1. Summary of Significant Accounting Policies

Basis of Presentation - Southwestern Bell Telephone Company (SWBell) provides telecommunications services in Texas, Missouri, Oklahoma, Kansas and Arkansas. SWBell is a wholly-owned subsidiary of SBC Communications Inc. (SBC).

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Certain amounts in prior period financial statements have been reclassified to conform to the current year's presentation.

Comprehensive Income - Comprehensive income for SWBell is the same as net income for all periods presented.

Operating Segments - In June 1997, the Financial Accounting Standards Board issued Statement No. 131, "Disclosures About Segments of an Enterprise and Related Information" (FAS 131), which establishes standards for the way that public business enterprises report information about operating segments in quarterly and annual financial statements. FAS 131 changes segment reporting from an industry segment basis to an operating segment basis defined based on how the business is managed. As SWBell operates in only one of SBC's segments, wireline telecommunications services, separate segment reporting does not apply to SWBell.

Income Taxes - SWBell is included in SBC's consolidated federal income tax return. Federal income taxes are provided for in accordance with the provisions of the Tax Allocation Agreement (Agreement) between SWBell and SBC. In general, SWBell's income tax provision under the Agreement reflects the financial consequences of income, deductions and credits which can be utilized on a separate return basis or in consolidation with SBC and which are assured of realization.

Deferred income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

Investment tax credits earned prior to their repeal by the Tax Reform Act of 1986 are amortized as reductions in income tax expense over the lives of the assets which gave rise to the credits.

Cash Equivalents - Cash equivalents include all highly liquid investments with original maturities of three months or less.

Revenue Recognition - SWBell recognizes revenues as earned. Amounts billed in advance of the period in which service is rendered are recorded as a liability.

Property, Plant and Equipment - Property, plant and equipment is stated at cost. The cost of additions and substantial betterments of property, plant and equipment is capitalized. The cost of maintenance and repairs of property, plant and equipment is charged to operating expenses. Property, plant and equipment is depreciated using straight-line methods over their estimated economic lives, generally ranging from 3 to 50 years. In accordance with composite group depreciation methodology, when a portion SWBell's depreciable property, plant and equipment is retired in the ordinary course of business, the gross book value is charged to accumulated depreciation; no gain or loss is recognized on the disposition of this plant.

Software Costs - The costs of computer software purchased or developed for internal use are expensed as incurred. However, initial operating system software costs are capitalized and amortized over the estimated economic lives of the associated hardware. The American Institute of Certified Public Accountants has issued a Statement of Position (SOP) that requires capitalization of certain computer software expenditures beginning in 1999.

Management continues to evaluate the impact of the change in accounting required by the SOP and anticipates that it will increase net income by less than $100 in 1999. With comparable levels of software expenditures, the SOP would tend to increase net income in comparison with SWBell's current method of accounting for software costs. However, the increases would be largest in the year of adoption with diminishing levels of increases compared with current accounting throughout the amortization period. Consequently, given otherwise comparable income levels excluding software, and otherwise comparable software expenditures, the effect of the SOP would be to increase income in the first year and decrease income in each subsequent year until the number of years affected by the SOP equals the amortization period.

Advertising Costs - Costs for advertising products and services or corporate image are expensed as incurred (see Note 9).

Derivative Financial Instruments - SWBell does not invest in any derivatives for trading purposes. From time to time as part of its risk management strategy, SWBell uses immaterial amounts of derivative financial instruments including interest rate swaps to hedge exposures to interest rate risk on debt obligations. Derivative contracts are entered into for hedging of firm commitments only. SWBell currently does not recognize the fair values of these derivative financial investments or their changes in fair value in its financial statements. Interest rate swap settlements are recognized as adjustments to interest expense in the statements of income when paid or received.

2. **Completion of Merger** On April 1, 1997, SBC and Pacific Telesis Group (PAC) completed the merger of an SBC subsidiary with PAC, in a transaction in which each outstanding share of PAC common stock was exchanged for 1.4629 shares of SBC common stock (equivalent to approximately 626 million shares). With the merger, PAC became a wholly-owned subsidiary of SBC. The transaction has been accounted for as a pooling of interests and a tax-free reorganization.

   On October 26, 1998, SBC and Southern New England Telecommunications Corporation (SNET) completed the merger of an SBC subsidiary with SNET, in a transaction in which each share of SNET common stock was exchanged for 1.7568 shares of SBC common stock (equivalent to approximately 120 million shares). SNET became a wholly-owned subsidiary of

SBC effective with the merger and the transaction has been accounted for as a pooling of interests and a tax-free reorganization.

Post-merger initiatives

During the second quarter of 1997, SBC announced several strategic decisions resulting from the merger integration process that began with the April 1, 1997 closing of its merger with PAC. The decisions resulted from an extensive review of operations throughout the merged company and include significant integration of operations and consolidation of some administrative and support functions. In connection with these initiatives, SWBell recognized several charges during the second quarter.

During the fourth quarter of 1998, SBC again performed a complete review of all operations affected by the merger with SNET to determine the impact on ongoing merger integration processes. Review teams examined operational functions and evaluated all strategic initiatives.

As a result of these reviews, a benefit of $20 ($13 after-tax) in the fourth quarter of 1998 and charges of $141 ($87 after tax) in the second quarter of 1997 were recognized. At December 31, 1998 and 1997, remaining accruals for anticipated cash expenditures related to these decisions were approximately $27 and $78.

Reorganization SBC is centralizing several key functions that will support the operations of SWBell, Pacific Bell, Nevada Bell and The Southern New England Telephone Company (collectively the Telephone Companies), including network planning, strategic marketing and procurement. It is also consolidating a number of corporate-wide support activities, including research and development, information technology, financial transaction processing and real estate management. The Telephone Companies will continue as separate legal entities. These initiatives continue to result in the creation of some jobs and the elimination and realignment of others, with many of the affected employees changing job responsibilities and in some cases assuming positions in other locations.

SWBell recognized a benefit of approximately $20 ($13 net of tax) during the fourth quarter of 1998 and charges of $57 ($36 net of tax) during the second quarter of 1997 in connection with these initiatives. The charges were comprised mainly of postemployment benefits, primarily related to severance, and costs associated with closing down duplicate operations, primarily contract cancellations. The benefits were associated with an adjustment to the postemployment accrual necessitated by the review. Other charges arising out of the merger related to relocation, retraining and other effects of consolidating certain operations are being recognized in the periods those charges are incurred. The initial integration process subsequent to the PAC merger resulted in SWBell incurring expenses for these merger-related items in advance of any substantial synergistic benefits. During the second half of 1997, these merger-related charges totaled $181 ($113 net of tax).

Impairments/asset valuation As a result of SBC's merger integration plans, strategic review of domestic operations and organizational alignments, SWBell reviewed the carrying values of related long-lived assets in the fourth quarter of 1998 and the second quarter of 1997. The reviews were conducted company-wide, although the fourth quarter 1998 review focused primarily on SNET and did not result in any additional impairments at SWBell. These reviews included estimating remaining useful lives and cash flows and identifying assets to be abandoned. Where this review indicated impairment, discounted cash flows related to those assets were analyzed to determine the amount of the impairment. As a result of these reviews,

SWBell wrote off some assets and recognized impairments to the value of other assets, recording a combined charge of $84 ($51 after tax) in 1997, including the write off of voice dial equipment that was discontinued.

3. Property, Plant and Equipment

Property, plant and equipment is summarized as follows at December 31:

	1998	1997
Land	**$ 187**	$ 182
Buildings	**2,755**	2,622
Central office equipment	**13,097**	12,137
Cable, wiring and conduit	**14,291**	13,759
Other equipment	**2,010**	1,970
Under construction	**262**	341
	32,602	31,011
Accumulated depreciation and amortization	**19,398**	18,460
Property, plant and equipment-net	**$ 13,204**	$ 12,551

SWBell's depreciation expense as a percentage of average depreciable plant was 6.4%, 6.5% and 6.4% for 1998, 1997 and 1996.

Certain facilities and equipment used in operations are under operating or capital leases. Rental expenses under operating leases for 1998, 1997 and 1996 were $134, $122 and $99. At December 31, 1998, the future minimum rental payments under noncancelable operating leases for the years 1999 through 2003 were $34, $24, $6, $3 and $2 and $50 thereafter. Capital leases were not significant.

4. Debt

Long-term debt, including interest rates and maturities, is summarized as follows at December 31:

	1998	1997
Debentures		
5.38%-5.88% 2003-2006	$ 500	$ 500
6.13%-6.88% 2000-2048	1,750	1,550
7.00%-7.75% 2009-2027	1,150	1,750
	3,400	3,800
Unamortized discount--net of premium	(38)	(36)
Total debentures	3,362	3,764
Notes		
5.04%-7.67% 1998-2010	1,063	1,236
Unamortized discount	(5)	(6)
Total notes	1,058	1,230
Capitalized leases	2	2
Total long-term debt, including current maturities	4,422	4,996
Current maturities	(64)	(172)
Total long-term debt	$ 4,358	$ 4,824

In February and September 1998, SWBell called $600 of long-term debt for retirement. SWBell recognized after-tax charges of $9 associated with the calling of this debt.

At December 31, 1998, the aggregate principal amounts of long-term debt and average interest rate scheduled for repayment for the years 1999 through 2003 were $64 (6.4%), $150 (6.1%), $237 (6.3%), $326 (6.4%), $298 (6.1%) with $3,390 (6.8%) due thereafter. As of December 31, 1998, SWBell was in compliance with all covenants and conditions of instruments governing its debt.

Debt maturing within one year consists of the following at December 31:

	1998	1997
Intercompany loans	$ 1,766	$ 473
Current maturities of long-term debt	64	172
Total	$ 1,830	$ 645

During the third quarter of 1997, SWBell's commercial paper was replaced by intercompany loans from SBC. The weighted average interest rate on debt maturing within one year, excluding current maturities of long-term debt, at December 31, 1998 and 1997 was 5.0% and 6.0%.

5. Financial Instruments

The carrying amounts and estimated fair values of SWBell's long-term debt, including current maturities, are summarized as follows at December 31:

	1998		1997	
	Carrying Amount	**Fair Value**	Carrying Amount	Fair Value
Debentures	**$3,362**	**$3,531**	$3,764	$3,828
Notes	**1,058**	**1,129**	1,230	1,271

The fair values of long-term debt were estimated based on quoted market prices. The carrying amounts of cash and cash equivalents and customer deposits approximate fair values.

SWBell does not hold or issue any financial instruments for trading purposes.

6. Income Taxes

Significant components of SWBell's deferred tax liabilities and assets are as follows at December 31:

	1998	1997
Depreciation	**$ 1,716**	$ 1,580
Other	**50**	158
Gross deferred tax liabilities	**1,766**	1,738
Employee benefits	**1,248**	1,235
Unamortized investment tax credits	**73**	85
Other	**136**	227
Gross deferred tax assets	**1,457**	1,547
Net deferred tax liabilities	**$ 309**	$ 191

The components of income tax expense are as follows:

	1998	1997	1996
Federal			
Current	**$ 707**	$ 593	$ 665
Deferred-net	**109**	64	77
Amortization of investment tax credits	**(31)**	(31)	(31)
	785	626	711
State and local			
Current	**87**	58	70
Deferred-net	**11**	17	18
	98	75	88
Total	**$ 883**	$ 701	$ 799

A reconciliation of income tax expense and the amount computed by applying the statutory federal income tax rate (35%) to income before income taxes, extraordinary loss and cumulative effect of changes in accounting principles is as follows:

	1998	1997	1996
Taxes computed at federal statutory rate	**$ 843**	$ 661	$ 759
Increases (decreases) in taxes resulting from:			
Amortization of investment tax credits over the life of the plant that gave rise to the credits	**(20)**	(20)	(20)
State and local income taxes-net of federal tax benefit	**64**	49	57
Other-net	**(4)**	11	3
Total	**$ 883**	$ 701	$ 799

7. Employee Benefits

Pensions - Substantially all employees of SWBell are covered by noncontributory pension and death benefit plans sponsored by SBC. The pension benefit formula used in the determination of pension cost is based on a flat dollar amount per year of service according to job classification for nonmanagement employees. For management employees, benefits accrue in separate account balances based on a fixed percentage of each employee's monthly salary plus interest or are determined based upon a stated percentage of adjusted career income.

SBC's objective in funding the plans, in combination with the standards of the Employee Retirement Income Security Act of 1974 (as amended), is to accumulate funds sufficient to meet its benefit obligations to employees upon their retirement. Contributions to the plans are made to a trust for the benefit of plan participants. Plan assets consist primarily of stocks, U.S. government and domestic corporate bonds and real estate.

Significant assumptions used by SBC in developing pension information include:

	1998	1997	1996
Discount rate for determining projected benefit obligation	**7.0%**	7.25%	7.5%
Long-term rate of return on plan assets	**8.5%**	8.5%	8.5%
Composite rate of compensation increase	**4.3%**	4.3%	4.3%

GAAP require certain disclosures to be made of components of net periodic pension cost for the period and a reconciliation of the funded status of the plans with amounts reported in the balance sheets. Since the funded status of plan assets and obligations relates to the plans as a whole, which are sponsored by SBC, this information is not presented for SWBell. SWBell recognized pension cost for 1998, 1997 and 1996 of $15, $43, and $104. As of December 31, 1998 and 1997, the amount of SWBell's cumulative amount of pension cost recognized in excess of its cumulative contributions made to the trust was $284 and $269.

Postretirement Benefits - Under SBC's benefit plans, SWBell provides certain medical, dental and life insurance benefits to substantially all retired employees and accrues actuarially determined postretirement benefit costs as active employees earn these benefits.

GAAP require certain disclosures to be made of components of net periodic postretirement benefit cost and a reconciliation of the funded status of the plans to amounts reported in the balance sheets. Since the funded status of assets and obligations relates to the plans as a whole, this information is not presented for SWBell. SWBell recognized postretirement benefit cost for 1998, 1997 and 1996 of $192, $176 and $211. At December 31, 1998 and 1997, the amount included in the balance sheets for accrued postretirement benefit obligation was $2,566 and $2,599. Significant assumptions for the discount rate, long-term rate of return on plan assets and composite rate of compensation increase used by SBC in developing the accumulated postretirement benefit were the same as those used in developing the pension information.

SBC maintains Collectively Bargained Voluntary Employee Beneficiary Association (CBVEBA) trusts to fund postretirement benefits. During 1998 and 1997, SWBell contributed $80 and $111, into the CBVEBA trusts to be ultimately used for the payment of postretirement benefits. SWBell also funds postretirement life insurance benefits at an actuarially determined rate. Assets consist principally of stocks and U.S. Government and corporate bonds.

The assumed medical cost trend rate in 1999 is 7.0%, decreasing linearly to 5.5% in 2002 prior to adjustment for cost-sharing provisions of the plan for active and certain recently retired employees. The assumed dental cost trend rate in 1999 is 5.75%, reducing to 5.0% in 2002. Raising the annual medical and dental cost trend rates by one percentage point increases the net periodic postretirement benefit cost for the year ended December 31, 1998 by approximately 8.9%. Decreasing the annual medical and dental cost trend rates by one percentage point decreases the net periodic postretirement benefit cost for 1998 by approximately 7.1%.

Postemployment Benefits - Under SBC's benefit plans, SWBell provides employees varying levels of severance pay, disability pay, workers' compensation and medical benefits under specified circumstances and accrues these postemployment benefits at the occurrence of an event that renders an employee inactive or, if the benefits ratably vest, over the vesting period.

Savings Plans - Substantially all employees are eligible to participate in contributory savings plans sponsored by SBC. Under the savings plans, SWBell matches a stated percentage of eligible employee contributions, subject to a specified ceiling.

SWBell's match of employee contributions to the savings plans is fulfilled with SBC's shares of stock allocated from two Employee Stock Ownership Plans and with purchases of SBC's stock in the open market. SWBell's costs relating to these savings plans were $23, $26 and $29 in 1998, 1997 and 1996.

8. Stock Option Plans

Management employees of SWBell participate in various stock option plans sponsored by SBC. Options issued through December 31, 1998 carry exercise prices equal to the market price of the stock at the date of grant and have maximum terms ranging from five to ten years. Depending upon the plan, vesting of options occurs up to four years from the date of grant. Up to 206 million shares may be issued to SBC employees under these plans.

In 1996, SWBell elected to continue measuring compensation cost for these plans using the intrinsic value based method of accounting prescribed in the Statement of Financial Accounting

Standards No. 123, "Accounting for Stock Based Compensation" (FAS 123). Accordingly, no compensation cost has been recognized for the stock option plans. Had compensation cost for stock option plans been recognized using the fair value based method of accounting at the date of grant for awards in 1998, 1997 and 1996 as defined by FAS 123, SWBell's net income would have been $1,487, $1,154 and 1,354.

For purposes of these pro forma disclosures, the estimated fair value of the options granted after 1994 is amortized to expense over the options' vesting period. Because most employee options vest over a two to three year period, these disclosures will not be indicative of future pro forma amounts until the FAS 123 rules are applied to all outstanding non-vested awards. SBC estimates the fair value of stock options at the date of grant, using a Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1998, 1997 and 1996: risk-free interest rate of 5.72%, 6.56% and 6.25%; dividend yield of 2.21%, 3.07% and 4.91%; expected volatility factor of 15%, 15% and 18%; and expected option life of 5.3, 5.8 and 4.7 years. As options are exercisable in SBC common stock, separate assumptions are not developed for subsidiaries of SBC.

FAS 123 requires certain disclosures to be made about the outstanding and exercisable options, option activity, weighted average exercise price per option and option exercise price range for each income statement period. Since the stock option activity relates only to SBC's shareowners' equity, this information in not presented for SWBell.

9. Additional Financial Information

	December 31,	
Balance Sheets	**1998**	1997
Accounts payable and accrued liabilities:		
Accounts payable	**$ 856**	$ 956
Advance billing and customer deposits	**337**	302
Compensated future absences	**198**	193
Accrued interest	**79**	93
Accrued payroll	**176**	184
Other	**677**	871
Total	**$ 2,323**	$ 2,599

Statements of Income	**1998**	1997	1996
Advertising expense	**$ 68**	$ 73	$ 78
Interest expense incurred	**$ 392**	$ 370	$ 348
Capitalized interest	**(18)**	(27)	(21)
Total interest expense	**$ 374**	$ 343	$ 327

Statements of Cash Flows	**1998**	1997	1996
Cash paid during the year for:			
Interest	**$ 388**	$ **330**	$ 327
Income taxes	**$ 721**	$ **629**	$ 721

Approximately 9% in 1998, 11% in 1997 and 12% in 1996 of SWBell's revenues were from services provided to AT&T Corp. No other customer accounted for more than 10% of total revenues.

Approximately three-fourths of SWBell's employees are represented by the Communications Workers of America (CWA). A new agreement between the CWA and SWBell was reached on April 7, 1998, covering an estimated 39,000 employees through April 1, 2001. Among other items, the agreement specifies an 11% increase in wages over the life of the contract. No contracts are expiring in 1999.

10. Quarterly Financial Information (Unaudited)

Calendar Quarter	Total Operating Revenues		Operating Income		Net Income	
	1998	1997	**1998**	1997	**1998**	1997
First	**$ 2,601**	$ 2,485	**$ 738**	$ 710	**$ 402**	$ 395
Second	**2,700**	2,491	**730**	454	**402**	228
Third	**2,743**	2,579	**736**	666	**403**	374
Fourth	**2,708**	2,561	**590**	362	**320**	190
Annual	**$10,752**	$10,116	**$ 2,794**	$ 2,192	**$ 1,527**	$ 1,187

Net income includes $13 in fourth quarter 1998 benefits and $139 million in second quarter 1997 charges related to post-merger initiatives (see Note 2), $4 and $109 of third and fourth 1997 quarter merger integration costs and $15 fourth quarter 1997 gain on sale of SWBell's interest in Bell Communications Research, Inc.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

No changes in accountants or disagreements with accountants on any accounting or financial disclosure matters occurred during the period covered by this report.

PART III

ITEMS 10 THROUGH 13.

Omitted pursuant to General Instruction I(2).

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) Documents filed as a part of the report: Page

(1) Report of Independent Auditors 22
Financial Statements Covered by Report of Independent Auditors:
Statements of Income 23
Balance Sheets 24
Statements of Cash Flows 25
Statements of Shareowner's Equity 26
Notes to Financial Statements 27

(2) Financial Statement Schedules:
II - Valuation and Qualifying Accounts 39

Financial statement schedules other than those listed above have been omitted because the required information is contained in the financial statements and notes thereto, or because such schedules are not required or applicable.

(3) Exhibits:

Exhibit Number	
4	Pursuant to Regulation S-K, Item 601(b)(4)(iii)(A), no instrument which defines the rights of holders of long-term debt of the registrant is filed herewith. Pursuant to this regulation, the registrant hereby agrees to furnish a copy of any such instrument to the SEC upon request.
12	Computation of Ratios of Earnings to Fixed Charges.
23	Consent of Ernst & Young LLP.
24	Powers of Attorney.
27	Financial Data Schedule.

(b) Reports on Form 8-K:

There were no reports on Form 8-K filed during the fourth quarter ended December 31, 1998.

SOUTHWESTERN BELL TELEPHONE COMPANY
SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
Allowance for Uncollectibles
Dollars in Millions

COL. A	COL. B	COL. C		COL. D	COL. E
		Additions			
		(1)	(2)		
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts -Note (a)	Deductions -Note (b)	Balance at End of Period
Year 1998	**$ 33**	**133**	**39**	**158**	**$ 47**
Year 1997	$ 23	123	29	142	$ 33
Year 1996	$ 15	102	27	121	$ 23

(a) Amounts previously written off which were credited directly to this account when recovered.

(b) Amounts written off as uncollectible.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 12th day of March, 1999.

SOUTHWESTERN BELL TELEPHONE COMPANY

By /s/ William B. McCullough
(William B. McCullough
Vice President and Chief Financial
Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Principal Executive Officer:
John H. Atterbury III*
President and Chief
Executive Officer
and Chairman of the Board

Principal Financial and
Accounting Officer:
William B. McCullough
Vice President and Chief Financial
Officer

Directors:

John H. Atterbury III*
Royce S. Caldwell*
Cassandra C. Carr*
Charles E. Foster*
Karen E. Jennings*
Donald E. Kiernan*
Richard G. Lindner*
Alfred G. Richter, Jr.*

/s/ Alfred G. Richter, Jr.
(Alfred G. Richter, Jr., as attorney-in-fact
and on his own behalf as Associate
General Counsel)

March 12, 1999

---

* by power of attorney

EXHIBIT INDEX

Exhibit Number	
4	Pursuant to Regulation S-K, Item 601(b)(4)(iii)(A), no instrument which defines the rights of holders of long-term debt of the registrant is filed herewith. Pursuant to this regulation, the registrant hereby agrees to furnish a copy of any such instrument to the SEC upon request.
12	Computation of Ratios of Earnings to Fixed Charges.
23	Consent of Ernst & Young LLP.
24	Powers of Attorney.
27	Financial Data Schedule.

EXHIBIT 12

SOUTHWESTERN BELL TELEPHONE COMPANY
COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES
Dollars in Millions

	YEAR ENDED DECEMBER 31,				
	1998	1997	1996	1995	1994
Income Before Income Taxes and Extraordinary Loss	**$ 2,410**	$ 1,888	$ 2,168	$ 1,688	$ 1,586
Add: Interest Expense	**374**	343	327	340	358
1/3 Rental Expense	**45**	41	33	26	25
Adjusted Earnings	**$ 2,829**	$ 2,272	$ 2,528	$ 2,054	$ 1,969
Total Interest Charges	**$ 392**	$ 370	$ 348	$ 340	$ 358
1/3 Rental Expense	**45**	41	33	26	25
Adjusted Fixed Charges	**$ 437**	$ 411	$ 381	$ 366	$ 383
Ratio of Earnings to Fixed Charges	**6.47**	5.53	6.64	5.61	5.14

EXHIBIT 23

Consent of Independent Auditors

We consent to the incorporation by reference in the Registration Statement (Form S-3 No. 333-37515) of Southwestern Bell Telephone Company and in the related Prospectus of our report dated February 12, 1999, with respect to the financial statements and schedules of Southwestern Bell Telephone Company included in this Annual Report (Form 10-K) for the year ended December 31, 1998.

ERNST & YOUNG LLP

San Antonio, Texas
March 8, 1999

CC DOCKET 99-253
REVIEW OF ACCOUNTING / ARMIS REQUIREMENT
SBC COMMUNICATIONS

SBC Supports

- Expense Matrix Elimination – Not needed in a price cap environment.
  - Significant amount of detail. Requires maintenance in accounting systems.
  - Wage data still available without matrix.

- Biennial CAM audits (Attest opinion) – Provides some simplicity; some savings.
  - Recommend 1 year opinion for price cap carriers. Provides greater savings.
  - CAM reporting does not meaningfully change from year to year.
  - CAM filings still point out changes to the process.

- FMV elimination below $500,000 – Eliminates inordinate burden on smaller transactions.

  - Impact on FMV "adjustments to FDC" are not significant – 1% of affiliate transactions.
  - Only 7% of the $1.1 Billion in affiliate transaction services in SWBT were priced based on FMV in 1998.
  - 3 levels of control are already stringent – tariff, prevailing price, FDC.

- CAM Prefiling Elimination – File once per year per the Act.
  - More meaningful consolidation of work efforts. Saves Company resources.
  - Staff generally reviews CAM changes in the succeeding year after ARMIS data has been released.
  - Companies generally discuss significant changes in advance with Staff to streamline process.
  - Many of the CAM changes are responding to Commission orders which are already well understood (e.g., E911). Thus, CAM filings are rarely challenged.

- Section 32.13 Elimination (Notification of Temporary/Experimental Accounts) – Waste of Company / Staff time to file temporary account changes.

- Section 32.15 Elimination (Notification for Extraordinary Items/Contingent Liabilities) – Extraordinary items and contingent liabilities no longer impact access rates.

- Section 32.2002 (Property for Future Use- 2 year limit) / 32.2003 (Plant under Construction – 6 months) reclassification to nonoperating plant(2006) elimination.
  - SBC supports allowing costs to reside in the original accounts but believes the carrier should have the option of reclassifying it to account 2006. Specific identification within the original account for purposes of special treatment in ARMIS reporting and IDC accrual calculations may represent more work and not less work.

CC DOCKET 99-253
43-02 RECOMMENDATIONS
SBC COMMUNICATIONS

C Tables

- C-1, 2, 3, 4 — Consolidate as per NPRM. Only provide Company name, address, States.

- C-5
  - → Eliminate extensions and property sold reporting. CAM Section IV reflects purchase and sale of companies i.e. affiliated relationships illustrated.
  - → Eliminate direct / indirect control – See CAM Section IV.
  - → Important Agreements / Contracts - Provide only those over $1 million.
  - → Important Changes – Only report changes over 1% change in revenues.

B Tables

- B-1 — Balance Sheet – Eliminate; data found in 43-01 and 10K.

- B-2 — Cash Flows – Eliminate; found in 10K.

- B-3 — Investment in Affiliates – Retain

- B-4 — Assets Purchased from (sold to) Affiliate – Retain

- B-5 — Accumulated Depreciation Entries – Eliminate. Table contains excessive detail. Depreciation rate represcriptions are endogenous.

- B-6 — Investment/Accumulated Depreciation by State – Eliminate. State balances are found on the 43-01. Remaining information does not justify the preparation of a table.

- B-7 — Bases for Depreciation – Eliminate. Generally nothing to report.

- B-8 — Leases, B-9 Deferred Charges, B-11 Debt, B-12 Deferred Taxes, B-13 Deferred Credits, B-14 Capital Stock and B-15 Stock, Reacquired/Retired Debt.
  - → NPRM recommends elimination
  - → Tables reflect inordinate detail of questionable value
  - → Debt, taxes, stock are reflected in 10K.

CC DOCKET 99-253
43-02 RECOMMENDATIONS
SBC COMMUNICATIONS

I Tables

- I-1 Income statement. This is formatted like the Expense Matrix, and thus, with elimination of the Expense Matrix, all except the total column should be eliminated.

- I-2 Services Purchased from/sold to Affiliates – Retain

- I-3 Pension Costs, I-4 Other Taxes, and I-5 Prepaid Taxes.
  - ➔ NPRM recommends elimination. SBC agrees due to the highly detailed and for the most part trivial detail in these tables.
  - ➔ Pension information is in the 10-K.

- I-6 Special Charges –
  - ➔ Eliminate below-the-line routine expenses of membership fees, dues, charitable, social and community welfare payments.
  - ➔ Report only abandoned projects over $1 million.

- I-7 Payments to Persons Other Than Employees – Eliminate
  - ➔ Routine business expenses e.g. advertising, office services, financial services etc.
  - ➔ Table generates pages and pages of trivia.

Phase II Recommendation

- Highly recommend combining 43-01, 43-02, and 43-03 into 1 report as illustrated in comments by SBC and USTA in Docket 98-117.
  - 43-01 would be the general format.
  - 43-02 schedules would be greatly reduced and appended to the 43-01.
  - 43-03 would be eliminated. The nonregulated account data is found in the 43-01. The remaining columns of the 03 such as directly assigned, attributed, and generally allocated are unnecessary detail for the reader. The only significant data on this report is the total nonregulated column. Audit opinion would accompany the consolidated report and opine on the nonregulated column.

Name of Telephone Company
Statement of Cost Allocation System Compliance
For the Year Ended December 31, XXXX

Our Cost Allocation Manual as amended through December 31, XXXX (the "Manual") has been filed with the Federal Communications Commission. The Manual provides criteria against which the Company's Cost Allocation System (CAS) can be evaluated. The system is supported by cost allocation methods which are consistent with the Manual and utilized methods which permit preparation of the attached Automated Reporting Management Information System (ARMIS), Form 43-03, ARMIS Joint Cost Report, in accordance with the Manual. The actual cost allocation methods and procedures implemented and performed conform with the objectives, approach and procedures described in the Manual, the FCC's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, and the FCC's published rules and regulation thereto (47 CFR Sections 32.23, 32.27, 64.901, and 64.903) in force as of December 31, XXXX.

We believe that, for the year ended December 31, XXXX, the Cost Allocation System, as implemented, conforms with the criteria set forth in the Manual, the FCC's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, and the FCC's published rules and regulation thereto (47 CFR Sections 32.23, 32.27, 64.901, and 64.903) in force as of December 31, XXXX and the report referred to above has been prepared in accordance with these criteria."

signed by an Officer of the Telephone Company

Officer of the Telephone Company
Title
Name of Telephone Company

We have examined the accompanying Statement of Cost Allocation System Compliance of Name of Telephone Company for the year ended December 31, XXXX. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

Our examination included the following procedures:

- Obtaining an understanding of the Company's Cost Allocation Manual as amended through December 31, XXXX ("the Manual");

- Reviewing Company policies and procedure for implementation of the Manual, the FCC's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, and the FCC's published rules and regulation thereto (47 CFR Sections 32.23, 32.27, 64.901, and 64.903) in force as of December 31, XXXX.;

- Determining the consistency of the cost allocation methods with the Manual;

- Evaluating the materiality and criticality of data sources utilized;

- Evaluating the reasonableness of data sources utilized in providing costing information for selected cost allocation methodologies;

- Obtaining an understanding of the Company policies and procedures relating to incidental activities and transactions with affiliates and determining that such transactions were accounted for in conformity with the Manual; and

- Determining that the data reported in columns (b) through (j) in the attached Company Automated Reporting Management Information System (ARMIS), Form 43-03, ARMIS Joint Cost Report agrees with the information produced by the Cost Allocation System.

In our opinion, the accompanying Statement of Cost Allocation System Compliance of Name of Telephone Company presents, in all material respects, the operation of the cost allocation system for the year ended December 31, XXXX, in conformity with the criteria set forth in the Manual, the FCC's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, and the FCC's published rules and regulation thereto (47 CFR Sections 32.23, 32.27, 64.901, and 64.903) in force as of December 31, XXXX.

This report in intended for the information of the Company and the Federal Communications Commission, which established the criteria under which the Statement of Cost Allocation System Compliance was evaluated. Accordingly, the report should not be used by those who did not participate in establishing the criteria.

Date of Report *Signed by CPA Firm*

Name of Telephone Company
Statement of Cost Allocation System Compliance
For the Year Ended December 31, XXXX

Our Cost Allocation Manual as amended through December 31, XXXX (the "Manual") has been filed with the Federal Communications Commission. The Manual provides criteria against which the Company's Cost Allocation System (CAS) can be evaluated. The system is supported by cost allocation methods which are consistent with the Manual and utilized methods which permit preparation of the attached Automated Reporting Management Information System (ARMIS), Form 43-03, ARMIS Joint Cost Report, in accordance with the Manual. The actual cost allocation methods and procedures implemented and performed conform with the objectives, approach and procedures described in the Manual.

We believe that, for the year ended December 31, XXXX, the Cost Allocation System, as implemented, conforms with the criteria set forth in the Manual and the report referred to above has been prepared in accordance with these criteria."

signed by an Officer of the Telephone Company

Officer of the Telephone Company
Title
Name of Telephone Company

We have examined the accompanying Statement of Cost Allocation System Compliance of Name of Telephone Company for the year ended December 31, XXXX. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

Our examination included the following procedures:

- Obtaining an understanding of the Company's Cost Allocation Manual as amended through December 31, XXXX ("the Manual");
- Reviewing Company policies and procedure for implementation of the Manual;
- Determining the consistency of the cost allocation methods with the Manual;
- Evaluating the materiality and criticality of data sources utilized;
- Evaluating the reasonableness of data sources utilized in providing costing information for selected cost allocation methodologies;
- Obtaining an understanding of the Company policies and procedures relating to incidental activities and transactions with affiliates and determining that such transactions were accounted for in conformity with the Manual; and
- Determining that the data reported in columns (b) through (j) in the attached Company Automated Reporting Management Information System (ARMIS), Form 43-03, ARMIS Joint Cost Report agrees with the information produced by the Cost Allocation System.

In our opinion, the accompanying Statement of Cost Allocation System Compliance of Name of Telephone Company presents, in all material respects, the operation of the cost allocation system for the year ended December 31, XXXX, in conformity with the criteria set forth in the Manual.

This report in intended for the information of the Company and the Federal Communications Commission, which established the criteria under which the Statement of Cost Allocation System Compliance was evaluated. Accordingly, the report should not be used by those who did not participate in establishing the criteria.

Date of Report *Signed by CPA Firm*

C. Auditing

1. Independent audit requirement

243. a. Introduction. In the NPRM, we concluded that it would be unrealistic to rely exclusively upon Commission staff audits to enforce our cost allocation policies. Therefore, as an adjunct to an intensified Commission audit program, we proposed to require each company to submit annual reports "of an independent auditor attesting that the company has designed and implemented its cost allocation manual in a manner consistent with regulatory requirements."[361] We also stated that "[w]e will expect the auditing firms to examine both the cost allocation manual and the manner in which the manual is implemented, and to express an opinion on whether the carrier is in compliance with our cost allocation and accounting rules."[362] Finally, we described the proposed reports as "attest" audits, and noted that standards for such audits were then under consideration by the American Institute of Certified Public Accountants (AICPA).

244. b. Comments. The comments that were filed reflect only limited and qualified opposition to our independent audit proposal. NTCA and Western Union argue that this Commission cannot delegate its responsibility to audit and monitor compliance with cost allocation standards.[363] Western Union believes that only Commission audits will be able to ensure compliance because cost allocations involve too many technical issues and too many matters of judgment for this Commission to be able to establish meaningful guidelines for independent auditors.[364] NATA and DOJ also stress the importance of Commission audits and express their belief that this Commission does not have sufficient audit resources to satisfy its increasing responsibilities.[365]

---

361 NPRM, 104 FCC 2d at 84.

362 Id. at 85.

363 NTCA Comments at 13-14 and Western Union Comments at 9.

364 Western Union Comments at 10-11.

365 NATA Comments at 38-39 and DOJ Comments at 36.

245. Several parties argue that independent audits are unnecessary, overly burdensome, and should not be required of small exchange carriers. Anchorage argues that local exchange carriers are already subject to annual independent audits which include cost allocations, and any attest audit requirement would be redundant and impose needless expense on the ratepayer.[366] North-West and Rochester also question the need for an additional independent audit in light of the cost and the present extensive federal and state review of carrier books.[367] These parties also argue that, to the extent that the auditing costs are allocated to unregulated activities, such costs may prevent the carriers from entering or effectively competing in such markets.[368] Finally, several parties argue that small exchange carriers should be exempt from any independent audit requirement, at least in the absence of a problem with a particular carrier.[369]

246. The vast majority of the commenters recognize the need for independent audits and generally support the proposal.[370] Some of the support, however, is qualified. For example, while U S West recognizes the need for carriers to verify initial compliance, it argues that the requirement for an annual independent audit should last for no more than three years.[371] Several commenters question the need for a separate attest audit report, arguing that the attest could be part of the yearly financial audit.[372] PacTel believes that a separate detailed attest audit is appropriate for only the first year, while GTOCs advocate combining the

---

366 Anchorage Comments at 8.

367 North-West Comments at 3 and Rochester Comments at 24.

368 North-West Comments at 3 and Rochester Reply at 14-15. See also WSTA Comments at 9.

369 See, e.g., NTCA Comments at 12-13, Kiesling Comments at 1, Michigan Comments at 19.

370 See, e.g., Bell Atlantic Comments at 12-13; NYNEX Comments at 57; SWB Comments at 41-42; Centel Comments at 16-17; GTOCs Comments at 27; United Comments at 13; MCI Comments at 20; Sprint Comments at 41; Idaho Comments at 3; Michigan Comments at 19; New York Comments at 10; Ad Hoc Comments at 43; ADAPSO Comments at 14-15; IDCMA Reply at 25; NATA Comments at 39; and Telocator Comments at 15.

371 U S West Comments at 44-45.

372 See, e.g., SNET Comments at 20.

attest with the financial audit after the first two years.[373] Finally, there is a wide divergence of opinion regarding the proper allocation of the costs of compliance. Various commenters support the assignment of independent audit costs: entirely to regulated activities;[374] entirely to nonregulated activities;[375] or primarily to nonregulated activities.[376]

247. There is widespread agreement among the commenters that the scope and other requirements of the independent audit need further clarification.[377] Coopers & Lybrand notes that the AICPA standards cited in the NPRM have now been issued in final form and include two levels of attest assurance, an examination leading to a positive opinion and a review leading to a negative assurance. Coopers & Lybrand states that the NPRM appears to require an examination leading to a positive opinion, but requests clarification.[378] Those parties which address the appropriate level of assurance universally favor an examination leading to a positive opinion.[379]

248. Coopers & Lybrand also believes that the NPRM fails to provide an adequate definition of the basic purpose and scope of the independent audit. It states that paragraph 54 of the NPRM appears to require a "compliance" audit which would provide an opinion as to the carrier's compliance with a set of established criteria. However, paragraph 56 of the NPRM mentions compliance with accounting rules, which Coopers & Lybrand characterizes as "tantamount to requiring an audit opinion on

---

373 PacTel Reply at 16 and GTOCs Comments at 27.

374 See, e.g., United Comments at 14, GTOCs Comments at 27.

375 See, e.g., IDCMA Reply at 31, Xerox Reply at 10.

376 See New York Comments at 10.

377 See, e.g., NTCA Comments at 15, AT&T Comments at 60-63, MCI Reply Comments at 56, IDCMA Reply at 27-28, NATA Comments at 40, DOJ Reply Comments at 14, Coopers & Lybrand Comments at 4-5, Arthur Andersen Comments at 12, AT&T Comments at 59-63, and USTA Comments at 22-25.

378 Coopers & Lybrand Comments at 4.

379 See, e.g., MCI Comments at 22, Xerox Reply at 9, Florida Comments at 10, US Sprint Reply at 35, and AT&T Reply Comments, App. B, Section III., at 4.

compliance with the Uniform System of Accounts and most of Form M.*[380] Even if this Commission desires to have an opinion only as to the amounts of costs allocated, Coopers & Lybrand argues that the work involved in such an attestation engagement would require several times the effort required for a compliance audit. Coopers & Lybrand argues that such extra work is unnecessary to provide this Commission with reasonable assurance regarding carrier compliance with the new cost allocation standards.[381]

249. Other parties argue that the independent audit should be more extensive than a compliance audit and should also require an opinion as to the appropriateness or fairness of actual cost allocations.[382] The statement of Peat, Marwick, Mitchell and Company (PMM), attached as Appendix B to AT&T's Reply Comments, presented the most comprehensive comments regarding the scope and requirements of the proposed independent audit. PMM proposes that this Commission require the auditor to express a conclusion with positive assurance upon three assertions, as follows:

1. The company's cost manual satisfies the requirements set forth by the Commission.

2. The cost system in place in the company accurately reflects the company's cost manual requirements.

3. The cost allocations are appropriate and reasonable in meeting the requirements set forth by the Commission.[383]

PMM also makes specific proposals regarding the scope and content of the attest audit and resulting report.[384]

---

380 Coopers & Lybrand Comments at 4.

381 Coopers & Lybrand Comments at 5. Accord, PacTel Reply at 15.

382 See, e.g., Florida Comments at 10 and AT&T Reply App. B., Section III., at 3.

383 AT&T Reply App. B., Section III., at 2-3.

384 Id. at 4-5 and 8-9.

250. c. Discussion. We strongly disagree with those parties which characterize our independent audit proposal as delegation of Commission responsibility and otherwise question this Commission's commitment to an adequate monitoring and enforcement program. This Commission is both fully cognizant of and committed to fulfilling its responsibility to monitor carrier compliance with our cost allocation requirements. In the NPRM we clearly indicated that the independent audit proposal was an adjunct to, not a replacement for a Commission audit program. While we will utilize the independent audits in our monitoring program, the final decisions regarding carrier compliance will in all cases be made by this Commission. Thus, we view the independent audits as an important aid in fulfilling our responsibilities, not a delegation of such responsibilities.

251. While, in retrospect, the language used in the NPRM to describe the scope of our independent audit proposal was not as precise as we would have liked, it was never our intention that all carriers, regardless of size, would be subject to the annual independent audit requirement. Rather, consistent with our intention to use such audits in our review of filed cost manuals, we intended the annual independent audit requirement to be applicable only to those carriers that are required to file their cost manuals with the Commission. Since the NPRM proposed the filing of cost manuals only by those carriers which are either Tier 1 local exchange carriers (more that $100 million in total company regulated annual revenues) or dominant interexchange carriers and which engage in unregulated activities,[385] our proposal would exempt small exchange carriers from the annual independent audit requirement. From the carrier financial data filed with the Commission, of which we take official notice, it appears that none of the parties opposing independent audits would be subject to such a requirement. Accordingly, we believe that our decision adequately addresses the concerns expressed by these parties.

252. Virtually all of the carriers that would be subject to our independent audit requirement recognize the need for such audits and generally support our proposal. Many parties argued, however, that the basic purpose and scope of the independent audits need further clarification. The need for clarification is heightened because of our recent decision in the BOC Structural Relief Order, discussed supra. Under our modified cost manual filing and approval requirements, the timing, purpose and scope of the independent audits has necessarily been altered.

253. Our proposal in the NPRM contemplated the filing of the independent audit report within a year after the filing and implementation

---

385 See NPRM, 104 FCC 2d at 82.

of the cost manuals, and annually thereafter.[386] We also proposed that the audit report attest that the carrier has designed and implemented its cost allocation manual in a manner consistent with regulatory requirements.[387] Under the NPRM proposal, which would have allowed the implementation of cost allocation manuals and the elimination of structural separation without prior Commission approval of a cost manual, the annual independent audit requirement was properly viewed as a device to aid this Commission in our detailed compliance review and, thereafter, to provide some assurance regarding continuing compliance. However, since cost allocation manuals must now be approved prior to the elimination of structural separation, and since all substantive amendments to approved manuals must also be approved prior to implementation, the value of an attestation regarding cost manual compliance has been greatly reduced, if not eliminated. We must decide whether a cost manual complies with our requirements prior to approval, and we do not believe that the opinion of an independent auditor regarding the ultimate legal conclusion at issue would add significantly to the record for such decision. Thus, we do not believe that the costs that would be imposed by requiring a cost manual compliance attestation are justified, and we have decided not to adopt that proposal.

254. On the other hand, we believe that our proposed requirement for attestation regarding proper cost manual implementation has continuing validity. As we stated in the NPRM, the real test of our rules and the carriers' cost allocation manuals "will be the reasonableness of the allocations which result from applying those rules and procedures."[388] Our proposal for proper implementation attestation was premised upon our belief that even a cost manual in complete compliance with our requirements will not produce reasonable results absent proper implementation. Our belief in this regard remains unchanged. In addition, we do not believe that proper implementation of an approved cost manual can be judged without direct observation and analysis of the carrier's financial operations. Since this Commission does not have the auditing resources to perform an on-site examination of the implementation of all approved cost manuals on an annual basis, we believe that a requirement for an annual independent auditor attestation of proper implementation is both necessary and, indeed, indispensable to an effective monitoring and enforcement program. Finally,

---

386 See id. at 83.

387 See id. at 84.

388 See id. 84.

the comments submitted have convinced us that it would be possible, without prohibitive cost,[389] for the independent auditors to attest to the reasonableness of the carrier procedures to implement cost allocations.[390] Furthermore, we believe that the cost of such yearly attestations is justified because both the independent attestation and the underlying documentation will be invaluable to this Commission's cost allocation monitoring activities.[391] Accordingly, we will require that the annual audit report also attest to the accuracy of the carrier's cost allocations as reported to this Commission.

255. For the reasons stated above, we have decided to modify our independent audit proposal. Carriers that are required to file their cost allocation manuals with this Commission will also be required to comply with the following annual independent audit requirements.

256. After Commission approval of a carrier's cost allocation manual, such carrier shall, on an annual basis,[392] file the report of an independent auditor attesting that: (1) the cost system in place in the company reflects the company's cost manual requirements; and (2) the cost allocations performed in accordance with that system are the product of

---

389 While Coopers & Lybrand is undoubtedly correct that an audit of the amount of costs allocated to regulated and unregulated activities would involve several times the effort required for a compliance audit, there is no evidence that the cost involved would be prohibitive.

390 We do not expect that the manuals that carriers will submit for approval will contain a complete description of all implementation procedures. We envision a level of detail in the manuals that is comparable to the Separations Manual rather than the former Bell System Division of Revenues (DR) procedures. We do expect the independent auditors to review DR type procedures to determine whether such procedures are consistent with the carrier's cost manual and will produce accurate results.

391 The availability to Commission staff of the workpapers and other documentation prepared in connection with the annual audit will expedite the conduct of Commission staff audits, thus increasing the scope of the auditing work that the Commission staff can accomplish in our intensified auditing program.

392 An initial interim report might also be necessary. That possibility will be considered in proceedings to review the manuals that are submitted.

accurate methods. The level of attest assurance shall be an examination leading to a positive opinion and shall include:

(1) A compliance review attesting that a costing system is in place in the company which appropriately reflects the company's cost manual and that the results furnished in any required reports to this Commission are an accurate reflection of the data produced by the cost system. This review need not test data sources for accuracy but would comment on the reasonableness of such data sources in providing costing information.

(2) An identification of underlying data sources and the provision of: (1) an evaluation of the criticality and materiality of each data source to the results of the cost allocation report. (2) a workplan describing the activities and estimated hours required to express a positive opinion on the reliability of each data source; and (3) a description of the major data sources selected for examination. This selection would consider such factors as materiality, length of time since the last review, changes that have been made in the system and overall assessment of vulnerability.

(3) An examination of the data sources selected.

257. The independent auditor's report filed with this Commission shall include:

(1) The scope of the work conducted, specifying the items examined and the extent of the examination.

(2) The auditor's conclusion as to whether the actual methods and procedures implemented and performed by the company conform with the objectives, approach and procedures described in the cost manual.

(3) Any material exceptions or qualifications the auditor may have identifying the adequacy of the procedures.

(4) Any limitations of scope imposed on the auditor by the company or other circumstances which could have an impact on the auditor's opinion.

(5) A statement that the Attestation Standards have been fully met during the examination.

258. As noted above, there was wide divergence of opinion as to whether the costs incurred to comply with the annual independent audit requirements are properly allocated to regulated or to nonregulated activities. We view this debate essentially as a chicken or egg question which has no completely satisfactory solution. We do not believe that a direct assignment of the entire cost of the independent audit to either regulated or nonregulated operations would be appropriate. We are also unaware of any acceptable attribution factor to support an indirect assignment of such costs. Accordingly, unless a carrier is able to demonstrate that there is an appropriate attribution factor to support an indirect assignment, we believe that the auditing costs should be allocated according to the general composite allocator for expenses.

259. Finally, in light of our modified independent audit requirements as set forth above, we do not agree with the suggestion that annual audits should not be required for more than two or three years. The audit requirements we have adopted are not limited in utility to initial compliance determinations but rather will be an important part of this Commission's continuing cost allocation monitoring activities. Clearly, no present limitation on the duration of such requirements is warranted.

2. Designated auditor

260. a. Introduction. In the NPRM we cited the 1983 GAO report for its observation that "...one potential drawback to reliance on independent audits is the perception that auditors hired by the company may not be wholly objective." [393] We sought comment on whether the reliability and usefulness of independent audits could be improved if this Commission designated which firms could be used for the required audits. We proposed to grant designated auditor status freely "... subject to revocation in the event that a firm's audits prove biased or unreliable."[394]

261. b. Comments. The designated auditor proposal was generally supported by the states, by user and consumer groups, and by CPE and enhanced service providers.[395] Such support is premised upon the belief

---

393 NPRM, 104 FCC 2d at 85.

394 Id.

395 See, e.g., Idaho Comments at 3, Pennsylvania Comments at 1, West Virginia Comments at 3, Ad Hoc Comments at 43-44, Reply at 28-30, ADAPSO Comments at 14-15, ANPA Comments at 7, NATA Comments at 40, Telocator Comments at 15, and NASUCA Comments at 67-68, Reply at 13-14.