23. Accounting and information management costs should be directly assigned whenever possible.

Summary

The auditors' review of billing by affiliates to SB in 1991 revealed three nonregulated projects which were allocated instead of directly assigned to nonregulated. One of the projects was related to accounting, and the other two were related to information management work. The latter projects could not be directly assigned because the Company has not established a direct charge cost pool for information management expense. The auditors recommend that the Company establish a "Direct Regulated/Nonregulated" cost pool for information management, and directly assign accounting and information projects whenever possible.

Criteria

Part 64 of the FCC's rules states:

> Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.[72]

In conformance with this rule, accounting and information projects should be directly assigned whenever possible.

Condition

The auditors examined the cost pool assignment of successive

[72]Code of Federal Regulations, Title 47, §64.901 (b)(2).

samples of projects billed to SB by affiliates through the Incoming Billing Interface Tracking System ("IBITS"). The official description of related IBITS Authority codes was reviewed and interviews were conducted as necessary to determine the appropriateness of cost pool assignments.

Although most assignments appeared to be appropriate, three projects were found that should have been directly assigned to nonregulated, but were instead allocated between regulated and nonregulated. In all three cases, the official description of the project was marked nonregulated, and the work involved was, indeed, solely related to nonregulated operations. These projects and their 1991 billing to Georgia were as follows:

ACT3111 - Invoicing, Voucher Preparation for CPE ($14,035)

ACT2079 - Enhanced Voice ($3,955)

ACT2405 - Billing of Unregulated Pulselink ($884)

Effect

Because these projects were allocated, instead of directly assigned, most of the costs charged to them were assigned to regulated.

Cause

The first project (ACT3111) involved the invoicing and voucher preparation for non-stock service order related purchases of customer premises equipment ("CPE"). This project was properly classified to Accounting and Finance expense (Account 6721), but

not to the "Direct Regulated/Nonregulated" cost pool. The reason this project was allocated instead of directly assigned to nonregulated could not be specifically determined. The fact that most accounting work relates to both regulated and nonregulated services may have been a factor, although for this project direct assignment was clearly appropriate.

The other two projects (ACT2079 and ACT2405) were properly charged to information management expense (Account 6724). Since this account does not have a "Direct Regulated/Nonregulated" cost pool, the costs involved were allocated. The Company contends that this is appropriate since information management work relates to data base and application systems for general purpose computers. Since such computers run programs related to both regulated and nonregulated operations, the company contends that all information management costs should be allocated.

The Company's argument is relevant to General Purpose Computer Expense (Account 6124), which includes the cost of maintaining general purpose computers and their operating systems. The auditors do not challenge the lack of a direct charge cost pool in that account, since Account 6124 costs are computer asset related, and not associated with data base and applications systems.

These Company arguments are not relevant to information management costs, however. If a project is solely related to either regulated or nonregulated services, it must be directly assigned, whether it involves a computer program run on a general purpose computer or not. Recognizing this, the FCC has approved

Account 6724 direct charge cost pools for the other six Bell Regional Holding Companies.[73]

Recommendation

The auditors recommend, therefore, that the Company establish a "Direct Regulated/Nonregulated" cost pool for account 6724, and directly assign accounting and information management costs whenever possible.

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[73]NYNEX has "Attributed Regulated" and "Attributed Nonregulated" cost pools in Account 6724. NYNEX states the "Projects that directly identify regulated or nonregulated investment, expense or revenue are placed in the regulated or nonregulated pool." NYNEX CAM, 12/31/93, p. VI-47.

24. BSC international calls should be directly assigned to nonregulated in most cases.

Summary

BSC procedures result in the cost of international telephone calls placed by the staff of BSC becoming part of departmental overhead and allocated based upon the individual department's established allocators. Because most such calls relate to BellSouth nonregulated ventures, the auditors recommend that the cost of BSC international telephone calls be directly assigned to nonregulated unless a definite regulated cause can be identified.

Criteria

Part 64 of the FCC's rules states:

> Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.[74]

Since international telephone calls are readily identifiable and relatively expensive, they should be directly assigned whenever possible in conformance with this rule.

Condition

The auditors found that international telephone calls made by the staff of BSC are not segregated from domestic long distance calls. All long distance costs are charged to Occupancy Expense - Utilities (Account 744.2) and treated as departmental overhead.

[74]Code of Federal Regulations, Title 47, § 64.901(b)(2).

The cost of international long distance calls is, therefore, allocated to regulated and nonregulated according to established departmental allocators.

Effect

Since the Company does not segregate the costs of international calls, the auditors were not able to quantify the effect of the current allocation system. Because the cost of individual international calls is much greater than that of domestic calls, however, it is likely that treating them as an overhead is effectively resulting in a cross-subsidy of nonregulated by regulated.

The nature of this cross-subsidy can best be illustrated by an example. Suppose a BSC task requires a hundred calls each to employees working on regulated work domestically and nonregulated work overseas. Assuming the time required to make these calls is equally divided, most overheads, such as floor space, can be equitably allocated according to the time spent by the BSC staff on regulated and nonregulated calls. Because the cost of international calls is much greater than that of domestic calls, however, such a simple allocation of long distance expense will result in regulated being charged too much and nonregulated too little. This effect can be eliminated by the direct assignment of international telephone calls.

Cause

It is likely that Company procedures have always treated telephone calls of all sorts as overheads, and allocated their cost accordingly. The rapid increase in BellSouth involvement in nonregulated overseas ventures since divesture, however, has made such accounting inappropriate.

Recommendation

The auditors recommend, therefore, that the Company revise its procedures to directly assign international telephone calls to nonregulated unless a definite regulated cause can be identified. International calls can be readily identified and assigned automatically. Exception reporting can be authorized in those relatively few cases when an international call is required in support of regulated operations.

25. A portion of BSC unattributable costs should be retained by BSC.

Summary

All BSC "unattributable" expenses are billed to subsidiary entities as corporate services. The auditors recommend that an equitable portion of these costs be retained by BSC and not billed to subsidiaries.

Criteria

Part 32 of the FCC's rules states:

> When a carrier provides substantially all of a service to or receives substantially all of a service from an affiliate which are not also provided to unaffiliated persons or entities, the services shall be recorded at cost which shall be determined in a manner that complies with the standards and procedures of the apportionment of joint and common costs between the regulated and nonregulated operations of the carrier entity.[75]

Part 64 of the FCC's rules states:

> When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.[76]

Taken together, these rules require that the "unattributable" costs of BSC be allocated based upon a general allocator computed by using the ratio of all expense directly assigned or attributed to

[75]Code of Federal Regulations, Title 47, § 32.27(d).

[76]Code of Federal Regulations, Title 47, § 64.901(b)(iii).

regulated and nonregulated activities.

Condition

The auditors found that the company's procedures for complying with these rules involve the calculation of a monthly "General Allocator" which is than applied to all BSC unattributable costs. Examination of the allocator calculation revealed that costs retained by BSC are not included in the development of entity factors. The absence of retained costs in the development of entity factors results in all "unattributable costs" being billed to entities, and none being retained by BSC.

Effect

Since BSC retained costs are nonregulated, the effect of the Company's procedures is an understatement of nonregulated expense and an overstatement of regulated expense. The auditors estimate that, if retained costs had been included as an element in the development of the 1991 General Allocator, over $225,000 of unattributable costs would have been retained by BSC. This would have reduced BSC's billing to SB by over $25,000.[77]

Cause

The auditors were not able to determine why the General

[77]See Appendix H. BSC retained costs are currently at a lower level than in 1991. General Allocator procedures should recognize the existence of retained costs regardless of their level in any particular year.

Allocator calculation excluded retained costs, although the relatively small impact of retained costs on overall allocations may well have been a factor.

Recommendation

In any case, the auditors recommend that the BSC General Allocator calculation be revised to include retained costs. This change will better conform the Company's procedure to the FCC's rules without adding any significant administrative burden. This simple revision will, however, ensure that an equitable portion of "unattributable costs" are retained by BSC and not billed to the regulated entities.

26. The transactions between BAPCO and SGI should be specifically covered by Rule 32.27(d) for the purposes of the Georgia Surveillance Report. Substantial third party sales should be interpreted to mean that 75 percent or more of the sales are to non-affiliated companies.

Summary

Had BAPCO's transactions with it's affiliate Stevens Graphics, Inc. ("SGI") been specifically subject to the FCC's cost allocation rules, and if a clear-cut definition of "substantial" existed, Southern Bell of Georgia's regulated earnings would have been greater during the audit period. Thus, SGI obtained a subsidy. The auditors recommend that the transactions between BAPCO and SGI be specifically covered, and that substantial be interpreted to mean 75 percent or more of the sales are to third parties.

Criteria

The FCC's interpretation of Part 32.27 of its Joint Cost Order rules requires the use of fully distributed costs ("FDC") to limit the price of nonregulated affiliates' products that pass into regulated operations unless the level of unaffiliated business of the nonregulated affiliate meets certain tests. In order for affiliated transactions to be exempt from FDC, all three of the following tests must be met.

Are there:

1. substantial third party sales,
2. of the same or similar product or service,
3. at the same or lower price?

Condition

SGI is an affiliated company that, among other things, prints Southern Bell's white and yellow page directories. SGI charges BellSouth Advertising and Publishing Co. ("BAPCO") for directory printing at a negotiated price. The Georgia Surveillance Report includes an imputation of 50 percent of BAPCO's earnings above a stipulated 10.15 percent return on investment ("ROI"). Thus the cost of directory publishing has a direct impact on intrastate earnings in Georgia. If SGI had used fully distributed costs to set its prices in 1992, BAPCO's Georgia earnings would have been approximately $_____ higher based on an estimate provided by the Company.[78]

BAPCO has taken the position that "the negotiated pricing methodology has been accepted by the FCC and included in the BellSouth Cost Allocation Manual, and thus does not subject BAPCO's affiliated transactions to the pricing hierarchy as set forth in Part 32.27." BAPCO also states that "although the level of non-affiliated business necessary to establish a substantial outside market under the FCC's definition is subject to interpretation, Stevens Graphics believes that [its] market pricing is supportable by the level of non-affiliated business in 1992."

The Company could only provide the auditors with "off the top of the head" estimates of the relative levels of SGI's directory printing business with affiliated versus non-affiliated companies. Based on these estimates, it appears that in 1992 BAPCO represented

[78]Amount is proprietary.

at least 78 percent of SGI's directory printing business. In other words, the non-affiliated directory sales were apparently 22 percent of SGI's directory printing business. This does not appear to be substantial.

Effect

Had BAPCO's transactions with SGI been specifically identified as being covered by Rule 32.27(d), Southern Bell's Georgia intrastate earnings would have been $_____ higher in 1991. This equates to a $_____ understatement of intrastate earnings. This understatement constitutes a cross-subsidy. Since the Company was unable to provide any estimates for the other audit years, the auditors assumed the results were the same in all four audit years. We estimate the amount for all four audit years, therefore, as $____ (____x 4).[79]

Cause

BAPCOs transactions with SGI are not specifically identified as being covered by Rule 32.27(d) and there is no clear cut definition of "substantial" in the interpretation and application of the tests applicable to third-party markets.

Recommendation

On a going-forward basis the Commission should require that, for the purposes of the Georgia Surveillance Report, FCC Rule

[79]Amounts are proprietary.

32.27(d) shall apply to the transactions between BAPCO and Stevens Graphics, Inc., and the concept of substantial third-party sales should be interpreted to mean that 75 percent or more of sales are to non-affiliated companies.

The Company has termed the 75 percent threshold recommended by the auditors "ludicrous, unreasonable, overly burdensome, unnecessary and unwarranted".[80] The FCC, however, has also proposed the establishment of a 75 percent threshold. The FCC states:

> We tentatively conclude that any nonregulated affiliate that sells less than 75 percent of its output to nonaffiliates has too large a volume of affiliate transactions to be deemed to have a predominant purpose of serving non-affiliates.[81]

That consideration aside, the purpose of the cost allocation manual, and the Part 32 affiliated transaction rules, is to protect regulated customers from cross-subsidies. This is consistent with Georgia Statute 46-2-23(g). The intent of the 75 percent threshold recommendation is to provide such protection.

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[80]Company response to Preliminary Finding No. 32.

[81]Amendment to Parts 32 and 64 of the Commission's Rules to account for transactions between Carriers and their Nonregulated Affiliates, CC Docket No. 93-251, Notice of Proposed Rulemaking, FCC 93-453, released October 20, 1993, para. 22.

27. BellSouth Enterprise's retention of expenses associated with its foreign subsidiaries should be referred to the Internal Revenue Service International Examination Branch and the Georgia Department of Revenue Income Tax Division for further investigation with regard to its tax deductions.

Summary

A review of the intercompany billing by BellSouth Enterprises, Inc. for projects and management fees to its foreign subsidiaries indicates that significant expense incurred for foreign companies is not billed to them. The auditors are concerned that BSE's action may have some negative federal and state tax consequences. The auditors are concerned that BellSouth may be overstating the expense associated with its domestic operations and understating the expense associated with its foreign operations.

From the data reviewed for the audit period, it is estimated that as much as $50 million in expense for these foreign subsidiary companies may have been incurred by BSE Headquarters, but not billed. The exact amount can not be determined by the auditors, as BellSouth and BSE have repeatedly denied them access to its 1988 through 1991 Federal Tax returns for the BSE companies. The non-billing of foreign company expense does not have a direct impact on Georgia's regulated telephone expense allocations, but there may indeed be an impact on BellSouth's Georgia tax obligation. The auditors recommend that the Commission refer this issue to the Internal Revenue Service International Examination Branch and the Georgia Department of Revenue Income Tax Division for follow-up review.

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Criteria

Article I, Scope of Services, dated July 8, 1992 defined the Scope and Objectives of the Audit. Section eight (8) states the following:

> "to receive a report of all instances of non-compliance with this COMMISSION'S rules concerning transactions with affiliates (FCC-Section 32.27), allocation of cost between regulated services and non-regulated activities or instances of illegal acts that could result in criminal prosecutions (these may be reported separately)."

Condition

During the audit period significant expenses were incurred at BSE Headquarters for specific projects and other services provided to BSE's foreign subsidiaries that were not billed to them. Binder 34 of Coopers & Lybrand's work papers for its 1991 Part 64 audit indicates that BSE, for the most part, does not bill its foreign subsidiaries for specific project costs or BSE management fees. It does bill its U.S. companies a 2.1 percent management fee to cover the cost of such items as Human Resource, Marketing, Legal Counsel, Financial Management, etc. expense. Two of the BSE foreign subsidiaries which were not billed during 1991 were BellSouth Australia and INVERSORA.

Binder 34 of C&L's Part 64 Audit work papers provides some information as to the amount of expense not billed to the foreign companies. From the data reviewed during the audit, for the 1988-1991 period the amount of expense not billed could exceed $50 million. For example, for only three of the foreign companies during the last half of 1991 alone, the expense retained by BSE

totaled $3.6 million. The specific financial information pertaining to any single BSE company is considered proprietary by BellSouth.

By not billing the foreign companies for the expense incurred, and keeping that expense on BSE's books, the expense would not be identified as being associated with its foreign operations. The Company has stated that the estimated $50 million expense is "stewardship expense" and is allowed to be retained. The auditors believe that the legality of retaining these expenses as "stewardship expenses" is a matter which can only be determined by the appropriate federal and state taxing authorities.

Effect

The effect may be an underpayment of U.S and Georgia taxes as the foreign company related expenses are being retained as deductions on U.S. tax returns, while the revenue of the foreign operations is not subject to U.S taxes.

Cause

Unknown

Recommendation

The auditors recommend that the Commission refer this issue to the Internal Revenue Service International Examination Branch and the Georgia Department of Revenue Income Tax Division for further investigation.

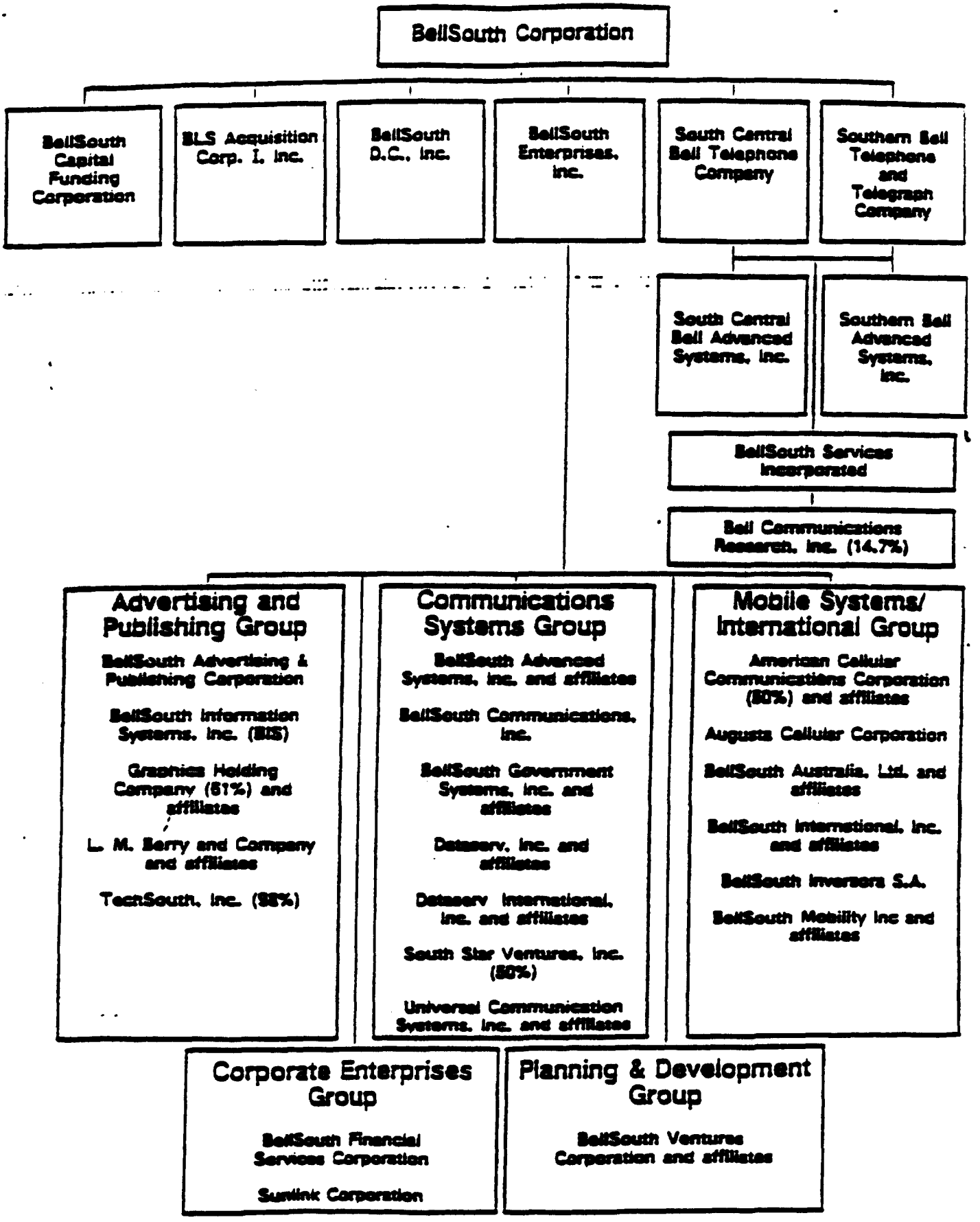
List of Acronyms

Acronym	Meaning
ADIT	Accumulated Deferred Income Taxes
AIC	Average Inward Cost
AT&T	AT&T Corporation
BAPCO	BellSouth Advertising and Publishing Corporation
Bellcore	Bell Communications Research
BRCS	Business Residential Calling Services
BSC	BellSouth Corporation
BSE	BellSouth Enterprises, Inc.
BSI	BellSouth International, Inc.
BSS	BellSouth Services, Inc.
BST	BellSouth Telecommunications, Inc.
CAM	Cost Allocation Manual
CAPRI	Computer Assisted Purchasing, Receiving, and Invoicing
CDAR	Customer Dialed Account Recording
CFITAP	Consolidated Federal Income Tax Allocation Policy
COE	Central Office Equipment
CPE	Customer Premises Equipment
CRIS	Customer Record Information System
CSS	Cost Separation System
CUCRIT	Capital Utilization Criteria
C&L	Coopers & Lybrand
DCPR	Detailed Continuing Property Record
DRMA	Detailed Regulatory Monthly Allocation
ESOP	Employee Stock Ownership Plan

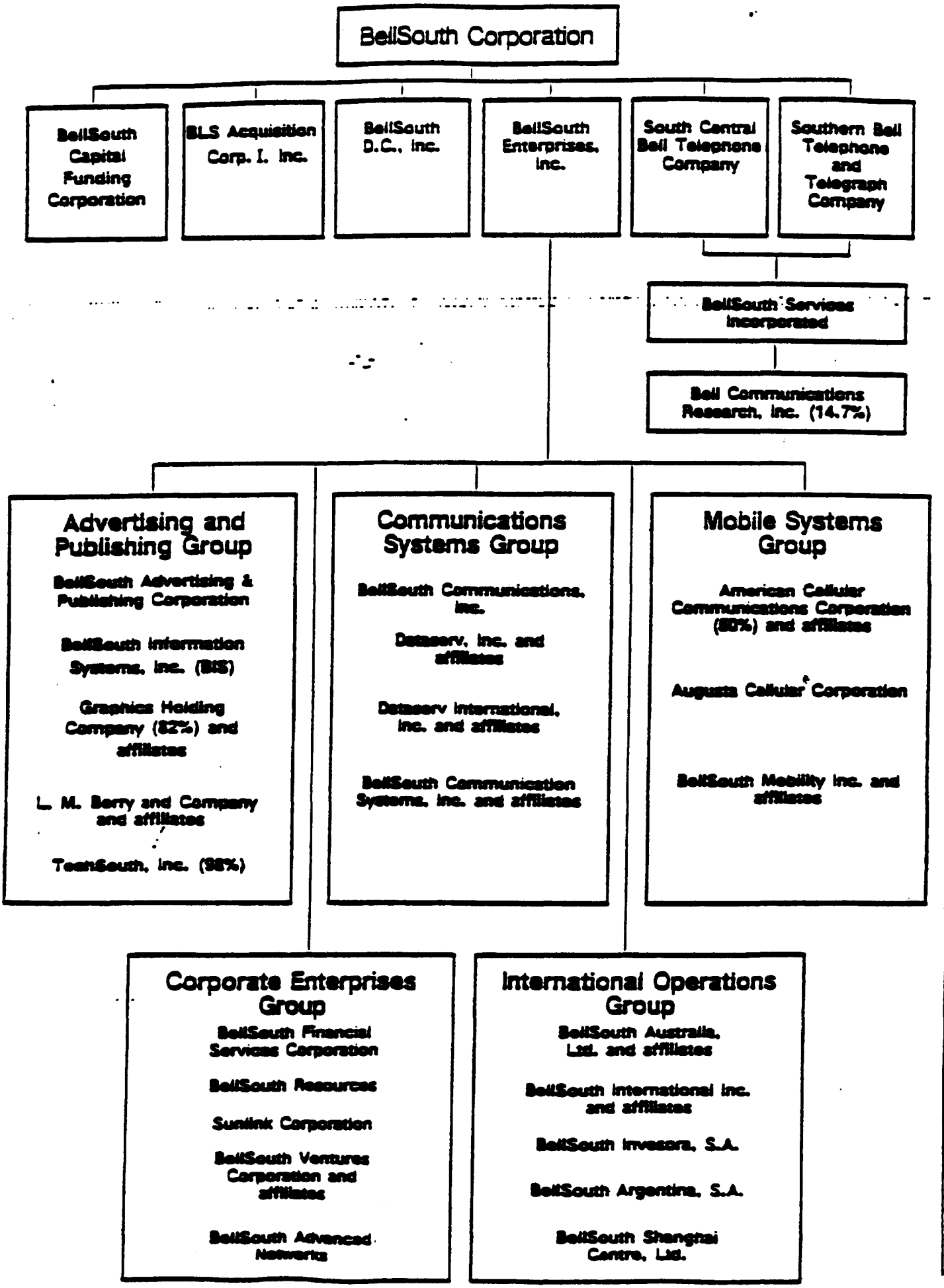
ESP	Enhanced Service Provider
FCC	Federal Communications Commission
FDC	Fully Distributed Costs
GA	Georgia
GAAP	Generally Accepted Accounting Principles
GPSC	Georgia Public Service Commission
HQ	Headquarters
HVAC	Heating Ventilation Air Conditioning
IBITS	Incoming Billing Interface Tracking System
IRC	Internal Revenue Code
IRP	Incentive Regulation Plan
IRS	Internal Revenue Service
ISDN	Integrated Services Digital Network
ITC	Investment Tax Credit
JCO	Joint Cost Order
JFC	Job Function Code
LESOP	Leveraged ESOP
LOB	Line of Business
MFJ	Modified Final Judgement
NOI	Net Operating Income
ONA	Open Network Architecture
OPCC	Outside Plant Control Center
OTC	Operating Telephone Company
PBX	Private Branch Exchange
PCS	Personal Communications Service
PICS	Plug-in Control System

POTS	Plain Old Telephone Service
PSC	Public Service Commission
PTVM	Public Telephone Voice Messaging
RFP	Request for Proposals
RTU	Right-to-Use
R&D	Research and Development
SB	Southern Bell Telephone and Telegraph Company
SCB	South Central Bell
SFAS	Statement of Financial Accounting Standards
SGI	Stevens Graphics, Inc.
SKA	Snavely, King & Associates
TPIS	Telephone Plant In Service
TPUC	Telephone Plant Under Construction
USOA	Uniform System of Accounts

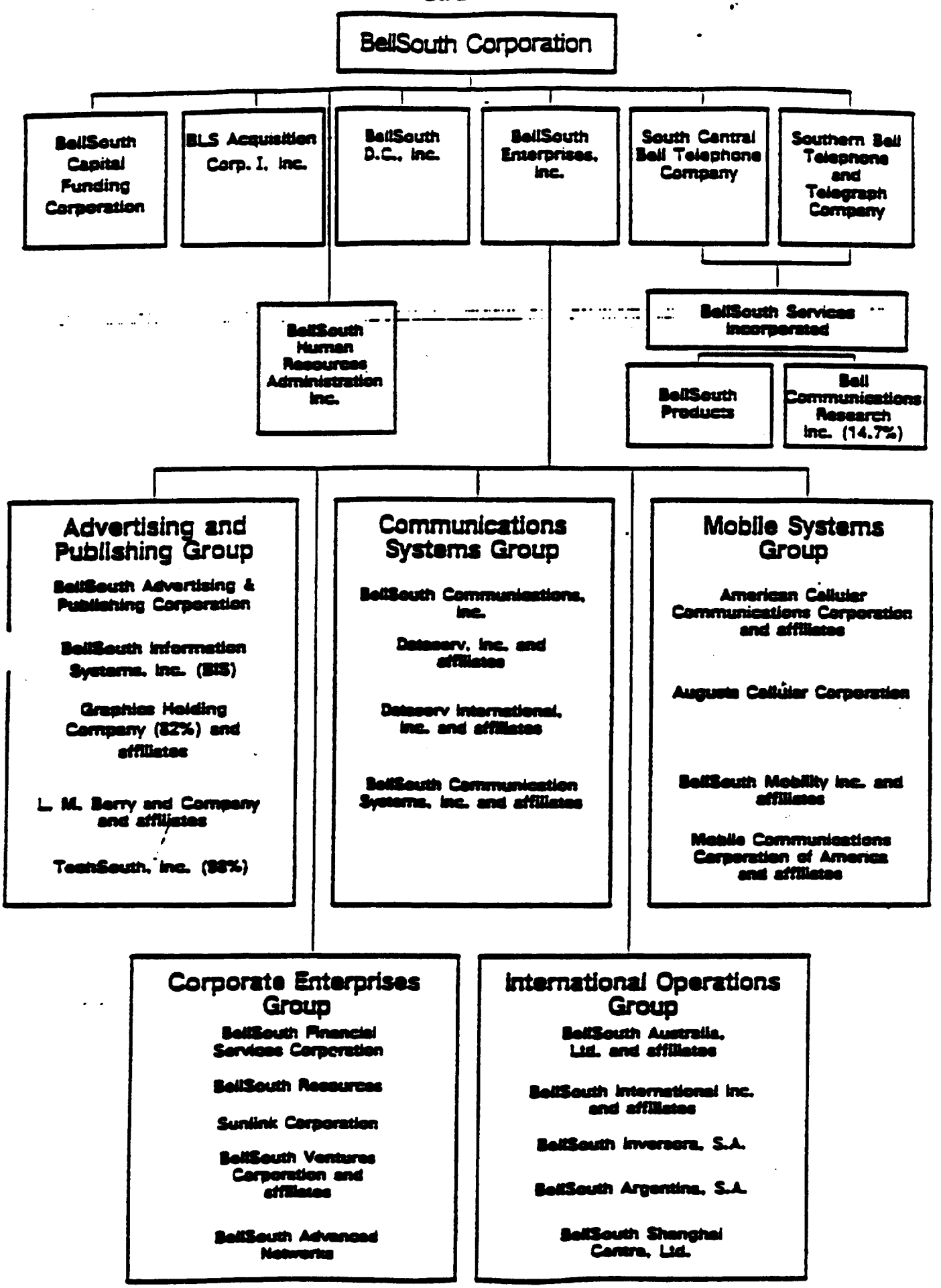
BellSouth Corporate Structure



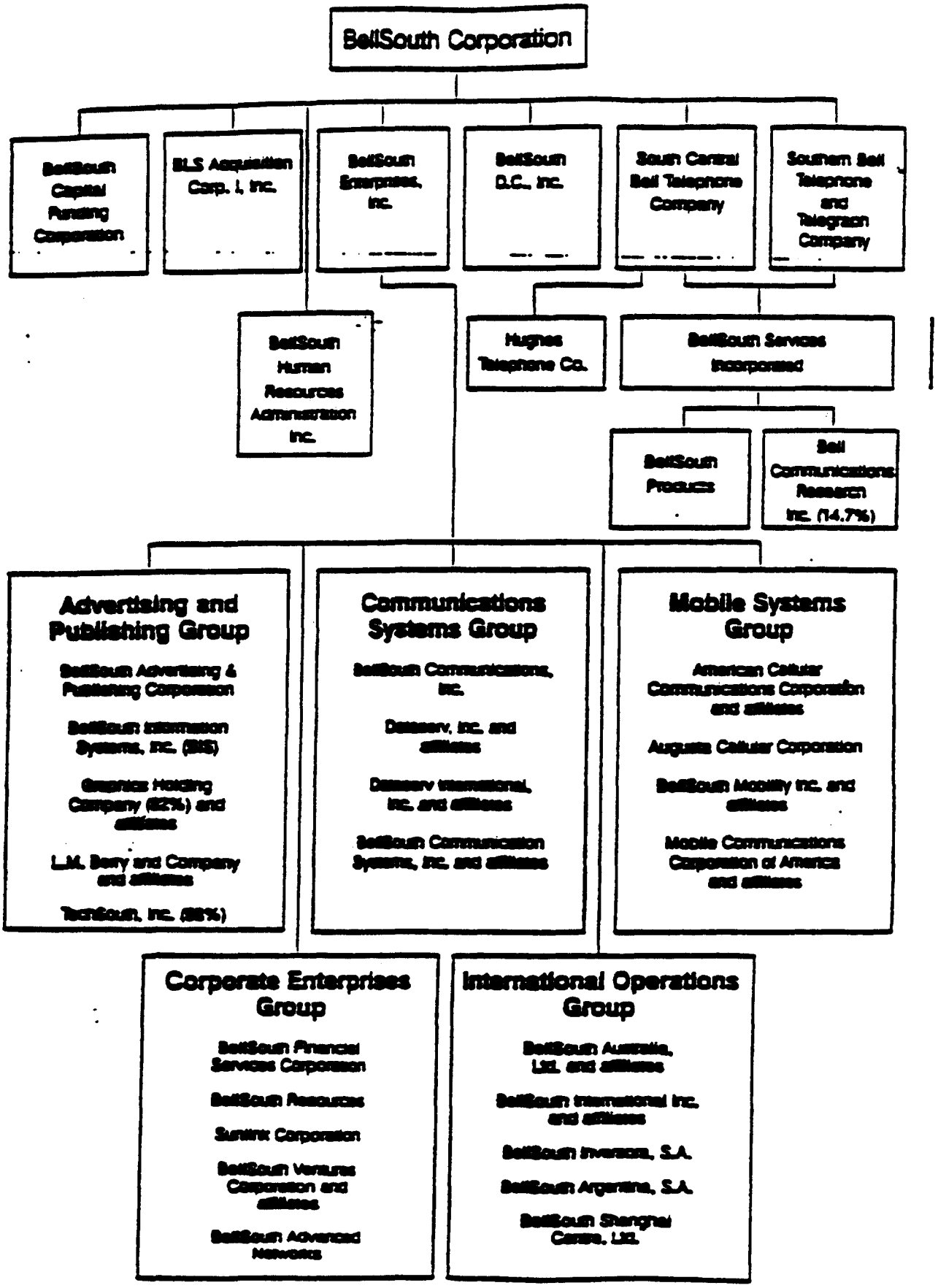
BellSouth Corporate Structure



BellSouth Corporate Structure



BellSouth Corporate Structure



(Revised 09-30-89)