

# REPORT

## Accounting Separation

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A Report issued by the Telecommunications  
Regulatory Authority on the draft regulation  
2 August 2004

**Purpose:** To summarise the responses received in relation to the draft Accounting Separation regulation published on 21<sup>st</sup> April 2004



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### 1 Introduction

In 2003, the Telecommunications Regulatory Authority launched a consultation on the matter of Accounting Separation and associated Costing Methodologies, on which it invited comments from interested parties. Comments were received from two organisations. In many cases the parties agreed with the proposals put forward by the TRA, and in some areas the parties expressed differing and opposing views. The main themes of the comments were that one organisation sought to reduce significantly the level and detail of separate reporting required and the other sought to increase the degree of separation.

On 21<sup>st</sup> April 2004, the TRA published a report that discussed the comments received, and drew conclusions and put forward the positions the TRA intended to adopt in the form of a draft regulation.

This report summarises the material input received, discusses it where necessary and sets out the Authority's position, highlighting changes that have been made in the regulation in light of the comments received.

In parallel with this report, a regulation has also been issued that sets out the requirements for Accounting Separation for licensed operators within Bahrain.

#### 1.1 Scope

As a Report, this document has no status other than as a means of disseminating information.

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### 2 Material responses received

The draft regulation invited comments in general with no specific questions being asked (as is the case with consultation papers). The comments received were selective and made in relation to some clauses and not others. The TRA has not, therefore, strictly followed the structure of the regulation in this report, but has highlighted those areas where comments were received.

The TRA received eight responses in total to the draft report and regulation published on 21st April 2004. Responses were received (in alphabetical order) from:

1. Batelco
2. The Bahrain Chamber of Commerce and Industry
3. The Ministry of Commerce
4. The Ministry of Education
5. The Ministry of Finance and National Economy
6. The Ministry of Industry
7. The Ministry of Labour
8. The Ministry of Transportation
8. The University of Bahrain

#### 2.1 General response

Many of the respondents acknowledged the requirement for accounting separation and supported the contents of the draft regulation. Most of the respondents provided general comments on the draft regulation, whereas Batelco provided specific comments on the content of the draft regulation.

One of the respondents indicated that it was appropriate for licensees to account separately for each licensed activity, and that the rules and the extent of reporting should be fair to all licensees such as between Batelco's mobile unit and MTC-V. The TRA agrees in principle with this view, however, there is a requirement to regulate those firms with significant market power or dominance in a relevant market, to a greater degree than those without such market power, sections 57(b) and 58(a) of the Telecommunications Law. It therefore follows that the reporting requirements also need to be more detailed (and possibly more onerous) for those firms deemed to have some form of market power.

One of the respondents highlighted the current legal requirements for companies to use approved auditors, as listed on the register in the Ministry of Commerce, under Legislative Decree No. (26) of 1996 regarding accounting auditors and confirmed that the TRA's request for the preparation of disciplinary accounting does not lead to any contradiction between what has been declared in annual financial reports required under the Legislative Decree No. (21) of 2001 regarding commercial companies and those set out in the regulation.

Two respondents expressed concern that the licensed operator's obligation to submit audited accounts under the regulation may be unduly onerous, especially where the Accounting Separation subject may require significant changes to procedures of its accounting systems and suggested possibly relaxing the timescales.

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One respondent also suggested providing guide samples to prepare the information the Authority needs (which can change from time to time) in accordance with the situations and complications of the licensed operator's activities, in common with the Bahrain Monetary Agency practices regarding its request to get periodical reports called "prudential returns". The TRA may issue guidelines in due course in this respect but has not sought to provide such guidelines as part of the regulation.

One respondent suggested there needs to be a balance between restrictions which may increase costs and limit entry (by effectively creating barriers to entry) and the requirement for operators to submit regulatory accounts that help determine a fair rate of profits for companies, the respondent further suggested the draft regulation seemed to balance these in principle.

One respondent suggested that current cost accounting (CCA) could be a costly methodology, specifically for incumbent operators, and suggested including an option to allow for historic cost accounting (HCA), if a current cost accounting system is not immediately available or feasible for a licensee.

The regulation splits the requirements for reporting on a fully allocated basis, which is by definition HCA and reporting on a LRAIC basis, which by convention is CCA. Only those licensees with Significant Market Power (SMP) are required to report on the basis of CCA. It is quite conceivable that those licensees with SMP will not be small entities where the cost of a CCA system will have a material impact on the business of the licensee, nevertheless the regulation now allows for all licensees to apply in writing to the TRA for time extensions where it may not be feasible to report under the CCA standard immediately.

One respondent also suggested that un-audited quarterly accounts by licensees should be encouraged and available when requested by the TRA.

The TRA on reflection of the balance of effort required by licensees to produce quarterly accounts and value such accounts would add to regulatory decisions leads it to believe this requirement may be unduly onerous on licensees.

Two respondents indicated that the regulation was silent in the manner in which the submitted regulatory accounts may be used, in essence requiring clarification on whether these accounts would be made public. For the avoidance of doubt, the regulatory accounts will be treated as confidential and not published by the TRA, until such time when a consultation on market information requirements has been conducted and agreement reached on the necessity of making such material available to the public or the TRA considers it appropriate for the proper exercise of its functions. The accounting manual may be made public.

## 2.2 Specific responses

### Clause 1.1(a)

One respondent suggested the deadlines as indicated in 1.1(a), and the definition of the submission date, was very tight and felt this to be unrealistic and impossible to meet. The respondent suggested alternative proposals to make this requirement less onerous:

1. Proposal 1 (Most favoured) – For the financial year ended 31 December 2003, audited FAC reports and pro-forma (un-audited) CCA and LRIC results within

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9 months of the final regulation. For the year ended 31 December 2004, full audited accounts within 9 months of the year-end.

2. Proposal 2 – Full audited accounts for 2003, within 9 months of publication of the final regulation and thereafter within 9 months of the relevant year-end; or
3. Proposal 3 (Least favoured) - At the very least, suggested that FAC information be made available after 6 months (of the final regulation in the first year and the year-end thereafter) and supplementary CCA and LRIC data after 9 months

In response to this comment, the TRA would like to reiterate that the Authority is attempting to balance the need for requiring accurate information on costs, such that it can evaluate the basis of regulated prices more closely, with the need to minimise the effort and costs incurred by licensees in fulfilling such requirements.

The underlying purpose for the regulatory accounts comes into sharp focus when setting interconnect and access prices where accurate and up to date information is critical. As is stands, the TRA already has to rely upon historic accounts from the year end, adding an additional long time-lag in preparation would exacerbate the problem further. Under proposal 1, data for year 2003 would be available sometime in Q1 2005 and subsequently 9 months after each year-end. Proposal 2 doesn't provide any further advantage in this sense. Proposal 3 appears to balance the interests of the operator with the interests of the TRA and thus ultimately the market.

The regulation has been changed in line with proposal 3.

### Clause 1.1(b)

The respondent also suggested amending point 1.1(b), on accounting procedures manual. The respondent indicated that there may be occasions when the procedures adopted in preparing the accounts may need to be revised in light of experience.

The TRA agrees this may be the case in practice and has changed the regulation to this effect.

The TRA has adopted a regime where each year an operator needs to submit to the TRA, an updated procedures manual, with an explanation of the reasons for any changes.

The respondent also suggested it would be helpful if there was an indication of the timescales by which the TRA will provide written approval of the procedures manual.

This has now been added to the regulation, stating that the TRA will provide a written approval (where applicable) within 45 working days. This provision has also been added to the requirements for regulatory accounts that reflect LRAIC, in section 7.2.

### Clause 1.3

A major issue raised by the respondent was in relation to point 1.3, the audit standard required. The respondent claimed the precise audit standard required remains unclear, and suggested in other jurisdictions, a distinction is drawn between an opinion stating "properly prepared in accordance with...." and an opinion stating "fairly presents (or reflects) in accordance with....". The respondent believes that the TRA should make

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clear which standard is expected as any auditor will otherwise have to assume the more or most onerous standard.

The respondent believes that not only will the choice of “fairly presents or reflects” increase the cost of implementation to levels that are out of keeping with the additional regulatory benefit derived but also it seems likely – as has been the case with many other jurisdictions – that such an opinion will not be achievable – at least for some of the separated businesses - in the first years of implementation resulting in a qualified opinion.

The respondent therefore requested that the TRA make clear that the initial requirement is for an audit opinion of the “properly prepared in accordance with...” nature. The TRA could reserve the right to revise this to “fairly presents...” or “fairly reflects...” at some point in the future.

The TRA would concur with this view and has reflected the change in the regulation to require “properly prepared” audit standard, which will be reviewed by the TRA within two years of the regulation coming into force with a view to establishing whether the audit standard provides the necessary level of assurance that is required.

### Clause 1.4

On point 1.4 - Licence based requirements, the respondent believes that basing the accounting separation requirement on licences is unduly onerous and will require significant effort to be invested in the regulatory statements (and audit) of minor services such as Paging or Public Access Mobile Radio. The respondent noted the dispensation provisions but suggested instead that the starting point for the Regulation should be Combined Accounting for such services, and if additional detail becomes necessary, the TRA can make a specific request or investigation.

The TRA is not convinced by the argument and believes in the interest of transparency (especially in the early stages of liberalisation) licenced operators should be required to account separately and seek dispensation where relevant in accordance with the draft regulation.

### Clause 2.4

On point 2.4 - Differences between costs, the respondent suggested that a comprehensive reconciliation between costs approved by the TRA for the purposes of determining charges and the full costs attributed to the separated businesses will be impracticable given the extent and nature of adjustments requested by the TRA. As an alternative, the respondent suggested to describe such differences by means of notes to the Regulatory Statements, and in addition, the reconciliation between the aggregated Regulatory Accounts and the published Financial Accounts will highlight any costs excluded entirely from the Regulatory Accounts.

The TRA agrees with such a view, and the regulation has been amended to this extent.

### Clause 4

On the issue of requirements for Persons that supply products or services in a market or markets in which they are determined to have SMP, the respondent claimed that the operator has SMP for a number of services which are immaterial when considered

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against the total revenues earned for a licensed activity or unit, The respondent suggested amending the clause such that it permits the operator to include appropriate revenues and costs within other material categories.

The respondent suggested products and services are not specifically defined in the draft regulation and it is therefore difficult to understand the level of disaggregation required under this provision, claiming further definition or guidance in this area would be helpful. The respondent noted that the complexity and data requirements of any costing or accounting separation system increase with the number of products addressed.

The TRA understands the reasons why an operator may wish to group products / services that are considered immaterial in the context of aggregate revenues, however, section 57(b) of the Telecommunications Law, requires those operators deemed to be dominant in a particular relevant market to offer those services where “tariffs and terms shall be fair and reasonable and non-discriminatory and tariffs shall be based on forward-looking incremental costs and by benchmarking such tariffs against tariffs in comparable telecommunications markets”.

Such a requirement obliges the operator to develop separate pricing and account separately for such products and services, and placed a duty on the Authority to ensure such prices are in accordance with the provisions within the Law. The TRA therefore believes the current clause is appropriate and has not amended the clause.

### Clause 6.2.3

The respondent on point 6.2.3 suggested that all Unattributable costs be allocated by a “reasonable” basis and not an Equal Proportionate Mark-up method, suggesting it was difficult to establish a strictly causal cost-cost relationship.

For reasons of transparency and the TRA’s duties to ensure the allocations are appropriate, the TRA does not believe it appropriate to change this requirement.

### Clause 7.1

On point 7.1 relating to costing methodologies to Persons that are subject to the provisions of section 4, one respondent objected to the fact that the operator would need to prepare LRAIC based cost allocations for a very wide range of products and services. It further claimed that the TRA is well aware of the complexity and effort involved in preparing LRAIC based information and is also well aware that the operator’s development of LRAIC information has focused on particular areas and that the TRA raised no objection to the scope of development of LRAIC systems.

In response to this, the TRA would like to assert that it has maintained at all times, that the systems implemented need to be flexible enough to allow them to meet future regulations which may require a product or service to be based on LRAIC.

The TRA however understands the complexity of changing the systems in order to provide LRAIC based cost information for services and has therefore made provisions within the regulation that allow the development of such information for a new product / service over time by means of seeking an extension from the TRA.

In order to clarify the requirements under section 7, the TRA would like to re-state that the requirement could be met by means of the statement of LRAIC costs which would form a supplement to the regulatory accounts prepared on fully allocated basis. Such a

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statement of costs would underpin the transfer pricing and pricing on interconnect services (and other services where the TRA has deemed it appropriate) and give the TRA clear visibility of the relationship of such prices to long run average incremental costs.

These statements will need to be supplementary to the actual profit and loss account and balance sheet for each separated business (which are prepared on an FAC-CCA basis).

### Clause 10.2

The final issue discussed by the respondent was in relation to section 10.2. The respondent stated that it was unclear which items should be reported in the Regulatory Accounts and which items should be described in the Accounting Manual. The respondent also suggested a demarcation of information. The TRA broadly agrees with the demarcation suggested and has suggested the demarcation along the following lines:

#### Regulatory Accounts:

- Brief statement of accounting policies applied
- Profit & loss accounts (which details the composition of revenues, transfer charges, transactions with other licensed operators and operating costs)
- Balance sheets (that differentiates between fixed assets, investment, current assets and current liabilities, including assets and liabilities that arise from transfer charges)
- Statement of transfer charges
- Reconciliation between Regulatory Accounts and Financial Accounts (which will highlight disallowed costs)
- A statement reflecting the application or implementation of adjustments under section 7.4;
- Audit certificate
- CEO's statement

#### Accounting Manual:

- Detailed listing of accounting policies
- Allocation methodology (including allocation of indirectly attributable costs)
- Methodologies for preparation of LRAIC information including the application of Current Cost Accounting asset valuations

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### 3 Conclusion

Material comments from respondents have been used, where relevant to amend the draft regulation, which has been published in parallel with this report.