Regulatory Financial Reporting

Final Statement

Statement

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About this document

This document sets out the changes that we have decided to make to BT's regulatory financial reporting requirements.

We explain that BT's regulatory financial reporting should provide us with the information that we need to make informed regulatory decisions, monitor BT's compliance with regulatory obligations, ensure that obligations address underlying competition issues and investigate potential breaches of obligations. It should also provide reasonable confidence to stakeholders that BT has complied with its SMP conditions while adding credibility to the regulatory financial reporting regime.

The changes that we have decided to make will:

- give Ofcom a greater role in the way that BT prepares its regulatory financial statements;
- improve the presentation of the published regulatory financial statements and supporting documentation; and
- ensure that Ofcom and other stakeholders have the information that they need.

Contents

Section 1

Summary

1.1 In September 2012, we set out the case for making changes to the current framework for BT's Regulatory Financial Reporting (the "2012 Consultation").

1.2 We explained that since the framework was first implemented in 2004, the use of financial data has evolved.[1] We also explained that stakeholders' confidence in Regulatory Financial Statements has gradually been eroded, that BT considers that it is required to publish unnecessary levels of detail, and that we frequently have to make material adjustments to reported information in order to make regulatory decisions.

1.3 In a second consultation, in December 2013 (the "2013 Consultation"), we set out our views on the purpose and attributes of effective Regulatory Financial Reporting, assessed how the current framework measured up against these attributes and made proposals to address the gaps we identified.

1.4 Informed by responses to both consultations, in this Statement we set out our decision on how the framework needs to change.

Improvements to the Regulatory Financial Reporting framework

1.5 In the 2013 Consultation, we concluded that the purpose of the regulatory financial reporting regime was to provide us with the information necessary to make informed regulatory decisions, monitor compliance with SMP conditions, ensure that those SMP conditions continue to address the underlying competition issues and investigate potential breaches of SMP conditions and anti-competitive practices.

1.6 In deciding how much of this information should also be published, we considered that the published financial information should provide reasonable confidence to stakeholders that BT has complied with its SMP conditions while adding credibility to the regulatory financial reporting regime.

1.7 As explained in this Statement, our assessment of the objectives for regulatory financial reporting and the published financial statements has not changed, although, in response to stakeholders' comments, we have provided further clarity around the nature of these objectives.

1.8 In the 2013 Consultation, we identified the aspects of the current regulatory financial reporting regime that we considered could be improved. In this Statement, we set out the issues that we have decided should be addressed. As explained in Section 2, these are broadly similar to the issues identified in the 2013 Consultation and include the need for regulatory financial data to be prepared on a basis that is more closely aligned with our regulatory decisions.

1.9 In this Statement, we also set out the steps that we have decided should be taken to address these issues. These steps are also broadly similar to those proposed in the

[1] Regulatory financial reporting: a review. Consultation. 6 September 2012. http://stakeholders.ofcom.org.uk/consultations/regulatory-financial-reporting/summary

2013 Consultation, subject to some changes to address concerns raised by stakeholders, particularly in respect of the way these changes will be implemented.

1.10 We set out our decisions under the same headings that we used in the 2013 Consultation, as follows: basis of preparation; scope and format of reports; audit and review; and transition to the new regulatory accounting system. We have summarised our key decisions below.

Basis of preparation

1.11 In the 2013 Consultation, we proposed changes to the requirements regarding the way BT is required to prepare its Regulatory Financial Statements. These were proposed with the following broad objectives in mind:

- Increasing our involvement in setting the basis of preparation;
- Aligning the published regulatory financial statements with regulatory decisions; and
- Maintaining greater control over the basis of preparation.

1.12 We made three main proposals. As explained in Section 3, we have decided to implement most of the proposed changes, which can be summarised as follows:

- Establishing new Regulatory Accounting Principles: these new principles will include the requirement for consistency with regulatory decisions.
- Establishing Regulatory Accounting Guidelines: we will provide accounting rules to be followed when preparing the Regulatory Financial Statements. These will evolve over time to reflect regulatory decisions.
- Introducing a change control process: BT must notify us about proposed changes to its regulatory accounting methodology and we will, where we consider it necessary, block changes proposed by BT. We have made some changes to our proposals set out in the 2013 Consultation and have provided some further explanation of how this process will work, having taken account of stakeholders' concerns around the practicality of some of our earlier proposals.

Scope and format of reporting

1.13 In the 2013 Consultation, we set out our proposed changes to the way the Regulatory Financial Statements are presented and the extent to which the data is published. As explained in Section 4, we have decided to adopt most of the proposals with three broad objectives in mind, as follows:

- Improving transparency of the basis of preparation: we have decided to amend directions regarding transparency and audit of BT's accounting documents so that they better meet the needs of stakeholders.
- Ensuring we have access to the information that we need to be able to regulate effectively: we have removed the requirement for BT to publish the Network Services Reconciliation but will require BT to provide it to Ofcom on a confidential basis. We will consider how on demand and scenario reporting can best be delivered once BT has implemented its new regulatory accounting system.

- Ensuring that Published Regulatory Financial Statements provide relevant information and the appropriate level of detail: BT must publish annual reconciliation reports that show the impact of material changes and errors, report Equivalence of Input (EOI) costs, and non-confidential compliance reports.

1.14 Informed by stakeholders' responses we consider that some disclosure of information regarding BT's financial performance from a regulatory perspective is appropriate. We will therefore consult on the appropriate form and content of the additional disclosure.

Audit and review

1.15 In the 2013 Consultation, we explained that some stakeholders had lost confidence in the audit of the Regulatory Financial Statements. We suggested that the problems identified by stakeholders reflected concerns about BT's level of control over the basis of preparation, a lack of transparency about the basis of preparation, and the way that data is reported. We explained why we did not think that the audit alone could address these concerns in full.

1.16 In light of the other changes we had proposed aimed at building stakeholder confidence in BT's Regulatory Financial Reporting, we did not propose any significant changes to the current regulatory audit arrangements (other than some additional requirements relating to the additional reports that BT will be now be required to provide). However, we did propose that the Published Regulatory Financial Statements should be signed by a director for and on behalf of BT's board of directors as a means of increasing BT's internal scrutiny of the data and reports.

1.17 As explained in Section 5 we have decided to adopt the proposals set out in the 2013 Consultation.

Transition to a new accounting system

1.18 We explained in the 2013 Consultation that BT intended to move to a new regulatory accounting system and proposed that certain safeguards should be put in place. We said that this is to ensure that the introduction of the new system does not cause material changes to the numbers that would have been reported in the Regulatory Financial Statements under the current system, or at least that those changes are explained and understood.

1.19 As explained in Section 6, we have decided to require BT to ensure to the best of its ability that the financial data produced by the new regulatory accounting system is the same as that produced by the current system. BT must also provide a report that sets out all differences between the outputs of the new and current system, and explain all material differences between the outputs.

Implementation of these changes

1.20 We proposed in the 2013 Consultation that we would formally implement these changes to those markets considered in the Wholesale Broadband Access markets[2]

[2] Wholesale broadband access in Market A.

and Fixed Access markets.[3] Our draft decisions in relation to these markets have been published today.

1.21 To preserve the integrity and consistency of BT's Regulatory Financial Reporting, we consider that the changes we are proposing should be implemented across all regulated markets (including for example, reporting of markets considered as part of the Narrowband market review and the Business Connectivity market review. We consider that there are significant advantages to BT and other stakeholders of BT applying one set of accounting rules across all markets.

1.22 We will therefore work with BT to ensure that, as far as possible, the decisions set out in this document can be applied on a consistent basis to all markets. This may take the form of an agreement by BT to do so on a voluntary basis.

1.23 It would not be practicable for BT to enter into such arrangements before the details of our decisions are known to them. However, we have discussed, at a high level and in general terms, some of the practical issues around the implementation of our decisions across all markets with BT.

1.24 At this high level (and without knowing the specifics of our decision on reporting) BT is broadly supportive of the principle of applying a consistent approach across all markets

1.25 Some of the changes described in this Statement will therefore be applied with immediate effect in WBA and Fixed Access markets. Some changes will take longer to implement or provide the framework for further analysis at a later date, such as the review of BT's cost allocation bases. We set out an indicative timeline for the implementation of these changes in Section 7.

[3] The supply of copper loop-based, cable-based and fibre-based wholesale local access at a fixed location in the United Kingdom excluding the Hull Area; Wholesale fixed analogue exchange line services in the United Kingdom excluding the Hull Area; Wholesale ISDN2 exchange line services in the United Kingdom excluding the Hull Area; and Wholesale ISDN30 exchange line services in the United Kingdom excluding the Hull Area.

Section 2

Introduction

Summary

2.1 In the 2012 Consultation, we invited stakeholders' views on the key objectives for Regulatory Financial Reporting and provided initial proposals on how we might improve the reporting regime. We explained that we would set out detailed proposals in a second consultation.

2.2 In the 2013 Consultation, we summarised the responses and set out what we considered to be the appropriate objectives and attributes for effective Regulatory Financial Reporting. We identified areas where improvement is required and set out our proposals to improve the way BT's Regulatory Financial Statements are prepared and presented.

2.3 Responses were broadly supportive of the need for the review and to make changes to the existing framework, although BT argued that we had not adequately made the case for some of the proposed changes. Stakeholders' views also varied on the appropriate objectives for the published financial data, and whether it is enough that they should provide stakeholders with "reasonable confidence" that BT has complied with its regulatory obligations. Several stakeholders also expressed concerns about our ability to implement detailed aspects of the proposed changes from both a legal and practical perspective.

2.4 Informed by these responses, in this section we set out our final views on what we consider to be the purpose of Regulatory Financial Reporting in general and the Published Regulatory Financial Statements in particular. We then provide our assessment of how well the current framework meets these objectives. In doing so we address BT's argument that we have not justified the need for change.

Scope

2.5 In this Statement, we use the term **Regulatory Financial Statements** 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 us confidentially.

2.6 We use the term **Regulatory Financial Reporting** to refer to the whole of the regulatory reporting methodology, systems and legal framework, as well as the Regulatory Financial Statements. The scope of this review therefore includes regulatory financial reporting and the principles and methodologies under which the accounts are prepared.

2.7 The term **Published Regulatory Financial Statements** refers only to the subset of the Regulatory Financial Statements that is published by BT.

Background to this review

2.8 Informed by responses to a Call for Inputs seeking stakeholders' views about Regulatory Financial Reporting and cost orientation remedies[4], we published a consultation on the regulatory reporting regime in September 2012.

2.9 In the 2012 Consultation, we noted that communications technology and the way that we use financial data have evolved significantly since the current framework for BT's Regulatory Financial Reporting was introduced in 2004.[5] We said that stakeholders had expressed concerns with current Regulatory Financial Reporting and raised issues around the accuracy, timeliness and relevance of BT's Published Regulatory Financial Statements. In particular, some stakeholders had expressed concerns about the extent to which BT could change the allocation bases used to prepare its Regulatory Financial Statements. We also noted BT's view that any reporting requirements should be proportionate to the benefits.

2.10 We also set out our thoughts on the purpose and attributes of an effective regulatory reporting regime and invited views on whether we had identified the appropriate set of issues. We considered how well the current regime met those objectives and set out some early thoughts on how the reporting regime might be improved. We published the responses that we received on our website.[6] We explained that, informed by stakeholder responses, we would set out detailed proposals in a second consultation on Regulatory Financial Reporting.

2.11 In December 2013 we published the second consultation on Regulatory Financial Reporting, setting out our views on the purpose and attributes of effective Regulatory Financial Reporting and an assessment of how the current framework measures up against these attributes. We set out our detailed proposals to improve the way BT's Regulatory Financial Statements are prepared and presented. We proposed a timeline for implementation of the proposed changes to the Regulatory Financial Statements.

2.12 We received nine responses to the 2013 Consultation, from stakeholders including BT, UKCTA and other fixed and mobile communications providers. We have published these on our website.[7]

2.13 We have continued to meet with stakeholders since December 2013 to discuss the issues raised in their responses and the particular circumstances of the 2012/13 Regulatory Financial Statements (as further discussed at paragraphs 2.95 and following) which has further reduced stakeholder confidence in BT's Regulatory Financial Reporting. A number of stakeholders have also raised concerns about Regulatory Financial Reporting and the 2012/13 Regulatory Financial Statements in

[4] Review of cost orientation and regulatory financial reporting in telecoms – Call for inputs. 8/11/2011. http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/

[5] The current regulatory 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 of the 'CRF'). It also followed the creation of Ofcom under the Communications Act 2003 and the removal of the BT Licence. The BT Licence already contained accounting obligations providing a framework for regulatory reporting. In a statement of 22 July 2004, Ofcom imposed a range of SMP conditions in relation to regulatory accounting.

[6] http://stakeholders.ofcom.org.uk/consultations/regulatory-financial-reporting/?showResponses=true

[7] http://stakeholders.ofcom.org.uk/consultations/bt-transparency/?showResponses=true

the context of the Fixed Access and WBA market reviews and associated charge controls.

The purpose of regulatory financial reporting

2.14 In this section we consider stakeholders' questions and concerns and set out our final assessment of the objectives of Regulatory Financial Reporting. We first consider Regulatory Financial Reporting as provided to Ofcom and then set out the reasons for publishing information in the form of the Published Regulatory Financial Statements or otherwise (such as the information provided in the context of consultations).

2.15 In the previous Consultations, we explained that the Access Directive and the Communications Act 2003 ('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 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 this information aids transparency.

2.16 This is also addressed in the EC Recommendation adopted in 2005 which addressed the implementation of a cost accounting and/or accounting separation system,[8] 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 charge 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."[9]
>
> "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."[10]

[8] "Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications", OJ L 266, 11.10.2005, p 64. An explanatory memorandum to the EC Recommendation was published alongside.
[9] "Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications", OJ L 266, 11.10.2005, p 64, at paragraph 1
[10] "Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications", OJ L 266, 11.10.2005, p 64, at paragraph 2

> "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 provisions of services internally and those provided externally and allow identification of the average cost of services and the method by which costs have been calculated(...)"[11]

2.17 In a judgment of the Competition Appeal Tribunal ("CAT") of 22 March 2011[12], the purpose of Regulatory Financial Reporting, and the Published Regulatory Financial Statement in particular, was also touched on. In relation to the regulatory financial reporting obligations imposed by us 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."[13]

2.18 Responses to the 2013 Consultation indicated that stakeholders broadly agreed with our assessment of the purpose of regulatory financial reporting.

2.19 For example, BT said that it "identifies much common ground between Ofcom, BT and Communications Providers (CPs) in relation to the role of Regulatory Financial Reporting"[14] and that they "broadly accept the "characteristics" of an effective Regulatory Financial Reporting regime defined by Ofcom."[15]

2.20 Nevertheless, some stakeholders expressed concerns about specific aspects of our assessment of the role for Regulatory Financial Reporting.

2.21 For CPs other than BT, these questions focussed on our view that Published Regulatory Financial Statements should provide stakeholders with "reasonable confidence" that BT is complying with its obligations, while BT submitted that we should adopt a more focussed definition of the purpose of Regulatory Financial Reporting based on a tighter set of objectives defined by reference to the exercise of our specific regulatory functions as follows:

- providing Ofcom with information necessary for setting charge controls;
- allowing Ofcom to monitor compliance with charge controls; and

[11] "Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications", OJ L 266, 11.10.2005, p 64, at paragraph 5.
[12] 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.
[13] BT v Ofcom, Case 1146/3/3/09, Judgement of 22 March 2011, paragraph 161. The judgement of the CAT was upheld by judgement of the Court of Appeal of 27 July 2012, Case C3/2011/1683.
[14] BT, 2013 consultation response, page 1, paragraph 1.
[15] BT, 2013 consultation response, page 7, paragraph 26.

- providing a reliable source of information to support investigations of disputes or potential breaches of SMP remedies.[16]

2.22 We discuss the purpose of Regulatory Financial Reporting as provided to us in more detail below. We also discuss CPs' concerns about the meaning of reasonable confidence and BT's view that the purpose of Regulatory Financial Reporting should be more focussed than that set out by Ofcom.

Regulatory Financial Reporting (as provided to us)

2.23 We proposed that Regulatory Financial Reporting should provide us with the information necessary to make informed regulatory decisions, monitor compliance with SMP conditions, ensure that those SMP conditions continue to address the underlying competition issues, and investigate potential breaches of SMP conditions and anti-competitive practices.

2.24 Stakeholders other than BT broadly agreed with our views about the purpose of Regulatory Financial Reporting. BT has, however, questioned whether information provided in any one year through Regulatory Financial Reporting can be sufficient to make a "judgement on the overall efficacy of incentive–based regulation"[17], and believes that it should not be used to generally assess whether SMP remedies are working.

2.25 BT also considers that annual Regulatory Financial Reporting cannot provide a complete, definitive view on compliance with SMP remedies and/or whether there is any evidence of anti-competitive practices.

2.26 As we explained in the 2013 Consultation, we agree that Regulatory Financial Reporting alone cannot always provide all the information necessary to demonstrate BT's compliance with its SMP conditions. We also accept, as BT points out, that on its own the information provided in any one year might not provide a sufficient basis on which to judge the effectiveness of incentive-based regulation. In forming a view, Ofcom might need to consider information over a time series, and additional information provided through other mechanisms. It would be impossible, as we said in the 2013 Consultation, to impose requirements for all the information that we might require in standardised annual reports. This is because we will not know in advance all of the information that would be required to support our decision making.

2.27 However, while recognising the limitations of any regulatory reporting requirements and the extent to which they can demonstrate compliance with and the effectiveness of SMP conditions, we remain of the view that appropriately specified reporting requirements can and should make a significant contribution to our understanding of both. Our view remains that the Regulatory Financial Statements are a useful source of information and serve as an anchor point to reconcile other data with, which we are able to request through our formal information gathering powers in order to support our decision making. We consider that it is important that information which informs any assessment of compliance or effectiveness is captured in a timely manner. In practical terms this is likely to be annually, when the underlying information is readily available and the results can be audited and reconciled back to other financial information, such as BT's statutory accounts.

[16] BT, 2013 consultation response, page 7, paragraphs 24 and 25.
[17] BT, 2013 consultation response, page 6, paragraph 21.

2.28 Having considered responses to the 2013 Consultation we confirm our view that Regulatory Financial Reporting should provide us with the information necessary to make informed regulatory decisions, monitor compliance with SMP conditions, ensure that those SMP conditions continue to address the underlying competition issues and investigate potential breaches of SMP conditions and anti-competitive practices.

Published Regulatory Financial Statements (available to all parties)

2.29 In the 2013 Consultation we said that sufficient information should be published to enable informed stakeholders to contribute to the development of robust regulatory decisions by allowing them to review and potentially challenge the data on which those decisions are made.

2.30 We further explained that stakeholders have a role to play in assisting us to monitor compliance effectively and to intervene in a timely fashion when required. We considered that publishing Regulatory Financial Statements supports stakeholders' contribution to an informed regulatory framework, as stakeholders (who may have a better understanding of the relevant activities and costs than us) can review and comment on the data that might otherwise only be seen by us. We noted that 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."[18]

2.31 We explained that we consider 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.

2.32 However, we did not consider that the Published Regulatory Financial Statements can or should provide stakeholders with all the information necessary for them to determine whether an SMP provider has complied with its obligations. It is for BT to demonstrate its compliance to us.

2.33 Instead, it was our view that the level of information to be published should be appropriate such that, when considered alongside other information provided to stakeholders (such as in the context of a charge control consultation), it provides reasonable confidence to stakeholders that the SMP provider has complied with its SMP conditions.

2.34 Several CPs have asked what we meant by "reasonable confidence". Other stakeholders argued that it was not enough just to be given reasonable confidence; instead they said that they should have access to the information necessary to satisfy themselves that BT complies with its obligations. Talk Talk Group (TTG) said that they were "unconvinced" that "data checking by stakeholders may not be of primary

[18] Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications, Official Journal L 266, 11/10/2005 P. 0064 - 0069, Annex – Guidelines on reporting requirements and publication of information.

importance"[19] and Verizon said that it "cannot see how stakeholders' can have "reasonable confidence" of BT's compliance without seeing the full range of available information at first hand".[20] Vodafone said that it "would like to gain a clearer understanding of what Ofcom see as the delineation that separate CPs from being able to witness BT categorically demonstrating compliance first hand from the accounts and from only being able to' provide CPs with reasonable confidence about compliance' from the accounts."[21]

2.35 Verizon said that full disclosure of information is important given the perception that Ofcom lacks sufficient resources. Verizon explained that "given Ofcom's failure to monitor BT's compliance with its costs orientation obligations in the past (as demonstrated by the PPC and Ethernet disputes/ appeals) stakeholders will hold justifiable reservations about Ofcom's ability and appetite to perform such monitoring in the future."[22] Vodafone also expressed concern that Ofcom's "ambition must be matched by an increase in specialist resources and relevant expertise if the task is to be completed with rigor."[23]

2.36 The timing of publication of information was also seen as important by Vodafone who said that "a bias should be set in favour of information disclosed on a set timetable to give the regime rigor and prevent information that is in the wider consumer interest information [*sic*] from being disclosed only at [a] point where it suits Ofcom's work programme." [24]

2.37 We consider that reasonable confidence means something less than absolute confidence; we remain of the view that the Published Regulatory Financial Statements cannot provide stakeholders with all the information necessary for them to determine whether an SMP provider has complied with its obligations. As highlighted above, even the information provided annually to Ofcom cannot always, on its own, be sufficient to demonstrate compliance with the SMP conditions.

2.38 However, how reasonable confidence should be achieved cannot be definitively set out for all cases. Reasonable confidence is likely to be different for each individual CP, and may be different depending on the circumstances of each case as well as the wider general context. For example, a CP's confidence in a more limited set of data may be greater in circumstances where there are other safeguards for ensuring compliance with SMP conditions.

2.39 In those circumstances, it is for Ofcom to consider and determine what level of information would provide reasonable confidence in any particular case, following input from stakeholders.

2.40 We note stakeholders' concerns about Ofcom's ability to implement any changes effectively and recognise that this new framework may require Ofcom to commit additional resources. As explained in Section 3, a key step will be the review of BT's existing cost allocation rules which we expect to start shortly and plan to present our findings for consultation alongside the BCMR in due course. At this point, stakeholders will be invited to provide their views on the appropriateness of the allocation rules. We expect that this review will provide a further opportunity to

[19] TTG, 2013 consultation response, page 16, paragraph 5.8.
[20] Verizon, 2013 consultation response, page 2, paragraph 7.
[21] Vodafone, 2013 consultation response, page 9, question 3.2.
[22] Verizon, 2013 consultation response, page 2, paragraph 11.
[23] Vodafone, 2013 consultation response, page 3, paragraph 1.8.
[24] Vodafone, 2013 consultation response, page 9, question 3.1.

increase stakeholders' understanding and confidence in Regulatory Financial Reporting.

2.41 Having considered responses to the 2013 Consultation our view remains that the Published Regulatory Financial Reporting should provide reasonable confidence to stakeholders that the SMP provider has complied with its SMP conditions and add credibility to the Regulatory Financial Reporting Regime.

The attributes of good regulatory reporting

2.42 In our previous Consultations, we proposed that effective Regulatory Financial Reporting should have 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 and the presentation of the data should be clear.
- **Proportionality.** The reporting requirements should be proportionate to the benefits.

2.43 We considered this approach was 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."[25]

2.44 We set out our position on these attributes in more detail below.

Reporting should be relevant

2.45 In the 2013 Consultation we identified the questions that Regulatory Financial Reporting needed to answer and the information that we considered should be provided. In particular, we explained that stakeholders have a legitimate interest in seeing the following information, although we noted that it did not follow that this should necessarily be provided within annual Published Regulatory Financial Statements:

- visibility of information that will be taken into account in regulatory decisions, such as charge controls;

[25]Commission Recommendation on "accounting separation and cost accounting systems under the regulatory framework for electronic communications", 19 September 2005 Recommendation 2, paragraph 3.

- a reasonable understanding of BT's financial performance from a regulatory perspective;
- reasonable confidence regarding compliance with non-discrimination obligations; and
- reasonable confidence of compliance with cost orientation obligations and monitoring compliance with cost orientation is an important consideration.

2.46 We also said that products which BT needs to provide on an EOI basis under the Undertakings which are also covered by SMP regulation should be reported as required under BT's Regulatory Financial Reporting obligations

2.47 We proposed that we should be able to assess our effectiveness at forecasting costs for the purpose of setting charge controls by periodically comparing actual data to the assumptions we made when making regulatory decisions. We noted that the Published Regulatory Financial Statements for some other UK sectoral regulators did include information with this aim in mind. We noted that, having set a charge control, we would not typically expect to re-perform our cost calculations but there are a number of key assumptions, such as volume and efficiency forecasts and capital expenditure forecasts, which can be difficult to predict precisely, where it might be helpful for us to have the information that would enable us to build up a longer term picture of trends in general and outturns against forecasts.

2.48 We said in the 2013 Consultation that we do not consider that all such information should be published annually. The information that we need to make these assessments may change from year to year and may be commercially sensitive. Whilst we encourage stakeholders to provide their views and opinions on the effectiveness of regulation at the relevant decision points, we do not believe such information should be published outside of the formal consultation processes (at which stage it would be possible for us to properly consider the need for adequate disclosure to allow effective consultation alongside BT's legitimate concerns around confidentiality).

2.49 We also set out our view that Regulatory Financial Statements should be prepared on a basis that is, as far as possible, consistent with our regulatory decisions. We said that, subject to that requirement, the basis of preparation should also be consistent with other financial data (specifically BT's statutory accounts) and then, consistent over time.

Stakeholder comments

2.50 Stakeholders broadly agreed that the Regulatory Financial Statements should provide this information. Verizon said that it agreed that the Regulatory Financial Statements should be prepared on a basis that is, as far as possible, consistent with regulatory decisions explaining that "this works to the benefit of all concerned and should not be controversial."[26] Verizon also agreed that publication should take place within four months of the year end and urged Ofcom to "be more proactive in the enforcement of this deadline."[27]

[26] Verizon, 2013 Consultation response, page 3 paragraph 15.
[27] Verizon, 2013 Consultation response, page 3, paragraph 17.

2.51 Vodafone explained that having a view of profitability was important both within regulated markets and across the range of regulated markets. While it is possible for stakeholders to gather the information themselves and to commission exercises such as that undertaken by Frontier Economics[28], Vodafone said that they are not a substitute for an "official overview included within the Regulatory Financial Statements themselves."[29]

2.52 Vodafone argued that "this information is squarely in the public interest and should be produced routinely and made accessible to all stakeholders, with the regulatory accounts representing the ideal place to publish it."[30] TTG agreed that a schedule that allowed stakeholders to compare BT's profits on regulated services against the "allowed profit"[31] would be useful and could "enhance transparency."[32]

2.53 BT did not agree with the provision of financial performance information as proposed. It said that it does "not accept that regulatory reporting should be designed to serve some more general set of regulatory objectives – e.g. to demonstrate the general effectiveness of current regulatory remedies or track BT's profitability over time."[33] BT went on to explain that "Ofcom should not propose to introduce any requirements which are solely driven by more general potential benefits of publication of additional information, such as to allow broader analysis of markets and trends and the making of inferences about underlying drivers of those trends."[34]

2.54 However, BT said that subject to its concerns about the need for a more focussed definition of the purpose of Regulatory Financial Reporting that "we broadly accept the "characteristics' of an effective Regulatory Financial Reporting regime defined by Ofcom."[35]

2.55 Vodafone considered that Ofcom should "value the importance of informed build or buy decision making as a key secondary purpose of the accounts."[36] Vodafone also said that robust and accurate recording of internal and external volumes is important and that "it is important that Ofcom is explicit in ensuring the reporting of volumes follows rules and process that give all parties' confidence in their accuracy." [37]

2.56 Virgin Media is concerned that the impact of fair and reasonable charges appears to have been omitted from the discussion, save for the brief discussion on margin squeeze (which has been regulated under the fair and reasonable access condition). [38]

Ofcom's response

2.57 Regulatory Financial Reporting should support stakeholders' contribution to an informed regulatory framework as stakeholders (who may have a better

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[28] 'The profitability of BT's regulated business, July 2013'. Frontier Economics (prepared for Vodafone).
[29] Vodafone, 2013 Consultation response, page 4, paragraph 2.2.
[30] Vodafone, 2013 Consultation response, page 4, paragraph 2.3.
[31] TTG, 2013 Consultation response, page 20, paragraph 5.27.
[32] TTG, 2013 Consultation response page 20, paragraph 5.27.
[33] BT, 2013 Consultation response, page 3, paragraph 8.
[34] BT, 2013 Consultation response, page 3, paragraph 8.
[35] BT, 2013 Consultation response, page 7, paragraph 26.
[36] Vodafone, 2013, consultation response, page 9, question 3.2.
[37] Vodafone 2013, consultation response, page 9, question 3.2.
[38] Virgin Media, 2013 Consultation response, page 2, paragraph 10

understanding of the relevant activities and costs than us) can review and comment on the data that might otherwise only be seen by us. We noted that this is consistent with the guidance given in the EC Recommendation, as set out above at 2.30.

2.58 In light of this, we consider that in some circumstances it will be appropriate to publish information which gives stakeholders the ability to interpret the returns that BT makes on regulated services in order to inform stakeholders' views on what such information might mean if and when we decide to make further regulatory decisions. In the absence of this information on underlying returns, stakeholders are likely to continue to form their own views of underlying returns based on different assumptions and incomplete information. This outcome does not seem to be in any of the stakeholder's interests.

2.59 Stakeholders other than BT asked for a clearer understanding of BT's financial performance in and across regulated markets. The current form of reporting in the Published Regulatory Financial Statements has led to a lack of certainty about BT's underlying returns.

2.60 We do not agree with BT's narrow interpretation of what Regulatory Financial Reporting should cover and believe that there is now a need to consider the introduction of this new form of reporting. We said in the 2013 Consultation that stakeholders have a legitimate interest in seeing information that gives them "a reasonable understanding of BT's financial performance from a regulatory perspective."[39] We agree with both Vodafone and TTG that the type of analysis we suggested in the 2013 Consultation is appropriate.

2.61 With regard to Vodafone's comments about build or buy decisions, we remain of the view that providing information to inform stakeholders' make or buy decisions should not be an objective of the Published Regulatory Financial Statements. We explained in the 2012 Consultation that 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) but we would not require additional information to support this where that information is not also required for other purposes.

2.62 In relation to Virgin Media's comment concerning fair and reasonable charges, where this is imposed on BT in SMP markets, this constitutes an important constraint on BT's charges. Such requirement, as a form of price regulation, may also in certain circumstances give rise to supporting regulatory reporting requirements. That being said, any assessment of whether charges are fair and reasonable would need to consider a number of factors other than financial information (such as industry practices and norms). On this basis, we do not consider that there can or should be a general requirement for Published Regulatory Financial Statements to provide reasonable confidence that BT has complied with requirements for charges to be fair and reasonable, over and above any specific reporting requirements that might be identified at the remedy stage.

2.63 Therefore, having considered stakeholders' responses, our view remains that stakeholders have a legitimate interest in seeing the following information in annual Published Regulatory Financial Reporting, prepared on a basis that is, as far as possible, consistent with our regulatory decisions, within four months of the year end:

[39] Regulatory financial reporting: a review. Consultation. 20 December 2013 page 27, paragraph 3.107. http://stakeholders.ofcom.org.uk/binaries/consultations/bt-transparency/summary/BTRFS.pdf

- visibility of information that will be taken into account in regulatory decisions, such as charge controls;
- a reasonable understanding of BT's financial performance from a regulatory perspective;
- reasonable confidence regarding compliance with non-discrimination obligations;
- reasonable confidence of compliance with cost orientation obligations and monitoring compliance with cost orientation is an important consideration; and
- products which BT needs to provide on an EOI basis under the Undertakings which are also covered by SMP regulation should be reported as required under BT's Regulatory Financial Reporting obligations.

Reporting should be reliable

2.64 We explained in both the 2012 and 2013 Consultations that the underlying data must be reliable and be seen to be reliable, if Regulatory Financial Reporting is to be effective. With this in mind, we proposed that:

- reporting financial reporting should be free from error and should be capable of reconciliation to the statutory accounts;
- the accounting rules used to prepare the Regulatory Financial Statements should be aligned with the purposes of those statements and chosen on an objective basis. We said that we should have involvement in determining those rules; and
- it is not enough to have an appropriate and objective set of rules, if those rules are not followed; and
- There should be some assurance to users of the Regulatory Financial Statements that the published rules have been followed.

<u>Stakeholder comments</u>

2.65 Stakeholders generally agreed, although they expressed views about our specific proposals to take a greater role in the basis of preparation and about the level of assurance that the audit could provide.

2.66 Verizon expressed concern about the reliability of DSAC data published by BT. Verizon noted that "even in mature and stable markets, DSAC values for certain products remain volatile and unpredictable."[40] Verizon explained that the unaudited nature of the cost standard means that "BT has the ability to apportion common costs free of regulatory oversight, and is incentivised to maximise its opportunities to create competitive distortions in its favour." [41] Verizon argued that Ofcom should require BT to audit DSAC.

[40] Verizon, 2013 Consultation response, page 4, paragraph 19.
[41] Verizon, 2013 Consultation response, page 4, paragraph 19.

Ofcom's response

2.67 We note Verizon's comments about DSAC values and the suggestion they should be subject to the regulatory audit.

2.68 Before 2007, Ofcom required the outputs from BT's LRIC model to be audited. However, in our May 2007 statement on Changes to BT's Regulatory Reporting and Audit Requirements[42], we noted that, as services migrate from old to new technologies, the appropriate definition of network components and the way in which costs vary with volume (a factor which is crucial to the way incremental costs are calculated in the LRIC model) are likely to change. This can be seen within the Fixed Access markets with respect to the move to NGA from PSTN.

2.69 We explained in 2007, that in these circumstances, an audit of the LRIC model responsible for DSAC values would provide little assurance about its outputs while imposing significant audit costs. We still consider this to be the case. We do not, therefore, intend to re-introduce the audit requirement at this stage.

2.70 Having considered responses our view remains that:

- reporting financial reporting should be free from error and should be capable of reconciliation to the statutory accounts;
- the accounting rules used to prepare the Regulatory Financial Statements should be aligned with the purposes of those statements and chosen on an objective basis, and we should have involvement in determining those rules;
- it is not enough to have an appropriate and objective set of rules, if those rules are not followed; and
- there should be some assurance to users of the Regulatory Financial Statements that the published rules have been followed.

The basis of preparation should be transparent

Our proposal

2.71 Transparency is essential to ensure that the data can be understood by the target audience and tested and challenged when necessary. We identified two key aspects to transparency:

- clarity of presentation; and
- clarity around basis of preparation

2.72 We explained that there should be clarity of:

- the purpose of the Regulatory Financial Statements in aggregate and of any individual statement;
- the methodologies that BT follows in preparing the Regulatory Financial Statements, such as how to allocate costs and how to value assets; and

[42] http://stakeholders.ofcom.org.uk/binaries/consultations/obligations/statement/statement.pdf

- the respective roles and responsibilities of Directors.

Stakeholder comments and Ofcom's response

2.73 Other than Verizon, who agreed with Ofcom's views on clarity and the basis of preparation of reporting, stakeholders did not comment on the need for the basis of preparation to be transparent. Our views on transparency, therefore, remain as described above.

The reporting requirements should be proportionate

2.74 We explained in the 2012 and 2013 Consultations that the requirements imposed on BT should be proportionate to the benefits that are expected to result from those requirements. The CRF[43] and the Act specify that obligations placed on operators should be proportionate. We noted that a related issue is that of confidentiality.

Stakeholder comments

2.75 In its response, BT argued that we "should resist calls to increase the amount of information in the published RFS."[44] Conversely, a number of CPs said that they are concerned that our 2013 Consultation proposals might lead to the loss of published information. For example, Verizon said that they "do not want to see precious detail lost from reporting."[45] Sky said that while it "recognises that there is a balance to be struck in terms of the level of disclosure within BT's RFS, CPs have duties to their own shareholders such that it is not sufficient for them to be dependent solely upon Ofcom to perform its functions."[46]

2.76 Vodafone argued that Ofcom's "starting position should always be that all cost information relating to SMP products must be open to scrutiny, unless there is a sound justification for it remaining confidential."[47] Vodafone went on to "urge Ofcom to explain the criteria that [it] would use to identify commercially sensitive information so that all stakeholders have this insight upfront."[48]

Ofcom's response

2.77 Our view remains, as set out in the 2013 Consultation, that the appropriate level of disclosure requires a balance to be struck between the need to publish to achieve regulatory objectives and BT's legitimate concerns around the publication of commercially sensitive information. It is for Ofcom to take a view on the information BT is required to publish. In doing so we will consider whether it is proportionate for BT to gather and publish information in terms of both the burdens imposed and commercial confidentiality. The decision needs to be made, by Ofcom, on a case by case basis taking account of the specific circumstances.

[43] The Common Regulatory Framework (CRF) is composed of five Directives. For more information about the CRF see Section 3 of the 2012 Consultation.
[44] BT, 2013, consultation response, page 3, paragraph 8.
[45] Verizon, 2013 consultation response, page 2, paragraph 11
[46] Sky, 2013 Consultation response, page 2, paragraph 2.5.
[47] Vodafone, 2013 Consultation response, page 7 paragraph 5.3.
[48] Vodafone, 2013 Consultation response, page 7 paragraph 5.3.

The need for change

2.78 In the 2013 Consultation, we considered how well current Regulatory Financial Reporting arrangements achieve the proposed objectives. We concluded on the basis of Ofcom's experience and in the light of stakeholders' responses to the 2012 Consultation that there were areas where improvements could be made to existing Regulatory Financial Reporting arrangements. We proposed changes to current arrangements in line with our findings.

2.79 Our proposals were based around four key elements of the reporting framework, as follows:

- the information that BT produces for regulatory reporting purposes ("Basis of Preparation");
- the published and unpublished reports ("Scope and format of reporting");
- the mechanisms by which the data, reports and systems are defined, updated, reviewed and verified ("Audit and Review"); and
- the infrastructure by which the data is produced (and the "Transition to the new regulatory accounting system").

2.80 Most of our proposals related to changes to the basis of preparation and the way in which data should be provided.

2.81 In respect of the basis of preparation, our main concerns related to the following issues:

- regulatory financial data not being consistent with regulatory decisions;
- the basis of preparation not being consistent over time;
- the current regulatory reporting arrangements giving BT too much discretion over the choice of accounting rules; and
- the rules are followed but mistakes are made.

2.82 In respect of the format and content of the reporting, our main concerns were as follows:

- stakeholders cannot see whether BT has complied with charge controls;
- reporting of cost orientation should follow the obligation;
- EOI reporting is not clear;
- aspects of the financial data do not appear to be as robust as we would expect;
- the basis of preparation is not always clear; and
- Regulatory Financial Reporting should follow policy and should explicitly be linked to SMP conditions.

Stakeholder comments

2.83 Vodafone and Verizon agreed that Ofcom had identified the key areas where improvement can be made. Sky agreed that our proposals "are justified"[49] but said that "they may not prevent BT from acting upon its incentives to overstate the costs of regulated services"[50] and that "the proposals do not go far enough."[51]

2.84 TTG said that the approach that BT currently takes to prepare the Regulatory Financial Statements on its own assumptions and not Ofcom's, including CCA and not RAV, "clearly diminishes the usefulness of the Regulatory Financial Statements."[52] TTG also said that greater consistency will lead to greater stakeholder confidence.[53] Virgin Media also explained that "the current regime has lost credibility with … the continued divergence between the cost base for regulated prices (through charge controls) and the cost attributed to those services as reported by BT."[54]

2.85 TTG submitted that in respect to transparency of the basis of preparation "a key failing of the current RFS and the manner in which the accompanying documentation is prepared is the lack of transparency. It is impossible from the current documentation to understand what costs have been included in each category, and how they have been allocated between different products."[55] TTG also provided specific examples of what it considered to be a lack of effective transparency.

2.86 However, while BT accepted that in some areas there is a need for improvement to ensure "clarity of compliance with charge control basket requirements"[56] and that "reporting requirements linked to cost orientation must reflect the specific way in which the remedy has been imposed."[57] BT said that Ofcom's proposals were not justified and that there was a lack of evidence to justify our proposed intervention.

2.87 BT stated that it was "surprised", in light of the UK "having one of the most competitive telecommunications markets", where "regulatory reporting obligations are the most intrusive", that there was the "overall implication that regulatory reporting is currently giving rise to "problems."[58] It said that "Ofcom's rationale for greater intervention is not supported by the evidence in the consultation"[59] and provided a report that it commissioned from FTI Consulting ("FTI") to support its view.[60]

2.88 BT explained that "inconsistencies between information in the published RFS and the way Ofcom uses cost information in making regulatory decisions should not, in themselves, be presented as a problem."[61] BT said that it provides CCA FAC information as required "on the basis of transparent allocations that are consistent with established RAP"[62] and that "policy debates around how that information should

[49] Sky, 2013 Consultation response, page 1, paragraph 1.1.
[50] Sky, 2013 Consultation response, page 1, paragraph 1.1.
[51] Sky, 2013 Consultation response, page 1, paragraph 1.5.
[52] TTG, Call for input response, paragraph 24.
[53] TTG, 2013 Consultation response, page 4-5, paragraphs 3.4-3.5.
[54] Virgin Media, 2013 Consultation Response, page 1, paragraph 3.
[55] TTG, 2013 Consultation response, page 14, paragraph 5.3
[56] BT, 2013, Consultation response, page 8, paragraph 28.
[57] BT, 2013, Consultation response, page 8, paragraph 29.
[58] BT, 2013, Consultation response, page 4, paragraph 12.
[59] BT, 2013, Consultation response, page 2, paragraph 4.
[60] FTI Consulting. Ofcom's consultation on BT's Regulatory Financial Reporting. February 2014.
[61] BT, 2013, Consultation response, page 8, paragraph 30.
[62] BT, 2013, Consultation response, page 8, paragraph 30.

be used in setting process do not invalidate the approach that BT has taken to produce the published RFS."[63]

2.89 BT noted Ofcom's concerns, which were set out Section 4 of the 2013 Consultation, about the process by which BT changes methodologies and the overall discretion BT has in producing the Regulatory Financial Statements. BT said that it believes "that the current process for implementing changes to methodologies over time is transparent and fair and should not be presented as a problem that needs fixing." It went on to state that its ""discretion" is also clearly bounded by the need to be consistent with the RAP and the need for the auditor to accept any changes."[64]

2.90 In its report FTI explained that "Ofcom's stated rationale for increasing control, relating to consistency, is not supported by either the evidence it sets out in relation to CPs' concerns which relates to transparency), or by its decision to make Consistency the lowest ranking accounting principles."[65] FTI also said that "it is clear that Ofcom has not tested whether the CPs' claims are valid. Ofcom has simply taken their comments at face value. Hence, the only evidence Ofcom uses to support its proposal for greater control over cost allocations are the CPs' assertions."[66]

Ofcom's response

2.91 We remain of the view that we should have greater control over the way the Regulatory Financial Statements are prepared. Our proposals to increase our control over the basis of preparation were not the result of taking stakeholders' comments at face value, as FTI suggested; instead, we consider that stakeholders' comments were consistent with the concerns we had previously identified.

2.92 We have already explained why we consider that the Regulatory Financial Statements should be, as far as possible, consistent with the basis of Ofcom's regulatory decisions and have shown that this is not the case.

2.93 We explained in the 2012 Consultation that we have had to make material adjustments to reported information in order to make regulatory decisions. For example, in the 2013 Consultation we said that the relevance of the Regulatory Financial Statements is reduced because they are not prepared on a RAV basis,[67] and that BT's choice of allocation rules that differ from those used by Ofcom in its decisions and that this reduces stakeholders' understanding of the Regulatory Financial Statements.

2.94 Further, even if, as BT asserts, at the time of its response its choice of allocations were consistent with the established Regulatory Accounting Principles, we do not consider that this is a reason for Ofcom not to have the ability to review and input into the basis of preparation in the future to ensure that the Regulatory Financial Statements are, and continue to be, prepared on a consistent basis.

[63] BT, 2013, Consultation response, page 8, paragraph 30.
[64] BT, 2013, Consultation response, page 8, paragraph 32.
[65] FTI, 2013, Consultation response, page 8, paragraph 2.9.
[66] FTI, 2013, Consultation response, page 8, paragraph 2.13.
[67] The RAV is a methodology we apply for valuation of access duct an copper in our charge controls, However, in the Regulatory Financial Statements and Information BT values these assets on a CCA basis.

2.95 Our concerns were to some extent borne out by the changes and errors in the 2012/13 Published Regulatory Financial Statements.

2.96 In July 2013, BT published its 2012/13 Regulatory Financial Statements (for the year ending 31 March 2013).[68] These Statements reflected significant changes in the way BT chose to allocate its costs. We used our statement at the beginning of BT's 2012/13 Regulatory Financial Statements to draw stakeholders' attention to changes in the way in which BT had allocated its costs and assets. We also requested that BT prepare and publish a report setting out the reasons for, and effects of the changes. The report was published on 3 October 2013.[69]

2.97 The report showed the extent to which BT's changes to its allocation rules had led to a significant reallocation of costs to services in the WBA and Fixed Access markets at a time when they were under review by Ofcom for the purposes of setting price controls.

2.98 In addition, BT issued an addendum to its 2012/13 financial statements in late 2013 (following the discovery of an error by Ofcom) in relation to the disaggregation of the total mean capital employed between the different asset and liability categories shown for Wholesale broadband access (WBA) Market 1 and (WBA) Market 2.[70]

2.99 In relation to the Fixed Access markets review we undertook a significant amount of work to scrutinise, interrogate and reconcile the data provided by BT in the October Regulatory Financial Statements and, subsequently, in responses to statutory information requests for the purposes of establishing that the 2012/13 cost data on a 2011/12 basis were sufficiently robust for use as the base year data for our charge control cost modelling.

2.100 In the course of that work BT discovered a material error in the 2012/13 RFS data that had been propagated in the October report. Specifically, BT identified that it had incorrectly allocated some costs associated with engineering time not directly attributable to jobs.[71] We understand that this error may lead to the restatement of the 2012/13 comparatives in the 2013/14 Regulatory Financial Statements.

2.101 We subsequently decided that it would not be appropriate to use the allocation methodology used in the 2012/13 Regulatory Financial Statements for the purpose of the charge controls.[72] Therefore, the 2012/13 Regulatory Financial Statements did not meet one of our primary objectives of Regulatory Financial Reporting, being to provide us with the information necessary to make informed regulatory decisions.

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[68] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/CurrentCostFinancialStatements2013.pdf

[69] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/ReportrequestedbyOfcomfortheyearended31March2013.pdf

[70] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/AdditionalinformationinrelationtoBTsCurrentCostFinancialStatements2013.pdf

[71] Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30 – Annexes. http://stakeholders.acmpub.intra.ofcom.local/telecoms/ga-scheme/specific-conditions-entitlement/market-power/fixed-access-market-reviews-2014/draftstatement/

[72] Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30 – Annexes. http://stakeholders.acmpub.intra.ofcom.local/telecoms/ga-scheme/specific-conditions-entitlement/market-power/fixed-access-market-reviews-2014/draftstatement/

2.102 We also do not accept the argument that BT’s cost allocations are already transparent. We explained in the 2013 Consultation that the basis of preparation (including the choice of allocations) is not clear.

2.103 We explained why we did not consider BT’s current secondary accounting documents provide the necessary level transparency in Section 4 of the 2013 Consultation. For example, we explained that the Detailed Attribution Methodology (DAM) is unlikely to be clear to even the most experienced of users. We explained that it appeared to us that the DAM fails to be transparent because it aims to do two things; as well as providing a description of BT’s cost allocation system, it sets out the detailed rules that BT staff and auditors use for reference. With nine levels of allocation and attribution rules it is difficult to understand.

2.104 BT had previously appeared to accept this. In its response to the 2012 Consultation, BT stated that “The transparency principle as currently defined has actually resulted in us having to produce a voluminous level of explanatory documentation that is actually opaque to the majority of users. It is obviously not fulfilling its purpose”.

2.105 We do not agree with BT that there is already sufficient clarity around changes to its allocation rules.

2.106 Before 2013, BT would give some information to Ofcom ahead of publication of the Regulatory Financial Statements, as it informed Ofcom of the significant changes it intended to make to its allocation bases in the year. This information, while helpful, was typically at a fairly high level, not obtained under formal powers, not subject to independent scrutiny (other than by Ofcom) and was not provided in a form that could be published. It did not provide sufficient clarity of changes to Ofcom and provided little transparency for stakeholders

2.107 In 2013, BT advised Ofcom of several significant changes it intended to make in the 2012/13 Regulatory Financial Statements. We therefore required, for the first time, that BT produce and publish a report setting out the reasons for and impact of its changes. This report was published in October 2013.

2.108 We consider that this report represented a significant improvement in the transparency provided to Ofcom and other stakeholders regarding the changes to BT's allocation rules, compared with previous years. However, we do not consider that the process in 2013 provided Ofcom or stakeholders sufficient clarity or would provide a robust basis for providing this clarity in the future.

2.109 Ofcom needs to understand the changes BT intends to make ahead of publication, if it to have sufficient notice to consider and if necessary respond to this information. In 2013, the information provided by BT regarding the extent of and reasons for its proposed changes was revised

2.110 We consider that stakeholders are entitled to understand the impact of the changes on the Regulatory Financial Statements (partly in order to allow comparison of data over time). We consider that this information should therefore be published alongside the Regulatory Financial Statements. However, although Ofcom first requested in [month] that the report should be provided by [month], and subsequently agreed with BT that the report should be published in September, the report was only published in October, over two months after publication of the Regulatory Financial Statements. During that period, we were aware of stakeholders incorrectly interpreting the cause and effect of the changes.

2.111 We therefore consider that the process first seen in 2013, that led to the publication of the report in October 2013 needs to be improved and then established on a more robust basis.

2.112 We therefore consider that concerns identified in the 2013 Consultation are valid and justify the changes we are now making.

Our powers to make changes

2.113 Ofcom's powers to impose Regulatory Financial 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.[73] SMP remedies cannot be imposed in a market which has been found to be effectively competitive.

2.114 When imposing SMP conditions and directions, Ofcom needs to consider its general duties under Section 3, Section 4 and Section 4A of the Act.

2.115 Section 3 of the Act sets out Ofcom's duties in carrying out its functions, in particular that it furthers the interests of citizens in relation to communications matters and furthers the interests of consumers in relevant markets, where appropriate by promoting competition.

2.116 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements concerning: the promotion of competition; the development of the European internal market; the promotion of the interests of all EU citizens; non-discrimination; encouraging the provision of network access and service interoperability for the purpose of securing efficiency and sustainable competition, efficient investment and innovation and the maximum benefit for consumers; and facilitating service interoperability and securing freedom of choice for consumers.

2.117 Section 4A of the Act requires Ofcom to take into account all applicable recommendations issued by the European Commission under Article 19(1) of the Framework Directive[74].

2.118 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.[75]

2.119 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

[73]Under paragraph 5.31 of the Undertakings, BT is also required to present the financial result of Openreach in the Regulatory Financial Statements. See http://stakeholders.ofcom.org.uk/binaries/telecoms/policy/bt/Consolidated_Undertakings.pdf
[74] Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common framework for electronic communications and services (OJ L 108 24.04.2002, p33), as amended,
[75] Section 47(2) of the Act (in relation to SMP conditions) and Section 49(2) of the Act (in relation to Directions).

greatest possible benefits on the end-users of public electronic communications services (Section 88 of the Act).

Implementation is the markets considered in the fixed access and wholesale broadband access market reviews

2.120 As further explained in Section 7, the changes we have decided are necessary will be introduced in those markets considered in the Fixed Access and WBA market reviews. Our decisions in those markets were notified to the European Commission 19 May and published today in draft. We set out in those documents why we believe accounting separation and/or cost accounting are necessary in the relevant markets and how those requirements meet the relevant legal tests. This document on the other hand specifically focuses on the changes required to the regulatory reporting regime and how the requirements for change meet the relevant legal tests.

Legal Tests

2.121 In order to make changes to the regulatory reporting regime, we need to change the SMP conditions and directions set out in the statement of 22 July 2004. We set out below how we meet our duties under sections 3, 4 and 4A of the Act. We discuss how our decisions meet the tests set out in Sections 47(2) and 49(2) of the Act where we discuss our decisions in detail.

2.122 Our decisions are designed to give Ofcom a greater role in determining how BT should prepare its Regulatory Financial Statements, thereby ensuring the Regulatory Financial Statements are aligned with Ofcom's regulatory decisions and giving confidence to stakeholders about the absence of bias in the preparation of the Regulatory Financial Statements. They also ensure that the presentation and usability of the Regulatory Financial Statements is improved, and that the obligations that are imposed on BT are proportionate. The decisions thereby seek to ensure the RFS remain relevant, thereby increasing transparency. Ultimately, this promotes competition.

2.123 In deciding to make the changes in detail described in the sections below, Ofcom has also taken into account all applicable recommendations issued by the European Commission under Article 19(1) of the Framework Directive, in particular Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications.[76]

2.124 In consequence Ofcom believes the amendments meet the tests in Sections 3, 4 and 4A.

Our changes do not affect KCOM

2.125 We explained in the 2013 Consultation that our proposals were focussed on BT. Nevertheless we note KCOM's view that "any major changes to the regulatory

[76] OJ L 266 11.10.2005, p64. This recommends, amongst other things, that "a national regulatory authority, when assessing the features and specifications of the cost accounting system, reviews the capability of the notified operator's cost accounting system to analyse and present cost data in a way that supports regulatory objectives", and that "national regulatory authorities make relevant accounting information from notified operators available to interested parties at a sufficient level of detail" (see paragraphs 3 and 5 respectively).

accounting regime as it applied to KCOM are potentially very disruptive and costly."[77] KCOM also argued that there is "scope for the removal or simplification of the reporting obligations which currently apply to KCOM."[78]

2.126 We confirm that the decisions that we make in this statement relate to the Regulatory Financial Reporting arrangements for BT. We will, in due course, consider whether any of the changes for BT might be appropriate to apply to KCOM.

Impact assessment and EIA framework

Impact assessment

2.127 Section 7 of the Act requires Ofcom to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. Impact assessments form part of best practice policy-making as they provide a valuable way of assessing different options for regulation and showing why the preferred options was chosen. Ofcom is committed to carrying out and publishing impact assessments in relation to the majority of its policy decisions.

2.128 We set out our impact assessment in the 2013 Consultation. In this document we take into account relevant responses and set out our conclusions on the impact of the changes.

Equality Impact Assessment

2.129 Ofcom is also required to assess the potential impact of all our functions, policies, projects and practices on the equality of individuals to whom those policies will apply. Equality impact assessments ('EIAs') assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.

2.130 We have given careful consideration to whether or not our decision will have a particular impact on race, age, disability, gender, pregnancy and maternity, religion or sex equality. We do not envisage that our decision in this statement will have a detrimental impact on any particular group of people.

Structure of this document

2.131 In **Section 3** we set out our decision to take a greater role in the way that BT's Regulatory Financial Statements are prepared through new Regulatory Accounting Principles and Regulatory Accounting Guidelines. We also explain our decisions about how to better align the Regulatory Financial Statements with regulatory decisions and how we will maintain greater on-going control over the basis of preparation through a change control process. Our decision to introduce a change control process allows us to prevent material changes to cost allocation methodologies that we consider are not consistent with the Regulatory Accounting Principles or Guidelines.

2.132 Our decisions about the scope and format of reporting in **Section 4** are largely unchanged from the proposals that we set out in December 2013. Our decisions will

[77] KCOM, 2013 Consultation response, page 1, paragraph 2.
[78] KCOM, 2013 Consultation response, page 2, paragraph 7.

ensure that we get the information that we need to regulate effectively while providing stakeholders with reasonable confidence that BT is complying with its obligations.

2.133 We have decided in **Section 5** that BT's Regulatory Financial Statements should be signed by a Director for and on behalf of BT's Board of Directors.

2.134 In **Section 6** we confirm the arrangements that we consider are needed to provide assurance to us about BT's move from ASPIRE to a new regulatory accounting system.

2.135 We set out a timeline for the implementation of our decisions in **Section 7**. We explain the point at which elements will take effect and the point at which BT will need to be able to comply with these elements. We also explain the arrangements under which the changes will take effect in the markets in which BT has SMP.

2.136 In **Annex 2** we set out a pro forma of the SMP Conditions which implement our decisions. **Annex 3** sets out the Regulatory Accounting Principles. In **Annex 4** we set out the template that BT will use for change control notification and in **Annex 5** we provide information about the objectives and scope of the regulatory audit..

Section 3

Basis of Preparation

Summary

3.1 In the 2013 Consultation we identified the areas where improvements could be made to the current Regulatory Financial Reporting arrangements by making changes to the way BT is required to prepare its Regulatory Financial Statements.

3.2 In this section we set out our decisions on the necessary changes to BT's obligations relating to the basis of preparation.

3.3 In the 2013 Consultation we made proposals around the following three themes:

- *Establishing new Regulatory Accounting Principles.* We proposed that revised Regulatory Accounting Principles will set out the fundamental principles with which BT's Regulatory Financial Reporting must comply. These will replace the existing Regulatory Accounting Principles. We proposed that the revised Regulatory Accounting Principles will be aligned to our regulatory objectives and will provide the basis for the 2014/15 Regulatory Financial Statements.

- *Establishing Regulatory Accounting Guidelines.* We proposed that Regulatory Accounting Guidelines will be prepared by us and will set out high level accounting rules with which BT's Regulatory Financial Reporting must comply. In particular they will ensure consistency with our regulatory decisions. We proposed that they will replace the existing Primary Accounting Documents, which are prepared by BT, but will be similar in scope and level of detail to BT's current Primary Accounting Documents. We explained that developing the Regulatory Accounting Guidelines is likely to be a significant exercise that will require further review and consultation.

- *Maintaining greater control over the basis of preparation*. We proposed that responsibility for the preparation and accuracy of BT's regulatory financial data should remain with BT. This means that BT will still be able to propose changes to the detailed rules that it uses to apply the requirements set out in the new Regulatory Accounting Principles and Regulatory Accounting Guidelines. We proposed that BT will be required to notify us of material changes to its accounting methodologies and source data in advance. A version of the notification will also be published by BT and will include the reason for the change and an estimate of the financial impact of each proposed change, based on the previous year's Regulatory Financial Statements. We proposed that we could prohibit the change if we consider it is not in accordance with the Primary Accounting Documents or Regulatory Accounting Guidelines, but not 'approve' any change and our silence on proposed changes will not indicate our agreement. We proposed that our view, or absence of a view on any proposed changes, will be in the context of Regulatory Financial Reporting only.

3.4 In this section we consider stakeholders' responses to these proposals. Informed by these responses we have made some changes to the proposals relating to change control and our right to veto a change proposed by BT that does not comply with the Regulatory Accounting Principles or the Regulatory Accounting Guidelines. We have also amended the proposals in relation to error notification and production of

Regulatory Accounting Guidelines. We also provide more detail about the work we are planning for a detailed review of existing BT cost allocation rules.

Introduction

3.5 Stakeholders made a number of general comments about our proposed approach to taking greater involvement in the basis of preparation, which we consider briefly below, before addressing the individual proposals in turn.

3.6 BT said that it is concerned "that Ofcom is proposing a significant increase in the level of regulation in this area." However, other stakeholders welcomed our proposals.

3.7 Vodafone said that it welcomed our proposals believing that they "represent a significant improvement on the current approach to regulatory accounting and help address the disconnect between the numbers used to set regulatory charges and those published within the accounts."

3.8 Sky said that it supported our proposals because the Regulatory Financial Statements should reflect regulatory decisions, BT should have "far less flexibility in how it prepares the RFR", and if Ofcom "deems the proposed allocation changes inappropriate then it should be able to reject their adoption within the RFR."

3.9 UKCTA welcomed Ofcom's proposals for "a significantly enhanced role for itself in attribution decisions." Verizon said that taken as a whole Ofcom's proposals "constitute a constructive and reasonable set of measures which should help to increase confidence in the integrity of the RFS and regulatory reporting more broadly."

Establishing new Regulatory Accounting Principles

3.10 In the 2013 Consultation we proposed to amend the regulatory reporting obligations on BT so that BT's Regulatory Financial Reporting must comply with the Regulatory Accounting Principles directed by Ofcom.

Review of our proposals on the Regulatory Accounting Principles

3.11 We proposed that, in order of priority, the Regulatory Accounting Principles should be:

i) Completeness

ii) Accuracy

iii) Objectivity

iv) Consistency with regulatory decisions

v) Causality

vi) Compliance with statutory accounting standards

vii) Consistency of the Regulatory Financial Statements as a whole and from one period to another

3.12 We proposed that the requirement to comply with the Regulatory Accounting Principles will be implemented in the SMP conditions and the Regulatory Accounting Principles will be directed. We also said that the new Regulatory Accounting Principles will apply to the 2014/15 Regulatory Financial Statements.

3.13 Stakeholders said that they agreed with our proposal about setting new Regulatory Accounting Principles. Verizon said that it "agrees with Ofcom's intention, described at paragraph 5.10, to make clear that the ownership of the Regulatory Accounting Principles ("RAP") lies with Ofcom."[79] Verizon went on to say that they "hope that in doing so, Ofcom will set a sound framework for regulatory reporting going forward and ensure that consistency and quality are maintained."[80] BT said that "we welcome Ofcom's replacing of the existing RAP with the new RAP."[81]

3.14 Verizon also said that it "also agrees that Ofcom has identified the appropriate RAPs in Figure 1, and that they appear to be in the correct order in terms of priority and weight that should be attributed to them."[82]

3.15 BT said that they "accept the inclusion of a new "Consistency with regulatory decisions" principle, as well as the new principles of "Completeness" and "Accuracy"."[83] BT went on to say that they had "no objection to the removal of some of the principles ("Sampling", "Definitions", "Transparency" and "Priority")".[84] BT also did not object to the new Regulatory Accounting Principles coming into effect for the 2014/15 Regulatory Financial Statements.

3.16 We note that there is wide support for our proposal to replace the existing Regulatory Accounting Principles with new Regulatory Accounting Principles. We also note that there is broad agreement about the content of new principles and the suggested hierarchy. As we explain below, we have therefore decided to adopt our original proposals.

3.17 Stakeholders commented on three main categories of issues, which we set out and deal with in turn:

- Interaction of the Regulatory Accounting Principles with economic principles;
- Regulatory consistency principle and its place in the hierarchy of principles;
- Other comments, including requests for clarification.

Stakeholder comments on the relevance of economic principles

3.18 TTG said that while they "broadly agree with Ofcom's proposed Regulatory Accounting Principles"[85] there were two additional principles that should be included. TTG consider that allocation of costs should primarily be based on economic rather than accounting principles. To that effect TTG suggested that the Regulatory Accounting Principles should include the principles that only forward looking and

[79] Verizon, 2013 Consultation response, page 5, paragraph 28.
[80] Verizon, 2013 Consultation response, page 5, paragraph 29.
[81] BT, 2013 Consultation response, page 12, paragraph 40.
[82] Verizon, 2013 Consultation response, page 5, paragraph 29.
[83] BT, 2013 Consultation response, page 12, paragraph 40.
[84] BT, 2013 Consultation response, page 12, paragraph 40.
[85] TTG, 2013 Consultation response, page 6, paragraph 3.7.

efficiently incurred costs should be allocated to regulated products in the Regulatory Financial Statements.

3.19 TTG said that this will ensure that the Regulatory Financial Statements are prepared in line with the principles that are used to set prices. TTG also considered that the Regulatory Financial Statements should be based on LRIC because pricing decisions are based on LRIC.

3.20 In its report, prepared for BT, FTI argued that our proposals constrain BT's ability to change cost allocation rules and therefore effectively limit BT's flexibility about how it recovers the costs of regulated products through prices, which would lead to a reduction in allocative efficiency. FTI explain that "currently, if BT changes prices to reflect demand conditions, it may also decide to change the allocation of common costs to reflect demand conditions."[86]

3.21 FTI argued that, "it is difficult to see which new Regulatory Accounting Principle BT could use to support such a change."[87] FTI said that Ofcom has in the past acknowledged that competitive prices can fall in a range between LRIC and stand-alone costs. FTI also explained that common costs can be allocated across products using a number of allocation rules and that Ofcom previously recognised that BT was best placed to assess how most efficiently to set prices to recover its common costs.

Ofcom's response on the relevance of economic principles

3.22 We do not agree with TTG's suggestion that the Regulatory Accounting Principles should require only forward looking and efficiently incurred costs to be allocated to regulated products in the Regulatory Financial Statements.

3.23 As noted above, we consider that regulatory reporting should, amongst other things, provide us with the information we need to make informed regulatory decisions (including the setting of price controls) and monitor compliance with SMP conditions (including cost orientation obligations). To this effect we consider that we need a record of BT's actual costs. We explained that the information should be reliable, and be seen to be reliable, and with that in mind should be capable of reconciliation to BT's statutory accounts.

3.24 We noted the EC Recommendation adopted in 2005 which considered the implementation of cost accounting and accounting separation systems, which stated that the purpose of these obligations is to ensure that fair, objective and transparent criteria are followed by operators in allocating their costs and to provide a higher level of detail of information than is derived from the statutory accounts.

3.25 TTG's suggestion appears to be for something other than a record of BT's actual costs and appears to be more about the level of costs than how they should be allocated. Specifically, TTG's proposal appears to envisage a report based on the costs of a hypothetical efficient network. Given the complexities involved and the need for significant judgement as to what the hypothetical network would look like and the costs that would possibly be incurred using that network, we do not consider that such an approach would either be practicable for BT or provide a reliable or relevant source of data for Ofcom or stakeholders. For similar reasons, we do not consider it appropriate to require BT to attempt to adjust its actual costs in the

[86] FTI, 2013 Consultation response, page 36, paragraph 6.15.
[87] FTI, 2013 Consultation response, page 36, paragraph 6.15.

Regulatory Financial Statements to reflect either the efficient level of costs on its current network or what those costs might be on a more efficient version of its network.

3.26 We disagree with TTG's suggestion that the Regulatory Financial Statements should be prepared on a LRIC basis. Reporting should follow regulatory decisions. The Regulatory Financial Statements are predominately presented on a Fully Allocated Cost (FAC) basis because where we currently impose charge control remedies the predominant cost standard is currently CCA FAC, which we consider to be a reasonable proxy for LRIC+EPMU (equal proportionate mark-up). We have traditionally used FAC as a cost standard as it allows BT to recover an appropriate level of its efficiently occurred common costs. The choice of cost standard is an issue for consultation and decision in the context of, for example, charge controls rather than regulatory reporting.

3.27 We disagree with FTI's view that our Regulatory Accounting Principles will unfairly constrain BT's pricing. FTI's concerns appear to conflate two issues: the use of appropriate rules to allocate costs to services (or groups of services) and the flexibility afforded to BT to determine how it recovers those costs (for example through the design of baskets for price controls).

3.28 In some circumstances, Ofcom may consider it appropriate to impose a price control remedy that constrains the revenue that BT can earn across a group or basket of services (informed by an assessment of the costs incurred in delivering those services) but gives BT some flexibility as to how it sets prices within that basket. As such, BT has some flexibility regarding the way it can recover its costs.

3.29 Increasing Ofcom's control over the way costs are allocated may therefore constrain BT's ability to choose how costs are allocated to a basket of services. However, it is likely that Ofcom would, in any event, review cost allocations for the purposes of determining the appropriate level of costs to be recovered from that basket. To the extent that Ofcom will have more say in how costs are allocated, it would have no bearing on the flexibility afforded to BT to determine how those costs might be recovered from services within that basket, which would be determined by the basket design.

3.30 Therefore, to the extent that FTI's view is that the Regulatory Accounting Principles might limit BT's ability to vary its pricing by changing the way it chooses to allocate its costs, it is possible that our proposals will limit BT's ability to do this, but we consider that this would represent an appropriate, rather than unfair, constraint.

Stakeholder comments on the Principle of Consistency

3.31 TTG said that "we fully support Ofcom's proposal to require that the RFS are aligned with regulatory decisions."[88] TTG provided what it considered to be examples from the Regulatory Financial Statements and elsewhere "which serve to demonstrate that at present there is insufficient consistency."[89] TTG highlighted what it considered to be the benefits of consistency of approach:

- The Regulatory Financial Statements will be less prone to error and misunderstanding;

[88] TTG, 2013 Consultation response, page 4, paragraph 3.1.
[89] TTG, 2013 Consultation response, page 4, paragraph 3.4.

- Charge control models will be easier to develop as cost adjustments will not be required.

- Greater confidence in the regulatory accounting system as CPs will be able to observe compliance with regulatory obligations.

- CPs will be able to provide better informed views to Ofcom.

3.32 Verizon said that the 'consistency with regulatory decisions' principle "although highly welcome, will need explaining in some detail"[90] so that BT and industry have clear expectations.

3.33 TTG argued that objectivity should move below causality and consistency with regulatory decisions in our proposed priority ranking. This is because they consider that appropriately cost causal allocations will be objective. Alternatively, TTG suggested combining objectivity and causality. TTG also said that consistency should be ranked above compliance with statutory accounting standards.

3.34 BT "said that it, "broadly accept[s] the hierarchy of principles"[91] but expressed concern that consistency with regulatory decisions "could conflict with the principle of causality."[92] While BT agrees that this principle "will provide greater regulatory certainty and confidence in the reported information,"[93] BT asked for clarification about the precise meaning and application of the principle and about how it would be applied by Ofcom "when assessing BT's proposed changes to cost allocations and the implications if this principle contradicts the International Financial Reporting Standards."[94]

3.35 FTI in its report for BT considered that the Consistency with regulatory decisions principle "may prevent BT from implementing reasonable improvements to cost allocations, based on cost causality."[95] FTI also argued that any constraint on BT from making changes that are more cost causal contradicts the 'six principles of cost recovery' that Ofcom normally applies when considering cost recovery issues.

Ofcom's response on the Principle of Consistency

3.36 The principle of Consistency with regulatory decisions requires Regulatory Financial Reporting to be consistent with Ofcom's regulatory decisions. When the Regulatory Accounting Guidelines are introduced in 2016/17, they will include guidance on what this principle means in practice.

3.37 In the interim, in order to enable BT to produce its 2014/15 and 2015/16 Regulatory Financial Statements consistent with the new Regulatory Accounting Principles, we will direct BT as to the specific reporting requirements arising from regulatory decisions.

3.38 BT and FTI are concerned that BT will not be able to put through changes that are cost causal, if they contradict the consistency with regulatory decisions principle. We

[90] Verizon, 2013 Consultation response, page 5, paragraph 29.
[91] BT, 2013 Consultation response, page 12, paragraph 40.
[92] BT, 2013 Consultation response, page 13, paragraph 40.
[93] BT, 2013 Consultation response, page 13, paragraph 41.
[94] BT, 2013 Consultation response, page 13, paragraph 43.
[95] FTI, 2013 Consultation response, page 32, paragraph 5.34.

agree that there may be circumstances when a certain cost allocation may be considered by BT to be more cost causal than a methodology set out in a regulatory decision and with which BT needs to comply by virtue of the consistency with regulatory decisions principle. However, we remain of the view that it is important that the regulatory accounts reflect regulatory decisions. When we apply economic principles to set charge controls, we consider cost causality as one of the six economic principles of cost recovery.[96] Cost causality is therefore considered alongside other economic considerations and the resulting cost treatments within the regulatory decisions are intended to strike a right balance. It is therefore inappropriate for cost causality, on its own, to be ranked above the principle of consistency with regulatory decisions which contain the right balance of all economic considerations.

3.39 In any case, BT will continue to be able to respond to charge control and market review consultations, and through those responses make sure that its views on all economic considerations including cost causality are conveyed.

3.40 We do not agree that the consistency with regulatory decisions should be ranked below compliance with statutory accounting standards as BT argued. The accounting standards in the IFRS are designed for statutory financial reporting, not for regulatory reporting. It is more important for the Regulatory Financial Statements to reflect regulatory decisions specific to our regulatory needs and concerns, rather than general accounting standards.

3.41 We do not agree with TTG's suggestion that the Consistency of the Regulatory Financial Statements as a whole and from one period to another should be ranked above compliance with statutory accounting standards. We consider that consistency over time is less important than reflecting the appropriate accounting treatments, which includes changes to statutory accounting standards. The principle of 'consistency with regulatory decisions' will ensure that any departure from the statutory accounting standards in charge controls is picked up in the Regulatory Financial Statements.

3.42 TTG also argued that objectivity should move below causality and consistency with regulatory decisions in the hierarchy. In our view the order of priority where objectivity precedes causality would help ensure the most appropriate allocations. It is important that the cost allocation is objectively evaluated to identify the most appropriate allocation method. Cases may, for example, arise where there are several choices of methodology all of which are equally cost causal but where one method is not supported by all the available evidence or is unduly beneficial to BT.

Stakeholder comments and Ofcom's response on other issues

3.43 TTG also made the following comments related to the proposed Regulatory Accounting Principles:

- The principles need to cover asset valuation.
- Clarification of the terms 'free from double counting' within the "Accuracy" Principle is needed.

[96] We have set out the six principles of cost recovery in the charge controls that we have published alongside this statement.

- Clarification is needed on the approach to take if there is no obvious cost causal allocation. TTG suggested two approaches: allocating in the same way as the variable portion of the cost and/or ensuring that cost allocations did not cause competitive distortions to any other product.

3.44 TTG also suggested that clarification is needed about what happens where a product is not allocated any cost (e.g. cease charges) or the relevant cost is LRIC rather than FAC (e.g. migrations).

3.45 FTI argued that meeting the Objectivity principle would be "unachievable"[97] because BT would not be able to show that any new methodology would not be more or less unfair or biased towards either BT or other operator. This may mean that "Ofcom might use this outcome to veto any proposed changes."[98] FTI suggest that Ofcom need to clarify what the terms "unfairly benefits BT" or "creates undue bias" mean. FTI argued that Ofcom should allow BT to make changes to cost allocations that are consistent with its pricing decisions.

3.46 In response to TTG's suggestion, we confirm that the Regulatory Accounting Principles should cover all regulatory accounting areas including asset valuation, and that the same general principles will apply to asset valuation as to cost allocation methodologies. For example, we expect an asset valuation method chosen by BT to be accurate and objective. We will consider asset valuations in more detail as part of our work on the Regulatory Accounting Guidelines. We discuss asset valuation in more detail later in this section.

3.47 TTG asked for a clarification of the term 'free from double counting'; in simple terms it means that items should be included only once (or, in the case of allocated costs, that the total of the allocated costs should not exceed the total cost incurred).

3.48 TTG asked[99] for clarification on the appropriate way to allocate costs in the event that there is no cost causal allocation (e.g., 'genuine' common costs which are not variable in the long run with respect to changes in demand for the product). In the absence of Regulatory Accounting Guidelines, BT must follow the order of the Regulatory Accounting Principles as set out in Annex 3, which means that regardless of whether a cost can be allocated in a cost causal way, the allocation should comply with the four Regulatory Accounting Principles above Causality followed by 'Compliance with statutory accounting standards' which follows after it.

3.49 TTG also said that the Regulatory Accounting Principles "should deal with situations where a particular product or set of products are not allocated any cost (a good example of this would be cease charges), or the relevant cost for regulatory purposes is not the FAC cost (for example, migrations whose prices are set at LRIC)"[100]. Situations where services are not allocated costs can only exist where that treatment is consistent with the Regulatory Accounting Principles. In the case of migrations set at LRIC, this would be a result of a regulatory decision, in which case BT would be

[97] FTI, 2013 Consultation response, page 36, paragraph 6.17.
[98] FTI, 2013 Consultation response, page 36, paragraph 6.17.
[99] TTG, 2013 Consultation response, page 7, paragraph 3.9
[100] TTG, 2013 Consultation response, page 8, paragraph 3.9

following the Consistency with Regulatory decisions Principle. This would also be the case where in the past BT has not allocated costs to ceases[101].

3.50 We will provide further guidance on specific terms when we develop the Regulatory Accounting Guidelines, particularly in the context of the review of BT's cost allocations.

3.51 FTI argued that the objectivity principle as currently defined means that BT cannot make any methodology changes as any changes would create winners and losers. They requested a more detailed definition of terms. We may provide further guidance on the terms in the Regulatory Accounting Guidelines in the context of specific examples that may arise as a result of our review of BT's cost allocations. We consider that the principle is sufficiently clear to be applied and interpreted by BT in the meantime.

3.52 We recognise that a methodology change may create winners and losers but will only contradict the objectivity principle when it 'unfairly benefits BT' or 'creates undue bias'. The principle of objectivity does not preclude BT from introducing methodology changes. Where a change is a result of a more accurate data source, where previously the data had been estimated, the change is objective and there is no undue selection bias by BT. We will also define the terms and the acceptable methodologies with more precision to the extent required in the Regulatory Accounting Guidelines.

Ofcom's decisions on the Regulatory Accounting Principles and legal tests

3.53 Having considered stakeholders' responses to the 2013 Consultation proposals we have decided that:

- We will introduce new Regulatory Accounting Principles (see Annex 3). The new principles will include a requirement for "consistency with regulatory decisions".
- The new Regulatory Accounting Principles will come into force upon publication of the relevant direction and will apply to the 2014/15 Regulatory Financial Statements.

3.54 The requirement to comply with the new Regulatory Accounting Principles will be implemented in the SMP conditions. The Regulatory Accounting Principles itself will be directed separately.

3.55 We have considered our decisions regarding the Regulatory Accounting Guidelines against the tests set out in S.47(2) of the Act and have concluded that they are:

- Objectively justifiable because we need to take a greater role in the basis of preparation of the Regulatory Financial Statements to ensure they are free and are seen to be free of any bias and are consistent with regulatory decisions. The Regulatory Accounting Principles will establish the basic attributes for BT's Regulatory Financial Reporting and provide a necessary reference point in the absence of more specific guidelines.

[101] Paragraph 5.15-5.155 Charge Control Review for LLU and WLR services Statement, March 2012 http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc/statement/LLU_WLR_CC_statement.pdf

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. We will however keep under review whether any of the decisions that we have made may be appropriate to apply to KCOM in due course.

- Proportionate because our decisions, in conjunction with our other decisions which see us taking a greater role in establishing the basis of preparation of the Regulatory Financial Statements, are no more than is required to ensure an absence of bias and consistency with regulatory decisions. While we are establishing Regulatory Accounting Principles, as well as Regulatory Accounting Guidelines and implementing a change control process, BT retains an important role in determining the basis of preparation of the Regulatory Financial Statements, and can continue to put through changes where this is in line with the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

- Transparent because it is clear that the intention of our decisions is to ensure we take a greater role in the basis of preparation of the Regulatory Financial Statements to ensure an absence of bias and consistency with regulatory decisions.

Establishing Regulatory Accounting Guidelines

3.56 In the 2013 Consultation we proposed that we would introduce new Regulatory Accounting Guidelines.

Review of our proposals on the Regulatory Accounting Guidelines

3.57 We explained that the Regulatory Accounting Guidelines will replace the Primary Accounting Documents that are currently prepared by BT. We proposed to remove the requirement for BT to prepare and publish its Primary Accounting Documents. We said that the Regulatory Accounting Guidelines will set out high level accounting rules with which Regulatory Financial Reporting must comply. As such, they will be similar in scope and level of detail to BT's Primary Accounting Documents.

3.58 We proposed that the initial version of the Regulatory Accounting Guidelines will be based on the current Primary Accounting Documents. We said that we would provide guidance about the application of our proposed new principle of Consistency with regulatory decisions in the initial version of the Regulatory Accounting Guidelines.

3.59 We said that we would review and consult on changes to the Regulatory Accounting Guidelines. We explained that the Regulatory Accounting Guidelines would have to be updated to align them with regulatory decisions such as those made in charge control decisions and market reviews. The relevant considerations and the detail of the change would be set out in charge control consultations and statements. We proposed that the updated Regulatory Accounting Guidelines would come into force at the date of the relevant charge control statement. If a subsequent appeal and a decision by the Competition Appeal Tribunal or Competition Commission affect one of our policy decisions, we will revise the Regulatory Accounting Guidelines accordingly.

3.60 We also said that we will ensure that the Regulatory Accounting Guidelines comply with the Regulatory Accounting Principles. We explained that where there is no clear guidance in the Regulatory Accounting Guidelines, then the appropriate methodology must be determined by reference to the Regulatory Accounting Principles, i.e. by going back to first principles.

3.61 We also proposed that BT must prepare the Regulatory Financial Statements on a RAV basis.

3.62 TTG and BT commented on our proposals to introduce Regulatory Accounting Guidelines. BT also referred to the report that it had commissioned from FTI consulting. We set out stakeholder comments about these proposals before providing our response and setting out our decisions. We have considered stakeholders' comments on the Regulatory Accounting Guidelines below, within the following headings:

- The need for Regulatory Accounting Guidelines;
- The implementation of the Regulatory Accounting Guidelines; and
- The requirement for the Regulatory Financial Statements to reflect the Regulatory Asset Value ("RAV").

Stakeholder comments on the need for Regulatory Accounting Guidelines

3.63 Both BT and TTG welcomed the proposal to establish Regulatory Accounting Guidelines. In its response TTG said that it "welcomes Ofcom taking control of the Regulatory Accounting Guidelines (RAG) and ensuring that BT uses methodologies that reflect the RAP and regulatory decisions."[102] BT said that its detailed views on the Regulatory Accounting Guidelines will depend on their content and noted that Ofcom said that it will consult on this content in due course.

3.64 BT agreed with the proposal that its Regulatory Financial Reporting must comply with the Regulatory Accounting Guidelines but made clear that this agreement was subject to concerns set out below.

3.65 BT also said that there are practical aspects of the Regulatory Accounting Guidelines which need to be addressed by Ofcom. These included:

- The legal status of the Regulatory Accounting Guidelines as guidelines, how they would be introduced, and whether they are appealable.
- Appeal routes when the Regulatory Accounting Guidelines are changed.
- Application of the Regulatory Accounting Guidelines to markets not covered by regulatory decisions leading to the change.
- Practical aspects of updating the Regulatory Accounting Guidelines and applying it to the production of the Regulatory Financial Statements.

3.66 BT said that in its view the Primary Accounting Documents would no longer be useful, once the Regulatory Accounting Guidelines are introduced. However, BT explained that, its auditors have advised that more prescriptive Regulatory Accounting Guidelines may not be consistent with FPIA assurance. BT said that there is therefore a risk that auditors may disagree with Ofcom's requirement in the

[102] TTG, 2013 Consultation response, page 8, paragraph 3.10.

Regulatory Accounting Guidelines and qualify the audit opinion. BT said that such an outcome "will reduce stakeholders' confidence."[103] Further stakeholder comments on the audit including those made in FTI's report for BT are set out in Section 5 on Audit and Review.

3.67 BT said that the Regulatory Accounting Guidelines should remain at a high level "to avoid a much more intrusive regulatory regime, which is neither proportionate nor objectively justifiable, without achieving any significant benefits to end-users or foster greater or improved competition."[104] However, TTG asked us to provide more clarity on the level of detail in the Regulatory Accounting Guidelines and the regulatory decisions that the first Regulatory Accounting Guidelines will cover. TTG suggested that setting guidelines at too high a level will allow BT to game the outcome by interpreting the guidelines to its benefit. TTG strongly urged "that all of BT's material cost allocations are reviewed for the first RAG."[105]

3.68 TTG also said that Ofcom should consider whether there might be a way to increase the role of stakeholders other than BT through the Regulatory Accounting Guidelines. TTG suggested that Ofcom seek input on the Regulatory Accounting Guidelines from stakeholders although this does not have to be a formal requirement to consult.

Ofcom's response on the need for Regulatory Accounting Guidelines

3.69 Both BT and TTG supported the proposal to put in place Regulatory Accounting Guidelines. BT accepted that its Regulatory Financial Reporting must comply with the Regulatory Accounting Guidelines subject to its stated concerns.

3.70 In response to the request for clarification about their content we confirm that the Regulatory Accounting Guidelines will contain high level guidelines and accounting rules together with the detail necessary to enable compliance with the 'consistency with regulatory decisions' principle and any other detail required flowing from, for example, our review of BT's current cost allocation (see below). The requirement that BT must comply with the Regulatory Accounting Guidelines will be imposed in the form of an SMP condition. The Regulatory Accounting Guidelines themselves, and any changes to the Regulatory Accounting Guidelines, will be introduced through a direction.

3.71 We consider that the first Regulatory Accounting Guidelines should reflect the findings from our review of BT's current cost allocations. We set out more detail about our planned review of BT's cost allocations, including intended timings, later in this section. We intend to consult on the Regulatory Accounting Guidelines alongside the BCMR. Our intention is to publish Regulatory Accounting Guidelines by early 2016. We recognise that this is later than we expected in the 2013 Consultation. This means that the 2016/17 Regulatory Financial Statements will be the first to be based on our Regulatory Accounting Guidelines. We set out below what we will require BT to do in the interim. When the Regulatory Accounting Guidelines are in place, we will update them in relation to the specific cost allocations and other reporting requirements arising from regulatory decisions (such as charge controls) which BT is required to reflect in its Regulatory Financial Reporting. Any specific requirements in relation to consistency with regulatory decisions will normally be consulted and decided on in the context of those regulatory decisions themselves.

[103] BT, 2013 Consultation response, page 14, paragraph 55.
[104] BT, 2013 Consultation response, page 14, paragraph 51.
[105] TTG, 2013 Consultation response, page 8, paragraph 3.10.

These decisions will, as appropriate, be captured within the Regulatory Accounting Guidelines.

3.72 In the event that a regulatory decision is appealed, that decision will stand unless and until it is reversed by the judgment. In the interim, BT will therefore be required to comply with the decision under appeal, unless Ofcom consents otherwise.

3.73 Once in place, the Regulatory Accounting Guidelines will evolve over time to:

- reflect the latest regulatory decisions in a charge control;
- reflect decisions following an appeal; and
- incorporate other updates, caused by other work, such as investigations.

3.74 As a general rule we would expect the Regulatory Accounting Guidelines to include guidance and rules consistent with the approach taken when making regulatory decisions which have therefore been subject to consultation in the course of making those decisions. Where we have consulted in this way, we will not separately consult on the changes needed to incorporate this guidance into the Regulatory Accounting Guidelines. The regulatory decision leading to guidance will be subject to the normal process of appeal.

3.75 Where the need arises to change the Regulatory Accounting Guidelines other than in the course of making a regulatory decision, we will consult separately on such changes. Changes will be implemented by direction and can be appealed through the normal process. In either case stakeholders will have the opportunity to respond to proposed changes to the Regulatory Accounting Guidelines. Should decisions about changes be appealed, the Regulatory Accounting Guidelines will be amended to incorporate the outcome of the appeal.

Stakeholder comments on the implementation of the Regulatory Accounting Guidelines

3.76 Both BT and TTG said that there is a need for clarity about the implementation of the Regulatory Accounting Guidelines. TTG said that it was concerned that the Regulatory Accounting Guidelines might be implemented too late for the next round of charge controls given that the new Leased Lines Charge Control (LLCC) starts from April 2016 and new Fixed Access and WBA Charge Controls from April 2017. TTG said that the information and costs to inform these reviews will be needed for the 2014/15 and 2015/16 Regulatory Financial Statements.

3.77 TTG also said that to minimise disputes and appeals the new Regulatory Accounting Guidelines should be in force in time to inform the 2015/16 Regulatory Financial Statement at the latest. TTG also said that it would be best practice for Ofcom to issue a detailed timetable for the production of the Regulatory Accounting Guidelines, including consultations and CP involvement.

3.78 TTG went on to say that Ofcom should as a priority provide a timetable showing the transition to the new documentation and regulatory reporting framework and said that it would like Ofcom to provide guidance on how frequently the Regulatory Accounting

Guidelines will be updated. This would prevent "BT using the excuse that a particular amendment had been "timed out" or that it is "not practical to implement changes."[106]

3.79 TTG commented on Ofcom's proposal to remove Condition OA5(f) which relates to the reporting of any material changes. TTG explained that given Ofcom's proposal to put the materiality definition in the Regulatory Accounting Guidelines it is concerned that BT can set its own rules for materiality for 2-3 years until the first Regulatory Accounting Guidelines is published. TTG suggested that the materiality definition should stay in the Conditions with the option to be amended by the Regulatory Accounting Guidelines.

Ofcom's response on the implementation of the Regulatory Accounting Guidelines

3.80 We have considered the issues raised by TTG and BT about the practicalities of implementing the Regulatory Accounting Guidelines. We note TTG's concerns that the next round of charge controls will be based on the 2014/15 and 2015/16 Regulatory Financial Statements and that the Regulatory Financial Statements should be prepared on a basis consistent with the regulatory objectives as soon as possible.

3.81 We now intend to publish the Regulatory Accounting Guidelines in time for the 2016/17 Regulatory Financial Statements. As set out above, we consider that the Regulatory Accounting Guidelines should incorporate the results of our review of BT's existing cost allocations and therefore include more specific guidelines where required. This means that the Regulatory Accounting Guidelines published in 2016 will contain guidance and rules about BT allocations methodologies informed by our review of cost allocations. They will also contain the guidance that we provide on consistency with regulatory decisions and the RAV.

3.82 While the Regulatory Accounting Guidelines will not be in place in time for the 2014/15 and the 2015/16 Regulatory Financial Statements we agree that future charge controls should take account of the findings of our review of the cost allocation bases. BT will be required to ensure that its Regulatory Financial Statements comply with the new Regulatory Accounting Principles.

3.83 In addition, in order to enable BT to produce its 2014/15 and 2015/16 Regulatory Financial Statements consistent with the new Regulatory Accounting Principles, we will issue a direction as to reporting requirements arising from regulatory decisions (specifically in relation to consistency with our decisions in the Fixed Access and WBA Markets). We will also set out in a direction other information which we said we would include in the Regulatory Accounting Guidelines, but which is required before we will adopt those. In particular, will also set out in a direction the definition of materiality for the purpose of change control and error notification, and guidance on RAV. Our intention is to issue such direction(s) to BT by the end of October 2014, in time for BT to take into account in the preparation of 2014/15 Regulatory Financial Statements.

3.84 In the future we expect the Regulatory Financial Statements to comply with the most recent version of the Regulatory Accounting Guidelines. We would expect that if a new version of the Regulatory Accounting Guidelines is published by the end of October, the Regulatory Financial Statements published in the following July must comply with that version of the Regulatory Accounting Guidelines.

[106] TTG, 2013 Consultation response, page 27, paragraph 8.13.

3.85 Given that the Regulatory Accounting Guidelines will not be in place until 2016, BT will initially be required to retain its Primary Accounting Documents in its Accounting Methodology Documents. BT must ensure that the Accounting Methodology Documents comply with the new Regulatory Accounting Principles and with any guidance that we direct BT to apply to its Regulatory Financial Reporting.

3.86 In addition, the Regulatory Accounting Guidelines will not cover the LRIC or transfer charges elements of the current Primary Accounting Documents until we have reviewed these elements. BT will therefore be required to retain these elements of its Primary Accounting Documents in the interim within the Accounting Methodology Documents. We intend to review the LRIC component and the Transfer Charge element alongside future Market Reviews and associated charge controls. Once the LRIC and transfer charge elements, together with the guidance and rules on cost allocations are contained within the Regulatory Accounting Guidelines, the Accounting Methodology Documents will no longer contain elements that would have been in BT's Primary Accounting Documents.

Stakeholder comments on the requirement for the Regulatory Financial Statements to reflect the Regulatory Asset Value

3.87 For the purpose of some price controls ,we use the Regulatory Asset Value (or "RAV") of access duct and copper. This has some similarities with, but is not the same as, the CCA value. However, in the Regulatory Financial Statements BT values these assets on a CCA basis. This means that we have to make an adjustment for each charge control and investigation that includes access duct and copper to revalue these assets on a RAV adjusted basis. It also makes it difficult for stakeholders to see in the Regulatory Financial Statements the revised returns for the markets where we apply the RAV adjustment, which we consider to be a more accurate representation of the returns in those markets.

3.88 We proposed in the 2013 Consultation that BT must prepare the Regulatory Financial Statements on a RAV basis.

3.89 In its response, BT said that a RAV valuation is not consistent with GAAP or normal CCA principles and is therefore likely to attract a PPIA level of assurance.[107] In its supplementary response, TTG considered that 'the gains of moving to a RAV basis for the RFS comprehensively outweigh any downside of moving from an FPIA to a PPIA basis."[108]

Ofcom's response on the requirement for the Regulatory Financial Statements to reflect the Regulatory Asset Value

3.90 While a RAV valuation may not be consistent with GAAP the Regulatory Financial Statements are prepared for regulatory not statutory purposes. Our regulatory concerns and decisions take precedence over guidance and standards set out in IFRS or GAAP (as reflected in the ranking in our proposed Regulatory Accounting Principles). In any case a PPIA audit opinion on an accounting treatment may in due course become more appropriate as we take more of a role in determining the appropriate accounting treatments. We set out our views about the impact of our decisions on the level of opinion provided by the audit in Section 5.

[107] BT, 2013 Consultation response, page 15, paragraph 59.
[108] TTG, 2013 Supplementary response, page 8, paragraph 6.6.

3.91 We agree with TTG about the benefits of a RAV basis despite the potential effect on the type of audit assurance. We have decided that BT must prepare the Regulatory Financial Statements on a RAV basis. The Regulatory Accounting Guidelines will provide the guidance necessary for BT to prepare the Regulatory Financial Statements on a RAV basis. We will issue a direction providing RAV guidance alongside guidance about consistency with regulatory decisions by the end of October 2014. This will allow BT to take the RAV guidance into account in the preparation of the 2014/15 Regulatory Financial Statements.

Ofcom's decisions on the Regulatory Accounting Guidelines and legal tests

3.92 Having considered stakeholders responses to the 2013 Consultation proposals we have decided that:

- Ofcom will issue Regulatory Accounting Guidelines. These will set out the accounting rules to be adopted when preparing the Regulatory Financial Statements.

- The Regulatory Accounting Guidelines will be introduced in 2016/17 and will apply for the 2016/17 Regulatory Financial Statements. For the 2014/15 and 2015/16 financial years, we will issue directions to BT about the specific reporting requirements arising from regulatory decisions (specifically in relation to consistency with our decisions in the Fixed Access and WBA markets).

- The Regulatory Accounting Guidelines will evolve over time to reflect policy including outcomes of charge controls and investigations as well as discrete policy initiatives. They will, in particular, be amended to reflect our regulatory decisions, and as such create consistency between our decisions and BT's reporting.

- We will review the BT Primary Accounting Documents as part of the production of Regulatory Accounting Guidelines.

- We will require BT to continue to prepare the documentation covering those components of regulatory accounting currently included in BT's Primary Accounting Documents to the extent that they have not been replaced by the requirements imposed in the Regulatory Accounting Guidelines. BT will be required to include such components of the existing Primary Accounting Documents in the Accounting Methodology Documents . Once the Regulatory Accounting Guidelines fully address all the relevant components of regulatory accounting currently covered in the Primary Accounting Documents, there will be no need for BT to prepare those components of Primary Accounting Documents within the Accounting Methodology Documents.

- BT must prepare the Regulatory Financial Statements on a RAV basis.

3.93 The requirement to comply with the new Regulatory Accounting Guidelines will be implemented in the SMP conditions. The Regulatory Accounting Guidelines itself (as well as any interim guidance) will be directed separately.

3.94 We have considered our decisions to take greater control over the basis of preparation against the tests set out in S.47(2) of the Act and have concluded that they are:

- Objectively justifiable because establishing Regulatory Accounting Principles alone is not sufficient to ensure Regulatory Financial Reporting is free and is seen to be free from bias and is consistent with regulatory decisions. The Regulatory Accounting Guidelines will establish further detail and will also provide BT with clarity as to the implementation of the "consistency with regulatory decisions" principle.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. We will however keep under review whether any of the decisions that we have made may be appropriate to apply to KCOM in due course.

- Proportionate because our proposals, in conjunction with our other proposals which see us taking a greater role in establishing the basis of preparation of the Regulatory Financial Statements, are no more than is required to ensure an absence of bias and consistency with regulatory decisions. While we are establishing Regulatory Accounting Guidelines, as well as Regulatory Accounting Principles and implementing a change control process, BT retains an important role in determining the basis of preparation of the Regulatory Financial Statements, and can continue to put through changes where this is in line with the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

- Transparent because it is clear that the intention of our proposals is to ensure we take a greater role in the basis of preparation of the Regulatory Financial Statements to ensure an absence of bias and consistency with regulatory decisions.

Maintaining greater control over the basis of preparation

3.95 In the 2013 Consultation we proposed that, while responsibility for the preparation and accuracy of BT's regulatory financial data will remain with BT, we will take greater involvement in setting the basis of preparation.

3.96 We explained that under our proposals BT will be responsible for updating the Accounting Methodology Documents that describe BT's regulatory financial reporting (as currently set out in its Secondary Accounting Documents). We proposed that BT must, however, ensure that the Accounting Methodology Documents are consistent with the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

3.97 In broad terms, our proposals to give us greater control over the basis for preparation could be considered in two parts: reviewing the basis of preparation as it is now; and having more control over how that could and should be changed in future (via the introduction of a new change control process).

Review of our proposals relating to the review of allocation bases

3.98 In the 2013 Consultation we said that it may be appropriate for Ofcom to consider BT's DAM in more detail to identify and assess the most significant allocation bases. We explained that this would be considered as part of an assessment of BT's financial information for the purpose of modelling charge controls. Any outcome would be consulted on in the course of the market review and be reflected in the Regulatory Accounting Guidelines.

3.99 We explained that this would be a significant piece of work and a review would need to be conducted in the context of the framework that will be provided by the new Regulatory Accounting Principles and Regulatory Accounting Guidelines.

3.100 We also said that for the time being at least, we did not intend to propose specific requirements relating to the way BT should value its assets provided that it complies with the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

3.101 We consider our proposals and stakeholders' responses review of the cost allocation bases and the asset valuation methodology in turn below.

Stakeholder comments on the review of allocation bases

3.102 We note that BT did not provide any comments about our intention to review its allocation bases. Sky commented that our proposals to take a greater role, although a positive step, are insufficient without consideration about whether current cost allocations and current costs are appropriate.

3.103 TTG explained that there is a need for an early and comprehensive review of existing allocations as some, what it sees to be inappropriate allocation methods, may not otherwise be addressed by our proposals to take and maintain a greater level of control over the basis of preparation. TTG said that the current Regulatory Financial Statements had been "gamed by BT to meet its commercial interests"[109] by including inappropriate costs (such as deafness claims) and by allocating excessive levels of costs to regulated products (through overhead cost allocations).

3.104 TTG suggested that the changes proposed by Ofcom in its 2013 Consultation would "only correct the most egregious current allocations and not ensure that all allocations are reasonable."[110] In TTG's view Ofcom should quickly undertake a bottom-up review of all of BT's material allocations including those that have not previously been subject to review as part of a regulatory decision.

3.105 TTG also suggested that Ofcom should review what costs are included and all material asset valuations. In particular, they are concerned that there is no increase in fibre assets in the Regulatory Financial Statements despite the high build costs alleged by BT. TTG also requested guidance from Ofcom about how genuinely common costs should be allocated.

3.106 TTG and Sky set out examples of the ways BT are able "to exaggerate costs of regulated products"[111] and the behaviours that BT is incentivised to adopt under the current Regulatory Financial Reporting framework.

3.107 TTG also suggested that the costs of BT's regulatory litigation should be excluded from the cost of regulated products. In TTG's view these costs are discretionary and provide the ability to allocate them to regulated products which incentivises BT to appeal more of Ofcom's decisions and spend more on litigation.

3.108 TTG suggested that BT should not be able to amend the allocation rules once set by Ofcom without prior authorisation.

[109] TTG, 2013 Consultation response, page 13, paragraph 4.1.
[110] TTG, 2013 Consultation response, page 13, paragraph 4.2.
[111] TTG, 2013 Consultation response, page 8, paragraph 3.4.

Ofcom's response on the cost allocation bases

3.109 We note stakeholders' comments about the need for a review of existing material cost allocations that inform the Regulatory Financial Statements. We now consider that a review is needed ahead of publishing the Regulatory Accounting Guidelines. The review will inform us in determining which areas the Regulatory Accounting Guidelines need to address, and to what level of detail they need to address those areas.

3.110 Regarding the content of the Regulatory Accounting Guidelines, we note BT's point about keeping "the new RAG at a high level, to avoid a fundamental shift in responsibility resulting in a much more intrusive regulatory regime."[112] We expect that in comparison with BT's Secondary Accounting Documents, the Regulatory Accounting Guidelines will contain considerably less detail. We intend the Regulatory Accounting Guidelines to address overall high level accounting rules and treatments and to only set out further detail where it is necessary for us to provide more guidance.

3.111 We note the examples that TTG and Sky have provided of cost allocations that they consider inappropriate (e.g. litigation costs). We also note the request for guidance on cost allocation of common costs. We will consider the examples provided and the need for further guidance on common costs during our review of BT's cost allocations.

3.112 TTG suggests that BT should not be allowed to make cost allocation changes without prior authorisation from Ofcom. As we explain below, with the introduction of the new change control regime, BT will be required to inform us about its proposed allocation changes in time to allow us to take action (including should it be necessary the veto of a change), if we consider those changes to be contrary to the Regulatory Accounting Principles or Regulatory Accounting Guidelines. If BT proposes to change a cost allocation approach which we have clearly prescribed in the Regulatory Accounting Guidelines, it is likely that BT as a result will not be compliant with the Regulatory Accounting Guidelines, and we will need to consider taking action in that regard.

3.113 These measures will give us adequate control of BT's regulatory accounting methodology. An authorisation regime that TTG proposes would not bring further control but would result in more time and effort being spent by both us and BT, as every material change will have to be formally approved. We do not believe that this would be proportionate.

Review of our proposals relating to the asset valuation methodology

3.114 We explained in the 2013 Consultation that we did not intend to propose specific requirements relating to the way BT should value its assets for the time being (providing that BT complies with the Regulatory Accounting Principles and Regulatory Accounting Guidelines).

Stakeholder comments on the asset valuation methodology

3.115 We received responses from two stakeholders about asset valuation. TTG said that we should review BT's asset valuations saying that they had particular concerns that

[112] BT, 2013 Consultation response, page 12, paragraph 38, second bullet.

there is no increase in fibre assets in the Regulatory Financial Statements despite the high build costs alleged by BT. Verizon said that it would like BT's asset valuations to be subject to third party oversight, rather than relying on guidelines for valuation.

Ofcom's response on the asset valuation methodology

3.116 BT's asset valuations are subject to review by the regulatory auditors. Additionally, we consider whether the valuations reflected in the Regulatory Financial Statements provide an appropriate basis for calculating costs for the purpose of price controls and have in the past replaced BT's valuation with an alternative estimate (BT's duct valuation, for example). Therefore, while important, we do not consider that the need to review BT's asset valuation bases is as pressing as the need to review cost allocations bases. However, we intend to review asset valuation rules in the future as appropriate as part of the on-going work associated with regulatory decisions (such as price controls) and the development of the Regulatory Accounting Guidelines.

Review of our proposals for a new change control process

3.117 Our 2013 Consultation proposals were:

- BT must notify any proposed material changes (materiality being a 5% change to any figure) to allocations (together with impact) by 30 November and publish any notification on its website. The notification will include an evaluation of the financial impact for each proposed change based on the previous year's Regulatory Financial Statements. The evaluation must include the value of all the figures affected by the proposed change on both the old and proposed basis. BT's regulatory auditors will be required to report whether BT has notified us of all the material changes it will apply to the Regulatory Financial Statements for the relevant financial year by 31 December.

- We will not approve any proposed changes that are notified but may block any proposed change. If this is the case, we will notify BT by 31 January of the relevant financial year.

- We will not consult on any proposed changes that are notified or on any Ofcom course of action.

- BT must publish the impact of all material changes in an annual reconciliation report with an accompanying assurance report from their regulatory auditors, alongside the Regulatory Financial Statements.

- BT must notify any material error (the same level of materiality as for change control i.e. 5%) within 30 days of deciding to correct the error (together with impact) and publish the notified error on its website. The impact of the error for each affected market and service is measured as the difference in the numbers which were reported in the previous financial year, and the numbers that would have been reported had the error been corrected in the previous financial year (or such error not been made).

- BT must publish the impact of all material errors that it decides to correct in an annual reconciliation report alongside the Regulatory Financial Statements, and provide a description of the circumstances of how the error was discovered and the reason for the error.

3.118 We said that the amended obligations will be implemented in the SMP conditions.

3.119 Stakeholders' comments were generally related to one of the following broad categories, which we refer to organise the comments, below:

- general approach;
- change control;
- error notification;
- materiality; and
- the Reconciliation report.

Stakeholder comments on the general approach

3.120 TTG said that it "broadly supports" our proposed approach but recommended a number of amendments that could be made which it said would have the "effect of significantly improving the practical outcomes of the change control process."[113] TTG also said that the burden of proof should be on BT to demonstrate that changes represent an improvement. Verizon said that it fully supported our proposal for notification of proposed material changes and the proposed error notification process. Sky also said that it supported our proposal but argued that the proposals do not disincentivise BT from continuing to put forward profit maximising but inappropriate cost allocation and cost reporting changes 'in the hope that some will be accepted'. Sky suggested that we introduce sanctions such as "significant fines for obviously inappropriate costs and allocations."[114]

3.121 BT argued that our proposals to maintain greater control over the basis of preparation "constitute a clear shift towards a much more intrusive regulatory regime." BT went on to say that this move "sits uneasily with Ofcom's own principle that it "will always seek the least intrusive regulatory mechanisms to achieve its policy objectives."[115] BT said that in its view "Ofcom's key proposals in relation to change plainly go beyond what is legally allowed."[116]

3.122 BT suggested that Ofcom's concerns can be addressed by maintaining the current regime where BT makes changes to the Regulatory Financial Statements and the Regulatory Financial Statements are subject to audit. BT said that this is sufficient combined with the requirement to produce a reconciliation report.

3.123 In its report for BT, FTI said that it considered that the current change control process already constrains BT's ability to implement change explaining that BT can only change cost allocations when they are more cost causal and/or more objective with the current set of principles. FTI explained that there are three safeguards that "ensure compliance with the current Regulatory Accounting Principles"[117]:

- BT's internal change control process;

[113] TTG, 2013 Consultation response. page 22, paragraph 6.2.
[114] Sky, 2013 Consultation response, page 9, paragraph 6.2 (iii).
[115] BT, 2013 Consultation response, page 15, paragraph 60.
[116] BT, 2013 Consultation response, page 16, paragraph 62.
[117] FTI, 2013 Consultation response, page 12, paragraph 3.7.

- the regulatory audit; and
- BT's notification to Ofcom of all material changes, Ofcom's ability to object and Ofcom's statements in the Regulatory Financial Statements.

3.124 FTI argued that as "a thorough review process for cost allocations already exists in the charge control process"[118] Ofcom's proposals are 'unnecessarily duplicative of the current process.'[119]

3.125 FTI went on to say that having examined Ofcom's statements in the Regulatory Financial Statements over the last five years and having found no statements that Ofcom disagrees with BT changes "Ofcom has no evidence to support a change to the current Change Control process based on its own analysis of notified changes."[120]

3.126 FTI explained that BT's track record of unqualified audit opinions and Ofcom's 'statements' in the Regulatory Financial Statements indicate that the current Change Control process is effective'. FTI also explained that Deloitte's review[121] of the 14 largest cost allocation methodology changes in the 2012/13 Regulatory Financial Statements against existing the Regulatory Accounting Principles had "found that all but one of the changes were justified on the basis that they improved cost causality, and/or were necessary to reflect changes on organisational structure"[122] in a manner that was consistent with the Regulatory Accounting Principles.

3.127 TTG suggested that we allow CPs to propose changes to Regulatory Financial Statements. Increased involvement of CPs would help ensure a balanced and effective regulatory process. TTG suggest a formal process to bring changes and a dispute process in case BT disagrees.

Ofcom's response on the general approach

3.128 We note the support from CPs other than BT for our change control and error notification proposals. We also note BT's opposition to our proposals.

3.129 We do not agree with BT's suggestion that the addition of a reconciliation report to BT's current change control arrangements would be sufficient to reassure either Ofcom or other CPs that BT's ability to make inappropriate changes has been constrained. While the purpose of the reconciliation report is to explain the changes which have been implemented, it does not prevent BT from making changes which Ofcom considers inappropriate. The transparency provided by the reconciliation report is therefore necessary but not sufficient. We consider that we should also be able to prevent BT from implementing changes which in our view do not comply with the Regulatory Accounting Principles and/or the Regulatory Accounting Guidelines. Such preventative measures may be necessary to preserve confidence in the Regulatory Financial Statements.

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[118] FTI, 2013 Consultation response, page 13, paragraph 3.21.
[119] FTI, 2013 Consultation response, page 13, paragraph 3.21.
[120] FTI, 2013 Consultation response, page 13, paragraph 3.11.
[121] Deloitte, "*BT RFS Attribution Methodology Changes",* 15 October 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-llu-wlr-charge-controls/responses/BT_Group_-_Deloitte_Report_on_BT_RFS_Attribution_Methodology_Changes.pdf
[122] FTI, 2013 Consultation response, page 13, paragraph 3.13.

3.130 For similar reasons we do not agree with FTI's argument that the current regime already adequately constrains BT. The current governance process and audit have not been sufficient to limit methodology changes introduced by BT; we consider that the report that explained the allocation rule changes made by BT in the preparation of the 2012/13 Regulatory Financial Statements illustrates the extent to which BT has discretion over the choice of allocation methodology and the impact this can have.

3.131 The requirement for BT to comply with the Regulatory Accounting Guidelines and the new Regulatory Accounting Principles will go some way to address this concern and it will ensure the audit is conducted in light of principles set by Ofcom. However, we believe the additional check provided for by the change control process is necessary. The change control process would enable us to have further influence on how BT complies with the Regulatory Accounting Guidelines and the new Regulatory Accounting Principles. More importantly, it will enable us to exercise this influence early in the process and if necessary block any non-compliant changes. As such, change control is a key element of our proposals to have more involvement in the preparation of the Regulatory Financial Statements.

3.132 In response to FTI's observations about the use of the Ofcom statement in the Regulatory Financial Statements, we note that the current arrangements do not provide sufficient opportunity for Ofcom to investigate methodology changes, for BT to answer our questions, and for us to form a firm view in order to include a meaningful statement in the Regulatory Financial Statements. Under the current regime, without a firm cut-off date, BT continues to provide Ofcom with changes to allocations after the end of its financial year, through June and just prior to publication of the Regulatory Financial Statements in July. We also note that the current practice where BT informs Ofcom of changes is an informal arrangement rather than a regulatory requirement.

3.133 The new Regulatory Accounting Principles and the Regulatory Accounting Guidelines, once in place, will mean that only those changes that are consistent with regulatory decisions and that are most objective can proceed. As we explained above, a change control process would enable us to intervene where necessary.

3.134 The FTI report also states that a process for review of cost allocations already exists through the charge controls. While we will conduct a review of existing material cost allocations, our change control process (a proactive tool to stop inappropriate on going changes) is not duplicative of charge controls or of the planned one-off review of existing cost allocations. We discuss BT's suggestion about the potential role of the reconciliation report later in this section.

3.135 While Deloitte's review of cost allocations may have found that BT's changes were 'justified' when assessed against the existing Regulatory Accounting Principles we do not, as already discussed, consider that that the existing Regulatory Accounting Principles are sufficient. Most significantly the existing Regulatory Accounting Principles do not require consistency with regulatory decisions and do not therefore sufficiently constrain BT's discretion.

3.136 We do not agree with TTG that a separate formal process for CPs to propose changes to the Regulatory Financial Statements is appropriate. Such an arrangement would undermine the status of the Regulatory Financial Statements as BT's accounts. Stakeholders will remain able to submit their views about cost allocations in response to charge control consultations.

3.137 In light of the above, we continue to believe that a change control process is necessary.

3.138 We note that in our 2012 and 2013 Consultations we explained that the proposed change control process would apply to changes to cost allocations. We recognise that accounting methodologies is a wider concept than cost allocations. While in the past we had predominately identified particular concerns about BT's changes to cost allocations, we consider that it would be appropriate to require BT to notify Ofcom of all changes to its methodologies more broadly to the extent that they could have an impact on its Regulatory Financial Statements, and not just cost allocations. For clarity we have therefore introduced a new term 'Regulatory Accounting Methodology' which we have defined so as capture rules, policies, methods, allocations, calculations, assumptions and procedures, used by BT for the purpose of preparing Regulatory Financial Statements.

Stakeholder comments on the change control process

3.139 We proposed in the 2013 Consultation that BT must notify any proposed material changes (together with impact) by 30 November and publish any notification on its website. The notification will include an evaluation of the financial impact for each proposed change based on the previous year's Regulatory Financial Statements. The evaluation must include the value of all the figures affected by the proposed change on both the old and proposed basis. BT's regulatory auditors will be required to report whether BT has notified us of all the material changes it will apply to the Regulatory Financial Statements for the relevant financial year by 31 December. We explained that we would not approve any proposed changes that are notified but may block any proposed change. If this is the case, we will notify BT by 31 January of the relevant financial year.

3.140 This process has been described in discussions with stakeholders as Ofcom's right of veto and we use this term below.

3.141 In its response to the 2013 Consultation, it appears that one of BT's main concerns related to our proposals for the change control process and the right of "veto". BT explained that its concerns related "to both the impracticality of Ofcom's proposals and the substance of the proposals."[123] BT said that Ofcom's proposals go beyond what is legally allowed. BT explained that regulatory reporting obligations have to be linked back to the specific potential for harm identified by Ofcom in its market review.

3.142 FTI in its report for BT said that the proposed right to veto is inconsistent with Ofcom's regulatory principles as they fail on the grounds of accountability and transparency.

3.143 Other stakeholders supported Ofcom's proposal for a veto. Virgin Media welcomed the proposal and said that "this is an important step forward in placing a check on the potential or incentive for BT, an SMP provider, to change methodologies in order to maximise benefit to itself."[124] Sky said that "if Ofcom deems the proposed allocation changes inappropriate then it should be able to reject their adoption within the RFR."[125]

[123] BT, 2013 Consultation response, page 16, paragraph 64.
[124] Virgin Media, 2013 Consultation response, page 4, question 5.1.
[125] Sky, 2013 Consultation response, page 9, paragraph 6.1.

3.144 TTG said that Ofcom should be clear that its exercise of the veto should not fetter Ofcom's discretion in respect of future charge controls or other regulatory decisions.

3.145 From a practical perspective, BT explained that it had serious concerns that following a two month review and without consultation, Ofcom could block proposed changes, but will not approve proposed changes. BT questioned whether two months provides Ofcom with sufficient time to review proposed material changes and said that the proposed 30 November deadline is impractical because changes to methodologies can be discovered later. By way of example BT explained that in the 2012/13 Regulatory Financial Statements BT changed methodologies after a business reorganisation. BT said that reporting obligations should not prevent BT from making changes to its organisational structure.

3.146 TTG expressed concern that BT will try to "game this process"[126] by discovering changes and trying to implement them after the 30 November deadline. TTG proposed that Ofcom explicitly states that no material changes can be implemented by BT after 30 November without prior approval.

3.147 BT also explained that its regulatory auditors had noted that the proposal that they report that BT have notified Ofcom of all material changes applied to the Regulatory Financial Statements would not be practical. BT explained that assurance could only be given on or after the publication of the Regulatory Financial Statements.

3.148 BT argued that the proposal provides no regulatory certainty as Ofcom could make a different decision about a methodology in a subsequent charge control at which point appeals could be made. This, BT considered, would be likely to lead to two versions of the Regulatory Financial Statements (based on Ofcom and BT views), which would "inevitably lead to confusion amongst stakeholders,"[127] the potential for increased litigation, and would, BT argued, be "disproportionate, objectively unjustifiable and non-transparent."[128]

3.149 BT also explained that it was unclear which legal instrument Ofcom would use to reject proposed changes and the routes of appeal for BT. BT explained that the process may lead to multiple appeals by BT, where BT may appeal Ofcom's veto and this may lead to significant delays in publication of the Regulatory Financial Statements and to inconsistent reporting.

3.150 BT pointed out that Ofcom's proposals would only apply to recently reviewed markets and that this may lead to inconsistencies, or to two sets of reports which "is clearly not to the benefit of end users."[129] BT also explained that Ofcom's greater involvement in the "determination of detailed costing methodologies would impact on both the Board's ability to sign-off the Regulatory Financial Statements, and the level of assurance that can be given by auditors. As an alternative, BT suggested that, it maintains its current processes with the addition of the proposed reconciliation report, in line with Ofcom's requirements.

3.151 In its report for BT, FTI supported BT's position arguing that the consultation did not explain:

[126] TTG, 2013 Consultation response, page 26, paragraph 8.8.
[127] BT, 2013 Consultation response, page 18, paragraph 73.
[128] BT, 2013 Consultation response, page 18, paragraph 73.
[129] BT, 2013 Consultation response, page 18, paragraph 76.

- How Ofcom will determine if a proposed change is consistent with the Regulatory Accounting Principles or the Regulatory Accounting Guidelines;
- If there will be discussions with BT and other stakeholders before deciding to veto a change; and
- If there will be an appeal process.

3.152 In addition FTI argued that the change control process could generate a delay in cost allocation changes until they could be approved during a charge control. This would unnecessarily increase the amount of work at the time of a charge control process. FTI said that it is unclear what the benefits of the publication requirement are for the change control if there is no consultation process in place.

Ofcom's response on the change control process

3.153 We note that CPs other than BT have broadly welcomed our proposal to be able to block material changes proposed by BT that are inappropriate in the context of the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

3.154 As we explain below, there are other measures, of varying degrees of effectiveness, which we can pursue to prevent inappropriate methodology changes by BT.

3.155 Our first course of action, when BT proposes a change that we consider is inappropriate would be to engage with BT to give BT the opportunity to amend or withdraw the proposed change. Should we be unable reach agreement with BT we would first consider whether the use of our other powers would, as explained below, provide sufficient remedy.

3.156 BT must publish with the Regulatory Financial Statements any written statement made by Ofcom commenting on the Regulatory Financial Statements or accounting documents. Such a statement allows us to set out any concerns that we may have about changes to methodologies. We most recently used this statement in the 2012/13 Regulatory Financial Statements to set out concerns.

3.157 We could therefore use this statement to highlight what we considered to be changes that are not consistent with the underlying reporting rules and the impact of the changes could be set out in a reconciliation report. In such case, BT's regulatory auditor would need to consider whether they should provide a qualified opinion on the particular methodology.

3.158 We could also consider whether it would be appropriate to direct BT to restate the Regulatory Financial Statements on the basis that they are deficient[130] or whether enforcement action would be appropriate given our view that BT had failed to comply with the Regulatory Accounting Principles and, once in place, Regulatory Accounting Guidelines.

3.159 We expect such measures would act as a deterrent against implementing some non-compliant changes which BT may propose.

[130] Under the 2004 accounting separation and cost accounting conditions Ofcom can require BT to amend accounting documentation and/or restate, have audited and republish Regulatory Financial Statements where Ofcom believes them to be deficient.

3.160 In addition, any changes to methodologies would, in the normal manner, be subject to consultation in the context of relevant regulatory decisions such as charge controls.

3.161 Nevertheless, there may be circumstances where the measures set out above may not be sufficient. In particular, there may be circumstances where we believe that a methodology change proposed by BT or the introduction of a new methodology would, if implemented, would distort the figures in the Regulatory Financial Statements to such an extent that it would render the Regulatory Financial Statements misleading or unreliable. We consider that it is important for Ofcom, in such circumstances and as a measure of last resort to preserve confidence in the Regulatory Financial Statements, to be able to prevent BT from implementing a proposed change. We have therefore decided to implement our proposal giving Ofcom a right of veto. In the exceptional circumstances that we consider a veto is appropriate we will exercise the veto through a direction normally following consultation. Consultation on any changes that we decide to veto will include a justification for our proposal to exercise a veto. While BT can appeal the decision, it will stand until the outcome of the appeal confirms or otherwise rejects our decision. In practical terms this means that BT will have to prepare the Regulatory Financial Statements on the basis of our decision in force at the time, pending the outcome of the appeal.

3.162 We recognise that should we decide there is a need to consult on a veto, particularly in light of amendments to the process we have set out below, it is unlikely that we would be able to reach a decision before the publication deadline for the Regulatory Financial Statements at the end of July. On balance, delaying publication would, in our view, be more acceptable than the publication on time of Regulatory Financial Statements that would undermine Regulatory Financial Reporting.

3.163 Ensuring that stakeholders have transparency about proposed changes is important. Publication of proposed changes on BT's website will mean that other CPs can raise concerns with Ofcom. This is not a consultation and Ofcom does not undertake to respond to issues raised by CPs about BT's proposed changes. A consultation on a proposed direction to exercise the veto would be a formal consultation where stakeholders would be invited to respond.

3.164 We accept that in the case of an appeal of a direction to exercise a veto, BT could prepare and publish additional financial statements that reflect its view. However, such statements would not have the status of the Regulatory Financial Statements. Ofcom would only use the "official" Regulatory Financial Statements as the basis for its further work (e.g. for any analysis in market reviews). We also note that the exercise of a veto will not preclude Ofcom from considering BT's methodologies including cost allocations afresh during the setting of future charge controls.

3.165 We have in the light of BT's comments about the practicalities of our proposed veto reconsidered our proposed timetable. We accept that BT may not know about all changes that it may make by 30 November, four months before BT's year end. We have therefore amended the approach as follows:

- BT must notify us of any changes to the Regulatory Financial Statements by 31 March and publish these changes on its website using our template.

- We will endeavour to notify BT by 31 May, if we have identified any potential issues with any of the proposed changes. We will then consult on our proposal to veto the changes.

3.166 In order for the process to function effectively there must be a cut-off point after which BT must not propose further changes. Aligning this point with BT's financial year end (31 March), will allow any methodology changes from reorganisations to be taken into account. The list of proposed changes submitted by BT on 31 March must be a complete list of all the changes which BT intends to apply in the Regulatory Financial Statements. We note that this is a change from what we proposed in the 2013 Consultation and we set out an explanation for that change below.

3.167 We are aware that the auditors review allocations as part of audit work and therefore changes to allocations (and indeed changes to other methodologies and accounting treatments) may be recommended by the auditors. Where changes to methodology are specifically requested by the auditor, they may be made in the Regulatory Financial Statements. Apart from these changes introduced by the auditors, the list of changes submitted on 31 March must therefore be complete.

3.168 We understand BT's concerns that the two month period will not provide Ofcom with sufficient time to consider proposed changes. We consider that two months would be sufficient based on the usual number of changes that BT make each year. In assessing the appropriateness of changes our investigation will focus on whether the proposed change is consistent with the Regulatory Accounting Principles and, once in place, the Regulatory Accounting Guidelines.

3.169 We understand the auditor's concerns that they may not be able to comment on the disclosure of changes at the time of BT's notification of the changes. We are now requesting that the auditor reports on whether BT's notification to Ofcom of all changes on 31 March included all material changes (with the exception of any specifically requested by the auditors) implemented in the Regulatory Financial Statements. The auditor's report will be issued at the same time as the audit opinion on the Regulatory Financial Statements.

3.170 We accept BT's observation that we are only able to formally implement the veto and our other proposals for a new regulatory accounting framework to those markets for which we have alongside this statement made decisions. These are the markets in which we find SMP and impose a cost accounting and accounting separation obligation in the WBA and Fixed Access market reviews. As we explained in our 2013 Consultation, the application to the Narrowband and BCMR markets will depend on BT's agreement to implement the changes on a voluntary basis. We do not consider that it would be in the interest of BT, Ofcom or any other stakeholder to have two different regimes with different sets of requirements operating in parallel until the completion of the Narrowband market review in 2016.

3.171 BT will, under change control, retain responsibility for producing the Regulatory Financial Statements in accordance with the Regulatory Accounting Principles and the Regulatory Accounting Guidelines. While Ofcom will have a greater role in setting rules for preparation, the Regulatory Financial Statements remain BT's accounts. We do not foresee any issue with obtaining an audit opinion, although we accept that the new framework may be more conducive to a PPIA opinion.

Stakeholder comments on error notification

3.172 We proposed that BT must notify any material error within 30 days of deciding to correct the error (together with impact) and publish the notified error on its website. We proposed that the impact of the error for each affected market and service was to be measured as the difference in the numbers which were reported in the previous financial year, and the numbers that would have been reported had the error been corrected in the previous financial year (or such error not been made).

3.173 BT stated that, together with its concerns about the level of materiality, the requirement to publish a report notifying an error within 30 days of discovery is disproportionate, unjustified and, in any event, impracticable. BT suggested that Ofcom can use its existing powers to obtain information if it is needed for disputes. Errors of the magnitude that we wish to see are not reported to the regulatory team and could not therefore be subject to the notification process we proposed.

3.174 Virgin Media noted that the error notification proposal contained no Ofcom right of veto and suggested that “Ofcom should ensure that the system ensures that there is no incentive for BT to create methodology changes by presenting them as error corrections.”[131]

Ofcom’s response on error notification

3.175 Our 2013 Consultation proposals did not require BT to look for errors in its system on a regular basis. Our proposal was that BT will be required to notify us of the material errors that it decided to correct within 30 days of such a decision. We note BT’s explanation of the practical difficulties of notifying every material error within 30 days of discovery. However, our proposal was for BT to notify not within 30 days of discovery but within 30 days of a decision to correct the error being made. Nevertheless, we can still see the practical issues of a deadline of 30 days and the likely consequence of having to issue various reports throughout the year.

3.176 We have therefore decided to amend our proposal to require BT to report within the annual reconciliation report all the material errors that have been identified throughout the financial year. This requirement will apply from the financial year 2014/15 (the 2013/14 reconciliation report will not cover errors). This amended approach also has the benefit of disclosing all the errors and their impact in one place and calculating their impact in one consistent exercise.

3.177 We will issue separately a direction which sets out how materiality of errors should be measured. However, we have considered BT’s concerns in relation to materiality (as further set out below) and consistent with the materiality threshold for change control, expect the following to be set out:

> **Error notification materiality** – An error is material if the required percentage correction (be it positive or negative) in any figure in the Regulatory Financial Statements exceeds the higher of 5% or £1 million. The required percentage correction in a figure shall be calculated by taking the value of the affected figure in the Regulatory Financial Reporting before the error is corrected, and subtracting from it, the value of the same figure after the error is corrected, and then dividing this result by the former value.

3.178 We do not consider that BT will be able to present methodology changes as error corrections. Error corrections are data or mathematical errors, which are distinct from methodology changes. As we proposed in Annex 14 of our December consultation document (‘Template for error notification’), BT will be required to provide “A description of the circumstances of how the error was discovered and the reason for

[131] Virgin Media, 2013 Consultation response, page 3, question 5.1.

the error." It is therefore unlikely that it could pass a methodology change as an error correction.

Stakeholder comments on the reconciliation report

3.179 We proposed that BT must publish the impact of all material changes and errors in an annual reconciliation report with an accompanying assurance report from their regulatory auditors, alongside the Regulatory Financial Statements.

3.180 Verizon welcomed the proposal to publish a reconciliation report and emphasised that it is insufficient just to publish a report, the issues raised should be fully investigated. TTG said that the reconciliation report should list the total number of changes made by BT and quantify their aggregate value and impact on markets. TTG suggested that the minimum disclosure should be in line with that provided for BT's 12/13 Regulatory Financial Statements and include among other things an impact of the changes by product. TTG also said that the reconciliation report should also provide prior year information to ensure comparability.

3.181 BT agreed with the proposal to require publication of the impact of all material changes in an annual reconciliation report with an accompanying assurance report from its regulatory auditors. BT considered that this report would provide transparency about the impact of all material changes. However, BT went on to explain that the requirement for a reconciliation report made obsolete Ofcom's proposed right of veto. BT also said that they do not think it is practicable to publish a reconciliation report at the same time as the Regulatory Financial Statements in 2013/14 as the changes to the annual timetable cannot be reasonably implemented in time. BT suggested the deadline of 30 September 2014 in the first year and the deadline of 31 July in future years.

Ofcom's response on the reconciliation report

3.182 We note that stakeholders generally agreed with our proposal to require BT to publish a reconciliation report and note TTG's comments about the content of the reconciliation report. The reconciliation report, as set out in the 2013 Consultation, will broadly follow the format of the report that was published in 2013.[132] As we explained above, the reconciliation report will cover all changes that BT has made and disclose the impact of all material changes separately. We provide further detail about the contents of the reconciliation report in Section 4.

3.183 We do not propose that BT should include comparatives in the reconciliation report. Assuming the comparatives would be restated prior year figures with this year's changes rather than restated prior year figures with last year's changes, it may not be possible for BT to re-calculate comparatives on the basis of new methodologies if the relevant data did not exist at the time (e.g. the change following the TSO re-organisation in 2012/13). In such circumstances, BT may only be able to provide an estimate of what the impact of the change would be on last year's results, possibly on a modelled basis. As this information would have already been provided to Ofcom as part of the Change Control notification requirement, requiring BT to provide again on an 'improved' basis would be disproportionate for the minor benefits it may provide.

[132] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/ReportrequestedbyOfcomfortheyearended31March2013.pdf

3.184 We disagree with BT's suggestion that the reconciliation report makes obsolete the need for a veto. The purposes of the reconciliation report and the veto are different. The reconciliation report, together with the published notification about proposed changes, makes the implemented changes and their impacts on markets and products transparent. It is by nature a reactive tool. The veto ensures that a proposed change if so inappropriate and inconsistent with the Regulatory Accounting Principles and the Regulatory Accounting Guidelines that it would undermine Regulatory Financial Reporting is not carried into the Regulatory Financial Statements.

3.185 We accept BT's argument that given the timing of this statement there is insufficient time for BT to produce and publish the reconciliation report at the same time as the Regulatory Financial Statements in 2013/14. We agree that the deadline of 30 September 2014 is acceptable for the 2013/14 Regulatory Financial Statements, and 31 July thereafter.

3.186 We set our requirements on the form and content of the reconciliation report in section 4.

3.187 We have also decided to require an audit on the reconciliation report, broadly in line with our proposals as set out in the 2013 Consultation, and set out further details in this respect in section 4 and 5.

Stakeholder comments on materiality

3.188 TTG said that they would like us to clarify the materiality threshold for change control. TTG suggests that the proposed threshold of 5% change in any variable in the Regulatory Financial Statements would mean that a change from £0.1m to £0.11m would trigger the control but not a change from £100m to £104m. TTG cautioned that Ofcom will need to make sure BT does not make many small allocation changes which are significant in aggregate.

3.189 BT explained that the proposed Change Control materiality threshold of 5% of any figure in the Regulatory Financial Statements would require the publication of almost any change, however small. BT reiterated its proposal that "material changes should be assessed by reference to 5% of market costs or revenues, modified for smaller markets."[133] In clarifying their response, BT has subsequently informed us that in practice, calculating the impact of proposed changes on any figure would require considerable additional effort and in practice it would be easier for BT to submit all proposed changes showing their impact.

3.190 For error notification BT said that the precision required for reporting errors at the proposed level of materiality is far in excess of current requirements and would require considerable resources. It would lead to the investigation and publication of "any item we find to have been inaccurate, however trivial the amount and inconsequential its impact."[134] BT argued that it would also require implementation of disproportionate control and notification systems throughout BT's organisation, in part because some errors are part of underlying ledgers.

3.191 BT also explained that their regulatory auditors had expressed concerns about the definitions of materiality and that they would lead to a very significant increase in audit testing and would be impractical in a reasonable timeframe. Further details

[133] BT, 2013 Consultation response, page 17, paragraph 69.
[134] BT, 2013 Consultation response, page 20, paragraph 90.

about stakeholders concerns about materiality in the context of the audit are set out in Section 5.

Ofcom's response on materiality

3.192 We have considered stakeholders comments about an appropriate level of materiality and the practical issues concerning the quantification of impact. It is important that sufficiently granular information is provided to us so that we can understand the impact of proposed changes to cost allocations. We now understand that to calculate the impact of proposed changes on each and every figure in the Regulatory Financial Statements at the end of March is a significant and disproportionate task which would require BT to prepare the Regulatory Financial Statements on two bases considerably earlier.

3.193 Given that we initially proposed the materiality threshold to make the requirement to report changes more proportionate, we have now decided not to apply a materiality threshold for BT's change control notification report in March. Instead, we will require BT to report all proposed changes, explaining the reasons for the proposed change and showing their impact on the relevant market costs or revenues (using our template) rather than every figure in the Regulatory Financial Statements. We would then consider which changes are sufficiently important to warrant a review.

3.194 However, for the purposes of the annual reconciliation report to be provided by 31 July, we will require BT to disclose separately all material changes as we proposed. We will issue separately a direction which sets out how materiality of changes should be measured. However, we have considered BT's concerns in relation to materiality and expect to apply a de minimis limit of £1 million. This amendment is intended to ensure insignificant amounts are not captured. The amended criterion is set out below:

> **Change control materiality** - A change in any element of the Regulatory Financial Reporting is material if the resultant percentage change (be it positive or negative) in any figure in the Regulatory Financial Statements exceeds the higher of 5% or £1 million. The resultant percentage change in a figure shall be calculated by taking the value of the affected figure before the change in the Regulatory Financial Reporting is applied, and subtracting from it, the value of the same figure after the change in the Regulatory Financial Reporting is applied, and then dividing this result by the former value.

3.195 We have decided to apply the above amended materiality criterion to error notification to ensure the reporting requirement is proportionate. The Regulatory Financial Statements are currently restated for any errors that have an effect that is more than 5% effect on a market's revenues, costs and Mean Capital Employed (as required by auditors). We recognise that our requirement for error notification is likely to capture a larger number of errors than would be captured by restatement. However, we consider that this level of granularity is required to provide adequate assurance and transparency about the impact of material errors.

3.196 As we explain below, the definition of materiality as it relates to change control and error notification will be specified in a direction. For the purpose of preparing the reconciliation report on the 2013/14 Regulatory Financial Statements we consider that the change control materiality criterion set out above is appropriate. On this basis, a change in 2013/14 will be material if any figure in the Regulatory Financial Statements changes by the higher of 5% or £1million as a result.

3.197 The definition of materiality as it relates to change control and error notification is not intended to be applied more widely for regulatory audit purposes, which is a matter for the auditor to determine.

Ofcom's decisions about maintaining greater control over the basis of preparation and legal tests

3.198 Having considered stakeholders responses to the 2013 Consultation proposals we have decided that:

- BT must notify to us all proposed changes to its regulatory accounting methodology by 31 March of the relevant financial year. The notification must include a description of the change, the impact on the relevant market costs or revenues (by setting out, for each change separately, the figures which were presented in the previous Financial Year alongside the figures that would have been presented had such change been made in the previous Financial Year) and the reasons for the change including justification by reference to the Regulatory Accounting Principles and, once in place, the Regulatory Accounting Guidelines. The notification must be published on BT's website at the same time.

- BT must prepare and publish a reconciliation report by 30 September for the 2013/14 Regulatory Financial Statements and by 31 July thereafter, setting out the changes and the impact of the changes to its regulatory accounting methodology on the Regulatory Financial Statements.

- BT must also set out in the reconciliation report all material errors it decided to correct and the impact of such errors on the Regulatory Financial Statements. .

- BT must secure an audit opinion on the reconciliation report.

3.199 These decisions will be implemented in the SMP Conditions. The detailed requirements concerning the content of the reconciliation report, the content of an audit opinion on the reconciliation report, the change control materiality threshold and the error notification materiality threshold will be specified in a direction.

3.200 We have considered our decision to take greater control over the basis of preparation against the tests set out in S.47(2) of the Act and have concluded that they are:

- Objectively justifiable because it is necessary for there to be visibility in relation to changes to the basis of preparation of the Regulatory Financial Statements both for us and for other stakeholders in order for us to maintain greater control over the basis of preparation of the Regulatory Financial Statements.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. We will however keep under review whether any of the decisions that we have made may be appropriate to apply to KCOM in due course.

- Proportionate because our decisions are no more than is required to ensure we maintain greater control over the basis of preparation of the Regulatory Financial Statements. While we are establishing a change control process, BT will retain the ability to implement changes where this is necessary and in line with the Regulatory Accounting Principles and Regulatory Accounting Guidelines.

- Transparent because it is clear that the intention of our decisions is to ensure that we maintain control over the basis of preparation of the Regulatory Financial Statements.

Conclusion and summary of our decisions

3.201 We have after having considered comments made by stakeholders decided:

3.202 We will establish new Regulatory Accounting Principles:

- We will replace the existing Regulatory Accounting Principles with new Regulatory Accounting Principles (see Annex 3). Such principles will include, in particular, a new "consistency with regulatory decisions" principle.

- The new Regulatory Accounting Principles will come into force upon publication of the relevant direction and will apply to the 2014/15 Regulatory Financial Statements.

- BT's Regulatory Financial Reporting must comply with the new Regulatory Accounting Principles.

3.203 We will establish Regulatory Accounting Guidelines

- The Regulatory Accounting Guidelines will be introduced in the 2016/17 financial year and will apply for the 2016/17 Regulatory Financial Statements. For the 2014/15 and 2015/16 financial years, we will issue directions to BT as to the specific reporting requirements arising from regulatory decisions (specifically in relation to consistency with our decisions in the Fixed Access and WBA markets and charge controls).

- BT's Regulatory Financial Reporting must comply with the Regulatory Accounting Guidelines.

- The Regulatory Accounting Guidelines will evolve over time to reflect policy including outcomes of charge controls and investigations as well as discrete policy initiatives. They will, in particular, be amended to reflect our regulatory decisions, and as such create consistency between our decisions and BT's reporting.

- We will review BT's Primary Accounting Documents as part of the production of Regulatory Accounting Guidelines.

- We will require BT to retain those components of regulatory accounting currently included in BT's Primary Accounting Documents to the extent that they have not been replaced by the requirements imposed in the Regulatory Accounting Guidelines. BT will be required to include such components of the existing Primary Accounting Documents in the Accounting Methodology Documents to the extent that its content is not addressed by the Regulatory Accounting Guidelines. Once the Regulatory Accounting Guidelines fully address all the relevant components of regulatory accounting currently covered in the Primary Accounting Documents, there will be no need for BT to retain and include components of Primary Accounting Documents within the Accounting Methodology Documents.

- BT must prepare the Regulatory Financial Statements on a RAV basis.

3.204 In order to maintain greater control over the basis of preparation:

- BT must notify to us all proposed changes to its regulatory accounting methodology by 31 March of the relevant financial year. The notification must include a description of the change, the impact on the relevant market costs or revenues (by setting out, for each change separately, the figures which were presented in the previous Financial Year alongside the figures that would have been presented had such change been made in the previous Financial Year) and the reasons for the change including justification by reference to the Regulatory Accounting Principles and, once in place, the Regulatory Accounting Guidelines. The notification must be published on BT's website at the same time.

- BT must prepare and publish a reconciliation report, setting out the impact of the changes on its regulatory accounting methodology.

- BT must also set out in the reconciliation report all material errors it decided to correct and the impact of such errors on the Regulatory Financial Statements.

- BT must secure an audit opinion on the reconciliation report.

- BT must publish the reconciliation report by 30 September for the 2013/14 Regulatory Financial Statements and by 31 July thereafter.

Section 4

Scope and format of reporting

Summary

4.1 In this section we set out our decisions on the changes that need to be made to the way in which the Regulatory Financial Statements are presented and the extent to which that information is published. The changes are intended to address those areas of the current Regulatory Financial Reporting arrangements that we have identified as needing improvement.

4.2 Our decisions were made in the light of stakeholder responses and consideration of the balance that needs to be struck between ensuring that stakeholders have access to the correct level of information for it to be relevant and the need to ensure that the requirements that we impose are proportionate. We have also considered the concerns expressed by BT about the publication of what it considers to be commercially confidential information. While our decisions will lead to a reduction in the amount and detail of information that BT is required to publish in some areas, they will lead to more being published in others.

4.3 In the 2013 Consultation we made proposals under three broad themes for reporting, as follows:

- *Ensuring that Published Regulatory Financial Statements provide relevant information.* We indicated that we believe stakeholders should be able to gain a better understanding of BT's financial performance and invited views on this from stakeholders. We also proposed that where products which are subject to EOI regulation are also covered by SMP regulation, BT must report such products at the same level as products which are covered by SMP regulation but not by EOI regulation; and that BT must publish non confidential compliance statements. This will result in a significant increase in published information while imposing minimal burdens.

- *Improving the presentation of the basis of preparation.* The basis of preparation should be transparent and understood by users of the Published Regulatory Financial Statements. We proposed that the regulatory reporting obligations on BT be amended so that BT needs to comply with less burdensome transparency requirements, in particular by amending the Transparency Direction and the Direction relation to the form of the FPIA and PPIA audit opinion.

- *Ensuring that the Published Regulatory Financial Statements provide the appropriate level of detail.* We said that we should only require BT to publish information to the level that is proportionate. Stakeholders should not expect information to be published that goes beyond the regulatory purposes that we have identified in our statement. We proposed that BT must report volume and revenue information so as to reconcile with the non-confidential charge control compliance statements and BT must no longer publish the Network Services Reconciliation statement.

4.4 In this section we set out our decisions on our proposals having considered the responses that we received to the 2013 Consultation. In broad terms our decisions are in line with the proposals that we made in the 2013 Consultation. We confirm how our decisions will be implemented in Section 7. These include the transitional arrangements necessary during the move from BT's existing to its new regulatory accounting system.

Ensuring the Published Regulatory Financial Statements provide relevant information

4.5 In the 2013 Consultation, we made a series of proposals to ensure that the Published Regulatory Financial Statements provide the relevant information, addressing four broad issues: understanding BT's financial performance, EOI reporting, explaining year on year changes and confidence that BT is complying with its regulatory obligations. We consider these in turn, below.

Understanding BT's financial performance

4.6 We proposed, in the 2013 Consultation, that users of the Published Regulatory Financial Statements should be able to gain a reasonable understanding of the impact of regulation on BT and its ability to recover costs. While noting that we do not regulate the returns that BT can make, we also explained that we consider that stakeholders should be able to interpret the returns that BT does make, in part to inform their view on what this might mean if and when we need to make further regulatory decisions.

4.7 We considered that this meant that information should be, as far as possible, consistent with the basis of our regulatory decisions. We noted that, in theory this could mean reflecting any 'pricing adjustments' made to BT's costs by Ofcom for policy reasons for the purpose of informing pricing decisions.

4.8 We explained that we did not consider it appropriate to require BT to model the impact of all recent price adjustments (such as steady state valuation adjustments) as this would require BT to make difficult judgements about how it thinks we might deal with these costs on an on-going basis. We noted that this would mean that differences remain between the reported view of BT's financial performance and the way we might interpret the data in the context of regulatory decisions.

4.9 We therefore invited views on if and how stakeholders can be given a better understanding of BT's financial performance from a regulatory perspective.

Stakeholder Comments and Ofcom's response

4.10 As explained in section 2, stakeholders other than BT broadly agreed with our proposal for this additional reporting. In light of stakeholder responses, we consider that some limited disclosure of this information is appropriate. However, we consider that more consultation is required before determining the appropriate form and content of the additional disclosure.

4.11 We will put forward proposals about the information that we consider the Published Regulatory Financial Statements should provide and how it will be implemented later this year.

Transparent Reporting of EOI costs

4.12 In the 2013 Consultation, we said that monitoring BT's compliance with EOI obligations required in the Undertakings should not be a specific objective for the

Published Regulatory Financial Statements. We noted, however, that where there is a product which is subject to SMP regulation, it should continue to be reported as required under BT's Regulatory Financial Reporting obligations, even where that product also needs to be provided on an EOI basis under the Undertakings.

4.13 We explained that BT had been reporting inputs which BT needed to provide on an EOI basis under the Undertakings in a way that we consider is less transparent than other inputs into other products subject to SMP regulation.

4.14 As a result we proposed that BT should disclose all inputs on the same basis, whether they need to be provided on an EOI basis under the Undertakings or not. This would provide, for regulated products published within the Regulatory Financial Statements, more transparency of year on year movements of inputs BT needs to provide on an EOI basis under the Undertakings.

4.15 We proposed that BT would only be required to report EOI at the same level that they are regulated. We noted that, as BT is required to publish the price of all products that BT is required to provide on an EOI basis under the Undertakings, this information will not be confidential.

4.16 We set out in the 2013 Consultation pro-formas for the WBA market setting out what EOI reporting would look like in the published Regulatory Financial Statements.

Stakeholder Comments

4.17 Verizon said that products "BT is required to provide on an equivalence of inputs ("EOI") basis should be set out on a disaggregated basis in the RFS." [135] Verizon said that the reporting of EOI cost should "help towards consistency in BT's reporting and make the RFS more user friendly and intuitive."[136]

4.18 BT also agreed that products subject to SMP regulation should be "reported at the same level whether they are covered by EOI Regulation or not."[137] BT were, however, concerned that for WBA disclosures set out in the proposed proforma, EOI inputs such as Tie Cables and SFIs would reveal "commercially sensitive information such as our fault rates."[138] BT said that this information should be redacted.

4.19 TTG argued that the EOI proposal was not relevant. It explained that if the information that we proposed were disclosed it would not set out the true cost of the EOI component. TTG explained that EOI reporting "provides no additional confidence or transparency."[139]

4.20 Vodafone questioned the meaning of Ofcom's statement in its 2013 Consultation that "EOI reporting is not itself seen as a core objective of the accounts." Vodafone went on to say that it continues "to need detailed cost, volume and revenue information for individual SMP products covering internal and external supply."[140]

[135] Verizon, 2013 Consultation response, page5, paragraph 24.
[136] Verizon, 2013 Consultation response, page 7, paragraph 37.
[137] BT 2013 Consultation response, page 22, paragraph 98.
[138] BT 2013 Consultation response, page 23, paragraph 105.
[139] TTG, 2013 Consultation response, page 21, paragraph 5.30.
[140] Vodafone, 2013 Consultation response, page 11, Question 6.2.

Ofcom's response and decision

4.21 Stakeholders broadly support our proposal about EOI reporting. We do not agree with BT that for WBA markets, the publication of EOI cost component information for regulated products would reveal commercially sensitive information. Whilst we recognise that the information may disclose information about the relative importance of faults (to the extent it can be identified within EOI cost components) this information would be at an aggregate industry level. CPs would already have their own information on the level of faults that they experience in the products that they buy. This information may give rise to questions from stakeholders if the faults they appeared to experience diverged markedly from those of the rest of the industry. However, we believe that these questions are legitimate where BT recovers fault repair costs through regulated charges.

4.22 TTG are correct that disclosed EOI component costs are the prices determined for those components rather than the underlying cost of the components. EOI components are themselves regulated products that have been subject to scrutiny in their own right, usually as part of another market review. A reader of the Regulatory Financial Statements could find the input price in another part of publication, nevertheless there is a benefit in providing this information for ease of reference.

4.23 Having considered stakeholders comments we have decided that BT must report EOI cost components on the same basis as non-EOI components, at the level that they are regulated. The form that this reporting will take in the 2014/15 Regulatory Financial Statements will be set out in a direction to be published separately.[141] We expect BT to voluntarily disclose EOI components in the BCMR and Narrowband markets where relevant.

4.24 We have considered our decision against the tests set out in S.49(2) of the Act and have concluded that they are:

- Objectively justifiable because the Regulatory Financial Statements do not currently contain sufficient detail in relation to EOI reporting. The changes will ensure that the Published Regulatory Financial Statements will provide stakeholders with relevant information.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. In any case, KCOM is not subject to EOI regulation.

- Proportionate because the changes are no more than is required to ensure that published Regulatory Financial Statements provide relevant information.

- Transparent because it is clear that the intention of our changes is to ensure that the Regulatory Financial Statements provide relevant information.

Explaining year-on-year changes and their causes

4.25 In section 3, we set out the need for a change control and error notification process. We explained that it was important that stakeholders understand the reasons for any changes, errors and restatements, and their impacts.

[141] Regulatory financial reporting: a review. Consultation. 20 December 2013. Page 88, paragraph 7.13. http://stakeholders.ofcom.org.uk/binaries/consultations/bt-transparency/summary/BTRFS.pdf

4.26 In this section we consider the form of that report. We proposed that BT must produce and publish an annual reconciliation report, in the same format as the reconciliation report that we required for the 2012/13 Regulatory Financial Statements, and obtain an audit opinion on the report.[142]

Stakeholder Comments

4.27 TTG said that the "reconciliation report and the auditors' assurance report should list and note the total number of changes made by BT and quantify their aggregate value and impact on individual markets together with the "material" changes which are separately identified."[143] They also suggested that we publish "change control templates that show the form of the reconciliation report BT needs to publish, detailing the way changes should be reported by market and by product, not just for the current year but also the prior year to allow for comparability."[144]

4.28 BT also agreed and said "we welcome the proposal to publish the impact of all material changes in an annual reconciliation report with an accompanying assurance report from our regulatory auditors, alongside the RFS."[145] Verizon said that it was "pleasing to see that Ofcom recognises the importance of an auditor's report to sit alongside the proposed reconciliation report produced by BT."[146]

Ofcom's response and decision

4.29 We have set out in Section 3 our decisions about the proposals that we made about change control and error notification in the 2013 Consultation, including the appropriate levels of materiality.

4.30 We have decided to require BT to publish and prepare a reconciliation report, the content of which will be directed separately. However, we expect that, in relation to changes to regulatory accounting methodology, from 2014/15 the reconciliation report will cover all changes and will individually disclose the impact of all material changes. Changes below the materiality threshold will be aggregated. The reconciliation report will set out the impact, expressed as an absolute amount and as a percentage change.

4.31 We expect that in relation to errors, from 2014/15, the reconciliation report will cover all material errors that BT has decided to correct. It will set out the impact of such errors, as an absolute amount and as a percentage change.

4.32 The reconciliation report to be published on 30 September 2014 will not be informed by the change control process. It will cover all changes to methodologies, but will not include or set out the impact of errors. In relation to the impact of changes, the report will set out the impact of all changes to the Regulatory Financial Statements on an aggregated basis, and separately the impact of each material change at the level of Markets and Technical Areas on an individual and aggregate basis and the impact of all other changes which are not material changes on an aggregate basis.

[142] Regulatory financial reporting: a review. Consultation. 20 December 2013. Page 28, paragraph 3.110. http://stakeholders.ofcom.org.uk/binaries/consultations/bt-transparency/summary/BTRFS.pdf
[143] TTG, 2013 Consultation response, page 26, paragraph 8.6.
[144] TTG, 2013 Consultation response, page 27, paragraph 8.9.
[145] BT, 2013 Consultation response, page 28, paragraph 84.
[146] Verizon, 2013 Consultation response, page 7, paragraph 38.

4.33 Published change control notifications will set out the impact of proposed changes on the basis of the prior year Regulatory Financial Statements.

4.34 We have also decided that from 2014/15, BT must secure an audit opinion on the reconciliation report, the content of which will be directed separately. This must confirm that the notification by BT on or before 31 March of changes to its regulatory accounting methodology contained all material changes put through by BT (with the exception of any specifically requested by the auditors). The auditor's report must also confirm that BT included and correctly calculated the impact of all material changes in its reconciliation report.

4.35 In relation to errors, we expect that the auditor's report must confirm that all material errors which BT has decided to correct are included in the reconciliation report and that the impact of such errors was correctly calculated.

4.36 The auditor must also provide an opinion as to whether the descriptions of the material changes, and material errors given by BT are correct.

4.37 The reconciliation report condition will replace Condition OA5f. [147]

Providing reasonable confidence that BT is complying with its regulatory obligations

4.38 In the 2013 Consultation, we explained that providing stakeholders with reasonable confidence that BT has complied with its regulatory obligations is a key purpose of the Published Regulatory Financial Statements.

4.39 We noted that stakeholders other than BT consider that they need to understand the way in which the products and services that they buy are captured in the Published Regulatory Financial Statements. At present stakeholders are unable to see whether BT has complied with some of its charge control obligations. In part this is because they are not able to map the products that they buy to charge control baskets.

4.40 As a result, we proposed that BT should publish more detailed compliance information in the form of non-confidential versions of the compliance statements that it provides to us. We said that the publication of a non-confidential compliance statement should provide assurance about BT's compliance with charge controls. By assurance we meant the non-confidential versions of the compliance statements would provide 'reasonable confidence' (as set out in Section 2) that BT had complied with its basket charge control.

4.41 We said that although this will result in an increase in published information it imposes minimal additional burden. The information that we will require to be published is already produced and provided to us confidentially. BT will continue to provide the confidential version of the information to us.

4.42 We proposed in Annex 10 of the 2013 Consultation the format and content of the non-confidential compliance statements for the WBA and Fixed Access markets. The proposed statement would require BT to list, on a price list basis, every product within the basket (split internal and external which will provide assurance about non-

[147] The regulatory financial reporting obligations on BT and Kingston Communications Accounting separation and cost accounting: Final statement and notification 22 July 2004. http://stakeholders.ofcom.org.uk/consultations/fin_reporting/?a=0

discrimination), price movements (internal and external) in the year, basket relevant revenue and actual basket yields. We also proposed that the relevant basket revenues must reconcile to those published in the Regulatory Financial Statements.

Stakeholder Comments

4.43 We have already discussed in Section 2 the comments and concerns that stakeholders raised about the meaning of ‘reasonable confidence’ and our views about what this means. We do not seek to repeat that discussion here and instead focus on the comments received about the content of the proposed compliance reports.

4.44 Verizon welcomed our proposal for BT to publish a non-confidential version of its compliance statement. It said that “the type of data that such a statement would contain also appears to be the sort of useful information that would help stakeholders form a better picture of BT’s overall compliance.”[148]

4.45 BT agreed in principle that the publication of compliance statements would add confidence to stakeholders and would not be unduly burdensome. Nevertheless BT questioned whether compliance statements are needed to show in which baskets regulated products sit. BT argued that the Regulatory Financial Statements should not report the volumes or revenues of individual products. It noted that the proformas we proposed in the 2013 Consultation would need to be updated to reflect the final outcome of the market reviews.[149]

4.46 Vodafone said that they **“**need detailed cost, volume and revenue information for individual SMP products covering internal and external supply.”[150]

Ofcom’s response and decision

4.47 We note that stakeholders broadly agreed with our proposal to require publication of compliance statements.

4.48 We agree with BT that compliance statement proformas should be updated to reflect our final decisions on the Fixed Access and WBA markets. These will be reflected in the form of reporting that will be set out in a direction to be published separately. Having considered responses our view remains that it should be clear in which basket regulated products sit. At present, in some cases (such as Tie cable baskets in Fixed Access markets) baskets are set at an aggregate not product level. BT also has some flexibility to remove and introduce new products. However, we agree that information, such as individual volume information, should not be provided unless it is regulated at the individual product level.

4.49 Having considered stakeholders comments our decision is that BT must produce non-confidential compliance schedules for each regulated market. These non-confidential compliance statements must be published on BT’s website in the same location as the Published Regulatory Financial Statements and at the same time as the confidential compliance statements are provided to Ofcom.

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[148] Verizon, 2013 Consultation response, page 7, paragraph 39.
[149] BT, 2013 Consultation response, page 23, paragraph 102.
[150] Vodafone, 2013 Consultation response page 11, question 6.2.

4.50 BT must continue to provide to Ofcom, confidential Compliance Statements after the end of the relevant charge control year. This requirement is set as part of the SMP conditions imposed in charge controls. A charge control year will end 12 months from the point that the charge began (i.e. the point that it came into force). Charge control years do not in practice allow for alignment of the publication of the Regulatory Financial Statements and compliance statements.

4.51 We will set out in a direction to be published separately the form that this reporting will take for the 2014/15 Regulatory Financial Statements. We expect BT to voluntarily provide the non-confidential compliance reports for the BCMR and Narrowband markets.

4.52 We have considered our proposals against the tests set out in S.49(2) of the Act and have concluded that they are:

- Objectively justifiable because the Regulatory Financial Statements do not currently contain sufficient detail in relation to BT's compliance with charge controls. The changes will ensure that the Published Regulatory Financial Statements will provide stakeholders with relevant information.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. In any case, KCOM is not subject to any charge controls.

- Proportionate because the changes are no more than is required to ensure that published Regulatory Financial Statements provide relevant information.

- Transparent because it is clear that the intention of our changes is to ensure that the Regulatory Financial Statements provide relevant information.

Improving the presentation of the basis of preparation

4.53 In the 2013 Consultation, we explained that the basis of preparation of the Published Regulatory Financial Statements should be understood by users of the reports. We proposed that Accounting Methodology Documents should replace BT's current Secondary Accounting Documentation[151], and that these documents should be clear and easy for stakeholders to use. We said that stakeholders find aspects of BT's Secondary Accounting Documents difficult to understand and explained that the Transparency Direction (which specifies the level of transparency required to be met by BT for the purposes of preparing and maintaining the accounting records, accounting documents and Regulatory Financial Statements) and Directions 5 and 6 (relating to the form of the audit opinion) may have contributed to the current level of detail (and size and complexity) of those documents.

[151] The current Secondary Accounting Documents include the Detailed Attribution Methods (DAM), Long Run Incremental Cost model: Relationship and Parameters, Detailed Valuation Methods and Wholesale Catalogue.
http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/index.htm

4.54 The Transparency Direction[152] specifies the level of transparency required to be met by BT for the purposes of preparing and maintaining the accounting records, Accounting Documents and Regulatory Financial Statements in respect of wholesale cost accounting, accounting separation and retail cost accounting.

4.55 Having considered these issues we proposed that the transparency requirements as set out in the Transparency Direction should be revised, as follows;

> "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 ~~detailed~~ *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 clear 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.~~ […]

4.56 Direction 5 , relating to the form of the fairly presents in accordance with (FPIA) opinion includes the requirement for BT's auditors to give an opinion on whether the current Secondary Accounting Documents are appropriate to implement the Primary Accounting Documents.

4.57 Direction 6 , relating to the form of the properly prepared in accordance with (PPIA) opinion, includes the requirement for BT's auditor to give an opinion on whether, having reviewed the Accounting Documents, nothing has come to his attention that would lead him to conclude that the Secondary Accounting Documents are unreasonable in the context of the Primary Accounting Documents.

4.58 We proposed to amend Direction 5 and Direction 6, removing the requirement for BT's auditors to give an opinion on whether the Accounting Methodology Documents (rather than the Secondary Accounting Documents) were appropriate to implement the Regulatory Accounting Principles (rather than BT's Primary Accounting Documents) in the 2013 Consultation.

4.59 Taken together these proposals sought to require BT to produce sufficiently transparent Accounting Methodology Documents to give a suitably informed reader a clear understanding of such documents and of all the material, methodologies and drivers applied in their preparation.

[152] The regulatory financial reporting obligations on BT and Kingston Communications Accounting separation and cost accounting: Final statement and notification 22 July 2004. http://stakeholders.ofcom.org.uk/consultations/fin_reporting/?a=0

Stakeholder Comments

4.60 Stakeholders generally supported the proposals. CPs were, however, concerned about the potential for a loss of detail in the DAM. BT welcomed the proposals to amend the Transparency Direction and to remove the requirement for an FPIA level of assurance on the Accounting Methodology Documentation. Verizon said that they "agree that an emphasis on greater descriptive clarity of how the allocation system works and about how costs are allocated to markets would be highly beneficial and may go a long way to dispelling the distrust with which the current DAM is viewed by CPs." [153] Verizon went on to say that they had "significant concerns that the document will become too high level and will not provide all of the data necessary in order to achieve Ofcom's main goal of providing stakeholders with reasonable confidence that an SMP provider is complying with its regulatory obligations."[154]

4.61 Vodafone, while welcoming the proposal for simplification through a more accessible document expressed concern that "inevitably that means some detail will be lost. To counter this impact the introduction of a formal feedback loop would provide real benefits to stakeholders, enabling them to ask questions and receive answers within a formal context."[155]

4.62 TTG set out in detail what they thought the DAM should show including the:

- 'source' cost (using a range if necessary to protect commercial sensitivities),
- nature of the cost and the reason for incurring the cost, a description of the components of the 'source' cost, and
- a rough idea of the proportionate shares of the main components, and the underlying rationale for the allocation of the source cost between different products.

4.63 Sky said (as did TTG) that it was not always possible to follow simple cost allocations all the way through to the relevant product or service and it is not possible to understand certain costs and allocation methods.

4.64 BT provided its views on the other elements of the Accounting Methodology Documents arguing that the Long Run Incremental Cost Model: Relationships & Parameters will no longer be of relevance to stakeholders and the requirement for its publication should be withdrawn.

4.65 TTG argued that the Detailed Valuation Methodology will become more important due to RAV reporting and more information on the impact of CCA adjustments should be included.

Ofcom's response and decision

4.66 We note the broad support that our proposals received. Having considered stakeholders comments we have decided to amend the Transparency Direction in line with the proposals that we set out in the 2013 Consultation. We have also decided to amend Direction 5 and Direction 6 amending the current requirements for

[153] Verizon, 2013 Consultation response, page 8, paragraph 43.
[154] Verizon, 2013 Consultation response, page 8, paragraph 43.
[155] Vodafone, 2013 Consultation response, page 11, question 6.3.

the FPIA and PPIA levels of assurance. The changes will be implemented by way of a direction to be published separately. The amendments will take effect for the 2014/15 Regulatory Financial Statements and the Accounting Methodology Document to be published July 2015.

4.67 We will work with BT to ensure that Accounting Methodology Documents (which will replace the current Primary Accounting Documents (to the extent they have not been replaced by the Regulatory Accounting Guidelines) and Secondary Accounting Documents are transparent and user friendly. We will assess how well the 2015 Accounting Methodology Documents meet the needs of stakeholders. If, we consider that that the Accounting Methodology Documents fail to meet the needs of stakeholders (including Ofcom's needs) and our expectations, we will consider whether more prescriptive action might be necessary to ensure that the Accounting Methodology Documents meet their intended purpose.

4.68 Our proposals will, in the short term, have most impact on how BT drafts the DAM. In addition to changes as a consequence of the previously described amendments to directions, the new Accounting Methodology Documents published alongside the 2014/15 Regulatory Financial Statements will also reflect the new Regulatory Accounting Principles and any changes as a consequence of BT's move to a new regulatory accounting system.

4.69 The current DAM seeks to meet two purposes. It provides information to stakeholders and serves as a user manual for BT's own internal processes. We expect that the new Accounting Methodology Documents will no longer include the description of sector allocations contained in spreadsheets that are used for BT's own purposes. However, we expect that the Accounting Methodology Documents will explain the allocation of cost components to products and services alongside the relevant usage factors. The current documents stop at the cost component level.

4.70 We expect that BT would need to produce and maintain a detailed internal accounting manual that is similar in nature to the existing DAM. This manual is likely to include the allocation rules needed for its own internal control purposes. We will continue to need access to this BT information in order to understand how BT's attribution methodology works in detail. BT must provide this and other internal documentation to Ofcom on request.

4.71 Having considered BT's argument we have decided that the "Long Run Incremental Cost Model: Relationships & Parameters" component of the Accounting Methodology Documents should continue to be published. LRIC continues to serve a regulatory purpose and has been used in determining Call Origination and Call Termination charges in the Narrowband market, and Ancillary Charges in Wholesale Local Access. Publishing this component in the Accounting Methodology Documents will aid stakeholders' understanding. We do not expect much change to the current LRIC documentation before 2016. More substantial changes may be required following any Ofcom review of the LRIC documentation.

4.72 The Detailed Valuation Methodology should be updated by BT to reflect changes in regulatory requirements (such as the requirement for BT to value certain assets on a RAV basis) and to ensure that it provides clear and transparent descriptions on how BT values its assets. Updating the Detailed Valuation Methodology should not be burdensome given that the required information is in the RAV model and the Cost of

Copper Statement.[156] We do not think the Detailed Valuation Methodology should include the impact of CCA adjustments. CCA adjustments should be described, where they are material, in the Regulatory Financial Statements.

4.73 Once in place, the Accounting Methodology Documents will describe attributions and valuations of assets that cut across markets. BT must therefore update the Accounting Methodology Documents to take account of Ofcom's guidance set out in the Regulatory Accounting Guidelines.

4.74 We remain of the view, as set out in the 2013 Consultation that a formal requirement for BT to answer questions from stakeholders about its Regulatory Financial Statements would be difficult to monitor and enforce, and would be disproportionate. BT may however seek to agree with stakeholders about how questions could be asked and answers given.[157]

Legal tests

4.75 As indicated above, the changes to the regulatory requirements which flow from this decision will be implemented in directions published separately. We have considered our decision against the tests set out in S.49(2) of the Act and have concluded that they are:

- Objectively justifiable because the Secondary Accounting Documents currently prepared by BT are difficult to understand. The changes to the directions seek to clarify that BT should be providing less detailed, but clearer Accounting Methodology Documents.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such changes. In any case, KCOM's Secondary Accounting Documents do not exhibit the same level of complexity as BT's.

- Proportionate because the changes are no more than is required to ensure that presentation of the basis of preparation is clear for users, and they reduce the regulatory burden on BT.

- Transparent because it is clear that the intention of our changes is to ensure that presentation of the basis of preparation is clear for users.

Ensuring that the Published Regulatory Financial Statements provide the appropriate level of detail

4.76 In the 2013 Consultation we proposed that the cost, volume and revenue information within the Published Regulatory Financial Statements should continue to be published at the level of the remedy. We also proposed that the volume and revenue information must reconcile with the non-confidential charge control compliance basket submissions. We set out in Annex 10 of the 2013 Consultation the proposed form of the Regulatory Financial Statements schedules for the current WBA markets and the proposed Fixed Access markets charge controls.

[156] http://stakeholders.ofcom.org.uk/consultations/copper/value2/statement/
[157] Regulatory financial reporting: a review. Consultation. 20 December 2013. Page 44, paragraph 4.100. http://stakeholders.ofcom.org.uk/binaries/consultations/bt-transparency/summary/BTRFS.pdf

4.77 We also proposed that we remove the requirement to publish the Network Services Reconciliation statement, which we will still receive as an AFI.

Stakeholder Comments

4.78 BT agreed in principle with the proposals. In connection with the requirement to reconcile the non-confidential compliance statements to the Regulatory Financial Statements they felt it would not be possible where the control was based on prior year revenues. They disagreed with the disclosure proposed for the WBA markets as it included disclosure about Wholesale Broadband Connect (WBC) products which they felt were not appropriate as they were not explicitly charge controlled at that level. They also commended that the reporting proposals should cover ISDN and wanted them extended to Narrowband and BCMR. TTG agree with our proposals.[158]

4.79 BT welcomed the removal of the Network Services Reconciliation but questioned the basis on which we require it to be supplied as an AFI.[159] They also questioned why both the Network Activity Statement and Attribution of Current Wholesale Costs and Mean Capital Employed statement had been retained given that, in BT's view, they are not linked to an SMP regulation.

4.80 Vodafone supported the retention of the Network Activity statement which they said was vital. Vodafone went on to say that "its removal would hamper stakeholders in responding to key charge control consultations. The information given in this section is not available elsewhere." [160] Vodafone also said that they welcomed "the retention of the Attribution of Current Wholesale Costs and Mean Capital Employed statement, regarding it as useful in helping to provide an overall picture across a range of regulated markets."[161]

Ofcom's response and decision

4.81 We note stakeholders' broad support for our publication proposals. Given that the Regulatory Financial Statements contain prior year comparatives for volumes and revenues we do not consider there will be an issue in reconciling the non-confidential charge control compliance basket submissions to the prior year revenues in the Regulatory Financial Statements.

4.82 We will set out in a direction to be published separately the form of basket reporting for Fixed Access ISDN and WBA markets from 2014/15. We also expect BT to publish those statements for the BCMR and Narrowband markets. The justification for publishing additional WBC information we proposed in the 2013 Consultation is set out in the WBA Statement.[162]

4.83 We have decided to remove the requirement for BT to publish the Network Services Reconciliation from the 2014/15 Regulatory Financial Statements onwards, but will require BT to provide it to Ofcom on a confidential basis.

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[158] TTG, 2013 Consultation response, page 19, paragraphs 5.20 and 5.21.
[159] BT, 2013 Consultation response, page 24, paragraph 111.
[160] Vodafone, 2013 Consultation response, page 12, question 7.1.
[161] Vodafone, 2013 Consultation response, page 12, question 7.1.
[162] Review of the Wholesale Broadband Access markets. Draft statement on market definition, market power determinations and remedies.
http://stakeholders.ofcom.org.uk/consultations/review-wba-markets/draftstatement/

4.84 We use the information provided in the Network Services Reconciliation Statement in the course of charge control reviews, particularly for assessing the relative importance of cost components across regulated and unregulated markets. It also provides control totals for reconciling S.135 information.

4.85 The Network Activity Statement allows users to see total aggregate costs on a component basis across all markets (regulated and unregulated). Combined with information provided in Annex 16 of the Published Regulatory Financial Statements (Cost Components on a market level) they can see how much of a particular Component Cost is allocated into the market they are interested in compared to the total Component Cost. The Network Activity Statement also breaks down the Cost Component cost into Capital Costs, CCA costs and HCA costs. The attribution of Wholesale Current Costs and MCE shows the breakdown of total market costs into aggregate cost (such as Network Support, Accommodation and Depreciation) and asset (Access Copper, Transmission, Other) headings. It gives Stakeholders a view of how costs are split across regulated and unregulated products and gives them an idea of the nature of operating and capital costs that are included in the markets they are interested in. We consider that it is appropriate that stakeholders are able to see this information and, we will therefore continue to require BT to publish the Network Activity statement, and the Attribution of Current Wholesale Costs and Mean Capital Employed Statement.

Legal Tests

4.86 As indicated above, the changes to the regulatory requirements which flow from this decision will be implemented in directions published separately. We have considered our decision to ensure that the Published Regulatory Financial Statements provide the appropriate level of detail against the tests set out in S.49(2) of the Act and have concluded that they are:

- Objectively justifiable because, in relation to the reconciliation of volume and revenue with the charge control compliance statements, it provides CPs with reasonable assurance that BT is complying with its charge controls and, in relation to the Network Services Reconciliation statement, we should not require BT to publish more than is necessary in light of its other SMP obligations.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation. In any case, KCOM is not subject to charge controls

- Proportionate because the changes are no more than is required to ensure that published Regulatory Financial Statements provide the appropriate level of detail.

- Transparent because it is clear that the intention of our changes is to ensure that the Regulatory Financial Statements provide the appropriate level of detail.

Future provision of information to Ofcom

4.87 In the 2013 Consultation we said that our aim was to work with BT during the development and implementation of its new regulatory accounting system to develop more efficient means of obtaining the information that we require. This we hoped would reduce the need for elements of the AFI, including the need for BT to provide a data file (the ‘Flat File’). We said that we could not propose that AFI requirements are removed until we have a better understanding of how we can access the information we need. This was not expected to be until after the new regulatory accounting system is operational. We said that we hoped to introduce ‘On demand Reporting’ and ‘Scenario Reporting’ in due course.

Stakeholder Comments

4.88 TTG was in favour of both ‘On Demand Reporting’ and ‘Scenario Reporting’. TTG said that Ofcom’s greater role in the basis of preparation means that it will be very important to be able to “assess the impacts of different cost allocations and methodologies quickly and effectively. This makes it very important that BT implements this facility.”[163] BT was concerned about the continued provision of the flat file which they considered was not proportionate.[164] BT said that its removal should not be dependent on REFINE.

Ofcom’s response and decision

4.89 BT has continued to make progress implementing its new regulatory accounting system. We understand that it will be fully implemented by December 2014. Our review of BT’s existing cost allocations will provide an opportunity to test the capability of the ‘Scenario Analysis’ tools within the new regulatory accounting system.

4.90 Should we find that the new systems and its tools are effective we will at this stage be in a position to draw up proposals for ‘On Demand’ and ‘Scenario Reporting’. This will allow us to consider which AFI’s, including the Flat File, should be retained. The Flat File and Data Extract tool will be important in the course of our review of Cost Allocations. Their need for their availability and continued development will therefore remain in the interim.

Conclusion and summary of our decisions

4.91 We have after having considered comments made by stakeholders decided:

- BT must report EOI cost components on the same basis as non-EOI components, at the level that they are regulated. The form that this reporting will take in the 2014/15 Regulatory Financial Statements will be set out in a direction published separately. We expect BT to voluntarily disclosure EOI components in the BCMR and Narrowband markets where relevant.

- BT must produce non-confidential compliance schedules for each regulated market. These non-confidential compliance statements must be published on BT’s website in the same location as the Published Regulatory Financial Statements at the same time the confidential compliance statements are provided to Ofcom. The form that this reporting will take in the 2014/15 Regulatory Financial Statements will be set out in a direction published separately. We expect BT to voluntarily provide the non-confidential compliance reports for the BCMR and Narrowband markets.

- We have decided to amend the Transparency Direction, Direction 5 (FPIA audit assurance) and Direction 6 (PPIA audit assurance) by way of directions published separately. The amendments will take effect for the 2014/15

[163] TTG, 2013 Consultation response, page 32, paragraph 9.2.
[164] BT, 2013 Consultation response, page 25, paragraph 116.

Regulatory Financial Statements and the Accounting Methodology Document to be published July 2015.

- BT must replace BT's current Primary and Secondary Accounting Documentation with Accounting Methodology Documents by July 2015. BT must keep these up to date in accordance with our regulatory decisions and any guidance that we produce.

- We will set out in a direction published separately the form of basket reporting for Fixed Access, ISDN and WBA markets from 2014/15. We expect BT to voluntarily provide those statements for the BCMR and Narrowband markets.

- We will set out in the direction published separately the form of non-confidential compliance reports for Fixed Access, ISDN and WBA markets from 2014/15. We expect BT to voluntarily provide those statements for the BCMR and Narrowband markets.

- We have decided to remove the requirement for BT to publish the Network Services Reconciliation from the 2014/15 Regulatory Financial Statements onwards, but will require BT to provide it to Ofcom as an AFI.

Section 5

Audit and Review

Introduction

5.1 In the 2013 Consultation, we recognised that stakeholders other than BT did not attach much value to the audit. We said that the problems identified by stakeholders reflected their concerns about BT's level of control over the basis of preparation, a lack of transparency about the basis of preparation, and the way that data is reported.

5.2 We explained that the audit alone cannot be relied upon to address those concerns and instead made proposals as set out in the previous sections. As a result, we did not propose significant changes to audit requirements. We did however propose that the Regulatory Financial Statements should be signed by a Director, for and on behalf of the Board of Directors.

5.3 Informed by responses to the 2013 Consultation and subsequent discussions with BT, we recognise that some existing audit requirements will need to change. This is as a result of decisions that we have made to address the way data is prepared and reported and to increase the transparency of BT's accounting documentation.

Proposed changes relating to audit and review

5.4 In this section, we summarise the proposals made in the 2013 Consultation, set out the stakeholder comments that we received about our proposed changes and present our final decisions.

5.5 In the 2013 Consultation, we did not propose significant changes to audit requirements but did propose that the Regulatory Financial Statements should be signed by a Director and that the requirement for BT to arrange for assurance reports where so directed by Ofcom should be formalised. We consider these proposals in turn below.

No significant changes to the audit requirements

5.6 In the 2013 Consultation, we explained that, while some stakeholders believed that there may be some scope for changes to audit requirements, we considered they were appropriate and that there was no need for change.

5.7 We recognised the limitations that an audit has as a standalone tool for detecting errors and explained that while the purpose of the regulatory audit cannot be to prevent all errors or changes to methodologies it should be expected to detect material errors and identify clearly inappropriate changes to methodologies.

5.8 We also said that if the regulatory audit was conducted by someone other than the statutory auditor it might improve CPs' perception of the independence of the auditor but could increase audit fees without delivering any additional benefits. We explained that the current auditor has a good understanding of BT's regulatory accounting systems which will be useful during the transition to the new regulatory accounting system.

5.9 We explained that there was no reason to move away from the current audit arrangements where the auditor provides opinions on the Regulatory Financial Statements as a whole and on some of the individual markets (as required by us). We said that it would be disproportionate to require audit to the product level. We therefore proposed that we will still require audit opinions at the market level and the specific requirements for FPIA and PPIA opinions will continue to be determined by us.

5.10 However, we proposed updating Direction 5 on FPIA opinions and Direction 6 on PPIA opinions to reflect our proposals to take control of the Regulatory Accounting Principles and Regulatory Accounting Guidelines as well as new requirements for BT to replace the Secondary Accounting Documents with new Accounting Methodology Documents.

Stakeholder comments

5.11 Overall, stakeholders agreed that changes did not need to be made to current audit arrangements. BT said that "we welcome Ofcom's conclusion that no change in arrangements regarding the audit is needed."[165] Verizon agreed noting that "the lack of trust stakeholders have in relation to Regulatory Financial Reporting has less to do with the audit regime than the lack of control applied to the basis of preparation of the statements."[166]

5.12 Verizon also recognised that "trying to make too many changes at this time, when BT is changing to a new accounting system, could present problems and introduce difficulties in accessing *[sic]* the effectiveness of the changes Ofcom has proposed and highlighting precisely where additional changes may need to be made."[167]

5.13 While it considered that "currently the audit is ineffective", TTG was unclear about the cause of this ineffectiveness and therefore has not "developed a view on how it might be changed."[168]

5.14 FTI Consulting in its report for BT concluded that the existing "regulatory audit provides a high level of assurance that numbers contained within the RFS are robust and derived from cost allocation methodologies that comply with the Regulatory Accounting Principles."[169] FTI also referred to the statements that Ofcom made in the 2012 Consultation and then in the 2013 Consultation about CPs' understanding of the meaning of the audit and the process. FTI referred to the 2012 Consultation in which we considered it "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."[170] FTI said that "it is not clear from the December 2013 RFR Consultation what, if anything, Ofcom had done to improve stakeholders' understanding regarding what the audit can and cannot achieve."[171]

[165] BT, 2013 Consultation response, page 27, paragraph 127.
[166] Verizon, 2013 Consultation response, page 9, paragraph 48.
[167] Verizon, 2013 Consultation response, page 10, paragraph 54.
[168]TTG, 2013 Consultation response, page 23, paragraph 7.1.
[169] FTI, 2013 Consultation response, page 25, paragraph 4.28.
[170] Regulatory financial reporting: a review. Consultation. 6 September 2012 Consultation paragraph 4.176 http://stakeholders.ofcom.org.uk/binaries/consultations/reg-financial-report/summary/condoc.pdf
[171] FTI, 2013 Consultation response, page 23 paragraph 4.19.

Ofcom's response and decision

5.15 Stakeholders' responses were consistent with our view that there is no compelling case for significant changes to the audit requirements and we have therefore not introduced or changed any obligations relating to the nature and scope of the audit.

5.16 We note FTI's comments about Ofcom's previous statements on the need for stakeholders to gain a better understanding of the audit. In the 2013 Consultation we examined concerns about the audit in the light of responses received to the 2012 Consultation and explained that "in our view, concerns over the audit can be better resolved by dealing with the root causes"[172] of the problems, such as frequent restatements cited by stakeholders.

5.17 We continue to consider that stakeholders' concerns are better addressed through the changes that we have decided on with respect to the basis of preparation and reporting. Nevertheless, we have considered whether it would be appropriate to formally require BT to provide stakeholders with a better understanding of the role and purpose of the regulatory audit beyond that which is provided currently within Section 4 of the Published Regulatory Financial Statements. Section 4, the Report of the Independent Auditor, sets out, in accordance with normal practice, a description of the auditor's responsibilities and the basis for opinions. Having considered this option we conclude that such a requirement placed on BT would be disproportionate.

5.18 We do however believe that there remains some scope to provide further information to provide a better understanding of the objectives, scope and limitations of the regulatory audit. With that in mind, we include in Annex 5 to this Statement a short summary what the audit does and does not do and the assurance it provides. It should be noted that this summary is not comprehensive and cannot answer all of the questions that specialist advisors are better placed to advise on.

Regulatory Financial Statements should be signed at board level

5.19 In the 2013 Consultation, we proposed that the Regulatory Financial Statements should be signed by a Director for and on behalf of BT's Board of Directors with effect from the 2013/14 Regulatory Financial Statements. We said that this would help provide confidence by confirming that BT's Directors have given Regulatory Financial Reporting adequate attention.

5.20 We said that although regulatory reporting is not (unlike statutory reporting) governed directly by the Companies Act 2006, Regulatory Financial Statements should reflect best practice in acknowledging the responsibilities of the Directors regarding their preparation.

5.21 We also said that sign-off by a Director for and on behalf of BT's Board of Directors would also be consistent with other elements of the regulatory audit framework. A Director currently signs off the regulatory audit engagement letter for and on behalf of BT's Board of Directors and receives a copy of the "duty of care" letter from the auditor to us. Sign-off by a Director for and on behalf of BT's Board of Directors would therefore be consistent with these other elements of Regulatory Financial Reporting, bringing it into line with the requirements for statutory reporting.

[172] FTI, 2013 Consultation response, page 41, paragraph 4.81.

Stakeholder comments

5.22 Stakeholders other than BT supported our proposal.

5.23 Verizon considered that the proposal for Director sign-off "appear[s] reasonable"[173]and Vodafone said that they "warmly welcome the proposal to require director level sign off of the accounts." Vodafone went on to say that "we believe BT's PLC Board has direct responsibility for its regulatory accounting obligations and as such we would like to see the BT Group CFO sign off the accounts. This would underline the importance of BT's accountability and give the regulatory accounts a much higher prominence within BT, something which we believe is needed to ensure quality."[174]

5.24 TTG "agree with Ofcom that there should be sign-off of the RFS at a company director level." However TTG said that they "believe that Ofcom should go further and insist that the RFS is taken as seriously as the statutory accounts and be signed off by the BT Group Finance Director." We note TTG's suggestion that there is a correlation between the number of issues that have arisen in recent years and seniority of review. In TTG's view, "the RFS is not being taken as seriously as it should be, or has previously been. The reduced level of seniority of sign-off has been accompanied by an increasing number of errors, restatements and corrections, undermining the credibility of the RFS."[175]

5.25 However, BT argued against the proposal, saying that they "believe the current arrangements have worked well and the proposed requirement for a Director sign-off is unnecessary."[176] BT argued that given our proposals for a greater role in the basis of preparation and the move from FPIA to PPIA opinion "it is unclear what additional benefits sign off by the Board has, and how this requirement could be objectively justifiable and / or proportionate."[177]

Ofcom's response and decision

5.26 While most stakeholders agreed with our proposal, we note BT's view that Ofcom's increased role in the basis of preparation and the move towards more PPIA opinions means that the additional benefits of Director sign-off for and on behalf of BT's Board of Directors are unclear. We explained in the 2013 Consultation that our proposal will provide additional benefit (beyond current arrangements) by making clear that BT should treat the Regulatory Financial Statements in the same manner and seriousness as the Annual Report required for its statutory accounts. Director sign-off for and on behalf of BT's Board of Directors will provide additional assurance and confidence to stakeholders. It is not entirely clear to us how a move towards a PPIA audit opinion changes this.

5.27 We do not agree that we should specifically require that the Regulatory Financial Statements are signed-off by the BT Group Finance Director. Our proposal that a Director signs off the Regulatory Financial Statements for and on behalf of BT's Board of Directors provides BT with flexibility while ensuring that the whole board has joint responsibility. BT may nevertheless decide that it would be most appropriate

[173] Verizon, 2013 Consultation response, page10, paragraph 53.
[174] Vodafone, 2013 Consultation response, page 12, question 7.1.
[175] TTG, 2013 Consultation response, page 25, paragraph 7.14.
[176] BT, 2013 Consultation response, page 27, paragraph 123.
[177] BT, 2013 Consultation response, page 27, paragraph 124.

that BT's Group Finance Director sign the Regulatory Financial Statements for and on behalf of the BT Board of Directors.

Formalising the requirement for BT to arrange ad-hoc assignments

5.28 In the 2013 Consultation, we said that audit and assurance is an important verification tool available to us in ad-hoc situations outside the annual regulatory audit. We explained that these ad-hoc assignments may be carried out by BT's regulatory auditor or by other providers of assurance, including consultants.

5.29 We provided examples of their use, and said that we would continue to commission ad-hoc audit and assurance in future as and when necessary, and when it would be proportionate to do so. We explained that while in many cases it will be appropriate for BT to bear the cost of such engagements, it will depend upon the circumstances.

5.30 Our proposal was to formalise our powers to require ad-hoc assurance reports, as well as "Agreed Upon Procedures" engagements through an additional SMP condition. Our proposal was that BT must arrange and pay for third party assurance for these as required.

Stakeholder comments

5.31 Verizon said that our proposals "appear reasonable"[178] and TalkTalk said that it "welcomes Ofcom's proposal to formalise its power to appoint external assurance reviews and make BT bear the cost of these reviews."[179]

5.32 However, BT disagreed, arguing that in their view "the proposed new SMP condition is neither proportionate nor objectively justified by the problem identified."[180] BT argued that ad-hoc assignments should be funded as part of the Ofcom annual fees so that the whole industry pays for required reports. BT argued that "it is not justified that where investigative work is carried out directly by Ofcom this would be funded in one way, but where carried out by a third party working to Ofcom's instruction it would be funded in another."[181]

Ofcom's response and decision

5.33 We have, in the light of stakeholder comments, re-considered our proposals set out in the 2013 Consultation. We note that our proposals concerned both 'ad hoc assignments' and 'Agreed Upon Procedures'. We also included two examples of ad hoc assignments.

5.34 We recognise that there is a distinction between ad hoc assignments and Agreed Upon Procedures. Agreed Upon Procedures' means an engagement carried out in accordance with a set of audit agreed by Ofcom and based on Ofcom's specific requirements in relation to the Regulatory Financial Statements, and reports the findings of that work to Ofcom.

5.35 In relation to ad-hoc assignments, our proposal sought to ensure that where necessary Ofcom would be able to investigate and understand issues which may

[178] Verizon, 2013 Consultation response, page 10, paragraph 53.
[179] TTG, 2013 Consultation response, page 23, paragraph 7.3.
[180] BT, 2013 Consultation response, page 27, paragraph 126.
[181] BT, 2013 Consultation response, page 27, paragraph 126.

arise from time to time, and be able to obtain a sufficient level of assurance on these issues from a third party. To date Ofcom has largely funded these investigations, appointing a third party to undertake the work, and recovering the costs through the annual fees charged to CPs. This arrangement has worked well and has not prevented us from obtaining the information that we need. At present there is only an occasional need for these investigations and we do not expect that the need will rise significantly in future.

5.36 Having considered stakeholder responses, we now consider that it would be disproportionate for the burden of ad hoc assignments to necessarily (or usually) fall on BT, and that there is no need for Ofcom to have the ability to impose this on BT.

5.37 However, we remain of the opinion that this is different for Agreed Upon Procedures. In this respect, we note that we already have the ability, under the SMP condition OA2, to "make such directions as [we] consider appropriate in relation to BT's Cost accounting System, Accounting Separation System and its obligations under these conditions" and that such direction making power may relate to a requirement to obtain assurance through Agreed Upon Procedures. We also note that we have already used this power by requiring BT to obtain assurance in relation to the information disclosed in AI-28 (disclosure of NTS Retail Uplift and PRS Bad Debt Surcharge service information).[182]

5.38 We have decided that it would provide further clarity to expressly provide for the power to require BT to obtain Agreed Upon Procedures in an SMP condition. As a result we will direct BT to obtain Agreed Upon Procedures as and when it is objectively justifiable, not unduly discriminatory, proportionate, and transparent.

Implications of other decisions for the audit arrangements

5.39 In the 2013 Consultation we explained that we had made other proposals that would benefit from third party review. We have set out, in the light of stakeholder comments, the decisions that we have taken about these proposed changes in the relevant sections of this document. We have provided below some clarity on the implications of these changes for the nature of the audit opinion, the auditor's assessment of materiality and the need to provide assurance on the new reporting requirements.

Additional reporting requirements

5.40 We have decided that BT must provide and publish two new reports; the reconciliation report and the systems reconciliation report. We will require BT to procure a report from its regulatory auditor on both.

<u>Reconciliation Report</u>

5.41 We have set out in Section 4 that the regulatory auditor must perform certain controls on the reconciliation report. For the reconciliation report BT must secure an audit opinion confirming that the notification by BT on or before 31 March of changes to its regulatory accounting methodology contained all material changes put through by BT (with the exception of any specifically requested by the auditor); and that BT has

[182] Annex 5, page 53. Changes to BT and KCOM's regulatory and financial reporting 2010/11 update Statement.- Annex 26 http://stakeholders.ofcom.org.uk/binaries/consultations/bt-kcom-reporting/statement/statement.pdf

included and correctly calculated the impact of all the material changes, and all the material errors that are included in the reconciliation report. The auditor must also provide an opinion as to whether the descriptions of the material changes, and material errors given by BT are correct.

5.42 In order to provide a PPIA level of assurance the auditors must have 'rules' against which they can provide an audit. These 'rules' will initially be set out in the SMP conditions, and then once published, will be within the Regulatory Accounting Guidelines.

5.43 In the period up to the point that the Ofcom Regulatory Accounting Guidelines are in place, we expect the regulatory auditor to give a publishable PPIA opinion on the Reconciliation Report, with the opinion referencing whether the report has been properly prepared in accordance with the SMP condition. Once the Regulatory Accounting Guidelines are in place, the opinion will continue to be a PPIA opinion, however this time it will be in accordance with the Regulatory Accounting Guidelines.

Systems migration

5.44 We have set out in Section 6, that a systems reconciliation report between the numbers generated by BT's current regulatory accounting system (which it calls ASPIRE) and its proposed new system (REFINE), must be prepared and provided to us by BT.   BT's report must explain and account for differences that arise between the results produced by ASPIRE and its proposed new system for the 2013/14 Regulatory Financial Statements.

5.45 The assurance provided by the regulatory auditor on the systems reconciliation report must show that:

- The results of the old accounting system and the new system have been properly extracted;
- The differences have been correctly calculated; and
- The explanations given by BT for the differences are an accurate representation of the cause of the difference.

5.46 We have decided that this assurance is best provided in the form of 'Agreed Upon Procedures' engagement with the regulatory auditor.

5.47 Under the terms of an Agreed Upon Procedures engagement, the auditor carries out tests of an audit nature as agreed between the auditor and the contracting parties. The auditor then reports on factual findings. The report is restricted to the parties than have agreed the procedures; as such it will not be published.

5.48 However, the report will either give us the necessary assurance that the numbers generated by the new system are similar to those from the old system, in which case BT will continue to use its new system, or it will not, in which case we will bring to stakeholders' attention any issues of concern and take the steps proposed in section 6 to address those concerns.

The level of opinion provided by the audit on the Regulatory Financial Statements

5.49 In the 2013 Consultation we said that given that we did not propose any significant changes to audit requirements and that it would be disproportionate to require audit to the product level, we will continue to require audit opinions at the market level. We also said that the specific requirements for FPIA and PPIA opinions would continue to be determined by us.

5.50 We proposed updating Direction 5 on FPIA opinions and Direction 6 on PPIA opinions to reflect our proposals to take control of the Regulatory Accounting Principles and Regulatory Accounting Guidelines as well as new requirements for BT to replace the Secondary Accounting Documents with new Accounting Methodology Documents.

5.51 Stakeholders in response to the 2013 Consultation proposals commented on the need for clarity and certainty as to the level of the assurance that is provided. Comments were also made about the potential impacts of changes that we proposed to the basis of preparation.

5.52 It is clear from stakeholders' comments that there continues to be a lack of certainty, at least for some stakeholders, about the levels of assurance that can be provided by the audit. UKCTA asked for clarity saying that they "would like to gain a better understanding of what Audit level will apply to each area of the accounts, including what areas are to be signed off at the PPIA level (properly prepared in accordance with) and what areas are to signed off at the higher standard of FPIA (Fairly Presented in accordance with)."[183]

5.53 TTG commented that "the effect of these different opinions is opaque to TalkTalk (and, we would expect, other stakeholders) as it is not clear what additional level of assurance the seemingly more onerous FPIA opinion gives over the PPIA opinion."[184] TTG also argued that "apart from a lack of understanding of what the audit opinions mean and how the auditors exercise them in practice, it is equally unclear how the opinions are applied to the various parts of the RFS."[185] They suggested that Ofcom should "consider arranging an industry workshop with BT's regulatory auditors to explain how they undertake the audits under the two different approaches."[186]

5.54 TTG and UKCTA's comments are in addition to those made by FTI about Ofcom improving stakeholders' understanding of the audit that we have already set out.

5.55 While there is lack of understanding about what the different levels of assurance mean, there is also concern about the impact that proposed changes to the basis of preparation may have on the level of assurance. In its response to the 2013 Consultation BT said that its regulatory auditor has "also advised that an over-prescriptive RAG would be inconsistent with any requirement for an FPIA form of audit."[187] BT considers that "this will clearly result in less confidence for

[183] UKCTA, 2013 Consultation response, page 5, paragraph 11.
[184] TTG, 2013 Consultation response, page 24, paragraph 7.7.
[185] TTG, 2013 Consultation response, page 24, paragraph 7.8.
[186] TTG, 2013 Consultation response, page 24, paragraph 7.7.
[187] BT, 2013 Consultation response, page 27, paragraph 125.

stakeholders."[188] However, UCKTA said that while it still had questions about the proposals for the audit, "Ofcom's proposed enhanced role in decision making will go some way to improving assurance and confidence in the output."[189]

5.56 In its report for BT, FTI argued that "a fairly presents audit opinion does more than only identify whether a stipulated methodology has been reasonably carried out. In fact, a fairly presents opinion considers whether the methodology is itself reasonable. It does this in the context of whether it is in accordance with the accounting framework (in this case the PADs, including the Regulatory Accounting Principles). In addition, it considers whether it would be necessary to deviate from the accounting framework to present fairly the results."[190]

5.57 FTI Consulting explained that "Ofcom could reduce the level of opinion required to a properly prepared opinion. However, a reduction in the level of audit opinion means that the overall level of assurance is reduced."[191] In its view, FTI considered that "Ofcom would be over-riding (or replacing) the regulatory auditor as the judge of what is reasonable. FTI also considered that "it is not clear that Ofcom is necessarily best placed to fulfil this role given the depth of experience and resources needed to provide an audit opinion."[192]

5.58 Further, FTI continue "Ofcom's proposals to take greater control leads to an unnecessary duplication of the role of the regulatory auditor. In addition, there is a risk that greater control will lead to a dilution in the audit opinion (i.e. to a 'properly prepared' opinion), which could increase the risk of disputes and appeals."[193]

5.59 For its part Vodafone said that more detail is required about the audit moving forward, together with "confirmation that the current auditor can audit to the proposed level (a statement from PwC would be helpful) following the changes in regulatory reporting proposed by Ofcom."[194]

5.60 We note stakeholders' comments about the need to improve understanding about the regulatory audit and in particular that there is a need to explain the different levels of assurance provided by PPIA and FPIA opinions. We have already set out in relation to our decision not to make significant changes to the existing audit requirements, our decision to include in Annex 5 a summary about the audit. Nevertheless, we do not agree with TTG's suggestion that industry workshops with BT's regulatory auditor would be appropriate. The obligations of BT's auditors are to BT (and, under the terms of the Tripartite Agreement, to Ofcom) and this would make it difficult if not impossible for the auditor to participate in any meaningful way in industry workshops. Such a requirement would not be proportionate.

5.61 Nevertheless, the combination of the additional information within Annex 5 as well as the information already provided within Section 4 of the Regulatory Financial Statements should in our view provide the information required to suitably improve the understanding of stakeholders.

[188] BT, 2013 Consultation response, page 27, paragraph 125.
[189] UKCTA, 2013 Consultation response, page 5 paragraph 11.
[190] FTI Consulting, 2013 Consultation response, page 23, paragraph 4.20.
[191] FTI Consulting, 2013 Consultation response, page 24, paragraph 4.26.
[192] FTI Consulting, 2013 Consultation response, page 24, paragraph 4.26.
[193] FTI Consulting, 2013 Consultation response, page 25 paragraph 4.31.
[194] Vodafone, 2013 Consultation response, page 8, paragraph 7.3.

5.62 In relation to the points that BT and FTI have made about our proposals leading to a reduced level of assurance we would note that at present the regulatory auditor provides a single overall FPIA opinion on the Regulatory Financial Statements and individual FPIA or PPIA opinions on groups of markets or markets of particular interest. The specific requirements for FPIA or PPIA opinions are agreed each year through Tripartite meetings and are set out in the Regulatory Financial Statements (within the Audit Report). Typically, Ofcom requests that an FPIA opinion is provided for those markets which are under review and for which charge controls are due to be set. For example, an FPIA opinion was given for the WBA markets in 2013.

5.63 Both BT and the regulatory auditor have told us that our proposals to take a greater role in the basis of preparation will impact on the level which is appropriate for the audit. The regulatory auditor has told us that an FPIA opinion would not be appropriate in respect of markets impacted by allocation methodologies which are covered by the Regulatory Accounting Guidelines from the 2016/17 Regulatory Financial Statements onwards.

5.64 Having considered BT's views and those of other stakeholders we are satisfied that a greater level of assurance and therefore confidence will result from our taking and maintaining a greater role in the basis of preparation than would have been provided by an FPIA opinion.

5.65 Indeed TTG in its' supplementary response commented that Ofcom's proposals will increase its confidence in the Regulatory Financial Statements "even if a consequence is that an FPIA opinion no longer being able to be given."[195] TTG explain in relation to the FPIA opinion "its loss will not materially impact our confidence in the RFS."[196]

5.66 Before the Regulatory Accounting Guidelines are in place but the new Regulatory Accounting Principles have been implemented, the level of audit opinion will remain as at present a mix of PPIA and FPIA opinions.

5.67 We would expect that once the Regulatory Accounting Guidelines are in place for the 2016/17 Regulatory Financial Statements, BT's regulatory auditor will provide a PPIA opinion against the Regulatory Accounting Guidelines. Where there is no guidance in the Regulatory Accounting Guidelines we would expect that the regulatory auditor will provide a PPIA opinion against the Regulatory Accounting Principles. Where the regulatory auditor is unable to reach an opinion against the Regulatory Accounting Guidelines or Regulatory Accounting Principles we would expect that they will qualify their opinion making clear that for the identified issues they have been unable to give an opinion.

5.68 We do not accept FTI's argument that we are duplicating the role of the regulatory auditor. The regulatory auditor's role will remain unchanged (providing audit opinions on the relevant market and the Regulatory Financial Statements as a whole) while we will become more involved in the basis of preparation by setting the Regulatory Accounting Principles and Regulatory Accounting Guidelines with which BT must comply. Nor do we accept that there is a risk of an increase in 'disputes and appeals' due to what FTI see as a "dilution in the audit opinion."[197]

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[195] TTG supplementary response page 7, paragraph 6.4.
[196] TTG supplementary response page 7, paragraph 6.45.
[197] FTI Consulting, 2013 Consultation response, page 25 paragraph 4.31.

5.69 We explain in Section 4 that having considered the responses provided by stakeholders we have decided to update Direction 5 on FPIA opinions and Direction 6 on PPIA opinions to reflect our proposals to take control of the Regulatory Accounting Principles and Regulatory Accounting Guidelines, as well as new requirements for BT to replace the Secondary Accounting Documents with new Accounting Methodology Documents.

Materiality and the audit

5.70 In its response to the 2013 Consultation, BT explained that the definition of 'material change' for the purpose of the proposed notification to Ofcom of material changes to cost allocations (and the assurance requested from auditors with respect to that) is "inconsistent with the definition of accuracy included in the proposed new RAP."[198] BT drew attention to the guidance provided by the Institute of Chartered Accountants in England and Wales and explained that the definition of materiality in the form proposed by Ofcom would "lead to a very significant increase in the required level of audit testing and would likely be impractical in a reasonable timeframe." BT also explained that the requirement to report on the completeness of disclosure of methodology changes using the proposed 'material change' definition would be likely to lead to an increase in testing over and above that required for the audit of the Regulatory Financial Statements.[199] In addition to this, the current regulatory auditor expressed some concern about the use of the term "competent user"[200] within the introductory paragraph to the draft Regulatory Accounting Principles.

5.71 The definition of 'material change' as defined for the change control process (i.e. 5% of any figure in the RFS, with a de-minimis threshold of £1m) only applies for those purposes, and does not apply more generally. It is purely there to identify the material changes to BT's Regulatory Accounting Methodologies which BT is required to set out and describe the impact of in its reconciliation report.

5.72 The concept of materiality accompanying the Regulatory Accounting Principles is the concept that applies for the purposes of the audit of the Regulatory Financial Statements as well as the accuracy principle. It is consistent with the guidance provided by the Institute of Chartered Accountants in England and Wales, because it is a high-level over-arching concept without a defined quantitative threshold, which leaves the application of materiality in individual circumstances to the auditors' judgement and their decision as to at what level they should set quantitative thresholds. Our concept of materiality accompanying the Regulatory Accounting Principles is also consistent with the foundational concept of materiality on which auditors base their audit.

5.73 With regard to the existing regulatory auditor's concern relating to the use of the phrase 'competent user', it is well defined within accounting standards that the user of any financial information would have a "reasonable knowledge"[201] of the information that they are using. This relates to a key principle of 'understandability'. We do not therefore believe that there is a need to specify that the user of the Regulatory Financial Statements should be a competent user and we will therefore

[198] BT, 2013 Consultation response, page 17, paragraph 70.
[199] BT, 2013 Consultation response, page 17, paragraph 71.
[200] Regulatory Financial Reporting. A review. 2013 Consultation, paragraph 5.11.
[201] FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland, paragraph 2.4.

remove the reference to the term “competent user” within the introductory paragraph of the Regulatory Accounting Principles.

The preparation of the Regulatory Financial Statements on a RAV basis

5.74 We explained in Section 3, that we have decided that the Regulatory Financial Statements must be prepared on a RAV basis. The Regulatory Accounting Guidelines that will be available for the financial year 2016/17 will provide BT with the guidance that it needs to prepare the Regulatory Financial Statements on a RAV basis. We expect that the regulatory auditor will provide assurance in the form of a PPIA opinion to the Regulatory Accounting Guidelines for the preparation of the Regulatory Financial Statements on a RAV basis.

5.75 In the interim we will direct by October 2014 those requirements and guidance necessary to allow BT to prepare the Regulatory Financial Statements on a RAV basis. We anticipate that this direction will be sufficient to allow the regulatory auditor to provide assurance in the form of a PPIA opinion.

Stakeholder proposals for further changes

Stakeholder comments

5.76 In its response to the 2013 Consultation TTG suggested further changes that it considered would improve audit arrangements.

5.77 Specifically, TTG suggested that Ofcom should “ensure transparency of the audit requirements and process” and set “clear rules” for “when each level of audit opinion is required.”[202] TTG suggested that in order to bring clarity about the different levels of assurance Ofcom should “develop and publish transparent rules for use by external auditors and require the auditors to explain any changes in allocations from the prior year for comparability.”[203]

5.78 TTG also suggested that the outputs of the dialogue between Ofcom and the regulatory auditor under the Tripartite arrangements about audit findings and suggestions for audit improvement should be shared with stakeholders. TTG said that “greater industry confidence in the quality of the RFS could be gained by sharing these audit findings with stakeholders together with the actions BT has agreed to make to address any identified deficiencies or weaknesses in the RFS.”[204]

Ofcom’s response and decision

5.79 We have considered whether it would be appropriate for Ofcom to set clear rules for when each level of audit opinion is required. We have already recognised that there is some benefit in providing more information above that already set out in Section 4 of the Published Regulatory Financial Statements and include a summary explanation of the audit process in Annex 5. Some further insight into the nature of the audit arrangements is also given in the Institute of Chartered Accountants in

[202] TTG, 2013 Consultation response, page 25 paragraph 7.13.
[203] TTG, 2013 Consultation response, page 24, paragraph 7.9.
[204] TTG, 2013 Consultation response, page 24, paragraph 7.11.

England and Wales' technical release on 'Reporting to Regulators of Regulated Entities'. [205]

5.80 In general terms, our decision as to the appropriate level of audit opinion for each has reflected our assessment of the relative importance of the market (for example by reference to its size or forthcoming market review), such that we would typically require an FPIA opinion if we considered that there was a case for the additional assurance this provides. We have also considered practical issues (for example, for some smaller markets, a requirement for an FPIA opinion may not be reasonably practicable). In future, we may no longer require, or be able to obtain FPIA opinions, in light of the other changes set out in this Statement, but we consider that the decision is best made on a case by case basis. We do not think it would be helpful to set out clear rules in advance, other than the general approach described above.

5.81 We have considered TTG's suggestion that we should publish the outputs of the dialogue under the Tripartite agreement for stakeholders to see. We have concluded that any benefit for stakeholders of a requirement for the detail of discussions between BT, its regulatory auditor and Ofcom to be published could limit the effectiveness of those discussions.

Summary of our decisions and legal tests

5.82 We have after having considered comments made by stakeholders decided not to make any significant changes to the current audit arrangements. We have however decided that a Director of BT must sign off the Regulatory Financial Statements for and on behalf of BT's Board of Directors and that BT must obtain assurance through Agreed Upon Procedures as directed.

5.83 These amendments will be implemented in the SMP conditions.

5.84 We have considered our decisions about audit and review against the tests set out in S.47(2) of the Act and have concluded that they are:

- Objectively justifiable because signature by a BT Director will ensure that the Regulatory Financial Statements get the necessary attention within BT, and that Ofcom's ability to obtain assurance under Agreed Upon Procedures is clear;

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation;

- Proportionate because the changes are no more than is required to ensure that there is an appropriate level of assurance; and

- Transparent because it is clear that the intention of our proposed changes is to ensure that there is an appropriate level of assurance.

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[205] The Tripartite arrangements allow us access to BT's Regulatory Auditors to discuss matters arising surrounding the Regulatory Audit. The details of the arrangement are outlined in the Institute of Chartered Accountants in England and Wales' technical release on 'Reporting to Regulators of Regulated Entities' (available at:http://www.icaew.com/~/media/Files/Technical/technical-releases/audit/AUDIT-05-03-Reporting-to-Regulators-of-Regulated-Entities.pdf).These arrangements allow us to discuss matters with BT's regulatory auditors, as the release stipulates that the regulatory auditors owe a duty of care to us.

5.85 In previous sections, we have made a range of decisions which will impact on the audit reports we require BT to obtain as follows.

5.86 For the reconciliation report BT must secure an audit opinion confirming that the notification by BT on or before 31 March of changes to its regulatory accounting methodology contained all material changes put through by BT (with the exception of any specifically requested by the auditor); and that BT has included and correctly calculated the impact of all the material changes, and all the material errors that are included in the reconciliation report. The auditor must also provide an opinion as to whether the descriptions of the material changes, and material errors given by BT are correct.

5.87 In relation to the systems reconciliation report BT's regulatory auditor must report whether:

- The results of the old accounting system (ASPIRE) and the new system (REFINE) have been properly extracted;
- The differences have been correctly calculated; and
- The explanations given by BT for the differences are an accurate representation of the cause of the difference.

Section 6

Transition to a new regulatory accounting system

Introduction

6.1 We explained in the 2013 Consultation that the regulatory accounting systems that BT uses to produce Regulatory Financial Reporting information have developed over time, evolving to meet the changing regulatory context. We explained that the main regulatory accounting system that BT uses is called ASPIRE. This is used to produce FAC data. A subsidiary LRIC model draws on the ASPIRE FAC data. Additionally, BT provides the Flat File which allows Ofcom to interrogate BT's data.

6.2 We provided an update on BT's proposal to deliver a new regulatory accounting system and set out proposals to ensure that Ofcom and other stakeholders have visibility of how the transition to the new regulatory accounting system is managed in order to prevent the transition itself causing differences in the figures reported in the Regulatory Financial Statements.

6.3 The introduction of BT's new regulatory accounting system is expected to address many of the issues such as the lack of transparency that we identified in the 2012 and 2013 Consultations. This section provides an update on how the new regulatory accounting system is being implemented.

Update on BT's new regulatory accounting system

6.4 We set out in the 2013 Consultation BT's intention to implement a new regulatory accounting system that will be more flexible than ASPIRE and able to more easily support new requirements and methodologies. BT had told us that a unified regulatory accounting system should make it quicker to produce reports, and undertake analysis including scenario analysis (such as the impact on services of alternative allocation bases).

6.5 We also explained that BT had told us that the focus of its proposed new regulatory accounting system (REFINE) is on the replacement of ASPIRE, the system that produces FAC data in the Regulatory Financial Statements. At this stage, the proposed new regulatory accounting will not incorporate the BT LRIC model. Instead, outputs from the proposed new regulatory accounting system will feed into the BT LRIC model in the same way that outputs from ASPIRE currently feed into it.

6.6 We understand that BT's current plan remains on target to deliver the following outcomes:

- The 2013/14 Regulatory Financial Statements will be the last produced using ASPIRE.
- Following publication of the 2013/14 Regulatory Financial Statements, the proposed new regulatory accounting system will be tested to ensure it produces results for 2013/14 that are consistent with ASPIRE.

- The proposed new regulatory accounting system will ‘go live’ around December 2014, subject to satisfactory testing.

- The 2014/15 Regulatory Financial Statements will be produced using the proposed new regulatory accounting system.

Managing the transition to the proposed new regulatory accounting system

6.7 We explained in the 2013 Consultation that the transition to a new regulatory accounting system requires certain safeguards to be put in place. We said that this is to ensure that its introduction does not cause material changes to the numbers that would have been reported in the Regulatory Financial Statements under ASPIRE, or at least that those changes are explained and understood.

6.8 We welcomed BT’s on-going cooperation and recognised the importance of continuing the collaborative approach between BT and Ofcom. Nevertheless, we said that it would be helpful to formalise existing arrangements because of the importance of likely future changes to BT’s regulatory accounting systems.

6.9 Our 2013 Consultation proposals were to amend BT’s regulatory reporting obligations so that:

- Where BT develops or replaces any of its regulatory accounting systems, it must keep us informed about its progress against milestones at the design, build, test and implementation stages of development. The frequency and content of these progress updates will be agreed between BT and us. We said that this proposal formalises the existing informal arrangements that work well currently.

- BT must ensure, to the best of its ability, that the financial data produced by the new regulatory accounting system is the same as that produced by ASPIRE.

- BT must produce and provide to us a report that explains and accounts for any differences between the outputs of the new regulatory accounting system and ASPIRE in relation to the 2013/14 Regulatory Financial Statements (’systems reconciliation report’).

- BT must, where we require it to do so provide a report from its regulatory auditors confirming that the explanations given by BT for any differences are a reasonable representation of the underlying cause.

6.10 BT must, where we require it to do so, prepare the 2014/15 Regulatory Financial Statements on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE. We proposed to implement the condition with immediate effect when we make our decision.

Stakeholder comments

6.11 BT said that they “share Ofcom’s views that our meetings with Ofcom to keep them informed of progress in developing our new regulatory accounting system have worked well to date"" [206] but were "unclear" [207] about the need to formalise the arrangement.

6.12 BT cautioned that by formalising the process Ofcom would need to specify arrangements including written reports on progress, agendas, and format for the project plan. BT considered that current arrangements should be sufficient, and that updates "should continue to be limited to significant changes to scope and high level milestones only, including expected go-live dates."[208] BT also said that such reports should "continue to be provided on a confidential basis to Ofcom only."[209]

6.13 TTG said that it "believes that Ofcom should keep CPs regularly updated with the progress it hears from BT on this project."[210]

6.14 Verizon agreed that Ofcom's proposals "are proportionate and well balanced."[211]

6.15 Vodafone said that it supported the proposed safeguards but had no insight into the new system or transitional arrangements. Vodafone went on to say "given stakeholders have a vested interest in the smooth transition to the new platform"[212] early sight of any concerns about either the outputs or timetable and the potential impact on stakeholders would be welcome.

Ofcom's response and decision

6.16 Both BT and Ofcom recognise that current arrangements have worked well to date. Our proposal to formalise the existing arrangements was not, however, limited to the implementation of BT's new regulatory accounting system, known as REFINE. As we set out in the 2013 Consultation, there are likely to be future developments to BT's regulatory accounting systems about which we need to be informed. For example, the BT LRIC model is not currently within the scope of the new regulatory accounting system and is likely to be developed at some point in the future.

6.17 We do not agree that our proposal to formalise arrangements will require Ofcom's greater involvement to the extent that we will need to specify arrangements for the format of project plans, progress reports or agendas. We would expect that meetings and updates would take the form that have been successful to date for the development and implementation of REFINE. Rather than specifying progress reports and agendas we would look to discuss and agree with BT, on a case by case basis, the format of plans, reports, and agendas. In agreeing with BT the form and frequency of updates we would consider the scope and importance of the project, and the timing of milestones and key deliverables. We agree that stakeholders should understand the extent to which BT's systems transition has met the expected outcomes. We set out proposals in the 2013 Consultation about how outcomes could be reported and we deal with responses to these proposals later in this section.

6.18 We do not agree, that Ofcom should provide regular updates to stakeholders on BT's progress in implementing its new regulatory accounting system (other than that which we have already set out). We believe it would be disproportionate for Ofcom to

[206] BT, 2013 Consultation response, page 29 paragraph 128.
[207] BT, 2013 Consultation response, page 29 paragraph 128.
[208] BT, 2013 Consultation response, page 29, paragraph 129.
[209] BT, 2013 Consultation response, page 29, paragraph 130.
[210] TTG, 2013 Consultation response, page 31, paragraph 8.25
[211] Verizon, 2013 Consultation response, page 10, paragraph 56.
[212] Vodafone, 2013 Consultation response, page 12, question 8.1 and 8.2.

provide regular updates to stakeholders, whose primary interest is about the output of the regulatory accounting system rather than the system itself. Updates provided by BT would therefore be expected to be confidential and would not be made available to other stakeholders. However, there might be times when Ofcom needs to provide stakeholders with information about important changes or the timing of changes both about the implementation of REFINE and for future changes to BT's systems.

6.19 We have already set out the timetable that BT is working to and we explain later in this document the steps BT will need to take to demonstrate that its new regulatory accounting system delivers the same results as ASPIRE.

6.20 Having considered stakeholders' responses our decision is that where BT develops or replaces any of its regulatory accounting systems, it must keep us informed about its progress against milestones at the design, build, test and implementation stages of development. The frequency and content of these progress updates will be agreed between BT and us on a case by case basis.

BT must demonstrate that the move to the new system does not cause changes in the reported numbers

6.21 We explained in the 2013 Consultation that the introduction of a new regulatory accounting system has the potential to give rise to changes that are the direct result of the use of a different regulatory accounting system to produce the Regulatory Financial Statements. We said that this is a concern since we do not consider it would be appropriate for the financial data appearing in the Regulatory Financial Statements to be different simply because a new regulatory accounting system was used to produce it. Any differences that did arise would need to be explained and accounted for.

6.22 We said that BT had told us that it was designing a new regulatory accounting system to replicate the output of ASPIRE.[213] BT said in its 2012 Consultation response that any new regulatory accounting system will deliver identical results compared to the previous regulatory accounting system.[214] In the 2013 Consultation we pointed out that in practice, it may be difficult to achieve exactly the same results in the new regulatory accounting system as in ASPIRE for two reasons:

- First, testing the new regulatory accounting system against ASPIRE may reveal mathematical or input errors in ASPIRE. We would expect ASPIRE to be corrected, as is currently the case when BT discovers such errors. If any errors were material, we would expect the Published Regulatory Financial Statements to be restated. Such differences, if they arose, would therefore be capable of being disclosed and reconciled.

- Second, the new regulatory accounting system may process data in a different way which could lead to differences from ASPIRE. For example, we understand ASPIRE needs to be run several times to produce a set of results due to the way feedback loops work. The new regulatory accounting system will not necessarily run in the same way. It is possible that this could lead to differences between the results generated from the two regulatory accounting systems.

[213] BT told us that the new system will initially be a system upgrade and that the new system will not introduce any methodology changes.
[214] BT, 2012 Consultation response, page 35, paragraph 195.

6.23 While we said that it may be difficult to ensure the new regulatory accounting system produces exactly the same results as ASPIRE, we also considered that it is important that the new regulatory accounting system does not introduce material changes to the numbers previously reported by ASPIRE.

6.24 We therefore proposed that BT must ensure, to the best of its ability, that the financial data produced by the new regulatory accounting system is the same as that produced by ASPIRE. We said that this proposal will be implemented with immediate effect when we make our decision.

Stakeholder comments

6.25 BT said that it "aims that the financial data produced by the new system will be the same as that produced by the existing system (ASPIRE)"[215] and argued that the requirement that "BT must ensure, to the best of its ability" is not clear.[216] BT suggested that alternative wording of "BT must take reasonable endeavours to ensure" would be better. [217] TTG, however, considered that the requirement that BT must ensure that the results of the new system are the same as the old system 'to the best of its ability' "will give BT too much latitude to interpret improvements and changes as part of the transition to the new system" and argue "that changes [that] are not material overall and are an "improvement" so should be allowed."[218]

6.26 BT also said that it would not implement something in REFINE just because it was in ASPIRE, noting that this would compromise the project's objectives. Verizon commented that "the proposals recognise, correctly, that when introducing a new regulatory accounting system the financial results produced may vary to some degree."[219]

6.27 TTG explained that while it welcomed an improved BT regulatory accounting system with fewer errors and a faster response, TTG "have some serious concerns about the risk to data quality from the proposed BT transition to new regulatory accounting system."[220] TTG argued that there are risks and opportunities for BT to exploit. TTG explained that BT could roll forward disallowed changes from the 2012/13 Regulatory Financial Statements into the new reporting system, and introduce additional changes which Ofcom and CPs will be unaware of until the accounts are published. To mitigate this risk TTG said that Ofcom should ensure "all RFS13 disallowed changes are removed from RFS14, by issuing a Direction to that effect."[221]

6.28 TTG cautioned that moving from BT's existing manually intensive offline models to the new fully automated system is "bound to result in errors being discovered that may have existed for many years."[222] TTG said that it "is concerned that the cumulative effect of correcting these "errors" as part of the transition to the new system could result in material changes to the allocations. TTG is also concerned

[215] BT, 2013 Consultation response, page 29, paragraph 131.
[216] BT, 2013 Consultation response, page 29, paragraph 131.
[217] BT, 2013 Consultation response, page 29, paragraph 131.
[218] TTG, 2013 Consultation response, page 31, paragraph 8.23.
[219] Verizon, 2013 Consultation response, page 10, paragraph 56.
[220] TTG, 2013 Consultation response, page 29, paragraph 8.16.
[221] TTG, 2013 Consultation response, page 26, paragraph 8.4.
[222] TTG, 2013 Consultation response, page 29, paragraph 8.18.

that BT will selectively cherry pick and reveal those errors which (if corrected) will be in BT's favour."[223]

6.29 TTG went on to say that it "believes there is a real risk BT could exploit this major systems change to align costs and allocations in its favour under the guise of "improvements". Given the recent experience with BT's latest regulatory accounts TalkTalk believes this risk to be very real indeed."[224]

Ofcom's response and decision

6.30 We do not agree with BT's suggestion that the requirement that "BT must ensure, to the best of its ability" is not clear and proportionate. This requirement would mean that BT is obliged to take all necessary and proportionate steps which BT is capable of taking, to ensure that the financial data produced by REFINE is the same as that produced by ASPIRE. However, this requirement would not impose an absolute obligation on BT in this regard. Given the importance of the new system, we believe that this requirement would strike an appropriate balance between ensuring that BT is not required to take steps which are beyond its power or control or which are disproportionate, whilst at the same time providing assurance to Ofcom and stakeholders that BT is acting to the best of its ability when managing the transition to the new system.

6.31 In relation to the comments raised by TTG, we have set out above the importance of ensuring the transition to the new system is well managed, and it is with this in mind that we developed these proposals. While the transition to the new system could reveal historical errors, we strongly believe that BT should rectify such errors during the transition, rather than to carry them over to the new system. We also note that the audit requirements would provide a strong incentive for BT to rectify any errors and prevent BT from "cherry-picking" which errors to correct. Nevertheless, it is important to ensure that the outputs of the two systems are shown to be the same. We would therefore expect that errors would be corrected both in the old and the new regulatory accounting system. Large differences would undermine the credibility of not only Regulatory Financial Statements but would more widely have an impact on the information that we require to make decisions about, for example, charge controls. As far as changes to Regulatory Accounting Methodology are concerned, those would, as set out earlier in this statement, be subject to the change control process.

6.32 We note TTG's concerns that BT may seek to use allocation methodologies that have been 'disallowed' in its 2013/14 Regulatory Financial Statements. In Section 3 we explain our decision that Regulatory Financial Reporting must be consistent with regulatory decisions as set out in the Regulatory Accounting Guidelines once they are in place. As we set out in Section 3, we will issue directions to BT about the specific reporting requirements arising from regulatory decisions (specifically in relation to consistency with our decisions in the Fixed Access and WBA markets).

6.33 Having considered stakeholders responses we have decided that BT must ensure to the best of its ability that the financial data produced by the new regulatory accounting system is the same as that produced by ASPIRE.

[223] TTG, 2013 Consultation response, page 29, paragraph 8.18.
[224] TTG, 2013 Consultation response, page 31, paragraph 8.26.

BT must provide a systems reconciliation report between ASPIRE and the new regulatory accounting system

6.34 We recognised in the 2013 Consultation that despite BT's best efforts, there may be differences between the outputs of ASPIRE and the new regulatory accounting system. We said that differences will need to be explained by BT and understood by us, and potentially other stakeholders.

6.35 We proposed that BT must produce and provide to us a systems reconciliation report which will explain and account for any differences between the outputs of the new regulatory accounting system and ASPIRE in relation to the 2013/14 Regulatory Financial Statements. We proposed that the report should be provided to us by 31 December 2014.[225]

6.36 We said that the report must be accompanied by an assurance statement by a third party confirming that the numbers used in the report have been properly extracted from ASPIRE and the new regulatory accounting system. We said that we may require all or part of this report to be published and that this proposal will be implemented with immediate effect when we make our decision.

6.37 We also set out two proposals in the 2013 Consultation about the preparation of the 2014/15 Regulatory Financial Statements. These were that where the systems reconciliation report indicates that any number published in the 2013/14 Regulatory Financial Statements under ASPIRE would be more than 1% different using the new system, BT must do the following, where we require it to do so:

- provide an assurance statement by an independent third party confirming that the explanations given by BT for any differences are a reasonable representation of the underlying cause; and

- prepare the 2014/15 Regulatory Financial Statements on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE. We could require this where there are a number of significant differences between the new system and ASPIRE or where we consider BT has not sufficiently explained those differences.

6.38 We said that our proposals would be implemented with immediate effect when we make our decision.

Stakeholder comments

6.39 Stakeholders, including BT, agreed that a systems reconciliation report should be provided.

6.40 However, stakeholders had different views about the proposed 1% materiality threshold. Verizon said that it "strongly agrees with Ofcom that a materiality level of 1% is appropriate given that the new regulatory accounting system should not lead to significantly different results to ASPIRE."[226]

[225] We note in this regard that while our proposal in paragraph 8.23 of the 2013 Consultation provided that the systems reconciliation report should be delivered to us by 31 December 2014, draft SMP condition 23(iii) referred to 31 January in error.
[226] Verizon, 2013 Consultation response, page 10, paragraph 57.

6.41 BT and TTG disagreed that a 1% materiality level is appropriate.

6.42 BT argued that the "materiality gauge of 1% (presumably applied to any number) is wholly disproportionate and unnecessary."[227] BT explained that the size of some markets and services is so small that a rounding would trigger this requirement. BT argued that a report on this basis would be excessive and of little use to stakeholders. BT questioned why a lower materiality level should apply to a systems change than for other purposes.

6.43 TTG also said that the level of materiality was too low, stating that "the practical effect of this could be to swamp Ofcom in change reports, as the 1% limit appears to apply to any number in the published RFS."[228] TTG suggested a variation of the current 5% change control materiality limit by amending it to the lower of 3% or £1m.

6.44 In relation to the proposal to provide assurance reports, TTG argued that "Ofcom should publish the audit assurance reports for the transition to the new system, showing that the information has been properly extracted and that there were no material reconciliation issues. This would help give CPs confidence that BT was not using this transition to game the situation."[229] TTG also recommended that "Ofcom insist on a truly independent (i.e. not BT's regulatory auditors or any other firm with an on-going commercial relationship with BT) review of the actual process of transition and the differences between the two systems."[230]

6.45 BT said that they do not understand the purpose of the proposal requiring an additional assurance statement confirming that the explanations given by BT in the systems reconciliation report are a reasonable representation of the underlying cause. BT explained that "the underlying system exists only for the purposes of producing regulatory information and, where used in the RFS, this is already audited. A report as proposed would be of no value to Ofcom or any other stakeholders."[231]

6.46 In relation to the proposal to require BT to prepare the 2014/15 Regulatory Financial Statements on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE, Verizon said that it agrees with "Ofcom's safeguard proposal." [232] Verizon said that it considered it to be "very important in order to protect against any unexpected cost increases purely resulting from the introduction of a replacement regulatory accounting system." [233]

6.47 BT however, argued that "this proposal is wholly disproportionate. The cost to BT would be substantial and involve a significant amount of time and resource. It would be entirely unnecessary given the requirements already in place over the production of the 2014-15 RFS".[234]

Ofcom's response and decision

6.48 In respect of the systems reconciliation report, we have, in the light of stakeholder comments, re-considered our proposals set out in the 2013 Consultation. In

[227] BT, 2013 Consultation response, page 30, Paragraph 132.
[228] TTG, 2013 Consultation response, page 30, paragraph 8.22.
[229] TTG, 2013 Consultation response, page 26, paragraph 8.7.
[230] TTG, 2013 Consultation response, page 31, paragraph 8.24.
[231] BT, 2013 Consultation response, page 30, paragraph 133.
[232] Verizon, 2013 Consultation response, page 10, paragraph 58.
[233] Verizon, 2013 Consultation response, page 10, paragraph 58.
[234] BT 2013 Consultation response, page 30, paragraph 134.

particular, we have re-considered the differences for which we should require BT to provide an explanation, the purpose of the materiality threshold and the circumstances where we should require BT to provide a further assurance statement.

6.49 We note the overall support for our proposal to require BT to produce a systems reconciliation report. We have decided that BT must produce a systems reconciliation report by 31 December 2014. This systems reconciliation report must set out any differences between the outputs of the new regulatory accounting system and ASPIRE in relation to the 2013/14 Regulatory Financial Statements. The systems reconciliation report will need to set out the percentage difference between each number shown in the 2013/14 Regulatory Financial Statements (prepared under ASPIRE) and what those same numbers would be if prepared using the new system.

6.50 We proposed in the 2013 Consultation that BT should also provide explanations for each of the differences in the reconciliation report. BT pointed out in its consultation response that relatively small rounding differences could result in BT being required to provide an explanation given that some markets are relatively small and some figures in the Regulatory Financial Statements are reported on a unit basis to the nearest penny. We consider that BT has raised a valid point. While the systems reconciliation report will show all differences between the Regulatory Financial Reporting outputs in 2013/14 under ASPIRE and REFINE, it would not be proportionate to require BT to provide an explanation for very small differences which may be caused by rounding effects. However, we consider that BT should provide explanations for material differences.

6.51 We have decided that it is appropriate to require BT to provide explanations for the differences in the systems reconciliation report. We consider that a materiality level of 1% or £1m is reasonable. We have taken account of BT's concern that the size of some markets and services is so small that a rounding would trigger this requirement. To prevent this we have therefore introduced a de minimis level of £1m. We consider that a lower materiality level should apply to a systems change than for other purposes because the replacement of ASPIRE by REFINE should not in itself lead to changes in the numbers being reported in the Regulatory Financial Statements. We do not agree with TTG that we will receive an excessive number of change reports as there is no requirement for BT to provide us with individual reports, just a single systems reconciliation report. We consider that our materiality level strikes a balance between ensuring that BT provides an explanation for differences that are larger than anticipated from the introduction of a new regulatory reporting system, while ensuring that BT does not need to provide explanations for immaterial differences that may be due to rounding issues.

6.52 We will issue separately a direction which sets out how materiality of differences should be measured. However, we have considered stakeholders' concerns in relation to materiality and expect that for any number reported in the Regulatory Financial Statements that is rounded to £millions, BT must explain any differences in the systems reconciliation report that are greater than 1% or £1m, whichever is the highest. For any other number reported in the Regulatory Financial Statements (e.g. unit volumes or unit cost figures) BT must explain any differences in the systems reconciliation report that are greater than 1%.

6.53 We have considered further whether BT should publish the systems reconciliation report. We have decided that BT should publish the systems reconciliation report, in order to increase transparency and enable stakeholders to see that the migration to the new system has not resulted in material changes. Further, we believe that the migration to a new regulatory accounting system is of such importance to the users of the Regulatory Financial Statements, that we believe it is right for the report to be published so that all such users can see the results of the migration to the new system.

6.54 In the 2013 Consultation we did not discuss a proposed publication date for this report. As we have concluded that publication will be required, we have decided that the report should be published at the same time as it is provided to us i.e. by 31 December 2014. This imposes the same requirement as for the change notification process (set out in Section 3) where BT must publish this notification at the same time as it submits it to Ofcom.

6.55 In the 2013 Consultation, we proposed that BT must obtain an assurance statement by an independent third party confirming that the numbers used in the systems reconciliation report have been properly extracted from ASPIRE and the new regulatory accounting system, and that the explanations given by BT for any differences are a reasonable representation of the underlying cause*.* We have reconsidered this requirement. We note BT's view that this requirement adds no value as the regulatory information used in the Regulatory Financial Statements is already subject to audit. In our view, the proposal for an assurance statement confirming that the explanations given by BT for any differences are a reasonable representation of the underlying cause went beyond that provided by the existing regulatory audit because the regulatory audit would not specifically cover in detail changes to the regulatory accounting systems.

6.56 We continue to believe the requirement to obtain an assurance statement which considers the explanation provided by BT for the differences between the output of the old and the new regulatory accounting system will provide assurance to us that these explanations have been scrutinised and verified by an independent third party. As such it provides assurance for an issue of considerable importance about which Ofcom might require BT to prepare its 2014/15 Regulatory Financial Statements on a basis consistent with that for ASPIRE.

6.57 However, we have reconsidered the scope of this assurance statement, and believe that the assurance should relate to the accuracy of BT's calculations of differences and explanations as to the underlying causes of material differences, rather than a confirmation as to whether these explanations are reasonable or not. It is more appropriate for Ofcom, as the regulator, to determine whether the reasons for any differences between different regulatory reporting systems are reasonable or not. Therefore, we have decided that any assurance statement should show whether the explanations given are accurate, following which we will consider whether those explanations are reasonable. In addition to obtaining an assurance statement in relation to the accuracy of descriptions of differences BT must obtain an assurance statement reporting whether the figures in the systems reconciliation report have been properly extracted from the old and the new system, and whether differences in the systems reconciliation report have been correctly calculated.

6.58 This assurance statement must be provided to Ofcom at the same time as the systems reconciliation report. The assurance will, as already explained in Section 5, be in the form of Agreed Upon Procedures. Although we indicated in the 2013 Consultation that we may require the assurance statement to be published, we note that we do not consider this necessary. Furthermore Agreed Upon Procedures are a private matter between the parties in the Tripartite Agreement namely BT, Ofcom and the regulatory auditor. As such the auditor cannot publish its opinions relating to Agreed Upon Procedures.

6.59 Whilst this assurance statement will not be published, we will bring to stakeholders' attention any issues of concern, should they be identified, about the preparation of the systems reconciliation report.

6.60 We do not agree with TTG that the assurance statement should be provided by an auditor that is unconnected with BT. We do not consider that an assurance statement from an unconnected auditor would carry any greater weight than the same statement from the current regulatory auditor (who is likely to have a greater knowledge of BT's existing regulatory reporting systems).

6.61 In respect of the preparation of the 2014/15 Regulatory Financial Statements, we proposed that where the systems reconciliation report indicates that any number published in the 2013/14 Regulatory Financial Statements under ASPIRE would be more than 1% different using the new system, BT must, where we require it to do so, prepare the 2014/15 Regulatory Financial Statements on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE.

6.62 We said that we were more likely to require BT to do this where there were a number of significant differences between the new system and ASPIRE or where we consider BT has not sufficiently explained those differences. While Verizon agreed with this safeguard proposal, BT thought it was disproportionate and would be expensive for BT to implement.

6.63 We accept that requiring the 2014/15 Regulatory Financial Statements to be prepared on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE might impose significant burdens on BT. We made this proposal having carefully considered the implications of BT publishing 2014/15 Regulatory Financial Statements on a REFINE basis should significant differences be found which BT is unable, or unwilling to correct.

6.64 While BT is confident that the transition to its new regulatory accounting system will not lead to significant differences, there remains the possibility that differences could arise. Where such differences are significant, and BT is not able to justify those differences or is unwilling or unable to correct them within a reasonable time period, we continue to believe it is appropriate to ensure that we have the ability to require BT to report the 2014/15 Regulatory Financial Statements on a basis consistent with that from ASPIRE.

6.65 Where the systems reconciliation report reveals significant differences (either individually or in aggregate) we would first seek to understand the reason for these differences. Our intention would be to enter into a dialogue with BT with the aim of resolving identified differences. We would publish BT's responses to our questions in order to ensure that stakeholders understand the cause of Ofcom's concern and the work being undertaken to rectify any differences. Publication would be necessary to ensure that stakeholders have confidence in a system that will be central to Regulatory Financial Reporting for what is likely to be many years.

6.66 Should we reach the view that BT is unable to justify the material differences, or be unable or unwilling to correct them within a suitable period of time, we would direct BT to publish the 2014/15 Regulatory Financial Statements on a basis consistent with that from ASPIRE. We note that we proposed in the 2013 Consultation that we would notify BT of the requirement to do this if we considered this course of action necessary and appropriate. However, we conclude that it would be appropriate to exercise our right to impose this requirement through a direction normally following consultation.

6.67 We consider that our ability to require this course of action is justified and proportionate given the central role that BT's regulatory accounting system has in its Regulatory Financial Reporting. We expect to use the right to require BT to prepare the 2014/15 Regulatory Financial Statements on a basis consistent with ASPIRE only in circumstances where the results produced by the new system would fundamentally undermine our and stakeholders' confidence in the Regulatory Financial Statements. In such circumstances, Ofcom must have the ability to rectify such issues to preserve confidence in the Regulatory Financial Statements.

Summary of our decisions and legal tests

6.68 In summary, we have decided after considering comments made by stakeholders, to amend the regulatory reporting obligations on BT so that:

- Where BT develops or replaces any of its regulatory accounting systems, it must keep us informed about its progress against milestones at the design, build, test and implementation stages of development. The frequency and content of these progress updates will be agreed between BT and us on a case by case basis.
- BT must ensure to the best of its ability that the financial data produced by the new regulatory accounting system is the same as that produced by ASPIRE.
- BT must produce and provide to us a report that:
    - o sets out all differences between the outputs of the new regulatory accounting system and the old regulatory accounting system.
    - o for any number reported in the Regulatory Financial Statements that is rounded to £millions, explain any differences in the systems reconciliation report that are greater than 1% or £1m, whichever is the highest.
    - o for any other number reported in the Regulatory Financial Statements (e.g. unit volumes or unit cost figures) explain any differences in the systems reconciliation report that are greater than 1%.
- This report is required to be submitted to us by 31December 2014 and published at the same time as it is delivered to us.
- The reconciliation report must be accompanied by an independent third party assurance statement in the form of the Agreed Upon Procedures confirming that:

i) the results of the old regulatory accounting system (ASPIRE) and the new system (REFINE) have been properly extracted;

ii) the differences have been correctly calculated; and

iii) the explanations given by BT for the material differences are an accurate representation of the cause of the difference.

6.69 In the event that the systems reconciliation report reveals that the new regulatory accounting system produces results that are significantly different, either individually or in aggregate, from the old regulatory accounting system, BT must, where we require it to do so, prepare the Regulatory Financial Statements on a basis consistent with the old regulatory accounting system.

6.70 We will implement these decisions in the SMP conditions.

6.71 We have considered our decisions to manage the transition to a new BT system against the tests set out in S.47(2) of the Act and have concluded that they are:

- Objectively justifiable because the requirements imposed on BT will ensure that we remain engaged with BT’s plans for a new system and that stakeholders and Ofcom understand any differences resulting from the transition.

- Not unduly discriminatory because KCOM is the only other SMP provider which has regulatory accounting obligations, but we have not at present established the need for such regulation.

- Proportionate because the changes are no more than is required to ensure that Ofcom remains engaged with BT’s plans for a new system and that stakeholders and Ofcom understand any differences resulting from the transition.

- Transparent because it is clear that the intention of our proposed changes is to ensure that Ofcom remains engaged with BT’s plans for a new system and that stakeholders and Ofcom understand any differences resulting from the transition.

Section 7

Implementing the new framework

Summary

7.1 In the 2013 Consultation, we explained that implementing our proposals fully would take time. We explained that this was for a number of reasons, including the need for BT to amend its processes, the need for Ofcom to consult further on the detail of some of the measures, and the need for Ofcom to apply these changes to market reviews as and when they happen.

7.2 In the previous sections, we set out our decisions in relation to the changes we proposed in the 2013 Consultation, and we have, in those sections, set out how and when our decisions will be implemented. However, for the sake of clarity, this section pulls that information together. We also address how our decisions will be applied to different markets in which BT has SMP and regulatory reporting remedies have been implemented.

Stakeholder comments

7.3 In the 2013 Consultation we set out an indicative timeline for the implementation of changes and asked stakeholders whether it provided a suitable basis for the implementation of changes.

7.4 BT explained that subject to the requirement relating to the publication of a reconciliation report for the 2013/14 Regulatory Financial Statements it agreed with the proposals for implementation in relation to the 2014/15 Regulatory Financial Statements. BT pointed out that "many of the changes are substantial and will require some months to implement."[235]

7.5 Vodafone said that it welcomed "the new proposed timeline and believe that the sooner the new regime is implemented the better."[236] Verizon said that it was concerned that it would take until 2016/17 to complete implementation. Verizon argued that it is "hard to see why the guidelines cannot be in place within the 2015/16 period and as a result the total project completed by end March 2016."[237] Verizon explained that its concern was about whether there was anything of significance which made this timeline necessary that should be brought to the attention of stakeholders.

7.6 Virgin Media considered that the proposed timetable was suitable in the context of the identified market reviews. It stressed the importance of BT's voluntary cooperation for implementation and the need for Ofcom to look to "other ways of transitioning to a single reporting system" without BT's cooperation.[238]

7.7 TTG argued that "it is imperative that the harm to consumer, CPs, and the regulatory process caused by the inadequate RFS and BT's gaming of the regulatory system is

[235] BT, 2013 Consultation response, page 31, paragraph 137.
[236] Vodafone, 2013 Consultation response, page 12, question 9.1.
[237] Verizon, 2013 Consultation response, page 11, paragraph 63.
[238] Virgin Media, 2013 Consultation response, page 4, question 9.1.

stemmed as quickly as possible."[239] TTG said that Ofcom should ensure that the new arrangements including the review of existing cost allocations should be in place "sufficiently soon that they can be used in the regulatory review of LLU and other prices which is due to be concluded in March 2017."[240] TTG observed that "prices will not reflect Ofcom's views of costs until 2019." [241] TTG argued that "there can be no excuse that BT does not have sufficient time to make an orderly transition to a new approach." [242]

7.8 TTG went on to set out its concerns in the context of the forthcoming 2013/14 Regulatory Financial Statements, 2014/15 Regulatory Financial Statements, and for the Regulatory Accounting Guidelines. TTG argued that the "need for a timetable showing the transition to the new documentation and regulatory reporting framework should be seen as a high priority by Ofcom to ensure that there is an effective transition to the new regulatory reporting framework."[243]

7.9 We note the overall support that stakeholders have given to the implementation timeline that we set out in the 2013 Consultation. The majority of comments made and questions raised by stakeholders including TTG and BT about implementation have been dealt with in previous sections. We address any remaining comments and questions here.

Implementation of our decisions

7.10 This statement is published alongside our decisions in the Fixed Access and WBA Market Reviews. The new SMP conditions which implement our decisions in relation to regulatory reporting have been notified with those market reviews to the Commission on 20 May 2014 and will be adopted, subject to comments from the Commission. The legal instruments which implement the new SMP requirements are included in the relevant market reviews, but for the sake of clarity, we include a pro forma of the conditions at Annex 2.

7.11 With two exceptions, our decisions implemented in the SMP conditions will take effect from 1 August 2014, for the financial year 2014/15 to be reported in July 2015. The first exception concerns the requirement for the Regulatory Financial Statements to be signed by a Director for and on behalf of BT's Board of Directors. The second exception concerns the requirement for BT to publish a reconciliation report. Those requirements will take effect on 1 July 2014, after publication of Ofcom's final decisions and subject to comments from the Commission for the financial year 2013/14 to be reported in July 2015.

7.12 In addition, certain decisions will be implemented by way of directions. We expect to publish these directions towards the end of the summer, and that these directions will come into effect immediately for the financial year 2014/15 to be reported in July 2015. Where we have not already done so as part of the 2013 Consultation or otherwise (e.g. as part of the Fixed Access market review or WBA market review), we may also consult on required directions in the early part of the summer.

7.13 Those directions concern, in particular:

[239] TTG, 2013 Consultation response, page 25, paragraph 8.1.
[240] TTG, 2013 Consultation response, page 25, paragraph 8.2.
[241] TTG, 2013 Consultation response, page 25, paragraph 8.2.
[242] TTG, 2013 Consultation response, page 25, paragraph 8.2.
[243] TTG, 2013 Consultation response, page 27, paragraph 8.12.

- a direction setting out Regulatory Accounting Principles;
- a direction setting out transparency requirements;
- a direction setting out the form of the FPIA opinion;
- a direction setting out the form of the PPIA opinion;
- a direction setting out certain requirements in relation to consistency with regulatory decisions and the RAV; and
- a direction setting out the form and content of the reconciliation report and accompanying audit opinion.

7.14 In addition, we note that, in the 2013 Consultation, we proposed that certain directions given under the conditions set out in the statement "The regulatory financial reporting obligations on BT and Kingston Communications – Final Statement and notification – Accounting Separation and cost accounting: final statement and notification" of 22 July 2004 and in the statement "Review of the wholesale local access market – Identification and analysis of markets, determination of market power and setting of SMP conditions – Explanatory statement and notification" of 16 December 2004, would continue to have force as if they were given under the proposed new SMP conditions. However, we have decided that for reasons of clarity, those directions (with the amendments proposed in the 2013 Consultation) should be issued afresh under the new conditions. They will therefore be included with the other directions to be published towards the end of the summer.

Implementation in markets considered as part of the Business Connectivity Market Review and the Narrowband Market Review

7.15 We proposed in the 2013 Consultation that we would formally implement these changes to those markets considered in the Wholesale Broadband Access markets[244] and Fixed Access markets.[245] Our draft decisions in relation to these markets have been published today.

7.16 To preserve the integrity and consistency of BT's Regulatory Financial Reporting, we consider that the changes we are proposing should be implemented across all regulated markets (including for example, reporting of markets considered as part of the Narrowband market review and the Business Connectivity market review. We consider that there are significant advantages to BT and other stakeholders of BT applying one set of accounting rules across all markets.

7.17 We will therefore work with BT to ensure that, as far as possible, the decisions set out in this document can be applied on a consistent basis to all markets. This may take the form of an agreement by BT to do so on a voluntary basis.

[244] Wholesale broadband access in Market A.

[245] The supply of copper loop-based, cable-based and fibre-based wholesale local access at a fixed location in the United Kingdom excluding the Hull Area; Wholesale fixed analogue exchange line services in the United Kingdom excluding the Hull Area; Wholesale ISDN2 exchange line services in the United Kingdom excluding the Hull Area; and Wholesale ISDN30 exchange line services in the United Kingdom excluding the Hull Area.

7.18 It would not be practicable for BT to enter into such arrangements before the details of our decisions are known to them. However, we have discussed, at a high level and in general terms, some of the practical issues around the implementation of our decisions across all markets with BT.

7.19 At this high level and without knowing the specifics of our decision on reporting, BT is broadly supportive of the principle of applying a consistent approach across all markets.

Implementation timeline

7.20 We set out below a summary of the timing of implementation of our decisions below.

The Regulatory Accounting Principles.

7.21 We have set out above that BT will be required, by virtue of the new SMP conditions, to comply with the Regulatory Accounting Principles. Those Regulatory Accounting Principles will be directed by Ofcom. The Regulatory Accounting Principles will come into force immediately upon their adoption. The 2014/15 Regulatory Financial Statements will be the first to be published consistent with the new Regulatory Accounting Principles.

The Regulatory Accounting Guidelines

7.22 BT will also be required, by virtue of the new SMP conditions, to comply with the Regulatory Accounting Guidelines. In the 2013 Consultation, we explained that BT would no longer be required to publish a Primary Accounting Document with effect from the 2014/15 financial year. Instead BT would be required to comply with the Regulatory Accounting Guidelines. However, as set out above, we have now decided not to introduce Regulatory Accounting Guidelines until we have completed our review of BT's existing cost allocations alongside our BCMR and LLCC work. Such review will input into the Regulatory Accounting Guidelines. The 2016/17 Regulatory Financial Statements will now be the first to be published consistent with Regulatory Accounting Guidelines.

7.23 Nevertheless, we acknowledge that until then, BT will require further guidance on a number of points which will be included in the Regulatory Accounting Guidelines. These include, in particular, guidance around the concept of "materiality" for the purpose of change control and error notification, guidance around the requirement that Regulatory Financial Reporting must be consistent with Ofcom's regulatory decisions (and in particular, any requirements flowing from the Fixed Access and WBA market reviews in this respect), and guidance around the preparation of the Regulatory Financial Statements on a RAV basis. We will therefore issue a direction with Regulatory Accounting Guidelines around those subjects. As highlighted above, we expect to publish that direction towards the end of the summer.

7.24 In addition, the Regulatory Accounting Guidelines will be updated from time to time, in particular to ensure that they remain aligned with our decisions made in for example market reviews and charge controls. We will normally consult on such changes when consulting on the substance of the relevant regulatory decision, and update the Regulatory Accounting Guidelines alongside our decisions. We have also set out above that in preparing regulatory financial statements, BT will be required to comply with the Regulatory Accounting Guidelines in force in October of the previous year (so, for the 2016/17 Regulatory Financial Statements, BT will be required to ensure it complies with the Regulatory Accounting Guidelines in force in October 2016).

7.25 Our intention is that the Regulatory Accounting Guidelines will cover all of the areas covered currently by the Primary Accounting Documents. It is our aim to complete the review of all such areas as soon as practicable.

Change control and error notification

7.26 As set out above, the change control and error notification process will come into effect (subject to comments from the EU Commission), on 1 August 2014. The first changes will therefore be formally notified to Ofcom by 31 March 2015.

7.27 BT will be required to produce the reconciliation report for the financial year 2013/14 (in relation to any changes made by BT, but not formally notified under the change control process given that the 2014/15 Regulatory Financial Statements will be the first to be subject to change control). As set out in Section 3: Basis of Preparation, we agree that for the financial year 2013/14 the reconciliation report should be produced by 30 September 2014. In subsequent years, the reconciliation report will need to be published with the Regulatory Financial Statements on 31 July.

7.28 From 2014/15, BT's regulatory auditors must provide audit the reconciliation report.

Changes to BT's reporting requirements

7.29 We have set out above that we will set out further proposals in relation to reporting BT's financial performance later this year. We envisage consulting on a direction setting out such requirements shortly after publishing our final decisions in the Fixed Access and WBA market reviews and adopting such direction alongside the other directions referred to above.

7.30 Our decisions in relation to reporting of EOI components, the publication of non-confidential compliance statements, basket reporting and the Network Services Reconciliation statement will be implemented by way of direction to be published at the end of the summer. The 2014/15 Regulatory Financial Statements will therefore be the first to include the new reports.

7.31 The amendments to the transparency requirements and the audit requirements will also be implemented by way of direction to be published at the end of the summer. Therefore, the Accounting Methodology Documents to be published in July 2015 will need to meet the new transparency requirement. We will work with BT to ensure that Accounting Methodology Documents are transparent and user friendly and assess how well the 2015 Accounting Methodology Documents meet the needs of stakeholders. If necessary we will consider what further action may be required to further improve the Accounting Methodology Documents in future years. We also note that such Accounting Methodology Documents will need to be consistent with any guidance provided in the Regulatory Accounting Guidelines and before that, with any direction setting out requirements in relation to consistency with regulatory decisions and RAV.

Transition to a new regulatory accounting system

7.32 BT's current timetable for changing its regulatory accounting system envisages that the 2013/14 Regulatory Financial Statements will be the last produced using ASPIRE, with the 2014/15 Regulatory Financial Statements to be produced using

REFINE. In the intervening period, we will require a systems reconciliation report to be submitted and published by 31 December 2014. Agreed Upon Procedures will be performed on the reconciliation and submitted to us by the same date.

Changes to BT's audit and control requirements

7.33 As set out above, the requirement for the Regulatory Financial Statements to be signed by a Director for and on behalf of BT's Board of Directors will come into force on 1 July, after publication of our final decisions in the Fixed Access and WBA market reviews (and subject to comments from the Commission). The 2013/14 Regulatory Financial Statements will therefore be signed by a BT Director on behalf of the Board.

Simplification of conditions

7.34 In the 2013 Consultation we proposed changes whose aim was to simplify the SMP services conditions in order to bring greater transparency and increased understanding of the obligations that are imposed on BT. We set out the intent of our proposed changes and included proposed modifications within the draft conditions.

7.35 We received no responses to our proposals for simplification and have included the changes that we proposed within our decisions as set out in the SMP conditions in Annex 2.

Summary

7.36 A summary of our decisions about the timing of the implementation of our decisions by financial year is set out in table 2.

Table 2: Timeline for implementing key changes to the reporting framework

When:	Key deliverables:
2013/14 – The year to March 2014; Regulatory Financial Statement published July 2014	• Regulatory Financial Statements signed off by a Director for and on behalf of BT's Board. • Regulatory Financial Statements published in line with current arrangements e.g. CCA basis. • Final year ASPIRE is used to prepare the Regulatory Financial Statement. • Reconciliation reports for material changes and material errors to be produced and published by 30 September 2014.
2014/15 – The year to March 2015; Regulatory Financial Statement published July 2015	• Regulatory Financial Reporting in line with new Regulatory Accounting Principles. • Regulatory Financial Reporting in line with direction setting out certain requirements in relation to consistency with regulatory decisions and the RAV • Regulatory Financial Statements prepared on a RAV basis. • BT notifies Ofcom and publishes any proposed changes to allocation methodology by 31 March 2015. • BT publishes any material errors that it has decided to correct in the reconciliation report. • Reconciliation report to be produced and published alongside Regulatory Financial Statement by 31 July annually. • BT's new regulatory accounting system used to prepare the Regulatory Financial Statements. • BT must provide to Ofcom and publish a systems reconciliation report between new system outputs and ASPIRE by 31 December 2014. Assurance statement in relation to the systems reconciliation report to be provided to Ofcom by the same date. • BT must publish Compliance Statements at the same time as non-confidential compliance statements are provided to Ofcom. • BT publishes transparent Accounting Methodology Documents
2015/16 – The year to March 2016; Regulatory Financial Statement published July 2016	• As above (no systems reconciliation report required)
2016/17 – The year to March 2017; Regulatory Financial Statement published July 2017	• Ofcom publishes Regulatory Accounting Guidelines and updates them to reflect Network Charge Control decisions. • BT updates its Accounting Methodology Documents in line with Ofcom's Regulatory Accounting Guidelines.

Annex 1

Glossary

A1.1 **Accounting Methodology Documents.** Comprise the Primary Accounting Documents (to the extend they have not been replaced by the Regulatory Accounting Guidelines and the current Secondary Accounting Documents.

A1.2 **Additional Financial Statements (AFS)** and **Additional Financial Information (AFI):** Consist of additional financial reporting by BT to Ofcom on a confidential basis.

A1.3 **ASPIRE:** BT's Accounting Separation System used to produce fully allocated costs (FAC) according to the Regulatory Financial Reporting structure of markets, services, products and components.

A1.4 **CAT**: Competition Appeal Tribunal

A1.5 **CC:** Competition Commission

A1.6 **CFI:** Call for Inputs

A1.7 **Charge control:** A control which sets the maximum price that a communication provider can charge for a particular product or service. Most charge controls are imposed for a defined period.

A1.8 **Common costs:** Costs which are shared by all the services supplied by a firm.

A1.9 **Communications Act or "the Act":** Communications Act 2003

A1.10 **Cost orientation:** The principle that the price charged for the provision of a service should reflect the underlying costs incurred in providing that service.

A1.11 **CP**: Communications provider.

A1.12 **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.

A1.13 **DLRIC:** Distributed long run incremental cost. A cost measure that is equal to the LRIC of a service plus a share of the common costs.

A1.14 **DSAC:** Distributed standalone cost. An accounting approach estimated by adding to the DLRIC a proportionate share of the inter-increment common costs. Rather than all common costs shared by a service being allocated to the service under consideration, the common costs are instead allocated amongst all the services that share the network increment.

A1.15 **Data File (Flat File):** BT Regulatory Financial Reporting information provided annually on a confidential basis to Ofcom.

A1.16 **Data Extraction Tool (DET):** The DET is an Ofcom tool that allows Ofcom to access financial reporting information provided in confidence by BT in the form of the Flat File.

A1.17 **Equivalence of Input (EOI):** The concept established by the undertakings in which BT provides, in respect of a particular product or service, the same product or service to all CPs (including BT) on the same timescales, terms and conditions (including price and service levels) by means of the same systems and processes, and includes the provision to all CPs (including BT) of the same commercial information about such products, services, systems and processes.

A1.18 **Fully Allocated Cost (FAC):** An accounting approach under which all the costs of the company are distributed between its various products and services. The fully allocated cost of a product or service may therefore include some common costs that are not directly attributable to the service.

A1.19 **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.

A1.20 **KCOM**: KCOM Group PLC, formerly Kingston Communications

A1.21 **Long Run Incremental Cost (LRIC):** A measure of the change in total costs of the firm that arises from a discrete increment in output in the long run.

A1.22 **LLU:** Local Loop unbundling allows CPs to physically control (or share control) of BT's existing copper lines between the local exchanges and the customer premises.

A1.23 **Market summary statements:** For example, see 2011 RFS, "Market summary" at the top of page 37, Section 7.3, comprising two rows of data for 2011 and 2010. However, by market summary statement, we exclude "Note1: Comparison of average internal and external charges with each other and with FAC", provided below the summary on the same page (this sets out the reporting at a service level including unit costs etc.)

A1.24 **Openreach:** A BT group business offering communications providers products and services that are linked to BT's nationwide local access network.

A1.25 **Primary Accounting Documents:** Currently sets out the Regulatory Accounting Principles, the attribution methods, the transfer charge system methodology, accounting polices (including the principles of calculation of fixed assets) and the LRIC methodology.

A1.26 **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.

A1.27 **Regulatory Accounting Guidelines (RAG):** A complete set of guidelines for the preparation of BT's regulatory accounts.

A1.28 **Regulatory Accounting Principles (RAP):** The RAP are a set of guiding principles with which BT's Regulatory Financial Reporting must comply

A1.29 **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).

A1.30 **Regulatory Financial Reporting:** refers to the whole of the regulatory reporting methodology, systems and legal framework, as well as the Regulatory Financial Statements. The scope of this review therefore includes regulatory financial reporting and the principles and methodologies under which the accounts are prepared.

A1.31 **Regulatory Financial Statements:** 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 us confidentially.

A1.32 **Secondary Accounting Documents:** Comprises four main elements: the Detailed Attribution Methods (DAM), the Detailed Valuation Methodology (DVM), and the LRIC Relationships and Parameters (LRIC R&P).

A1.33 **SMP:** Significant Market Power. SMP is determined by a market review which is conducted under the relevant provisions of the Communications Act 2003

A1.34 **SMP conditions**: Regulatory conditions imposed on a specific CP that has been found to have significant market power in a market review conducted by Ofcom.

A1.35 **Transparency Direction**: The Transparency Direction (Direction 2) imposes a transparency principle on BT in relation to the accounting documentation.

A1.36 **WLA:** Wholesale local access

A1.37 **WLR:** Wholesale line rental. Used by CPs (including BT) to provide narrowband telephony (but not broadband) using BT’s network

Annex 2

SMP Conditions

Part 1: Definitions and Interpretation of these conditions

1. For the purpose of interpreting these conditions the following definitions shall apply:

   ‘Accounting Methodology Documents’ means the documentation maintained by BT setting out in detail the rules, policies, methods, allocations, calculations, assumptions, procedures and Processes used by BT for the purpose of preparing Regulatory Financial Statements in accordance with the Regulatory Accounting Guidelines and the Regulatory Accounting Principles;

   ‘Accounting Policies’ means the manner in which BT applies the requirements of Regulatory Accounting Guidelines and the Regulatory Accounting Principles in each of the Regulatory Financial Statements;

   ‘Alternative Regulatory Auditor’ means any auditor not for the time being appointed as BT’s Regulatory Auditor;

   ‘Agreed Upon Procedures’ means an engagement carried out in accordance with international standard (ISRS 4400) under which the Regulatory Auditor or another independent third party performs a set of audit procedures agreed by Ofcom and based on Ofcom’s specific requirements in relation to the Regulatory Financial Statements, and reports the findings of that work to Ofcom;

   'Attribution Methods’ means the practices used by BT to attribute revenue (including appropriate Transfer Charges), costs (including appropriate Transfer Charges), assets and liabilities to activities or, insofar as those activities have been aggregated into Wholesale Segments or Retail Segments in a given Market or Technical Area (as applicable), to each Wholesale Segment or Retail Segment;

   ‘BT’ means British Telecommunications plc, whose registered company number is 1800000, and any British Telecommunications plc subsidiary or holding company, or any subsidiary of that holding company, all as defined by Section 1159 of the Companies Act 2006;

   ‘Current Year Figures’ means, in relation to any set of Regulatory Financial Statements, the amounts relating to the Financial Year to which the statements relate;

   ‘External Wholesale Services’ means services supplied or offered to any Communications Provider other than BT;

   ‘Financial Year’ means a financial year of BT in respect of which the Statutory Financial Statements are required to be (or to have been) prepared and audited in accordance with the requirements of the Companies Act 2006;

   ‘ICAEW Guidance’ means the technical release titled “Reporting to Regulators of Regulated Entities: Audit 05/03” issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales in October 2003;

   ‘Internal Wholesale Services’ means services supplied within BT;

‘Long Run Incremental Cost Methodology’ means the long run incremental cost principles, procedures and Processes which form the framework under which long run incremental costs are determined by BT;

‘Market’ means the market to which these conditions apply;

‘Material Error’ means a deviation from accuracy or correctness which meets the materiality threshold as directed by Ofcom from time to time for the purpose of these conditions;

‘Material Difference’ means a difference identified in a systems reconciliation report which meets the materiality threshold as directed by Ofcom from time to time for the purpose of these conditions;

‘Network Component’ means an element of the network that is used to provide Wholesale Services, and, to the extent the network components are used in the Market or Technical Area (as applicable), specified in a direction given by Ofcom from time to time for the purposes of these conditions;

‘Network Services’ means those groups of Network Components used directly (or which in the absence of horizontal or vertical integration would be used directly) in the course of supplying Wholesale Services;

‘Prior Year Comparatives’ means, in relation to any set of Regulatory Financial Statements, the amounts relating to the Financial Year immediately preceding the Financial Year to which the Regulatory Financial Statements relate, re-evaluated if necessary to ensure that such figures are comparable to the Current Year Figures;

‘Process’ means the series of inter-related activities or actions to obtain, record or hold data or information or to carry out any operation or set of operations on the data or information, including:

i. organisation, storage, adaptation, or alteration of the data or information;

ii. retrieval, consultation, computation or use of the data or information;

iii. disclosure of the data or information by transmission, dissemination, or otherwise making available; or

iv. alignment, combination, blocking, erasing or destruction of the data or information;

‘Product’ means any product or service comprised in a Market or Technical Area to which these conditions apply;

‘Regulatory Accounting Guidelines’ means documentation setting out the policies, methodologies, systems, Processes and procedures for deriving or calculating costs, revenues, assets and liabilities as directed by Ofcom from time to time for the purpose of these conditions;

‘Regulatory Accounting Methodology’ means the rules, policies, methods, allocations, calculations, assumptions and procedures used by BT for the purpose of preparing Regulatory Financial Statements.

‘Regulatory Accounting Principles’ means the principles as directed by Ofcom from time to time for the purpose of these conditions;

‘Regulatory Accounting System’ means the set of computerised and manual accounting methods, procedures, Processes and controls established to determine and attribute the costs, revenues, assets and liabilities and summarise, interpret, and present the resultant financial data in an accurate and timely manner;

‘Regulatory Auditor’ means the auditor for the time being appointed by BT in accordance with these conditions;

‘Regulatory Financial Statement’ means any financial statement in respect of a Financial Year prepared or required to be prepared by BT in accordance with these conditions;

‘Retail Activities’ means any activity or activities wholly and exclusively carried out (or which in the absence of horizontal or vertical integration would wholly and exclusively be carried out) in the course of supplying Retail Products and any activity or activities wholly and exclusively carried out in the course of such activity or activities, excluding any activity or activities which are Wholesale Services;

‘Retail Products’ means services used by or offered to any End Users (including BT);

‘Retail Segments’ means groups of Retail Products;

‘Retail Support Activities’ means any activity or activities carried out directly or indirectly (or which in the absence of horizontal or vertical integration would be carried out directly or indirectly) in the course of supplying Retail Products and any activity or activities directly or indirectly carried out in the course of such activity or activities, excluding any activity or activities which are Retail Activities or Wholesale Services;

‘Statutory Accounting Standards’ means the accounting standards, including the requirements of the Companies Act 2006, by reference to which BT are required to prepare the Statutory Financial Statements;

‘Statutory Auditor’ means the auditor for the time being appointed by BT in accordance with the requirements of the Companies Act 2006;

‘Statutory Financial Statements’ means any annual account required to be prepared by BT in accordance with the requirements of the Companies Act 2006;

‘Technical Area’ means the technical area to which these conditions apply;

‘Transfer Charge’ means the charge or price that is applied, or deemed to be applied, within BT by one division or business unit of BT to another for the use or provision of an activity or group of activities. For the avoidance of doubt, such activities or group of activities include, amongst other things, Products provided from, to or within the Market or Technical Area (as applicable) and the use of Network Components in the Market or Technical Area (as applicable);

‘Transfer Charge System Methodology’ means the methodology of the system employed by BT which enables an activity to use a service or good from another activity and to account for it as though it had purchased that service or good from an unrelated party (including accounting for it at an appropriate amount);

‘Wholesale Catalogue’ means the documentation required to be produced by BT under condition 33;

‘Wholesale Segments’ means groups of Wholesale Services;

‘Wholesale Services’ means services related to network access on BT’s network used by or offered to any Communications Provider (including BT).

Part 2: Conditions

General requirements

1. BT must maintain a separation for accounting purposes between such different matters relating to network access to the relevant network or the availability of the relevant facilities, as required by conditions 3 to 36 including as Ofcom may from time to time direct under those conditions 3 to 36.

2. BT must comply with such rules made by Ofcom about the use of cost accounting systems as required by conditions 3 to 36, and must comply with such requirements about the description to be made available to the public of the cost accounting system as required by conditions 3 to 36, in each case including as Ofcom may from time to time direct under conditions 3 to 36.

3. Except in so far as Ofcom may consent otherwise in writing, BT shall act in the manner set out in these conditions.

4. Ofcom may from time to time make such directions as they consider appropriate in relation to BT's obligations under these conditions.

5. BT shall comply with any direction Ofcom may make from time to time under these conditions.

6. Where BT is required to comply with:

   (i) these conditions;

   (ii) the Regulatory Accounting Guidelines; and

   (iii) the Regulatory Accounting Principles,

   and it appears to BT that any of these requirements conflict with each other in a particular case, BT must resolve such conflict by giving priority to them in the order in which they are set out above.

7. For the purpose of these conditions, publication shall be effected by:

   (i) placing a copy of the relevant information on any relevant publicly available website operated or controlled by BT; and

   (ii) sending a copy of the relevant information to any person at that person's written request.

Requirements relating to the preparation, audit, delivery and publication of the Regulatory Financial Statements

8. BT shall in respect of the Market, Technical Areas, Products, Network Components and Network Services (as applicable), for each Financial Year:

   (i) prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with these conditions, the Regulatory Accounting Guidelines, the Regulatory Accounting Principles and the Accounting Methodology Documents (the relevant Accounting Methodology Documents to be identified in the Regulatory Financial Statements by reference to their date);

(ii) prepare a reconciliation report as set out in condition 23;

(iii) secure the expression of an audit opinion upon the Regulatory Financial Statements as notified by Ofcom from time to time and on the reconciliation report as set out in condition 24;

(iv) secure the approval of the Regulatory Financial Statements by the board of directors of BT and secure the signature of the Regulatory Financial Statements by a director of BT for and on behalf of the board of directors;

(v) deliver to Ofcom copies of the Regulatory Financial Statements, the reconciliation report and any corresponding audit opinion, each and all of which shall be in the form in which they are ultimately to be published, at least two weeks before they are required to be published;

(vi) publish the Regulatory Financial Statements, the reconciliation report and any corresponding audit opinion, within four months after the end of the Financial Year to which they relate;

(vii) ensure that any Regulatory Financial Statement and corresponding audit opinion that it delivers to Ofcom and/or publishes are fit for such purpose (or purposes), if any, as notified by Ofcom in writing; and

(viii) publish with the Regulatory Financial Statements any written statement made by Ofcom and provided to BT commenting on the figures in, the notes to or the presentation of any or all of the Regulatory Financial Statements, the reconciliation report and/or the Accounting Methodology Documents.

9. BT shall make such amendments to the form and content of the Regulatory Financial Statements as are necessary to give effect fully to the requirements of these conditions. BT shall provide to Ofcom particulars of any such amendment, the reasons for it and its effect, when it delivers the Regulatory Financial Statements to Ofcom.

10. BT shall prepare all Regulatory Financial Statements, explanations or other information required by virtue of these conditions on a regulatory asset value adjusted current cost basis as directed by Ofcom from time to time and shall be capable of doing so in relation to any period. Such Regulatory Financial Statements, explanations or other information shall be, in the opinion of Ofcom, meaningfully reconcilable to the Statutory Financial Statements.

11. Each Regulatory Financial Statement shall include Prior Year Comparatives which shall be prepared on a basis consistent with Current Year Figures. BT may depart from this requirement in preparing the Regulatory Financial Statements for a Financial Year if there are reasons for doing so provided that the particulars of the departure, the reasons for it and its effect are stated in a note in the Regulatory Financial Statements in accordance with the Statutory Accounting Standards.

Requirements relating to audit of the Regulatory Financial Statements

12. The Regulatory Auditor that BT from time to time appoints shall at all times be satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall notify Ofcom in writing of the Regulatory Auditor appointed to secure compliance with these conditions before the Regulatory Auditor carries out any work for that purpose. BT shall notify Ofcom of any proposed change of Regulatory Auditor 28 days before effect is given to that change.

13. In the event that the Regulatory Auditor is in the opinion of Ofcom unsatisfactory, BT shall appoint and instruct an Alternative Regulatory Auditor that is at all times satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall ensure that the Alternative Regulatory Auditor:

    (i) carries out such on-going duties as are required to secure compliance with these conditions;

    (ii) carries out work or further work, in addition to that performed by the Statutory Auditor and/or by the former Regulatory Auditor, in relation to such matters connected to compliance with these conditions as are of concern to Ofcom and notified to BT in writing; and/or

    (iii) re-performs work previously performed by the Statutory Auditor and/or by the former Regulatory Auditor in relation to such matters connected to compliance with this condition as are of concern to Ofcom and notified to BT in writing.

14. BT shall extend to the Alternative Regulatory Auditor such assistance and co-operation as would be extended to the Statutory Auditor and/or to the Regulatory Auditor and, to the extent similar assistance and co-operation may be required from the Statutory Auditor and/or from the former Regulatory Auditor, BT shall use its best endeavours to secure such assistance and co-operation.

15. BT's letter of engagement appointing the Regulatory Auditor or Alternative Regulatory Auditor shall include such provisions acknowledging the acceptance by the Regulatory Auditor or Alternative Regulatory Auditor of duties and responsibilities to Ofcom in respect of its audit work, audit report and audit opinion as are consistent with the ICAEW Guidance.

16. BT shall use its best endeavours to obtain from the Regulatory Auditor or Alternative Regulatory Auditor any further explanation and clarification of any audit opinion required under these conditions and any other information in respect of the matters which are the subject of that audit opinion as Ofcom shall require.

17. BT shall obtain such assurance statement in the form of the Agreed Upon Procedures in relation to BT's obligations under these conditions as directed by Ofcom.

Requirements relating to the Accounting Methodology Documents

18. BT must prepare, maintain and keep up-to-date the Accounting Methodology Documents in accordance with these conditions, with the Regulatory Accounting Guidelines, and with the Regulatory Accounting Principles.

19. BT must include in the Accounting Methodology Documents documentation setting out a description of each of the Attribution Methods, the Transfer Charge System Methodology, the Accounting Policies and the Long Run Incremental Cost Methodology, to the extent not covered in the Regulatory Accounting Guidelines.

20. BT must deliver an up-to-date version of the Accounting Methodology Documents to Ofcom when it delivers the Regulatory Financial Statements to Ofcom in accordance with condition 8 and publish such up-to-date version on or before the day of publication of the Regulatory Financial Statements which have been prepared in accordance with such version.

Requirements relating to changes to the Regulatory Accounting Methodology and the correction of Material Errors

21. BT must publish and deliver to Ofcom a list of each and every change to the Regulatory Accounting Methodology, by 31 March of the Financial Year in which the change to the Regulatory Accounting Methodology is to be made (the “Change Control Notification”). The Change Control Notification must be accompanied by a description of each of the changes, the reason for making each of the changes (including by reference to their compliance with the Regulatory Accounting Guidelines and the Regulatory Accounting Principles), and the impact of each of the changes on the figures at the level of the Markets and Technical Areas (as applicable) by setting out the figures which were presented in the previous Financial Year alongside the figures that would have been presented had such changes been made in the previous Financial Year.

22. Where in Ofcom’s opinion any change referred to in condition 21 does not comply with these conditions, the Regulatory Accounting Principles or the Regulatory Accounting Guidelines, BT shall not make such change, if so directed by Ofcom.

23. BT must prepare a reconciliation report as referred to in condition 8 and as directed by Ofcom from time to time, which sets out changes to the Regulatory Accounting Methodology and the impact of such changes on the Regulatory Financial Statements, and Material Errors corrected in the Regulatory Financial Statements and the impact of such Material Errors on the Regulatory Financial Statements.

24. BT must obtain an audit opinion on the reconciliation report as directed by Ofcom from time to time.

Requirements relating to the Regulatory Accounting System

25. BT’s Regulatory Accounting System must be able to produce the Regulatory Financial Statements as directed by Ofcom under condition 8 in accordance with these conditions, the Regulatory Accounting Guidelines, the Regulatory Accounting Principles and the Accounting Methodology Documents.

26. Where BT replaces the whole or part of its Regulatory Accounting System, or substantially modifies such Regulatory Accounting System, BT must:

    (i) notify Ofcom in a timely manner of the replacement or modification, and, where so requested by Ofcom, inform Ofcom of progress towards completion and such other information as Ofcom may reasonably request;

    (ii) ensure, to the best of its ability, that the replacement or modification does not cause the figures contained in the Regulatory Financial Statements to be different from the figures that would have been contained in the Regulatory Financial Statements had such Regulatory Financial Statements been prepared using the old or unmodified Regulatory Accounting System;

    (iii) in relation to the final Financial Year for which the Regulatory Financial Statements are prepared using the old or unmodified Regulatory Accounting System, prepare a systems reconciliation report, which must:

        a. set out the difference between the Current Year Figures presented in the Regulatory Financial Statements and the Current Year Figures had such Regulatory Financial Statements been prepared on the basis of the new or modified Regulatory Accounting System, expressed as a percentage change; and

b. explain each and every Material Difference between the Current Year Figures presented in the Regulatory Financial Statements and the Current Year Figures had such Regulatory Financial Statements been prepared on the basis of the new or modified Regulatory Accounting System;

(iv) publish and deliver the systems reconciliation report to Ofcom by 31 December of the Financial Year for which the figures will be prepared using the new or modified Regulatory Accounting System for the first time;

(v) obtain an assurance statement in the form of Agreed Upon Procedures on the systems reconciliation report, which must report:

a. whether the figures in the systems reconciliation report referred to in condition 26(iii)(a) have been properly extracted from the old or unmodified Regulatory Accounting System and the new or modified Regulatory Accounting System respectively;

b. whether each and every difference in the systems reconciliation report referred to in condition 26(iii)(a) has been correctly calculated; and

c. whether the explanation of each and every Material Difference in the systems reconciliation report referred to in condition 26(iii)(b) is an accurate representation of the cause of each such Material Difference.

(vi) deliver the assurance statement in the form of the Agreed Upon Procedures to Ofcom when it delivers the systems reconciliation report to Ofcom in accordance with condition 26(iv).

(vii) where the systems reconciliation report referred to in condition 26(iii) indicates that the replacement or modification causes the Current Year Figures contained in the Regulatory Financial Statements to be significantly different, either individually or in aggregate, from the Current Year Figures that would have been contained in the Regulatory Financial Statements had such Regulatory Financial Statements been prepared using the new or modified Regulatory Accounting System, prepare, if so directed by Ofcom, the Regulatory Financial Statements on a basis consistent with the old or unmodified Regulatory Accounting System.

Requirements relating to deficiencies in the Regulatory Financial Statements and the Accounting Methodology Documents

27. Where Ofcom have reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Methodology Documents are deficient, BT shall, where directed by Ofcom:

(i) amend the Accounting Methodology Documents in order to remedy the deficiencies identified by Ofcom;

(ii) restate the Regulatory Financial Statements identified by Ofcom as requiring restatement in accordance with the Accounting Methodology Documents which have, where necessary, been amended pursuant to condition 27(i);

(iii) prepare a reconciliation report as set out in condition 23, whereby any reference to the Regulatory Financial Statements should be understood as a reference to the restated Regulatory Financial Statements;

(iv) secure in accordance with any relevant notification of Ofcom under this condition the expression of an audit opinion on the restated Regulatory Financial Statements;

(v) deliver to Ofcom the restated Regulatory Financial Statements, the reconciliation report and corresponding audit opinion; and

(vi) publish the restated Regulatory Financial Statements, the reconciliation report and corresponding audit opinion.

Requirements relating to the maintenance of sufficient accounting records

28. BT shall maintain accounting records for a period of six years from the date on which each Regulatory Financial Statement is delivered to Ofcom.

29. BT shall maintain the accounting records in accordance with these conditions, the Regulatory Accounting Guidelines, the Regulatory Accounting Principles and the Accounting Methodology Documents.

30. BT shall maintain accounting records in a form which, on a historical cost basis and on a current cost basis:

(i) separately identifies each of the Markets, Technical Areas, Products, Network Components and Network Services;

(ii) separately attributes the costs, revenues, assets and liabilities of each of the Markets, Technical Areas, Products, Network Components and Network Services; and

(iii) shows and explains the transactions underlying each of the Markets, Technical Areas, Products, Network Components and Network Services.

31. BT shall maintain the accounting records so that they are sufficient:

(i) to provide an adequate explanation of each Regulatory Financial Statement;

(ii) to show that charges are non-discriminatory;

(iii) to provide a complete justification of BT’s charges for Network Access; and

(iv) to provide a complete justification of BT’s charges for the provision of services to End Users.

Requirement to facilitate on-demand reporting

32. BT shall ensure that its Regulatory Accounting System and accounting records are sufficient to enable BT, at all times, to be capable of preparing in relation to any specified calendar month or months a financial statement in accordance with the Accounting Methodology Documents.

Requirements relating to the preparation and maintenance of a Wholesale Catalogue

33. BT must prepare, maintain and keep up-to-date a Wholesale Catalogue. Such Wholesale Catalogue should separately identify and describe:

(i) External Wholesale Services;

(ii) Internal Wholesale Services;

(iii) Wholesale Services supplied both externally and internally; and

(iv) Network Services and the extent to which these activities are used in the course of supplying Wholesale Services.

34. BT must deliver an up-to-date version of the Wholesale Catalogue to Ofcom when it delivers the Regulatory Financial Statements to Ofcom in accordance with condition 8 and publish such up-to-date version on or before the day of publication of the Regulatory Financial Statements which have been prepared by reference to such version.

Requirements relating to the demonstration of non-discrimination

35. BT shall ensure it is able to demonstrate that at any point in time:

(i) where a Network Service or combination of Network Services is used by BT in providing Internal Wholesale Services, the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in respect of the use of the Network Service or combination of Network Services is equivalent to the amount applied and incorporated for the use of the Network Services or combination of Network Services in the charge payable for an equivalent External Wholesale Service;

(ii) the same amount as applied and incorporated in the Transfer Charge for the Internal Wholesale Service in condition 35(i) in respect of the use of the Network Service or combination of Network Services is applied to the Network Service or combination of Network Services whenever it is or they are used by BT in providing that same Internal Wholesale Service; and

(iii) the same amount as applied and incorporated in the Transfer Charge for the equivalent External Wholesale Service in condition 35(i) in respect of the use of the Network Service or combination of Network Services is applied to the Network Service or combination of Network Services whenever it is or they are used by BT in providing that same External Wholesale Service;

(iv) the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in condition 32(i) in respect of the use of the Network Service or combination of Network Services shall be the cost of those Network Services unless the Network Service concerned is provided from a Market which is different from the Market which comprises the Internal Wholesale Service.

36. BT shall ensure it is able to demonstrate that at any point in time:

(i) where a Retail Support Activity or combination of Retail Support Activities is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the Retail Support Activity or combination of Retail Support Activities is used by BT in the course of supplying Retail Products;

(ii) where a Wholesale Service or combination of Wholesale Services is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the Wholesale Service or combination of Wholesale Services is used by BT in the course of supplying Retail Products; and

(iii) the amount applied and incorporated in the charge for Retail Products in respect of the use of Wholesale Services shall be the Transfer Charge of those Wholesale Services unless no Transfer Charge exists in which event it shall be the cost of those Wholesale Services.

Annex 3

Regulatory Accounting Principles

The Regulatory Accounting Principles set out below must be applied to all material items of revenue, costs, assets and liabilities in the Regulatory Financial Statements, or material changes in those items. A material item of revenue, costs, assets or liabilities, or a material change in those items, is one which is reasonably expected by virtue of its magnitude or nature, to affect the views of any user of the Regulatory Financial Statements.

1. Completeness

Regulatory Financial Reporting must encompass all revenues, costs, assets and liabilities of the Markets and Technical Areas, together with residual activities (including wholesale and retail).

2. Accuracy

Regulatory Financial Reporting must maintain an adequate degree of accuracy, such that the information included in the Regulatory Financial Statements are free from material errors and double-counting. Materiality must be determined in accordance with the definition set out above.

3. Objectivity

Each element of Regulatory Financial Reporting, so far as is possible, must take account of all the available financial and operational data that is relevant to that element.

Where an element of Regulatory Financial Reporting is based on assumptions, those assumptions must be justified and supported by all available relevant empirical data. The assumptions must not be formulated in a manner which unfairly benefits BT or any other operator or entity, or creates undue bias towards any part of BT's or any other operator's business or product.

4. Consistency with regulatory decisions

Regulatory Financial Reporting must be consistent with OFCOM's regulatory decisions as set out in the Regulatory Accounting Guidelines.

5. Causality

Regulatory Financial Reporting must ensure that:

a) revenues (including revenues resulting from transfer charges)
b) costs (including costs resulting from transfer charges)
c) assets, and
d) liabilities.
e) are attributed 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 respectively.

6. Compliance with the statutory accounting standards

Regulatory Financial Reporting must comply with the accounting standards applied in BT's statutory accounts; with the exception of any departures as OFCOM may direct from time to time (including in the Regulatory Accounting Guidelines).

7. Consistency of the Regulatory Financial Statements as a whole and from one period to another

Regulatory Financial Reporting must be applied consistently in all the Regulatory Financial Statements relating to the same period.

Regulatory Financial Reporting must be applied consistently from one period to another.

All the changes in Regulatory Financial Reporting from one period to another must be justified by reference to the Regulatory Accounting Guidelines and the Regulatory Accounting Principles.

If there are material changes in Regulatory Financial Reporting from one period to another, BT must restate the previous period's Regulatory Financial Statements, applying the changes to the Regulatory Financial Statements for that period.

Annex 4

Template for change control

Title	Short title for each change
Type	Select from: 1) Change in allocation basis; 2) change in valuation methodology; 3) change in source data; or 4) other
Key driver for change	State key driver based on Regulatory Accounting Principles (Select from: 1) more complete; 2) more accurate: 3) more objective; 4) more consistent with regulatory decisions; 5) more cost causal; 6) more compliant with statutory accounting standards; or 7) more consistent.
Trigger for change	Select from 1)BT judgement 2) Regulatory decision 3) changes in available evidence 4) other
Description of change	A short explanation of the new methodology and how it differs from the old methodology
Effect of the change	A description of the impact of the change in terms of the components most affected and the general impact of the change and the markets and services that are most affected by the changes
Support for the change	A detailed justification for the change and the evidence taken into account to support the change
Key changes in accounting documents	Set out key changes to accounting documents

Annex 5

Objectives and scope of the regulatory audit

Introduction

A5.1 Ofcom and BT engage an auditor to perform an audit on the Regulatory Financial Statements on an annual basis.

A5.2 In light of stakeholders' comments regarding a possible lack of clarity around the scope and objectives of this audit, this annex is intended to provide stakeholders with a better understanding of the objectives and scope of the regulatory audit.

A5.3 Based upon our interactions with the auditors over several years, following the formal tri-partite arrangements[246] we have set out information relating to the audit to provide clarity on some of the matters highlighted by stakeholders over the course of our review.

Background to audit requirements and relationship

A5.4 The audit of the Regulatory Financial Statements is conducted separately to the audits of the statutory financial statements of BT Group plc and BT. The audit of the Regulatory Financial Statements is performed in accordance with and is governed by separate contractual terms between the auditor, BT and Ofcom.

A5.5 The auditor reports to both the board of BT and to Ofcom. Under this tri-partite arrangement we have access to the auditors and meet with them on a tri-partite basis when required. There are two formal tri-partite meetings each year. The first of these is at the planning stage where BT and Ofcom are presented with the proposed audit plan and have an opportunity to discuss this with the auditors. The second formal meeting takes place shortly prior to the publication of the Regulatory Financial Statements and provides an opportunity for us to hear and discuss audit outcomes and the results presented in the Regulatory Financial Statements with both BT and the auditor. In addition to these formal meetings the auditors meet with both BT and Ofcom whenever required to discuss matters such as proposed changes to audit requirements, BT costing methodology changes and fundamental issues arising from on going audit work.

Appointment of the auditor

A5.6 PwC is currently auditor of both the statutory financial statements of BT and the Regulatory Financial Statements.

A5.7 There is no requirement for BT to appoint the same auditor for the statutory financial statements and the Regulatory Financial Statements. As we explain in Section 5 there may, however, be benefits of aligning these roles as the Regulatory Financial Statements audit benefits from the knowledge and experience of BT's

[246] In accordance with ICAEW guidance – Audit 05/03 Reporting to Regulators of Regulated Entities

business and its financial reporting systems which the audit team gain from the audit of the statutory financial statements.

Audit scope

A5.8 The primary aim of the audit of the RFS is to provide assurance on the financial statements as a whole. However, where there is a reason for obtaining assurance at a more granular level Ofcom can require assurance opinions over the financial statements of an individual economic market.

A5.9 In undertaking their testing the auditor uses audit sampling methods. This means that testing is performed on a sample basis over revenues, attributions of costs, assets and liabilities to network components as well as over volume and usage factors which are aggregated to the market level. Although this testing addresses the attribution to individual components and services, and therefore provides a degree of indirect comfort over the amounts at an individual service level, testing is performed on a sample basis with the aim of reporting on the Regulatory Financial Statements as a whole, and where required individual markets. There is no direct assurance given over the accuracy of individual service level data.

A5.10 In determining their scope of testing and considering the results of their work the auditors consider materiality.

Materiality

A5.11 Materiality is one of the key concepts of any audit. Audits are designed to provide reasonable assurance that the financial statements are free from material misstatement. By their nature they are not intended to provide absolute assurance that the audited financial statements are free from all possible error. As noted above, the auditor's report on the overall Regulatory Financial Statements and on certain individual markets, as such the auditors' consideration of materiality is based in the scale of the revenues, costs, assets and liabilities at the overall Regulatory Financial Statements level and at the level of relevant markets.

A5.12 In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- determining the nature, timing and extent of risk assessment procedures;
- identifying and assessing the risks of material misstatement; and
- determining the nature, timing and extent of further audit procedures.

A5.13 International Standards of Auditing ("ISAs") provide guidance that the materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. PwC have explained that the circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the monetary materiality level. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of identified uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

A5.14 Based on our discussions with the auditors we understand that, considering the guidance in ISAs, their view of materiality applied consistently over several years is that matters exceeding 5% of the total revenue or costs in an individual market or, in the context of the RFS as a whole, a market group would generally be considered material.

A5.15 We have discussed the assessment of materiality with the auditors and the ability to provide assurance at a more granular level such as over very small markets or in respect of individual services. PwC have explained that information at this very granular level may be significantly impacted by very small changes in assumptions and estimates relating to the attribution of common costs which would necessitate an impractical degree of audit effort. Additionally, as noted in the audit report, the scope of the auditors testing does not include any testing over the underlying general ledgers used for the preparation of the statutory financial statements of BT as these are taken as an assumed starting point for the audit testing of the service costing process. As a result we understand that the auditors consider that the provision of assurance over more granular data would risk implying a spurious level of accuracy in the RFS results.

Forms of audit opinion

A5.16 In respect of assurance over the results of individual markets we have the option of requesting two forms of assurance opinion. These are commonly referred to as "Properly Prepared in Accordance with" ("PPIA") and "Fairly Presents in Accordance With" ("FPIA"). Both of these forms of opinion are issued in reference to an accounting framework. PwC have explained that this approach is consistent with the guidance provided in ISAs which uses the term "fair presentation framework" to refer to a financial reporting framework that requires compliance with the requirements of the framework but acknowledges that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework and that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Alternatively, the term "compliance framework" is used to refer to a financial reporting framework that simply requires compliance with the requirements of the framework, but does not contain these acknowledgements.

A5.17 To date, for the purposes of the Regulatory Financial Statements the principles set out in the Primary Accounting Documents have been considered to be the fair presentation framework for the purposes of a FPIA form of opinion. The detailed costing processes set out in the Secondary Accounting Documents have been the compliance framework for the purposes of a PPIA form of opinion.

A5.18 A FPIA opinion provides reasonable (but not absolute) assurance that the separated financial statements taken as whole have been drawn up in accordance with the prescribed framework and, only in the context of that framework, are free from material misstatement. There are a number of aspects of the implementation of a model to produce separated financial statements in accordance with a fair presentation framework, including systems and processes that involve choices, judgements, and estimates (including the use of sampling) such that the assurance given cannot be absolute. For example:

- When assessing the apportionment methodologies used in the preparation of the separated accounts, judgement must be made when determining the most appropriate methodologies, because there can be no absolute right or wrong methodology. Audit tests examine the selected methodologies to determine whether they are reasonable, fall within the terms of the defined framework and have been selected without bias.

- Many of the apportionment methodologies are supported by non-financial information (“data sources”). Audit testing is designed to provide reasonable assurance that the data source selected is appropriate to support the methodology. Also many of the data sources used in the cost apportionment methodologies are prepared on the basis of samples. When assessing the effect of data sources on apportionments, a judgement must be made as to whether the method of sampling is reasonable and therefore whether each data source forms a reasonable basis for the apportionment.

A5.19 In issuing a FPIA opinion an auditor would need to be satisfied, amongst other things, as to the reasonableness of the apportionment methodologies, the objectivity (i.e. the lack of bias towards any particular business, market or service) of the selection of those methodologies and the appropriateness and robustness of the data sources supporting the apportionments. However, in some cases there are many potential acceptable methods for the attribution of cost and the auditors’ role is not to determine whether the methodology being used is the “most appropriate” only that it is consistent with regulatory reporting principles.

A5.20 In forming a FPIA opinion the auditor will consider the reasonableness of proposed methodology changes against the reporting framework and will assess the justification for the change.

A5.21 As noted above we may not always seek, and it may not always be possible to obtain, a FPIA opinion over individual markets. In these circumstances we consider whether it is appropriate to obtain a PPIA opinion. Where detailed attribution methodologies exist as the framework for reporting then the level of effort required in reaching a PPIA opinion will be less than that required for a FPIA opinion. A PPIA audit provides reasonable (but not absolute) assurance that the detailed attribution methodologies defined in the preparation framework have been properly applied by BT in producing the results of the specific market.