information is included regarding their Bayesian analysis. In fact, because there is not just one Bayesian procedure, but a whole family of Bayesian approaches, the auditors' corroborating analysis cannot be evaluated by another statistician. As EY explained the problem with the auditors' Bayesian analysis:

> [The auditors'] claim that the Bayesian analysis corroborates their initial results is, however without foundation. No information regarding important aspects of the Bayesian analysis is given in the FCC's draft report. None of the claims made concerning how Bayesian methodology eliminates bias and other problems in the initial analysis are justified. And final results are given without any discussion of how they were derived. Thus, an unsubstantiated Bayesian analysis, using data containing biases, is being used to corroborate the staff's flawed initial analysis.[33]

US WEST's consultant, Deloitte & Touche, likewise concluded that "it is impossible to evaluate the Bayesian results presented in the December ASD Report."[34] Ameritech's consultant also complains that the "exact procedures used in the Bayesian analysis were not explained or revealed in this report."[35]

This is precisely the sort of conduct that earns the auditors' activities credit as a "game of Gotcha!"[36] as described by Commissioner Furchtgott-Roth. By not disclosing the details of the Bayesian analysis, the auditors make it impossible for the RBOCs to challenge the analysis directly. Instead, the auditors can represent to the unwary reader that the audit results have been "independently" confirmed by a separate statistical analysis. But, there was nothing "independent" about this Bayesian analysis, as it relied

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[33] SBC LECs' Response, Attachment B, at 3.

[34] US WEST, Attachment 2, Jan. 8, 1994, at 4.

[35] Ameritech Response at 7.

[36] NOI, Separate Statement of Commissioner Furchtgott-Roth, Dissenting in Part at 3.

upon all of the same flawed data and poorly designed sampling as the original analysis. "Like any other model, the outputs are only as valid as the inputs and assumptions."[37]

The SBC LECs question the auditors' statements regarding the advantages of its Bayesian analysis, especially as applied in the context of these audits. However, it is difficult to provide any details to back up this challenge when the auditors play "hide and seek" with the audited companies. While the SBC LECs would like to review the details of the FCC's Bayesian analysis so that they could have an independent statistician evaluate it thoroughly, the SBC LECs do not see how this analysis could ever overcome the significant flaws in the data and audit methodologies, sample design, etc. In an Attachment to BellSouth's Response,[38] EY rebuts some of the FCC auditors' specific assumptions concerning its Bayesian analysis, including the FCC auditors' unsubstantiated assumption that "the sample mean is the most likely estimate of the population mean."[39] As EY explains, this statement "is not warranted without imposing strong conditions on the prior and the data."[40] In effect, to properly apply a Bayesian type of analysis, one must have an initial description of the anticipated results of the analysis, which may be based on prior experience. This initial description or "prior" is then combined with the sample data to produce final results. Because any attempt to predict the most likely number – if such a prediction is even possible – depends on the initial description of the anticipated results, deficiencies or uncertainty in the initial

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[37] Bell Atlantic Response, Exhibit 2, at 6.

[38] BellSouth Response, Attachment at 5-6.

[39] SWBT Audit Report, Appendix B, at 16.

[40] BellSouth Response, Attachment at 5-6

description will make it inappropriate to make any claims about the most likely number in the final results.

Thus, here, the auditors' unexplained Bayesian analysis provides nothing more than a false sense of security, as it does nothing to fix the original, classical analysis.

## II. The SBC LECs Furnished Sufficient Evidence of the Existence of "Not Found" Items, Which the Auditors Rejected Without Any Explanation (Issue 2).[41]

In their responses, all of the RBOCs complained about the procedures used by the auditors to determine whether an item was found during or after the field audits. Bell Atlantic states:

> [T]he audit staff reports essentially ignore the documentation and other back-up materials that Bell Atlantic submitted to demonstrate that it was able to identify the overwhelming majority of the equipment that was missed in the initial inspections. . .Without any explanation at all, the draft reports nearly doubled the value of the items classified as missing compared to the original audit results.[42]

Similarly, US WEST complained that the auditors "made no attempt to verify any of the detailed information that US WEST submitted on all sample items that [the auditors] identified as 'not found.'"[43] Likewise, Ameritech complained that its supporting "documentation was apparently not fully taken into account in the December Report.

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[41] Nothing in this section or in Exhibit "B" is intended to waive the SBC LECs' arguments in their Application for Review of the Bureau's July 27, 1999 ruling on MCI's Freedom of Information Act request (FOIA Request Control No. 99-163). MCI should not be allowed access to raw audit data or auditors' workpapers, contrary to the FCC's long-standing policy of protecting this information.

[42] Bell Atlantic Response at 10.

[43] US WEST Response at 7.

The [auditors] changed very few items to a found designation based on additional supporting documentation."[44] In their Response, the SBC LECs specifically complained that each of the audit reports of the SBC LECs:

(1) improperly rejected the evidence of the existence of items;

(2) failed to explain the auditors' reasons for rejecting proof of the existence of many items;

(3) failed to describe the auditors' standard of proof for rescoring items; and

(4) failed to explain why the auditors neither sought additional information nor reinspected any locations.[45]

Now, for the first time, in the April 7, 1999 Public Notice,[46] the auditors have furnished some guidelines for the RBOCs' requests to rescore the late 1997 field audit findings. The SBC LECs received the preliminary field audit findings in November 1997. Certainly, the SBC LECs could have followed these guidelines if the auditors had furnished them with the preliminary field audit findings or in early 1998.[47] But, after the fact, these guidelines represent merely an attempt to rationalize the field audit results.

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[44] Ameritech Response at 5.

[45] SBC LECs Response at 23-24.

[46] Public Notice, DA 99-668, released April 7, 1999 (the "Rescoring Public Notice").

[47] Given that the auditors requested responses within about two weeks of providing the preliminary results, the guidelines should have been furnished at the same time, rather than seventeen months later.

These rescoring guidelines raise a number of serious concerns discussed in the letter from EY regarding the rescoring standards attached as Exhibit "B" to these Comments.[48] Some of these concerns are discussed below.

The Rescoring Public Notice states that the "type and quality of evidence submitted by the companies was not consistent, however, and often did not meet the standards to warrant rescoring."[49] The SBC LECs do not understand how the auditors can reasonably expect the evidence to meet standards that are released for the first time about seventeen months after the fact. Obviously, the RBOCs could not meet these standards in late 1997 or in 1998, as they did not obtain the standards until four months into 1999. And, nowhere does the Public Notice contend that the audited companies were given these standards before April 7, 1999, nor does the Rescoring Public Notice even contend that these standards existed in written form prior to the preparation of the Public Notice.[50] For all we know, the auditors formulated the standards after receiving all the evidence, or perhaps, only after being asked to do so in response to the joint letter from Congressmen Tauzin and Dingell[51] or the RBOCs' complaints about the auditors' procedures. In any event, it is fundamentally unfair to formulate standards after the fact

[48] Letter dated July 14, 1999 from John Putnam, Partner, Ernst & Young to B. Jeannie Fry, Director—Federal Regulatory, SBC ("EY Letter Regarding Rescoring Standards"), attached as Exhibit "B" to these Comments.

[49] Rescoring Public Notice at 2 (emphasis added).

[50] In fact, it appears that these standards did not exist in written form previously because they were not provided by the FCC in response to a request from Congress. *See* Feb. 24, 1999 FCC Letter to Congressmen Tauzin and Dingell at 2-3 (Letter from Congress asked the FCC to "provide the written standards used to evaluate the evidence collected" but the FCC did not furnish any written standards.)

[51] Letter dated Jan. 27, 1999 from Hon. W.J. Tauzin and John D. Dingell to William E. Kennard.

to support the previous findings when the audited companies were never before given these standards.[52]

In fact, the auditors never defined these standards for the SBC LECs, nor did the auditors explain to the SBC LECs their reasons for rejecting almost all of the over 200 write-ups that the SBC LECs submitted. And, if the auditors truly considered these to be deficiencies at the time, the SBC LECs would have expected the auditors to communicate these deficiencies to the SBC LECs at some point during the several months during which this evidence was submitted to the auditors.[53] Instead, despite repeated requests for earlier feedback, the SBC LECs did not discover the results of their efforts to correct the results until they received the draft reports in July 1998, and even then, they were left to guess why their many write-ups were rejected.[54] As EY explains, a "critical element

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[52] *See* EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 1.

[53] The SBC LECs sought guidance from the auditors early in the process of submitting their write-ups and specifically attempted to determine the sufficiency of the documentation they were submitting. Despite some general discussions, the auditors did not give the SBC LECs any definitive guidance or instructions. In fact, a few days after these general discussions, the SBC LECs received a letter advising them that further documentation and data would not be accepted. *See* Letter dated Jan. 27, 1998 from Ken Ackerman, Chief, Audits Branch, FCC to B. Jeannie Fry, Director—Federal Regulatory, SBC. While this letter was not enforced (although never retracted either), the auditors did not contact the company in response to numerous letters submitting documentation to the auditors. Typically, these letters invited the auditors to call the company representative "if you wish to discuss this further or have additional questions regarding this information." *See, e.g.,* Letter dated Mar. 17, 1998 from B. Jeannie Fry, Director—Federal Regulatory, SBC to Mr. Jeff Stover, Audits Branch, FCC. They should have done so if they considered the documentation to be inadequate, as the July 1998 draft audit reports ultimately revealed.

[54] Other RBOCs' Responses noted the lack of adequate communication between the auditors and the audited company, which is inconsistent with the procedures required by Generally Accepted Government Auditing Standards ("GAGAS"). *See, e.g.,* US WEST Response at 6-9 and Attachment 1, at 3-5.

of auditing is timely and frequent interaction with representatives of the company being audited to attempt to address issues raised in the audit."[55]

The Rescoring Public Notice recognizes that under Generally Accepted Government Auditing Standards ("GAGAS"),[56] "[e]vidence obtained through the auditor's direct physical examination, observation, computation, and inspection is more competent than evidence obtained indirectly."[57] However, the FCC auditors apparently cite this principle as a justification for rejecting most of the RBOCs' evidence verifying the physical existence of substantially all of the audited items. Indicating that this is the reason for citing this principle, the Rescoring Public Notice states that the audits "are based primarily on information collected in the field" and that "the best evidence that

[55] *See* EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 1.

[56] The Rescoring Public Notice states that the FCC auditors conducted their audits under GAGAS, but those are not the correct standards to use in auditing nongovernment entities. GAGAS is intended for audits of government agencies. GAGAS does not address how to perform audits regarding the fair presentation of a company's financial statements. Given that this was an audit of business enterprises for the purported purpose of expressing an opinion regarding the accuracy of their central office equipment account balances, the FCC auditors should have used Generally Accepted Auditing Standards ("GAAS"). *See* EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 5. In contrast, the audit of GTE's continuing property record was performed in accordance with GAAS, according to the GTE audit report released just last year. *GTE Telephone Operating Companies; Release of Information Obtained During Joint Audit*, 13 FCC Rcd 9179, Audit Report, Part V, Audit Team Reply at 1 (1998). Actually, the auditors contend that they "are not strictly required to operate under GAGAS" either, and thus, they appear to take the position that they are not strictly required to abide by any standards in performing their audits. *See* Letter dated Jan. 27, 1999 from Hon. W.J. Tauzin and John D. Dingell to William E. Kennard, Attachment at 2(response to question #2).

[57] Rescoring Public Notice at 1.

verified whether an item was accurately recorded in the CPRs was the auditors' physical inspection during the field audits."[58]

Given that the auditors recognized that direct physical examination was an important procedure in reaching their conclusions, it is surprising that the auditors did not return to any of the central offices to evaluate evidence provided by the RBOCs after the initial field visits. The procedures used during the initial visits were too restrictive and did not allow sufficient time to find items, much less to find, review and consider supporting documentation. And, when this supporting documentation was located and sent to the auditors after the field visits, the auditor could have verified the item by returning to the central offices. Instead, as other RBOCs note,[59] the auditors declined to return to any of the central offices. Generally Accepted Auditing Standards ("GAAS") require that "[s]ufficient competent evidential matter is to be obtained through inspection, observations, inquiries, and confirmations to afford a reasonable basis for an opinion . . ."[60]

The auditors would have been able to verify additional items by direct physical examination if they had returned to the central office after receiving the write-ups and supporting documents furnished by the SBC LECs. As Arthur Andersen observes, the auditors needed to consider additional procedures such as return visits to the central offices "in order to derive complete and accurate audit results."[61] This same principle of auditing is explained and illustrated by an example in the letter from EY attached as

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[58] Rescoring Public Notice at 1-2.

[59] *See, e.g.,* Bell Atlantic Response at 4.

[60] AICPA, Statements on Auditing Standards, AU Section 350.04, Audit Sampling.

[61] Ameritech Response, Appendix A-O, at 3 (citing AICPA, Statements on Auditing Standards, AU Section 350.25, Audit Sampling.)

Exhibit "B."[62] The example used by EY was an item called a "remote test port" that Pacific Bell's engineers located the day after the field visit, but the FCC auditors refused to make a return visit to verify the item and, without further inquiry, also rejected documentation showing the existence of the item. Another similar applicable principle of GAAS is summarized by Arthur Andersen as follows:

> GAAS require that, when an auditor becomes aware of information subsequent to the issuance of the audit report that would have prompted the auditor to investigate the information had it been known, the auditor must determine whether the information is reliable and whether the facts existed at the date of the audit report.[63]

In light of the evidence submitted by the SBC LECs that showed that items were found, the auditors did not have sufficient evidence to form a conclusion that these items were "not found." Here, the auditors did nothing to determine whether the facts existed as shown in the documentation submitted by the SBC LECs other than to apply secret standards to reject the documentation that it deemed insufficient. It applied these secret standards without further examination even though its on-site physical examination had not been adequate to evaluate the facts presented in the SBC LECs' documentation.

The GAAS standards for fieldwork contain another principle that demonstrates the importance of performing additional procedures, especially when the procedures that have been applied so far yield conflicting evidence. This portion of the standards states:

> [T]here will be circumstances when inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other procedures, or (c) yield evidence indicating that the assertion may be incomplete or

[62] EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 3.

[63] US WEST Response, Attachment 1, at 4 (citing AICPA, Statements on Auditing Standards, AU Section 561: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report).

> inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.[64]

In all three situations, GAAS recommends additional procedures. However, in these audits, the auditors chose not to perform additional procedures necessary to evaluate the companies' detailed, factual opposition to the preliminary field audit results.

Putting on blinders in this fashion is also contrary to the GAAS requirement that auditors consider all appropriate evidence in reaching a conclusion. The auditors did not consider all of the documentation submitted by the SBC LECs.[65] For example, the auditors did not consider evidence showing that an item had been retired if the documentation was not in the exact form required by its standards released seventeen months after the preliminary results. Mechanized order acknowledgments generated by a third party vendor clearly should be considered sufficient, but the Rescoring Public Notice now indicates that the vendor invoices are required. Nor should internally generated documents be dismissed summarily since they are the products of internal systems and controls that the auditors did not even bother to test.

Likewise, the auditors did not consider evidence that an item was actually found if certain details in the CPR did not match information on the supporting documents, such as invoices, or what the auditors observed during the field visits. The auditors rejected information that was not an exact match even if the nonmatching data was explained in detail. In some cases, the equipment descriptions did not match exactly for one reason or

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[64] AICPA, Statements on Auditing Standards, AU Section 2010.41, Standards of Fieldwork(emphasis added).

[65] *See* EY Letter Regarding Rescoring Standards at 3.

another, but the auditors simply rejected the explanations of nonmatching descriptions, without further inquiry. For example, the SBC LECs explained that a description did not match because Bellcore had assigned a single CPR number to multiple part numbers. In its response to the audit reports, Bell Atlantic noted the same difficulty persuading the FCC auditors to accept reasonable explanations for nonmatching descriptions.[66] Another example, described in the letter from EY attached as Exhibit "B", were 48-volt battery racks mislabeled in the CPR as 24-volt battery racks. Despite a detailed explanation, the FCC auditors did not alter their conclusions or make any further inquiries.[67] In another case, the SBC LECs explained that the vendor supplying the equipment had failed to include correct information in the mechanized equipment order that automatically updates the CPR.[68] In all of these cases, the equipment existed but the auditors failed or

[66] Bell Atlantic at 6 ("Such differences should not be unexpected given the nature of the property record system. Even aside from the potential for a minor error in inputting the information, the property records systems themselves automatically include a description based upon an item's continuing property record identification number. If multiple descriptions are available for a particular identification number, absent direct manual override, the property record will always display the first choice in the list. Nonetheless, Bell Atlantic was able to confirm that the record and the equipment that it found were indeed a match by relying upon its supporting documentation - just as the Commission's rules themselves contemplate.")

[67] EY Letter Regarding Rescoring Standards, at 3.

[68] In fact, in the 1994 audits of Pacific Bell, the FCC auditors had recognized the possibility of errors caused by vendors, especially when the vendor was a company other than AT&T, which had designed and was most familiar with the mechanized property record system. *See* Letter dated April 11, 1994 Jose Rodriguez, Chief, Audits Branch, FCC to Sheryl L. Herauf, Pacific Telesis at 7-8 ("CPRs for . . . equipment purchased from various manufacturers other than AT&T are also deficient in that they do not provide an adequate description of the equipment to enable a positive identification from the records.").

refused to accept what the documents showed or to perform additional procedures to confirm its existence.[69]

The Rescoring Public Notice also shows that the auditors' standards during the field visits were unreasonable. For example, the auditors apparently expected the RBOC employees to have engineering drawings or manufacturer schematics available for each and every one of the thousands of embedded items in the central office in case an embedded item was on the list of 36 selected items.[70] Not only did they expect these drawings to be available, but they expected the RBOC employee to find these documents in a matter of minutes and to provide a complete explanation.[71] Otherwise, the Rescoring Public Notice indicates that it would be practically impossible to persuade the auditors to rescore an item after the fact. In fact, the auditors' standards apparently did not permit

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[69] Bell Atlantic describes similar situations in its Response:

> For example, one selection was described as panel boards, but was in fact fuse boxes that included a panel board as a component. This was verified by referencing the supporting invoices for the items. Such differences should not be unexpected given the nature of the property record system. Even aside from the potential for a minor error in inputting the information, the property records systems themselves automatically include a description based upon an item's continuing property record identification number. If multiple descriptions are available for a particular identification number, absent direct manual override, the property record will always display the first choice in the list.

Bell Atlantic Response at 6.

[70] *See* Rescoring Public Notice at 4 ("If the company representative provided evidence (e.g., an engineering drawing or a manufacturer schematic) demonstrating that this was true, the auditor classified the item as 'found.' If no such evidence was provided <u>during the field audit</u>, but a credible claim was made that the equipment was embedded in other equipment present, the item was scored as 'unverified.'"(emphasis added)).

[71] In some cases, the auditors apparently even expected the SBC LECs to shut down a switch processor and disassemble it to locate an item, even though this would have interrupted or disrupted service. In any event, the auditors did not allow a sufficient number of hours to undertake that type of exhaustive search.

items initially scored as "not found" to be re-scored as "found" based on evidence that they were embedded.[72] To explain, the Rescoring Public Notice states as follows:

> If the companies provided documentation (*e.g.*, an engineering drawing or manufacturer schematic) that showed that an item initially scored as "unverified," functioned by design within another item listed on the frame, the item was re-scored as "found."[73]

Thus, embedded items that were initially scored as "not found" had no chance of being re-scored as "found" no matter what evidence was presented after the field audits.[74]

Not only were the rescoring standards flawed for all of the above reasons, they were also applied in an inconsistent fashion. As explained in the attached EY letter (Exhibit "B"), even when exactly the same or very similar documentation was furnished on two different items, the auditors reached opposite conclusions.[75]

In summary, there were serious problems with the FCC auditors' approach to rescoring. It is fundamentally unfair to judge the sufficiency of documentation by standards released long after the fact. Also, ignoring a critical element of auditing, the

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[72] *See* EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 4 ("Additionally, for embedded items, Ernst & Young determined the FCC's rescore criteria to be too limited.").

[73] Rescoring Public Notice at 4 (emphasis added).

[74] Apparently, the only limited exception was for items embedded within equipment that the auditors had actually observed during the initial field visit. However, if the company representative was unable to determine where the item was embedded in the limited time of the initial field visit, the "not found" conclusion apparently became immutable. The Rescoring Public Notice states "Generally, a claim was considered credible if the other equipment listed for the same frame was found to be in place as listed." The auditors would have found the other equipment in which the item was embedded if they had simply made a return visit to the central office location, assuming they were not going to accept documentary evidence.

[75] *See* EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 2.

auditors failed to perform additional procedures such as discussions with company employees, requests for clarification of complex, technical information, requests for further documentation or return visits to central offices. In addition, they did not even adequately consider the documentation that was submitted because, for instance, they insisted that it had to be in the exact format required by its rescoring standards when they should have considered additional types of documents that were submitted. Many items had little or no chance of being rescored such as embedded items initially scored as "not found." On top of all of these problems, when the rescoring standards are compared to the audit results, the results are inconsistent, such as opposite conclusions on the very same evidence.

Using these unfair and inconsistent procedures, the auditors improperly rejected the SBC LECs' proof that dozens of the items they had classified as "not found" actually existed. In effect, the SBC LECs showed that, on an investment basis, the "not found" items should have been reduced to 3 % of the sampled investment, if not lower. In view of the unfairness and inconsistency of the auditors' field audit and rescoring procedures, and especially the fact that the rescoring standards were not released until many months after the fact, the audit results should be rejected in their entirety.

## III. Serious Deficiencies in These Audits Prevent Them from Serving as a Basis to Require Corrective Action (Issue 3).

As the SBC LECs have shown above and in their Response, there are serious flaws in the audit procedures and statistical methodologies used by the auditors and the audit findings are contrary to the evidence submitted by the SBC LECs but largely ignored by the auditors. According to the other RBOCs' response, their audits were

plagued by comparably serious defects.[76] Under these circumstances, one cannot reach any reliable conclusion regarding the overall "degree of error" in any RBOC's property records based on these audits. Consequently, these audits cannot and should not serve as a basis for any further corrective action.[77]

The problems with these audits are described in detail in the SBC LECs' and other RBOCs' responses, but a few highlights will help show why the audit reports are so unreliable that they do not provide any justification for corrective action.

Because of deficiencies in the sample design and statistical methods, the audit reports provide extremely broad and imprecise estimates of the dollar values of allegedly "not found" equipment. For example, assuming the auditors correctly scored the "not found" items (which they did not), the audit reports reflect that the dollar value of the SBC LECs' "not found" equipment is $499.1 ± 216.5 million for Pacific Bell and $221.7 million ± 116.4 million for SWBT, that is, somewhere between $282.6 million and $715.6 million for Pacific Bell and between $105.3 million and $338.1 million for SWBT.[78] This represents spreads of $433 million and $232 million which are 87% and 105% of the midpoint of their respective ranges. Such estimates in the other RBOCs' audit reports were similarly imprecise.[79] The huge margin of error in dollar estimates is

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[76] *See, e.g.* US WEST Response at 14-20.

[77] The SBC LECs' Comments on Issue 3 do not address undetailed investment because that subject is considered separately in Issue 5.

[78] SWBT Reports at 15; Pacific Report, Appendix B, at 15.

[79] *See, e.g.*, BellSouth Response at 2.

only one of the problems with the auditors' statistical procedures. However, considering the problems with the auditors' methods of scoring and rescoring the field audit results, one must conclude that the audit results are extremely unreliable, even as they relate only to the degree of compliance with the CPR requirements. For example, while the auditors ultimately concluded that 198 out of the 2,304 items in the SBC LECs' sample were not "not found," the SBC LECs furnished proof that this number should have been reduced to 106, or 4.6% of the selected items in the sample, if not lower.[80] On an investment basis, these 106 items represent about 3% of the total investment in the sampled items. Thus, in effect, the SBC LECs were able to show that 97% or more of their sampled investment was found. And, if the SBC LECs had known the secret standards of proof being applied by the auditors, they would have been able to submit even more evidence to show the existence of additional items. When the auditors' estimates of the wide range of values for "not found" items are adjusted using the corrected scores for "not found" items based on the rescoring evidence submitted by the SBC LECs, the low end of the range approaches zero, and, if a conservative 99% confidence interval is used, the low end dips below zero.[81] Other RBOCs had a similar experience with the auditors' scoring and rescoring methods. The auditors simply refused to accept the vast majority of the RBOCs' evidence or to explain their reasons for rejecting that evidence.[82]

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[80] *See* SBC LECs Response at 23 n. 47.

[81] *See* EY Pacific Report at 21.

[82] *See, e.g.*, US WEST Response at 11-15 (US WEST found 78% of the items the auditors classified as "not found").

Not only did the auditors reject the RBOCs' rescoring evidence without explanation, they also refused to consider other evidence and information presented by the RBOCs. For example, the SBC LECs presented information concerning the performance and results of its SAVR inventory process, but the auditors summarily dismissed it, reasoning simply that it "was not accompanied by documentation."[83] As part of the SAVR process, initiated in early 1997, the SBC LECs hired independent contractors to perform a two-way physical verification or inventory of 100% of their central office hardwire investment. Thus, the SAVR process is extremely relevant to this audit in a number of respects, including the fact that, in conducting those SAVR inventories, the SBC LECs have been able to eliminate most of the undetailed investment. These results demonstrate that thorough review of the SBC LECs' hardwire inventory will verify its existence. The SBC LECs have offered to provide a detailed review of the SAVR process and its advantages to the auditors, but the auditors have chosen to ignore the SAVR process and results in their analysis.[84] The auditors should have reviewed the SAVR process as part of their procedures.

The auditors also apparently chose to ignore or downplay the significance of information regarding the RBOCs' internal practices, procedures and controls, such as

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[83] SWBT Report at 14 n. 40.

[84] The auditors' refusal to consider SAVR stands in stark contrast to the auditors' willingness to consider GTE's efforts to enhance its inventory procedure using a bar-coding process. *GTE Telephone Operating Companies; Release of Information Obtained During Joint Audit*, 13 FCC Rcd 9179, Audit Report at 3, 7 (1998).

Bell Atlantic's evidence of "separate safeguards [that] ensure that investment balances are tied to actual payments."[85]

When one considers these and the other deficiencies in the audit procedures, it is clear that the audit results cannot properly support any further corrective action. While the SBC LECs cannot claim that their property records are perfect, the SBC LECs are confident that they are substantially in compliance with the FCC's burdensome and unnecessary CPR requirements and that their books accurately reflect the investment in hardwired equipment.

Because the FCC requires ILECs to maintain CPRs in excessive and unnecessary detail, the likelihood of error is higher than it would be otherwise.[86] Under the current procedures, any changes to level of detail (i.e., property record unit definition) in the CPR must be submitted to the FCC for approval which gives the FCC the power to deny or delay any simplification of the CPR detail – as the FCC has done in the case of SWBT.[87] A typical large ILEC is required to keep track of as many as 30 to 50 million units overall in its CPRs. And, in the case of the hardwire CPRs, a large ILEC must keep track of several million units, regardless of their individual value. This CPR process was designed and made more onerous at a time when the large ILECs were subject to cost-

[85] Bell Atlantic Response at 14 and Exhibit 4.

[86] US WEST Response at 5.

[87] Two of SWBT's requests for simplification of the hardwire property records were denied in 1996. Letter dated July 10, 1996 from Kenneth P. Moran, Chief, Accounting and Audits Division, FCC, to Jane Knox, Director—Federal Regulatory, SBC; Letter dated Dec. 26, 1996 from Kenneth M. Ackerman, Chief, Accounting Systems Branch, FCC to Jane Knox, Director—Federal Regulatory, SBC.

based, rate-of-return regulation and rates were directly tied to the amount of investment. It would be unreasonable and unrealistic to insist that ILECs maintain absolutely perfect records of their property in view of the extremely onerous nature of these CPR requirements and the lack of importance of these requirements in regulating price cap ILECs.[88] Especially considering these circumstances and the deregulatory mandate of the 1996 Act(e.g., to review and streamline its rules), the FCC must have some reasonable standard of materiality for evaluating an ILEC's compliance with the CPR requirements other than perfection or near-perfection.[89]

On top of the excessive level of detail that the rules themselves require, the auditors used an unrealistically narrow and unprecedented interpretation of the rules in conducting these audits. An item that is found within the four walls of the central office location shown in the CPR should be deemed to comply with the CPR requirements. And yet, the auditors did not give the SBC LECs credit for certain items found in a different bay or shelf than that shown in the CPR even though the items were found within the four walls of the same central office location.[90] Also, items considered "found" should not be limited to those that can be found in an unreasonably short amount of time such as the ten to twenty minutes typically permitted by the auditors' procedure

[88] Even the federal government does not require accurate asset tracking for its own agencies, as the GAO's 1997 audit report for the federal government reflects. *See* GAO, Report to the Congress, Financial Audit: 1997 Consolidated Financial Statements of the United States Government.

[89] *See* SBC LECs Response at 50-51; BellSouth Response at 8; US WEST at 5-6, 16-17.

[90] *See also* Ameritech at 7; GTE's Motion for a Declaratory Ruling on Asset Verification, filed May 13, 1998.

in this audit, and without having sufficient opportunity to locate supporting documents before the auditors reach their steadfast conclusions.

The degree of error in the CPR records is not material, especially when it is measured in terms of the low end of the range of dollar values of the estimate of "not found" items using the corrected scores for "not found" items furnished in the RBOCs' responses and stated in terms of net, rather than gross, book values. Even in terms of the quantity of "not found" items, the SBC LECs have shown that, on an investment basis, 3% or less of the 2,304 sampled items are properly in the "not found" category, based on the evidence submitted. And, this should be deemed sufficient to comply with the CPR requirements in view of their excessive level of detail and the low value items that must be tracked.

While the audit reports claim that items other than those that were "not found" are seriously deficient and "apparent violations" of the rules, these technical errors are, by definition, not material to any FCC regulatory process. Besides, it is not at all clear that these technical errors in the CPR records are violations of the FCC rules, given that the records contain a number of details not expressly required by the rules.

For these reasons, the immaterial degree of error in the CPR records is clearly not sufficient to require any corrective action.

## IV. The Auditors' Recommended Write-Off Is Unjustified, Contrary to the Rules and Otherwise Improper (Issue 4).

In addressing Issue 3 above, the SBC LECs have already shown that the degree of error in the CPRs is immaterial and does not justify any corrective action. Issue 4 simply

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inquires about one form of corrective action, an accounting adjustment based on "missing" plant. Certainly, the same reasoning applies to accounting adjustments as to corrective action generally. Thus, the audit results do not provide any justification for requiring any accounting adjustments for the same reasons discussed under Issue 3 above. Because of the many flaws in these audits discussed above and in the responses, they provide no rational basis for any type of accounting adjustment.[91]

The audit reports recommend summarily writing off the auditors' estimate of the cost of "not found" items and undetailed investment. While Issue 4 does not specifically ask for comment on this recommendation, it is the main accounting adjustment recommended by the auditors. As the SBC LECs explained in their Response, this recommendation has a number of serious flaws.[92] The other RBOCs agree that this recommendation is seriously flawed.[93]

Like the other recommendations, this one is based on the premise that the auditors have proven that there is a material amount of "missing" plant. However, the audit reports "prove[ ] nothing of the kind."[94] The flawed audit methodology and procedures produce highly questionable results that cannot serve as the basis for any such write-off on the RBOCs' regulated books of account. There is simply no statistically valid basis to conclude that the RBOCs' books are overstated by hundreds of millions of dollars, as the auditors conclude. In fact, as noted above, in the SBC LECs' case, the low end of the

[91] In fact, according to EY, it would be inappropriate for the SBC LECs to make any financial adjustments based on the FCC's audit. SBC LECs Response, Attachment D.

[92] SBC LECs Response at 6-8.

[93] Ameritech Response at 17; Bell Atlantic Response at 23-24; BellSouth Response at 7, 32; US WEST Response at 26.

[94] Bell Atlantic Response at 23.

99% confidence interval for dollar values using the corrected data for "not found" items is well below zero.

Another problem with the recommended write-off is that it is contrary to the FCC's own accounting rules, as most of the RBOCs explained in their responses.[95] For example, Section 32.2000(d)(1)[96] requires all retirements to refer to the specific records in the CPR from which the retired cost was taken. However, in disregard of this requirement, the auditors recommend writing off an extrapolated amount based on their statistical analysis. Thus, the auditors apparently intend for the RBOCs to adjust their Part 32 books now, but leave the CPRs unchanged until after completion of the recommended inventory of all of their central office equipment. Making such an accounting adjustment would create a major out-of-balance situation between the detailed CPR (PICS/DCPR) and the books of account, contrary to the FCC's rules. Making this write-off adjustment without any tie-in to individual CPR records will render the CPR useless as a method of detailing the dollar value of equipment on the books. Further, as Bell Atlantic explains, this write-off "would make it impossible to do an annual reconciliation and to balance the two measures as is required under Commission rules. *See* 47 C.F.R. § 32.2000 (e)(2)(iii)."[97]

There is also a logical inconsistency in the auditors' recommendations. On the one hand, they recommend summarily writing off the estimated amounts and yet they

[95] *See* Ameritech Response at 17; Bell Atlantic Response at 23-24; BellSouth Response at 32 n.77; SBC LECs Response at 7.

[96] 47 C.F.R. § 32.20000(d)(1).

[97] Bell Atlantic Response at 24. Bell Atlantic explains that this recommendation is also contrary to the requirements for an extraordinary retirement, which is what the auditors are, in effect, recommending. The SBC LECs agree that the conditions for an extraordinary retirements in § 32.2000 (g)(4) are not satisfied. For further discussion of this rule, see section VIII(B) below.

state that "the only way to ensure a CPR line-item is correct is to examine the corresponding equipment items. The only way to validate all of the line-items is to conduct an inventory of the entire CPR."[98]

There is a similar lack of consistency in the auditors' jumping to the conclusion that the entire balance of the undetailed investment should be completely written off while claiming that an inventory of the entire CPR would be an effective means of confirming that SWBT has reduced its undetailed investment.[99]

Further, the auditors' recommendation does not consider all of the changes in the books of account and in the CPRs that have occurred since the sample was pulled two and a half years ago. For example, some of the RBOCs describe their own physical inventory procedures, which would have resulted in changes to the records.[100] Likewise, routine construction and replacement activities have already changed the records. In some cases, such as the SBC LECs, the changes have been dramatic. The SBC LECs' SAVR inventory process, which is already correcting any inaccuracies in each central office, has contributed to a substantial amount of change in the records. The auditors' recommended write-off does not take into consideration the significant record changes resulting from the SAVR inventory process. For example, the auditors recommend that SWBT write off $924 million of investment that was listed as undetailed in the CPR as of June 1997, but, as a result of the SAVR inventory process, this undetailed investment has been reduced to about $100 million currently.[101] Obviously, it would be impossible to

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[98] Pacific Audit Report at 17, ¶38.

[99] SWBT Audit Report at 18 n.51.

[100] *See, e.g.,* BellSouth Response at 6, 30-31.

[101] SBC LECs Response at 19-20.

write off $924 million when only $100 million remains as undetailed. In any event, a write-off is the wrong approach, as the SAVR inventory process further demonstrates. Once it is completed, the SAVR process will have identified and detailed or retired all of SWBT's remaining undetailed investment in hardwire central office equipment – despite the fact that it is permissible for the RBOCs to have undetailed investment for periods pre-dating implementation of the mechanized CPR designed by AT&T.[102] In all probability, the other RBOCs' records also experienced changes during the last two years. For instance, BellSouth's eight-year inventory cycle, combined with other special inventory programs, would have made inventory adjustments for over one-fourth of its locations.[103]

An inventory process such as SAVR or the periodic inventories described by BellSouth and Bell Atlantic[104] represent a much better approach than a summary write-off of an extrapolated figure – even if the auditors were able to perform a statistically valid inventory process. However, as discussed under Issue 6 below, this does not mean that these audit results justify requiring the RBOCs to conduct any additional inventories because they certainly do not.

The auditors write-off recommendation raises concerns similar to those expressed by AT&T in challenging the FCC's USOA before the United States Supreme Court.[105] AT&T was concerned that the operation of the USOA might require certain accounts to be summarily written off. Resolving AT&T's concern, the FCC assured the Court

[102] *See* SBC LECs Response at 34-46. For further details, see the discussion under Issue 5 below.

[103] BellSouth Response at 6, 30-31.

[104] BellSouth at 30-31; Bell Atlantic at 24.

[105] Brief for Appellants, AT&T *et al.*, *AT&T v. United States*, No. 97, filed Oct. 29, 1936, at 3, 21-24.

> that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired . . ..[106]

The Court "accepted this declaration as an administrative construction binding upon the Commission in its future dealings with the companies"[107] and explained that "only such amount will be written off as appears, upon application of appropriate directions, to be a fictitious or paper increments."[108] Thus, write-offs as substantial as those recommended by the auditors should not be required without a fair consideration of all the circumstances.[109]

In any event, the auditors' write-off recommendation is contrary to the evidence which shows among other things, that the RBOCs were able to find items deemed "not found" by the auditors, that the auditors' estimates of dollar values are highly inaccurate and unreliable, that a conservative low-end figure for the estimate would be close to or below zero, and that any remaining inaccuracies in the CPR are immaterial, and in any event, are being corrected in the ordinary course of existing inventory procedures.[110]

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[106] *AT&T v. United States*, 299 U.S. 232, 241 (1936).

[107] *Id.*

[108] *Id.*

[109] *See United States v. New York Tel. Co.*, 326 U.S. 638, 652-55 (1946).

[110] Further, we cannot safely assume that an inaccuracy in the CPR necessarily means an error in the account balances in all cases. As Bell Atlantic points out, there are separate practices, controls and procedures the auditors failed to consider that assure that the investment on the books is accurate and is tied to actual payments and costs incurred. Bell Atlantic Response at 13-14 & Exhibit 4.