With this in mind, Ofcom requires BT to obtain an independent audit opinion on the financial statements (a regulatory financial audit). BT’s auditor (currently PricewaterhouseCoopers LLP (“PwC”)) provides its opinion to BT and Ofcom as to whether the financial statements for each relevant market are presented in accordance with the Accounting Documents.

What should the audit regime achieve?

3.74 The audit regime should give Ofcom and stakeholders some confidence that the published financial statements are reasonably reliable.

3.75 An opinion might be obtained at the level of the entity as a whole (similar to statutory audits) but can also potentially be obtained at a greater level of granularity, giving confidence about the reporting of the overall performance of the SMP operator and for example whether rules have been applied consistently.

3.76 In respect of the requirement for opinions at a more granular level (for example the summary market statements) there is a choice to be made. Inevitably, as the material to be audited becomes more subject to judgement and more granular, it becomes more difficult (or even impossible) to give an audit opinion and the cost of obtaining such an opinion rises. There is therefore a trade-off to be made between seeking assurance at a more granular level (which in some cases may correspond more closely to the data that stakeholders are using) versus the increased difficulty and cost of obtaining such assurance. However, the audit also involves the review of
data, systems, controls and processes that underlie the statements upon which an opinion is being given. This, combined with the existence of an audit regime as a whole, contributes to providing some measure of confidence, indirectly, about the information that underlies those statements which receive an audit opinion. In other words, it may not be necessary (or practical) to have an audit opinion at the level of granularity of information that is used (e.g. the service level). However, the audit must give Ofcom and stakeholders sufficient confidence about the data that they use, in order to be able to rely upon it for fulfilling regulatory objectives.

Does the manner in which the rules are applied yield robust and meaningful results?

3.77 Finally, in terms of reliability, it is necessary to consider whether the rules are applied in a way that delivers meaningful results.

3.78 The costs incurred by a communications provider typically include a large proportion of common costs. Therefore cost estimates for individual products and services depend in part upon the choice of the attribution basis and the extent to which these costs can meaningfully be attributed down to the required level of granularity.

3.79 BT stated: “Publishing costs at more aggregated market levels is more meaningful and relevant given the complexity and subjectivity of attributing common costs at lower levels of granularity”. BT further stated that “the level of detail we are required to report means attribution assumptions around common and shared costs become more and more subjective and thus less and less economically relevant in terms of signalling the levels at which individual prices should be set”.

3.80 We do not consider that greater aggregation means the data are necessarily more meaningful. For many purposes, more granular information is more relevant for regulatory purposes.

3.81 This is an issue which arises particularly in the context of cost orientation and how that concept should be interpreted. As noted earlier, we will address cost orientation in a separate consultation.

Question 3.3 - Have we identified the right factors to consider, in terms of what the regulatory audit should seek to achieve? If not, please provide your comments and suggestions and support them.

Transparency

3.82 Transparency is essential to ensure that the data can be understood by their target audience and tested and challenged when necessary. There are several aspects to transparency, as follows:

- Clarity of presentation

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34 Common costs are defined as “those which arise from the provision of a group of services but which are not incremental to the provision of any individual service. If the incremental costs of each service are removed from the total cost of providing all services, what are left are the common costs”. See Ofcom (2009), “Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT’s charges for partial private circuits”, annex 11 – The economics of cost orientation, pp.205-206.
35 BT call for inputs response page 16.
36 BT call for inputs response page 6.
Regulatory financial reporting: a review

- Clarity around basis of preparation
- Consistency

3.83 We consider these dimensions in turn.

Clarity of presentation

3.84 The presentation of the published financial statements should be clear and easy to understand. However, different users of the data will have different views on what is clear and easy to understand. We therefore need to identify the target audience for the published financial statements.

3.85 UKCTA stated that “The accounts are always going to be specialist publications, designed for industry experts”\(^{37}\).

3.86 However, Verizon argued that the accounts should be presented “in such a way as to make them accessible to a person familiar with BT’s regulatory obligations but not necessarily an expert in financial accounting or reporting”\(^{38}\).

3.87 We recognise that there may be benefits of making the published financial statements accessible to a wider audience, including for example analysts in the City. However, we do not consider that this should be at the expense of the information that we consider should be provided to answer the relevant regulatory questions proposed above. In this respect we broadly agree with UKCTA’s view that the published financial statements will always be targeted at industry specialists.

3.88 On the basis that the primary audience is likely to be the informed regulatory community across industry, we need to develop our thinking on what clarity of presentation for this audience actually means. Responses to the Call for Inputs included some suggestions, such as UKCTA’s request that “the information should be presented at a product level and contain details of internal and external pricing, volumes, revenue and costs, with both FAC floors and DSAC ceiling produced”\(^{39}\). However, there were few specific examples of how greater clarity might be achieved and, informed by responses to this consultation, we will develop our specific proposals in the second consultation.

Basis of preparation

3.89 It is essential that the user of any set of financial statements understands how and why they were prepared. In the case of the RFS, for example:

- A key requirement for any compliance regime is that the purpose of any compliance report (such as the RFS in this case) must be clear. One of the primary objectives for this consultation is to develop and communicate a clear purpose for the reporting framework ahead of our second consultation on the specific reporting proposals. More specifically, stakeholders need to understand which regulatory question(s) a given schedule is designed to address (see also our discussion above under the “Relevance” heading, where we discuss “What questions need to be answered?”).

\(^{37}\) UKCTA Call for Inputs Response page 23, question 26.
\(^{38}\) Verizon Call for Inputs Response question 23.
\(^{39}\) UKCTA Call for Inputs Response page 16, question 18.
A lack of appreciation of the roles and responsibilities of the directors, auditors and regulator is likely to reduce stakeholders’ confidence in the RFS. The roles and responsibilities should be clearly articulated.

A lack of understanding of the basis of reporting will further reduce stakeholders’ confidence in the RFS. By the basis of reporting, we mean the methodologies that BT follows in preparing the accounts, such as how to allocate costs and how to value assets. These are currently documented in the Primary and Secondary Accounting Documents (explained further in Section 4). It is essential that the basis of preparation is understood by the target audience. This may require balancing between the need for the information to be complete and sufficiently detailed with the need for the information to be accessible. In other words, a long and detailed document cataloguing the methodologies may provide technical explanations but may not necessarily allow a stakeholder to quickly get a basic grasp of the overall approach being taken to prepare the accounts. As set out in section 5, a key objective of this review will be to ensure that stakeholders get a better understanding of how the data in the RFS are prepared.

Consistency

3.90 We mentioned consistency with regulatory decisions earlier in this section. We now consider two further dimensions of consistency, as follows:

- consistency over time; and
- consistency with other financial data.

3.91 In respect of consistency over time, UKCTA said: “Accuracy along with predictability are the most crucial factors. It is very unhelpful to see large swings year to year when there is little underlying change in both the supply, demand or indeed the real cost of providing the service. This does not foster confidence or trust in the data”\(^{40}\). Three said that “Key assumptions and how they change between each year should be clearly set out”\(^{41}\).

3.92 We agree that unexplained variability over time potentially reduces confidence in the financial data, as it reduces stakeholders’ ability to review the information in one year in the context of another. Information that is comparable over a number of reporting periods therefore improves the value of that information. We consider that consistency over time is an important objective for the published financial statements, although we recognise that this may come into tension from time to time with the requirement for the published financial statements to be more closely aligned with regulatory decisions.

3.93 In respect of consistency with other financial data, there was general agreement from respondents that the RFS should be consistent with other financial information provided by the regulated company.

3.94 While there are potential advantages in requiring the RFS to be prepared on the same basis as the management accounts (notably the knowledge that the business is making decisions based on the same information that is being published, offers some assurance that the company considers the information to be relevant and

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\(^{40}\) UKCTA Call for Inputs Response page 22 question 25.

\(^{41}\) Three Call for Inputs Response question 16-34.
reliable), we also recognise that the information required for regulatory reporting is likely to be different from that required by the company to make business decisions.

3.95 In respect of consistency with the statutory accounts, we remain of the view that the ability to reconcile the published financial statements to the audited statutory accounts is essential if stakeholders (including Ofcom) are to gain confidence in the published financial statements.

Proportionality

3.96 The requirements imposed on BT should be proportionate to the benefits that are expected to result from those requirements. The CRF and the Act specify that obligations placed on operators should be proportionate.

3.97 BT stated in its response that “Ofcom needs to approach this project by referencing options back to the identified purposes and ensuring what is published/provided is the “minimum necessary” to meet policy objectives.” It further stated that “Regulatory reporting should be proportionate to the agreed policy purposes.”

3.98 A related issue is that of confidentiality. BT argued that:

“Ofcom should also give much greater weight to whether information should be treated as commercially confidential. Much of the data we currently require is clearly of commercial value to our customers who are also of course our competitors in various markets.”

3.99 Other respondents generally recognised that some information was by its nature confidential, and while it should be available to Ofcom, should not be published. For example, EE explained that it “recognises that there is likely to be more confidential information which is only provided to Ofcom. The needs to commercial confidentiality and the requirements for information for effective regulation make this inevitable.”

3.100 In principle, we agree that confidential data should normally not be published. Further, while we will require a better understanding of the details, we consider that there may be some merit in BT’s point that

“...as competition becomes more established over time and is expected to develop further (including in markets where BT may currently be found to hold SMP), there is a clear risk that placing commercially sensitive information on our costs and volumes into the public domain for our competitors to use could actually undermine the effectiveness of competition.”

3.101 However, while acknowledging BT’s concern, we also broadly agree with UKCTA’s statement that “Claims of confidentiality should be treated with caution.”

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42 This means that it should be possible to verify that their contents are compatible, i.e. that at a reasonable level the information contained in one document can be reconstituted by recombining the information contained in the other document, with a minimal margin of error.

43 BT Call for Inputs Response page 18 question 25
44 BT Call for Inputs Response page 17 question 23.
45 BT Call for Inputs Response page 18 question 25.
46 Everything Everywhere Call for Inputs Response page 10 question 24.
47 BT Call for Inputs Response page 7.
3.102 EE suggested that:

“The extent to which information should be published should be determined by true needs to commercial confidentiality, which may lead to different information being published where the degree of competition is different”\textsuperscript{48}.

3.103 Therefore, while the principle of not publishing commercially sensitive information is clear, the application of this principle is less so. While some data may be obviously commercially sensitive, most data will probably sit somewhere on a spectrum between public knowledge and business secrets.

3.104 Similarly the case for publication of those data is likely to be somewhere between strong, where publication is essential if the necessary confidence is to be provided, to weak, where publication perhaps provides some secondary evidence to support other data.

3.105 In the extreme cases (of business secrets that do not provide significant evidence, or of essential evidence that is not commercially sensitive), the decision on whether to require publication will be straightforward. However, most evidence will not fall into either of these categories and some judgment will be necessary.

3.106 We are therefore keen to better understand arguments that data should not be published on grounds of commercial sensitivity and the potential harm that might be caused by the publication of those data.

\textbf{Question 3.4.} – With reference to specific examples, how do you consider we should balance the needs for adequate disclosure with BT’s concerns around confidentiality? Where BT has stated that disclosure of information is commercially sensitive, please explain whether you consider this to be a valid concern. Please provide evidence to support your view.

\section*{Conclusion}

3.107 We consider that a key aim for the regulatory financial reporting obligations is to provide information in order to allow Ofcom to effectively monitor compliance with other SMP conditions (including cost orientation and non-discrimination), to enable our timely intervention to ensure that those other SMP obligations continue to effectively address the underlying competition problems identified in our market analysis and to inform our market reviews and the setting of SMP obligations including, potentially, charge controls.

3.108 We consider that stakeholders have a role to play in respect of financial reporting. We do not consider, in principle, that the published financial statements should provide CPs with all the information necessary for them to determine whether an SMP provider has complied with its obligations. Rather, our view is that the level of information to be published and the underlying methodological assurance procedures should be appropriate to provide confidence to CPs that an SMP provider is complying with its regulatory obligations.

\textsuperscript{48} Everything Everywhere Call for Inputs Response page 10 question 24.
3.109 We consider that an effective regulatory reporting regime needs to provide a proportionate amount of relevant and reliable information in a transparent way. The relevant information includes information related to compliance with cost orientation, price controls and non-discrimination.

3.110 We consider how well the current regime fulfils these objectives in section 4.
Section 4

The current regulatory reporting framework and issues identified

Summary

4.1 BT publishes a set of annual regulatory financial statements to which we refer in this document as the ‘published financial statements’. These statements include current cost based fully allocated costs\textsuperscript{49} (CCA FAC), distributed stand alone costs (DSAC)\textsuperscript{50} and distributed long run incremental costs (DLRIC)\textsuperscript{51} statements. They further include a set of supporting documents, which describe how the numbers are calculated.

4.2 Stakeholders have expressed concerns with the current arrangements, citing a variety of reasons. BT on the other hand is concerned about what it considers to be excessive disclosure. Other Communication Providers have raised concerns about what they see as BT’s discretion to set the basis of preparation and to change important parameters (such as the basis of common cost allocation across services). Some stakeholders also find the reports difficult to understand.

Introduction

4.3 The purpose of this section is to provide readers with an understanding of the current regulatory reporting arrangements. This section is in two main parts. The first part is an explanation of the current regulatory reporting arrangements. This sets out the factual background to regulatory reporting, looking at four elements: the data produced by BT; the systems that BT uses for the production of such data; the reports in which the data are published; and the control, or mechanisms by which the three previous elements are reviewed.

4.4 The second part of this section identifies the issues with the current arrangements. This assessment follows the same structure as the first part of the section, i.e. data, systems, reports and control. Within this structure, it evaluates each element of the

\textsuperscript{49} Current cost accounting (CCA) - An accounting convention, where assets are valued and depreciated according to their current replacement cost whilst maintaining the operating or financial capital of the business entity.

\textsuperscript{50} Distributed stand alone cost (DSAC) - The DSAC of each service in an increment (such as the access network or the core network) which is derived by establishing the stand-alone cost of the increment and distributing that cost among the services in that increment (via equi-proportionate mark-ups over LRIC). Therefore, rather than all common costs shared by a service being allocated to the service under consideration, the common costs are allocated amongst all the services in the increment that share the network increment. For detailed descriptions, see http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf.

\textsuperscript{51} Distributed long run incremental cost (DLRIC) - The DLRIC of each service in an increment is derived by establishing the LRIC of the increment and distributing that cost among the services in that increment (using equi-proportionate mark-ups over LRIC. Therefore it is the LRIC of the individual service, with a share of costs which is common with other services in the same increment. For detailed descriptions, see http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf.
reporting framework against the four attributes of effective regulatory financial reporting that we identified in section 3: relevance, reliability, transparency and proportionality.

4.5 Finally, this section looks briefly at KCOM, its published statements, and the preparation methodology used by KCOM to produce those statements.

4.6 In considering the current reporting arrangements, we have considered both the published financial statements and the annual information provided to Ofcom in the form of confidential statements (such as the AFI52 and the Data Extract Tool53).

4.7 Cost orientation is one specific regulatory obligation, compliance with which may be monitored via the published financial statements. However, as explained in Sections 1 and 2, Ofcom is planning to publish a separate consultation on cost orientation. We therefore do not comment further on cost orientation in this section. To the extent necessary, we will address the implications for reporting in our separate consultation on cost orientation and/or in our second regulatory financial reporting consultation.

**Explanation of the current arrangements**

4.8 We have broken the current reporting arrangements down into four elements, as follows:

- **Data**: a description of the information that BT produces for regulatory reporting purposes.

- **Systems**: the financial systems and processes through which the data are produced.

- **Reports**: the various forms in which data are produced by BT. These range from published reports, like the published financial statements, to unpublished spreadsheets provided confidentially by BT to Ofcom.

- **Control**: the mechanisms by which the data, systems and reports are reviewed and enforced.

4.9 We consider these four elements in turn, below.

**Data**

4.10 The source accounting data underpinning BT’s regulatory reporting information is the same as that used to prepare the statutory accounts for BT Group plc (i.e. the general ledger).

4.11 However, the requirements of regulatory reporting differ from those of either the statutory or management accounts. The two key areas in which differences arise are the structure and content:

- **Structure**: The data is structured around areas of regulatory focus, such as different economic markets, rather than operational businesses.

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52 Additional Financial Information (AFI) provided to Ofcom on a confidential basis
53 The Data Extract Tool enables Ofcom to access, replicate, and interrogate the data underlying the RFS at different levels of the cost structure.
• **Content:** Key differences include:
  
  o Asset Value Calculations: Assets are valued by BT on a CCA basis within the published financial statements. (In contrast however, note that in the case of copper and duct assets, in making certain regulatory decisions, Ofcom uses a Regulatory Asset Value (RAV).)
  
  o FAC Attributions: The regulatory framework requires products and services to be shown on a FAC basis.
  
  o Costing methods: Regulatory reporting information includes Long Run Incremental Cost (LRIC) data (specifically DLRIC, DSAC) which does not form part of the statutory reports.

4.12 We explain these two aspects of the data, structure and content, in more detail below.

**Structure**

4.13 The structure of the published financial statements data is based on groupings of regulatory markets: Access Markets, Other Wholesale Markets and Retail Markets.

4.14 These groupings were first established when the regulatory focus was on end user prices and wholesale inputs. Regulation, whilst still at the wholesale level, has also moved further upstream with attention on services provided by Openreach which must be provided on an EOI basis. Retail Markets data are no longer reported in detail. The split between Access Markets and Other Wholesale Markets does not correspond exactly to the boundaries of Openreach or EOI requirements.

4.15 Access Markets and Other Wholesale Markets are further broken down into different SMP markets. These contain regulatory services based on products.

4.16 The services can be broken down either into costs according to expense type (e.g. depreciation) or by component.

4.17 Components represent the building blocks of the network and are intended to aid understanding of costs as they provide a constant reference point across products and services. The current component structure has evolved with the changing regulatory environment to include new 21CN and fibre components. It includes components which were developed within a copper based world e.g. e-side and d-side copper capital and current components which combine copper and duct access costs.

**Content**

4.18 In terms of content, the key differences between regulatory reporting information and statutory accounting information are as follows:

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54 Regulatory Asset Value (RAV) – the value ascribed by Ofcom to assets within the copper access network which were in existence prior to August 1997 (i.e. assets which were in existence prior to the change in valuation method from HCA to CCA).

55 Fully Allocated Cost (FAC) - all costs (including those which cannot be directly allocated) are attributed such that the complete end to end cost stacks can be understood.

56 Long Run Incremental Cost (LRIC) is the incremental cost over the long run, i.e. the period over which all costs can, if necessary, be varied.
4.19 In respect of asset values, regulatory reporting information is required on a Current Cost Accounting (CCA) basis, the basis on which BT publishes its published financial statements. We explain the basis for using CCA below. The assumptions and methodology underpinning the CCA valuation were developed primarily for regulatory reporting purposes.

4.20 BT has been reporting its costs on a CCA basis for a number of years. BT’s CCA reporting has its origins in the June 1996 retail price control statement and the July 1997 network charge control statement. It was introduced to provide more appropriate signals for investment and in particular for upstream competitive entry. CCA was also seen as consistent with LRIC, in terms of its use in a charge-setting framework based on forward-looking costs, which should in turn provide efficient pricing signals.

4.21 The EC Directives do not specify which cost accounting method should be used, and whether it should be CCA or historic cost accounting (HCA). They however provide guidance as to the economic objectives to which the costing method should contribute.

4.22 Article 13 of the Access Directive (Price control and cost accounting obligations) says that:

"NRAs shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition" and later on refers to the "cost of efficient provision of services".

4.23 Under the EC Recommendation, the preliminary paragraph (6) says:

“Any mandated cost accounting or accounting separation methodology used in particular as a basis for price control decisions should be specified in a way that encourages efficient investment,..." 

4.24 In the ERG Common Position at section 3.2, Current cost accounting: guidelines for implementation:

“Historical cost information is generally accepted as being adequate for financial stewardship purposes but may provide unsatisfactory indicators for regulatory decision making. To recognise the effect of changing prices or when using a forward-looking costing methodology, a valuation of the relevant asset base to current replacement cost values (also known as ‘value to the business’) should be performed."

4.25 It is therefore clear that encouraging efficient investment is important, as well as the use of current replacement cost values for assets (or "value to the business").

4.26 There may be different costing methodologies that could be used to support these economic objectives. The choice will depend upon the objectives and the
circumstances. Currently, we require BT to report on a CCA basis, under SMP condition OA8 of the July 2004 statement.

4.27 Following our Cost of Copper Review, the Regulatory Asset Value (RAV) was assigned to BT’s copper and duct\textsuperscript{57}. This has since been incorporated into various charge controls including those of LLU and WLR but it has not been incorporated within BT’s published financial statements\textsuperscript{58}.

4.28 In respect of \textit{attribution methods}, regulatory financial reporting information is prepared such that costs, revenues and capital employed are fully allocated (i.e. all financial data is attributed) to products and services. Hence attribution methods are needed, including apportionment bases, for those costs which cannot be directly allocated. Apportionment bases may involve elements of judgement.

4.29 The development of these bases is guided by a set of Regulatory Accounting Principles, which are published by BT in its Primary Accounting Documents\textsuperscript{59}. The Regulatory Accounting Principles are as follows:

- Priority (the following order of principles to represent the hierarchy of their priority)
- Definitions (to be consistent with the SMP conditions)
- Cost causality (attributions to be in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred)
- Objectivity (treatments not to be intended to favour BT or any other operator)
- Consistency of treatment (from year to year)
- Compliance with applicable law and IAS (Companies Act 2006, Article 4 of the IAS Regulation and BT’s accounting policies subject to these principles)
- Transparency (to enable a suitably informed reader to gain a clear understanding of the overall structure of financial and information systems, and gain a detailed understanding of, and make their own judgement about all the material, methodologies and drivers)
- Sampling (to be based on generally accepted statistical techniques)

4.30 The requirement for fully allocated costs is specific to regulatory reporting, hence the attribution bases are developed to meet that requirement.

4.31 In respect of \textit{cost methodologies}, BT is required to prepare Long Run Incremental Cost (LRIC) statements and includes these within its published financial statements.

\textbf{Systems}

4.32 The systems used by BT to produce regulatory financial reporting information have been developed over time to meet the changing regulatory context. The two main

\textsuperscript{57} Ofcom Cost of Copper Statement 2004 – paragraph 1.7.
\textsuperscript{58} Ofcom Cost of Copper Statement 2004 – paragraph 1.18.
\textsuperscript{59} BT Primary Accounting Document 2011 page 11.
regulatory systems that BT uses are: the Accounting Separation system (known as “ASPIRE”) and the LRIC system, referred to as the “BT LRIC model”.

4.33 The ASPIRE model is the system which produces fully allocated costs (FAC) according to the regulatory financial reporting structure of markets, services, products and components. It does this by collating and attributing costs, revenues, assets and liabilities. ASPIRE is dependent on numerous other systems which provide financial input data and data for allocation bases. It also comprises off-line models which are used for various regulatory purposes including the production of apportionment bases, CCA valuation estimates and geographic market data splits, the requirement for which has arisen since the original structuring of the system.

4.34 The BT LRIC model is fed from the ASPIRE model. The BT LRIC model further depends on additional systems and off-line models which are used to generate the Cost Volume Relationships (CVRs).

4.35 Further detailed information on the BT systems can be found in BT’s Detailed Attribution Methods and BT’s LRIC Relationships and Parameters60.

4.36 A diagram illustrating BT’s accounting systems architecture is provided at Annex 1. This diagram is presented only to demonstrate the complexity of the existing systems. It is not however provided for detailed review.

4.37 In the following paragraphs, we provide further explanation about BT’s systems by considering the ASPIRE system, the BT LRIC system and the Ofcom Data Extract Tool.

The ASPIRE system

4.38 As outlined above, ASPIRE is the key BT system which collates and translates the various sources of input data to the regulatory structure of components, products, services and markets on a FAC basis.

4.39 The principal objectives of the ASPIRE systems are stated by BT to be:

- “To provide a high quality mechanism for the production of RFS”.
- “To provide the foundation for the derivation of LRIC Statement of Costs.”
- “To provide visibility of cost attributions.”
- “To demonstrate that the costs incurred in providing services and products in downstream markets include charges equivalent to those paid by other operators and service providers for services supplied from upstream markets.”
- “That it should be an integrated platform for the production of all BT’s regulatory and internal product reporting requirements”61.

4.40 The FAC system attributes costs according to the methodology outlined within the Primary Accounting Documents62 with further detail provided within the Detailed

Attribution Methods\textsuperscript{63}. The methodology adopted involves numerous steps including the translation of costs to “F8 codes”, “plant groups” (primary and support), “activity groups” and then to components, products and services, dependent on the precise cost being attributed.

The BT LRIC system

4.41 BT uses its LRIC model to identify the incremental costs of providing services and to apportion fixed common costs to derive DLRIC and DSAC estimates. The LRICs are calculated based on fully allocated cost data from the ASPIRE system.

4.42 The model derives LRICs by estimating the costs that would be saved by no longer producing an increment. The increments within the model include Core, Access, International, Rest of Network, Other. These increments are subdivided into components which are the basis for the LRIC calculations. The model estimates the costs which would be saved by no longer producing the increment by use of Cost Volume Relationships (CVRs)\textsuperscript{64}. The fact that the model is top down means that the input into the model is reliant on the FAC system.

4.43 BT's LRIC model contains BT's views of what its costs are and how they are distributed across the different revenue streams, including calculations of the relevant DSACs.

4.44 The model has not been audited since 2006/7, when the requirement for an audit was removed. “Given the inherent limitations on the robustness of LRIC estimates”, Ofcom considered that the audit of these estimates added little additional assurance, while amounting to a significant proportion of the cost of the regulatory audit.

4.45 In 2012, BT carried out a review of some of its CVRs, resulting in some changes, although prior to this, some of its CVRs (including duct and fibre) had been held constant over many years.

Reports

Published Financial Statements and Supporting Documentation

4.46 The published financial statements cover the regulated markets within BT’s business. They are published annually and are the primary source of data within our regulatory reporting framework. The published financial statements are prepared in accordance with the Accounting Documents, where the Accounting Documents means the supporting documentation which includes the Primary Accounting Documents (PAD), the Secondary Accounting Documents and the Wholesale Catalogue.

4.47 The PAD set out the framework under which the statements are to be prepared.

4.48 The Secondary Accounting Documents set out more detailed descriptions of the policies, methodologies, systems, processes and procedures for deriving or

\textsuperscript{63} http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2012/DAM_2012.pdf

\textsuperscript{64} Cost Volume Relationships (CVR) LRICs are derived using a CVR. A CVR is a curve which describes how costs change as the volume of the cost driver changes.

\textsuperscript{65} Changes to BT’s regulatory financial reporting and audit requirements, Explanatory statement and notification, 30 May 2007 (paragraphs 4.53 and 4.54): http://stakeholders.ofcom.org.uk/binaries/consultations/obligations/statement/statement.pdf
calculating the costs, revenues, assets and liabilities underlying the published financial statements and comprise the following three documents:

- **Detailed Attribution Method (DAM)** – this describes the processes used to derive the fully allocated costs of BT’s network components, SMP Markets, Technical Areas and Disaggregated Activities.

- **The Detailed Valuation Methodology (DVM)** – this describes the methods used to derive current cost valuations.

- **The Long Run Incremental Cost Model: Relationship and Parameters (LRIC)** - this describes the calculation of the long run incremental costs for network elements.

4.49 The Wholesale Catalogue identifies and describes the wholesale services included in the Wholesale SMP markets and technical areas for which BT has a regulatory financial reporting obligation.

4.50 The content of the supporting accounting documents is summarised in the table below, with reference to the 2012 documents:

**Figure 1: Summary of supporting accounting documents**

<table>
<thead>
<tr>
<th>Name</th>
<th>Description</th>
<th>No. of pages</th>
<th>Further information</th>
</tr>
</thead>
</table>
| **Primary accounting documents** | A manual describing the principles used by BT to prepare the current cost financial statements | 71 pages | These Primary Accounting Documents consist of the documentation setting out the:  
- Regulatory Accounting Principles (2 pages)  
- Attribution methods (16 pages)  
- Transfer Charge System Methodology (1 page)  
- Accounting Policies (9 pages)  
- Long Run Incremental Cost ("LRIC") Methodology (13 pages)  
- Openreach specifically (5 pages)  
- Annex; regulatory reporting conditions & network components (8 pages) |
| **Primary Accounting Documents** | | | |
| **DAM – Detailed Attribution methods** | A manual describing the processes used to derive the fully allocated costs of BT’s network components, SMP markets, Technical Areas and Disaggregated Activates. | 372 pages | Sections 1 – 9 (366 pages) explain how the BT business is structured in its financial systems, how the systems are designed, and the methodologies and accounting principles that are employed. Appendixes A – D and Appendix G (4 pages) diagrams and list of organisational unit codes. |
| **Detailed Attribution Methods** | | | |
| **Appendices E and F** | These Excel spreadsheets detail a glossary of accounting codes that are used for network elements | 841 pages | Appendix E lists key destinations and Appendix F lists sector allocations |
| **Appendix E and Appendix F** | | | |
| **Long Run Incremental Cost Model: Relationships & Parameters** | A manual describing the calculation of the long run incremental values of the network. | 187 pages | Chapters 1 – 5 (29 pages) explain the process and calculations behind LRIC values, source of the CVR information, and examples of LRIC calculations. |
| **Long Run Incremental Cost Model:** | | | |
4.51 The content of the published financial statements is summarised in the table below with reference to the 2012 published accounts.

**Figure 2: Summary of reports within published financial statements**

<table>
<thead>
<tr>
<th>Description</th>
<th>Purpose</th>
<th>Page numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement by Ofcom</td>
<td>Comments on the data in the notes, or the presentation of, any of the financial statements in relation to each of the markets</td>
<td>-</td>
</tr>
<tr>
<td>Introduction to current cost financial statements</td>
<td>Regulatory financial review, statement of responsibility, auditor’s report, basis of preparation, and consolidated performance summary</td>
<td>3-20</td>
</tr>
<tr>
<td>Attribution of wholesale current cost &amp; mean capital employed</td>
<td>Explanation of how key cost categories are attributed to markets, and a high-level summary of the bases for these assumptions</td>
<td>21-27</td>
</tr>
</tbody>
</table>
The Ofcom Data Extract Tool

4.52 In 2005, we placed a new reporting obligation on BT to provide us with a comprehensive data file of the transactions which underpin its regulatory financial statements. The data file was to be provided to enable us to develop a tool to access, replicate and interrogate the data underlying the published financial statements, at different levels of the cost structure. The data file produced by BT for this purpose is referred to as “the flat file”.

4.53 The provision of the flat file has resulted in us developing a tool, called the ‘Data Extract Tool’, which has two main functions:

- Report Generator: This produces Profit and Loss (P&L) and Mean Capital Employed (MCE) reports for each product, service and market in each area of SMP.
- Traceback: It produces a dynamic report which can drill down on market, product and service reports to reveal what is beneath the cost and turnover lines.

4.54 Subject to the timely provision of a satisfactory data file, we stated within the 2007 statement “Changes to BT’s regulatory financial reporting and audit requirements” that we did not consider it necessary for BT to continue to provide the Additional Financial Statements (AFS) and that the requirement to produce Additional Financial Information (AFI) would be reduced. In particular, we explained that we considered the data provided in the Data Extract Tool sufficient to satisfy the following reporting requirements:

- AFI 7: analysis of total mean capital employed and detailed activity analysis for all network components;
- AFI 8: analysis by type of product group and by type of operator of costs, mean capital employed and transfer charges to disaggregated activities in relation to Outpayments to other operators; and
• AFI 9: detailed network activity analysis of mean capital employed for all network components.

4.55 We explained that we expected that further reporting obligations would be satisfied once the Data Extract Tool was fully operational. We explicitly stated that the introduction of the Data Extract Tool does not affect BT’s obligation to provide information in response to specific requests from us.

The reporting requirement on BT

4.56 In our 2007 Statement “Changes to BT’s regulatory financial reporting and audit requirements” we set out the requirements on BT as follows (AI15).

“Delivery of “data file” in prescribed format containing all records from cost attribution system. Format of file to allow for identification of sources of data, data flows (from the input sources at F8 code level through to products and services) and attribution bases.

The data would as a minimum, be able to replicate the outputs of the financial statements, and therefore would include transfer charges and CCA adjustments, and be able to identify the attribution bases to those described in the DAM. The basis of preparation must be consistent with the Primary Accounting Documents.

The information to be provided annually within 10 days of the publication of the regulatory accounts.

The outputs of the annual file would be consistent with published audited information. BT to maintain file in format consistent with Ofcom/3rd party import routine, accompanied by provision of control totals, and any technical advice which allows seamless data transfers and it should be updated where appropriate. In consultation with Ofcom, BT shall procure an appropriate audit opinion in relation to the data file.”

Examples of how the tool has been used

4.57 Listed below are some examples of how we have previously used the tool:

• We generated data for specific markets (e.g. TISBO markets for PPC dispute) in the same format prepared by BT in its Additional Financial Statements\(^ {66}\).

• We used it to provide a breakdown by service or by market of the other cost category to a more granular level i.e. accommodation, computing costs (e.g. in our work on Openreach financial framework).

• We identified the proportion of depreciation element (by F8 code) for PSTN line cards (e.g. in our work on Openreach financial framework).

• We identified, by component, the use of the corporate cost plant group as a proportion of 2 Mbit/s link services costs.

\(^{66}\) Additional Financial Statements (AFS) are additional financial reports prepared by BT for Ofcom on a confidential basis.
Other reports

4.58 Other regulatory reports include the statements of Additional Financial Information (the “AFI”s).

4.59 Like the flat file, the AFIs provide further detail underpinning the published financial statements. These reports are not published. This data is a subset of the whole RFS excluded from publication on the basis of proportionality and confidentiality. We expect that our review of the published financial statements will equally inform these confidential elements.

Control

4.60 We consider that there are three main sources of control: BT’s internal controls; review by Ofcom and independent audit.

4.61 BT is responsible for its internal controls, and for reviewing the effectiveness of those controls each year. BT’s statutory auditors consider the effectiveness of the internal controls as part of the statutory audit and in arriving at their audit opinion. BT’s regulatory auditors are expected to consider the effectiveness of the specific internal controls associated with regulatory accounting, in arriving at their audit opinions on the RFS.

4.62 Our review is currently relatively high-level and tends to be in response to specific issues. We may make observations about the published financial statements, in its own short statement, which is published by BT at the beginning of the published financial statements.

4.63 We require BT to obtain an independent audit opinion on the financial statements. The audit of statutory accounts fulfills a specific role that is fairly well understood by the users of those accounts. Regulatory financial audits differ, however, from statutory audits in at least two ways.

4.64 First, the subject matter is different: statutory accounts are defined by company law (and UK/International GAAP – generally accepted accounting practice – in the form of statements of accounting practice), whereas regulatory accounts are defined by regulatory objectives and regulation.

4.65 Secondly, the relationship between the auditors and who they report to differs. For statutory audits, the auditor reports to the company, whereas for regulatory audits, we consider that the auditor should also owe a duty of care to the regulator. An audit (whether statutory or regulatory) is defined by a contract (or “letter of engagement”) between two parties: the auditor and the client or company being audited. The client pays the auditor to perform the audit. The respective responsibilities, scope of the audit, judgement areas for the auditor and the parties entitled to rely upon the audit are all clearly specified.

4.66 An audit opinion (whether statutory or regulatory) cannot be taken to be a certificate or guarantee that the financial statements are completely free from error. Rather, the auditor plans its work and tests, so as to have a reasonable expectation of picking up material misstatements.

4.67 In the case of BT’s regulatory financial audit, the current arrangements are that BT appoints/chooses the auditor and pays the auditor. The auditor reports to BT but acknowledges a duty of care to Ofcom via a separate letter. This arrangement is
sometimes referred to informally as the “tri-partite” arrangement (BT, the auditor, Ofcom). BT currently uses its statutory auditor (though this is the choice of BT and is not a requirement). Neither BT nor Ofcom currently require the auditor to be rotated. BT has used the same auditor – PricewaterhouseCoopers LLP (“PwC”) – for over ten years.

4.68 Two types of opinion are used currently for the regulatory audit: Fairly Presents in Accordance With (FPIA) and Properly Prepared in Accordance With (PPIA). Both types of opinion take into account the “rules”. The “rules” in this case refer to the Primary and Secondary Accounting Documents prepared by BT, as well as the regulation surrounding the regulatory financial statements.

4.69 The PPIA opinion represents a view on whether the rules have been followed while the FPIA opinion provides some additional assurance on whether those rules are reasonable. An FPIA opinion therefore involves a greater degree of judgment (and more work) by the auditor.

4.70 The level of opinion required on each market is determined annually by Ofcom. BT’s auditor provides its opinion to both BT and Ofcom, as to whether the financial statements for each relevant market are presented in accordance with the Accounting Documents. Currently, the auditors are required to express a mix of FPIA and PPIA opinions, depending on the subject matter, in particular the markets, concerned.

4.71 The current scope of the audit opinion covers only the SMP market summary statements and the regulated entity as a whole, rather than other schedules within the published financial statements. So, for example, it does not express an opinion on the published detailed service and component information supporting these statements. The LRIC floor and ceiling data are not audited.

4.72 By way of example, we discuss below how both types of audit opinion were applied to the 2012 published financial statements.

4.73 Firstly, in terms of the FPIA opinion, in the 2012 published financial statements, PwC reported its opinions as to whether the following were fairly presented in accordance with the Primary Accounting Documents and complied with the requirements of the Final Statements and Notifications and the Undertakings:

- the Market Financial Statements as a whole;
- each of the market group statements comprising the statement of financial performance in Access Markets and the statement of financial performance in Other Wholesale Markets;
- each of the Market Summary Statements for the markets and technical areas listed below (the “FPIA Markets”):

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67 For example, see 2012 RFS, “Market summary” at the top of page 36, Section 7.3, comprising two rows of data for 2012 and 2011. However, by market summary statement, we exclude “Detailed service analysis”, provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.).

68 For example, see 2012 RFS, “Market summary” at the top of page 36, Section 7.3, comprising two rows of data for 2012 and 2011. However, by market summary statement, we exclude “Detailed service analysis”, provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.).
o Wholesale analogue exchange line services;

o Wholesale business ISDN30 exchange line services;

o Traditional interface symmetric broadband origination (up to and including 8Mbit/s);

o Alternative interface symmetric broadband origination;

o Wholesale local access;

o Call Origination on fixed public narrowband networks;

o Fixed call termination; and

• the Openreach Information.

4.74 In respect of the Market Financial Statements as a whole, each of the Market Group Statements and each of the FPIA Markets, PWC also reported whether, in forming that opinion and having reviewed the Primary and Secondary Accounting Documents, the Secondary Accounting Documents were appropriate to implement the principles contained in the Primary Accounting Documents.

4.75 Secondly, in terms of the PPIA opinion in 2012, PWC also reported its opinion as to whether each of the Market Summary Statements for the selected markets listed below (the “PPIA Markets”) were properly prepared in accordance with the relevant procedures, defined in the Primary and Secondary Accounting Documents, and complied with the requirements of the Final Statements and Notifications:

• Traditional interface symmetric broadband origination (above 8Mbit/s up to and inc. 45Mbit/s);

• Traditional interface symmetric broadband origination (above 45Mbit/s up to and inc. 155Mbit/s);

• Technical areas (interconnect circuits);

• Wholesale trunk segments;

• Wholesale broadband access market 1; and

• Wholesale broadband access market 2.

4.76 PWC also reported whether, in forming that opinion, having reviewed the Primary and Secondary Accounting Documents, anything had come to its attention that would have lead it to conclude that the principles and procedures contained in the Primary and Secondary Accounting Documents had not been properly applied in the preparation of the PPIA Markets.

Issues with the existing framework

4.77 We now consider how well the existing framework, described above, meets the attributes of an effective reporting framework, described in section 3, i.e. relevance, reliability, transparency and proportionality. We do this by considering in turn, the four
elements of the reporting arrangements described at the start of this section (data; systems; reports; and control).

4.78 In identifying potential issues, we have considered stakeholders’ responses to our call for inputs, as well as our own experience of using the reports provided to us under the existing framework. At the end of this section, in our conclusion, we summarise the issues that we have identified.

Data

4.79 We have described, above, two aspects of the source accounting data: structure and content.

Structure

4.80 The structure of the reporting data has evolved over time to meet the changing regulatory environment. The current framework comprises SMP and non-SMP market groupings, individual SMP markets, SMP services, and cost components.

4.81 We believe that it is now appropriate to review the reporting structure to ensure it continues to meet our attributes of transparency and relevance.

4.82 Similar views on the need for a review of the structure were expressed by respondents to our call for inputs.

4.83 BT stated of the regulatory reporting framework that “A more root-and-branch review of what is required is [therefore] overdue” 69.

4.84 UKCTA stated that a “redesign of BT’s accounting structure is (also) required where the activities and costs associated with all regulatory products are separated as far as possible” 70.

4.85 Further, BT and TTG identified elements within the existing structure which they thought should be subject to review. TTG stated that “the cost categorisation could be improved to make it more understandable and useful” 71.

4.86 BT stated that:

“Ofcom’s legitimate focus in upstream SMP markets should be on preventing exploitative and/or exclusionary behaviour. The vast majority of these concerns can be addressed without Ofcom needing to assess the level of common costs attributed to (and recovered from) individual services or individual components comprising that service. A more proportionate focus should be on overall cost recovery within markets and the prevention of potentially harmful market effects” 72.

4.87 We disagree that there is no need for us to assess the level of common costs attributed to individual services or components; we believe that it is necessary to review financial information at a more granular level than that of an SMP market as BT proposes. We will consider this as part of the cost orientation consultation.

69 BT Call for Inputs Response page 7.
70 UKCTA Call for Inputs Response page 21, question 24.
71 TTG Call for Inputs Response page 11.
72 BT Call for Inputs Response page 4.
4.88 Further we believe that the component structure aids transparency in enabling costs to be compared on the basis of usage of network (and other) elements.

4.89 In summary we believe that the existing structure of markets, services, products and components to be proportionate to the current regulatory obligations. We believe the inclusion of component reporting aids transparency. However we consider that, given the changing regulatory landscape, it is appropriate to review definitions within that structure to ensure that the design allows the right questions to be answered.

Content

4.90 In respect of the information content of the RFS, the main issue appears to be one of reliability.

4.91 In section 3, we outlined the need for reliable data as a focus for our review. We consider the attributes of reliable data to include accuracy, objectivity and consistency, both over time and to other financial data.

4.92 We described how regulatory reporting information is based on the same accounting data as the statutory accounts. However, we explained that regulatory reporting information necessitates assumptions specific to regulation (attribution, valuation and costing methods) which are not required for other types of financial reporting. These additional inputs can have a significant impact on the resulting financials and mean that other sources of financial information are not directly comparable.

4.93 BT’s response made reference to issues surrounding the data content within the regulatory reporting framework. It stated:

“In considering issues [around cost orientation and] cost reporting we would note that the question of service “cost” in telecoms markets is both complex and subjective. BT is a multi-product business with significant general overheads and shared and common costs across markets and sets of services. Attributing those costs out to individual services may be achieved in a number of ways”.

4.94 Other stakeholders’ responses questioned the objectivity of the numbers within the published financial statements. They referenced recent changes in the assumptions driving BT’s regulatory reporting data.

4.95 C&WW stated:

“The events of the past few years, with two significant restatements and a major change to the underlying basis of asset valuations have undermined confidence in the BT regulatory account regime, casting doubt on the effectiveness of the regime”.

4.96 This sentiment was shared by UKCTA, which stated:

“Our confidence in the Regulatory Financial reporting regime covering BT has been severely dented in recent years with two restatements and a massive asset revaluation, all of which benefited

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73 BT Call for Inputs Response page 3.
74 C&WW Call for Inputs Response Introduction.
BT at a time when the company was subject to a charge control review and series of commercially sensitive overcharging investigations\textsuperscript{75}.

4.97 It further stated that: "BT's ability to bend and flex the figures to suit their own commercial ends is a deep cause for concern"\textsuperscript{76}.

4.98 In recent years BT has made a number of restatements or re-presentations to its published financial statements. For example:

- The 2006/07 volume and revenue data relating to PPC and AISBO services were restated in the 2007/08 published financial statements. Unit costs for the same services were also revised in a document entitled "Additional information in relation to BT's Current Cost Financial Statements for 2008"\textsuperscript{77}. In the 2007/08 published financial statements BT said that the 2006/07 restatement reflected "additional service granularity and revised revenue calculations in certain markets following Ofcom's replicability review" and the "exclusion of non chargeable in-span connection services from the Technical Areas (Interconnect Circuits) Market"\textsuperscript{78}.

- The 2007/08 prices and volumes in the AISBO market were amended "following review of main link distances and rental and connection prices and volumes"\textsuperscript{79}.

- The 2009/10 published financial statements were restated in 2010/11 to reflect BT's revised methodology for calculating LRIC, DLRIC and DSACs. There was also a restatement to the TISBO (above 45Mbit/s up to and including 155Mbit/s) Market "to reflect a correction in BT's calculation of internal links volumes"\textsuperscript{80}.

4.99 When BT becomes aware of errors in its published financial statements, then it is appropriate that the published financial statements are restated to the extent that the error materially affects the ability of Ofcom and stakeholders to use them for their intended purposes. Where there have been a number of corrections to volumes, as appears to have been the case for the PPC and AISBO markets in particular, confidence in the published financial statements can be affected. In the next section we consider how BT could improve its reporting systems, including the reporting of volumes.

4.100 Currently, the trigger for a restatement of the prior year data is a change of more than 5% of costs at a market level. A consequence of this rule is that a restatement of cost data may be required in a market with a total cost which is insignificant compared with BT's total costs. This is potentially an issue for us to consider, because requiring restatements for insignificant changes does little to inform the reader of the accounts, and may in fact undermine the credibility of the published financial statements.

4.101 Stakeholders were concerned that BT had revalued its duct assets in 2009/10 leading to a large increase in the replacement cost of duct. This increase in the

\textsuperscript{75} UKCTA Call for Inputs Response page 16.
\textsuperscript{76} UKCTA Call for Inputs response page 16.
\textsuperscript{77} http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/AdditionalinformationApr09.htm.
\textsuperscript{78} 2007/08 published financial statements, page 5. All published financial statements available here: http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/index.htm
\textsuperscript{79} 2008/09 published financial statements, page 16
\textsuperscript{80} 2010/11 published financial statements, page 17
replacement cost of duct was caused by BT revising one of the input assumptions forming part of the asset valuation. The increase in value was not caused by, for example, a significant increase in the cost of labour or materials associated with building duct.

4.102 While we already have some powers to review and challenge BT’s choice of bases of preparation, we consider that BT retains a lot of control of the basis of preparation and the frequency of changes to that basis. We consider whether and how we can or should intervene more in setting the basis of preparation in the next section.

4.103 The data content of regulatory reporting, whilst linked to other types of financial reporting data, is not directly comparable with them. Regulatory reporting information necessitates regulatory specific assumptions (e.g. apportionment bases, valuation methods) which are guided by the principles of objectivity and cost causation. Recent changes to key assumptions have led to questions around the objectivity of these assumptions and so to the reliability of the data.

4.104 The reduction of stakeholder confidence in the reliability of regulatory financial reporting is a significant area of concern, given that an objective of the published financial statements is to provide such confidence. We therefore seek to address this within our proposals section 5.

4.105 With respect to the issues associated with the data captured by BT, we welcome stakeholders’ responses to the following questions:

**Question 4.1 – Do you consider that we have correctly identified and described the main issues in relation to BT’s data? If you consider that there are additional issues, please provide evidence of them where possible.**

**Systems**

4.106 As set out above, the systems used by BT to produce regulatory financial reporting information have been developed over time, to meet the changing regulatory context. The two main regulatory systems that BT uses are: the Accounting Separation system, used to derive FAC data and the LRIC system. Additionally, BT provides a data file which allows Ofcom to interrogate BT data (the Data Extract Tool).

4.107 As explained below, it appears to us that BT’s regulatory accounting systems are complicated, and require a significant amount of manual intervention. Modifying these systems is difficult. It is also difficult to model the effects of potential modifications to the bases of preparation. Lack of clarity and transparency about the regulatory accounting systems (documented in the supporting accounting documents) in is an additional issue which has been raised by stakeholders.

4.108 These issues mean that it is difficult, particularly for the stakeholders, to be confident about the reliability of some of the information that BT produces.

**The accounting separation system (ASPIRE)**

4.109 We consider that the allocation processes within the FAC system are complex and lead to a lack of transparency in how the data is prepared.

4.110 Similarly, the evolutionary path of development taken by the FAC system has led to complexity in modelling and outputs, beyond that inherent in the original design. For example ASPIRE does not produce geographically disaggregated data, even though
there is a reporting requirement for, for example, PPC data to be reported on a geographic basis.\textsuperscript{81}

4.111 We asked BT to describe the current system. BT explained that: “Our regulatory process is complex and one which feeds into a multi-layered ABC system (ASPIRE) that performs 1.4 million separate calculations. There are a number of issues that add to the complexity of this process, for example many of the circa 200 off-line cost attribution models are interlinked and any changes made within one model would affect others. Furthermore, each change would then require processing through the ten stages of ASPIRE; similarly, each time a new published service has been defined; in certain cases, new or modified methodologies may also be required and built into the necessary cost models. The reference data and rules in ASPIRE would also need to be adapted to allow the appropriate costs to flow through the ten stages of allocations to a newly created service”\textsuperscript{82}.

4.112 TTG’s response makes reference to the allocation methodology within the existing system saying “From an outsider’s perspective the complex system they currently use appears unfit for purpose”\textsuperscript{83}.

4.113 In summary, the ASPIRE framework is complex. The original design included a significant number of steps to attribute costs. The changing regulatory environment has led to further complexity in modelling and outputs. This complexity leads to a lack of transparency in the data preparation.

4.114 However, we also recognise that BT has had to develop this level of complexity in response to changes in its business and our regulatory requirements to provide relevant and robust financial data.

4.115 In our proposals in Section 5, we discuss possible changes to the BT ASPIRE system which could improve transparency.

BT’s LRIC model

4.116 One of the main uses of LRIC data is in monitoring compliance with cost orientation obligations. As explained above, we are planning to publish a separate consultation on cost orientation. We therefore only discuss BT’s LRIC model in general terms here. To the extent necessary, we will discuss its specific application to cost orientation in our separate consultation on cost orientation and/or in our second regulatory financial reporting consultation.

4.117 BT has recently reviewed the methodology used by the BT LRIC model to calculate LRIC, DLRIC and DSAC. This resulted in BT making changes to its calculation method for certain cost categories which it now says are “consistent with that [the approach] used for all other cost categories”\textsuperscript{84}.


\textsuperscript{82} Email from BT to Ofcom dated 14 May 2012.

\textsuperscript{83} TTG Call for Inputs Response paragraph 33.

\textsuperscript{84} BT Current Cost Financial Statements 2011 page 7. For Ofcom’s analysis of these changes in the context of a current dispute, see Section 11 in Draft determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf.
4.118 As noted above, the model has not been audited since 2005/6, when the requirement for an audit was removed. In 2012, BT carried out a review of some of its CVRs, although prior to this, some of its CVRs (including duct and fibre) had been held constant over many years.

4.119 In summary, the reliability of the data produced by the BT LRIC model has been questioned by stakeholders. There have been recent changes which have not been subject to audit. Further it contains assumptions which have not been updated for some time.

The Data Extract Tool

4.120 The provision of the Data Extract Tool aligns with the overall purpose of regulatory financial reporting. It provides us with information to help us carry out our regulatory duties. In particular, we believe that a fully operational Data Extract Tool would support the attribute of relevance, allowing us to ask the right questions and obtain answers in an appropriate timescale. Specifically, it should enable us to:

- understand the data more fully;
- focus our attention on the key issues;
- ask BT the right questions; and
- get to the right answers more quickly.

4.121 We continue to believe that the Data Extract Tool is a valuable resource for Ofcom and can potentially reduce the reporting requirement on BT, particularly in respect of the AFIs. However, to date, our ability to use the Data Extract Tool has been limited by delays to the provision by BT of the necessary data. The data for 2012 has now been provided, on time. We will therefore consider whether we will continue to require the AFIs ahead of the second consultation.

4.122 In addition, we consider that there is potential for us to improve the tool itself. In the short term, we could improve its effectiveness via some small changes and in the longer term via some more fundamental alterations.

4.123 With respect to the issues associated with the systems that BT uses, we welcome stakeholders’ responses to the following questions:

Question 4.2 – Do you consider that we have correctly identified and described the main issues in relation to BT’s systems? Please provide evidence where possible.

Reports

4.124 We now consider the effectiveness of the published reports in fulfilling the objectives set out in section 3 and how well they measure up against out key attributes of relevance, reliability, transparency and proportionality.

Relevance

4.125 We consider the relevance of the published financial statements, by considering three questions: whether the reports that make up the published financial statements answer the right questions, whether they provide the information in an appropriate way and whether they provide it to an appropriate timescale.
Do the reports answer the right questions?

4.126 There is recognition amongst stakeholders that the published financial statements provide useful information but differences in opinion as to the questions they should be addressing.

4.127 UKCTA stated that:

“Even in their current imperfect state the regulatory accounts have provided an insight into BT’s cost base for regulated products and allow both CPs and Ofcom to investigate particular areas in more detail where necessary. They have also enabled CPs to escalate matters or bring formal disputes where appropriate, and over the years a number of cases have been brought before Ofcom that have relied in full or in part on the data contained within the published Regulatory Financial Statements”85.

4.128 To support this position, UKCTA provided some examples, as follows86:

“The 2008 PPC overcharging dispute would never have been possible without RFS data and while there was a great deal of frustration about the inadequate data around PPCs within the accounts, there was enough material to enable a dispute to be referred and for Ofcom to complete an investigation”.

“BCMR Consultation: the accounts were extensively used to help CPs respond to and challenge assumptions in the 2008 BCMR and 2009 Leased Line Charge Control. While much of the detail may have been absent, there was enough anomalous information to take the matter further, with BT having to re-price PoH charges as well as other SMP products.”

“In 2004 a dispute about the PPP charges for voice was referred on the basis of the information contain [sic] within the accounts. This was because year on year these charges moved around significantly relative to their floors and ceilings. Ofcom investigated BT’s regulatory accounts to strip out any cost elements which should not have been placed in the PPP category. The dispute resulted in a complete policy review by Ofcom – the PPP cost base now includes marketing costs to BTR as well as BT’s competitors and are recovered across all volumes (BT Retail included).”

“LLU /WLR 2009 Charge Controls: the accounts were used extensively by CPs responding to the consultation process and in the subsequent challenge of the charge control decision. The accounts were crucial in identifying areas that needed greater investigation and where further probing was required.”

“ISDN 30 Intervention: Ofcom launched a policy project to investigate BT’s high returns in the market for ISDN30 services”.

85 UKCTA Call for Input Response page 19 question 21.
86 UKCTA Call for Input Response page 19 question 21.
Based on our analysis, as summarised in the table below, we believe that the published financial statements broadly provide the information to answer the relevant questions:

**Figure 3: Information provided in the published financial statements**

<table>
<thead>
<tr>
<th>Questions which stakeholders want Published Financial Statements to answer</th>
<th>Where information is provided in the published financial statements</th>
<th>Pages - RFS 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Has BT complied with its non-discrimination obligations?</td>
<td>Sections 7 &amp; 8: Review of Access Markets / Review of Other Wholesale Markets Note 1: Comparison of average internal and external charges with each other and with FAC, below summary market statements Average price for internal and external sales, volumes and revenue by service</td>
<td>36 - 80</td>
</tr>
<tr>
<td>Has BT complied with Equivalence and Equality of Inputs (EOI)?</td>
<td>As above</td>
<td>As above</td>
</tr>
<tr>
<td>Are BT’s prices cost oriented?</td>
<td>Sections 7 &amp; 8: Review of Access Markets / Review of Other Wholesale Markets Note 1: Comparison of average internal and external charges with each other and with FAC, below summary market statements FAC, unaudited DSAC and unaudited DLRIC per unit, by service</td>
<td>36 - 80</td>
</tr>
<tr>
<td>Has BT complied with its charge controls?</td>
<td>Appendix 2: Price Control Statements</td>
<td>122</td>
</tr>
<tr>
<td>What are the returns and costs of the key wholesale inputs which CPs buy?</td>
<td>Sections 7 &amp; 8: Review of Access Markets / Review of Other Wholesale Markets Sections 7.1 and 8.1: Financial Performance in market. Return on MCE %, listed by SMP market Note 1: Comparison of average internal and external charges with each other and with FAC, below summary market statements Average price, FAC per unit, by service - Return by service can be calculated by deduction Appendix 1.2. Calculation of FAC based on component costs and usage factors. Lists out unit FAC by service, broken down into the component costs</td>
<td>29 – 80 29 &amp; 58 101 - 114</td>
</tr>
<tr>
<td>Have the right costs been used in developing charge controls?</td>
<td>Appendix 1.2. Calculation of FAC based on component costs and usage factors. Lists out unit FAC by service, broken down into the component costs</td>
<td>101 - 114</td>
</tr>
<tr>
<td>Does BT have the systems to generate information upon request to demonstrate compliance?</td>
<td>Primary and Secondary Accounting Documents. Supported indirectly by audit opinion and published financial statements</td>
<td>n/a</td>
</tr>
<tr>
<td>Does BT have the systems to generate information upon request for Ofcom to conduct investigations?</td>
<td>Primary and Secondary Accounting Documents / Flat File. Supported indirectly by audit opinion and published financial statements</td>
<td>n/a</td>
</tr>
<tr>
<td>Do the published financial statements provide comfort that the regulatory financial information has been prepared using the rules and has been subject to an independent verification process?</td>
<td>Audit opinion Basis of Preparation Primary and Secondary Accounting Documents BT and Openreach Reconciliation Statements</td>
<td>11-12 15-19 n/a</td>
</tr>
</tbody>
</table>

As part of the published financial statements, BT provides a statement of compliance with certain price controls. This is done on a voluntary basis. However, we do not consider that the information provided is not sufficiently detailed or clear to enable

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**Equivalence of Input (EOI) “Equivalence of Inputs” or “EOI” means that BT provides, in respect of a particular product or service, the same product or service to all Communications Providers (including BT) on the same timescales, terms and conditions (including price and service levels) by means of the same systems and processes**
the stakeholders to check BT’s compliance for themselves. In particular, the statement does not provide the information related to the individual products within a price control basket. It only shows compliance at the headline total basket level, while CPs are particularly interested in the specific products that they purchase, and how they contribute to the overall performance of the basket.

Do the reports answer the questions in the right way?

4.131 As well as answering the right questions, we need to consider whether the published financial statements answer these questions in an appropriate way.

4.132 An important issue for stakeholders regarding their ability to use the published financial statements to answer their regulatory questions was the apparent lack of consistency between the data content of the published financial statements and that used in regulatory decision-making, for example in setting charge controls.

4.133 BT referred to the difference between the data set out in the published financial statements and the data used in charge controls. BT said:

“in setting charge controls our CCA FAC cost information is only used as a starting point for base year costs. Ofcom often over-rides our data for policy reasons (for example it applies the RAV adjustment and disallows certain operation costs and or allocation methods)”88.

4.134 Everything Everywhere stated:

“It is (more) important to ensure that regulatory financial reporting links back to the market assessments and reasons for applying SMP remedies. These reporting requirements should make it easier to make assessments of whether prices are cost orientated, non-discriminatory and provide useful information which can be compared across years for the purpose of setting charge controls. “Good” regulatory financial reporting makes other regulation more effective and transparent”89.

4.135 TTG stated:

“The RFS must be prepared on Ofcom’s view of assumptions. Currently the RFS are prepared on BT’s assumptions even where Ofcom has stated its own assumptions (which are different). For instance, the asset valuation is BT’s preferred approach (direct CCA) rather than the one Ofcom considers appropriate (CCA and RAV). The costs include (we understand) costs that Ofcom disallows. Also the costs are based on BT’s allocations. This means that the costs shown do not represent Ofcom’s view of the costs. This clearly diminishes the usefulness of the RFS”90.

4.136 We believe that greater consistency of data between the published financial statements and regulatory decision-making, would support the provision of relevant

88 BT Call for Inputs Response page 7.
89 Everything Everywhere page 10.
90 TTG Call for Input response paragraph 24.
data that was understood by users of the published financial statements. We further address this issue in Section 5.

4.137 A further issue is caused by the fact that the figures in the published financial statements can change significantly from year to year. Some stakeholders\textsuperscript{91} stated that the published financial statements did not help them to understand these changes.

4.138 Some of these changes are one-off changes in asset values (resulting in large holding gains or losses), while others reflect changes in the way BT allocates costs. The issue is that the causes of these changes are not clearly set out in the information provided in the published financial statements or the supporting accounting documentation.

4.139 Stakeholders are also concerned by restatements to the published financial statements. Restatement of the published financial statements, particularly if it is frequent, confuses the users of the published financial statements, and makes the published financial statements difficult to understand.

4.140 Frequent restatements, therefore, tend to have a detrimental effect on the confidence stakeholders place in the published financial statements and their ability to interpret the data. Currently, the trigger for a restatement of the prior year data is a change of more than 5% of costs at a market level.

4.141 A consequence of the current practice is that they may require a restatement of cost data in a market – when there is a reallocation of costs which exceeds the relevant 5% threshold for that market – which may actually be insignificant comparative to BT’s total costs. It could be argued that restatements for insignificant changes do little to inform the reader of the accounts, and may in fact undermine the credibility of the published financial statements.

4.142 Finally, some stakeholders stated that it is difficult to compare the price of the products that they purchase with what is reported in the published financial statements, and with what is included in the price control\textsuperscript{92}. There is no clear mapping of products included in the published financial statements.

\textit{Are the answers provided to an appropriate timescale?}

4.143 Finally, we consider whether the information is provided within an appropriate timescale. We discuss firstly the published financial statements and secondly the confidential annexes and the flat file.

4.144 Timeliness is key to relevance. BT is currently required to publish its published financial statements within four months of the year end (i.e. by the end of July). This can be compared with the statutory accounts, which must be filed at Companies House within 10 months of the year end. However, listed companies often produce their annual accounts and associated compliance and sustainability reports more promptly than this. For 2012, BT’s Annual Report was produced within six weeks of its year end.

4.145 BT’s regulatory financial statements have not always been published in a timely manner. The following table shows the publication dates in the past ten years:

\textsuperscript{91} UKCTA’s response, page 22.
\textsuperscript{92} Talk Talk’s response, page 10, paragraph 46; UKCTA’s response page 16.
Figure 4: Summary of publication dates for the published financial statements

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Date of publication</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>31 July</td>
</tr>
<tr>
<td>2011</td>
<td>15 September</td>
</tr>
<tr>
<td>2010</td>
<td>28 July</td>
</tr>
<tr>
<td>2009</td>
<td>13 August</td>
</tr>
<tr>
<td>2008</td>
<td>16 September</td>
</tr>
<tr>
<td>2007</td>
<td>23 August</td>
</tr>
<tr>
<td>2006</td>
<td>7 September</td>
</tr>
<tr>
<td>2005</td>
<td>2 September</td>
</tr>
<tr>
<td>2004</td>
<td>17 August</td>
</tr>
<tr>
<td>2003</td>
<td>19 August</td>
</tr>
<tr>
<td>2002</td>
<td>6 December</td>
</tr>
<tr>
<td>2001</td>
<td>14 December</td>
</tr>
<tr>
<td>2000</td>
<td>15 September</td>
</tr>
</tbody>
</table>

4.146 In terms of the confidential AFIs and the flat file, timeliness is also an issue. The flat file should be provided to us ten days after the publication of the published financial statements. Although in 2012 it was provided on time, for many years it has not been. Late provision of data means that alternative methods are required to obtain data which might otherwise have been obtained more efficiently.

4.147 We discuss timeliness of both the published financial statements and the confidential AFIs and the flat file in more detail in our proposals section 5, taking into account realistic timescales for the production of data.

Reliability

4.148 In considering how reliable the reports are, we have considered whether the rules used in their preparation are objective, whether they are applied in an appropriate way and whether they are then followed.

Are the rules objective?

4.149 We noted above that the regulatory data differed from statutory accounts data, in that they required particular assumptions and relied upon the principles of cost causation and objectivity. We also summarised stakeholders concerns about the objectivity of the assumptions within the published financial statements, caused by BT’s recent revaluations and restatements.

4.150 BT commented with reference to the assumptions within the published financial statements that "Many of the biggest attribution methodologies will have been
This links to the issue of relevance, and that the data within the published financial statements should link to regulatory decision making. In this way the scrutiny in place on the data in the process of decision making should be reflected back into the accounts. This feedback loop does occur but does not constitute a formal process. We discuss how assurance that this feedback process is working might be achieved and how it might work more effectively in the future within our proposals in Section 5.

Are the rules applied in an appropriate way?

4.152 BT expressed concerns about the level of detail that it is required to report, both in terms of proportionality and in terms of the granularity of reporting and its implications for attribution assumptions. BT stated that “the level of detail we are required to report means attribution assumptions around common and shared costs become more and more subjective and thus less and less economically relevant in terms of signalling the levels at which pricing should be set”.

4.153 We understand BT’s concerns but do not believe that greater granularity necessarily leads to less accuracy, provided that the cost driver or attribution base can be identified at that level. We will consider this as part of our review of cost orientation.

Transparency

4.154 We consider that requirements for transparency impact on both the transparency of the basis of preparation and the ease of use of the data produced.

4.155 UKCTA stated “well presented detail is the key to transparency. Less detail is not the answer with more effort put into better presentation and more accessible formats”.

4.156 In terms of the basis of preparation, there appears to be an abundance of information, but much of this is unclear. The supporting documentation to the published financial statements, in particular the DAM, illustrates how at present the provision of detailed information is contributing to a lack of transparency of data.

4.157 The DAM details the methods adopted by BT in attributing its costs. It is large, difficult to negotiate and stakeholders find it difficult to extract any meaningful information. This issue has arisen in part due to the complexity of the allocation structure inherent in BT’s systems.

4.158 TTG stated with reference to the DAM:

“We note (with a small hint of irony) that the intent of the DAM is stated as follows: The principle of Transparency requires the attribution methods used to be transparent. The descriptions of the attribution methods should provide sufficient information such that a suitably informed reader can easily: … Make their own judgement as to the reasonableness of these methodologies. Frankly the DAM is

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93 BT Call for Inputs Response page 19.
94 BT Call for Inputs response page 6.
95 UKCTA Call for Inputs Response page 5.
nigh on useless and it certainly does not meet that stated objective"[^96].

4.159 However, we understand from BT that it has considered simplifying the Secondary Accounting Documents, but it believes that its ability to do so is limited by the Transparency principle. Specifically, based on our discussions with BT, we understand that it considers there to be two specific requirements that “force” it to produce “excessive” documentation, as follows:

- Firstly, Direction 2 Transparency principles, which states:

  “BT shall ensure that any data, information, description, material or explanatory document prepared under Conditions OA1 to OA34 in respect of accounting and other methods used in the preparation of the accounting records and Regulatory Financial Statements shall be sufficiently transparent and prepared such that a suitably informed reader can gain a clear understanding of such data, information, description, material or explanatory document, and, if necessary, the overall structure of BT’s financial and information systems from which regulatory accounting data is derived and in particular the sequence of the processing and ‘cascade’ effect of the intermediate cost centres; gain a detailed understanding of all the material, methodologies and drivers (e.g. systems, Processes and procedures) applied in the preparation of regulatory accounting data; and make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them”[^97].

- Secondly, the requirements for an audit opinion which state (for example at page 13, paragraph 20 [g], of the 2012 RFS), “…the Secondary Accounting Documents all dated 31 July 2012 are appropriate to implement the principles contained in the Primary Accounting Documents dated 31 July 2012”.

4.160 In terms of ease of use, the way the published data is presented, both in terms of the published financial statements and supporting documentation (pdf and word files) does not allow easy use of the data. There is also currently no formal mechanism for CPs to directly raise questions on the accounts to BT.

4.161 In summary, the presentation of the published financial statements needs improvement to make them more accessible and transparent. This could be achieved through extending the formats and mechanisms by which the data is presented, for example provision in Excel and industry presentations. This is discussed in more detail in our proposals section 5.

Proportionality

4.162 We discussed the issue of proportionality in section 3. In summary, BT does not consider it is necessary to publish as much as it does, while stakeholders feel that the detail is necessary to ensure the accuracy of the accounts. CPs feel that industry has a key role holding BT to account.

[^96]: TTG Call for Inputs Response paragraph 31 and 32.
4.163 UKCTA stated “As much material as possible should be published as the data only relates to markets where BT has significant market power”\textsuperscript{98}. They also say “While Ofcom may have access to a greater level of information and are free to prove further, other stakeholders, who have become key in pursuing enforcement action to ensure compliance must rely upon the Regulatory Financial Statements”\textsuperscript{99}.

4.164 In contrast, BT states “We believe our reporting requirements in terms of what we have to produce and publish on an annual basis in the Regulatory Financial Statements (RFS) go beyond what is actually necessary for these purposes”\textsuperscript{100}.

4.165 In our view, the current level of disclosure remains proportionate for the time being. CPs’ concerns over areas such as the basis of preparation have eroded confidence. They seek to gain additional confidence through their own review using the detail in the published financial statements. If confidence could be built in other ways, such as improving the basis of preparation, then it may be possible to reduce the need for some detail in the future. We return to this point in Section 5.

4.166 With respect to the issues associated with BT’s reports, we welcome stakeholders’ responses to the following questions:

\textbf{Question 4.3 – Do you consider that we have correctly identified and described the main issues in relation to BT’s reports? Please provide evidence where possible.}

\textbf{Question 4.4 – Do you agree with our analysis, as summarised in Figure 3, concluding that, in terms of scope, the published financial statements broadly answer the right questions?}

\section*{Control}

4.167 As noted above, we consider that internal controls, review by Ofcom and independent audit, all have a role to play in providing confidence that the published rules are followed.

4.168 BT is responsible for the group’s internal controls, and for reviewing the effectiveness of those controls each year. BT’s statutory auditors consider the effectiveness of the internal controls as part of the statutory audit and in arriving at their audit opinion. The auditors’ United States opinion on the statutory accounts sets out the auditors’ opinion (including any qualifications) on the internal controls\textsuperscript{101}. We also expect BT’s regulatory auditors to consider the effectiveness of the specific internal controls associated with regulatory accounting, in arriving at their audit opinions on the published financial statements. We rely on the work and opinions of both statutory and regulatory auditors to form a view on the effectiveness of the internal controls.

4.169 As for our own review of the published financial statements, we currently conduct such reviews mainly in response to specific issues, for example, in response to changes proposed by BT. We believe we could improve stakeholder confidence by increasing the level of our own review. We discuss this further in the proposals section 5.

\textsuperscript{98} UKCTA Call for Inputs Response page 25.
\textsuperscript{99} UKCTA Call for inputs Response page 14.
\textsuperscript{100} BT Call for Inputs Response page 6.
\textsuperscript{101} See page 97 in the following document: \url{http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/2012_AnnualReport_FinStats.pdf}. 
4.170 We continue to attach significant value to the annual audit, although we agree with BT’s comment that “no audit opinion can confirm that a set of accounts is absolutely ‘correct’.”\textsuperscript{102} BT additionally stated that “the auditor will form an independent view on the judgements and assumptions made by management but it is entirely possible that other users, including Ofcom, may take a different view when considering the costing of individual products and services. As a result, it may be more appropriate to consider the audit largely as a means to provide assurance of compliance.”\textsuperscript{103}

4.171 However, it appears that other users of the published financial statements attach little value to the audit opinion and that their apparent lack of confidence in the audit may go beyond the inherent limitations to any audit.

4.172 UKCTA stated that: “an audit regime which apparently signs off each iteration, regardless of that [sic] fact that it may completely contradict the previous set of numbers covering the same product areas highlights the chronic weaknesses in the current framework.”\textsuperscript{104}

4.173 UKCTA stated that its members “have little confidence in the current audit approach as it has failed to prevent a series of damaging restatements and asset revaluations. Ofcom has rightly highlighted that not all parts of the Published RFS are currently audited; and the audit is carried out at market level rather than product level. These limitations need to be carefully addressed in order to build a level of confidence that can give the assurance that we believe is necessary.”\textsuperscript{105}

4.174 Verizon noted that it has “little faith in the current audit opinions as they clearly have been ineffective, as confirmed by the number of disputes and that [sic] fact that the number of restatements that have been required to BT’s Regulatory Financial Statements”\textsuperscript{106}.

4.175 More generally, UKCTA stated:

“In practical terms, we are unclear just how effective the duty of care to Ofcom has proved to be and we’d welcome some insight from Ofcom on how duty of care is viewed, the extent of the dialogue that currently takes place between the auditor and Ofcom, and whether there is any way in which the duty of care to Ofcom can be strengthened, for instance by Ofcom taking a greater role in the instructions that are given to the auditor prior to their audit.”\textsuperscript{107}

4.176 Informed by these comments, we consider that it is important to improve stakeholders’ understanding of what an audit can and cannot achieve and the extent to which they can take comfort from the audit opinion as evidence of BT complying with its accounting rules. Ahead of the second consultation we will seek to gain a more detailed understanding of the nature of the recent restatements and the extent to which they reflect the inherent limitations of an audit rather than potential weaknesses in the audit approach.

4.177 With respect to the issues associated with control, we welcome stakeholders’ responses to the following questions:

\textsuperscript{102} BT Call for Inputs Response, page 20.
\textsuperscript{103} BT Call for Inputs Response, page 20.
\textsuperscript{104} UKCTA Call for Inputs response page 16 question 18.
\textsuperscript{105} UKCTA Call for Inputs Response page 24 question 31.
\textsuperscript{106} Verizon Call for Inputs Response question 31.
\textsuperscript{107} UKCTA Call for Inputs Response page 24 question 31.
Question 4.5 – Do you consider that we have correctly identified and described the main issues in relation to controls around the data and systems? Please provide evidence where possible.

**KCOM**

4.178 We require KCOM to report, both publicly and confidentially, on their regulatory financial performance, through SMP conditions set in July 2004 and updated since then. These conditions apply to KCOM’s wholesale telecommunication and broadband markets.

4.179 KCOM therefore publishes a set of annual regulatory financial statements for the wholesale markets. There are no charge controls in these wholesale markets.

4.180 KCOM’s wholesale operations are within the KC business unit (‘KC’) which itself is a part of the KCOM Group plc. KC provides telecommunication and broadband services to businesses and consumers in Hull and East Yorkshire.

4.181 The published financial statements are prepared using current cost accounting. For each market, they include a profit and loss account and a statement of mean capital employed. They also include a consolidated profit and loss account and statement of mean capital employed for the regulated entity as a whole, together with a reconciliation of these figures to the statutory accounts of KCOM.

4.182 KCOM also publishes a supporting document, Description of Cost Accounting Systems (‘DOCAS’). DOCAS represents KCOM’s Primary and Secondary Accounting Statements and describes the costing and accounting methodologies applied in the published financial statements. In particular, it addresses cost and balance sheet attribution methods, as well as the accounting separation methodology.

4.183 In their responses to the CFI, stakeholders have not expressed any concerns about KCOM’s current regulatory reporting arrangements. However, we recognise that these arrangements have not been reviewed for some time and may benefit from a fresh review.

**Conclusion**

4.184 BT’s main concern is about the level of detail in the information that it is required to report. BT argues that some of this disclosure is commercially damaging, and that it reports more information and more detail than is necessary.

4.185 On the other hand, one of the key concerns of the CPs is that BT has significant influence over how the accounts are prepared. They are also concerned by errors, restatements and changes in accounting treatment over recent years.

4.186 We understand both CPs’ and BT’s concerns. We also believe that the reporting needs to align more closely with the regulatory decisions that we make.

4.187 We summarise below all the issues which we consider to be important:
Data

- BT has considerable control over both the selection of the preparation basis, and the changes to that basis. Stakeholders claim this permits BT to shape the data in its favour.

- Errors and restatements of the RFS have undermined stakeholder confidence in the reliability of the data.

- The trigger for restatement may be too low, resulting in unnecessarily frequent restatements of the RFS.

Systems

- BT’s systems are overly complex and time consuming to change. They require significant amount of manual intervention to run, and lack transparency.

Reports

- The data published for the purpose of demonstrating compliance with charge controls is not sufficiently detailed and clear.

- The RFS are not always published by the deadline.

- BT considers that some of the data it publishes should be treated as commercially confidential.

- The RFS do not help the users adequately understand year-on-year changes and their causes.

- The data is difficult to convert into an easily usable format.

- The RFS are prepared based on BT’s assumptions, not Ofcom’s assumption (e.g. RAV).

- Stakeholders find the RFS and the supporting accounting documents unclear and difficult to use.

- There is no formal mechanism for the CPs to raise questions with BT directly.

- There is no clear mapping of products included in the RFS to the commercial products.

Control

- Stakeholders have little confidence in the audit process. They consider the significant restatements of the RFS have undermined the effectiveness of the audit opinions.
Section 5

Proposals for improved regulatory financial reporting

Summary

5.1 In Section 3, we explained that the regulatory financial reporting obligations should provide information to allow us to monitor compliance with SMP conditions and support our regulatory decisions, such as the setting of charge controls. We also explained that the published financial statements should provide confidence to CPs that an SMP provider is complying with its regulatory obligations.

5.2 In this section, we consider how the regulatory financial reporting regime might be improved to provide a proportionate set of reporting requirements that deliver relevant and reliable information to support our regulatory decisions and published information that provides the necessary confidence to stakeholders that BT is complying with its obligations.

5.3 We propose that the reporting regime should be updated to give us and CPs more confidence in the data and systems that deliver the regulatory financial information, and the controls over the data and systems. This will require greater Ofcom involvement in setting the rules by which the financial data are prepared and increased transparency of those rules and their impact on the numbers.

5.4 It is possible that these proposals will require the implementation, by BT, of new regulatory accounting systems. We recognise that this would require a significant investment by BT. We also recognise that the transition to a new regulatory accounting system is not without its challenges; users of the accounts will want assurance that the changes are reasonable and that the impact of those changes will be transparent and will not unfairly disadvantage them, while BT will require some clarity about how we will use the data that it delivers.

5.5 Further, we will need assurance that the improvements will be delivered to an adequate standard within an appropriate timescale. BT has indicated that it would be several years before the benefits of a new regulatory accounting system would be seen. Specifically, BT has indicated that, if it was necessary to design and implement significant improvements to its regulatory accounting systems, it would not be able to produce audited regulatory financial statements prepared using those systems before 2015/16.

5.6 However, until stakeholders have more confidence that BT has a robust and reliable reporting system that is supported by a strong review process, we consider that the scope to reduce the level of published information is limited.

5.7 In our second consultation, we will also set out our proposals for the reporting framework for KCOM (if we believe that any change is needed). We are currently reviewing aspects of their regulatory financial statements and, if necessary, will consider these further in the second consultation. At this stage, we have received no comments from stakeholders on KCOM’s regulatory financial statements and have therefore focused on BT, although we do briefly discuss KCOM at the end of this section.
Introduction

5.8 In this section, we consider how the regulatory financial reporting regime might be improved to provide a proportionate set of reporting requirements.

5.9 In section 4, we considered the reporting framework in four key areas:

- the information which serves the regulatory requirements (which we termed “Data”);
- the published and unpublished reports designed to meet regulatory objectives (“Reports”);
- the infrastructure by which the data is produced (“Systems”); and
- the mechanisms by which the data, reports and systems are defined, updated, monitored and verified (“Controls”).

5.10 In this section, we have set out our emerging thinking and developed a number of broad proposals, broadly mapped to these four elements of the reporting framework. Responses to this consultation will inform our detailed proposals to be set out in the second consultation document in early 2013. Our second consultation will also include the steps needed to implement the proposals. We outline the proposals under each theme below.

5.11 Under the current regime, stakeholders have little confidence in the way that data is prepared by BT, or is reviewed by BT’s auditors or by Ofcom. As a result, stakeholders rely on the publication of detailed financial information to inform their own review. An effective regime would enable stakeholders to draw more confidence from the way the financial information is prepared and reviewed and will therefore need to rely less on the publication of detailed financial data.

5.12 If BT can deliver a robust and transparent reporting system, supported by a strong review process, some of the current publication requirements may be reduced in the longer term. Therefore, our proposals need to be considered in the context of a move towards an improved regulatory reporting framework, rather than in isolation.

Data

5.13 We include a number of proposals aimed at increasing stakeholder confidence, and our own, in BT’s financial information, around the following themes:

- *Increasing Ofcom’s involvement in setting the basis of preparation.* We propose to take a more proactive role in defining the basis of preparation of the RFS. This would reduce BT’s control over the main rules and assumptions used to prepare the RFS.

- *Aligning the published financial statements with regulatory decisions.* We propose that the published financial statements are prepared on a basis that is, where appropriate, consistent with the basis of our regulatory decisions.

- *Improving transparency of the basis of preparation.* We propose that BT should set out the rules that it follows more clearly, in order to ensure that stakeholders understand what the accounts show, how they have been prepared and what has changed since the previous year.
5.14 We include some proposals aimed at making the financial reports easier to understand and use. These focus on the following issues:

- **Ensuring the published financial statements provide relevant information.** We do not propose significant changes to the questions to be answered in the published financial statements or the reporting deadlines although we do propose to formalise BT's reporting on charge control compliance.

- **Ensuring that the published financial statements provide the appropriate level of detail.** We propose to remove the need for publication of some elements of detail. However, we propose to keep other elements, where there is still a need for them and it is proportionate to require publication of such information. This includes the continued requirement for reporting at the level of products and services.

- **Ensuring that the reports are easy to understand.** We propose to make changes to the way that data is presented in the published financial statements. We would like to give greater visibility of the underlying costs and the effects of one-off changes (such as holding gains) and the reasons for changes over time. We would also like to make this data more accessible.

5.15 We also invite views on whether there may be alternative approaches to providing stakeholders with the information that they need, potentially including a shift of emphasis away from the current level of detail.

5.16 We have considered the scope for improving the mechanisms by which data, systems and reports are defined, updated, monitored and verified. At this stage, we do not propose to significantly alter the current audit requirements (although we propose steps to improve stakeholders’ understanding of the scope and limitations of the audit). We do, however, propose to increase Ofcom’s role in the review of the published financial statements and invite stakeholders’ views on whether the published financial statements should be signed by a BT Director.

5.17 Finally, we consider whether improvements to BT’s regulatory accounting systems may be necessary if the stakeholders’ confidence in the published financial statements is to increase and invite views on how such improvements might best be implemented.

5.18 We consider our proposals under these four headings in turn, below.

5.19 We set out below our broad proposals for increasing stakeholder confidence in the financial information. We consider these under three headings, as follows:

- increasing Ofcom’s involvement in setting the basis of preparation;
- aligning the published financial statements with regulatory decisions; and
- improving the transparency of the basis of preparation.
1. Increasing Ofcom’s involvement in setting the basis of preparation

5.20 In section 4, we noted that BT had significant control over both choosing the bases of preparation and the frequency of changes to those bases. This has created a concern amongst stakeholders that the accounting rules are selected by BT. We consider that this concern significantly reduces stakeholder confidence in the RFS and needs to be addressed.

Stakeholder comments

5.21 In our Call for Inputs, we asked who should control the rules for preparation of regulatory financial reports and whether a third party might be able to do so.

5.22 In BT’s response\textsuperscript{108}, it set out the context of the current arrangements and says that it sees “no role for a third party”. It argued that:

- “the ‘rules’ are transparent” and “the DAM is a public document”;
- “many of the biggest attribution methodologies will have been scrutinised at various points during the regulatory decision process”; and
- “BT informs Ofcom of material methodology changes as they arise and full restatements may be made”.

5.23 Regarding the use of a third party to set the “rules”, BT argued that it could lead to\textsuperscript{109}:

- “a lack of ownership of the reporting and the RFS within the business”;
- “credibility issues”;
- an increase in disputes; and
- “multiple versions of the RFS”.

5.24 Other stakeholders were in broad agreement that Ofcom should become more involved. Indeed, it was one of their main proposals.

5.25 Talk Talk provided information which, it claimed, showed that “BT sets these allocations in its favour”\textsuperscript{110}.

5.26 UKCTA recommended that: “Ofcom needs to take steps to create the right kind of culture around the preparation of the accounts. It is vital that cost allocations are made using transparent and objective criteria that are designed to align with regulatory objectives and aren’t influenced by the needs of the BT business”\textsuperscript{111}.

5.27 UKCTA made two specific proposals in this area:

i) “A move to a more independent basis of preparation is needed. There may be a role for a third party to oversee the process...”\textsuperscript{112}. It suggested “...a ring fenced..."
independent body (such as or similar to the Equality of Access Office). A board of Independent overseers should be required to make some of the fundamental attribution decisions. 

ii) “Ofcom itself needs to have a much firmer role in developing the guidance....”  
It compared this with Ofwat setting firm guidelines.

5.28 TalkTalk proposed that: “Ofcom must stipulate allocation rules”. Specifically, it proposed that: “Ofcom must stipulate its own allocation assumptions for all major cost categories.....”. A benefit of this would be that this would “...reduce the work required in each charge control or cost orientation project.”

Our proposals

5.29 As explained below, we propose that:

• primary responsibility for ensuring that the basis of preparation is consistent with the Regulatory Accounting Principles should remain with BT;

• Ofcom should review and, if necessary revise the Regulatory Accounting Principles, to ensure that they provide the appropriate framework for determining the appropriate basis of preparation;

• Ofcom should identify and review the most significant allocation bases; and propose changes where appropriate;

• BT should notify Ofcom in advance of any proposed changes to accounting methodologies of its own, sufficiently far in advance to allow a review of the proposals; and

• where BT disagrees with Ofcom’s preferred bases, BT can, if it wishes to do so, illustrate the impact of the different approaches as a note to the published financial statements.

Proposal 1a: Primary responsibility for ensuring that the basis of preparation is consistent with the Regulatory Accounting Principles should remain with BT

5.30 We tend to agree with BT’s arguments regarding the use of a third party to set the “rules”. Specifically, we share BT’s concern that the use of a third party would risk causing a lack of ownership of the reporting with BT and could lead to different versions of the RFS (e.g. the “public” view and BT’s view). Therefore at this stage, we consider that primary responsibility for preparing the RFS should remain with BT. It follows that BT should therefore be responsible for ensuring consistency with the Regulatory Accounting Principles.

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113 Page 16, third paragraph; page 23 third paragraph; page 26 first bullet.
114 Page 3, fifth bullet; page 26 third bullet.
115 Page 21, fourth paragraph.
116 Page 3, second heading.
117 Page 6, paragraph 21.
118 Page 6, paragraph 23.
Proposal 1b: Ofcom should review and, if necessary revise the Regulatory Accounting Principles to ensure that they provide the appropriate framework for determining the appropriate basis of preparation

5.31 Regardless of who defines the detailed rules and treatments, we consider it necessary that they should continue to be consistent with a set of Regulatory Accounting Principles. We further consider that the detailed rules should also be applied in a manner that is consistent with the Regulatory Accounting Principles. We view these principles as a frame of reference against which the appropriateness of any basis of preparation or accounting rule or treatment can be judged.

5.32 This concept of Regulatory Accounting Principles is consistent with our approach to regulation of post. In its Universal Service Provider Accounting Condition, Ofcom has set out a set of Guiding Principles with which Royal Mail’s regulatory costing and accounting methodologies must comply\(^{119}\). Royal Mail applies these methodologies in preparing all of its regulatory financial reports and statements. We consider that the Regulatory Accounting Principles for BT should have the same status and fulfil a similar role.

5.33 Currently, the Regulatory Accounting Principles are published by BT in its Primary Accounting Documents. These principles address the following areas:

- Priority (the following order of principles to represent the hierarchy of their priority)
- Definitions (to be consistent with the SMP conditions)
- Cost causality (attributions to be in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred)
- Objectivity (treatments not to be intended to favour BT or any other operator)
- Consistency of treatment (from year to year)
- Compliance with applicable law and IAS (Companies Act 2006, Article 4 of the IAS Regulation and BT’s accounting policies subject to these principles)
- Transparency (to enable a suitably informed reader to gain a clear understanding of the overall structure of financial and information systems, and gain a detailed understanding of, and make their own judgement about all the material, methodologies and drivers)
- Sampling (to be based on generally accepted statistical techniques)

5.34 We propose to review, and if necessary revise the Regulatory Accounting Principles, for two reasons:

i) One logical step for us to take in order to have greater involvement in setting the basis of RFS preparation, would be to have more involvement in defining the

principles that guide the selection of preparation bases, namely the Regulatory Accounting Principles.

ii) We need to ensure that the Regulatory Accounting Principles are defined not only in sufficient and effective detail, but in a manner that reflects Ofcom’s regulatory objectives and priorities which may not always be consistent with those of BT’s.

5.35 Our initial view is that some of the current Regulatory Accounting Principles need to be clarified, and some new principles may need to be added.

5.36 For instance, the current principle of ‘Objectivity’ states that “The attribution shall be objective and not intended to benefit either BT or any other Operator, or any product, service or network component” 120. This principle could be strengthened further by requiring that BT must also ensure that, as far as possible, its accounting treatments take account of all the available financial and operational data that are relevant, and where a treatment is based on assumptions, those assumptions are justified and supported, as far as possible, by all available relevant empirical data.

5.37 The current principle of ‘Consistency of treatment’ can also be extended to require BT to ensure that the rules underpinning the RFS reflect, as far as possible, Ofcom’s latest regulatory decisions and statements.

5.38 Additionally, we consider there may be benefit in adding an equivalence principle which enshrines BT’s obligations relating to ‘non-discrimination’. We also consider there may be a need for a principle of accuracy which requires BT to ensure its accounting rules and treatments maintain an adequate degree of accuracy, such that the RFS are free from material errors.

5.39 We invite stakeholders to express their views as to how the current set of BT’s Regulatory Accounting Principles can be improved and what further principles may need to be added.

Proposal 1c: Ofcom should identify and review the most significant allocation bases

5.40 We have considered two options. The first is to review and revise only the most significant allocation rules in a one-off review. The second is to review and revise allocation rules as and when regulatory decisions are made.

5.41 Under the first option, we would identify the most significant allocation rules (in terms of their potential impact on the way costs are allocated) and review these alongside the Regulatory Accounting Principles.

5.42 Under the second option, the most likely trigger for changes to the allocation rules would be work on regulatory decisions such as price controls and investigations that reveal allocation rules that we do not consider to be appropriate for the purpose of that decision. In such circumstances, it is likely that we would flag the required change to the RFS at the time of the regulatory decision.

5.43 Both options would go some way to addressing stakeholder concerns that BT selects the most favourable allocation rules, which in turn might be adopted in pricing decisions. They would also help to ensure that the RFS were more closely aligned with recent Ofcom decisions, which we consider in more detail later in this section.

120 BT Primary Accounting Document 2011, Section 1.2, pages 15-16.
5.44 However, both options carry risks. For example, Ofcom may not be best placed to choose the most appropriate bases. Therefore, at this stage, we propose to require changes to allocation bases only following regulatory decisions. For example, analysis carried out during a charge control might establish that a certain cost should be allocated in a particular way; only at that point would we want to ensure that BT reflects the same approach in regulatory financial reporting. This should ensure that we have had the opportunity to consider the case for changes to the rules in the context of a consultation. However, we would welcome stakeholders’ views on the respective merits of these options.

5.45 In reaching these provisional views, we have also considered but rejected the following options:

- maintaining the status quo (which would not address the concerns expressed by all stakeholders);
- conducting a full review of the cost allocation rules or devise new bases of preparation; and
- requiring the RFS to be prepared, or potentially the basis of preparation to be set, by an independent third party.

5.46 We do not consider that a full review of the rules would be appropriate or practicable. The current set of rules, as defined by BT in its Primary and Secondary Accounting Documents, determines the treatment of data included in 31,000 general ledger codes. It would therefore be a very substantial task to create our own set of rules from the bottom up. In addition, BT itself is still likely to be best placed to make the necessary judgements.

5.47 Similarly, even if we were only to review and approve the current set of rules, this would require a large exercise of checking the suitability of each rule. With either of these approaches, the scale of the exercise increases the risk of making a decision based on incomplete information and not considering all the consequences of each choice of basis across all regulated products. We therefore do not think that would be the best course of action.

5.48 We have considered whether an independent third party should set the rules by which the RFS are prepared. We can understand the reasons for some stakeholders suggesting this – it would go a long way to removing any concerns about bias by BT in setting the basis of preparation to suit its own goals. However, there are likely to be significant practical difficulties associated with it which would outweigh the potential advantages. In particular, a third party would be much less familiar with cost causality in a complex business such as BT’s; increasing objectivity in this way would therefore risk reducing accuracy. In addition, a third party replicating BT’s regulatory reporting function would be likely to be very expensive.

Proposal 1d: BT should notify Ofcom in advance of proposed changes to accounting methodologies, sufficiently far in advance to allow a review of the proposals

5.49 From time to time, BT makes changes to the basis of preparation of its RFS. Ofcom recognises that in many cases these are sensible changes that reflect the underlying nature of the costs and how those costs are incurred, or improvements in the way information is gathered and we do not consider it appropriate or beneficial to prevent BT from doing so. However, as explained above, these changes are a particular cause of concern to stakeholders. Therefore, as well as proactively proposing
changes to the allocation rules, Ofcom intends to be more involved in the review of these changes and will inform BT when it considers that the proposed changes are not appropriate and instruct BT not to make the proposed changes.

5.50 Currently, BT informs us of restatements and methodology changes, although this is often late in the process – sometimes only a matter of weeks before publication of the published financial statements. We might then be faced with a choice whether to accept the proposed approach or delay publication while we investigate and potentially propose changes to that approach.

5.51 In future, we propose that BT should notify us in advance of proposed changes to its methodologies that would have a material impact on the RFS. We would then be in a position to properly assess the rationale and impact of the proposed changes alongside the Regulatory Accounting Principles before accepting, revising or potentially rejecting the proposed change.

Proposal 1e: BT can illustrate the effect of areas of disagreement with Ofcom

5.52 We recognise that increased Ofcom involvement in the rules might lead to a requirement on BT to prepare a set of accounts on a basis that it considers to be less appropriate. We are therefore minded to allow BT to illustrate the effects of these areas of disagreement, probably in the form of a note to the published financial statements.

Question 5.1 - Do you consider our proposals relating to Ofcom’s role in setting basis of preparation to be effective and proportionate? Please provide explanations and evidence to support your views.

Question 5.2 - Do you have any comments on the status and detail of the Regulatory Accounting Principles and their role in determining the appropriate basis of preparation for the RFS?

2. Aligning the published financial statements with regulatory decisions

5.53 In broad terms we consider that the published financial statements should, where appropriate, be prepared on a basis that is consistent with that used in regulatory decisions. If there were greater consistency between the published financial statements and other regulatory decisions:

- we would be able to use the published financial statements and the supporting figures behind them with the minimum of adjustments; and

- stakeholders would be able to use the published financial statements with reasonable confidence that they reflect the most up-to-date regulatory view of revenues and costs.

Stakeholder comments in response to our call for inputs

5.54 Stakeholders’ opinions on the relationship between the RFS information and Ofcom’s view of the assumptions and its assessment of the markets, are illustrated by the comments set out below.

5.55 According to TalkTalk:
“Ensuring the costs in the RFS reflect Ofcom’s view of assumptions is critical for stakeholders to be able to assess cost orientation”\textsuperscript{121}.

5.56 Everything Everywhere’s view was that:

“It is more important [compared to ensuring consistency with statutory accounts] that regulatory financial reporting information links back to the market assessments and reasons for applying SMP remedies”\textsuperscript{122}.

**Our proposals**

5.57 As explained below, we propose that:

- We will review and if necessary revise existing requirements for consistency of the RFS with regulatory decisions.

- We will specify necessary changes to align the RFS more closely to regulatory decisions, as and when they come to light.

- We will not require the RFS to be prepared on a RAV basis. The RFS should continue to be prepared on a CCA basis, but with a reconciliation to equivalent numbers prepared on a RAV basis.

5.58 An important aspect of these proposals is that the reporting requirements should follow policy, rather than be used to set it. We would expect the RFS to reflect the treatment of a particular cost as set out in a charge control, for instance, rather than the charge control necessarily following the treatment adopted in the RFS. In considering policy decisions and investigations which may arise, we would not expect to be bound by the rules in the RFS. New evidence or approaches may be discovered that lead to a better treatment. For example, a subsequent investigation may reveal a better way of allocating costs.

5.59 It will not be appropriate to require consistency in all circumstances. For example, some charge controls have been set to reflect the costs of a “hypothetical ongoing network” rather than the costs of the network BT actually operates. Where this is done, BT’s assets are usually heavily depreciated, and the charge control is set to reflect projected costs derived from the values of similar assets in a “steady state”, typically one in which the net replacement cost of the assets is roughly 50\% of their gross replacement cost. The “steady state adjustment" is thus a modelling assumption, made for the purposes of generating cost projections, and we do not consider it would be appropriate to replace, for the purposes of financial reporting, BT’s actual costs or asset values with an estimate of costs and asset values in the “steady state”.

*Proposal 2a: Apply an overarching consistency requirement*

5.60 The current degree of freedom means that BT might not always apply accounting bases which Ofcom considers to be consistent with our regulatory decisions.

\textsuperscript{121} TalkTalk response to Call for Inputs, page 6.
\textsuperscript{122} EE response to Call for Inputs, page 10.
5.61 Under condition OA21, BT is currently required to keep its systems, its accounting documents and the form and content of the financial statement up to date to ensure they are consistent with certain regulatory decisions.

5.62 Until now, the way in which this condition has led to changes to the basis on which the RFS is prepared is not always clear. We will therefore review BT’s existing requirement and ensure any consistency requirement would also require alignment of the RFS with regulatory decisions where appropriate.

Proposal 2b: Specify necessary changes to align the RFS more closely to regulatory decisions

5.63 If we were to adopt an approach whereby we specified the necessary changes, we could seek to bring about a number of types of changes to BT’s accounts, which might include the following:

- **Allocation bases**: as set out above, one of the most critical determinants of the outputs of BT’s regulatory financial modelling is cost allocation. Where we decide on an appropriate cost allocation basis in a charge control, or where we adjust BT’s approach if we carry out some analysis of BT’s figures during a dispute, we could require that altered basis to be reflected in the RFS.

- **Excluded costs**: where we exclude a certain type of cost from the cost stack associated with a regulated service, for instance as part of analysis carried out for a charge control or dispute, we might require BT to do the same in the RFS.

- **Correction of errors**: where Ofcom discovers an error in the published financial statements as part of a charge control, dispute or other project, the error should be corrected in the following published financial statements. If an error is significant such that it materially affects the ability of Ofcom and stakeholders to rely on the published financial statements, Ofcom might require BT to re-publish some or all of the statements.

- **Matching of revenues and costs**: for each service reported in the published financial statements it should be possible to compare the reported revenues and costs without adjustment. Currently this is not always the case because the data for a particular service may include revenues and costs associated with a different service, or relevant revenues and costs may be reported elsewhere. In addition the cost accrual and charging approach may be inconsistent. This was highlighted by TalkTalk in its response: “There is inconsistency between the cost accrual and charges approaches for certain products. For example, certain co-mingling capex costs are charged to wholesale customers in full (as part of the upfront charge) yet for purposes of cost the amounts are capitalised and depreciated. This makes it difficult to assess cost orientation”

5.64 Providing a list of any required changes should also aid transparency. Stakeholders should be better able to understand the basis of preparation of the published financial statements if they know that the published financial statements are in general prepared using this consistency principle. At the moment, as set out in section 4, the reader of the published financial statements has little knowledge, based on simply reading the published financial statements, of which aspects of previous regulatory decisions have been taken into account in the basis of preparation.

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123 Page 11, paragraph 47 of Talk Talk’s response.
5.65 One drawback of both an overarching requirement and requirements for specific changes is that they could potentially introduce frequent changes of assumptions to the published financial statements. There is a tension between year-on-year consistency and keeping up to date with the latest treatments of particular costs in other relevant pieces of regulatory analysis. We see no obvious ways of removing this tension. In the short term, our view is that consistency with regulatory decisions is more important than year on year consistency. In the long term, we hope that there would not be a significant number of changes every year.

5.66 A possible risk associated with this requirement is that BT could seek to distance itself from the accounts, because the published financial statements would not necessarily represent its view of how costs should be treated. We consider that it remains important that BT retains ownership of the RFS, particularly for its demonstration of compliance with its obligations.

5.67 In this respect, we see some parallels with the IFRS regime (international financial reporting standards) and the statutory accounts, although we would not wish to stretch the comparison excessively. Under that system, companies prepare their accounts in accordance with a set of rules determined by a central body. The statutory accounts remain the companies’ responsibility, but the accounts are made more useful for stakeholders because of the knowledge that they are prepared in accordance with a set of independently determined rules.

5.68 Our own decisions are not the only findings that would in principle need to be reflected in the RFS. Judgments made on appeals to the Competition Appeal Tribunal, for instance, might well also include points which should be reflected in the RFS.

Proposal 2c: The RFS should continue to be prepared on a CCA basis, but with a reconciliation to equivalent numbers prepared on a RAV basis

5.69 A significant source of differences between the numbers reported in the published financial statements and those that we use in our regulatory decisions relates to the Regulatory Asset Value (“RAV”). We discuss this and the bases of asset valuations more generally, below.

5.70 We introduced the Regulatory Asset Value (RAV) following a review into valuing BT’s copper access network in 2005.

“...In this review, Ofcom has looked again at cost recovery by BT and has determined that if nothing is done the current prices, as set by Ofcom, that BT charges competitors for access to its network will result in BT recovering more than its costs for all the copper access network assets that were already deployed at the time the change in accounting treatment was made, that is 1 August 1997. There should be no systematic over- or under-recovery of cost related to network assets purchased after 1997 as these have been consistently treated under current cost accounting.

Ofcom has therefore decided to create a regulatory asset value, or RAV, to represent the remaining value of the pre-1997 copper...
access network assets rather than continuing to value those assets at their current cost. The value of the RAV is set to equal the closing historical cost accounting value for the pre 1 August 1997 assets for the 2004/5 financial year and its value will be increased each year by the Retail Price Index to ensure it is not eroded by inflation. Over time the RAV will gradually disappear as the pre-1997 assets are gradually replaced with new ones."

5.71 We have implemented the RAV through various charge controls, including, for example, LLU and WLR prices\textsuperscript{126}. Therefore, for the purpose of setting prices for these services, we do not use the CCA values set out in the published financial statements. This creates a difference between the numbers reported in the published financial statements and those used in some regulatory decisions.

5.72 There are good reasons why the published financial statements should normally be prepared on a CCA, rather than HCA, basis. The CCA approach requires BT to value its network assets based on the amounts it would cost to replace them at current prices, rather than the actual amounts it cost BT to acquire those assets (or HCA). The main rationale for applying CCA to BT’s network assets is that it enables the regulated prices to be set based on what it would currently cost to replace or build the network. This in turn allows a potential operator, which may be able to provide the same services as BT more efficiently, to be encouraged to build its own network, and charge prices which are lower than BT’s prices\textsuperscript{127}.

5.73 As part of the overall objective of providing Ofcom with the information it needs to make its regulatory decisions and making the published financial statements more consistent with those decisions, we propose that there should be additional disclosure in the published financial statements to allow users of the statements to better understand the effect of the RAV adjustment on the cost estimates of relevant services.

5.74 We therefore propose that the published financial statements should include a reconciliation of the CCA numbers to the equivalent numbers prepared on a RAV basis. The format of this reconciliation is to be determined, but it might include a requirement on BT to provide some headline numbers prepared on the alternative RAV basis, plus a reconciling statement of the difference between the two numbers.

5.75 A related issue is the basis of the CCA value reflected in the RFS.

5.76 Estimating the cost of a theoretical project to replace an asset, like BT’s copper and duct network, which has been installed over many decades and cannot easily be measured, is inevitably difficult and subject to a large degree of judgment.

5.77 However, in recent years, there have been significant swings in BT’s CCA estimates of the value of its assets (in both directions) as BT changed the way it derived its valuation. This has created uncertainty amongst stakeholders about the credibility of

\textsuperscript{126} This has been challenging by BT in its appeal against Ofcom’s statement of 7 March 2012 setting the charge control for WLR and LLU for 2012/13 and 2013/14: Case No 1193/3/3/12.

\textsuperscript{127} An additional point is that charges should reflect forward-looking costs. For assets which will at some time require replacement, CCA is a reasonable measure of forward looking costs. However, for assets which will never need replacement, which we consider as sunk assets, full CCA may not be appropriate because it is likely to overstate forward-looking costs (see our March 2012 LLU/WLR statement \url{http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/statement/annexesMarch12.pdf}, paragraphs A1.23 – A1.31).
the valuations and the resultant holding gains and losses have made it harder for stakeholders to understand movements in the underlying costs.

5.78 In our 2012 consultation on prices for LLU and WLR services we concluded that the absolute valuation of duct assets did not seem to be an appropriate basis for charge controls. For the purpose of setting these prices, we concluded that “CCA remains the appropriate approach for valuing post-1997 duct assets” and stated that, “We consider that the appropriate method for estimating CCA value in this case is indexing annual spend on the network by RPI”\(^{128}\).

5.79 There is therefore a difference between the CCA value reported in the BT’s published financial statements and the value used by Ofcom in its pricing decision. We propose that the impact of such differences should be illustrated in the published financial statements.

5.80 We deal with the disclosure of information relating to holding gains later in this section, under the heading “Improving the presentation of data”.

**Question 5.3** - Do you consider our proposals to align the RFS more closely to regulatory decisions to be appropriate, effective and proportionate? Please provide explanations and evidence to support your views.

**Question 5.4** - Do you agree that the basis for valuing BT’s assets should be determined by BT? If not, how would you propose that the assets be valued?

3. Improving transparency of the basis of preparation

5.81 BT sets out the basis of its preparation of the RFS in its Primary Accounting Documents (PAD) and its Secondary Accounting Documents (SAD).

5.82 The Primary Accounting Documents set out the regulatory accounting principles, the attribution methods, the transfer charge system methodology, accounting policies (including the principles of valuation of fixed assets) and the LRIC methodology. The Secondary Accounting Documents comprise four main elements: the Detailed Attribution Methods (DAM), the Detailed Valuation Methodology (DVM), the LRIC Relationships and Parameters (LRIC R&P) and the Wholesale Catalogue.

**Stakeholder comments**

5.83 BT’s Primary and Secondary Accounting Documents are detailed documents containing several thousand pages of complex technical drafting. As a result, while they are detailed, stakeholders consider that they are not sufficiently accessible to a stakeholder who wants to understand broadly how the published financial statements are prepared\(^{129}\).

5.84 BT proposed that it should continue to publish, but look to rationalise and simplify the accounting documentation\(^{130}\). UKCTA however stated that the answer to the current


\(^{129}\) Talk Talk’s response, page 7.

\(^{130}\) BT’s submission of 6 December 2011, pages 8 and 16.
issues is not less detail, but detail which is presented well and in more accessible formats\textsuperscript{131}.

5.85 Specifically, stakeholders want to understand how BT allocates its costs\textsuperscript{132}. Stakeholders expect the published financial statements to provide comfort that the costs are reasonably allocated\textsuperscript{133}. In particular, stakeholders want to ensure that BT is not choosing allocation bases that allocate too much cost to the regulated services which they buy.

5.86 The allocation rules are set out in BT’s DAM, which is over 1,000 pages long. The stakeholders consider the DAM to be difficult to understand\textsuperscript{134}, because the detail provided by BT makes the overall picture hard to discern\textsuperscript{135}. Everything Everywhere stated that it would be in favour of a high level description of cost allocation rules to complement the detailed descriptions currently produced\textsuperscript{136}.

Our proposals

5.87 We propose that:

- we review the current transparency obligations to ensure that BT can publish accounting documents that are more accessible to the users and simpler to produce for BT;
- BT should publish revised accounting documents that are more accessible to the users of the financial statements;
- BT should publish an additional overview document that provides stakeholders with an overview of the key allocation bases and the impact of those bases; and
- the current requirement for BT to publish schedules showing the Attribution of Wholesale Current Cost and Mean Capital Employed is removed.

Proposal 3a: We will review the current transparency obligations to ensure that BT can publish accounting documents that are more accessible to the users and simpler to produce for BT

5.88 The level of detail and presentation of the Primary and Secondary Accounting Documents has been a matter for BT to determine. We understand that BT has considered simplifying the Secondary Accounting Documents, but it believes that its ability to do so is limited. Specifically, based on our discussions with BT, we understand that it considers there to be two specific requirements that force it to produce the current detailed documentation, as follows:

- Firstly, Direction 2 Transparency principles, which states:

  “BT shall ensure that any data, information, description, material or explanatory document prepared under Conditions OA1 to OA34 in respect of accounting and other methods used in the preparation of

\begin{footnotesize}
131 UKCTA’s response, page 5.
132 Talk Talk’s response, page 8; and UKCTA, page 8.
133 Talk Talk’s response, page 8.
134 Talk Talk’s response, page 7.
135 EE’s response, page 9.
136 EE’s response, page 9.
\end{footnotesize}
the accounting records and Regulatory Financial Statements shall be sufficiently transparent and prepared such that a suitably informed reader can gain a clear understanding of such data, information, description, material or explanatory document, and, if necessary, the overall structure of BT’s financial and information systems from which regulatory accounting data is derived and in particular the sequence of the processing and ‘cascade’ effect of the intermediate cost centres; gain a detailed understanding of all the material, methodologies and drivers (e.g. systems, Processes and procedures) applied in the preparation of regulatory accounting data; and make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them.”

- Secondly, the requirements for an audit opinion which state (for example at page 13, paragraph 20 [g], of the 2012 RFS), “…the Secondary Accounting Documents all dated 31 July 2012 are appropriate to implement the principles contained in the Primary Accounting Documents dated 31 July 2012”.

5.89 It appears that BT’s decision is made more complicated because the Accounting Documents seek to achieve two objectives simultaneously:

i) to provide clarity for stakeholders as to how the published financial statements are prepared, which would suggest accessible and simple, but sufficiently detailed explanations; and

ii) to provide a full detailed exposition of the rules that the RFS follows, to enable the auditors to reach an opinion on the RFS, which necessitates a highly detailed explanation.

5.90 Ahead of the second consultation, we intend to work with BT and its auditors to better understand why it considers these two requirements necessarily result in the documents being produced in their current format.

5.91 We recognise that these objectives are possibly in conflict and that it may be difficult to meet both with a single document. However, we also recognise that there are potential problems associated with having two separate documents that are trying to serve each of these objectives, not least of which is that they might not be completely consistent.

Proposal 3b: BT to publish revised accounting documents that are more accessible to users of the financial statements

5.92 We have considered whether BT should revise its existing accounting documentation and/or publish an additional overview document with an emphasis on cost allocation, with a view to providing further clarity to other stakeholders.

5.93 The first option would require BT to make the accounting documentation clearer and also to simplify the documentation, and where appropriate, reduce the level of detail.

5.94 One of the risks of this approach is over-simplification of the documentation by BT, and loss of useful detail. One of the key tests of whether the level of detail in the accounting documentation is adequate should therefore be whether the auditors can audit the published financial statements on the basis of the documentation.

5.95 In addition, if, as we discuss later in this section, BT builds new regulatory accounting systems, we would expect the accounting documents to be simpler than they are now. This would be the case if BT, as part of its systems rebuild, also updated and simplified its methods for cost allocation and the other bases of preparation. In other words, simpler methods should logically lead to simpler accounting documents.

Proposal 3c: BT should be required to publish an additional overview document

5.96 The second option, requiring BT to publish an additional overview document, would potentially allow BT to decouple the objective of clarity for stakeholders from the objective of enabling the auditors to opine on compliance with the rules. While the existing accounting documentation can primarily be targeted at enabling audit, the new overview can be focused on providing accessible and clear information to other stakeholders about accounting rules, and in particular cost allocation.

5.97 The two approaches might complement each other. In one document, BT might be able to streamline the documentation to fit the audit requirements more efficiently and without excessive detail, while giving stakeholders further clarity without forcing them to go through enormous amount of detail.

Proposal 3d: The requirement to publish schedules showing the Attribution of Wholesale Current Cost and Mean Capital Employed\(^{138}\) should be removed

5.98 Discussions with stakeholders to date indicate that an overview document of the type described above would, if appropriately defined, be more useful than the Attribution of Wholesale Current Cost and Mean Capital Employed schedules, which are currently published in the published financial statements, with the objective of providing an overview of the way costs are allocated across markets but do not appear to be widely used. Therefore, we currently propose that the requirement to publish these schedules would be replaced by a requirement to produce an overview document of the type described above.

Question 5.5 – Do you consider our above proposals to improve transparency to be effective and proportionate? Please provide explanations and evidence to support your views.

Question 5.6 – Do you believe that, in relation to transparency, there is a tension between the objectives of stakeholders and the need for detailed rules to allow auditors to reach an opinion, as discussed above? If applicable, do you have suggestions for resolving this tension?

Reports

5.99 We set out below our broad proposals for making the financial reports easier to understand and use. We consider these under three headings, as follows:

- ensuring the published financial statements provide relevant information;

- ensuring that the published financial statements provide the appropriate level of detail; and

- improving the presentation of data.

\(^{138}\) See the published financial statements for 2012, Section 6, pages 21 to 27.
5.100 We consider each of these proposals in turn below.

4. Ensuring the published financial statements provide relevant information

5.101 In section 3 we identified relevance as a key attribute of good regulatory financial reporting. We said that for information to be relevant, it needs to answer the right questions, in an appropriate way, at the appropriate time. We consider each of these elements below. In section 4 we explained that we considered that the published financial statements broadly answer the right questions but noted that, for example, stakeholders found it difficult to check compliance with price controls.

Stakeholder comments

5.102 We considered stakeholder responses in respect of the right questions to be answered in section 3.

5.103 Some stakeholders\textsuperscript{139} considered that BT’s statement of compliance with certain price controls, which it publishes voluntarily within the published financial statements\textsuperscript{140}, is not detailed or clear enough to provide them with useful information, and it does not enable them to check BT’s compliance for themselves. In particular, it does not show the information related to the individual products within a price control basket. It only shows compliance at the headline total basket level. CPs are particularly interested in the specific products that they purchase, and how they contribute to the overall performance of the basket.

5.104 Stakeholders have raised points around the reconciliation of the published financial statements to other sources. BT has argued that publication of such reconciliations is not necessary.

5.105 In respect of timeliness, BT noted the potential trade-off between the required level of reporting and the speed and accuracy of reporting\textsuperscript{141}.

5.106 On timeliness, UKCTA expressed the view that:

“If we set a realistic timetable for publication such [sic] (e.g. 14 weeks after year end) and ensure extensions are only granted in exceptional circumstances, with a hefty fine structure in place for late publication, this will drastically improve the delivery of the information and ensure adequate resources are deployed and that BT places the appropriate emphasis on preparing this vital information”\textsuperscript{142}.

Our proposals

5.107 We should ensure that the published financial statements answer the various regulatory questions in the most relevant way. We are keen to get stakeholder input on these proposals and other options which we may not have considered, as we develop our proposals for the second consultation.

5.108 We propose that:

\textsuperscript{139}Talk Talk’s response, page 11, paragraph 48.
\textsuperscript{140}2011 RFS, pages 124 and 125.
\textsuperscript{141}BT response to Call for Inputs, page 19.
\textsuperscript{142}UKCTA response to Call for Inputs, page 24.
• reporting on charge control compliance should be formalised and extended;
• reconciliations to statutory financial statements should still be published; and
• reporting deadlines should not be changed.

5.109 In respect of the publication of data relating to BT’s compliance with its cost orientation obligations, this will depend on the definition of the cost orientation obligation itself. Therefore we do not deal with this in detail at this stage.

Proposal 4a: Reporting on charge control compliance should be formalised and extended

5.110 There is currently no formal requirement for BT to publish price control compliance statements. BT currently does so voluntarily, which we welcome.

5.111 To ensure that these statements are prepared in a way that is clearer and more helpful for stakeholders, we propose that the reporting requirements for charge control compliance should be formalised.

5.112 However, the information currently provided is not sufficiently detailed or clear to enable the stakeholders to check BT’s compliance. In particular, the statement does not provide the information related to the individual products within a price control basket. It only shows compliance at the headline total basket level while CPs are particularly interested in the specific products that they purchase, and how they contribute to the overall performance of the basket.

5.113 We believe that the implementation cost to BT of providing such information would be minimal. The underlying weights and the prices are already known to BT and are recorded by their systems for other purposes. It is simply a matter of formatting and presenting the data for publication.

5.114 In order for BT to set compliant prices it must perform similar calculations itself, which may also be used by BT to demonstrate compliance as part of the related charge control SMP conditions. We also think that a formal requirement for this information is essential, before we can consider if and how it might be necessary to modify the related reporting requirements elsewhere.

5.115 However, we understand that BT is concerned that disclosing underlying weights risks causing commercial harm to its business. We would therefore like to understand stakeholders’ views on potential harm and benefits of such disclosure.

5.116 Informed by stakeholder responses, we will consider whether the published information regarding charge control compliance should be more granular, including prior year weights (volumes or revenues) by product, within the baskets.

Proposal 4b: Reconciliations to statutory financial statements should still be published

5.117 In section 3, we explained that we gain some confidence that the data in the RFS is reliable because the RFS can be reconciled to the statutory accounts.

5.118 Under SMP condition OA8, BT is required to reconcile the published financial statements to the statutory financial statements. In the 2012 published financial statements, BT reconciled both published financial statements income statements.\(^{143}\)

\(^{143}\) Page 84, Section 9.1.1
and published financial statements mean capital employed (MCE)\textsuperscript{144}, at total BT level, to the statutory financial statements. In addition, BT reconciled the published financial statements Openreach income statement to the segmental financial information in BT’s annual report\textsuperscript{145}.

5.119 Some stakeholders stated that there are benefits in reconciling the published financial statements to the statutory accounts\textsuperscript{146}. However, they also stated that the challenges and costs of such an exercise should be considered. Other stakeholders responded that the reconciliation should not be done at the expense of the necessary detail in the published financial statements\textsuperscript{147}. Some stakeholders pointed to a need for reconciliation of specific items, as opposed to a full reconciliation\textsuperscript{148}.

5.120 We also note that the European Commission recommends that a reconciliation of the regulatory accounts to the statutory accounts should be required\textsuperscript{149}.

5.121 We therefore do not propose to remove the current requirement for a reconciliation at a total BT level. However, we welcome stakeholders’ views on whether any specific items or areas of the published financial statements may benefit from reconciliation to the statutory accounts and why such reconciliations are necessary.

5.122 One of BT’s general principles in preparing the published financial statements is to remain consistent, as far as possible, with the treatments adopted in the statutory financial reporting. This is to some extent reflected in Regulatory Accounting Principle 6 – “Compliance with applicable law and IAS”. Indeed, the starting point for generating the published financial statements is BT’s general ledger, which itself is prepared according to BT’s accounting policies for the statutory accounts. BT’s aspiration to remain consistent with the statutory accounts is therefore understandable.

5.123 However, if this principle is taken to mean consistency of accounting principles, the objective of making the published financial statements consistent with regulatory decisions may from time to time come into conflict with the principle of consistency with the statutory accounts. In such circumstances, we consider that consistency with regulatory decisions should take priority over consistency with the statutory statements. However, we would welcome stakeholder views on this.

5.124 Stakeholders’ views about reconciliation of the published financial statements to management accounts were similar to reconciliation to statutory accounts, as summarised above. In general, one benefit of using or comparing results with management accounting information is that it may be the basis upon which management make decisions in a business.

5.125 However, having considered stakeholder views, we do not see any significant benefits of reconciliation to management accounts. This is because the management accounts are not as robust a reference point as the statutory accounts. The basis of their preparation will be tailored towards satisfying the commercial information needs

\textsuperscript{144} Page 86, Section 9.1.3
\textsuperscript{145} Page 92, 93, Sections 10.5 and 10.6
\textsuperscript{146} UKCTA’s response, page 23; Three’s reply, last two pages
\textsuperscript{147} C&WW’s response, page 8
\textsuperscript{148} Talk Talk’s response, page 11
of management. They are not audited and are not required to comply with a clear set of accounting principles in the manner that statutory accounts are.

Proposal 4c: Reporting deadlines should not be changed

5.126 As we described in section 4, we currently require BT to publish its published financial statements four months after its financial year end, i.e. currently on 31 July. However, prior to the delivery of the 2011/12 published financial statements, BT had delivered the statements by this date only once in the previous ten years (although has mostly managed to do so within two months of the deadline).

5.127 We have considered whether the current deadline is unreasonably tight. In this respect, we recognise that given the obligations on BT and the complexity of its current systems, producing an adequate set of accounts is no straightforward task and note that, even when BT misses the four month deadline, its published financial statements tend to be delivered sooner than those of many other regulated telecommunication providers in Europe.

5.128 Based on our understanding of the work that needs to be done, we consider that, provided sufficient resources are directed at meeting this deadline, and Ofcom provides sufficient notice of any annual changes to the reporting and auditing requirements, this is not an unreasonable deadline. This view is supported by the fact that BT has on some occasion met this deadline. We consider that BT should ensure that its systems are capable of delivering the statements by this deadline.

5.129 We have also considered the implications of delay in publication. Some elements of the data reported within the published financial statements can be up to 16 months old by the time that they are published. The data reported within the published financial statements is used by us to inform our regulatory decisions and to act upon any non-compliance with BT’s regulatory obligations that we have identified. Similarly, it may also be used by CPs to submit disputes where they believe that there has been non-compliance. Therefore, any delay in publication could potentially lead to costs resulting from the delay in carrying out these activities.

5.130 We therefore do not propose any changes to the requirement on BT to publish its published financial statements four months after its financial year end.

Question 5.7 – Do you consider our above proposals to ensure that the RFS provide relevant information to be effective and proportionate? Please provide explanations and evidence to support your views.

Question 5.8 – To inform our assessment of the appropriate response to delays in the publication of the published financial statements, please explain if and how your organisation has been affected by such delays in the past.

5. Ensuring that the published financial statements provide the appropriate level of detail

5.131 BT’s published financial statements are relatively detailed, and run to hundreds of pages. We have considered whether the required level of detail is appropriate.
Stakeholder comments

5.132 Responses were broadly divided between BT pushing for less material to be published, and other CPs pushing for at least the same level of disclosure, if not more.

5.133 BT commented that:

“We think that regulatory reporting requirements can be simplified such that: we publish CCA cost and revenue information for regulated markets in aggregate alongside transparent, but more streamlined, accounting documentation... we no longer publish separate internal and external numbers (costs, volumes and prices) as these are unnecessary to actually demonstrate non-discrimination given that (a) EoI requirements are in place for many regulated services providing clear comfort that the same prices are faced downstream; and (b) the fact that for relevant services subject to non-discrimination, but not EoI, regulatory reporting can only ever provide a simple statement that prices faced are identical. This does not require full disclosure of relative volumes and such information should be treated as commercially confidential anyway”150.

“We believe less detailed reporting information should be published in the RFS each year... It has been recognised... that the level of detail provided in the UK exceeds that provided elsewhere”151.

“Ofcom should also give much greater weight to whether information should be treated as commercially confidential. Much of the data we provide is clearly of commercial value to our customers who are also of course our competitors in various markets”152.

5.134 Other CPs commented that:

UKCTA: “Well presented detail is the key to transparency. Less detail is not the answer, with more effort put into better presentation and more accessible formats”153. “It is the detail that is important, particularly volumes and breakdown of costs by individual components. The market statements provide context and guide the reader into the document”154.

C&WW: “Publication of detailed information is essential as history has shown that it is Communications Providers themselves who are most likely to see inconsistencies and inaccuracies in the information provided”155.

150 BT response to Call for Inputs, page 7.
151 BT response to Call for Inputs, page 17.
152 BT response to Call for Inputs, page 18.
153 UKCTA response to Call for Inputs, page 5.
154 UKCTA response to Call for Inputs, page 17.
TalkTalk: “Given the cost orientation obligation is for ‘each and every product’ without this product breakdown it is impossible to assess whether BT is meeting its cost orientation obligation”\textsuperscript{156}.

5.135 There was some agreement amongst CPs that the key sections in the published financial statements were the current sections 3 and 4 – the “Review of Access Markets” and the “Review of Other Wholesale Markets”\textsuperscript{157}. Stakeholders did not generally identify those parts of the published financial statements that they did not use but discussions with stakeholders indicate that some schedules (such as the Network Services Reconciliation) are not widely used.

5.136 BT commissioned Deloitte to examine the current state of regulation in a number of European countries, and consider how their regulatory reporting obligations compare to those in the UK (we refer to this as “the Deloitte report”). Deloitte examined six countries; France, Germany, Ireland, Italy, Spain, and Sweden.

5.137 The Deloitte report is published alongside this consultation document, and we invite other stakeholders to respond to the main conclusions\textsuperscript{158}.

5.138 The report contains three chapters. The majority of the regulatory reporting research is included in Chapter 3 of the Deloitte report and seems to focus around four main themes:

- The use of different models
- HCA and CCA valuation
- Product aggregation
- Level of published detail

5.139 Comparisons of regulatory reporting requirements need to be seen in the context of the overall regulatory regimes in place. With this in mind, we invite comments from stakeholders on the research and comments made in the Deloitte report and the extent to which it is relevant to our assessment of BT’s reporting requirements.

5.140 Some stakeholders also stated that it can be difficult for them to compare the price of the products they purchase with what is reported in the published financial statements and what is included in the price control\textsuperscript{159}. There is no clear mapping of products included in the published financial statements.

Our proposals

5.141 Our final proposals on the appropriate level of detail will be informed by our consultation on cost orientation. However, our current proposals are that:

- we will consider alternative approaches to providing stakeholders with the information they need;

\textsuperscript{156} TalkTalk response to Call for Inputs, page 11.
\textsuperscript{157} UKCTA, page 18 of its response to our Call for Inputs; Verizon (page 12).
\textsuperscript{158} http://stakeholders.ofcom.org.uk/binaries/consultations/reg-financial-report/annexes/deloitte.pdf
\textsuperscript{159} Talk Talk’s response, page 10, paragraph 46; UKCTA’s response page 16
• it is not sufficient to report only at market level; BT will still be required to report at the level of products and services;

• this information should include internal and external volume data;

• subject to the findings of our cost orientation consultation, there may continue to be services where it is not necessary and/or practicable to report at price list level, in which case some aggregation may be appropriate;

• where services are not reported at price list level, sufficient information should be provided to enable users of the financial statements to map the services to the aggregated entry in the financial statements;

• BT should continue to publish the calculation of FAC based on component costs, although this requirement will be reviewed in light of the outcome of the cost orientation consultation and, subsequently, in light of improvements to BT’s regulatory accounting systems; and

• as previously proposed elsewhere, the current requirement for the publication of some statements will be removed.

Proposal 5a: Consider alternative approaches to providing stakeholders with the information they need

5.142 In 2006, BT published, on a voluntary basis, an alternative regulatory financial report for 2006 (alongside its published financial statements for the year). BT proposed that its alternative report would provide stakeholders with summary assurance that BT had complied with its regulatory obligations in an accessible, simple and transparent manner that would enable stakeholders to quickly draw summary conclusions.

5.143 At the time, BT explained that it considered the format then being proposed by Ofcom for 2007 (which is similar to today’s format) required BT to publish a level of detail that was far in excess of what was needed to provide appropriate assurance of BT’s compliance with its regulatory obligations. However, while BT’s proposed format illustrated the level of detail that BT considered to provide appropriate evidence of compliance, BT did not explain why this level of disclosure was appropriate. Ofcom concluded that replacing much of the detail with a statement of compliance of the type proposed by BT increased the risk that important issues that might otherwise be identified by stakeholders instead remain unnoticed, or that Ofcom may receive an increased number of speculative complaints raised by less well informed stakeholders. Ofcom therefore concluded that reducing the published requirements to the extent suggested in BT’s alternative format would cost industry more in the long term than it would save BT in the short term.

5.144 Our current proposals, set out below, start from a similar position and include requirements to report at the level of products and services, together with some level of supporting disclosure. However, at this stage we do not rule out the possibility of alternative options that might provide stakeholders with the necessary assurance that BT has complied with its regulatory obligations in an accessible manner i.e. through the provision of different (rather than additional) information to that described later in this section.

5.145 We are keen to get stakeholders’ views on whether there may be benefits in changing the emphasis of the published financial statements, away from the provision of detailed information for all services on an annual basis. For example, some stakeholders might consider that publication and explanation of long term cost trends at a market level are more instructive than detailed cost breakdowns at a service level while others might consider that the published financial statements should focus on a few material (or timely) issues rather than try to deal with all issues to the same level of detail each year.

Proposal 5b: Continue to require BT to report at the level of products and services

5.146 Under the current reporting requirements, BT is required to provide information at a market level plus information at a service or product level (albeit with some aggregation). Where relevant, the note to each market statement compares the average internal and external charges which each other and with FAC to provide stakeholders with some assurance that BT has complied with its non-discrimination and cost orientation obligations.

5.147 BT has argued that publication of the market level data should be sufficient. Other stakeholders have argued that the information published in the note should be at the price list level (i.e. at a greater level of granularity than at present).

5.148 BT has made a number of arguments against the current level of disclosure, from confidentiality to proportionality. We agree with the joint principles that we should require a proportionate level of disclosure, while not requiring undue disclosure of potentially commercially sensitive information. At this stage however, we see the current level of detail as proportionate, given the need to provide confidence that BT has complied with its obligations that apply at a service level, rather than at a market level.

5.149 Reporting at market level would leave stakeholders with little information about BT’s compliance or otherwise with those obligations, apart from any commentary we make. Providing information at a market level would for instance result in one single line of data for the entire wholesale line access market, which encompasses a wide range of services, from core MPF and SMPF rentals, to New Provides and ancillary services.

5.150 We do not believe this would provide a sufficient level of transparency for stakeholders who are interested in the price they pay for the products they buy. This is also consistent with what stakeholders have told us about the parts of the published financial statements that they primarily use in practice, specifically the product-level information contained in the market statements.

5.151 In respect of the argument for confidentiality, we need further evidence from BT on what commercial harm it considers the current level of disclosure to be causing, especially in markets where it has SMP, and why it considers this is detrimental to competition and consumers.

5.152 Consistent with C&WW’s response quoted above, we see value in CPs having access to product-level data. While stakeholders should be able to take some

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161 For example, see 2012 RFS, “Market summary” at the top of page 36, Section 7.3, comprising two rows of data for 2012 and 2011. However, by market summary statement, we exclude “Detailed service analysis”, provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.).
confidence that Ofcom is closely involved in BT's RFS, this confidence may not be sufficient. While we have a good overview, and in some ways have greater access to data than other stakeholders, we are not ourselves engaged in the business of buying and using the products concerned. Companies that use these products are likely to have a better understanding of the costs involved.

5.153 Therefore, at this stage, we do not propose to remove the requirement to report cost information at the product/service level.

Proposal 5c: Service level information should continue to include internal and external volume data

5.154 In respect of the necessary disclosure relating to compliance with non-discrimination obligations, BT has argued that it should not be required to publish internal volume data. Specifically, BT argues that requiring external and internal volumes is excessive and potentially commercially damaging.

5.155 There are good regulatory reasons to require publication of this data. Unit prices alone are not the only issue when it comes to discrimination. The real situation is only revealed through the combination of price and volume. For instance, a certain service might be sold mostly internally within BT, whereas a slightly different service in the same market – perhaps a similar product but with a different bandwidth – might be sold mostly to external customers. CPs can only get full assurance that they are being offered the same products, on the same terms as internal customers, if they have access to both price and volume data. Further, volumes are a critical element of data in ensuring the integrity of the reporting system as a whole. We see little extra burden from requiring BT to publish internal and external volumes – this should be a relatively straightforward set of data to produce, and is important for BT's demonstration of compliance with non-discrimination obligations.

5.156 We are not persuaded by BT's argument that this information is commercially sensitive.

5.157 It would be helpful to receive further comments from stakeholders – from BT on the harm it suffers from disclosure, and from other CPs on the precise uses they make of internal/external volumes and prices – to develop our proposals in this area.

5.158 However, at this stage, we expect the requirement for publication of internal and external volumes to remain.

Proposal 5d: It is not necessary to report at price list level, based on current obligations

Proposal 5e: Where reporting is not provided at price list level, sufficient information should be provided to enable users of the financial statements to understand how services have been aggregated

5.159 In theory it is possible for BT to report at the price list level in the published financial statements. For some products there are many more services on the price list than appear in the published financial statements. It may not, however, be practical for BT to report the price list level across the board.

5.160 BT considers that, however robust or detailed a cost allocation system is, there comes a point when it has to allocate costs to such a level of granularity that the results (while materially correct at an overall level) cannot be demonstrated to be
materially correct at the detailed level. This may also make the published financial statements difficult to use, and present challenges in securing an audit opinion.

5.161 Therefore, at this stage we do not expect to impose a requirement to report cost data at a price-list level where it is disproportionate or unhelpful to do so. In practical terms, we would expect the level of aggregation to remain at around today’s level.

5.162 Currently, it is the level of the obligation (such as a requirement for prices to comply with obligations for each and every charge) that, to a significant extent, drives the reporting requirements. We will consider this issue in more detail as part of our consultation on cost orientation.

5.163 However, we recognise that this aggregation may make it difficult for CPs to compare the prices of the products they purchase with those disclosed in the published financial statements.

5.164 We therefore propose that BT should publish information that will allow users of the published financial statements to map the services on the price list to the categories in the published financial statements. However, we would like to better understand the practical implications of this proposal.

Proposal 5f: The requirement to publish the calculation of FAC based on component costs should remain, at least for the time being; and

Proposal 5g: The requirement to publish some other statements should be removed

5.165 More generally, we have considered whether it may be appropriate to reduce some publication requirements.

5.166 We have first considered whether it is appropriate to retain the current requirement to publish the schedules that break costs down by component (e.g. the Calculation of FAC based on component costs and usage factors and/or the Network Activity Statement).

5.167 We understand from BT that it considers that the requirement to publish this information is unnecessary and risks disclosing commercially sensitive information.

5.168 However, at this stage, we think the requirement to publish the Calculation of FAC based on component costs should remain.

5.169 We have not yet been convinced by the assertion by BT that publishing this data causes major commercial confidentiality concerns. This information provides benefits for stakeholders in terms of transparency (notably in providing back-up to inform stakeholder understanding of cost calculations which may be relevant to any assessment of BT’s compliance with its cost orientation obligations), particularly while confidence in the RFS may be low.

5.170 We will review this position following the conclusion of our consultation on cost orientation and again in light of any significant improvements to BT’s systems which might be a more effective way of providing stakeholders with an appropriate degree of confidence in the reports, without the need for publication of detailed data.

5.171 Responses to the CFI and subsequent discussions with stakeholders indicate that there may be other parts of the published financial statements that stakeholders do
not use significantly or at all. We might therefore reduce the reporting obligations on BT in these areas, if there is little benefit to stakeholders.

5.172 As previously noted, responses from stakeholders explaining how they use the published financial statements indicate that the following statements are rarely used, including:

- the Network Activity Statement\(^{162}\),
- the Network Services Reconciliation\(^{163}\), and
- the Attribution of Wholesale Current Cost and Mean Capital Employed\(^{164}\).

5.173 To inform our decision on whether to remove the obligations (possibly in conjunction with other changes, such as the proposals which we hope will increase transparency around the bases of cost allocations which might supplant the requirement for the Attribution of Wholesale Current Cost Statement), we invite stakeholders to explain if and how they have used these statements.

**Question 5.9** – Do you consider that there is scope to change the focus of the published financial statements? Please explain the impact this would have on the current approach to the published financial statements, including for example what information would need to be added and what requirements might no longer be necessary as a result. Please explain why you consider your proposals would allow stakeholders to monitor BT’s compliance with its regulatory obligations.

**Question 5.10** – Do you consider that our proposals regarding the level of detail to be published are effective and proportionate? Please provide explanations and evidence to support your views.

**Question 5.11** – How do you consider we should take account of the findings set out in the Deloitte report in determining the appropriate reporting requirements for BT? Please be as specific as possible.

### 6. Ensuring the reports are easy to understand

5.174 We now consider the presentation of the financial data in the published financial statements.

**Stakeholder comments**

5.175 Our experience of using the published financial statements indicates that, in some areas, the detail is useful for regulatory objectives such as monitoring compliance, whereas in other areas it is less so. In certain areas, the financial information would benefit from more clarity, explanation and better presentation.

5.176 The reported figures in the published financial statements can change significantly from year to year. Some stakeholders stated that the published financial statements did not help them to understand these changes\(^{165}\).

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\(^{162}\) See 2012 published financial statements, Appendix 1.1, pages 95 to 100.
\(^{163}\) See 2012 published financial statements, Appendix 1.3, pages 115 to 120.
\(^{164}\) See the published financial statements for 2012, Section 6, pages 21 to 27.
5.177 Some of these changes relate to one-off changes in asset values (resulting in large holding gains or losses), while others reflect changes in the way BT allocates its costs or correction of errors. The cause and effect of these changes are not always clear from the information provided in the published financial statements.

5.178 TalkTalk also mentioned in its response that stakeholders currently need to apply a considerable amount of effort and time to extract data from the current presentation of the published financial statements (which is as PDF files) and to convert this into an easily usable format. It is also our experience that it is often not easy for users to trace a figure in the published financial statements to its related explanation, or to its supporting or dependent figures elsewhere in the published financial statements.

Our proposals

5.179 As explained below, we propose that:

- Additional information could be provided to inform stakeholders’ understanding of changes in costs over a longer period than two years;
- The published financial statements should include additional disclosure that will enable stakeholders to better understand the impact of one-off events in the year, including holding gains, changes in allocation bases and other restatements.
- We will explore ways to make the information more user friendly; this could include the provision of the information in spreadsheet format and a requirement on BT to present and discuss the published financial statements.

5.180 Informed by stakeholders’ comments received to date and our own experience of using the published financial statements, we have identified a number of possible improvements in the way the required information is presented. In each case, more work is required ahead of the formal proposals to be published in the second consultation.

Proposal 6a: Greater visibility of long term movements

5.181 As explained above, the distorting effect of one-off movements in cost might be minimised, or at least better understood, if some of the data provided covered a longer period than the most recent two years to illustrate long term trends, possibly with some key data presented for a longer period, restated on the current basis, perhaps with some averaged holding gains.

Proposal 6b: Additional disclosure to illustrate the impact of one-off changes

5.182 In recent years, the reported costs and returns have been affected to a significant extent by the impact of holding gains or losses, notably due to changes in BT’s estimate of the cost of rebuilding its duct network, but also due to significant movements in the value of copper.

5.183 These holding gains and losses can obscure the underlying performance and cost trends. Discussions with users of the published financial statements for 2010/11, for example, indicated that stakeholders struggled to understand the cause and effect of

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165 UKCTA’s response, page 22.
166 TalkTalk’s response, page 8, paragraph 36.
the holding losses in the year or interpret the cost data that had been affected by
them.

5.184 We therefore propose that BT should be required to disclose and explain the impact
of holding gains and losses on market and product cost information. For example, in
respect of the breakdown of product level cost information contained in the
statements “Calculation of FAC based on component costs and usage factors”\(^{167}\), the
additional disclosure could be in the form of an extra line showing the impact of
holding gains and losses.

5.185 In respect of significant changes in allocation bases, we will also consider if and how
BT should provide additional disclosure on the cause and effect of significant
changes in allocation bases.

5.186 Related to this is the question of whether we need to revisit the trigger point
(currently 5%) for requiring a restatement of the prior year data in the event of
changes in allocation rules (or any other reason). If the trigger point is too high, the
accounts may become incomparable from one year to another, and hence less useful
to stakeholders. If the trigger point is too low it is likely that the financial statements
will be subject to frequent restatement which may do little to build confidence in and
understanding of the underlying numbers. Stakeholder views are invited on this point.

Proposal 6c: Making the information more user-friendly

5.187 There is scope to make the data easier to access, interpret and to use.

5.188 For example, at this stage, we consider that the published financial statements
should also be provided in a spreadsheet format (in line with the proposal from
TalkTalk\(^{168}\)). This would be of minimal cost to BT but would make it significantly
easier for other stakeholders to identify links across different schedules and to
analyse the data.

5.189 We would still require the current hard-coded format of the published financial
statements to be published by BT as the primary reference point and audited version,
so that there was a permanent reference point.

5.190 We also think that it would be helpful for BT to provide interested parties with an
opportunity to discuss the financial statements shortly after publication. Stakeholder
views on the implementation of such a requirement are invited.

**Question 5.12 - Do you consider our proposals to improve the presentation of RFS to
be effective and proportionate? Please provide explanations and evidence to support
your views.**

**Control**

7. Proposals relating to control

5.191 As explained above, controls are the mechanisms by which the data systems and
reports are reviewed. We consider that BT, its auditors, Ofcom and CPs all have a
role to play in this respect.

\(^{167}\) See 2012 published financial statements, Appendix 1.2, pages 101 to 114.

\(^{168}\) See Talk Talk paragraph 36, third bullet.
Stakeholder comments in response to our call for inputs

5.192 BT stated that there is no need to change the existing ‘tripartite relationship’ whereby we may have some capacity to “influence the appointment of auditors and communicate with the auditor regarding the scope of the audit”\(^{169}\). The same auditors would remain in charge of auditing the statutory accounts and the regulatory accounts. The audit standard would also remain a mixture of Fairly Presents and Properly Prepared, depending on the circumstances.

5.193 UKCTA recommended reinforcing the auditors’ duty of care towards us\(^{170}\). UKCTA strongly pushed for the audit standard to be ‘fairly presents in accordance with’, including comments on the reasonableness of the rules. For UKCTA, the audit should also cover the secondary accounting documents. Regarding the rules of appointment of auditors, UKCTA felt they would only need to be changed if the current ones lead to unsatisfactory outcomes in terms of instruction and scope of the audit and level of audit opinion.

5.194 Responses to the Call for Inputs indicated that some stakeholders are concerned about the perceived shortfalls of the audit, while others would welcome more clarity about what the audit currently does and does not tell them (and the maximum scope that it could have in the future).

Our proposals

5.195 As explained below, we consider that:

- It is important that stakeholders are given a better understanding of the current audit arrangements and the level of assurance a regulatory audit can provide.

- The current rules regarding the appointment of the auditor do not need to change; BT can continue to select the auditor (currently its statutory auditor).

- Opinions will continue to be sought at market level.

- The specific requirements for FPIA and PPIA opinions will continue to be determined annually by Ofcom, although increased Ofcom involvement in setting the basis of preparation may mean that FPIA opinions are not appropriate.

- We will consider whether it is appropriate to require the published financial statements to be signed by a BT Director.

Proposal 7a: Stakeholders should be given a better understanding of the current audit arrangements

5.196 BT, its auditors, Ofcom and other stakeholders each have a role in the review of the published financial statements. As we explain below, in our view, the current audit framework is broadly fit for purpose.

5.197 Ahead of our second consultation, we will explore ways to engage with BT more effectively to better understand and challenge the published financial statements and share its findings with other stakeholders. We will also consider if and how we might use the statement that Ofcom inserts at the first page of the published financial

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\(^{169}\) BT response to the call for inputs, page 20.

\(^{170}\) UKCTA response, pages 5 and 24-25.
Regulatory financial reporting: a review

statements, to give users of the published financial statements a better understanding of Ofcom’s views on the key issues.

5.198 As explained above, we consider that the review of the numbers in the published financial statements by the users of the published financial statements contributes to an informed and robust regulatory financial regime. We expect this review will continue.

5.199 In respect of the review by the auditors, we will work with stakeholders and BT’s auditors to find ways to improve stakeholders’ understanding of the nature and scope of the assurance offered by the audit. Specifically, based on stakeholder comments, we consider that it is important for stakeholders to understand what an audit can and cannot achieve and the extent to which they can (and cannot) take comfort from the audit opinion, as evidence of BT complying with its accounting rules.

5.200 Ahead of the second consultation, we will try to build a better understanding of the nature of the recent restatements and the extent to which they reflect the inherent limitations of an audit, rather than potential weaknesses in the audit approach.

5.201 The annual audit plays an important role in providing confidence to Ofcom that the published financial statements (and, indirectly, BT’s regulatory financial information more generally that has been produced by the same systems) have been prepared on a reasonable basis.

5.202 While the auditors owe a formal duty only to BT and to Ofcom, we consider that the audit does have a role to play in helping to build other stakeholders’ confidence in the published financial statements. However, it appears that some stakeholders do not draw much comfort from the audit. We believe that this is in part because of stakeholders concerns around the reliability of regulatory financial information and its suitability to answer regulatory questions (prompted in part by recent restatements and partly because of a lack of clarity about the role of audit and what it can hope to achieve).

5.203 For example, several respondents criticised the audit because it did not express a view on whether the accounting rules followed by BT were reasonable and other stakeholders argued that we should require the auditor to provide Fairly Presents opinions. As explained in section 4, however, the auditors are already required to provide Fairly Presents opinions in some markets, which require some assessment of the reasonableness of the rules.

Proposal 7b: No change to current rules regarding the appointment of auditors

5.204 One option would be to address perceptions of a lack of independence for a regulatory auditor that is also the statutory auditor.

5.205 This might include requirements for the regulatory auditor to be different from the statutory auditor, for Ofcom to appoint the regulatory auditor or for the auditor to be rotated every few years.

5.206 If we appointed the auditor, we would own the contractual relationship and would instruct the auditor and, potentially, the cost would be re-charged back to BT.

5.207 Any arrangements whereby the published financial statements were audited by a party other than the statutory auditor might improve CPs’ perception of the independence of the auditor. However, such an approach could lead to a higher audit
fee, while a new auditor recouped the initial fixed costs of familiarising itself with BT’s regulatory reporting requirements and systems and we are not yet convinced that appointing auditors different from the statutory auditors would deliver a more effective audit.

5.208 We consider that the current auditor has a deep understanding of the processes. If, as we discuss later in this section, BT starts to move to new regulatory accounting systems, this understanding of the existing processes and methodologies will be particularly valuable.

5.209 Therefore, we propose to leave the arrangements regarding the appointment of the auditor unchanged, at least in the short term.

Proposal 7c: Audit opinions will be required at the market level

5.210 We have also considered the scope and format of the audit and set out some of our initial thoughts below.

5.211 In terms of the granularity of the audit opinions, the auditors currently provide opinions on the financial statements as a whole and on some of the individual markets (as specified by Ofcom in advance each year).

5.212 As much of Ofcom’s and stakeholders’ interest is at the product level, we considered whether it might be appropriate to require audit opinions at an individual product level (at least for some of the most material items). We understand from BT and its auditors that auditing to such a level of granularity is difficult, and would result in significant extra costs, if indeed practicable at all.

5.213 To inform our decision on whether this level of audit is practicable and proportionate, we invite stakeholders’ views on the potential costs and benefits of such a requirement. We also welcome suggestions for alternative ways of increasing stakeholder confidence in the reliability of product level information.

5.214 We have also considered whether it would be sufficient to require opinions only on the published financial statements as a whole and not on individual markets. However, we do not consider that this provides the necessary level of assurance on the cost information at market level.

5.215 We therefore propose that we will continue to require audit opinions at the market level.

Proposal 7d: The specific requirements for FPIA and PPIA opinions will continue to be determined annually by Ofcom

5.216 We have considered the form of opinion to be provided on each market. We consider that the current arrangements, whereby the audit opinion is determined annually, in light of the materiality of the market involved and the issues related to those markets (such as forthcoming market reviews), is working reasonably well.

5.217 We therefore intend to continue with this approach but have considered what the appropriate opinion – i.e. Fairly Presents or Properly Prepared – should be.

5.218 As explained above, we currently require a combination of Fairly Presents and Properly Prepared opinions. As explained above, we take some comfort from a Fairly Presents opinion that the rules BT has followed to prepare its published financial
statements are reasonable. Therefore, for as long as the basis of preparation can be considered to be determined by BT, we will continue to require Fairly Presents opinions on the more significant markets.

5.219 However, as set out above, we now propose that we should have more involvement in setting the rules. We also recognise that this might result in RFS being prepared following rules set (at least in part) by Ofcom that may be considered less appropriate by BT (or, potentially, the auditors).

5.220 A requirement for a Fairly Presents opinion would effectively require the auditor to opine on whether the rules set by the regulator are reasonable. We recognise that this might cease to be appropriate if a significant proportion of the rules are considered to be Ofcom’s rather than BT. Further, if Ofcom does take a greater role in reviewing and setting the basis of preparation, such an opinion may be less important.

Proposal 7e: More work to be done to decide whether it would be appropriate to require the published financial statements to be signed by a director

5.221 In terms of review by BT, we consider that there are practical difficulties associated with a formal requirement to conduct an “adequate” review of the published financial statements before they are published. However, we consider that a formal requirement for the published financial statements to be signed by a director may encourage a higher degree of scrutiny and control over BT’s processes for preparing the statements and we invite stakeholders’ views on this proposal.

Proposal 7f: We need a better understanding of the cause and effect of errors in the RFS

5.222 Stakeholders have in the past argued that there are only limited incentives on BT to get the RFS “right first time”, as errors can be corrected with little or no consequence for BT. BT has argued that the nature of the reporting requirements themselves increases the likelihood of errors arising in the first place.

5.223 To inform our assessment of the appropriate action to take, if any, if the RFS contain material errors in future, it would be helpful to get a better understanding of the factors that have tended to lead to errors in the past and the impact of such errors on the users of the RFS.

Question 5.13 - Do you consider our above proposals regarding the review of the RFS to be effective and proportionate? Please provide explanations and evidence to support your views.

Question 5.14 - Do you have any further comments or evidence to inform our assessment of other issues identified in connection with the review of the RFS including a) the arguments for and against a requirement for a BT Director to sign the RFS and b) the cause and/or effect of errors in the RFS?

Systems

8. Proposals relating to systems

5.224 The design and specification of BT’s regulatory reporting systems is largely a matter for BT to determine.
5.225 However, as we explained in section 4, we understand that BT’s current reporting systems will, one day, reach the end of their useful lives. They appear to be complicated, require a significant amount of manual intervention, lack transparency and are difficult and time-consuming to modify. We also understand that it is difficult to model the effects of potential modifications to the bases of preparation.

5.226 Based on this understanding, we do not expect that continuing with the existing systems, without making any changes, will be a viable long-term option. Further, we consider that effective implementation of the improvements proposed above (such as increased transparency of the basis of preparation and greater Ofcom involvement in the basis of preparation) may depend on the development of a new reporting system.

Stakeholder comments

5.227 In BT’s CFI response it discussed the evolution of regulation and the associated reporting requirements\(^{171}\):

“As with much of the regulatory framework, the obligations around regulatory reporting have grown and incrementally evolved over the years. While they may have reflected the competitive conditions at the time, the initial development of methodologies such as CCA and DLRIC/DSAC in our regulatory reporting pre-date, among other things, broadband, LLU, PPCs and Ethernet. With such an incremental approach adding additional reporting lines year-on-year, it is not surprising that regulation and reporting have become complex, disproportionate and are not always appropriately applied. A more root-and-branch review of what it required is therefore overdue.”

5.228 We believe that the above comments, while addressed more at the regulatory obligations than the systems, nevertheless set a useful context for our proposal of an improvement in the regulatory reporting systems themselves.

5.229 Other stakeholders have made no proposals about updating BT’s systems. This is perhaps not surprising, since the details and condition of the current systems are not visible to such stakeholders. However, to some extent, they may see the indirect effects of this through the lack of transparency and complexity of the accounting documents.

Our proposals

5.230 As noted below, we consider that the design and specification of BT’s regulatory financial reporting systems is ultimately a matter for BT to decide. However, we also consider that the capabilities of those systems and the implementation of any changes to those systems could have significant implications for the effective implementation of our proposals to improve the regulatory reporting regime.

5.231 With this in mind, our current thinking on BT’s systems and the potential need for changes to them is as follows:

- Ofcom has the powers to require BT to make changes to its reporting systems. However, we consider that the objectives of this project are best served by a more collaborative approach to making such improvements

\(^{171}\) See page 7, first paragraph.
• We will require some assurance that these improvements will be delivered within an appropriate timescale;

• Stakeholders will want to understand the nature and effect of the changes;

• BT will want clarity on how the data extracted from the new systems might be used.

Proposal 8a: The objectives of this consultation are best served by a more collaborative approach

5.232 Ofcom has the powers to require BT to make changes to its reporting systems. However, we consider that the objectives of this project are best served by a more collaborative approach to making such improvements.

5.233 While ultimately a matter for BT to decide, we have considered whether improvements to the existing systems may be sufficient to deliver the proposals set out above or whether a more radical approach may be required in the form of new regulatory accounting systems.

5.234 Improving the existing systems would perhaps be less disruptive and less costly than building new systems. However, our view is that this approach may treat some of the symptoms but it will not address the fundamental causes.

5.235 However, a re-build of the accounting systems would require a significant investment for BT. It would also take time to develop and implement. We understand that BT considers that, even if it started work on designing the new systems this year, the first set of RFS prepared using the new system would be 2015/16 at the earliest.

5.236 We therefore need to think carefully about reporting during the transition phase (between now and 2015/16 i.e. the three years 2012/13, 2013/14 and 2014/15) and implementation. We will address this in more detail in our second consultation. Nevertheless, they provide important context for this discussion and we therefore set out some preliminary views on this below.

5.237 It is also worth noting that there is a degree of tension between devoting time and attention to short-term fixes rather than focusing on finding a lasting solution in the form of new accounting systems. Requiring short-term improvements could also push the time line out for delivering the new systems. We therefore think we need to be cautious about imposing too many additional requirements on BT in the short term. However, as discussed below under "Transition and Implementation" and elsewhere in this section, there may be a limited number of short term improvements that are realistically possible, without significantly delaying the longer term improvements.

5.238 Bearing in mind the above, we propose that we should work towards the implementation of new regulatory accounting systems by BT. We consider that this approach offers the most realistic chance of addressing some of the attributes that we identified in section 3, including transparency (especially if accompanied by improved documentation), reliability (if the need for manual intervention is reduced and the systems become easier to audit) and relevance (if it is easier to model the effects of potential improvements to the basis of preparation and easier to implement such improvements). Overall, we believe that it will help to build confidence in the regulatory reporting.
5.239 The development of new systems is a challenging and technical area. Its success will rely on BT applying its existing expertise in regulatory reporting and its knowledge of its own business, the way that its systems work and the cost drivers within that.

5.240 We understand that BT has commissioned a feasibility study into the possibility of replacing parts of its existing systems. Our discussions about its plans indicate that they are still at a preliminary stage. We will continue to work alongside BT in the months ahead before setting out our preferred basis for implementing the necessary improvements in the second consultation.

Proposal 8b: We will require some assurance that these improvements will be delivered within an appropriate timescale

Proposal 8c: Stakeholders will want to understand the nature and effect of the changes

5.241 We are in the process of developing our requirements for the design and implementation of an improved regulatory accounting system by BT, and considering how best to provide all interested parties with the necessary clarity about the scale and implications of the changes. In broad terms our objectives can be considered in three stages.

5.242 At the planning stage, we will need to know what BT is planning and when it is going to happen. For example, we might require the following:

- Early sight of the details of the project plan to develop the system and model specifications and model hierarchy with existing systems.
- Evidence of senior management ownership and commitment within BT and an overview of the internal BT model development review process and governance.
- Regular communication with BT to ensure the plans, specifications and model designs are acceptable and on track.
- The chance to monitor and provide input to system development at each stage in the building process (including model design and construction).
- Early identification of key model features / structure which differ from that of the existing regulatory models (ASPIRE / LRIC model).

5.243 During the implementation stage, we will need to provide stakeholders with confidence that the new data will be reliable and delivered on time. For example, we might expect to see the following from BT:

- The delivery of progress reports and model design documents to Ofcom, prepared in sufficient detail to ensure the model is compliant with regulatory reporting objectives / guidelines.
- Interim results and interim versions of the model and documentation made available to Ofcom following an agreed timetable.
- Regular update of model and documentation
- Audits of the model at key stages
• Review of process by which future updates and further model development will be undertaken

• Ofcom access to BT’s systems team, consultants and auditors

• Effective engagement with CPs, for example: (i) a series of timetabled workshops to inform other CPs of model development, assumptions and underlying structures, such that they can contribute to the model development and (ii) discussion with CPs about the specification of appropriate published documentation including methodologies adopted for valuation and allocation.

• Details of implementation plan / proposals for dual running changeover

• Clear measure of adequacy of when the system is “good enough”. This may be defined, at least in part, by the ability of BT to obtain an appropriate audit opinion.

5.244 By the end of the project, we will need reliable data to be provided in relevant and useful formats. This might include the following:

• Parallel running of the new and legacy systems and an explanation of the key changes in methodologies and output

• Simplified accounting documents – e.g. improved DAM

• Ability for Ofcom to understand and if necessary require changes to allocation rules and explain impact

• Ability to perform sensitivity analyses to assess the costing outcomes which would occur if certain assumptions or changes to assumptions (e.g. different allocation bases) were made (“what if” analyses)

• Specific requirements, e.g. geographic costs.

• Final documentation (user guide and methodology / assumptions documentation) and all relevant information on the model made available to Ofcom. This must be sufficient to allow us to assess whether that model complies with our regulatory reporting objectives (and/or any guidelines in existence, and the regulatory accounting principles) and to allow full understanding of the model features and all data.

5.245 Other factors to consider during implementation could include assurance opinions (from an independent auditor) over whether the new systems deliver our stated objectives.

5.246 As explained above, we consider that if stakeholders have confidence in the way that data is generated, there may be less of a need to check the derivation of that data for themselves. Therefore, it is possible that the delivery of a robust and transparent regulatory accounting system could mean that a lower level of disclosure is sufficient to provide the necessary confidence in the published information. We will be considering this further and would welcome stakeholder views on this issue.

5.247 We are considering if and how we might implement these requirements. Options include a series of deadlines for achieving critical milestones in the delivery of new systems; and /or some form of formal undertaking from BT.
In terms of setting deadlines, there may be challenges in enforcing this. In practice, it is common for information systems projects to run late. We would therefore need to consider how to deal with such delays.

Proposal 8d: BT will expect clarity on how the data extracted from the new systems might be used

One of the key considerations is that for a time there will be two different sets of financial data: those from the new system and those from the old. Even if the basic approach to allocating costs is not changed, it is inevitable that, by simplifying the way those allocations are modelled (for example by reducing the number of stages in the allocation process) that the costs allocated to some services will change. Although these lead to different results, it is not possible to say necessarily whether one way is right and another is wrong.

The existence of two systems and two sets of numbers during the transitional phase could lead to uncertainty during the period of transition from the old system to the new one, unless it is clear in advance how we are likely to refer to the two. We are aware that such uncertainty may potentially reduce or delay BT’s incentives to improve its regulatory accounting systems.

We do not anticipate that our current approach to the use of financial data would change. In principle, we rely on the most recent audited published financial statements as our starting point. Although there may be cases where we need to make adjustments to the data contained in those statements, we normally only do so if the data contains errors, is unreasonable in some respect or is not fit for purpose.

Therefore, as long as the audited published financial statements are generated by the old system, we would expect to use the data provided therein (and generated by the old system) as a starting point, but as soon as the audited published financial statements are generated by the new system, we would use as a starting point the data generated by the new system.

Question 5.15 - Do you agree with Ofcom’s proposed approach regarding potential improvements to BT’s regulatory reporting systems?

Question 5.16 – Do you have any comments on the suggested timing and implications of a transition to a new system?

Question 5.17 – Do you agree that there may be scope to reduce the level of published information if BT’s regulatory reporting systems are improved in the way described above?

BT’s LRIC model

Recent disputes about potential overcharging in the areas of PPCs and Ethernet have focused increased attention on the outputs of BT’s separate LRIC model (in particular DSAC, in the assessment of compliance with cost orientation).

As explained above, we are consulting separately on our approach to cost orientation. This may have implications for the way we use LRIC data. Informed by the outcome of the consultation on cost orientation we will consider what, if any, steps should be taken in respect of BT’s LRIC modelling.
KCOM: Is there a need to improve its regulatory reporting?

5.255 We received no comments from stakeholders in the responses to the CFI regarding the regulatory financial reporting of KCOM. We have conducted a brief review of KCOM’s regulatory financial statements. We have also had discussions with KCOM.

5.256 KCOM has informed us that it rarely receives any questions from users of its regulatory financial statements and KCOM has not proposed any changes to the current reporting requirements.

5.257 We will consider KCOM’s reporting requirements in more detail as part of our second consultation. To that end, we invite stakeholders’ response to the following question:

*Question 5.18 – Are there any specific changes which you would propose to KCOM’s regulatory reporting requirements?*
Annex 1

Diagram of BT’s accounting systems architecture for regulatory financial reporting
Regulatory financial reporting: a review

COST ALLOCATION MODELS
- Over 200 apportionment models + 160 other models

ASPIRE REFERENCE TABLES
- 15 data tables + 6 redundant tables to enable ASPIRE

ASSURE
- Rules of allocations and % apportionment tables to attribute Ledgered Money (£)
- Tables to apportion Activity Groups (%) System generated apportionments tables
- Rule and Data Tables for Network cost entities (using %, volume and factors to allocate – through ASPIRE stages)

ASPIRE

COSTING MODULE
- Exhaustion of BT Group Motor Transport, Group Property and Facility Management Activity Groups
- Allocation of Total Liquid Funds and Interest (Net Cash)
- Allocation of non-Core Suspense
- Allocation of Activity Groups
- Allocation of Plant Support Activities
- Allocation to Openreach and BT Wholesale Components
- Allocation of Openreach Components to Openreach Services and Part Services
- Allocation of BT Wholesale Components & Openreach Part Services to BT Wholesale Services
- Allocation to BT Retail & BT Global Services S Own Use Activity Groups Products

PRICE x VOLUMES FACTORS MODULE
- Volumes Module – Calls and non-Calls
- Prices Module
- Factors Module

Retail product DLRICs
- Regulatory Other Model Assembles RFS annexes e.g. market summary’s & reconciliations
- Cost Orientation Model Derives FAC/DLRIC/DSAC and service unit costs. Assembles Market annexes in RFS format
- Long Run Incremental Cost model
- Overlay

Compiled via Framemaker

Flat File

Regulatory Financial Statements
Annex 2

Glossary

A2.1 “Additional Financial Statements (AFS)” and “Additional Financial Information (AFI)” consist of additional financial reporting by BT to Ofcom on a confidential basis.

A2.2 “Information requests”. Under statutory information gathering powers, we can request a wide range of information, subject to limitations such as proportionality. We would typically use these on an ad hoc basis, to supplement information already available through regulatory financial reporting. Uses include: to support investigations, to assess market power and to set regulatory obligations.

A2.3 “Market summary statements”. For example, see 2012 RFS, “Market summary” at the top of page 36, Section 7.3, comprising two rows of data for 2012 and 2011. However, by market summary statement, we exclude “Detailed service analysis”, provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.).

A2.4 “Published financial statements” or published RFS. These terms refer to only the subset of the regulatory financial statements that is published by the SMP operator.

A2.5 “Regulatory financial reporting”. This is a wider term than RFS. As well as the RFS, (both the published and unpublished financial statements) and the Data Extract Tool, we define this term as embracing the whole of the regulatory reporting methodology, systems and framework. In other words, it includes the “machinery” that BT uses to prepare company-wide data, on a consistent basis, to support cost accounting and accounting separation obligations.

A2.6 “Regulatory financial statements (RFS)”. These relate to regulatory financial statements that are prepared for accounting periods – currently usually the same as the statutory accounting periods and therefore annually. They are formal statements, prepared according to a defined framework and methodology. We use the term in this document to refer to both the published and unpublished statements. The unpublished statements are submitted to Ofcom confidentially.

A2.7 “Unpublished financial statements”. The unpublished statements are submitted to Ofcom confidentially. They are the subset of the RFS that are not published.
Annex 3

Responding to this consultation

How to respond

A3.1 Ofcom invites written views and comments on the issues raised in this document, to be made by 5pm on 2 November 2012.

A3.2 Ofcom strongly prefers to receive responses using the online web form at https://stakeholders.ofcom.org.uk/consultations/regulatory-financial-reporting/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A3.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email Andrew.Boardman@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A3.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Louis-Philippe Carrier
Floor 4
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3333

A3.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

Further information

A3.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Louis-Philippe Carrier on 020 7981 3199.

Confidentiality

A3.7 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.
A3.8 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A3.9 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom’s approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A3.10 Following the end of the consultation period, Ofcom intends to publish a statement in early 2013.

A3.11 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom’s consultation processes

A3.12 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 4.

A3.13 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A3.14 If you would like to discuss these issues or Ofcom’s consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom’s consultation champion:

Graham Howell
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email Graham.Howell@ofcom.org.uk
Annex 4

Ofcom’s consultation principles

A4.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A4.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A4.3 We will be clear about who we are consulting, why, on what questions and for how long.

A4.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A4.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A4.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom’s ‘Consultation Champion’ will also be the main person to contact with views on the way we run our consultations.

A4.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A4.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.
Annex 5

Consultation response cover sheet

A5.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A5.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A5.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A5.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the ‘Consultations’ section of our website at www.ofcom.org.uk/consult/.

A5.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don’t have to edit your response.
## Cover sheet for response to an Ofcom consultation

### BASIC DETAILS

Consultation title:  
To (Ofcom contact):  
Name of respondent:  
Representing (self or organisation/s):  
Address (if not received by email):  

### CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

- Nothing
- Name/contact details/job title
- Whole response
- Organisation
- Part of the response

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

### DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name  
Signed (if hard copy)