5. We emphasize that in disclosing this information, we are not adopting any portion of the package or endorsing any of the analysis or conclusions contained in it.

IV. ORDERING CLAUSES

6. Accordingly, IT IS ORDERED, pursuant to Section 220(f) of the Communications Act of 1934, as amended, 47 U.S.C. § 220(f), that WE HEREBY DISCLOSE to the public certain financial information obtained during the joint audit of the Ameritech Telephone Operating Companies and their affiliate, Ameritech Services, Inc.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

CONCURRING STATEMENT
OF
COMMISSIONER ANDREW C. BARRETT

Re: Joint Audit of Ameritech Telephone Companies. Consent Decree and Consent Decree Order

This Joint Audit and Consent Decree covers transactions in 1992 between Ameritech Operating Companies (AOCs) and nonregulated, management and support affiliate Ameritech Services, Inc. (ASI). The purpose of this audit was to determine whether Ameritech was in compliance with the Commission's affiliate transaction rules, and the joint auditors found: (1) problems with the lack of documentation to support ASI cost allocations to affiliates, and (2) discrete findings of misallocations. The settlement agreement under the consent decree has achieved substantial accounting improvements sought by the joint auditors, and requires Ameritech to employ an outside auditor to evaluate compliance with terms of the decree within two years following the agreement. Ameritech also has agreed to make voluntary payments to the United States Treasury, as well as to the states of Wisconsin and Ohio.

I support this action addressing serious accounting problems by AOCs as revealed in the course of the Joint Audit, which may have resulted in cost misallocations associated with ASI services. It is necessary to emphasize, however, that this audit report finds no ratepayer harm, even if the misallocations were corrected, due the AOCs' practice of setting prices below their price cap level. I do not disagree with this Consent Decree to the extent that Ameritech has agreed to this settlement. I concur, however, because I question the intrusive purpose of including monetary payments in this settlement agreement despite the lack of harm to ratepayers. I am concerned that the Joint Audit's findings are focused specifically on a failure to provide documentation, which are most appropriately addressed by procedural requirements and subsequent audits. Given that this Decree is not pursued as an enforcement action, and correcting for the misallocations would lead to no rate reductions for ratepayers, I do not believe that a further requirement of monetary payments is appropriate in this instance.

PUBLIC UTILITIES COMMISSION OF OHIO
PUBLIC SERVICE COMMISSION OF WISCONSIN
AND
FEDERAL COMMUNICATIONS COMMISSION
JOINT AUDIT TEAM

REVIEW OF AFFILIATE TRANSACTIONS AT AMERITECH SERVICES, INC.

MAY 1995

JOINT AUDIT REPORT
ON
REVIEW OF AFFILIATE TRANSACTIONS
AT
AMERITECH SERVICES, INC.

I. EXECUTIVE SUMMARY

The Federal Communications Commission (FCC) and the National Association of Regulatory Utility Commissioners (NARUC) initiated a joint effort to review affiliate transactions involving the Regional Bell Operating Companies. As a result of their effort, a joint audit team, consisting of auditors from the Federal Communications Commission, Public Utilities Commission of Ohio, and Public Service Commission of Wisconsin, produced this report. Specifically, it covers the joint audit of transactions between the Ameritech Operating Companies (AOCs) and the affiliate company, Ameritech Services, Inc. (ASI), in 1992.

A. Objectives

The joint audit had two objectives: (i) to evaluate compliance with the affiliate transaction rules and (ii) to determine whether any noncompliance with these rules had adversely affected telephone ratepayers through the flow of cross-subsidies to nonregulated affiliates. The FCC established the affiliate transaction rules in CC Docket, 86-111, Report and Order, released February 6, 1987. The FCC codified these rules in Part 32, Section 32.27, Transactions with Affiliates, of the FCC's rules and Part 64, Section 64.901, Allocation of Costs. The audit team reviewed the rate of return earned by ASI on its sale of products and services to the AOCS and the procedures used by ASI to assign the costs of these products and services between the AOCs' regulated and nonregulated services. The audit team also examined the cost of ASI's consolidation of many of its operations at Hoffman Estates, Illinois.

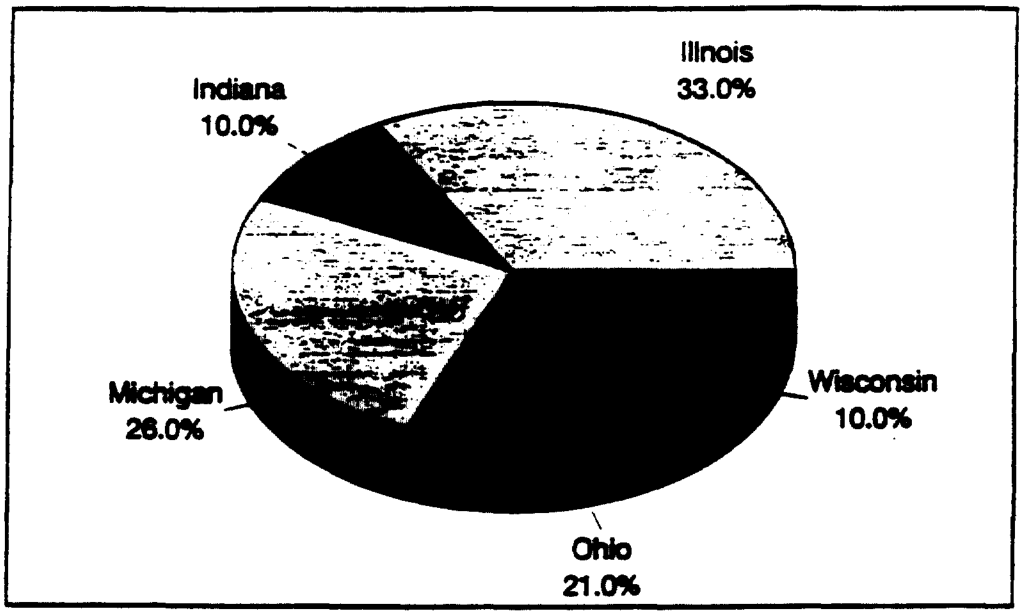
The opinions and conclusions contained in this report represent those of the audit team, not necessarily those of the participating regulatory agencies. The audit team has not presented this report to any of the participating agencies for approval as to the accuracy of conclusions or any recommendations contained herein. Authorization to publish this report does not constitute express or implied approval on any of this report's contents.

B. Structure of ASI

ASI is a wholly-owned subsidiary of the Ameritech Operating Companies (AOCs). Presently, all 200 shares of ASI stock are divided among the five AOCs in the following proportions:

AMERITECH OPERATING COMPANIES

Percentage Ownership of Ameritech Services, Inc.



ASI acts as a central purchasing agent and services provider for the AOCs. Ameritech states that ASI can provide these services more efficiently on a centralized basis than could the individual AOCs. ASI segregates the services into defined categories called work profiles. ASI subdivides work profiles into billable work profiles and nonbillable work profiles. Billable work profiles refer to activities for which ASI sends a bill to the AOC. Nonbillable work profiles designate the overhead-type costs that ASI adds to the costs of the billable work profiles. ASI further segregates each work profile into bill lines that reflect costs that are assigned to the AOCs' nonregulated or regulated operations or are shared between these operations. Bill lines also reflect the Part 32 account and the Part 64 cost pool that the AOCs use to record the costs on their books.

The following chart shows the growth of ASI's net revenues, operating expenses and rate base for three years:

AMERITECH SERVICES, INC.

(Millions)

	1990	1991	1992
Revenues	$550	$677	$1,010
Expenses	$530	$650	$ 967
Rate Base	$117	$153	$ 195

Ameritech Comments

On July 15, 1994, the joint audit team sent Ameritech Services, Inc. (ASI) a copy of its draft audit report on affiliate transactions between ASI and other Ameritech affiliates. The audit team asked ASI to submit its comments on the report including the accuracy of the facts contained in the report and the identification of information that ASI deemed proprietary. Based upon the joint audit team's review of ASI's comments, the team made all revisions that it believed the facts warranted. The revisions included minor revisions throughout the report. Ameritech's response and the audit team's reply to this response are attached to this report.

C. Findings and Observation

The following provides a summary of the joint audit team's findings and observation related to Ameritech Services, Inc.:

Findings

1. **ASI failed to provide sufficient written documentation to allow the audit team to analyze and substantiate, to the audit team's satisfaction, ASI's rationale for the apportionment of its costs between regulated and nonregulated AOC services.** ASI did not provide sufficient written documentation to explain, to the audit team's satisfaction, ASI's apportionment of many of its costs between regulated and nonregulated AOC services. As a result, the audit team had to rely too often on interviews with ASI project managers and employees in order to determine ASI's rationale for its cost allocations. However, these interviews were complicated by ASI's downsizing and reorganizing efforts in 1992 and 1993 during which time many employees left ASI. The audit team encountered further difficulties because some of the interviewed project managers and employees had changed job functions during

this period and, as a result had limited recollection regarding the basis upon which many allocations were made. Consequently, the audit team had difficulty in many instances verifying whether ASI's allocations of its costs of products and services among the AOCs' regulated and nonregulated services complied with the FCC's cost allocation standards.

Both the AOCs and ASI must provide information about their organization and their operations to the FCC upon request. The audit team found that ASI in many cases could not provide sufficient written documentation for the audit period. In order to satisfy the audit team's information requests, ASI could have provided to a greater extent various types of documentation. For example, ASI could have maintained documentation which established the benefit to the AOCs of different services provided by ASI. Such documentation would have included an analysis as appropriate, of (1) potential revenue losses or future costs if the project was not undertaken, compared to costs expected to be incurred; (2) additional regulated revenues expected to be generated compared to costs incurred; (3) improvement in the quality of AOCs' regulated services; or (4) other benefits. Additionally, ASI could have provided the auditors with written procedures that described, with particularity, why it separated the costs between billable and nonbillable work profiles.[1] While ASI directly bills billable work profiles to the AOCs, ASI allocates nonbillable work profiles among all billable work profiles. Without sufficient written procedures for allocations or documentation for AOC benefit verifications, the auditors could not, to their satisfaction, determine why ASI assigned costs to the various accounts and cost pools and whether the assignment of these costs complied with the FCC's affiliate transaction rules.

2. **ASI billed the AOCs for overhead costs that ASI should have allocated between the regulated and nonregulated affiliates.** ASI directly billed the AOCs for certain data center consolidation overhead costs. ASI failed to include these costs in billings for services that ASI provided to Ameritech Mobile and Ameritech (Corporate) as overhead costs. Thus, the work profiles billed to these affiliates did not represent fully-allocated costs as required by Section 64.901 of the FCC's affiliate transaction rules.

3. **ASI allocated all costs of developing new products and services not listed in the Ameritech Cost Allocation Manual**

[1] Billable work profiles contain costs that are directly billed to the AOCs while nonbillable work profiles contain indirect costs that are assigned to the AOCs' bills on the basis of direct costs.

<u>(CAM) to regulated operations.</u> ASI has established several work profiles to study new products or services that it might offer as either regulated or nonregulated services. ASI procedures, though, allocate all costs of these work profiles to regulated cost pools. ASI supports this policy by arguing that Ameritech's CAM lists none of these products or services.

ASI has established a classification system that is clearly biased against assigning costs to nonregulated activity. Even when ASI determines that it has developed a nonregulated product, no mechanism exists to reallocate those costs. A response from an ASI employee that noted, "None of my products were nonregulated when I was working on them," demonstrates ASI's disregard for allocation methods that would accurately distribute costs for new products and services.

4. <u>ASI failed to bill the nonregulated affiliate, Ameritech Advanced Data Services, Inc. (AADS) for development costs under work profile 100018.</u> Based upon trials in Ameritech's Switched Multimegabit Data Service (SMDS), Ameritech formed AADS to provide business customers with advanced data communications services in 1992. ASI allocated certain development costs of the service to work profile 100018. ASI charged all costs associated with this nonregulated service to the AOCs' regulated operations.

5. <u>The auditors found that ASI incorrectly charged the Personal Communications Services (PCS) trial to Account 6535, Engineering Expense instead of Account 6727, Research and Development. The auditors also found that ASI failed to directly assign the PCS trial and SMDS to nonregulated activity as required by the FCC's affiliate transaction rules.</u> Part 32 of the FCC rules states that an investigation aimed at the discovery of new knowledge or translating research findings into a plan or design for a new product should be charged to Account 6727, Research and Development.[2] ASI's PCS trial was a trial of a proposed new nonregulated service that included 100 base stations, 400 users and one PCS provider. ASI charged the costs of these trials to the Engineering expense account which includes the fundamental planning and preliminary work of any potential undertakings.

ASI also assigned the costs of PCS trials to a shared cost pool and the costs of SMDS trials discussed above to a regulated cost pool. The audit team considers these to be nonregulated services that should have been directly assigned to nonregulated cost pools.

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[2] See description of Account 32.6727 in Part 32 of the FCC rules.

6. **ASI leased excess space in its new headquarters in which ASI plans to house nonregulated affiliates.** After consolidating the majority of its operations at Hoffman Estates in 1991, ASI has more square footage of office space than prior to the consolidation. The excess square footage costs the AOCs' ratepayers approximately $30 million annually. ASI plans to lease some of the space to nonregulated affiliates as they expand their operations. The auditors believe this conflicts with the FCC's used and useful standard.[3]

7. **ASI failed to bill Ameritech Publishing, Inc. (API) for $142,838 worth of services provided under work profile 020003.** Under billable work profile 020003, ASI develops computerized billing procedures for new products and services. Due to a billing error, ASI billed the AOCs for costs that ASI should have charged to API for the development of new billing procedures.

Observation

1. **Ameritech's policy of transferring AOC employees to ASI may affect the AOC's wage allocator in the Ameritech CAM.** Ameritech has adopted a policy of transferring AOC employees, who perform functions that Ameritech believes should be provided as a centralized service, to ASI. As a result, costs that were formerly classified as wages and salaries on the AOCs' books become classified as other expenses. Because this reclassification could change the proportional allocation of costs between the AOC's regulated and nonregulated operations, the transfer of AOC employees could significantly impact the wage allocators described in Ameritech's CAM.

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[3] The FCC has historically been guided by the "used and useful" standard. This standard denotes property dedicated to the efficient conduct of a utility's business, presently or within a reasonable period. The standard reflects the principles that owners of public utilities must receive an opportunity to be compensated for the use of their property in providing a public service and that ratepayers must not be forced to pay a return on investment that does not benefit them directly. This standard was discussed in Docket 86-497, released December 24, 1987.

REPORT OF THE JOINT AUDIT TEAM'S REVIEW OF AFFILIATE TRANSACTIONS AT AMERITECH SERVICES, INC.

MAY 1995

II. BACKGROUND

A. Members of the Joint Audit Team

The Joint Audit Team consisted of auditors from the Federal Communications Commission, Public Utilities Commission of Ohio, and Public Service Commission of Wisconsin. The FCC provided one auditor who served as the lead auditor. Both the Ohio and Wisconsin commissions provided two auditors each. The Michigan, Indiana and Illinois commissions did not participate in the audit. The names of the auditors and their respective commissions are as follows:

Michael Wilson	Federal Communications Commission
Joe Buckley	Public Utilities Commission of Ohio
Jim Gould	Public Utilities Commission of Ohio
Kevin Klingbeil	Public Service Commission of Wisconsin
Anne Wiecki	Public Service Commission of Wisconsin

B. Protective Agreements

Each of the state commissions participating in the audit entered into Protective Agreements with the AOC in its state. For example, the Public Service Commission of Wisconsin (PSCW) and Wisconsin Bell, Inc. (WBI), entered an agreement that allowed auditors of the PSCW to discuss information about ASI with the auditors of other states that had executed a protective agreement and with the FCC auditor.

One of the provisions of the Wisconsin agreement stated, "PSCW agrees that, if it contemplates disclosing or publishing any information deemed to be Proprietary Information or document, it will advise WBI prior to such disclosure or publication, in sufficient time for WBI to seek judicial review before disclosure. WBI and the PSCW agree that they will work in good faith together (by means such as, for example, masking, exclusion, rewriting, or reorganizing) to allow desired disclosure or publication without compromising the Proprietary Information."

C. Organization of Ameritech

1. Ameritech

Ameritech serves as one of seven regional holding companies that resulted from the court-ordered January 1, 1984 divestiture of American Telephone and Telegraph Company (AT&T). Ameritech received 100 percent ownership in five communications subsidiaries: Illinois Bell, Indiana Bell, Michigan Bell, Ohio Bell and Wisconsin Bell. These five companies are generally referred to as the Ameritech Operating Companies (AOCs). Ameritech also received 100 percent ownership of Ameritech Mobile, a mobile communications service subsidiary, and a one-seventh interest in Bell Communications Research, Inc. (Bellcore), a central service and research organization. Ameritech has established additional wholly-owned subsidiaries that include Ameritech Credit, Ameritech Development, Ameritech Publishing and others that are described in various reports to shareholders.

2. Ameritech Services, Inc.

The Ameritech Operating Companies established Ameritech Services, Inc. (ASI), to provide centralized services for the operating companies. Services provided by ASI include purchasing, warehousing, material management, computer support, marketing, research and development, accounting, auditing, financial, personnel, legal, recruitment, facilities management, technical and other services. Ameritech believes that ASI can provide these services more efficiently on a centralized basis than could the individual AOCs.

Ownership of ASI is divided among the five AOCs. ASI owns Ameritech's one-seventh interest in Bell Communications Research, Inc. (Bellcore). Since Ameritech's share of Bellcore is owned by ASI, it is ASI's responsibility to manage the AOCs' business interest in Bellcore.

3. ASI-Related Restructuring

Ameritech completed several reorganizations in 1991 and 1992. These reorganizations included the consolidation of certain functions and the transfer of employees related to these functions from the AOCs to ASI. ASI's 1992 Annual Financial Report indicated that the AOCs transferred 306 employees in 1991 and 2,781 employees in 1992 to ASI in an effort to consolidate and streamline operations. In addition, ASI initiated a Work Force Resizing Program, whereby 1,168 employees left the payroll by December 31, 1992.

In 1991, ASI consolidated its operations from ten locations throughout the Chicago area into the Ameritech Center, a newly constructed office facility at Hoffman Estates, Illinois. ASI owns a 49 percent interest in Ameritech Center Phase I, Inc. (ACPI), owner of the office facility. Ameritech owns the other 51 percent of ACPI. ASI entered into a 25-year operating lease with ACPI for this facility.

III. SCOPE OF AUDIT

A. Scope of the Audit

In conducting its audit, the joint audit team focused on the 1992 operations of ASI and the consolidation of ASI operations at Hoffman Estates. The audit team selected sixteen work profiles covering a variety of the services and products provided by ASI to the AOCs. These work profiles represented 7.5 percent of the approximately 200 work profiles undertaken by ASI. This figure amounts to almost 36 percent of ASI's $856 million expenditures in 1992.

B. Objectives of Audit

The joint audit had two general objectives: (i) to evaluate compliance with the affiliate transaction rules and (ii) to determine whether any noncompliance with these rules had adversely affected telephone ratepayers through the flow of cross-subsidies to nonregulated affiliates. The specific objectives of the audit were as follows:

1. Obtain an overview of ASI operations.
2. Obtain an understanding of ASI's accounting system and the kind of reports that are generated by its system.
3. Determine whether ASI's instructions to the AOCs concerning the accounting for ASI costs complied with Part 32 of the FCC rules.
4. Determine whether ASI's instructions to the AOCs concerning the assignment of ASI costs to Part 64 cost pools complied with Part 64 of the FCC rules.
5. Determine whether the AOCs monitored the quality and costs of products and services received from ASI.
6. Determine whether ASI complied with the FCC's rate of return requirements.

C. Audit Procedures

The joint audit team conducted its audit by analyzing ASI's financial data and reviewing ASI's responses to the auditors' data requests. In addition, the auditors submitted written questions to work profile managers[4] to gain an understanding of the types of services included in selected work profiles. The auditors also submitted questions to the subject matter experts at the AOCs. Subject matter experts are AOC employees who have the responsibility for monitoring the quality and cost of products and services provided by ASI. Finally, the auditors conducted on-site interviews of selected ASI employees to gain an understanding of the work profiles and the services or products provided to the AOCs.

D. Ameritech Comments

On July 15, 1994, the joint audit team sent Ameritech Services, Inc. (ASI) a copy of its draft audit report on affiliate transactions between ASI and other Ameritech affiliates. The audit team asked ASI to submit its comments concerning the report including the accuracy of the facts contained in the report and the identification of information that ASI deemed proprietary. Based upon the joint audit team's review of ASI's comments, the team made all revisions that it believed the facts warranted. The revisions included minor revisions throughout the report. Ameritech's response and the audit team's reply to this response are attached to this report.

IV. ASI ACCOUNTING SYSTEM AND COST ALLOCATION PROCEDURES

ASI has a functional accounting system that generally complies with the FCC's Part 64 affiliate transaction standards. ASI assigns costs to bill lines that reflect the Part 32 accounts and cost pools identified in Ameritech's Cost Allocation Manual. ASI accumulates these bill lines into work profiles that reflect specific work activities that ASI provided to the AOCs. According to ASI, this system groups costs into cost pools that are comprised of logical, homogeneous groupings that maximize the extent to which cost-causative allocation factors can be used to divide the costs between the telephone companies' regulated and nonregulated operations. Finally, ASI groups the work profiles into business processes for budgeting and reporting purposes.

[4] According to ASI, a work profile manager has the responsibility for the overall management of the work profile. This includes monitoring the progress of the profile and the costs charged to AOCs for the work profile deliverables.

1. Bill Lines

ASI uses bill lines to capture the costs related to work performed for the AOCs and all nonregulated affiliates. Each bill line provides the means for capturing, separating and describing the costs associated with a particular work effort. Through these bill lines, ASI provides the classifications of costs to the uniform system of accounts (USOA) and cost pools for use by the AOCs. The AOCs follow these classifications to account for these costs and allocate ASI's costs to Part 64 cost pools. ASI has stated that it follows the principles of the Federal Communications Commission's Part 32 and Part 64 Common Cost Allocation and Affiliated Transaction rules and has incorporated these principles in the accounting and billing procedures.[5]

ASI's Accounting Standards group uses the same material requested by the auditors to create classifications of costs. The audit team found much of the material used to explain these classifications to be incomplete. For example, ASI had omitted certain bill lines from the translation tables that it provided to the auditors for translating the bill lines into USOA classifications and cost pools. ASI offered as a possible explanation that the time period of the transaction and the translation table did not match. In any case, auditors could not review the necessary source documents, rather, they had to rely on company personnel statements when examining some of these classifications.

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[5] The FCC's Part 64 rules require all local exchange carriers with $100 million or more in annual operating revenues to file a Cost Allocation Manual (CAM) that describes the methods used to separate the costs of regulated telecommunications services from the costs of nonregulated activities. Ameritech's CAM (ACAM) describes the allocation procedures that ASI uses to allocate ASI's costs that ASI charges to the Ameritech Operating Companies.

The following provides an example of the information that ASI transmitted on a bill for the work profile 060067, Ameritech Integrated Marketplace System, AIMS:

Bill Line	Project Name	1992 Costs ($000s)	USOA [6]	Cost Pool	CAM Allocator	% Non Reg
AU2Y00	AIMS Information Technology (IT)	$3	6724	Marketing	Marketing Allocator	1.9%
A199R0	AIMS Regulated	0	6611	Regulated	Directly Assigned to Regulated	0%
A199S0	AIMS Shared	379	6611	General Support-Other	Marketing Allocator	1.9%
A199S2	AIMS Shared Category 2	27	6611	General Support-Other	Marketing Allocator	1.9%
A19900	AIMS IT	6,162	6724	Marketing	Marketing Allocator	1.9%
NS9900	AIMS Indiana	.4	6724	Marketing	Marketing Allocator	1.9%
Total		$6,571				

AOCs receive billings and their associated classifications via a consolidated billing and crediting (CB&C) system. The system transmits files to the AOCs and electronically incorporates them into the AOCs' accounting records.

2. Work Profiles

ASI accumulates the bill lines into more than 200 work profiles. ASI's Part 64 Compliance Manual defines a work profile as "[a]n activity or set of activities that justifies and tracks

[6] Accounts prescribed by Part 32 of the FCC rules: 32.6724, Information Management; and 32.6611, Marketing.

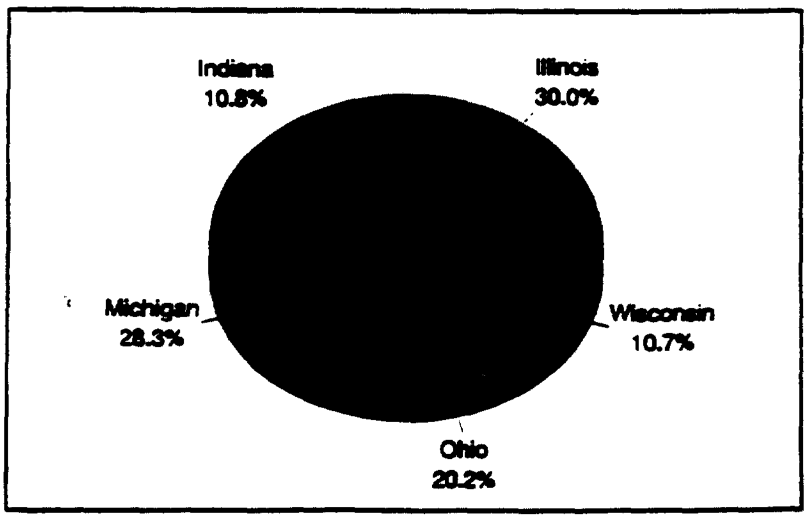
all the time and expenses within the Ameritech Services' Organization." ASI accumulates bill lines into two types of work profiles, billable work profiles and nonbillable work profiles. Billable work profiles contain costs for functions that are directly related to a product or service provided to the AOCs. Nonbillable work profiles contain overhead costs that are allocated to all billable work profiles. In 1992, billable work profiles accounted for $642 million and nonbillable work profiles for the remaining $214 million of ASI's $856 million in total costs.

ASI has no written procedures that describe how it makes the distinction between billable costs and nonbillable overhead costs. As a result the auditors found numerous instances of nonbillable work profiles that ASI should have treated as billable work profiles and billable work profiles or portions of billable work profiles that it should have treated as nonbillable work profiles.

Once ASI assigns a cost to a nonbillable work profile, it allocates costs to billable work profiles on the basis of project hours. Based on the auditors' analysis of the hours used in allocating the costs assigned to nonbillable work profiles, project hours serve as a reasonable indirect cost-causative allocator. ASI allocates billable work profiles that benefit all five AOCs between the companies on the basis of the average of total plant in service and total operating expenses (TPIS/TOE) of each AOC. This is commonly referred to as the Weighted Ameritech Allocation Factors. The following depicts the 1992 Weighted Ameritech Allocation Factors when all five AOCs participated in a project:

AMERITECH SERVICES, INC.

Weighted Ameritech Allocation Factors



In some situations, ASI's use of the Weighted Allocation Factor did not serve as a cost-causative allocator.[7] For example, ASI allocates all costs of business process 5, Manage Material Logistics, on the basis of the Weighted Ameritech Allocation Factor regardless of an entity's level of purchases. The auditors believe that ASI should have assigned the costs of operating the Material Management Process, other than state specific costs, to the costs of products sold to the various entities of Ameritech.

3. Business Processes

ASI groups work profiles into three Business Processes for budgeting and reporting purposes:

1. Front Line Processes
2. Support Processes
3. Administrative Processes

The Front Line Processes have a direct and immediate impact on Ameritech customers. The activities in Support Processes contribute to the long-term viability of Front Line Processes, but do not have an immediate impact on customer services. Administrative Processes are of a general nature that do not directly contribute to the delivery of any one product or service, but rather make direct contributions to the overall management of the corporation.

[7] The weighted allocation factor was used for 55% of the direct costs. ASI assigned the remaining 45% of direct costs to specific states.

In 1992, ASI had 16 Business Processes that related to products and services provided to the AOCs. The following provides a list of ASI's Business Processes and 1992 costs:

	(000's)
Front Line Processes	
1. Establish Customer Services	$129,192
2. Deliver Customer Services	57,938
3. Assure and Maintain Customer Service	85,549
Support Business Processes	
4. Create Service Inventory	16,625
5. Manage Material Logistics	113,239
6. Develop and Manage Markets	120,377
7. Develop and Maintain Business Processes	7,158
8. Develop and Support Information Systems	10,563
9. Operate Data Centers and Network	206,942
10. Conduct Research and Development[8]	16,411
Administrative Processes	
11. Support External Business Operations	17,772
12. Support Internal Business Operations	938
13. Manage Human Resources	6,480
14. Manage Financial Resources	37,180
15. Manage Information Resources	18,300
16. Manage Integrated Planning	4,545
Total	$849,209

ASI conducted a limited amount of work for selected Ameritech nonregulated affiliates. ASI accumulated the costs for these affiliates in two ways. First, ASI assigned certain costs for the nonregulated affiliates in the 16 business processes listed above and identified them as billings to nonowners. Because ASI is owned exclusively by the AOCs, ASI identifies any costs for nonregulated affiliates as billings to nonowners. Second, ASI accumulated all costs of other projects in a special business process 18 that ASI used for billings to nonregulated affiliates.

[8] In 1993, ASI changed this business process name to "Network Technical Applications." ASI eliminated Business process 16, Manage Integrated Planning, and combined it with this new business process.

4. ASI Charges to AOCs

ASI's total billings to the AOCs and other Ameritech Affiliates (Nonowners) in 1992 amounted to $856 million. The billings to affiliates are broken down as follows:

Billed To	(millions)
AOCs & Nonowners	$849
Ameritech affiliates	3
Ameritech for Commercial Credit Card	2
Lease Reimbursement	2
Miscellaneous	-
Total	$856

In addition to the above-noted costs, the following costs also passed through ASI:

1. Bellcore billings	$150 million
2. Category II employees	$11 million
3. Procured Goods	$764 million

Category II employees consist of AOC employees who are temporarily assigned to ASI or do work for specific AOCs. These employee costs are accumulated via a Keep Cost/Job Order (KC/JO) and are billed to ASI for redistribution to the applicable AOCs.

V. WORK PROFILES REVIEWED

A. Selection of Work Profiles Reviewed

The audit team selected a variety of work profiles for review based on the 1992 costs, descriptions of work profiles and the associated approval process, and interviews with ASI personnel regarding the nature of services performed in work profiles. The team focused on examining work profiles that contained significant costs as well as work profiles that had benefited, or could potentially benefit, nonregulated activities. Finally, the audit team reviewed the nonbillable (or overhead) work profiles for profile content and allocation of these costs to billable work profiles.

The joint audit team did not review business process 05, Manage Material Logistics. The audit team recommends that the costs assigned to this process be reviewed in the future because of the significant costs assigned to this process.

B. Results of Work Profiles Review

The audit team's examination of the selected work profiles included a review of the written description of the work profile, the costs assigned to the work profile and the accounting for these costs. The audit team also submitted questions to the work profile managers and the AOCs' subject matter experts who had the responsibility for reviewing the quality and costs of the product or service delivered by ASI. Finally, the audit team interviewed the ASI staff who had prepared the specific product or service provided to the AOCs.

VI. Savings From Reduction in Staff

The auditors attempted to determine if the AOCs passed on any savings that resulted from a reduction in staff to the ratepayers. Ameritech reduced its staff by 5,890 employees between 1990 and 1992. The auditors calculated the annual savings that should have resulted from this reduction in employees as reported in the report to shareholders. By using figures for total Ameritech Operating Company employees, the auditors looked at the net benefit of reducing the number of AOC employees and increasing ASI employees.

Ameritech Operating Company Employees [9]	
1990	69,564
1992	63,674
Reduction in Number of Employees	5,890
Average wage rate [10]	$32,000
Plus Benefits at 24% [11]	7,700
Benefit per Headcount Reduction	$39,700
Total Annual Benefit of Work Force Reductions	$ 233.8
Other Savings[12]	1.8
Total Expected Annual Savings	$ 235.6 million

[9] Annual Report to Shareholders.

[10] Computed from ARMIS 43.03 and Annual Report to Shareholders.

[11] Wisconsin Bell Annual Report to the Public Service Commission of Wisconsin.

[12] This includes the reduction in travel and off-site meeting costs.

The reduction in employees created one-time costs of $65.6 million. These costs primarily related to termination benefits and settlements for the AOC employees. The audit team analyzed the ARMIS 43.03 Report to review the growth in operating expenses reported by the AOCs to determine if the AOCs passed on any of these savings to the ratepayers. Its analysis showed that from 1990 to 1992 the AOCs' expenses grew at a rate that was approximately equal to the rate of inflation. However, ASI's Marketing and Customer Services expenses, an area that ASI claimed would realize savings from consolidation, grew at a rate much greater than the rate of inflation. While the auditors could not conduct further analysis of this issue because of time constraints, they would suggest future investigation of this issue.

VII. Summary of Findings and Observation

Findings

1. **ASI failed to provide sufficient written documentation to allow the audit team to analyze and substantiate, to the audit team's satisfaction, ASI's rationale for the apportionment of its costs between regulated and nonregulated AOC services.** ASI did not provide sufficient written documentation to explain, to the audit team's satisfaction, ASI's apportionment of many of its costs between regulated and nonregulated AOC services. As a result, the audit team had to rely too often on interviews with ASI project managers and employees in order to determine ASI's rationale for its cost allocations. However, these interviews were complicated by ASI's downsizing and reorganizing efforts in 1992 and 1993 during which time many employees left ASI. The audit team encountered further difficulties because some of the interviewed project managers and employees had changed job functions during this period and, as a result had limited recollection regarding the basis upon which many allocations were made. Consequently, the audit team had difficulty in many instances verifying whether ASI's allocations of its costs of products and services among the AOCs' regulated and nonregulated services complied with the FCC's cost allocation standards.

Both the AOCs and ASI must provide information about their organization and their operations to the FCC upon request. The audit team found that ASI in many cases could not provide sufficient written documentation for the audit period. In order to satisfy the audit team's information requests, ASI could have provided to a greater extent various types of documentation. For example, ASI could have maintained documentation which established the benefit to the AOCs of different services provided by ASI. Such documentation would have included an analysis as appropriate, of

(1) potential revenue losses or future costs if the project was not undertaken, compared to costs expected to be incurred; (2) additional regulated revenues expected to be generated compared to costs incurred; (3) improvement in the quality of AOCs' regulated services; or (4) other benefits. Additionally, ASI could have provided the auditors with written procedures that described, with particularity, why it separated the costs between billable and nonbillable work profiles.[13] While ASI directly bills billable work profiles to the AOCs, ASI allocates nonbillable work profiles among all billable work profiles. Without sufficient written procedures for allocations or documentation for AOC benefit verifications, the auditors could not, to their satisfaction, determine why ASI assigned costs to the various accounts and cost pools and whether the assignment of these costs complied with the FCC's affiliate transaction rules.

2. **ASI billed the AOCs for overhead costs that should have been allocated between the regulated and nonregulated affiliates.** ASI billed the AOCs directly for certain overhead costs associated with the consolidation of many of Ameritech's data centers. Therefore, ASI did not include portions of the costs accumulated in this work profile in billings to nonregulated affiliates as a nonbillable work profile or overhead costs. This means that ASI's bills to nonregulated affiliates do not represent fully allocated costs as required by the FCC's affiliate transaction rules.

ASI assigned the costs of all aspects of mainframe computing services to Work Profile 090006, Data Center Consolidation. This included processing, storage and printing services as well as the consolidation of the AOCs' data centers. ASI billed the AOCs directly for $117 million[14] of the costs contained in this work profile for the overall administration of this profile even though certain of Ameritech's nonregulated affiliates benefitted from these functions. If ASI had treated the administration of this profile as an overhead or nonbillable work profile, similar to the way that ASI treated other overhead type costs, ASI would have billed a portion of these costs to the nonregulated affiliates that directly received service from ASI.

[13] Billable work profiles contain costs that are directly billed to the AOCs while nonbillable work profiles contain indirect costs that are assigned to the AOCs' bills on the basis of direct costs.

[14] The total costs of this work profile were $207 million.

The auditors found that ASI billed the nonregulated affiliates Ameritech Mobile and Ameritech Corporate for data processing services. These bills, however, failed to include any of the overhead costs associated with the consolidation of Ameritech's data centers.

3. __ASI allocated all costs of developing new products and services not listed in the Ameritech cost allocation manual (CAM) to regulated operations.__ ASI established several work profiles that it designed to study new products or services that might be offered as either regulated or nonregulated services. Current ASI allocation procedures allocate the cost of these work profiles to regulated cost pools. ASI supports this policy by arguing that none of the services or products being studied were listed in the Ameritech CAM. ASI argues that if the product or service is not listed in the CAM then the costs should be assigned entirely to the regulated cost pool.

Based on this criteria, the following represents examples of activities that ASI classified as directly assigned to regulated activity that auditors believe benefit nonregulated operations: 060087--Ameritech Directory Search; 060088--Marketing New Applications Development; 060092--New Product Development; 060093--New Products - CIS, CNAM, Video; 100009--Speech Technologies Evaluation; 100010--Video Conferencing Prototype; and 100017--Human Factors Technology.

Because ASI charges all costs for developing future products to regulated activities, ASI has clearly established a classification system that is biased against assigning enough cost to nonregulated activity. Even when ASI determines that it has developed a nonregulated product, no mechanism exists to reallocate those costs. A response from an ASI employee that noted, "None of my products were nonregulated when I was working on them," demonstrates ASI's disregard for reasonable allocation methods for new products and services.

The audit team believes that Section 64.901 of the FCC rules for new products and services requires ASI to assign all work that ASI does not perform exclusively for either regulated or nonregulated activities to a shared cost pool with a reasonable basis of allocation applied.

4. __ASI failed to bill the nonregulated affiliate, Ameritech Advanced Data Services, Inc. (AADS) for development costs under work profile 100018.__ Ameritech formed AADS in 1992 to provide business customers with advanced data communications services based on knowledge obtained from trials in Ameritech's Switched Multimegabit Data Service (SMDS). ASI charged certain development costs of services now provided by this company to work

profile 100018. All costs in this work profile were charged to the AOCs' regulated operations.

5. The auditors found that ASI incorrectly charged the Personal Communications Services trial to Account 6535, Engineering Expense. The proper classification should have been to Account 6727, Research and Development. The auditors also found that ASI failed to directly assign the PCS trial to nonregulated activity as required by the FCC's affiliate transaction rules. Part 32 of the FCC rules states that an investigation aimed at the discovery of new knowledge or translating research findings into a plan or design for a new product should be charged to Account 6727, Research and Development.[15] The Engineering expense account includes the fundamental planning and preliminary work of any potential undertakings. The PCS trial is a trial of a proposed new nonregulated service that included 100 base stations, 400 users and one PCS provider. ASI should have classified the PCS trial as research and development.

ASI incorrectly assigned the PCS Trial costs to a shared cost pool that assigns only 0.1 percent of its costs to nonregulated operations. ASI should assign these costs to a cost pool that are directly assigned to nonregulated activity. Section 64.901(b)(2) of the FCC's rules requires that costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

The economic justification that ASI prepared in establishing the work profile states, "Ameritech believes it is likely that PCS will be defined by regulatory bodies as a competitive service available from multiple PCS providers. We have assumed such an industry structure in the development of the trial architecture."

In determining its classification of costs the company stated that the PCS Trial had two objectives: (i) to evaluate the technical and marketing aspects of PCS for the general public, and (ii) to evaluate the ability of the switched telephone network utilizing ISDN and IN functionalities to provide features to PCS providers.

The company acknowledged that the project's technical and marketing evaluation indicated that some aspects of the project could potentially fall into the category of enhanced services

[15] See description of Account 32.6727 in Part 32 of the FCC rules.