

RESPONSE
TO
THE TELECOMMUNICATIONS REGULATORY AUTHORITY OF BAHRAIN (TRA)
DRAFT DETERMINATION CHANGING THE AUDIT STANDARD
(REF MCD/03/11/027)

BY
BAHRAIN TELECOMMUNICATIONS COMPANY (BATELCO) BSC

ON
21 APRIL 2011
(Our Ref GCL/145/11)

Changing the Audit Standard Draft Determination Response

1. Batelco refers to the TRA's draft determination and reasoning for changing the regulatory audit standard from "properly prepared" to "fairly presents" for Batelco's regulatory accounts from 2010 onwards.
2. Batelco refers to its request dated 24 March 2011 (ref GCL/113/11) regarding an extension in relation to replying to this consultation and thanks the TRA for allowing an extra period in which to reply, especially bearing in mind the significance of the proposals.
3. Batelco's principal contact person for this response is:

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Executive summary

4. Batelco recognises the importance of the accounting separation system providing the TRA and the market with sufficient confidence in the robustness of the regulatory accounts as regards accuracy, reliability and quality of information. We believe the current system of accounting procedures manual, assessment by the TRA and production of the regulatory accounts is already best practice in the region. This consultation then is a good opportunity to address the TRA's concerns and make improvements.
5. In relation to the description of the two audit standards of "properly prepared" and "fairly presents", Batelco is largely in agreement with the concepts but has made a number of additional observations between pages 5 – 10 below.
6. We also recognise the issues raised by the TRA arising from review of the regulatory accounts and regulatory proceedings. Issues of data consistency and presentation of information to the regulator are commonplace in cases where the level of regulatory assessment is increased and the incumbent is subjected to increased scrutiny. These are not grounds for complacency though, but we would ask whether the examples cited are of a *material* nature to justify the fundamental changes sought by the consultation. Recognising these issues still need to be addressed, we propose more cost effective, proportionate and practical alternative approaches to resolve these problems whilst preserving the "properly prepared" audit standard.
7. The appropriate regulatory instrument to carry out these consultation proposals should in our view be an amendment to the regulation rather than a determination.
8. Batelco would like to propose alternatives to the "audit report" and "interim report" structure in the draft determination. These alternatives are to keep the "properly prepared" standard, but also offer:
 - a) consolidation of the more detailed information and disclosures Batelco makes to the TRA to support information in the regulatory accounts;
 - b) continuing to increase the depth of documentation provided, for example our initiative this year to submit a detailed chart to improve transparency and traceability of the cost;
 - c) commentary on the regulatory accounts to explain from an operational or markets based business perspective and/or regulatory perspective material movements in the accounts from one year to the next;
 - d) a tripartite agreement involving Batelco, the TRA and Batelco's regulatory auditors, including providing the TRA with a copy of an audit management letter after the finalisation of the audit which highlights those issues which are not material to the accounts but which should be addressed by Batelco in the

future. In this case, Batelco should also provide the TRA with its response to the auditors' management letter in which they should set out the details of the issue and how they intend to address it going forward;

- e) the regulatory auditors providing a "reasonableness review of methodology" at the time of submitting the regulatory accounts instead of an interim report;
- f) improvements in internal Batelco processes for responding to TRA requests for data and information in general to improve consistency; and
- g) improving quality control procedures internally in relation to the data inputs into the cost model and the cost model outputs.

In a steady state situation, and with these alternatives in place if the TRA would be prepared to forego the APM assessment stage, we consider the timetable for production of the audited accounts can be compressed in relation to the current experience. This would of course have the advantage of making available historic audited cost data in a faster time period than is currently the case.

- 9. The TRA's proposed timescales to introduce changes this year are not practicable, and the following year is also extremely challenging. We would ask the TRA to consider more reasonable timescales for the introduction of any reform, reasonable being phased changes over a 24 month period. The proposed changes for 2010 cannot be implemented in time and, given the likely testing requirements on processes and controls on data, likely not to be ready for 2011. If "fairly presents" was required, then we expect the 2012 regulatory accounts to be the first available set for submission.
- 10. Batelco believes the proposed measures, for which there are few precedents, are disproportionate and unreasonable in terms of cost and the size of the market. In France, for example, a much larger market, we understand there is only an audit opinion review with limitation in scope based on a specific format agreed with ARCEP. There is strong reliance on the auditor's opinion of the statutory accounts and limited role on cost accounting data extracted from business systems, relative to a standard audit opinion. It is impractical to require a "fairly presents" audit at the product and service level in Bahrain. We attach at Annex B a copy of the estimated incremental costs of the exercise. These estimates are in the order of USD [REDACTED] million, not excluding additional cost items such as increased insurance premiums should Batelco consider taking out additional insurance cover.
- 11. Should the TRA still be minded to introduce a "fairly presents" audit standard, we would ask the TRA to consider applying this only to markets where Batelco is still determined as dominant. In line with the approach taken in the European Union, the accounting separation regulation could be amended to apply a "fairly presents" audit to cover markets where an operator has a dominance designation, taking a prospective view of where Batelco might be dominant in 2013..

12. We understand comparable reporting requirements at the product and service level are unusual, especially taking into account the size of the Bahraini telecoms market.
13. We would expect any additional requirements to apply to other operators in similar circumstances. Since we consider there are valid alternatives to the current proposals, we agree these should apply to Batelco alone if the alternative proposals are adopted. There may be grounds in the future to extend the same requirements to other operators with a dominance designation, should the regulatory need arise taking into account the costs as well as the benefits.

Legal basis for the determination

14. The TRA proposes to issue a determination to amend a specific provision in the Accounting Separation Regulation 2004 using its powers under 1.2 of the regulation:

“The TRA shall issue determinations under this regulation as it sees fit”

and article 3(c)(1) of the Telecommunications Law which states:

“The Authority shall have the power to issue regulations, orders and determinations as may be necessary for the implementation of provisions of this Law....”

15. The “properly prepared” audit standard is set out at 1.3 of that regulation. Batelco asks the TRA to consider whether that “properly prepared” standard may only be changed by a similar instrument, that is by virtue of an amendment to the said regulation a new regulation. Batelco is of the view that such proposed determination may not change the standard set in the regulation as determinations are issued under the “umbrella” or scope of the existing regulation..

Different audit standards

16. The consultation describes the two commonly accepted audit standards in the telecommunications sector. Batelco in most part agrees with the stated differences between the two standards.
17. The two typical forms of reporting can be described as:
 - An opinion as to whether the regulatory financial statements have been properly prepared in accordance with a detailed methodology document (a compliance framework). Typically this form of opinion would not consider the appropriateness of the methodologies or the reliability of the non-financial source data used to drive cost attributions. The form of assurance is often described as “Properly prepared in accordance with...”.

- An opinion as to whether the regulatory financial statements are fairly presented in accordance with a methodology. In this case the key elements of the methodology are the costing principles such as “cost causality” and “objectivity” which form a “fair presentation framework”. This form of assurance would include consideration of the appropriateness of the detailed costing methodologies and robustness of data sources to implement these principles (note: the distinction between these two scopes is most significant where detailed methodology documentation is prepared. In the absence of a very detailed methodology document a “Properly prepared in accordance with...” audit opinion would need to apply judgement in considering the appropriateness of the actual methodologies employed).

18. The audit work Batelco understands is required to meet the different opinion levels are set out below.

Methodology Review

19. The methodology review for a “fairly presents” audit opinion will consist of a detailed assessment of the appropriateness of the methodologies used in the production of the regulatory accounts including an assessment of the robustness of the methodologies ensuring that the approaches used are objective i.e. not biased in any given direction. The auditor will also have to make a judgement about the level of granularity applied for a given methodology to ensure that it is appropriate for the level of opinion being provided. Typically the auditor would take a sample based approach to the review of methodologies, but in the first year this sample based approach must cover a very significant proportion of the allocated costs.

For a “properly prepared” audit opinion the auditor must ensure that the material methodologies used are not wholly unreasonable.

Methodology Application

20. Under a fairly presents audit opinion the auditor must ensure that for a given methodology the stated approach has been applied correctly, namely that the correct input data has been used, that the appropriate calculations have been used within the model used to produce the output driver data and that the output driver data has been produced accurately. This will involve substantive testing of the models used to derive the driver data including testing of the following:

- Accuracy of extraction of source data and its correct input into the model;
- Internal model consistency;
- Accuracy of intermediate calculations; and
- Accuracy of compilation of output results.

Under a properly prepared audit opinion the same level of testing would be required.

Data Sources

21. Under a fairly presents audit opinion detailed testing is required of all the material data sources which provide information to be used in the production of the Statements. The testing of material data sources comprises the following tests:
 - Substantive testing of the compilation and extraction of source data;
 - Testing source data systems with focus upon testing and assessment of management controls in place over the completeness, accuracy and validity of processing of amendments and periodic validation procedures;
 - Testing of controls over the conduct of each material survey with focus on the controls surrounding the collection of data and the validation of results; and
 - Assessment of sufficiency of data source in respect of
 - Objectivity; and
 - Statistical accuracy.
22. Under a properly prepared audit opinion, only the first test in relation to the testing of the compilation and extraction of source data would be required. The further tests required for the detailed testing of these data sources is the most significant component of the extra audit testing required above that included in a properly prepared audit.
23. The draft determination makes reference to the fact that the proposed fairly presents audit opinion should be implemented for the 2010 regulatory accounts, currently advised to be for 30 June 2011 and 30 September 2011¹. This proposed timetable does not take into account the fact that it is very unlikely to be possible to test the controls in place over the data sources during 2010 as this year has already past. Indeed it is unlikely given the timing of this draft determination that the relevant testing could be completed for 2011 either.

Systems review

24. Under both a fairly presents and properly prepared audit opinion the systems review will look at the underlying infrastructure of each stage of the costing model and ensure through testing of controls or detailed substantive tests that the models operate as intended. The review will look at the effectiveness of reconciliation procedures, control totals, systems interfaces, the periodicity of data refreshes and so on. Testing will be also conducted to ensure that all model elements have been correctly processed.

¹ Batelco has written to the TRA that it needs to discuss and agree rescheduling of these milestones once the shape of the proposed changes in audit standard are known.

Financial Statements

25. Under both a fairly presents and properly prepared audit opinion, substantive testing of the compilation of the financial statements will be carried out, including:
- Accuracy of inputs from underlying cost model;
 - Accuracy of additional calculations within the statements;
 - Internal consistency of the statements; and
 - Substantive testing of the key statement reconciliations

Analytical review

26. One of the other areas of the audit where there is a significant difference between a fairly presents and a properly prepared audit opinion is in relation to the audit of the Statements themselves. The additional audit steps consist of the following:
- Detailed review of each primary statement for businesses/activities, examining consistency with the trends apparent within the statutory accounts and assessing the reasonableness of the calculated profitability of each business/activity.
 - Detailed review of the calculated costs of network components/services to assess whether they fall within ranges experienced during our reviews of other territories, or identifying the local circumstances which lead to a justifiable variance from this average; and
 - Detailed line by line review of the CCA:HCA and LRIC:FAC ratios of network components/services.
27. Under a properly prepared audit opinion the statements would only be subject to a high level review of their overall consistency with the Batelco's published statutory accounts and investigation of any unusual trends or returns.

Documentation review

28. In relation to the review of documentation, both audit standards require largely the same work to be done, namely:
- Assessment of sufficiency of documentation, focussing on the completeness, transparency and suitability of the documentation of the model for use as a framework for audit purposes.
 - Assessment of consistency of model documentation with the principles in the framework documentation.

29. The consultation document states that:

“the assurance provided by the properly prepared audit opinion is largely dependent on the transparency and completeness of the APM and the extent to which it is free from ambiguity”².

It is true that the more clearly written and detailed the framework documents are, the easier it is for the regulatory auditors to give their opinion. However, the provision of an opinion does not require a very detailed document, it will mean however, that the regulatory auditors will be required to carry out more work to reach their opinion. If a framework document was not complete, that is, there were sections relating to certain parts of the model that were missing, then the regulatory auditors would require Batelco to complete those missing areas. In addition, if the documentation contained ambiguities, the regulatory auditors would request Batelco to make those areas of documentation more clear.

30. One difference between the two standards would be that in order to give a “fairly presents” form of opinion the regulatory auditor could require Batelco to override a particular requirement of any TRA instructions to change the accounting procedures manual if this were to lead to a set of regulatory accounts that did not fairly present if the framework was followed. Indeed, in Batelco’s view, this would also be true under a properly prepared audit opinion where the instructions of the TRA were wholly unreasonable.

Reasons for the change in scope of audit requirement

31. The consultation document highlights a non-exhaustive list of examples to demonstrate why the “properly prepared” standard failed to provide the TRA with the necessary level of assurance. The TRA then explains that these deficiencies require the scope of the audit to change in order to remove these deficiencies.
32. Our comments on the specific examples are contained at Annex A. Whilst not being complacent about the issues raised by the TRA we would ask whether all these examples are material and whether a costly “fairly presents” audit standard would remove all the issues which have been cited.
33. We would also mention that many improvements are currently in the process of being implemented, either as a result of instructions issued by the TRA as a condition of approval of the APM or as volunteered by Batelco.
34. The consultation (para 41) assumes that only the “fairly presents” audit standard would improve the reasonableness and appropriateness of the APM.
35. We would note that under the current “properly prepared” audit opinion, there were and are instances when the regulatory auditors requested Batelco to change methods of allocation different from the ones documented in the APM. A good

² Para 35 consultation document

example is the allocation of one of the retail activities, for which Batelco have used pure revenue. During the audit review, the regulatory auditor flagged up this issue and recommended to change the method to the use of an empirical revenue and volume methodology. The idea behind the combined revenue/volume methodology was to recognise that the activity of the staff was aimed at generating additional revenue but recognizing that some orders were more time consuming to delivery than others and therefore pure revenue was not a perfect representation of the time to which these staff were spending on each type of product/service. In this instance and other similar instances, the regulatory auditor flags issues up during the audit review to the team to ensure that the financial statements are presented in a fair manner. Therefore, the regulatory auditor does practise a similar responsibility to ensure reasonableness and appropriateness of the APM as well as the compliance with the framework under the current audit scope.

Audit report on APM and regulatory accounts

36. In paragraph 42 of the consultation the TRA requires the auditor to include in its audit report the results of the various tests that it has performed, namely in relation to:
- Inappropriate cost drivers or cost allocation and how the issue has been addressed/corrected;
 - Incomplete or absence of a cost driver or cost allocation process description in the APM and how the issue has been addressed/corrected;
 - Incomplete/inadequate documentation and how the issue has been addressed/corrected;
 - Issues with data sources (for example, robustness of data collection and reporting, accuracy of the data) and how these issues have been addressed/corrected;
 - Specific areas which the TRA requests the auditors to focus on as specified in the APM approval letter;
 - Changes made to the APM.
37. It is not clear which document the TRA is referring to when they talk about the audit report. If they are referring to the audit report, including the opinion, provided by the auditor as part of the regulatory accounts documentation, then the above requirements cannot be complied with as the form and content of audit opinions is tightly prescribed by international standards on auditing and are very specific.
38. A description of the basis of audit opinion would include wording similar to the following:

"An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal controls.

An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements."

39. The description of the audit cannot include a detailed description of the specific audit tests performed by the auditor and would not normally disclose the findings of those tests with the exception of an issue that leads to a modification to the auditor's opinion (e.g. a qualification or disclaimer of opinion) qualification. Further it would not include a description of any identified errors that were subsequently corrected prior to the finalisation of the accounts.
40. It is also unclear why the TRA would be interested in knowing what issues were identified by the auditors that required correction in order to provide an unqualified audit opinion and that had been successfully corrected as these issues will have clearly been dealt with. If the TRA insisted on receiving this information it should at the very least be limited to those issues that if not corrected would have caused a material error in the regulatory accounts and would need to be provided separately under appropriate contractual terms and conditions.
41. It would seem more appropriate for the TRA to seek a report identifying those issues identified by the auditors which were not corrected for in the regulatory accounts (by definition these items will not be material in the case where the opinion is unqualified). This would be akin to a management letter. This could be provided to the TRA together with Batelco's view of how they will fix each of the issues identified and over what timeframe subject to the agreement of suitable contractual terms for the audit.

Tripartite agreement

42. From the TRA's description of their reasoning for the draft determination it is clear that the TRA wishes to rely on the opinion provided by the auditors. In order for the auditors opinion to be relied upon by the TRA it is necessary that the TRA is a

party to the audit engagement, so that there is a tripartite agreement between Batelco, the TRA and Batelco's auditors.

43. There are many ways to provide additional comfort to the TRA besides the increase in level of audit assurance. These alternative approaches are more fully described in pages 20-23 below.
44. The inclusion of the TRA in a tripartite agreement would mean that the audit opinion on the regulatory accounts is addressed to both Batelco and the TRA and will allow the TRA to rely on the opinion on those regulatory accounts. The existence of the tripartite agreement would allow the TRA to participate at certain stages of the audit process at closer proximity than is currently done now, subject to limitations set out in the tripartite arrangements.
45. Whilst there is no Bahraini or international guidance specific to tripartite agreements we believe that the guidance issued by the Institute of Chartered Accountants in England and Wales could provide an appropriate framework for the agreement of contractual terms between the auditor, the company and the TRA under this guidance. The involvement of the TRA would be limited to:
 - some involvement in the audit planning process with the ability to request certain areas of the accounts for specific review (under a separate engagement contract for agreed upon procedures) or highlighting areas of specific interest which the auditor would take into account when determining their qualitative assessment of materiality on scoping their audit work (without introducing any specific reporting to the TRA), but they would not be able to direct the auditors on the specifics of the tests that they must perform as part of their audit;
 - taking part in a tripartite meeting at the finalisation of the audit at which the auditors would provide an overview of any significant issues affecting the audit opinion; and
 - potentially, receiving a copy of any management letter after the finalisation of the audit which would identify those items that the auditor has identified that require correction but are not material to the Accounts and therefore did not require correction at the time. Batelco would typically produce a response to the audit management letter addressing each of the issues identified and describing how they plan to address each of the issues and over what timeframe.

Interim audit report on APM

46. Additionally, the TRA has included a requirement for Batelco to submit an interim audit report to the TRA no later than 30 days from the date of submission of the APM. This audit report is to be produced in parallel with the TRA's own review. They are to state the changes to the APM required in order for the regulatory accounts to conform with the fairly presents audit requirement.

47. The TRA's reasoning for this interim audit is that they need to be able to monitor the audit work at the APM review stage. They anticipate that this requirement would only be in place for the first few years after the change in audit standard.
48. The key issue with this requirement is that it is not possible for the auditors to give an opinion on an interim APM i.e. before production of the regulatory accounts. This is because:
- The APM is not a set of financial statements and is therefore not capable of being subject to audit in accordance with international standards on auditing; and
 - A non-audit review of the interim APM cannot conclude as to the appropriateness and completeness of the detailed rules as this can only be determined in the context of a set of statements when the materiality of individual cost items can be considered.
49. It is also unclear why there would be a need for such an approach in the context of the provision of a fairly presents audit opinion. As the TRA has stated, in order to be able to provide this level of assurance the auditors must check the appropriateness of the documentation. In giving their opinion on the accounts they are by definition attesting to the appropriateness of the framework documentation.
50. One of the issues with the process of accounts production at the moment is that it takes so long after the year end to produce a set of audited accounts. A significant element of this delay is in relation to the process of agreement of the draft APM prior to production of the accounts, approval for which can take months from the time of submission of the draft APM. This is exacerbated by annual additional requirements and enhancements being made to the APM in the form of annual instructions issued as a condition of approval of the APM.
51. Under the old regime it is clear why the TRA took this approach. The TRA was the only body providing an assessment of the methodologies used in the preparation of the regulatory accounts and it was doing this via its review of the documentation of these methodologies. This is no longer the case as the TRA is seeking to transfer the onus of this review of the appropriateness of the methodologies and related documentation onto Batelco and its regulatory auditors.
52. During a "fairly presents" audit the regulatory auditors would review the methodologies of apportionment, valuation and other aspects to assess their reasonableness and would likewise assess the appropriateness of the final APM submitted to the TRA with the regulatory accounts. As discussed, it is only on this final APM issued in conjunction with a set of regulatory accounts that the auditors can pass judgement on the reasonableness of the methodologies and appropriateness of the documentation as this must be done in the context of the materiality of individual cost items to which these methodologies are applied.

53. One of the benefits of this new approach would be a more streamlined process for production of the final financial statements and related documentation. In the past this has taken more than a year to achieve. There is no reason why under steady state conditions the production of the accounts and APM could not be reduced to of the order of 6-7 months rather than the 14 months plus currently experienced. The timetable though remains subject to changes currently being implemented, for example, the development work required to lengthen asset lives as required by the TRA. Nonetheless, shortening of the timetable would give the TRA considerably more contemporaneous information which should be of considerable worth to them. Clearly in the first year or two of production this accelerated timetable could not be achieved as the new level of audit opinion would require significant enhancements to the current methodologies, systems, data and significant additional audit work which would take time to implement.

Feasibility of audit opinion at service/product level

54. Setting aside consideration of the incremental cost of requiring an audit at the service/product level, providing an audit opinion at such a granular level is unlikely to be possible for the following reasons:
- quality of data to support attribution methods may be insufficient for such a granular level of reporting and assurance;
 - the objectivity of generic attribution bases cannot be assessed at such a granular level; and
 - it may not be possible to assess the overall reasonableness of one service where it is too immaterial relative to the overall business.
55. Indeed, experience suggests that this can be an issue for individual markets, that is, at a much less granular level than product/service. In other jurisdictions such as the UK the requirement to provide assurance over individually small regulatory markets has lead to the qualification of audit opinions on numerous occasions including the following extract from the audit report on BT's 2005 regulatory financial statements:
- “In this regard, where the total costs, revenues, asset or liabilities of a Market are very small in the context of the Group the evidence available to us is insufficient to provide reasonable assurance that these Market Statements are fairly presented in accordance with the principles set out on pages 1 to 3 of the Primary Accounting Documents. Consequently, as agreed with the Company and Ofcom, we have modified our opinion in respect of the following Market Statements to be consistent with the opinions provided in respect of each Wholesale Service Statements:*
- *Single transit on fixed public narrowband networks*
 - *Wholesale Residential ISDN2 exchange line services*

- Wholesale local access
- Residential IDD calls category B routes (Retail IDD routes which are not competitive) in the UK”

56. It is instructive to consider the audit requirements in more mature regulatory markets such as the UK and Ireland.

57. *The UK*

In the UK, BT’s separated accounts are produced on a market basis. The audit arrangement is a tripartite agreement with the auditors, BT and Ofcom allowing Ofcom to rely on the audit opinion. The audit opinion to the standard “Fairly presents” is given on:

- Market Financial Statements as a whole;
- 9 individual Markets and/or technical area;
- 2 Market Groups (comprising 8 smaller markets each); and
- Openreach (Access Network);

58. Whereas for the five individual smaller Markets the standard required is “properly prepared”. It is also worth noting that less material markets may not be subject to an individual audit opinion – for example Wholesale ISDN2 exchange line services is included in a Market Group but as an individual Market is not required to have the “properly prepared” standard applied to it. Furthermore no audited information is provided at the level of product and/or service. In the Appendix additional information such as the unaudited FAC network costs are provided for services and also information for products and services subject to wholesale price controls.

59. *Ireland*

It is not unusual for a regulator to seek assurance at the granular level of products and services where associated issues are not well understood particularly in terms of the cost and particularly from an audit perspective. Indeed this was the initial position of ComReg, the Irish NRA, from its 2009 Consultation on changes to the Accounting Separation and Cost Accounting obligations on eircom³.

60. As stated in the section on Audit report & opinion⁴, ComReg was of the

“preliminary opinion that the a “Fairly presents in accordance with” audit opinion would be the most suitable form of audit opinion for both the Separated Accounts and the Additional Financial Information in that it would give a high level of audit assurance. ComReg notes that Eircom “s current Separated Accounts have an

³ ComReg (2009), Consultation Document no. 09/75 - Accounting Separation and Cost Accounting Review – Draft Accounting Direction to eircom Limited, 5 October 2009

⁴ Ibid. section 7.68, page 95

audit opinion, albeit not addressed to ComReg, to the equivalent of service level for “Retail” and “Other”⁵.

61. This preliminary opinion was despite ComReg’s acknowledged awareness of the UK experience whereby a full set of unqualified opinions could not be given for individual markets⁶ and that this arose from the relative materiality of certain markets:

“Ofcom’s view was that where the audit opinion had been qualified by way of a lesser opinion the reasons provided could not easily be addressed by improvements in BT Plc’s cost accounting systems. Rather, the problems related to the inherent difficulties of attributing relatively small proportions of large shared and common costs to relatively small market or product groups.”⁷

62. Following its review of the consultation responses, ComReg changed the requirement to a “fairly presents” audit standard to be applied to the statements as a whole and “fairly presents” or “properly prepared” for individual market statements. The rationale for this change was set out as follows:

63. *“However ComReg notes the concerns of respondents as to the practicalities, and in particular the **cost**, involved in obtaining this form of an audit opinion below the market level. It is also of the view that attempting to obtain a “Fairly presents in accordance with” opinion **below the market level would be rendered ineffective if the result was a qualified audit report.**”⁸ [emphasis added]*

64. As part of the final determination, ComReg removed the audit obligation from the Additional Financial Information. It is in the Additional Financial Information where eircom discloses product and/or service information such as volume information and details of bundled discounts allocated/apportioned.

65. As can be seen in the two examples set out above, the requirement for an audit opinion to be provided at the level of product and/or service is not something that has been required by regulators which have undertaken consultation and considered the practicalities and cost benefit trade-off of such a requirement.

Proportionality –accounting separation as a regulatory remedy

66. The EU approach to accounting separation is a useful reference in considering proportionality as it is based on principles which are generally accepted. Within the

⁵ *Ibid.* section 7.71, page 95

⁶ *Ibid.* section 7.53, page 92

⁷ *Ibid.* section 7.54, page 93

⁸ *ComReg (2010), Response to Consultation Document No. 09/75 and Final Direction and Decision: Accounting Separation and Cost Accounting Review of Eircom Limited, Decision No. D08/10, Document no. 10/67, 31st August 2010, section 3.417, page 74*

EU, accounting separation is a remedy specifically imposed on an operator in a particular defined relevant market in response to finding of SMP in that market. Its status as such is recognised in the EU framework's accounting separation measure⁹ as one of 5 specific wholesale remedies available to national regulatory authorities to impose on operators with SMP, where appropriate and proportionate. In addition, the SMP threshold under EC legislation is higher and akin to dominance under the Telecommunications Law in Bahrain.

67. In other words, accounting separation is not justified/needed/relevant where:
- an operator has SMP in a market, but transparency in relation to its treatment of its retail arm is not a concern (for example, where a Bottom Up cost model is used); or
 - the market is effectively competitive.
68. It would neither be appropriate nor proportionate to require an operator to prepare separated accounts in relation to services other than those in which it has been found to have SMP. Similarly it could not be considered proportionate to require an audit opinion for each product/service, including non-SMP services.
69. Whilst the regulatory regime in Bahrain is different – accounting separation is a general requirement for telecoms licensees currently, we propose a reduction in oversight/reporting for markets deemed to be competitive. In particular, we would base the separated accounts in markets where Batelco is still expected to have **dominance** within the timeframe for the revised audit requirements.
70. There are 4 retail markets and 3 wholesale markets where Batelco still expects to be found to have SMP or dominance, subject to the findings of the TRA's market review and actual evidence of market share at the time (and prospectively):
71. Batelco is expected to still have SMP in:
- Fixed access narrowband services markets;
 - Domestic calls originating on fixed lines markets;
 - Fixed originated international calls markets;
 - Dial-up internet access from a fixed location; and
72. expected to still have dominance in:
- Wholesale physical network infrastructure access;
 - Wholesale mobile termination on Batelco's network; and

⁹ EC Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities, article 11.

- Wholesale call termination on fixed public networks

Proportionality – “fairly presents” obligation

73. Whilst a “fairly presents” obligation levied at the level of more material markets may be appropriate for larger markets such as the UK, it does not necessarily follow that it is appropriate for a smaller jurisdiction such as Bahrain.
74. The role of producing regulatory accounts under the accounting separation regulation is understood to:
- act as an informational tool for the TRA; and
 - as an ex-ante remedy for competition concerns such as anti-competitive unfair cross-subsidies and/or undue discrimination
75. The role of regulatory accounts, in the second role – as a regulatory remedy – is valid but it is most important that:
- the regulator is clear and precise about the nature of the competition problem;
 - accounting separation is a suitable and efficient remedy for the identified problem;
 - any accounting separation remedy is at the level of the economic market where the competition problem has been identified;
 - the remedy is constructed in the least intrusive/burdensome form possible to address the identified completion problem; and
 - the expected benefits of the remedy outweigh the costs of the remedy.
76. This rigour is vitally important in Bahrain because of its small size. In small markets there is a real and present danger that remedies injudiciously applied may end up imposing net costs, instead of benefits on consumers. This is because the costs of compliance with accounting separation regulation do not scale with size and in a small jurisdiction can outweigh the benefits flowing from the regulation. This is particularly the case with a move to a fairly presents audit opinion as this places significant additional burdens on a telco.
77. The estimate of the increase in costs to Batelco of a move to a “fairly presents” audit opinion is considered in Annex B attached.
78. It is therefore imperative that the TRA adopts a careful and systematic approach to the specification of accounting separation which explicitly considers expected

costs and benefits. Without this the TRA would not be fulfilling its responsibilities to Bahrain and its citizens.

Alternative proposals

79. In order to meet the stated aims of providing more assurance in the robustness of the regulatory accounts, Batelco offers to the TRA following alternative approaches in addition to the currently provided “properly prepared” audit opinion instead of raising the audit standard to fairly presents at the product and the service level:

a. Provide more detailed non-audited information/disclosures

Batelco already produce Statements of Network Services Costs for Access, Core, International, Mobile and Other. Additionally, more detailed information on regulated products and services could be disclosed in an unaudited note, such as providing revenue, volume and cost information for individual products and services or providing unaudited product/service level information in a separate unaudited Additional Financial Information document.

This could include data such as:

- Volume information for regulated and unregulated products and services, including a comparison if appropriate with other volume data provided to the TRA and an explanation of material differences;
- Revenue and direct costs by products and services; and
- Detailed of FAC and LRIC network costs for products and services (there would be a development phase required to implement this).

Although much material is provided to the TRA as a result of:

- Monthly statistics
- Periodic market reports (quarterly, submitted every half year)
- Notified controlled tariff submissions
- Annual reference offer price submissions
- Ad hoc article 53 requests

Batelco still believes there is room to repackage and rationalise the data and information submitted to align and complement the regulatory accounts.

b. Increase depth of documentation provided

Batelco would continue with enhancements and additions to the APM as envisaged in part by the TRA’s instructions letter dated 9 November 2010 as modified by the proposals made by Batelco on 3 April and 7 April 2011 in relation to transparency and traceability of the 2010 APM.

c. Provide commentary on Regulatory Accounts

Batelco could provide greater commentary on the Regulatory Accounts to explain material movements in the year. For example, providing a management discussion of key market changes for each P&L and set out the key factors affecting costs, capital etc. This would not be audited but would enhance the TRA's ability to understand and review the Regulatory Accounts. This practice is seen in other jurisdictions such as the UK and Ireland. For example BT includes a summary of key market changes and key regulatory changes for market statements.

We would propose some form of commentary from the management to accompany the regulatory accounts which offers an explanation of changes which have taken place from an operational business and regulatory perspective causing material effect on the regulatory accounts.

d. Tripartite audit arrangement

We believe a tripartite agreement must be in place and that in order to have some direct interaction with and proximity to the regulatory auditors, a tripartite agreement is necessary to set those parameters. There are clear advantages to the TRA from having a tripartite agreement since it would be involved earlier and at closer quarters at various stages at the beginning, middle and end of the regulatory accounts process. In addition, the TRA would receive a management letter detailing items which were raised as an issue in the audit process which do not require correction of the regulatory accounts due to their immaterial nature.

Please see commentary at page 12 above relating to tripartite agreements.

e. Provide "reasonableness review of methodology" from regulatory auditors

We also propose, instead of an interim report, an external "reasonableness review of methodology" against good international practice. This combined with the current "properly prepared" audit standard could provide the TRA with greater confidence in the APM without changing the audit standard. It could also be shared with the TRA under a tripartite audit agreement.

f. Improve process for responding to other TRA requests

We are willing to review our current internal process for responding to other requests from the TRA for information or submissions. The quality and accuracy – and its reconciliation to the regulatory accounts – could be improved by ensuring that it is reviewed for consistency with the information used in the Regulatory Accounts. For example, data sources should be consistent as key metrics such as volumes may typically vary across different platforms.

In addition, where there are material variances – for whatever reason – then it would be sensible to provide explanation of these differences when the data is provided to the TRA.

We would set up a specific process to monitor the quality and consistency of the data being provided to the TRA. This could cause a slight delay in the time taken to provide data to the TRA but would ensure an improvement in the quality of data provided. In addition to current resources, we would expect this process may require one or two dedicated members of staff in order to carry out the detailed consistency and quality checks.

g. Improving internal quality control procedures

The internal process for ensuring quality control of the regulatory accounts can be considered to comprise two main aspects:

- review of data inputs for the cost model including analytical review to explain movements in the data; and
- review of the model outputs – at a product/service level as well as level of the statements.

Data for the model is reviewed by the relevant responsible member of the costing team. If there are concerns as to the data accuracy or validity he/she investigates further.

The outputs are reviewed by the costing team until they are satisfied as to the reasonableness of them before they are formally presented to the CFO for review.

This type of self-review approach can be reformed given the concerns raised by the TRA in relation to the regulatory accounts . As an alternative to a “fairly presents” regulatory audit, we would consider implementing a more formal approach to quality control involving several layers of review of both input data and output statements.

The different layers of review could be considered as follows:

Data review

- Initial review by data provider – the central costing team must place a requirement on all data providers to supply not only the data for the year but also written explanations for the movements in data/driver values from one year to the next. These explanations must tie back to real changes that have occurred in the business in the year;
- The second layer of review is for the central costing team to review the data and explanations provided by data providers to ensure that the explanations are sufficient to explain movements. This process should involve formal interviews with the providers of key material data or where explanations provided are not sufficient; and
- An oversight panel or person should be created which in the case of a panel includes key members from around the business, not just from finance/regulatory finance. The responsibility of this panel would be:
 - To provide review and sign-off of proposed methodology changes;

- To provide sign-off of the key driver data and associated explanations

Separated Accounts review

- Central costing team should produce detailed analytical review of the separated accounts providing explanations for movements from one year to the next. This review should consider the key areas of disclosure in the accounts, namely Business, sub-Business (if relevant) and network component.
- The oversight panel or person must review the regulatory accounts and associated analytical review explanations produced by the costing team to ensure explanations are consistent with their understanding of the performance of the business in the year. These explanations can form the basis of the commentary for the statements.

Timetable

80. Should the audit standard change to “fairly presents” then it ought to be possible to dispense with the reviews of the APM by the TRA which is a key factor in the current production timescales. This should enable Batelco to provide the TRA with regulatory financial statements sooner after the close of the financial year.
81. In a steady state situation the current timetable of FAC regulatory financial statements by 30 June after year close and CCA/LRIC by 30 September should be achievable – assuming the TRA review of the APM is removed. For the initial year of a ‘fairly presents’ audit standard it would be reasonable to assume an additional 3 months to the normal timeframe.
82. Under the alternative of a ‘properly prepared’ audit opinion with greater comfort provided to the TRA in terms of a more formalised review process or a ‘reasonableness review of the methodology’ performed by the auditors, Batelco would expect the overall timetable to be speeded up if the TRA dispensed with the need for an APM review in these circumstances.

Fairly presents opinion applied to Batelco

83. We would expect any additional requirements to apply to other operators in similar circumstances. Since we consider there are valid alternatives to the current proposals, we agree these should apply to Batelco alone if the alternative proposals are adopted. If the TRA is still minded to impose a form of “fairly presents” audit along the lines of markets, there may be grounds in the future to extend the same requirements to other operators with a dominance designation, should the need arise.

Annex A - of particular issues raised by TRA – Batelco commentary

| <p>Issues that have arisen during the Authority’s review of Batelco’s regulatory accounts and other regulatory proceedings</p> | <p>Costing Comments</p> |
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| <p>Appropriate cost apportionment/allocation:</p> <p>The cost driver for “21050 IT-Fixed Billing”: in the 2009 APM: Batelco used the number of staff and time analysis as the cost driver to allocate 21050 IT-Fixed Billing to “local billing & retail” and “IAA”. In the 2008 regulatory accounts it appeared that only 14% of IT-Fixed Billing total cost was direct opex (which will mainly be staff costs but not exclusively). Thus it is questionable whether the number of staff is an appropriate cost driver for allocating cost between retail and wholesale</p> | <p>Most types of assets including 21050 IT fixed billing would comprise of depreciation as the major component of its costs. Accordingly, the cost driver used to allocate an asset cost depends on the type of service the concerned asset serves. In case of 21050 IT fixed billing, this system is used by a number of IT specialists to do the bill processing function of the "local billing & retail" and "inter-admin billing". Therefore, despite the fact that the cost mainly consist of depreciation, the asset function and daily operation is maintained by number of IT specialists, hence the use of number of staff as the basis of allocation is appropriate from costing point of view. This was discussed with the TRA and further explanation provided into the driver and allocation details underpinning this particular cost item during the course of the reference offer assessment.</p> |
| <p>Inappropriate price trends used in the CCA valuation: The Authority has identified significant issues with the CCA valuation/price trends (e.g actual price trends proposed, method to</p> | <p>Batelco undertakes a detailed and time intensive data gathering process to collect this data as required by the TRA. There are also existing</p> |

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| <p>derive them and underlying data source, effect of foreign currency movements) in the past three years which have required substantial modifications following review by the Authority. Under a "properly prepared" audit opinion the auditor is only required to check that the price trends specified by the Authority in the APM approval letter are applied properly in Batelco's regulatory accounts. There is no requirement to check that the inputs used in the CCA valuation (e.g the price trends and the effect of foreign currency movements) are true and fair.</p> | <p>regulatory auditor checks of the CCA system and templates used. More specifically, the auditor perform sample based tests on the application of the methodology including the testing of prices which is also carried out in 2008. Hence, the overall price trend in the CCA valuation has all been subject to audit tests. The foreign currency point is now resolved after assessment and instructions in 2010.</p> |
| <p>Absence of information or misleading information:</p> <p>The current APM is incomplete. For example, the current APM prepared by Batelco under "properly prepared" does not include the description of cost centres or the complete list of allocation destinations, e.g. the "Retail to Ret Act" sheet in 2009 APM – FAC part indicates that the "Wholesale & Carrier relations" cost centre is only allocated to WS01, whereas in addition to WS01 it is actually allocated to CN90, IN01 and NA01.</p> | <p>This incompleteness of the APM should be resolved by the proposed enhancements as regards transparency and traceability of the 2010 APM.</p> |
| <p>SDH transmission cost: During the 2010 review of Batelco's RO submission, the Authority has identified significant issues regarding operational data that greatly impact SDH transmission costs.</p> | <p>This related to a network SDH migration project in 2010 which unearthed discrepancies in the historical data records held. This has been resolved.</p> |
| <p>Number of CAT/LLCO E1 equivalent circuits: During the 2010 review of Batelco's RO submission, the Authority identified other significant issues regarding operational data on CAT/LLCO which greatly impact</p> | <p>This point has been resolved and rectified for the 2009 regulatory accounts.</p> |

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| <p>transmission cost.⁸ First it would appear that a number of high speed circuits are not included in the total number of E1 equivalent circuits. Second, it is only after repeated questioning regarding the number of E1 used to calculate the transmission cost per E1 and despite initial denial by Batelco, that Batelco finally acknowledged that its calculation of the cost per E1 was erroneous.</p> | |
| <p>Routing factor table: During the 2010 review of Batelco’s RO submission, the Authority has identified several inconsistencies in Batelco’s routing factor table.⁹ For instance, routing factors of the RAN network elements applicable to mobile data services, SMS, and MMS were not divided by 2 as they were for voice services in order to account for the split of traffic between the 2G and the 3G radio access network.</p> <p>For SMS and MMS services, Batelco was applying different routing factors for the cost allocation of the mobile switching centre server and media gateway whether the service was on-net or off-net (regulated terminating services).</p> | <p>The routing factor table is one such additional information requirement added to the APM and regulatory accounts which we believe provides a significant net benefit to addressing the information asymmetry. We believe this inconsistency was resolved quickly. Further, the SMS and MMS issue was also resolved quickly by referring to the most up-to-date routing factor table. We do not expect a “fairly presents” audit to provide 100% assurance that such an error will not occur in the future.</p> |
| <p>Different cost allocation to retail service groups between FAC and LRIC accounts: During the review of the 2008 regulatory accounts the Authority found that the distribution of the costs of the international network to the retail service groups was different in the LRIC accounts compared to the FAC accounts. The above issue has arisen as a result of Batelco grouping together network components in the</p> | <p>We believe this was an understanding which was reached in 2004 but had to be readvised and resolved with the new TRA assessment team.</p> |

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| <p>LRIC accounts and adding the routing factors for individual components together to get the combined routing factor for the component group. This is being done with outpayments in the international network.</p> | |
| <p>Change in cost driver and cost allocation without prior approval: In the 2008 approved APM, the cost driver to allocate the cost of “Market comm” was actual marketing expenditure and this cost centre was allocated to only three activities FR21 - Market Comm- Marcom Residential (Fixed), MR21 - Market Comm- Marcom Residential (mobile) and OR21 - Market Comm- Marcom Residential (Others). However, during the 2010 RO review, the Authority noticed that the cost driver had changed to a combination of number of staff, number of services and actual marketing expenditure analysis and CN90 has been added as an allocation destination without approval from the Authority¹¹.</p> | <p>This change arose as a result of a known debate between the parties over the calculation of the interconnect specific cost, more particularly, which relevant cost categories should be included in the calculation. The TRA’s instructions letter dated 9 November 2010 removed this cost item.</p> |
| <p>Issue with operational data that may impact allocation of costs: During the 2010 review of Batelco’s RO submission, the Authority has identified potential issues with the total adjusted duct length which is decreasing by 36.3 km between 2007 to 2008. ¹²The Authority considers such decrease to be improbable and it raises concerns not only on the robustness of operational data sources but also on the appropriateness of the methodology used to collect and treat raw data.</p> | <p>The difference is not material (less than 1% of the overall reported kms). We maintain that there was indeed a drop in the total number of duct kms.</p> |

Annex B – DELETED

Annex C - SMP and dominance designations – now and in 18 months time

| Retail Market | Significant Market Power/Dominance | Comments |
|---|---------------------------------------|---|
| 1. Fixed access narrowband services markets: <ul style="list-style-type: none"> • 1a: For residential customers; • 1b: for non-residential customers. | Batelco holds SMP | 3 June 2008 determination |
| 2. Domestic calls originating on fixed lines markets: <ul style="list-style-type: none"> • 2a: For residential customers • 2b: For non-residential customers. | Batelco holds SMP | 3 June 2008 determination |
| 3. Fixed originated international calls markets: <ul style="list-style-type: none"> • 3a: to Zone 1 GCC countries; • 3b: to Zone 2 countries; • 3c: to Zone 3 countries; • 3d: to zone 4 countries. Mobile originated international calls markets: <ul style="list-style-type: none"> • 3e: to Zone 1; • 3f: to Zone 2; • 3g: to Zone 3; • 3h: to zone 4. | Batelco holds SMP in market 3a and 3c | 3 June 2008 determination |
| 4. Mobile services (excluding international calls) | N/A | |
| 5a Broadband internet access from a fixed | Batelco holds SMP Prospectively | 3 June 2008 determination. 14 December 2010 Batelco |

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| location. | competitive | proposes to TRA that market analysis and remedies need to be revised. |
| 5b Dial-up internet access from a fixed location. | Batelco holds SMP | 3 June 2008 determination. Irrelevant in practice. Batelco no longer offers dial-up. |
| 6 Domestic leased lines (6a). International leased lines (6b). | Batelco holds SMP Prospectively competitive | 3 June 2008 determination. If Batelco not dominant in wholesale markets, the downstream retail markets also expected to be prospectively competitive. |
| 7 Wholesale broadband access services. | Dominance Prospectively competitive | 14 September 2009 (to replace dominance determination 22 Jan 2006). 14 December 2010 Batelco advised that less than 50% market share and falling. |
| 8 Wholesale physical network infrastructure access. | Dominance | 14 September 2009 (to replace dominance determination 22 Jan 2006) |
| 9 Wholesale mobile termination on Batelco's network. | Dominance | 1 February 2010. Zain also considered dominant on termination of calls on its network. Services cover voice, SMS and MMS. |
| 10 Wholesale access to transmission capacity. | Dominance Prospectively competitive | 22 January 2006 determination (review due after 22 January 2008). 9 November 2010 RO response Batelco requests TRA to review market in light of proposed national broadband network and other competitive developments. |
| 11 Wholesale international facilities. | Dominance Prospectively competitive | 22 January 2006 determination (review due after 22 January 2008) 14 December 2010 Batelco makes non-dominance submission to TRA. |
| 12 – Wholesale call termination on fixed public networks | Dominance | 9 August 2003 |
| 13 – Wholesale market for international correspondent services, including international switching and conveyance | Dominance Prospectively competitive | 9 August 2003. 14 December 2010 Batelco makes non-dominance submission to TRA. |