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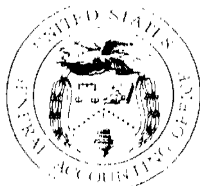
Report to Congressional Requesters

February 1993

TELECOMMUNICATIONS

FCC's Oversight Efforts to Control Cross-Subsidization



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Washington, D.C. 20548

Resources, Community, and
Economic Development Division

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February 3, 1993

The Honorable Mike Synar
House of Representatives

The Honorable Edward J. Markey
House of Representatives

Advances in technology and deregulation in the telecommunications industry have led to the evolution of companies (carriers) that provide both regulated and unregulated telecommunications services. Regulated services include basic interstate telephone service, and unregulated services include technologies, such as voice mail and electronic mail, that transmit computerized information over telephone lines. If carriers' costs for these two types of services are not properly allocated, customers of regulated telephone services (ratepayers) may be charged for some of the costs of the unregulated services. Such improper cost allocation is known as cross-subsidization.

In 1987, we reported that the Federal Communications Commission (FCC) had not assigned enough staff to monitor carriers' cost allocations to protect ratepayers from cross-subsidization.[1] Specifically, we reported that at the then existing staffing level, FCC would be able to examine audit areas, such as time reporting and affiliate transactions, at the major carriers only once every 16 years. We recommended that FCC develop a strategy for increasing its oversight of carriers' cost allocations, emphasizing the importance of FCC's providing enough funds for personnel and travel to permit additional on-site audits. As requested, this report reviews FCC's implementation of (1) our recommendation to increase on-site audits of carriers' cost allocations and (2) certain accounting safeguards established after 1987 to protect ratepayers from cross-subsidization, including audits of carriers' cost allocations performed for the carriers by certified public accounting (CPA) firms, FCC's reviews of these audits, and a computerized system for maintaining carriers' cost and revenue data known as the Automated Reporting Management Information System (ARMIS).

Results in Brief

While FCC has submitted budget proposals requesting additional auditors several times since 1987, no additional positions have been allocated to

[1]Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services (GAO/RCED-88-34, Oct. 23, 1987).

the on-site audit function. For fiscal years 1990, 1991, 1992, and 1993, FCC asked the Office of Management and Budget (OMB) for 3, 3, 21, and 10 additional auditors, respectively. However, OMB asked the Congress for only three additional FCC auditors for 1990 and 1992 and did not ask for any additional auditors for 1991 and 1993. In the 1990 and 1991 budgets, the Congress approved funds that allowed FCC to increase its staffing level, but no additional positions were allocated to the on-site audit function.

In fact, on-site audit staff have declined since 1987, while the staff's work load has increased by 35 percent since the implementation of FCC's accounting safeguards. As of September 1992, the FCC staff of 14 auditors could, on average, cover the highest-priority audit areas once every 11 years and all audit areas once every 18 years. This level of coverage is inadequate because FCC cannot impose any fines or penalties more than 5 years after a cost misallocation has occurred. Consequently, this staffing level cannot provide positive assurance that ratepayers are protected from cross-subsidization. Increasing the FCC staffing level, along with the appropriate travel funds, would have little or no effect on the federal budget because the government would be reimbursed for its on-site audits and reviews of CPA audits through fees FCC is authorized to collect from carriers.

Since 1987, FCC has established a number of additional safeguards that complement its on-site audits. Though useful, these safeguards have not detected all cases of cross-subsidization. CPA audits have extended FCC's audit coverage, but FCC auditors have found that they have often not been conducted in accordance with FCC guidance. Also, the FCC audit staffing level has not permitted reviews of all CPAs' audit workpapers and reports. Although ARMIS helped FCC to firmly identify one cross-subsidy problem, the system generally does not contain sufficiently precise and complete data to generate the comparisons of carriers' accounts that would allow FCC to readily identify potential cross-subsidy violations.

FCC auditors, through on-site audits, continue to detect instances of cross-subsidy that the other safeguards have not identified. For example, FCC's on-site audits uncovered cost misallocations totaling over $300 million that neither CPA audits nor FCC's reviews of the audits had found. While the other safeguards have limitations, FCC is studying ways to make carriers' cost allocation manuals uniform, which should increase the usefulness of the ARMIS data. Also, FCC has required CPA audits to implement further changes to improve compliance with FCC guidelines. However, on-site audits have demonstrated their effectiveness, and we

continue to believe that additional on-site audit coverage is necessary to protect ratepayers' interests.

Background

During the 1960s, telephone and computer technologies became increasingly interdependent. Although FCC had regulated traditional interstate telecommunications since the 1930s, it did not control the new activities that delivered data-processing services over telephone lines. In 1980, FCC issued a decision that created a regulatory distinction between basic communications services and "enhanced" services, such as voice mail and electronic mail. Under this decision, enhanced services were not regulated and "customer premises equipment" (devices located on customers' premises that are used to send or receive information over the telephone network) were deregulated. (App. I lists common unregulated services.) Data reported to FCC by carriers for ARMIS indicate that the market for unregulated services currently generates about $3.5 billion in annual revenues.

Early in the development of enhanced services, FCC had recognized that carriers might pass on to telephone ratepayers costs properly attributable to the carriers' unregulated services. To prevent such improper cost shifting, FCC initially required carriers to offer unregulated services through separate corporate subsidiaries, which were to maintain their own financial records, staff, computer equipment, and facilities. Later, however, FCC substituted nonstructural requirements for the structural separation requirements it had imposed on carriers. In 1986, FCC applied these requirements to all major carriers, including the seven regional Bell Operating Companies (BOC) that were formed after the American Telephone and Telegraph Company (AT&T) divested itself of its local telephone operating companies in 1984.

FCC employs several accounting safeguards to look for cross-subsidization, including detailed on-site audits of carriers' records. For over a decade, FCC has used on-site audits to meet its regulatory responsibilities—to determine whether carriers' practices and procedures (1) are in compliance with FCC standards and (2) are adequate to prevent cross-subsidization. In addition, on-site audits give FCC first-hand knowledge of carriers' cost allocation systems, serve as a check on CPA audits, and enable FCC to follow up on problems identified through other safeguards.

Since 1987, FCC has employed a number of accounting safeguards, including cost allocation standards prescribed by FCC; cost allocation manuals approved for carriers by FCC; annual independent audits performed by CPAs; FCC's reviews of these audits; and ARMIS, which FCC uses, among other things, to compare similar cost and revenue data between carriers. We did not review FCC's cost allocation standards or carriers' cost allocation manuals in this report. CPA audits are broad reviews performed for carriers in accordance with FCC guidance, often by the same firms that perform carriers' financial statement audits. Although CPAs are required to state whether carriers' cost allocation methodologies are consistent with carriers' cost allocation manuals, FCC determines, through its reviews of CPAs' workpapers and reports as well as through on-site visits, whether carriers' practices and procedures are in compliance with FCC standards. (See app. II for a more detailed discussion of FCC's regulatory actions and safeguards.)

The Accounting and Audits Division of FCC's Common Carrier Bureau is responsible for ensuring that telecommunications companies do not improperly allocate their costs. Fourteen auditors in the Audits Branch of that division are key staff responsible for oversight of carriers' cost allocations.

FCC Audit Staffing Level Is Not Adequate to Oversee Cost Allocations

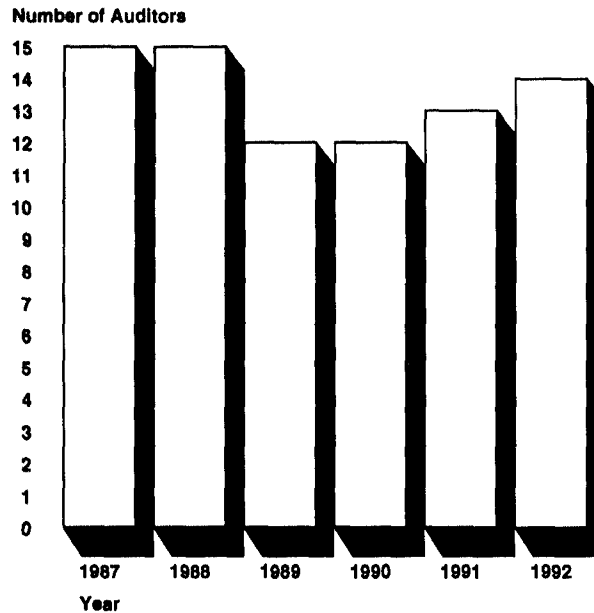
In our 1987 report, we concluded that the cost allocation standards and procedures that FCC was developing and implementing were all essential. We maintained, however, that on-site audits were still necessary to protect consumers from cross-subsidization not only because cost allocation systems were inherently subjective but also because FCC had not yet tested the new safeguards.

At the time of our 1987 review, FCC's Audits Branch comprised 22 staff, including 3 supervisors, 2 secretaries, 1 statistician, 1 economist, and 15 auditors. We concluded that this staffing level was insufficient to ensure that consumers were protected against cross-subsidization, and we recommended that FCC increase its oversight through more on-site audits.

Since our previous review, FCC has not expanded its oversight of carriers' operations through on-site audits. Over the past 4 years, FCC has conducted generally about the same number of audits annually as we reported in 1987. Furthermore, the number of staff available to perform these audits has decreased. Although the number of auditors in FCC's Audits Branch remained stable through fiscal year 1988, it dropped to 12 in fiscal years

1989 and 1990 and then increased to 13 in fiscal year 1991. As of September 1992, FCC's Audits Branch consisted of 18 staff—3 supervisors, 1 secretary, and 14 auditors (see fig. 1). Meanwhile, the staff's work load has increased by 35 percent since the implementation of the accounting safeguards. Additional audit areas have been designated for on-site review, and FCC has expanded its reviews of CPAs' workpapers to ensure that the CPA audits meet FCC's regulatory needs. The Audits Branch's work load will further increase as the market for enhanced services grows and the volume of carriers' unregulated business increases.

Figure 1: FCC Audit Staffing Level



FCC has acknowledged the limitations that its current audit staffing level imposes on its ability to detect cross-subsidization. In budget submissions for both fiscal years 1992 and 1993, FCC stated that this staffing level limits the assurance it can provide to the Congress and consumers that carriers are complying with cost allocation rules and that regulated services are not cross-subsidizing unregulated operations.

Since the issuance of our 1987 report, FCC has asked for additional auditors in four of its budget proposals to OMB. For fiscal years 1990 and 1991, FCC made proposals to increase the number of auditors by three for each fiscal

year. However, OMB's congressional budget submissions for FCC asked for three additional auditors in 1990 and no additional auditors in 1991. Although the Congress approved 1990 and 1991 budgets, which allowed FCC to increase its staffing levels, no additional positions were allocated to the audit function. According to the former Chief of FCC's Common Carrier Bureau, he had identified other areas in the Bureau that needed more attention, and at the appropriate time, FCC would request the number of additional auditors it needed.

Subsequently, in budget requests for fiscal years 1992 and 1993, FCC asked OMB for additional auditors. FCC requested 21 additional auditors for fiscal year 1992, stating that this increase would enable the Audits Branch to review the highest-priority audit areas of each regional BOC and major independent carriers once every 5 years. The 5-year period is important because FCC cannot impose any fines or penalties more than 5 years after a cost misallocation has occurred. However, OMB reduced FCC's staffing request to three additional auditors in its fiscal year 1992 budget proposal to the Congress, and no additional staff were received as a result of that request. For fiscal year 1993, FCC requested 10 additional auditors, stating that this increase would enable the Audits Branch to review the same significant audit areas once every 5 to 6 years. However, the fiscal year 1993 budget request that OMB submitted to the Congress contained no request for additional FCC audit staff.

To make more efficient use of existing staff, the Chief of Audits of FCC's Common Carrier Bureau has implemented a number of strategies: reducing the scope of on-site audits, reducing the size of audit teams from three to two persons where possible, targeting the most critical areas within the audit universe, and reviewing the CPA auditors' workpapers to identify potential cross-subsidies for targeting on-site audits. As an additional means of expanding its on-site audit coverage without increasing its own audit staff, FCC could consider engaging CPA firms to perform on-site audits at FCC's direction. We have not, however, evaluated the feasibility of such an approach.

Although increasing the number of FCC auditors, along with the appropriate travel funds, would increase FCC's budget, it would have little or no impact on the federal budget because FCC is authorized to charge fees to carriers for the on-site audits and reviews of CPA audits that it conducts. These fees, which are collected and deposited in the U.S. Treasury, would largely offset FCC's costs.

Given the current staffing level, FCC's on-site audits of company books and records continue to be infrequent. On average, FCC annually audits about 16 of the 297 audit areas that it has designated for routine auditing to assess major carriers' compliance with FCC standards. At the present staffing level, FCC could cover each area once every 18 years. If FCC confined its efforts to the 183 areas that it has designated as most critical, it could audit each area about once every 11 years. The Chief of Audits of FCC's Common Carrier Bureau has estimated that a total of 45 auditors, along with the appropriate travel funds, would be the ideal to permit on-site reviews of the most critical areas once every 5 years.

Additional Safeguards Can Be Useful, but On-Site Audits Are Still Needed

Since 1987, FCC has implemented a number of accounting safeguards to protect consumers from cross-subsidization, including (1) CPA audits of carriers' cost allocations; (2) FCC's reviews of CPAs' audit workpapers and reports; and (3) ARMIS, FCC's computerized system for maintaining carriers' cost and revenue data. Although these safeguards can give FCC useful information for monitoring carriers' operations, they have not detected all cases of cross-subsidization. Furthermore, as we noted in 1987, implementation of the safeguards does not diminish FCC's responsibility for ensuring the appropriateness of carriers' cost allocations. Finally, on-site audits have detected instances of cross-subsidization that the other safeguards have not found.

CPA Audits Frequently Have Not Been Performed in Compliance With FCC Guidance

CPA audits of cost allocation systems are required for 16 major carriers (AT&T and Tier I carriers, including the BOCs and all other local exchange carriers earning over $100 million annually in regulated revenue). In contrast to FCC's on-site audits, which review a carrier's cost allocations in a single audit area for as many as 5 years, CPA audits review a carrier's cost allocations in several related audit areas for 1 year. Whereas on-site audits emphasize detailed testing, CPA audits perform more general analyses of cost allocations in such broad categories as affiliate transactions, time reporting, cost pools, enhanced services, and the uniform system of accounts. CPA audits are required to provide positive assurance as to whether the carriers' methodologies for separating regulated and unregulated costs are consistent with the cost allocation manuals approved for the carriers by FCC. The results of the CPA audits are reported to FCC's Common Carrier Bureau.

Although carriers hire CPA firms to perform CPA audits, FCC establishes requirements for the audits through its rules and through the guidelines

that it develops in reviewing the CPAs' audit workpapers. FCC's authority to establish audit requirements is derived from regulations placed on carriers, which pass these requirements on to the CPA auditors. If a CPA audit is not performed in accordance with FCC guidelines and industry standards, FCC can prohibit a carrier from using that independent auditor for any future audit. In its rules, FCC has provided that CPAs are to follow Generally Accepted Auditing Standards except when these standards conflict with FCC rules.

In the order setting forth its accounting safeguards—known as the Joint Cost Order—FCC has provided that it will use CPA audits in its monitoring program but will itself make all final decisions regarding compliance. FCC will not delegate its responsibilities to the CPAs. As the order further states, the CPA audit process is an adjunct to, not a replacement for, FCC's on-site audit program.

CPA audits frequently have not been performed in compliance with FCC guidance, as FCC audit staff's reviews of 1990 workpapers for 17 audits have demonstrated. FCC staff identified at least one problem with 15 of 17 audits. Subsequently, FCC staff addressed the weaknesses in its guidance to carriers. The following examples illustrate some of the shortcomings that FCC audit staff found, the steps that they took to correct the shortcomings, and—in some instances—the importance of their monitoring the CPA audits through on-site audits.

- FCC audit staff have found that CPAs' workpapers have not always adequately supported the findings from their audits. For example, FCC's review of a CPA audit disclosed that the workpapers did not provide the calculations and assumptions used to quantify its finding or show the effect of the finding on the allocation process. Thus, FCC concluded that the CPA could not support its conclusion and recommendation, nor could FCC make its own determination as to the seriousness of the finding. Our review of FCC's reports on 1990 CPA audits showed that problems with quantifying some findings of the audit work occurred in 10 of 17 audits.
- FCC audit staff have found that CPAs' testing has not always been adequate to ensure that carriers are complying with cost allocation rules. For example, in reviewing a CPA audit of an area for which FCC had already conducted an on-site audit, FCC found that the workpapers failed to show that the CPA had appropriately tested carrier employees' reporting of administrative time and telemarketing time. Using the information obtained from the on-site audit, FCC was able to require the carrier to make an adjustment to comply with FCC rules. Our review of FCC's reports on

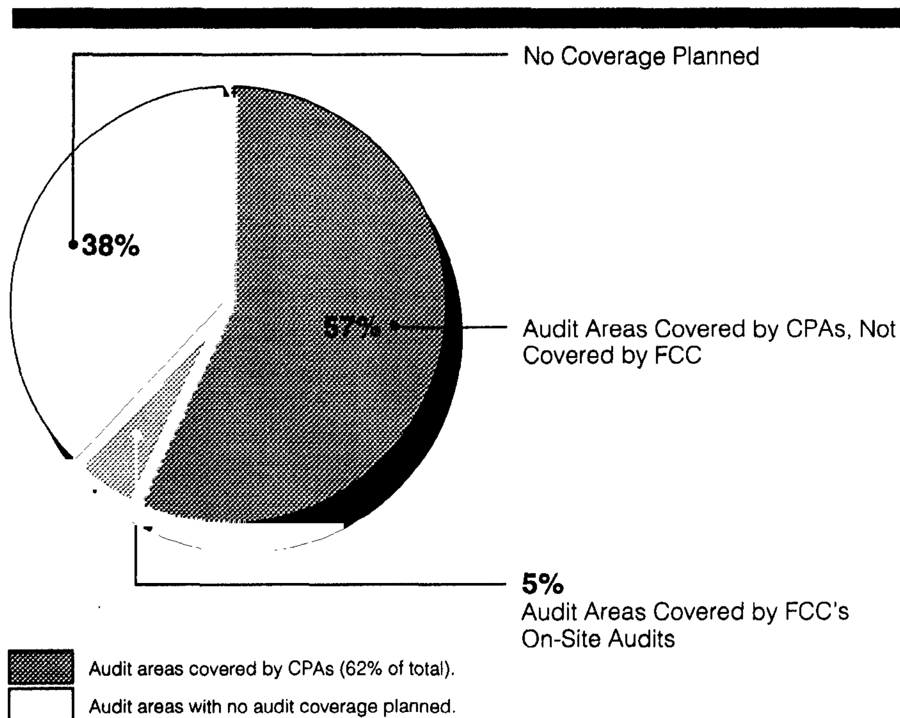
1990 CPA audits showed that FCC had found detailed testing problems in 15 of 17 audits.

- FCC audit staff have found that CPA auditors have not always identified the materiality standards, or the amount of cost misallocation that the auditors consider sufficiently significant to warrant reporting. To ensure consistent and appropriate independent audits, FCC guidance requires CPAS to report these standards so that FCC can assess the suitability of the standards for the carriers. Our review of FCC's reports on 1990 CPA audits showed that FCC had found problems with some aspect of reporting materiality standards in 11 of 17 audits.
- FCC audit staff have found that CPAs have not always adequately reviewed and tested the transactions of unregulated affiliate companies that provide substantially all of their services to a regulated affiliate company. Through information gained from on-site audits, FCC has identified components for testing and developed guidance and direction for CPA audits of affiliates' transactions. Our review of FCC's reports on 1990 CPA audits showed that FCC had identified problems with the CPAs' reviews of affiliate transactions in 13 of 17 audits.

FCC auditors are currently reviewing CPAS' workpapers for 1991 audits of carriers' cost allocation manuals. Although FCC believes the CPA audits have improved, further changes have been required to improve compliance with FCC guidelines. According to FCC audit staff, several of these changes have already been discussed in previous FCC communications. While recognizing that carriers may not have had time to comply with all of the new requirements for their 1991 CPA audits, FCC staff expect the requirements to be implemented in the 1992 audits.

In fiscal year 1993, independent CPA audits will cover 183, or about 62 percent, of the 297 audit areas that FCC has designated for all major carriers. FCC itself will perform on-site audits of only 15 audit areas covered by the CPAS. (See fig. 2.) Four of these audits will be performed only if the Audits Branch receives supplemental travel funds.

Figure 2: Percent of Audit Areas Planned for Audit Coverage During Fiscal Year 1993



Note: FCC audits cover the same areas audited by CPAs.

FCC's Reviews of CPAs' Workpapers and Audit Reports Are Not Complete

FCC oversees CPA audits and audit procedures by reviewing auditors' workpapers and audit reports, as well as by conducting on-site audits. In principle, these reviews enable FCC to ensure that the CPA audits are being, or have been, conducted in accordance with FCC specifications and therefore will be, or are, adequate to determine carriers' compliance. These reviews also enable FCC to identify weaknesses in its own guidance and to revise its requirements for CPA audits. For example, following reviews of CPA auditors' 1988 and 1989 workpapers, FCC determined that the CPA audit should be expanded to meet the standards applicable to a financial statement audit.

Because staffing limitations restrict FCC's oversight of CPA audits through on-site audits, FCC relies extensively on reviews of CPAs' workpapers to evaluate the reliability of the CPAs' work. Yet even these reviews have been limited. For the last 3 years in which review cycles have been completed, FCC auditors have been able to complete the reviews of workpapers for only 43 of the 58 CPA audits performed. Furthermore, FCC has reviewed five

carriers' CPA audits only once. For fiscal year 1991, FCC had planned to review all 20 CPA audits in order to determine CPAs' compliance with new FCC guidance. As of September 1992, FCC had completed reviews of 17 of the 20 CPA audits and performed some work on the remaining 3.

ARMIS Data Are Not Uniform

ARMIS is a computerized system containing cost, revenue, and forecast data reported by major carriers that FCC uses for a variety of its regulatory functions. FCC had anticipated that ARMIS would allow it to track trends in cost data over time and across companies, establish benchmarks for comparison, identify disproportionate cost allocations indicative of potential cross-subsidization, and target on-site audits to carriers whose allocations appeared problematic.

For several reasons, ARMIS has not generated the comparisons that would have allowed FCC to substitute "computerized auditing" for some on-site audits. First, ARMIS does not break out cost pool data—that is, report regulated and unregulated costs for individual subaccounts—because cost pools vary from one carrier to another. Therefore, only aggregate (and less useful) comparisons are possible. In addition, each carrier's cost allocation manual contains different procedures for allocating certain costs, and carriers change these procedures throughout the year with FCC's approval. According to the Chief of Accounting Systems of FCC's Common Carrier Bureau, FCC is currently studying ways to make the cost allocation manuals uniform. He also said that if the cost allocation manuals had more uniform standards for cost pools and cost allocation procedures, then the automated reporting system could be more useful in identifying possible instances of cross-subsidy.

Despite its limitations, ARMIS did enable FCC to detect "inside wire" misallocations amounting to over $200 million. Charges for time spent by service representatives locating trouble with indoor telephone wires were inappropriately allocated to regulated services. After deregulating inside wiring and making homeowners responsible for repairs to it, FCC was expecting the regulated account balances to decrease. When ARMIS data did not reflect the anticipated decrease, FCC auditors made on-site visits to determine the extent of the misallocation. According to FCC officials, this was the only instance in which ARMIS data had enabled them to firmly identify a cost misallocation for follow-up by FCC auditors. There have been instances in other regulatory areas where ARMIS was used to identify problems.

On-Site Audits Have Identified Cross-Subsidization

Through on-site audits, FCC auditors have identified cost misallocations that neither CPA audits nor FCC's reviews of CPAS' workpapers and audit reports had disclosed. For example, FCC auditors have found cases of misallocations totaling over $300 million in which carriers charged expenses to the regulated side of their businesses and carriers' affiliates had overcharged regulated carriers for services and supplies.

On-site audits have enabled FCC auditors to detect not only cost misallocations but also deficiencies in carriers' cost allocation procedures and in CPAS' audit practices and procedures. For example, in reviewing one carrier's time reporting, FCC auditors found that for a 3-year period the carrier's employees had not followed the proper procedures for allocating their time to regulated and unregulated services. The CPA was aware of the carrier's procedures, but the CPA believed it was in compliance with FCC rules. FCC auditors disagreed and required the carrier to make the appropriate changes. Because the carrier had not followed FCC's procedures and the CPA firm had not enforced FCC's procedures, about $130 million had been charged erroneously to the regulated services. Following the on-site audit, FCC auditors required the carrier to reallocate the costs that it had improperly charged to the regulated services and to revise its procedures to conform with FCC's policies and procedures.

Conclusions

In 1987, we reported that FCC had insufficient staff to ensure that consumers were protected from cross-subsidization. Since that time, FCC's responsibility for overseeing carriers' cost allocations have continued to grow, but the staff resources allocated to this function have declined rather than increased. We believe the number of FCC auditors remains inadequate to provide a positive assurance that ratepayers are protected from cross-subsidization.

Increasing the FCC staffing level, along with the appropriate travel funds, would have little or no impact on the federal budget because the government would be reimbursed for its on-site audits and reviews of CPA audits through fees FCC is authorized to collect from carriers. Given this trend of increasing work load and decreasing resources, the potential exists for ratepayers to be more vulnerable to inappropriate charges resulting from cross-subsidization in the future. Although CPA audits, FCC's reviews of these audits, and ARMIS can give FCC useful information for monitoring, they have not identified over $300 million in cross-subsidization. Further refinements to FCC audit guidance and greater uniformity in reporting cost data for ARMIS may improve FCC's information

for oversight, but expanded coverage through additional on-site audits by FCC would give ratepayers and the Congress greater assurance that cross-subsidization is not occurring.

Recommendation to the Chairman, Federal Communications Commission

We recommend that the Chairman, FCC, continue to pursue the Commission's quest for additional resources to improve assurance that cross-subsidization is not taking place.

Matter for Congressional Consideration

The Congress may wish to consider authorizing additional permanent positions for auditors and the appropriate travel funds, recognizing that the funds expended would have little or no impact on the federal budget.

Agency Comments and Our Evaluation

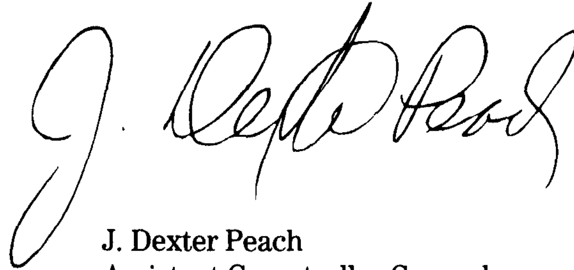
We discussed the information contained in this report with the Deputy Chief of FCC's Common Carrier Bureau and his staff. They generally agreed with the factual information in the report, and we have incorporated their comments where appropriate. As requested, we did not obtain written agency comments on a draft of this report.

The Commission's position is that all the safeguards taken together are an effective deterrent against cross-subsidization. However, as pointed out in this report, FCC audit staff continue to find significant problems in the audits that they have been able to conduct. It is our view that the FCC audit staffing level is not adequate to oversee cost allocations, and the additional safeguards FCC employs have not been effective in detecting all cases of cross-subsidization. Consequently, we continue to believe that our recommendation that FCC continue to seek the additional resources is valid.

To update our 1987 report and determine whether FCC had increased its oversight of carriers' operations as we had recommended, we reviewed FCC's efforts to obtain additional audit staff and examined FCC's implementation of nonstructural accounting safeguards. We performed our work in accordance with generally accepted government auditing standards from September 1991 through September 1992. Appendix III contains further discussion of our objectives, scope, and methodology.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of this report to interested congressional committees and subcommittees; individual Members of Congress; the Chairman, Federal Communications Commission; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others on request.

This work was performed under the direction of Kenneth M. Mead, Director, Transportation Issues, who can be reached at (202) 275-1000 if you or your staff have any questions. Major contributors to this report are listed in appendix IV.



J. Dexter Peach
Assistant Comptroller General

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Abbreviations

ARMIS	Automated Reporting Management Information System
AT&T	American Telephone and Telegraph Company
BOC	Bell Operating Company
CPA	Certified Public Accountant
CPE	customer premises equipment
FCC	Federal Communications Commission
GAO	General Accounting Office
LEC	local exchange carrier
OMB	Office of Management and Budget
VMS	voice messaging service

Listing of Common Unregulated Services

This appendix includes some of the unregulated services offered by major carriers. These are services that have never been subject to tariff regulations by FCC and those that FCC has preemptively deregulated under its regulations.

MESSAGE STORAGE SERVICE allows multiple information providers to store and update information remotely through the public switched network. The storage device will receive input messages and store them on magnetic disks for later retrieval by multiple callers.

PUBLIC DATA NETWORK: PROTOCOL CONVERSION SERVICE allows customers with different systems to communicate with each other. This public data network is a packet switched public data communications system that allows customers to send and receive interactive data communications at low to medium speeds.

GATEWAY SERVICE facilitates customer access to information services. Gateways can provide on-line, helpful directions to various information services, listings of service providers, service authorization features, and storage capacity.

COIN MESSAGE DELIVERY SERVICE is designed to provide a message delivery service for public telephone users. When there is a busy or no answer situation, the user can leave a recorded message for future delivery to the telephone number called. The coin message delivery service is triggered when the user, responding to the system's prompt, deposits an additional coin or presses a button on the telephone's touchtone pad.

VOICE MESSAGING SERVICE (VMS) allows the customer to receive, store, and send voice messages from a touch-tone telephone. VMS consists of two applications—call answering and messaging. Call answering takes the subscriber's telephone call when the subscriber is on the line or not at home. A message may be deposited in the subscriber's "mailbox" either by a caller who has called the VMS and left a message, or by another voice mail subscriber who has sent a message directly from mailbox to mailbox. VMS provides subscribers with 24-hour telephone answering and message storage, priority message delivery, delivery to a group list, call transfer to an attendant, remote message notification, and automatic response to messages from mailbox subscribers.

ELECTRONIC MAIL SERVICE is a computer-based method of transmitting information that involves composing messages on a computer terminal,

transmitting them electronically, and storing them in memory for later retrieval by a recipient. Electronic mail generally involves short memos, letters, or files in electronic text or format.

INSIDE WIRE SERVICES are products and/or services sold by carriers which are installed or performed within the customers' premises. The services include time and material charges for business and residential installation and repair of wire and telephone jacks that are the customers' responsibility within the home or building.

INSIDE WIRE MAINTENANCE PLANS provide customers with the option to pay a monthly maintenance fee covering all service instead of individual service charges for inside wire repair in the customers' premises.

DIRECTORY ADVERTISING AND ANCILLARY SERVICES includes such activities as advertising products and services that the directory organization markets to general and selected market segments. Examples of such products include the traditional yellow pages directories and the business-to-business directories.

TELEPHONE BOOTH ADVERTISING allows customers to lease advertising space on public telephone booths.

ELECTRONICS FUNDS TRANSFER includes switching, networking, and data processing for automated teller machines.

Background on FCC Regulation of Competitive Services

FCC has the major responsibility for policing the line between the legitimate sharing of costs between regulated and unregulated entities in the telephone industry and the improper allocation of costs or cross-subsidization. FCC has the authority to regulate only the interstate activities of that industry. Intrastate activities—local and long distance services within the state—are the responsibility of state regulators.

Recognizing its responsibility with regard to the new enhanced services industry, FCC moved in favor of a regulatory policy designed to promote competition. However, FCC was concerned that carriers would pass on to telephone ratepayers costs properly attributable to their unregulated enhanced services business. Through improper cost-shifting a carrier could effectively subsidize its unregulated activities, either from misallocation of joint costs or from improper pricing of services and products provided by one affiliate to another within the carrier's corporation, to the detriment of both its ratepayers and its competitors in the enhanced services market.

To guard against cross-subsidization, the FCC issued several rulemakings, including the First Computer Inquiry (Computer I) in 1971, the Second Computer Inquiry (Computer II) in 1980, the BOCs Separation Order in 1983, and the Third Computer Inquiry (Computer III) in 1986. The Computer I decision considered for the first time the appropriate way to regulate telephone companies' participation in the newly emerging, competitive business of delivering data-processing services over telephone lines. Computer I did not regulate data-processing services but required that any telephone carrier offering such enhanced services do so by means of a separate corporate subsidiary.[1] The subsidiaries had to maintain their own financial records; have separate offices; and use separate personnel, computer equipment, and facilities for their data processing-services. Although Computer I controlled cost shifting by prohibiting carriers from combining costs for operations and marketing, it did permit separate subsidiaries to share administrative and corporate overhead expenses.

As advances in technology made it more difficult to distinguish between data processing and communications, FCC issued the Computer II decision, which created a regulatory distinction between basic and enhanced services. FCC sought to clearly define which activities would be regulated as common carrier services and which would not. The Computer II

[1]The structural separation requirement was applied to all carriers with annual revenues exceeding $1 million. Structural separation was not initially regarded as applying to AT&T and its local exchange affiliates (the Bell System), because those companies were thought to be barred from offering data-processing services by a 1956 antitrust consent decree.

decision concluded that enhanced services were outside the scope of its authority to regulate under Title II of the Communications Act[2] and deregulated customer premises equipment (CPE).

In requiring separate subsidiaries, FCC did not expect to diminish carriers' incentive to cross-subsidize their nonregulated activities, but did believe that structural separation would make competitive abuses easier to detect and therefore more difficult to accomplish. Although FCC continued to rely in Computer II on structural separation as the principal means of preventing cross-subsidization, it restricted the requirement to AT&T and its operating subsidiaries and allowed all other carriers to rely on separate accounting records to keep track of their costs for CPE and enhanced services. Thus, only AT&T and its operating subsidiaries were required to form separate corporate subsidiaries to provide enhanced services.[3]

Following adoption of the Computer II requirements, AT&T divested itself on January 1, 1984, of its 22 local exchange telephone companies—(BOCs)—as part of a settlement of the government's antitrust suit against AT&T.[4] Upon divestiture, the 22 BOCs were grouped into 7 independent regional holding companies.

FCC concluded that the structural separation requirements it had imposed on AT&T should also apply to the seven newly formed regional BOCs. However, FCC did not apply the full range of separation requirements originally imposed on AT&T. FCC allowed the BOCs to carry out limited joint operations, including (1) joint CPE billing for 4 years following divestiture, (2) joint installation and maintenance of residential and single-line business telephones, and (3) sharing administrative services.[5]

[2]47 U.S.C. 201-224 (1980). Generally, Title II of the Act governing the regulation of common carriers requires communications common carriers to offer their interstate services and facilities at just, reasonable, and nondiscriminatory rates that are set forth in tariffs filed with FCC.

[3]According to FCC, AT&T remained subject to the 1956 antitrust consent decree when FCC adopted Computer II. However, in Computer II, FCC expressed its belief that the 1956 decree did not bar AT&T from offering CPE and enhanced services on a separated basis insofar as those services were subject to regulation by FCC. The 1956 decree was later vacated and the pertinent restrictions no longer applied.

[4]U.S. v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), aff'd sub nom., Maryland v. United States, 460 U.S. 1001 (1983).

[5]See, Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communication Services by the BOCs, 95 FCC 2d. at 117, 1139 - 1150 (1983) (BOC Separation Order) aff'd sub nom., Illinois Bell Tel. Co. v. FCC, 740 F. 2d 465 (7th Cir. 1984), recon. den'd, 49 Fed. Reg. 26,056 (June 26, 1984), aff'd sub nom., North American Telecommunications Ass'n v. FCC, 772 F. 2d 1282 (7th Cir. 1985).

AT&T, now divested of the BOCs, was free to enter virtually all other facets of the marketplace, including data processing. AT&T retained its long-distance telephone operations, its CPE manufacturing business, and Bell Laboratories. The divested BOCs were restricted generally to providing local exchange telephone service and other "natural monopoly" services actually regulated by tariff.[6] The BOCs were not allowed to provide long-distance telephone service or manufacture equipment. Also, they could not transmit or generate information services,[7] a category that substantially overlaps but may not be identical to FCC's enhanced services.

Subsequent to the approval of the consent decree and the submission of a report by the Department of Justice, a number of motions were filed with the District Court, which collectively sought removal of all of the line of business restrictions. In 1987, the District Court responded by removing the restriction on the transmission of information, as well as a comprehensive catch-all restriction on the entry of the BOCs into nontelecommunications markets. The court relaxed the information service restrictions and permitted the BOCs to offer voice-messaging services, voice storage and retrieval, and electronic mail services[8] —all of which are enhanced services under FCC's definition. The court concluded that there was no basis for removing the three core restrictions—on interexchange services, on the generation of information, and the manufacture of equipment—because the BOCs retained their monopoly control of the local telephone switches and wires. The District Court rulings were appealed. With respect to the ruling dealing with information services, the Court of Appeals specified that the District Court should determine whether removal of the information services restriction would be anticompetitive under present market conditions.[9] On the basis of this guidance, the District Court lifted the restriction on the generation of information by the BOCs.[10]

[6]A statement filed by a telecommunications common carrier with the appropriate public regulatory agency which describes the service it offers and lists a schedule of charges for the use of that regulated telecommunications.

[7]The court defined information services as the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information that may be conveyed via telecommunications.

[8]See generally United States v. Western Electric Co., 673 F. Supp 525 (D.D.C. 1987). United States v. Western Electric Co., 714 F. Supp. 1 (D.D.C. 1988).

[9]United States v. Western Electric Co., 900 F. 2d 283 (D.C. Cir. 1990), cert. den'd, MCI Communications Corp. v. United States, 11 S. Ct. 283 (1990); see also 915 F. 2d 738 (D.C. Cir. 1990).

[10]United States v. Western Electric Co., 767 F. Supp. 308 (D.D.C. 1991); stay vacated, 1991-2 Trade cas. (CCH) 69,610 (D.C. Cir. Oct 7, 1991) (per curiam), rev. denied, 112 S. Ct. 366 (1991).

Shortly after the AT&T divestiture in its proceeding to determine whether and how Computer II should be applied to the divested BOCs, FCC noted that the seven regional BOCs, although smaller than AT&T, remained titans in the telecommunications industry. FCC insisted that the BOCs' monopoly power would give them both the incentive and the ability to cross-subsidize. Absent structural separation rules, FCC found that the BOCs could install their own enhanced services equipment within the local networks and would be free to market enhanced services through the same organizations used for basic telephone service.

FCC found that structural separation continued to be an effective means of preventing cost-shifting. The separate subsidiary requirement forces the BOCs to produce and market enhanced services apart from basic telephone services and to maintain different books, different staffs, and different equipment premises for each service.

Computer III Reverses FCC's Position on Separate Subsidiaries

Even though FCC had taken a hard stand on separate subsidiaries, in August 1985, about 14 months after concluding the BOCs Separation Order, FCC reversed its course and announced in the Computer III Notice of Proposed Rulemaking its intention to relieve the BOCs of the separation requirements. FCC now concluded that divestiture and increased competition in the enhanced services market had diminished the value of structural separation as a safeguard against monopoly abuse. FCC argued that divestiture had drastically changed the competitive structure of the telecommunications industry. FCC concluded that the costs of separation now exceeded its public benefits and proposed to replace the requirement with accounting and other nonstructural regulations. FCC adopted the Computer III decisions in May 1986.

Specifically, Computer III permits carriers to offer nonregulated telecommunications services without having first to set up a separate subsidiary. In reaching this decision, FCC concluded that requiring separate subsidiaries impeded carriers from offering new nonregulated services and thus imposed costs on the public because such services were not available. FCC determined that these costs exceeded the benefits that separation provided in preventing cross-subsidy and other competitive abuses. FCC recognized, however, that the potential for cross-subsidy and competitive abuses still existed and needed to be addressed. Thus, regulatory controls were still needed to prevent carriers offering unregulated services from subsidizing these services through improper cost allocations and improper pricing by one affiliate to another. FCC

established nonstructural safeguards in Computer III and FCC's subsequent Joint Cost Rules.

Therefore, FCC set forth cost accounting rules in Computer III and deferred to the Joint Cost Proceeding[11] the development of specific standards for allocating joint and common costs between companies' regulated and nonregulated products and services provided without separate subsidiaries.

FCC's overall goal in the joint cost proceeding was to ensure the "just and reasonable" telephone rates, called for in the Communications Act of 1934. Through the joint cost proceeding, FCC aimed both to maximize the availability of efficient, low-cost telecommunications services and to ensure fair allocations of costs between carriers' regulated services and unregulated ventures. FCC stated that cross-subsidy could result either from misallocation of joint costs or from improper pricing of services and products provided by one affiliate to another within the carrier's corporation.

Accounting Nonstructural Safeguards

FCC's joint cost proceeding set up an overall program of nonstructural accounting safeguards. The accounting safeguards are aimed at protecting the ratepayer by placing specific accounting requirements on carriers to ensure that ratepayers do not incur any costs that should be applied to competitive services. FCC believes that all of the accounting safeguards taken together present a substantial deterrent to cross-subsidization.

FCC specific accounting safeguards are as follows:

- FCC adopted an approach—called fully distributed costing— that first assigns those costs directly associated with each product or service and then assigns any joint or common costs on some pro-rata sharing method.
- The major carriers file cost allocation manuals that apportion costs between regulated and nonregulated activities using the fully distributed costing approach.
- The major carriers obtain independent yearly audits by independent CPAs of their cost allocations, and the independent audit report must include a

[11] FCC's Joint Cost Order is FCC's rulemaking that adopted standards for carriers to follow in separating the costs of regulated telephone service from costs of their nonregulated lines of business. The decision set up the overall program of accounting safeguards. Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, 2 FCC Rcd. 1298 (1987) (Joint Cost Order), modified on recon., 2 FCC Rcd. 6383 (1987), modified on further recon., 3 FCC Rcd. 6701 (1988), aff'd sub nom., Southwest Corp. Bell v. FCC, 896 F. 2d 1378 (D.C. Cir. 1990).

positive assurance that the carriers' allocations comply with the approved cost manuals.

- ARMIS provides data on the costs assigned to regulated and nonregulated operations and is intended to permit FCC auditors to compare one carrier's results from one year to the next as well as one carrier's cost assignments with the assignments of other carriers.
- FCC staff review the CPAs' audit reports and workpapers, and, in specific instances, conducts its own on-site audits to review carriers' allocation of costs between regulated and unregulated activities.

U.S. Court of Appeals Vacates FCC's Computer III Decision

Several petitioners requested the U.S. Court of Appeals for the Ninth Circuit Court to review FCC's Computer III decision. First, the petitioners claimed that it was irrational for FCC to abandon structural safeguards so soon after imposing them on AT&T in Computer II and reimposing them on the divested BOCs in the BOC Separations Order. Second, they challenged the Commission's decision to preempt state regulation of communications common carriers' provision of enhanced services. In response to the petitioners request for review, on June 6, 1990, the Court of Appeals in the case of People of California v. FCC[12] granted the petition for review, vacated the Computer III decision, and sent it back to FCC for further proceedings consistent with the court opinion. The court found that FCC had not sufficiently justified its decision to replace structural separation requirements with nonstructural safeguards for BOCs enhanced service operations and the court held that FCC's preemption decisions were not justified. The vacating of the Computer III orders generally returned the industry and the FCC to the Computer II regulatory regime. However, to prevent industry disruption, FCC adopted an interim waiver of Computer II. In FCC's Memorandum Opinion and Order adopted on July 20, 1990, FCC responded to the BOC's Joint Petition for a waiver of Computer II rules. FCC said that while the Court was not convinced by the Commission's assertion that cost allocation safeguards would effectively prevent cross-subsidization, the Commission had subsequently developed and implemented a set of specific safeguards to guard against any cross-subsidization of nonregulated and regulated activities.

FCC Strengthens Its Cost Accounting Safeguards

After the Ninth Circuit Court vacated Computer III, the FCC reexamined its regulatory regime to consider what safeguards would best encourage the broad-based delivery of enhanced services to the American consumer. FCC proposed in its Computer III Remand Report and Order, adopted

[12]See, People of California v. FCC, 905 F. 2d/1217 (9th Cir./1990).

November 21, 1991, to allow the BOCs to provide enhanced services pursuant to a strengthened set of nonstructural safeguards. FCC readopted its findings that a structural separation requirement imposes substantial public interest costs and that permitting BOCs to integrate their enhanced and basic service operations would provide benefits to both the enhanced services industry and the consumer. Although the Computer III Remand focused on the BOCs because of the court's ruling, it is applicable to all Tier I carriers.

In the Computer III Remand Report and Order, FCC implemented the following strengthened cost accounting safeguards to protect ratepayers against cross-subsidization.

- Carriers are to treat enhanced services as nonregulated activities for accounting and federal and state jurisdictional separations purposes.
- CPA auditors are to provide the same level of assurance in cost allocation audits as in a financial statement audit engagement.
- The Common Carrier Bureau is to study the means of achieving greater uniformity in the carriers' cost allocation manuals and, if appropriate, take steps necessary to accomplish this goal.
- Carriers are to quantify the effects of cost allocation manual changes when such changes are submitted to FCC.
- FCC's Common Carrier Bureau is to study whether to establish a reasonable threshold for determining the materiality of errors and omissions discovered in the independent audits of carrier filings and, if appropriate, take steps necessary to implement such a threshold.

According to the Chief of Policy and Program Planning of FCC's Common Carrier Bureau, as early as February 1992, the People of California, the People of New York, MCI, and the American Newspaper Publishers Association began petitioning the Ninth Circuit Court of Appeals for a review of FCC's Computer III remand. The petitioners question FCC's use of nonstructural safeguards instead of separate corporate subsidiaries for providing nonregulated services.

Price Cap Regulation Is an Additional Safeguard FCC Believes Deters Cross-Subsidization

In addition to the accounting safeguards mentioned above, FCC believes that its price cap regulation[13] removes the underlying incentive for the carriers to cross-subsidize. According to FCC, unlike the rate of return system that limits profits to a certain percentage of cost, price cap regulation is supposed to reduce prices while at the same time encourage carriers through more efficient operations to earn reasonably higher profits than formerly allowed. FCC believes that under rate of return, profits did not depend upon companies being more efficient, rather they depended on spending as much as they reasonably could. Price cap regulation, however, is supposed to alter this situation by encouraging more emphasis on carriers reducing their expenses and stimulating demand. Therefore, FCC believes that under price caps, regulated firms have virtually no ability to pass along cost increases that are within their control.

According to the FCC, a price cap is a benchmark of cost changes that the local exchange carriers (LEC) must meet or fall below, moving in response to economic indicators that the LECs cannot influence. The FCC states that the cap does not change in response to a LEC's own cost changes. Thus, the FCC argues that cost shifting from nonregulated to regulated activities would not result in an increase in a LEC's price cap. FCC officials told us that it is too early to evaluate price caps for the LECs, because the price cap regulation was not implemented until 1991. Thus, we have not considered this regulation in our discussion of FCC oversight.

[13]See, eg. Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786 (1990) and Erratum, 5 FCC Rcd. 7664 (1990) (LEC Price Cap Order), modified on recon., 6 FCC Rcd. 665 (1991), petitions for further recon. pending, appeal docketed, D.C. PSC v. FCC, No. 91-1279 (D.C. Cir. June 14, 1991).

Objectives, Scope, and Methodology

Representatives Edward Markey and Mike Synar requested that we update our report entitled Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services (GAO/RCED-88-34, Oct. 23, 1987). As requested and subsequently agreed with their offices, we addressed FCC's efforts to oversee carriers' cost accounting to protect ratepayers from cross-subsidy. Specifically, we reviewed FCC's implementation of (1) our recommendation to increase on-site audits of carriers' cost allocations and (2) certain accounting safeguards established after 1987 to protect ratepayers from cross-subsidization, including audits of carriers' cost allocations performed for the carriers by CPA firms, FCC reviews of these audits, and a computerized system for maintaining carriers' cost and revenue data known as ARMIS.

Our 1987 recommendation called for FCC to develop a strategy for providing greater levels of oversight and assurance that carriers were properly implementing FCC's cost allocation procedures. We said that the key to the immediate success of such a strategy was FCC's commitment to allocate sufficient audit staff and travel funds.

To review FCC's response to our recommendation, we examined the progress of FCC's implementation of the safeguards to determine whether the FCC's oversight efforts satisfied our report recommendation. To evaluate the adequacy of FCC's resources to implement its program of safeguards, we tracked the program officials' requests for additional staffing and compared these requests with the resources approved by FCC and OMB. We sought to determine (1) the views of program officials as to the need to acquire additional resources to provide additional oversight and (2) the views of the Commission on the adequacy and effectiveness of the audit staff currently allocated to oversee the program's implementation.

To examine how the safeguards oversight process worked, we reviewed current FCC rules, regulations, and guidelines. We examined copies of FCC audit reports issued since 1987; FCC's reports on CPA audits of carriers' cost allocations; budget documents; and FCC orders, rules, and regulations pertaining to the authorization, operation, and evaluation of the safeguards issued since the publication of our previous report. We concentrated on the process of implementing the safeguards and the procedures in place for handling such contingencies as complaints, report recommendations, and follow-ups from the ARMIS system. We also tracked legislative proposals to determine the impact that they might have on the work being performed.

We did not evaluate the methodology used by FCC in developing its reviews of CPA workpapers or its reports of on-site field audits. We did not test the results of FCC's audit work to determine its validity. Our work focused on actions taken by FCC to ensure that ratepayers were not incurring the costs associated with competitive services. We used FCC's reviews of the CPAs' workpapers to examine FCC's oversight of the CPAs' work and the usefulness of the CPAs' workpapers in identifying targets for FCC on-site reviews. We also used these reviews to identify procedural weakness in the CPAs' audit process that FCC believed needed to be strengthened.

We used FCC's reports of on-site audits to identify areas where FCC had identified misallocations and improper procedures, as well as cost misallocations that CPAs had not identified. Our work focused on the actions taken by FCC to ensure that the CPAs were conducting the audits in accordance with FCC guidance and rules and that telephone companies were implementing the cost allocations in accordance with FCC rules. Also, FCC's on-site audit reports were used to identify the number of on-site audits performed, the areas where cost misallocations had occurred and the amounts discovered, and FCC's corrective actions to ensure that ratepayers had not absorbed the costs of such misallocations.

We performed our work in accordance with generally accepted government auditing standards from September 1991 through September 1992 at FCC headquarters in Washington, D.C. As requested, we did not obtain written agency comments on a draft of this report. However, we discussed the information contained in this report with FCC Common Carrier Bureau officials, and their comments were included where appropriate.

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Glossary

Basic Services	The traditional common carrier offerings of transmission services for the movement of information.
Common Carrier	A company, organization, or individual providing wire or electronic communications for hire.
Cross-Subsidization	Improper shifting of costs either through the misallocation of joint costs or from improper pricing of services and products provided by one affiliate to another within the carrier's corporation.
Customer Premises Equipment	Equipment, ranging from simple telephones to computers, that are located at the customers' premises and used to send or receive information over the telephone network.
Enhanced Services	Services offered over common carrier transmission facilities, that use computer processing applications acting on the format, content, code, protocol, or similar aspects of the subscribers' transmitted information; provide additional, different, or restructured information; or involve subscribers interaction with stored information.
FCC's Audit Universe	FCC identified a total of 297 areas requiring audit attention in 16 major carriers including AT&T and Tier I carriers, which are the seven regional BOCs and all other local exchange carriers earning over $100 million annually in regulated revenues. The regulatory areas include the uniform system of accounts, cost pool, time reporting, enhanced services affiliate transactions, separations, and depreciation rates.
Interstate Service	Telecommunications services between states. Such service presently falls under FCC's jurisdiction.
Intrastate Service	Service offered within the boundaries of a state, including both local and toll services. Such service presently falls under the jurisdiction of state regulatory commissions.

Local Exchange Service

Telephone service for single-line business service and residence customers which provides the capability for originating calls to a defined local calling area, for receiving incoming calls, and for access to and from the toll network.

Major Carriers

AT&T, the only long distance carrier subject to FCC regulation and LECs earning over $100 million annually in regulated revenues.

Network

A system where a number of terminal points are able to access one another through a series of communications lines and switching arrangements.

Tariff

A statement filed by a telecommunications common carrier with the appropriate public regulatory agency, which describes the service it offers and lists a schedule of charges for the use of that regulated telecommunications.

Tier I Local Exchange Carriers

LECs earning over $100 million annually in regulated revenues. FCC estimates that Tier I LECs comprise 86 Tier I companies, including 19 companies owned by the regional BOCs.

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