



Auditing regulatory accounts for a large incumbent

Presentation for the Regulatory Accounting Roundtable 2008
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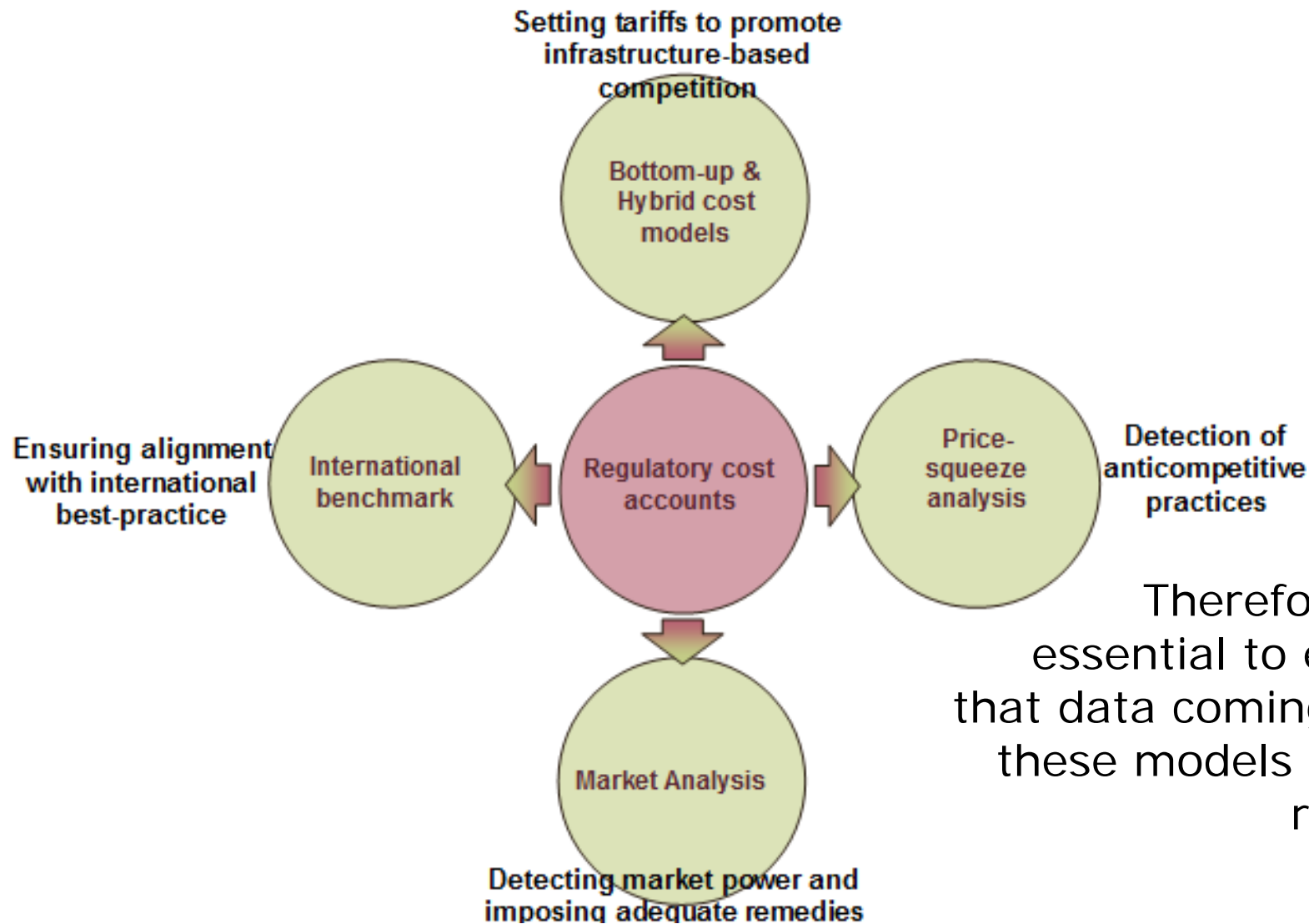
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About SVP Advisors

- SVP Advisors is a management consulting firm for the Telecommunications, Internet and Media industries, specialized in Business, Financial and Regulatory Strategy.
- **Our Mission** is to “**Rethink Communications**”, targeting innovative best practice solutions at a worldwide level and enhancing the intellectual leadership of our workforce.
- Fast market and technology transformation on a global stage demand **innovative thinking** to be always a step ahead of competitors and external threats.
- **Our Team** is formed by seasoned and independent professionals, with an **outstanding international track-record** in management consulting and industry leadership roles within the electronic communications sector.
- Our highly motivated multidisciplinary experts offer a unique 360° approach.

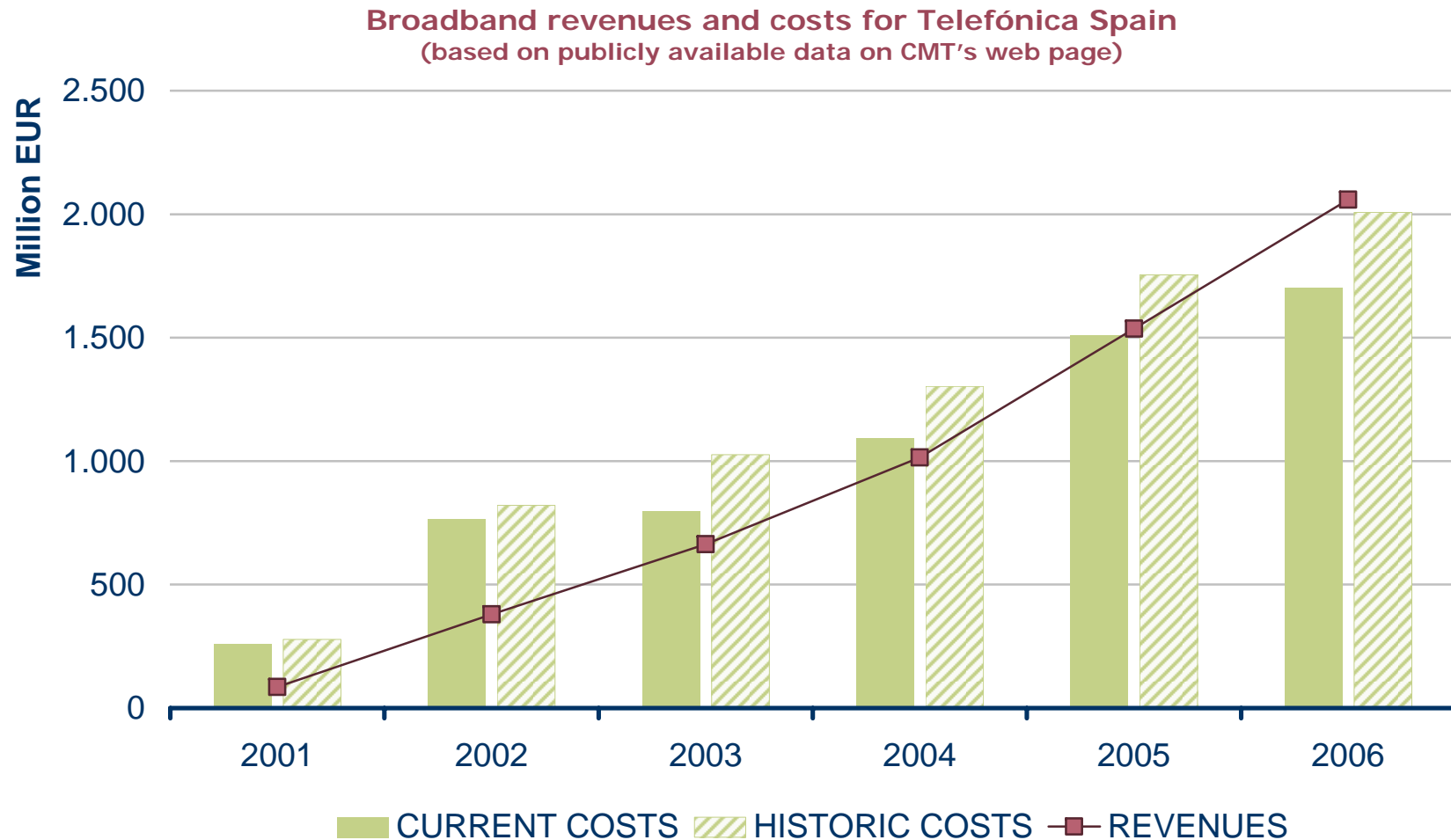


Regulatory accounts provide essential information for setting tariffs, as well as other regulatory tools and analyses



Therefore it is essential to ensure that data coming from these models is fully reliable

Regulatory cost accounts serve not only to establish and control tariffs. They provide a picture of a business in transformation



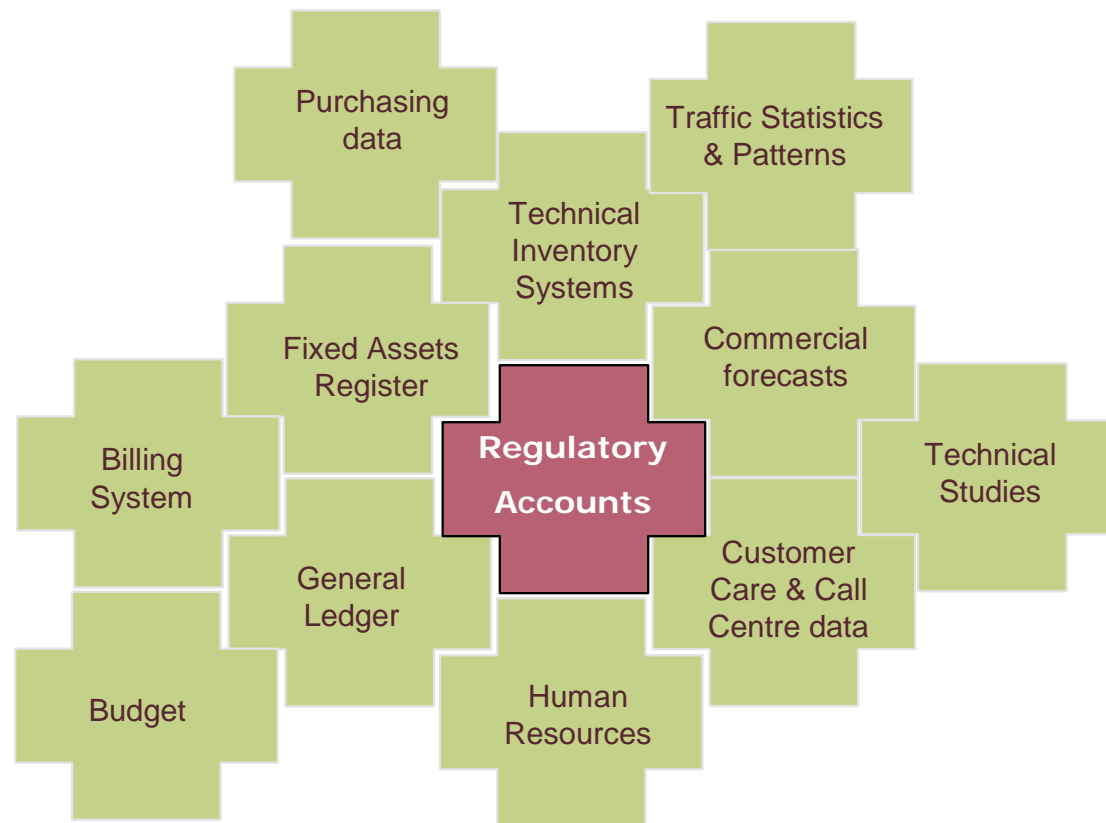
The audit of the regulatory accounts of a large incumbent is a process of considerable complexity

- The audit of a regulatory is a process involving significant **time** and **resources**
 - Typical duration is between 1.5 months and 3 months
 - Typical audit team will range between 3 and up to 8 members
- The **complexity** of the audit will be affected by the following considerations:
 - What is the degree of accuracy and confidence required
 - This will depend on the relevance of results for important regulatory decisions, such as tariff setting
 - What is the level of stability achieved in the system (status quo)
 - Audits can be twice or three times more complex in start-up process than afterwards

A typical regulatory costing system for a fixed incumbent in figures

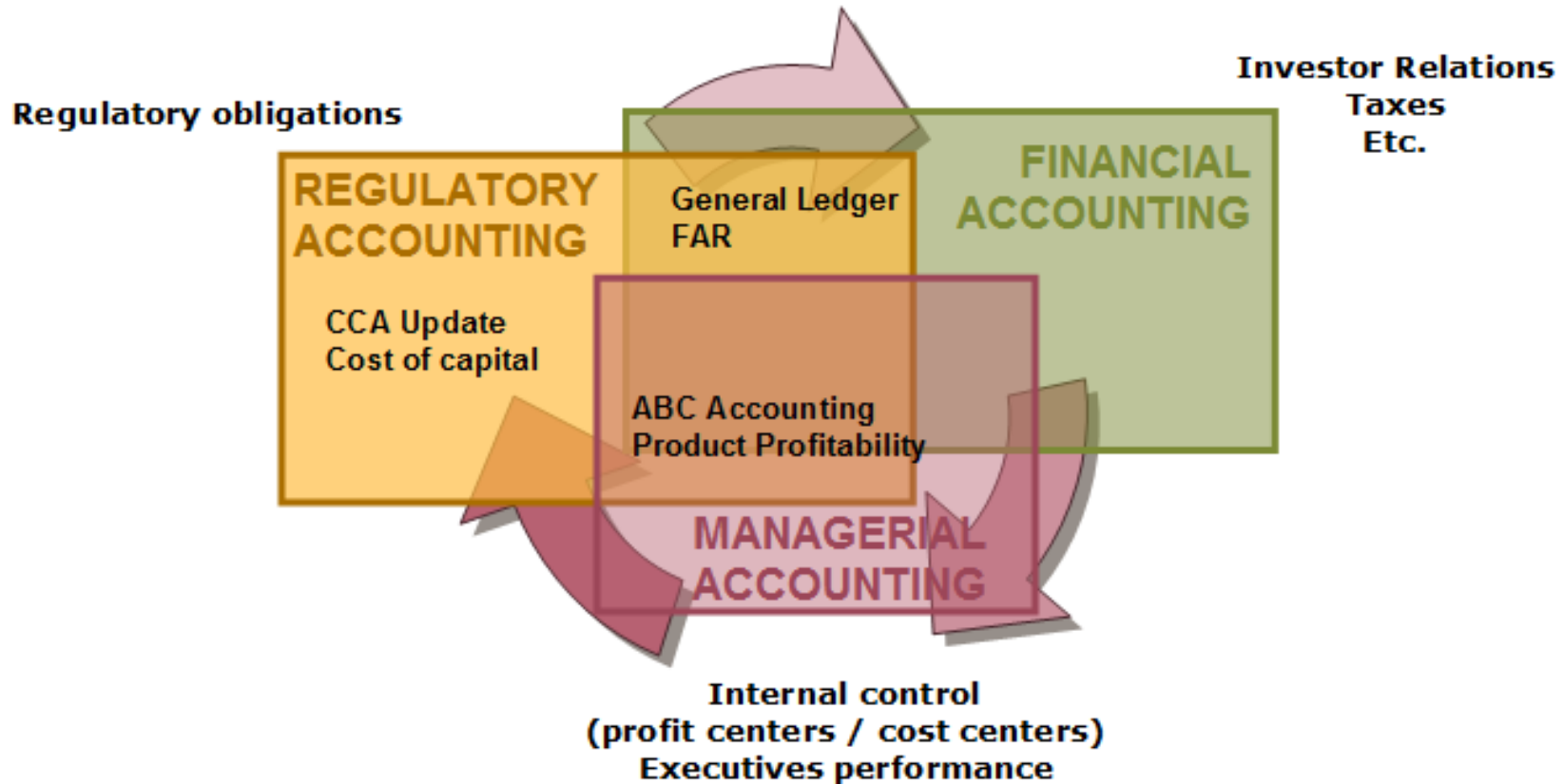
Indicator	Typical range of values
Number of services for which costs are calculated	100 to 300
Number of accounts or cost entities	10^3 to 10^4
Number of cost & revenue imputations	10^5 to 10^6

The audit of regulatory accounts is in reality the review of a complex web of processes and data sources



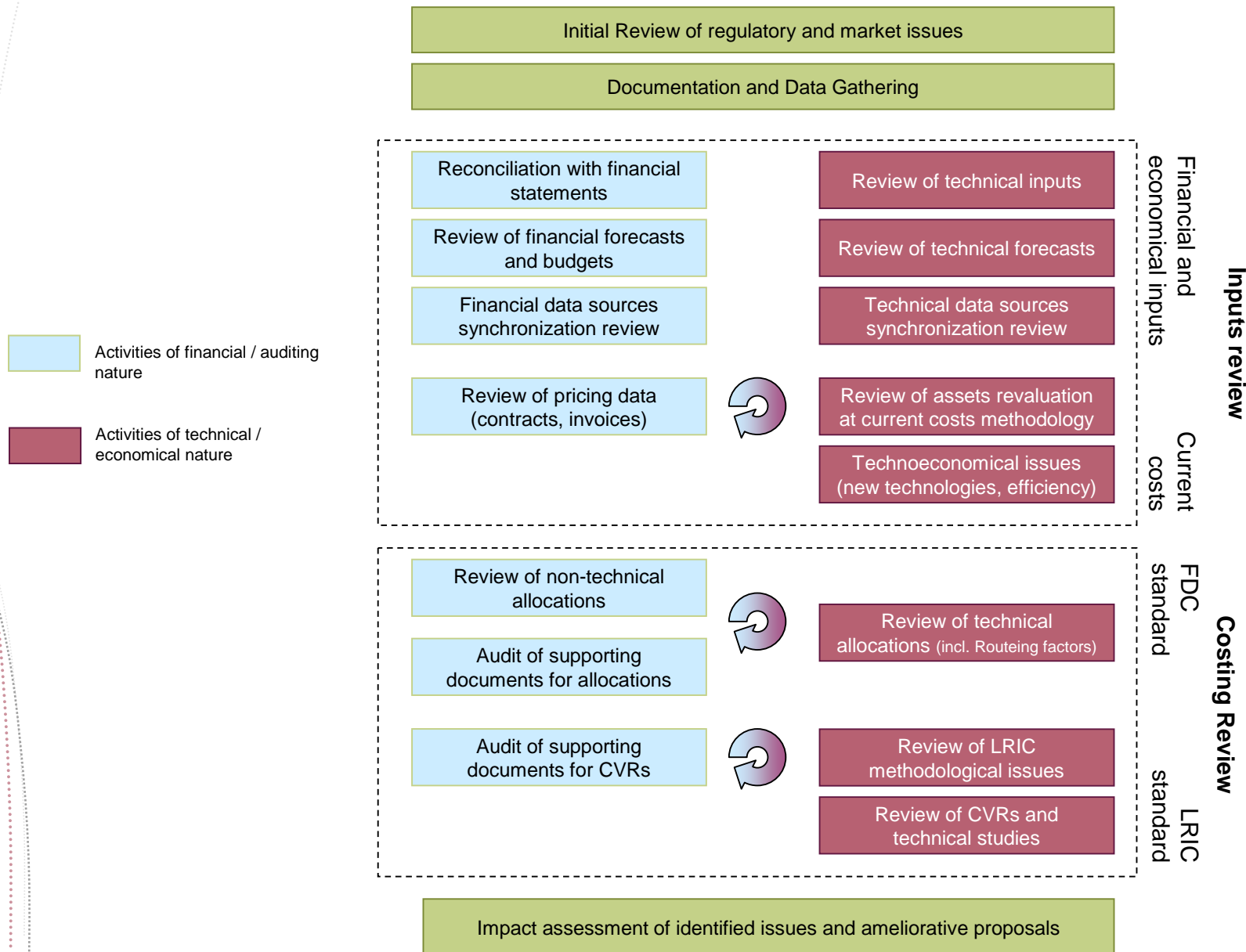
- The preparation of regulatory accounts is a **data intensive** process
- The **process** by which data is collected, handled and used is essential to assure the accuracy of results
 - Relations with other departments
 - Ownership of data
 - Formats and manipulation
- Also the integrity of original data is important, however this is in general much more difficult to assess

The Regulatory Cost Accounting system is intertwined with the financial and managerial accounting of the company

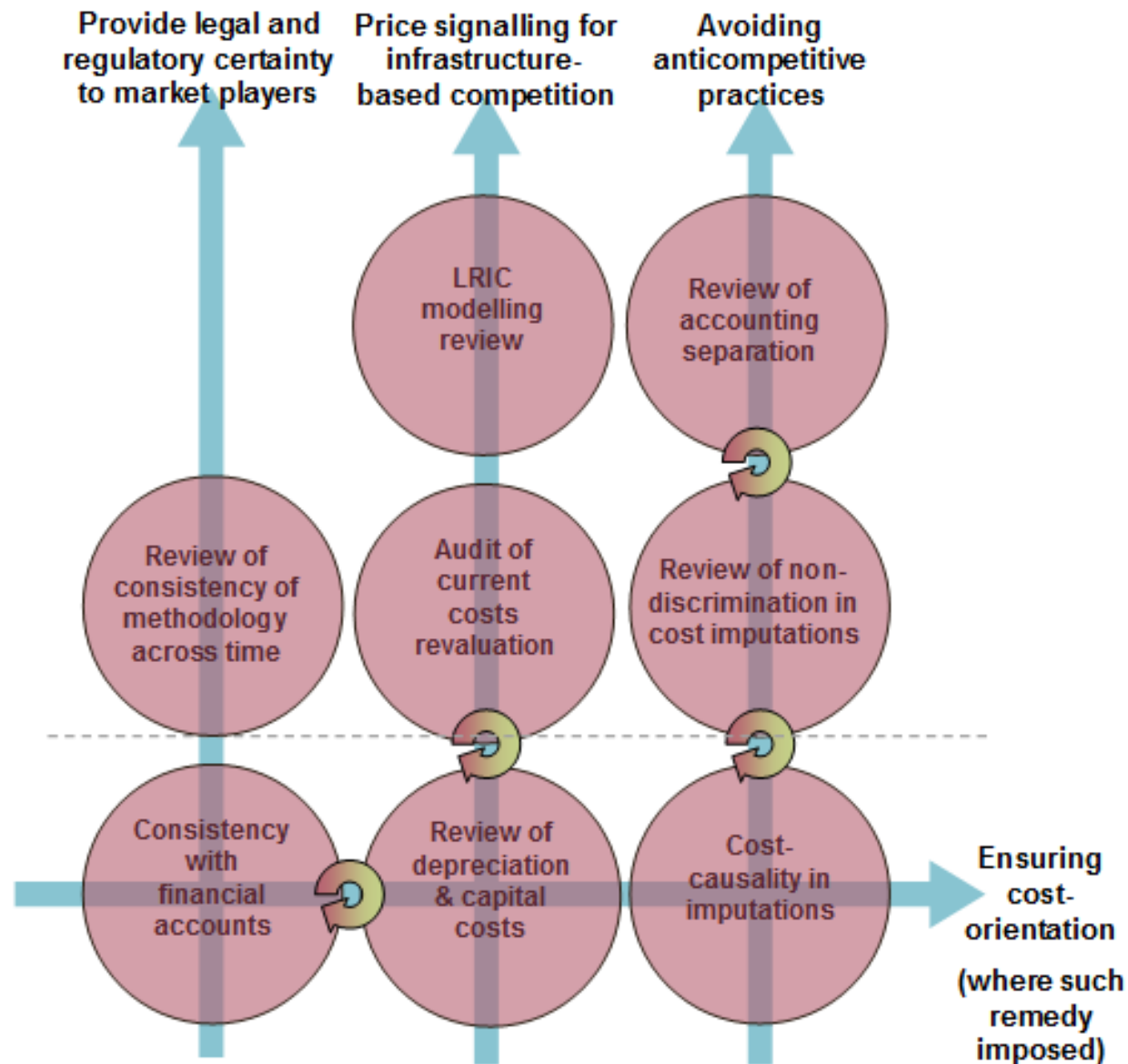


- In general, it should be a factor for comfort that the regulatory accounting system is heavily embedded into a wider accounting framework, as there are **less possibilities for manipulation** for regulatory purposes

The audit of regulatory cost accounts requires a mix of financial, economic, legal and technical expertise



The building blocks of the audit of regulatory cost accounts should be aligned with regulatory objectives of the NRA



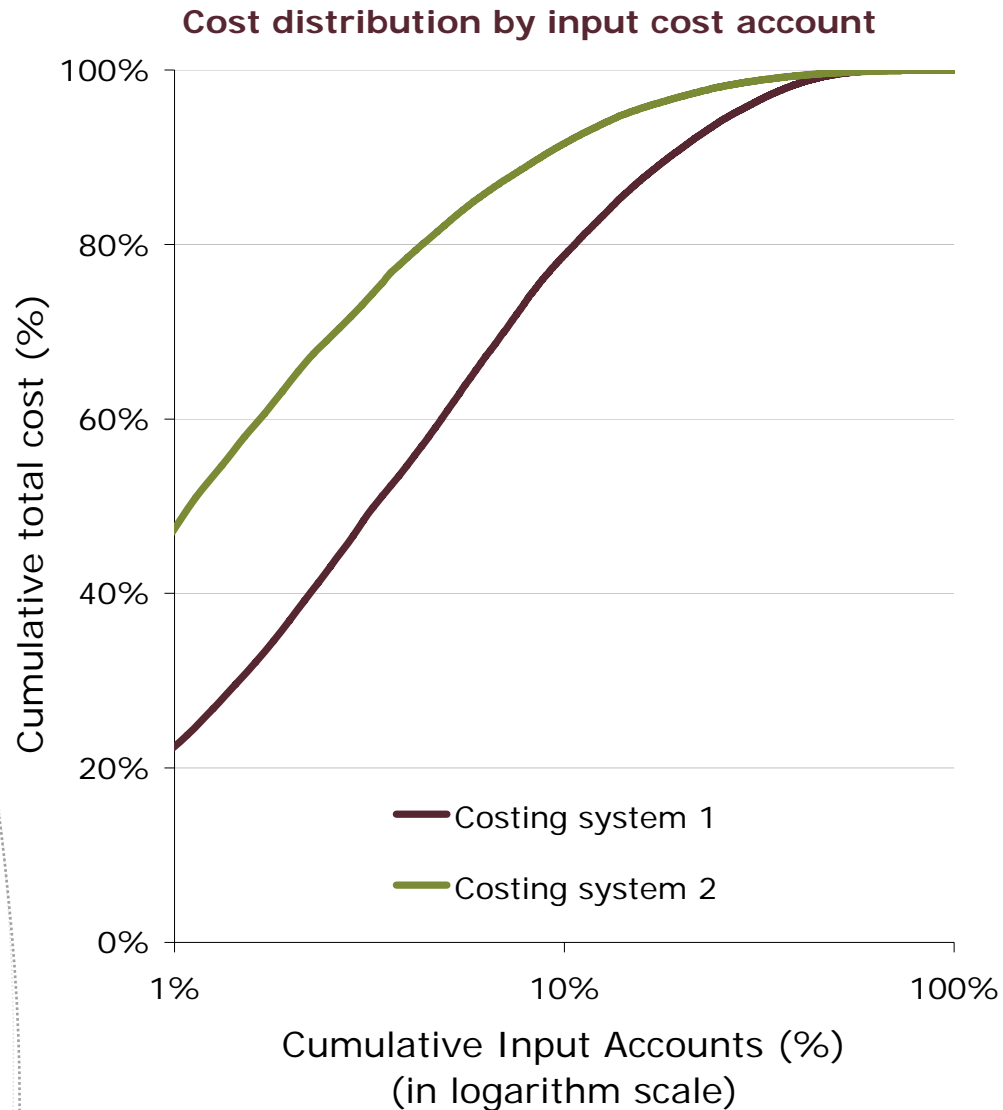
Most relevant tasks in the audit of a regulatory accounting system [1]

Audit item	Main considerations
Consistency with financial accounts	<p>Reconciliation with audited financial accounts of the company (pro-forma or budget if regulatory accounts for non-completed period of time)</p> <p>Impact of accounting rules (for instance, adoption of IFRS)</p> <p>Reclassifications</p>
Check consistency of methodology across time	<p>Identify major modifications – as result of request of NRA or responding to changes such as new services</p> <p>Impact of structural modifications in the company – for example, integration/divestment of subsidiaries, restructuring, functional separation</p>
Review of depreciation and capital costs	<p>Review of depreciation charges</p> <p>Review of useful lives – adjustments if regulatory useful lives different from accounting ones</p> <p>Application of cost of capital. Review of calculation of WACC (if not previously established by NRA)</p>
Cost Causality in cost imputations	<p>Review cost allocation criteria and assess causality</p> <p>Review accuracy in calculations of allocations (stratified sampling)</p>
Review of depreciation and capital costs	<p>Review of depreciation charges</p> <p>Review of useful lives – adjustments if regulatory useful lives different from accounting ones</p> <p>Review of calculation of WACC (if not previously established by NRA)</p> <p>Application of cost of capita (or annuity if applies)</p>

Most relevant tasks in the audit of a regulatory accounting system [2]

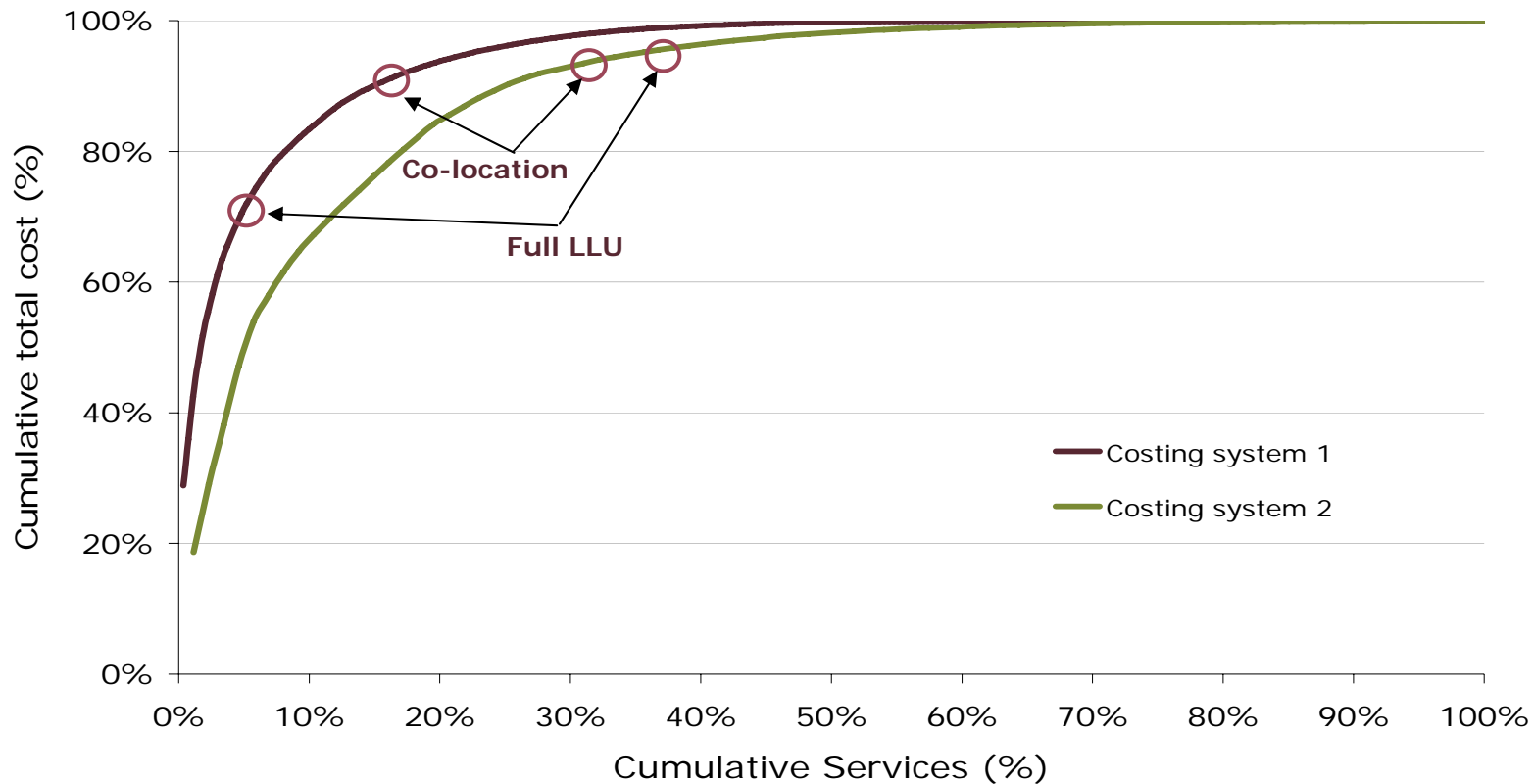
Audit item	Main considerations
Audit of current costs revaluation	Definition of asset categories consistent with those of FAR Application of MEA principles Number of units really in service Pricing data from actual purchases Effects of withholding gains and losses
Review of non-discrimination in cost allocations	Identify major modifications – as result of request of NRA or responding to changes such as new services Impact of structural modifications in the company – for example, integration/divestment of subsidiaries, restructuring, functional separation
Review of accounting separation	Definition of business units – relation with market definitions Methodology to identify transfer charges (based on costs or market prices)
LRIC modelling review	Definition of homogenous cost-categories (HCCs) and mapping of costs Calculation of cost-volume and cost-cost relationships (CVRs & CCRs) Treatment of increment-specific fixed costs and common costs

Regulatory cost accounts tend to show a great concentration of costs in a reduced number of key accounts or cost items



- Typically, regulatory accounting systems have a number of very relevant cost entities that represent a disproportionate share of overall costs
 - This results in a large concentration of costs, normally beyond the 20%-80% rule
- This concentration of costs can be exploited to reduce the complexity of the audit process without compromising the accuracy of the results
- Auditors should always bear in mind the materiality of the issues under review

...however the concentration of costs does not mean that auditors can focus exclusively on the top accounts



- New services can have crucial regulatory relevance but will be of relatively low importance in quantitative terms
 - The auditor needs to know what it is looking at, and be able to assess the implications of the results for the different services and products to use audit resources in an intelligent way

The conditions under which the audit is carried out are determinant for the effort required for the task and the quality of the outcome

Working process

- ✗ Q&A Sessions (presential or written requests)
- ✗ Highly bureaucratic, legally-charged relationship for requests and answers

- ✓ On-Site work with flexible access to key personnel
- ✓ Informal process for requests and answers (minor issues and clarifications)

Data provision

- ✗ Limited disclosure of internal calculations of model (high-level results)
- ✗ No disclosure of side models (such as CCA valuation / CVR calculations) and technical studies
- ✗ Vague descriptions of modifications from previous years
- ✗ Data provided in written or electronic format of difficult manipulation

- ✓ Full disclosure of internal calculations (imputations) of model
- ✓ Full disclosure of side models (such as CCA valuation / CVR calculations) and technical studies
- ✓ Clear and comprehensive description of modifications from previous years
- ✓ Data provided in easily-handled electronic format

The characteristics of the cost model and the specified methodology also play a key role in shaping the audit process

Methodological aspects

- ✗ Methodology with ambiguous adjustments and only broadly defined principles
- ✗ Methodology with potentially bumpy elements making (like withholding gain / losses)

- ✓ Methodology with clear criteria, limited ad-hoc adjustments (such as efficiency)
- ✓ Methodology based on stable (Annuity)

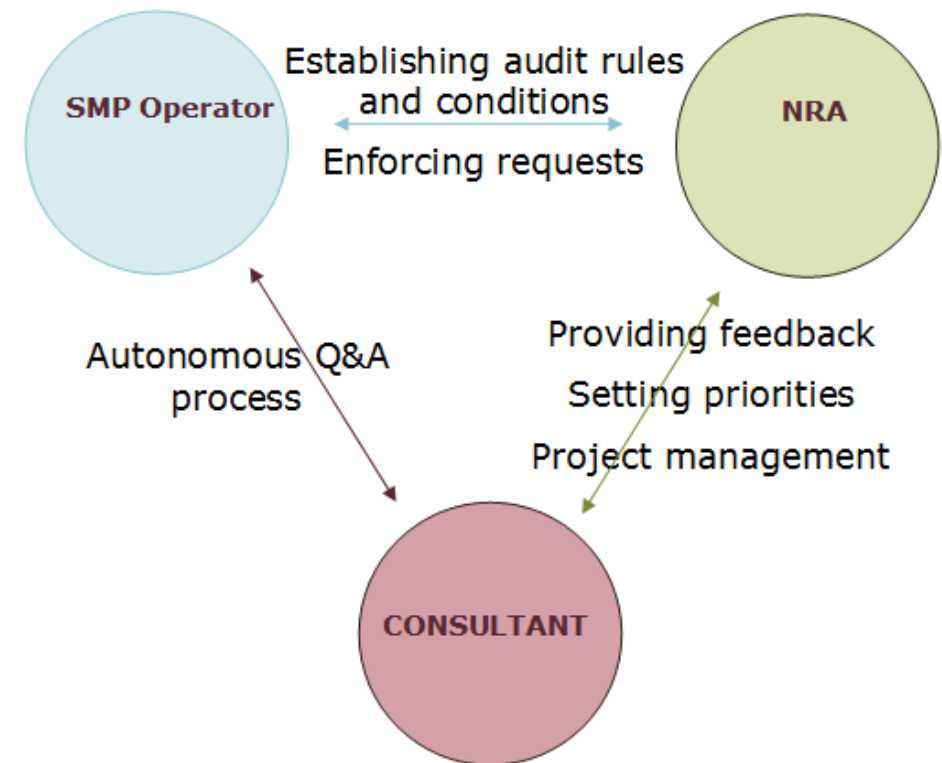
Model structure and consistency

- ✗ Model internal logic difficult to replicate (especially in case of LRIC)
- ✗ System in constant shift and limited comparability among different years' results and calculations

- ✓ Model internal logic clearly specified and possible to replicate
- ✓ System solidly established and possibility to establish meaningful comparisons from one year to another

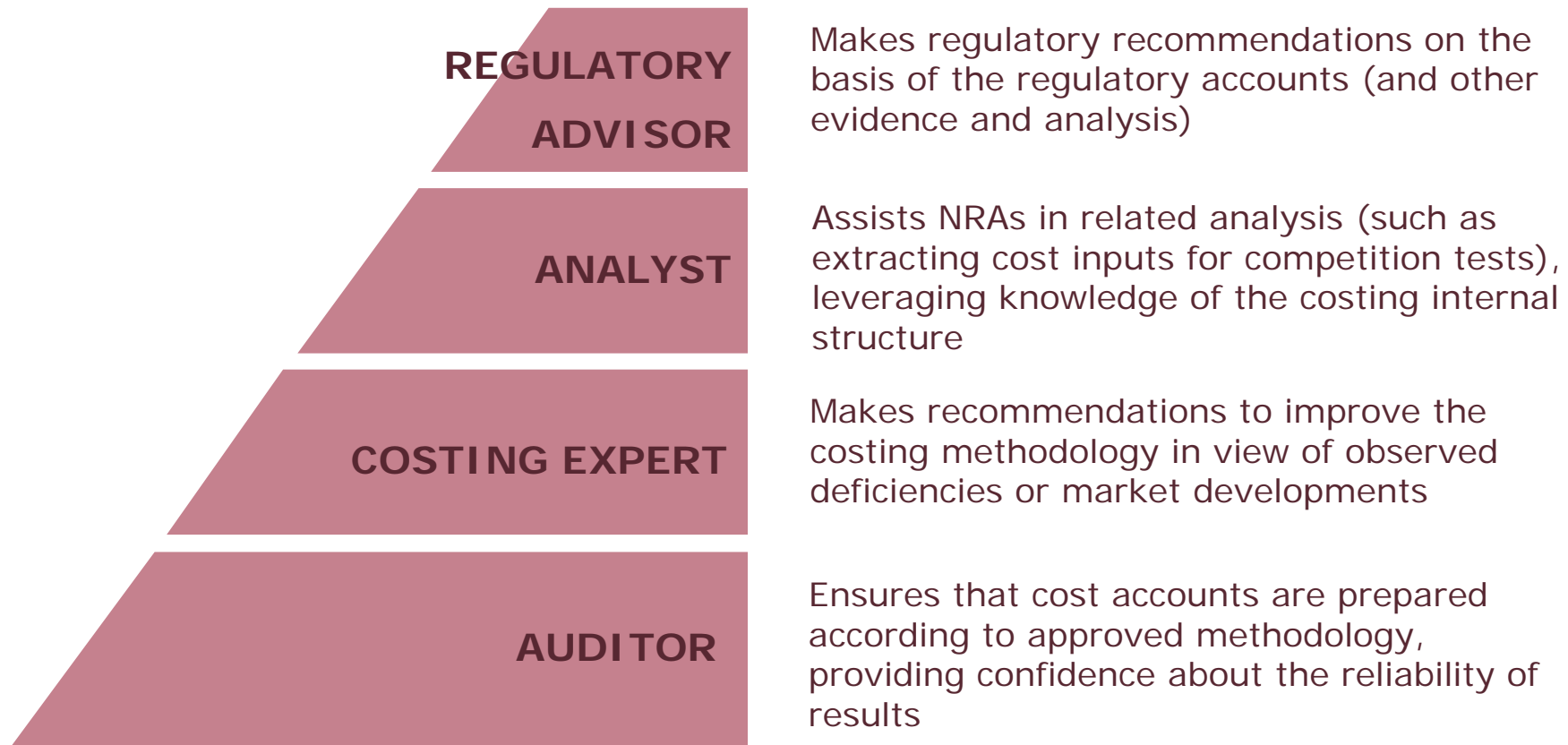
It is the NRA's responsibility to guarantee the necessary conditions for a successful audit

- The auditor's only authority stems from the **delegation of the competences** from the NRA
 - Therefore, full support from the NRA is required to enforce requests
 - In case of conflict, it is the turn of the NRA to intervene heavily
- However, NRAs should **prevent that other issues on the regulatory agenda get mixed** with the audit
- The NRA should also be heavily involved in project management and in the **setting of priorities** according to the more relevant regulatory challenges
 - But the auditor is an **independent** third party – and in the end should reflect its own judgment in the report



Relations between SMP Operator, NRA and Consultant in the audit of regulatory accounts

The organisation responsible for the regulatory audit can play different roles, all potentially value-added for the NRA



- The pertinence of each of these roles will depend on the specific requirements of the NRA (legal framework, internal organization, resources and skills, etc.)



THANKS FOR YOUR ATTENTION

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