

**Surrebuttal Testimony of Dr. John Lacey**

1 CPA's Accounting Principles and Auditing Standards Committee and serve on a  
2 task force of the Independence Standards Board.

3 I regularly teach accounting to federal and state judges through the Federal  
4 Judicial Center, the National Judicial College, and state judiciary organizations. I  
5 also teach regularly for two large banks, a large investment company, and the Los  
6 Angeles Society of Financial Analysts. I am the author of a research study on  
7 auditor independence commissioned by the Chief Accountant of the Securities &  
8 Exchange Commission. I have published books and articles in academic and  
9 professional journals. Prior to beginning my academic career, I was a supervisor  
10 in the national office of a major CPA firm and was controller of a manufacturing  
11 company.

12  
13 **Q. Do you have particular experience with respect to accounting standards and**  
14 **practices relating to depreciation lives?**

15 A. Yes. I served on the Accounting Standards Executive Committee (AcSEC),  
16 AICPA's senior accounting standards committee. In that capacity, I voted on the  
17 establishment and revision of Generally Accepted Accounting Principles  
18 ("GAAP") that must be followed by all companies whose financial statements are  
19 accompanied by a CPA's report. As discussed more fully below, GAAP includes  
20 the guidelines for determining the lives used to depreciate capital assets. As  
21 Chairman of the AICPA Real Estate Committee, I was responsible for drafting  
22 proposed accounting standards relating to the depreciation of assets on both a  
23 historical cost and current value basis. I was also responsible for establishing

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1 depreciation lives for assets at the manufacturing company at which I was the  
2 controller.

3

4 **Q. Have you previously testified on accounting, financial, or economic issues?**

5 A. Yes. I have testified about accounting, financial, and economic issues in  
6 the Federal Court of Claims, in other federal courts, and in federal and state  
7 administrative proceedings.

8

9 **Q. What is the purpose of your surrebuttal testimony?**

10 A. The purpose of this surrebuttal testimony is to respond to Mr. Lee's claim that  
11 depreciable lives determined under GAAP should not be used in forward-looking  
12 cost studies and that the regulatory lives last prescribed by the FCC for Verizon  
13 MA in 1996 are appropriate for use in this proceeding. I also respond to Mr.  
14 Lee's claim that Verizon MA's increasing depreciation reserve demonstrates that  
15 AT&T/WorldCom's proposed depreciation lives are forward-looking. Verizon  
16 witness Allen Sovereign also responds to Mr. Lee's proposed depreciation lives.  
17 Finally, I respond to Mr. Lee's claim that Verizon MA's proposed depreciation  
18 lives, prepared in accordance with generally accepted accounting principles  
19 (GAAP), are not reliable because they are "governed" by the accounting  
20 convention of conservatism, which he claims causes the financial books of a  
21 company to be biased.

22

23

24

1 Q. Please summarize your surrebuttal testimony.

2 A. As Mr. Sovereign explains, Verizon MA's proposed depreciation lives and net  
3 salvages were prepared in accordance with GAAP and reflect the economic lives  
4 of network assets. In my opinion, a forward-looking cost study should use  
5 depreciation lives that are based on GAAP instead of regulatory prescribed lives  
6 because GAAP lives better reflect all information known to the company,  
7 including the effects of competition and technological changes. Indeed, Verizon  
8 MA's use of GAAP lives in this proceeding is conservative because it experiences  
9 unique risks associated with providing UNEs to CLECs — risks not faced by  
10 other carriers. For example, competitors may use Verizon MA's UNEs for only a  
11 short period and then use their own facilities, leaving Verizon MA with  
12 undepreciated costs to be written off as a loss, resulting in stranded facilities.

13 Mr. Lee incorrectly claims that because Verizon MA's depreciation  
14 reserve has increased since 1997, the FCC prescribed depreciation lives are  
15 adequate and forward looking. Verizon MA's depreciation reserve is increasing  
16 simply because Verizon MA has been changing its mix of assets and because the  
17 age of Verizon MA's assets has increased (relative to their projected lives).  
18 Contrary to Mr. Lee's assertion, this fact does not mean that the depreciation lives  
19 prescribed by the FCC are forward-looking and appropriate for pricing unbundled  
20 network elements ("UNEs").

21 Finally, Mr. Lee's claim that Verizon's GAAP lives are biased because of  
22 the accounting convention of "conservatism" and therefore not appropriate for use  
23 in this proceeding is incorrect and in direct conflict with GAAP and the modern

1 practice of accounting. Verizon's depreciation lives are in accordance with  
2 GAAP and, consequently, must be unbiased.

3

4 **II. A FORWARD-LOOKING COST STUDY SHOULD USE GAAP LIVES TO**  
5 **DEPRECIATE ASSETS.**

6

7 **Q. Mr. Lee suggests that GAAP lives are inappropriate for use in rate setting.**

8 **[Lee Rebuttal at 2-5.] Please explain how GAAP depreciable lives are**  
9 **determined.**

10 A. GAAP depreciable lives are based upon the expected life during which the assets  
11 will produce economic benefits to the company. The goal is to allocate as  
12 equitably as possible the cost of using the depreciable asset over the period during  
13 which the company obtains economic benefits from the asset.

14

15 **Q. Are GAAP lives forward-looking?**

16 A. Yes. GAAP lives are forward-looking because they are based upon the expected  
17 period of future economic benefit to the company. The initial assessment of  
18 useful life is made based upon the period of time during which the asset will  
19 produce economic benefits to the company from the date of acquisition. The  
20 remaining useful life of the asset is reassessed as financial reports are released to  
21 reflect events as they occur and circumstances as they change. Thus, GAAP lives  
22 are, by their very nature, forward-looking.

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1 **Q. How is GAAP depreciation computed?**

2 A. The process is described in Financial Accounting Standards Board (FASB)  
3 Concept Statement 6. The FASB is the preeminent accounting standard-setting  
4 body in the United States. The Statements of Financial Accounting Concepts  
5 published by this organization set forth the objectives and fundamentals that are  
6 the basis for accounting and reporting standards in the United States.

7 A capital expenditure is initially recorded as an asset and then is charged  
8 to expense as its future economic benefits expire.<sup>1</sup> Upon acquisition, the  
9 expenditure is recorded as an asset in the amount of the acquisition cost. At the  
10 same time, the useful life to the company and the residual value expected upon  
11 disposition (positive or negative) is initially assessed. The process of allocating  
12 the cost of using the asset (the difference between the acquisition cost and  
13 residual value expected upon disposition) over its useful life also begins upon  
14 acquisition. The process results in a systematic and rational allocation of the cost  
15 of using the asset as a charge to the company's operating income over the time it  
16 produces economic benefits to the company.

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<sup>1</sup> FASB Concept Statement No. 6, "Elements of Financial Statements," describes the process in paragraph 149 as follows:

[M]any assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the period over which they are expected to provide benefits) by a "systematic and rational" allocation procedure, for example, by recognizing depreciation or other amortization.

The process is also described in FASB Concept Statement 5, "Recognition and Measurement in Financial Statements of Business Enterprises," at paragraph 86c where it states,

Some expenses, such as depreciation and insurance, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

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2 **Q. Is the useful life for computing economic depreciation consistent with the life**  
3 **used to compute depreciation under GAAP?**

4 A. Yes. Economic depreciation is the change in value of a depreciable asset during  
5 the period.<sup>2</sup> Both GAAP depreciable life and economic depreciable life reflect  
6 the period during which an asset is expected to provide future economic benefits.

7

8 **Q. Has the FCC addressed the use of depreciation in TELRIC cost studies?**

9 **[Lee Rebuttal at 2-5.]**

10 A. Yes. This FCC addressed the concept of depreciation in the *Local Competition*  
11 *Order*:

12 We conclude that an appropriate calculation of TELRIC will  
13 include a depreciation rate that reflects the *true changes in*  
14 *economic value of an asset* and a cost of capital that appropriately  
15 reflects the risks incurred by an investor.<sup>3</sup>

16

17

18

19 This FCC further stated:

20

21 Depreciation is the method of recognizing as an expense the cost  
22 of a capital investment. Properly calculated economic depreciation  
23 is a periodic reduction in the *book value of an asset that makes the*  
24 *book value equal to its economic or market value.*<sup>4</sup>

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26 The true change in the economic value of the asset is dependent upon the

27 economic benefits flowing from the asset. These economic benefits will, of

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<sup>2</sup> See, e.g., Carlton, Dennis and Perloff, Jeffrey M., *Modern Industrial Organization*, Addison Wesley, at 35.

<sup>3</sup> First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, ¶ 703 (Aug. 8, 1996) (emphasis added).

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1 course, be affected by competition and technological changes, which shorten the  
2 economic life of an asset, as Messrs. Sovereign and Gansert further explain in  
3 their surrebuttal testimony.

4  
5 **Q. Are the economic depreciation lives and the lives used to compute**  
6 **depreciation expense under GAAP, to which Mr. Lee objects [Lee Rebuttal**  
7 **at 2-5], consistent with the FCC rules?**

8 A. Yes. Economic and GAAP depreciation lives reflect the forward-looking period  
9 during which the asset produces economic benefits to the company. Both  
10 concepts are designed to write the asset down from acquisition cost to the net  
11 residual value over the course of the asset's depreciable life. In fact, the use of  
12 GAAP lives is conservative because GAAP lives do not take into account the  
13 added risk inherent in providing UNEs to CLECs.

14  
15 **Q. What would happen to depreciation lives if Verizon MA replaced its entire**  
16 **network simultaneously?**

17 A. Depreciation lives would be drastically shorter than current GAAP or economic  
18 lives. The depreciable life of the network would be the time from the initial  
19 installation of the new system until its expected instantaneous replacement with  
20 the new system. During that time, the asset would be written down to its salvage  
21 value. The salvage value would be the net salvage expected upon retirement of  
22 the new system and implementation of the next instantaneous replacement. Thus,  
23 if an instantaneous replacement is assumed every study period, the depreciable

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<sup>4</sup> *Id.* at n.1711.

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1           life is equal to that study period and the salvage value is the net salvage value of  
2           the system at the end of that period. For example, using a three year study period,  
3           depreciation expense each year would be one third of the cost of the new system  
4           (net of any salvage value expected at the end of its three-year life).

5

6   **III. VERIZON MA'S PROPOSED DEPRECIATION LIVES ARE RELIABLE,**  
7   **UNBIASED, AND CONSISTENT WITH GAAP.**

8

9                   **A. EFFECT OF DEPRECIATION ON FINANCIAL STATEMENTS.**

10 **Q. Verizon MA has proposed in this proceeding the depreciation lives reflected**  
11 **in its financial statements, prepared in accordance with GAAP. Mr. Lee**  
12 **asserts that such depreciation lives are inappropriate for regulatory**  
13 **purposes. [Lee Rebuttal at 2-5.] For whom are the financial statements**  
14 **prepared?**

15 **A.** Financial statements prepared in accordance with GAAP are general-purpose  
16 financial statements meant to meet the needs of external users, including  
17 investors, creditors, and others.<sup>5</sup> Other users include rating agencies, employees,  
18 labor unions, and government agencies, including regulatory authorities.<sup>6</sup>

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<sup>5</sup> FASB Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," ¶ 28.

<sup>6</sup> *Id.* at ¶ 24.

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1   **Q.    What is included in Verizon MA’s financial statements?**

2    A.    The financial statements, on which the auditors opine, include the following: (1)  
3           an income statement that reports on the results of operations for the period; (2) the  
4           balance sheet that reports the financial position at a specified date; (3) a statement  
5           of cash flows that reports on the sources and uses of cash for the period presented;  
6           and (4) the notes to the financial statements.

7  
8   **Q.    Where is depreciation reflected in those financial statements?**

9    A.    Depreciation is an integral part of the computation of net income on the income  
10           statement and total assets on the balance sheet. The owners’ equity on the  
11           balance sheet is also affected directly by depreciation, both because net income  
12           becomes part of owners’ equity and because owners’ equity is the difference  
13           between assets and liabilities. Also, the statement of cash flows usually discloses  
14           the amount of depreciation expense. The depreciation method, depreciable lives,  
15           and additional disclosures about depreciation are also included in the notes to the  
16           financial statements.

17  
18   **Q.    Mr. Lee asserts that the depreciation lives used for financial reporting are**  
19           **biased – that is, improperly short. [Lee Rebuttal at 4-5.] Do you agree?**

20    A.    No. The accounting information used in GAAP financial statements is intended  
21           to be unbiased. FASB Statement of Financial Accounting Concept No. 2 includes  
22           “relevance” and “reliability” as the two primary decision-specific qualities

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1 accounting information must possess in order for the information to be useful to  
2 users of financial statements.<sup>7</sup>

3 This concept statement further defines these two primary decision-specific  
4 qualities. For example, for the information to be reliable, it must be verifiable,  
5 neutral, and faithful.

6 The accounting concept of neutrality is, in turn, defined in the glossary to  
7 FASB Concept Statement 2 as:

8 Absence in reported information of bias intended to attain a  
9 predetermined result or to induce a particular mode of  
10 behavior.

11 This concept of neutrality must be followed in determining GAAP  
12 depreciable lives for depreciable assets. The determination of the GAAP  
13 depreciable lives should therefore be unbiased.

14

15 **Q. Mr. Lee states in his testimony that “[t]he lives used for financial accounting**  
16 **purposes are governed by the Generally Accepted Accounting Principle**  
17 **(GAAP) of ‘conservatism,’ which Mr. Lee claims, require a company to**  
18 **report shorter lives.” [Lee Rebuttal at 4.] Do you agree?**

19 A. No. The lives used for financial accounting purposes are part of the financial  
20 reporting process designed to produce *unbiased* financial statements. The choice  
21 of lives is certainly not “governed” by the accounting concept of conservatism.

22

23

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<sup>7</sup> FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” Figure 1.

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1   **Q.    What is the accounting convention of “conservatism” and how does it relate**  
2   **to the determination depreciable life and the depreciation computation?**

3    A.    The FASB has established in its Concept Statement 2 a hierarchy of accounting  
4    qualities that all accounting information should possess.  Importantly, the concept  
5    of conservatism is not included in the “Hierarchy of Accounting Qualities”  
6    established in the Concept Statement.<sup>8/</sup>

7                 Conservatism is, however, defined in the glossary of FASB Concept  
8    Statement 2 as follows:

9

10                Conservatism - A prudent reaction to uncertainty to try to  
11                ensure that uncertainty and risks inherent in business situations  
12                are adequately considered.<sup>9/</sup>

13

14   **Q.    Has the concept of conservatism changed over the years?**

15    A.    Yes.  The meaning of conservatism in accounting has changed over the years and  
16    may, consequently, be misunderstood.  In the past, accounting bodies, applying  
17    conservatism principles, suggested “that possible errors in measurement be in the  
18    direction of understatement rather than overstatement of net income and net  
19    assets.”<sup>10/</sup>  The FASB, however, has since recognized that applying conservatism  
20    principles may create bias in the financial statements and *conflict* with the  
21    significant qualitative characteristics in the hierarchy of accounting qualities

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<sup>8/</sup>        FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” Figure 1.

<sup>9/</sup>        FASB Statement of Financial Accounting Concepts No.2.

<sup>10/</sup>     Accounting Principles Board Statement No. 4, “Basic Concepts and Principles Underlying Financial Statements of Business Enterprises, AICPA, Oct. 1970, ¶ 171.

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1 established by the FASB, such as representational faithfulness, neutrality, and  
2 comparability.<sup>11/</sup> Thus, applying conservatism principles should no longer result  
3 in deliberate, consistent understatement of net assets and profits.

4  
5 **Q. Does Mr. Lee rely on FCC documents and filings based on accounting**  
6 **literature that has been rescinded to support his conservatism claims?**

7 A. Yes. Mr. Lee makes reference in his testimony to comments about conservatism  
8 in earlier FCC documents and filings based on accounting literature that has been  
9 rescinded.

10 Specifically, Mr. Lee references comments filed by GTE in the FCC  
11 Prescription Simplification proceeding stating that GAAP conservatism “prefers  
12 the understatement (versus overstatement) of net income and net assets where any  
13 potential measurement problems exist.” (Lee Rebuttal at 4.) However, the  
14 language Mr. Lee cites is merely paraphrasing of language in paragraph 171 of  
15 “Accounting Principles Board Statement 4, Basic Concepts and Accounting  
16 Principles Underlying Financial Statements of Business Enterprises,” (APB  
17 Statement 4) issued in October 1970. APB Statement 4, however, was *rescinded*  
18 by Statement of Position 93-3, “Rescission of Accounting Principles Board

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<sup>11/</sup> FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” ¶ 93.

There is a place for a convention such as conservatism – meaning prudence – in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference “that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets” introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency). To be clear about what conservatism does not mean may often be as important as to be clear about what it means.

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1           Statements,” issued on March 19, 1993 by the Accounting Standards Executive  
2           Committee, of which I was a member at that time. APB Statement 4 was  
3           rescinded because the Accounting Concept Statements issued by the Financial  
4           Accounting Standards Board effectively superceded it.<sup>12/</sup>

5

6   **Q.    How is the concept of conservatism used today in preparing financial**  
7   **statements?**

8   A.    The concept of conservatism must *not* introduce bias in financial reporting that  
9   violates the neutrality convention. Indeed, in the discussion of neutrality, FASB  
10   Concept Statement 2 emphasizes the importance of unbiased reporting as follows:

11

12                           To be neutral, accounting information must report economic  
13                           activity as faithfully as possible, without coloring the image it  
14                           communicates for the purpose of influencing behavior in *some*  
15                           *particular direction*.<sup>13/</sup>

16

17                           The determination of GAAP depreciable lives should, therefore be  
18   unbiased, and the convention of conservatism, which is not included among the  
19   Hierarchy of Accounting Qualities, should not cause the GAAP depreciable lives,  
20   nor the depreciation computation that depends upon those GAAP depreciable  
21   lives, to be biased in favor of shorter lives.

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<sup>12/</sup>       Statement of Position 93-3, “Rescission of Accounting Principles Board Statements,” March 19, 1993, ¶ 7.

<sup>13/</sup>       FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” ¶ 101 (emphasis in original).

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1 **Q. Does Verizon MA have the incentive to report short lives?**

2 A. No. GAAP lives are used to compute depreciation expense in financial  
3 statements prepared for investors and creditors. If a company uses biased  
4 (shorter) depreciable lives, its expenses are higher and its net income is lower.  
5 Reporting lower net income, of course, could have negative implications for the  
6 company's stock price, the interest rate it pays for borrowing, and its ability to  
7 meet the increasingly important earnings expectations of investors. Using biased,  
8 shorter lives would also have negative implications for debt covenants that  
9 include income or asset values in Verizon's loan agreements.

10 Finally, the total amount of depreciation to be charged is the same  
11 regardless of the depreciable life chosen. Once the cost of an asset is charged to  
12 depreciation expense, there will be no more charge for depreciation. This means  
13 that charging too much depreciation early in the asset's life leads to charging too  
14 little depreciation late in the asset's life. For example, assume that a machine that  
15 cost \$100,000 is assigned a life of five years when its life is really expected to be  
16 ten years. Depreciation expense charged to income in years one through five  
17 would be \$20,000 per year (\$100,000 divided by five years). No depreciation  
18 expense would be charged to income during years six through ten because the  
19 entire cost of the machine, \$100,000 in this example, was charged to expense  
20 during years one through five.

21 In short, a company and its managers have real incentives not to report  
22 biased (short) depreciation lives.

23

1 **Q. Mr. Lee cites a section of the FCC Memorandum which discusses**  
2 **“depreciation rate methodologies that go well beyond those that we have**  
3 **traditionally employed.” [Lee Rebuttal at 3.] Does Verizon’s proposal to use**  
4 **GAAP lives involve any depreciation rate methodologies not traditionally**  
5 **employed?**

6 A. No. Verizon MA is proposing no change in the methodology of computing  
7 depreciation. The methodology would continue to be based on traditional  
8 straight-line depreciation with a salvage value. The change being proposed is the  
9 use of GAAP lives.

10

11 **B. VERIZON MA’S PROPOSED DEPRECIATION LIVES ARE**  
12 **CONSISTENT WITH GAAP AND HAVE BEEN AUDITED BY AN**  
13 **INDEPENDENT AUDITOR.**

14

15 **Q. Does Verizon use GAAP lives in its annual report?**

16 A. Yes. Verizon uses GAAP lives in its annual report to shareholders.

17

18 **Q. Are the GAAP depreciable lives used by Verizon in its annual report the**  
19 **same lives used in its filings with the United States Securities & Exchange**  
20 **Commission?**

21 A. Yes. The financial statements Verizon files with the United States Securities &  
22 Exchange Commission (SEC) must be in conformity with GAAP. Verizon uses  
23 the same GAAP depreciable lives in its annual report to shareholders that it does  
24 in its filings with the SEC.

25

1 Q. What factors did Verizon MA consider in establishing its GAAP depreciable  
2 lives?

3 A. As Mr. Sovereign explains, Verizon MA considered the decline in its depreciable  
4 assets' value due to factors such as competition, technological change, and the  
5 inherent risk in providing UNEs.

6 Verizon MA also considered the National Association of Regulatory  
7 Utility Commissioners' (NARUC) description of factors that cause property to be  
8 retired.<sup>14</sup> These factors include physical factors, functional factors, and  
9 contingent factors. As Mr. Sovereign explains, Verizon MA used the NARUC  
10 factors as a guideline in determining its GAAP lives, but paid particular attention  
11 to the functional factors that consider technology and competition when  
12 determining lives for the technology-driven accounts. Due to the rapid pace of  
13 technological innovation in Massachusetts, these factors are especially important  
14 in establishing GAAP lives for Verizon MA's depreciable assets.

15 Verizon MA also used benchmarking to assess the reasonableness of its  
16 depreciable lives. Benchmarking provides an external validity check to confirm  
17 that the results obtained from the internal process used to assess depreciable lives  
18 are consistent with lives obtained by competitors using similar technology and  
19 operating in similar competitive markets. For example, Verizon MA compared its  
20 depreciable lives with the lives used by its competitors, AT&T and WorldCom.  
21 Verizon MA also compared its depreciable lives to lives used by cable television  
22 operators, which use similar technology in providing their services. Verizon

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<sup>14</sup> *Public Utility Depreciation Practices*, National Association of Regulatory Utility Commissioners (NARUC) at 15 (1996).

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1 MA's benchmarking analysis shows that its proposed depreciation lives are  
2 consistent with (and in some cases longer than) the depreciation lives used by  
3 other carriers.

4 Finally, Verizon MA used TFI studies, which, as Mr. Sovereign explains,  
5 analyze the remaining economic lives of assets.

6  
7 **Q. Do Verizon MA's proposed depreciation lives follow GAAP principles?**

8 A. Yes. Based on my review of Mr. Sovereign's testimony, I conclude that the  
9 factors Verizon MA considered in determining depreciation lives follow GAAP  
10 principles.

11 In addition, Verizon MA's financial statements – which include the  
12 depreciation lives proposed in this proceeding – have been audited by Ernst &  
13 Young, LLP. Ernst & Young issued an opinion letter stating:

14 In our opinion, the financial statements referred to above present  
15 fairly, in all material respects, the consolidated financial position  
16 of Verizon at December 31, 2000, and the consolidated results of  
17 its operations and its cash flows for the year then ended, in  
18 conformity with accounting principles generally accepted in the  
19 United States.

20  
21 Importantly, the auditors' statement that the financial statements "present fairly  
22 . . . in accordance with accounting principles generally accepted in the United  
23 States" includes the depreciation expense and accumulated depreciation contained  
24 in the financial statements, as well as the disclosures relating to depreciation and  
25 depreciable lives contained in the notes to the financial statements.

26 Ernst & Young also describes the scope of the audit they conducted:

27 We conducted our audit in accordance with auditing standards  
28 generally accepted in the United States. Those standards require

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1           that we plan and perform the audit to obtain reasonable assurance  
2           about whether the financial statements are free of material  
3           misstatement. An audit includes examining, on a test basis,  
4           evidence supporting the amounts and disclosures in the financial  
5           statements. An audit also includes assessing the accounting  
6           principles used and significant estimates made by management, as  
7           well as evaluating the overall financial statement presentation.

8           These statements include an evaluation of the material supporting depreciation  
9           lives.

10  
11   **Q.    Are the 1996 regulatory prescribed depreciation lives consistent with GAAP**  
12   **or forward-looking costing principles?**

13   **A.**    No. The current depreciation lives prescribed for Verizon MA were prescribed in  
14           1996. As a consequence and in contrast to the lives proposed by Verizon MA, the  
15           regulatory prescribed lives are outdated and do not reflect the advancements in  
16           technology over the last six years or the effect of competition. Verizon MA  
17           witnesses Dr. James Vander Weide and Al Sovereign further explain in their  
18           testimony the risks and competition facing Verizon MA today in Massachusetts.  
19           These Massachusetts-specific factors demonstrate that depreciation lives set in  
20           1996 for regulatory purposes are inappropriate for establishing forward-looking  
21           depreciation lives in this proceeding.

22  
23   **IV.    VERIZON MA'S INCREASING DEPRECIATION RESERVE DOES NOT**  
24   **SUPPORT AT&T/WORLDCOM'S PROPOSED DEPRECIATION LIVES.**  
25

26   **Q.    Do you agree with Mr. Lee's claims that Verizon MA's increasing**  
27   **depreciation reserve levels provides empirical evidence that**

1        **AT&T/WorldCom's proposed depreciation lives are forward-looking? [Lee**  
2        **Rebuttal at 5-8.]**

3        A.     No. Mr. Lee's attempt to use depreciation reserve levels to justify his proposed  
4        depreciation lives is off base. Mr. Lee makes much of the fact that Verizon MA's  
5        depreciation reserves are increasing. But this increase is to be expected and says  
6        nothing about whether AT&T/WorldCom's proposed lives are forward-looking.  
7        In fact, one would expect Verizon MA's reserve levels to have been even greater  
8        if proper forward-looking depreciation lives had been used.

9

10     **Q.     Please briefly explain Mr. Lee's reasoning.**

11     A.     Mr. Lee attempts to show through an example that the depreciation reserve would  
12     remain constant if depreciation lives were not forward-looking. Then, using the  
13     same simplistic and wholly unrealistic example, he attempts to show that using  
14     shorter depreciation lives would mean an increase in the accrual rate that would  
15     lead to an improper increase in the reserve balance.

16                 Specifically, Mr. Lee assumes in his example that the average age of  
17     assets remains constant (9 years in his example), that the average total life of  
18     assets remains constant (27 years in his example), and that replacements exactly  
19     equal retirements. In such a hypothetical, simple and unlikely model, the  
20     percentage of depreciation reserve would remain constant over time.

21

22     **Q.     Do you agree with Mr. Lee's analysis?**

23     A.     No. Mr. Lee's analysis is flawed for at least three reasons. First, Mr. Lee ignores  
24     that as the age of the assets increases, both the amount of depreciation reserve and

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1           the percentage of depreciation reserve increases. This result is true in a simple  
2           model or in the real world, whether or not depreciation lives are forward-looking.

3           Second, Mr. Lee also ignores that the depreciation reserve will grow if the  
4           company changes its asset mix and begins adding new assets that have a shorter  
5           life than the older assets that are in place and continuing to be depreciated.  
6           Because the average total life of the new assets is shorter, the total depreciation  
7           reserve and the percentage of depreciation reserve begin to grow faster after the  
8           asset mix changes than before. This result is also true whether depreciation lives  
9           are forward-looking or not.

10          Third, Mr. Lee further suggests in his model that the cause of an increase  
11          in the depreciation reserve is shorter asset depreciation lives. He describes an  
12          increased “accrual rate,” which is simply another way to describe a shorter  
13          depreciation life. It is true that a shorter life would lead to a higher depreciation  
14          reserve, but it is only one of several potential causes. The important fact here –  
15          and one that destroys Mr. Lee’s analysis – is that the prescribed lives for Verizon  
16          MA did *not* change during the time that Mr. Lee describes the increase in the  
17          depreciation reserve.

18  
19       **Q. Can you illustrate how the depreciation reserve increases as the age of the**  
20       **asset increases?**

21       A. Yes. For example, assume that a company purchases a machine for \$1,000 and  
22       expects to use it for ten years and then discard it. The depreciation expense every  
23       year is computed to be \$100 per year (\$1,000 divided by 10 years). In this

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1           example, 10% of the machine's cost is depreciated each year because the life is 10  
2           years ( $1/10=10\%$  per year).

3           The depreciation reserve is the accumulation of the depreciation taken to  
4           date. The depreciation reserve at the end of the first year is \$100, or 10% of the  
5           cost of the machine because 10% of the machine's life has passed. At the end of  
6           the second year, the depreciation reserve is \$200, or 20% of the cost of the  
7           machine because 20% of the machine's life has passed. By the end of the fifth  
8           year, the depreciation reserve is \$500, or 50% of the cost of the machine because  
9           50% of the machine's life has passed. The fact that the depreciation reserve is  
10          growing is simply a result of the machine getting older. By the end of the tenth  
11          year, the depreciation reserve is \$1,000, or 100% of the cost of the machine,  
12          because the machine's entire cost was charged to depreciation expense over its  
13          life.

14  
15       **Q. Does the fact that the depreciation reserve is growing mean that the**  
16       **depreciation life is forward-looking?**

17       A. No. The example above is a simple hypothetical with a made-up asset life. I  
18       made no assumption that the depreciation lives are forward-looking – in fact, the  
19       example does not even identify the asset. Thus, the example demonstrates that  
20       depreciation reserves increase as the asset increases regardless of the depreciation  
21       life assumed.

22

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1 **Q. Can you illustrate how the depreciation reserve increases as the asset mix**  
2 **changes?**

3 A. Yes. For example, assume, as above, that a company purchases a machine for  
4 \$1,000 and expects to use it for ten years and then discard it. The depreciation  
5 expense every year is computed to be \$100 per year (\$1,000 divided by 10 years).  
6 In this example, 10% of the machine's cost is depreciated each year because the  
7 life is 10 years ( $1/10=10\%$  per year). By the end of the second year the  
8 depreciation reserve balance is \$200, or 20% machine's cost.

9 Assume that at the beginning of the third year a second machine is  
10 purchased for \$1,000, but that the second machine is expected to be used for only  
11 five years and then discarded. For the second machine with the shorter life, the  
12 depreciation expense every year is computed to be \$200 per year (\$1,000 divided  
13 by 5 years).

14 The depreciation reserve grows by \$300 per year (\$100 from the first  
15 machine and \$200 from the second machine) so by the end of the sixth year it is  
16 \$1400 (\$600 from the original machine, because six years of its life has passed,  
17 plus \$800 from the second machine because four years of its life has passed.) The  
18 depreciation reserve by the end of the sixth year is 70% (\$1,400 of reserve  
19 divided by \$2,000 cost) instead of the 60% it would have been if the new, shorter-  
20 lived asset had not been added.

21

22

23

1 **Q. Does Mr. Lee's depreciation reserve analysis contain other flaws?**

2 A. Yes. Mr. Lee assumes that just because Verizon MA's depreciation reserve is  
3 growing, it must be adequate, and therefore existing FCC-prescribed lives must  
4 also be adequate. He is mistaken.

5 Mr. Lee, for example, ignores that the useful life of a machine may change  
6 during the time of its use. The change may result from physical, technological, or  
7 economic factors (such as increased competition). A change in the life of an asset  
8 may mean that the associated depreciation reserve is inadequate, even though it  
9 has grown.

10 Assume in the first example with a single machine that technology and  
11 competitive market changes require the company to reassess the expected life of  
12 the machine at the beginning of the fourth year. The depreciation reserve balance  
13 at the end of the third year is \$300 (\$100 per year for 3 years). The depreciation  
14 reserve percentage is 30% (\$300 depreciation reserve divided by the \$1,000 cost  
15 of the machine) because 30% of the machine's life had passed by the end of the  
16 third year. Assume further that the new expected life of the machine at the  
17 beginning of the fourth year, based upon the new information about technology  
18 and competition, is a total of six years instead of ten years. Based upon the new  
19 information, 50% of the machine's life has passed by the beginning of the fourth  
20 year (3 years out of the total 6 year life has passed), so the balance in the  
21 depreciation reserve account should be 50% of the machine's cost or \$500  
22 (\$1,000 multiplied times 50%).

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1            Even though the balance in the depreciation reserve account grew from  
2            \$100 at the end of the first year to \$300 at the end of the third year, the balance in  
3            the depreciation reserve is too low at the beginning of the fourth year because  
4            technology changes and competition have reduced the machine's useful life.

5

6    **Q.    Mr. Lee states that depreciation reserve level grew from 39.8 percent in 1991**  
7            **to 53.8 percent in 2000, while the plant reserve amount grew by over 50**  
8            **percent. [Lee Rebuttal at 12.] Does that mean that the depreciation reserve**  
9            **is adequate?**

10    A.    No. As discussed above, Mr. Lee argues that the fact that Verizon MA's  
11            depreciation reserve level for the plant grew means that an appropriate forward-  
12            looking life has been used, or that the depreciation reserve is adequate. As  
13            illustrated in the examples above, this is simply not true. Indeed, there is reason  
14            to believe that Verizon MA's current depreciation reserve is not growing enough  
15            and is therefore inadequate.

16            For example, based upon the implied age<sup>15/</sup> of Verizon MA's plant at the  
17            end of 2000, if the minimum life in the FCC's range of depreciable lives had been  
18            used to compute depreciation reserve instead of the prescribed Massachusetts  
19            lives, Verizon MA's percentage of depreciation reserve would have been

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<sup>15/</sup>        The implied average age for each asset category is computed by multiplying the percentage of the depreciation taken to date for that asset category times the Massachusetts prescribed life for that asset category. The implied average age for all assets is the weighted average of the implied asset life for each category. The weight used in computing the average is end-of-year plant adjusted for salvage. The percentage of depreciation taken to date is the end-of-year depreciation reserve divided by end-of-year plant adjusted for salvage.

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1 approximately 60% by the end of 2000 instead of 54%.<sup>16/</sup> This means that if  
2 Verizon had consistently used the minimum life in the FCC's range of depreciable  
3 lives instead of the prescribed Massachusetts lives, the implied depreciation  
4 reserve would have been greater by approximately \$500 million by the end of  
5 2000 than it was using the Massachusetts prescribed lives. If Verizon MA's  
6 GAAP lives had been used to compute the depreciation reserve instead of the  
7 prescribed Massachusetts lives, its percentage of depreciation reserve for 2000  
8 would have been even greater (approximately 64%).<sup>17/</sup>

9  
10 **Q. How does Verizon MA's 64% implied depreciation reserve percentage,**  
11 **computed based on its GAAP lives, compare to the depreciation reserve**  
12 **percentage AT&T has computed using its GAAP lives?**

13 A. Based on information Verizon received from AT&T in recent UNE proceedings  
14 in other Verizon-East proceedings, it is nearly identical. (See Attachment A).

15  
16 **Q. Did AT&T's reserve percentages increase during the 90s?**

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<sup>16/</sup> The reserve percentage using the minimum life in the FCC's range of depreciable lives is computed first for each asset category by multiplying the implied age as a percentage of the FCC minimum life times end of year plant adjusted for salvage to compute the implied depreciation reserve amount for the FCC minimum lives. The sum of the implied depreciation reserve is then divided by the end-of-year plant adjusted for salvage to obtain the estimated reserve percentage.

<sup>17/</sup> The reserve percentage using GAAP depreciable lives is computed first for each asset category by multiplying the implied age as a percentage of GAAP life times end of year plant adjusted for salvage to compute the implied depreciation reserve amount for GAAP lives. The sum of the implied depreciation reserve is then divided by the end-of-year plant adjusted for salvage to get the estimated reserve percentage.