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Atlanta, Georgia 30375

Thomas F. Lohman
Senior Director

January 30, 1998

Mrs. Blanca S. Bayo
Director, Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399

Dear Mrs. Bayo:

Enclosed is the response of BellSouth Telecommunications, Inc.'s to the Docket 920260-TL Surveillance Audit Report - Period Ending December 31, 1996.

Sincerely,

T. F. Lohman

Senior Director

Enclosure

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AUDIT DISCLOSURE NO. 1

SUBJECT: Removal of Sharing Accruals

STATEMENT OF FACTS: Account 4120.82 is used for accruals of estimated overearnings. It has a year end credit balance of $42,833,000. This amount included credits totaling $28,000,000 accrued in 1996 and debits of $1,500,000 in January 1996 and $7,217,000 in July 1996 for prior accruals. Also included in the account was a credit of $23,550,000 accrued in prior years.

The $7,217,000 debit was for the remainder of 1994 sharing refund. There was no sharing refund in 1995. The Preliminary refund of 1996 Sharing Amount per Order No. PSC-97-0632-FOF-TL is $50,100,000. The Surveillance Report shows an adjustment of $50,115,000 as "Sharing Computation" reducing revenue and shows an adjustment of $26,500,000 increasing revenue to: "Remove sharing accruals booked". This would leave a credit balance of $16,333,000 in the accrual account.

RECOMMENDATION: Surveillance Report revenue should be increased by $16,333,000. Since an adjustment for actual overearnings is made, the total accrual of estimated overearnings should be reversed.

COMPANY COMMENTS: The Company has removed the sharing amounts "as booked" from both the income statement and the rate base to get to a "pre-sharing" basis. The "pre-sharing" rate base and revenues include <u>no</u> effect of the sharing accruals. In fact, the methodology used for the proforma calculation is the same as used in calculating 1994 and 1995 pre-sharing earnings, and was approved by the Commission.

At issue are the proforma amounts to remove sharing "as booked". The purpose of the proformas is to totally remove the sharing effect on the income statement and the average rate base; i.e., the purpose is to restate operating results as if no sharing accrual had been booked. The proforma adjustment to remove the income statement impact is different from the proforma adjustment to remove the rate base impact, which is both an average balance and a summation of activity from prior year(s) as well as the current year. The revenue accounts are a summation of the current year activity only. To say that these two types of accounts should be the same is inappropriate. Using the

AUDIT DISCLOSURE NO. 1

COMPANY COMMENTS (Continued):

year-end balance in the liability account to adjust the income statement is absolutely incorrect, as is using a year-end amount to adjust an average rate base.

Attached is Schedule 1, showing the computation of the average sharing liability amount (Account 4120.8200) included in the "per books" rate base. The rate base amount is the **average** liability balance for the year, not the **year-end** balance. The entire average liability balance has been removed by the proforma adjustment of $26,555,000 ($26,554,708, rounded), leaving the pre-sharing rate base effect of the sharing accrual at zero.

Attached is Schedule 2, showing the income statement entries. The proforma adjustment is $26,500,000, which is total accruals (debits to revenue) of $28,000,000 less a credit to revenue of $1,500,000. The other entry to Account 5264.4200 is a credit of $7,217,000. This is a reversal of the 1994 accrual to Account 4120.8200. The reversal was booked in the same month in which the actual 1994 refund of $7,217,000 was recorded as a reduction to Accounts 5001/5010 as a result of credits on the customers' bills. Because the total income statement impact of the $7,217,000 is zero (the credit to Account 5264 offsets the debits to Accounts 5001/5010), there is no proforma adjustment necessary.

The auditor is asserting that the income statement proforma should be equal to a reversal of the ending balance of the liability account: $26,500,000 income statement proforma per the Company, plus $16,333,000 proposed FPSC Staff additional adjustment equals $42,833,000. It is totally inappropriate to adjust revenue by an additional $16,333,000. This would result in a increase to revenue of $16,333,000 more than the accrual reduction included in "per books" operating income.

The Surveillance Report revenue should **not** be increased by an additional $16,333,000.

AVERAGE RATE BASE IMPACT - Account 4120.8200
(000)

Month	Amount	Monthly Average *	12 month average
Dec-95	$ (23,550)		
Jan-96	(22,050)	$ (22,800)	
Feb-96	(22,050)	(22,050)	
Mar-96	(22,050)	(22,050)	
Apr-96	(22,050)	(22,050)	
May-96	(22,050)	(22,050)	
Jun-96	(27,050)	(24,550)	
Jul-96	(19,833)	(23,442)	
Aug-96	(19,833)	(19,833)	
Sep-96	(32,833)	(26,333)	
Oct-96	(32,833)	(32,833)	
Nov-96	(42,833)	(37,833)	
Dec-96	(42,833)	(42,833)	

Sum of Monthly Averages	(318,657)
Divide by 12 months	/12
Amount Included in Per Books Average Rate Base (Surveillance Report Page 1, Line 7, Column 3)	(26,555)
Proforma Adjustment, Page 1A, Line 5, Column 6	26,555
Amount Included in Pre-Sharing Rate Base	0

* Monthly Average is the sum of the current month and prior month ending balances divided by 2 [i.e. for Jan 96: (23,550 + 22,050)/2]

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Schedule 2

1996 REVENUE IMPACT OF SHARING ACCRUALS AND REVERSALS
Account 5264.4200
(000)

Month	(A) Accruals/ Adjustments	(B) Accrual Reversal	(A) + (B) Total DR/(CR)
Jan-96	(1,500)		(1,500)
Feb-96	0		0
Mar-96	0		0
Apr-96	0		0
May-96	0		0
Jun-96	5,000		5,000
Jul-96		(7,217)	(7,217)
Aug-96	0		0
Sep-96	13,000		13,000
Oct-96	0		0
Nov-96	10,000		10,000
Dec-96	0		0
Total	26,500	(7,217)	19,283
Refund of 1994 Sharing (out of period) (DR to local revenue 5001/5010)		7,217	7217
Amount in "per books" income	26,500	0	26,500
Removed by Proforma Adjustment	(26,500)	0	(26,500)
Amount Included in Pre-Sharing Revenue	0	0	0

AUDIT DISCLOSURE NO. 2

SUBJECT: Long-Term Debt

STATEMENT OF FACT: The Company recorded a $500,000,000 long-term debt titled Zero-To-Full (ZTF) Debenture at the price to the public of $126,175,000, due December 15, 2095. The interest is calculated monthly at 6.65% and charged to expense. The credit is added to the principal balance of $126,175,000. No interest is currently paid out. Beginning December 15, 2015, interest on the $500,000,000 aggregate principal amount of the ZTF Debentures will accrue and be payable semiannually on June 15 and December 15 of each year, commencing June 15, 2016, and such principal amount will be payable at maturity. The Debentures will not be redeemable prior to maturity. [See Audit Report for Table]

RECOMMENDATION: [See Audit Report for Table]

The Zero-To-Full Debenture should be recorded at the principle[sic] amount of $500,000,000.

In accordance with GAAP, the discount of $373,825,000 should be amortizied[sic] over the 100 year life of the bond. This results in an annual amortization expense of $3,738,250. Also in accordance with GAAP, the total issuing expense of $2,175,000 should be amortized over the life of the bond for an annual amortization issuing expense of $21,750.

The books should not reflect interest expense until paid beginning June 15, 2016.

COMPANY COMMENTS: The fact that the Company is not yet paying interest (cash) to the bondholders does not dictate whether the interest deduction is appropriate, as BellSouth Telecommunications is on an accrual basis, not a cash basis, for accounting purposes.

The GAAP rule which specifies accounting for Original Issue Discount is in APB 21. Specifically, paragraph 15 states as follows:

> "*Amortization of discount and premium.* With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or

AUDIT DISCLOSURE NO. 2

COMPANY COMMENTS (Continued):

> premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the "interest" method described in and supported by paragraphs 16 and 17 of APB Opinion No. 12, *Omnibus Opinion - 1967.* However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method." [Emphasis added] [See copy attached].

Usually, the bond discount or premium is an immaterial percent of the total bond issue. In such a case, it has been the practice to amortize the discount or premium on a straight-line basis over the life of the bond. However, with the ZTF bond in question, the discount is a **substantial** portion of the face amount of the debenture. Therefore, we are required to use the "interest" method as described in APB 21 and quoted above - a method which results in a **constant rate of interest** when applied to the amount outstanding at the beginning of any given period.

The ZTF debentures are different from traditional debentures issued at a premium or discount. On the ZTF debentures, it is as if the bondholders gave the Company a partial loan in year 1, and then increased the amount of the loan each month for 20 years until the full $500,000,000 amount is reached. As specified in the prospectus, the bondholders are required to recognize the accrued interest income for tax purposes each year, in years 1 through 20. The economics of the transaction are as if the Company paid the interest and then the bondholder returned the amount as an additional loan, thereby increasing the outstanding balance of the Company debt. The interest expense recognized by the Company matches the interest income being recognized by the bondholders.

Another way to explain the transaction is to **view it as if** the bondholders purchased two bonds. The first is a zero coupon bond for 20 years, which is then converted to a second issue, a regular interest-paying bond for the next 80 years. In effect, the zero coupon bond is purchased for cash of $126 million (rounded) and interest is recognized over the twenty-year life as the principal grows to $500 million. No cash is paid to the bondholder during this period, although the interest is recognized as expense on BST's books and as income on the bondholders' books. In effect, the bondholder is "loaning" the interest proceeds back to the Company each month. At the end of the 20 years, the

AUDIT DISCLOSURE NO. 2

COMPANY COMMENTS (Continued):

bondholders have $500 million invested and receive interest payments semi-annually on the total $500 million invested for the next 80 years.

The Company does not agree that it is appropriate to apply a straight-line amortization method to the ZTF debenture as this would not result in a **constant rate of interest** as prescribed by APB 21.

The other issue addressed in the FPSC Staff Recommendation is that the debt issuance expense of $2,175,000 should be amortized over the life of the bond for an annual amortization of Florida intrastate issuing expense of $3,720. The Company agrees that the $2,175,000 should be amortized over the 100 years. The amortization should be based on the interest method as described above. Using this method, the adjustment to Florida intrastate expenses would be less than one thousand dollars.

CONCLUSION: Based on the above discussion, BST believes its interest is properly stated and no adjustment is appropriate.

15. *Amortization of discount and premium.* With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium[8] and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the "interest" method described in and supported by paragraphs 16 and 17 of APB Opinion No. 12, *Omnibus Opinion—1967.* However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method.

16. *Statement presentation of discount and premium.* The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.[9] Amortization of discount or premium should be reported as interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.

EFFECTIVE DATE

17. This Opinion shall be effective for transactions entered into on or after October 1, 1971. The Board believes that the conclusions as to balance sheet presentation and disclosure in paragraph 16 should apply to transactions made prior as well as subsequent to the issuance of this Opinion. However, this Opinion is not intended to require the discounting of notes existing on September 30, 1971 which were not previously discounted. Notes that were previously recorded in fiscal years ending before October 1, 1971 should not be adjusted. However, notes that have previously been recorded in the fiscal year in which October 1, 1971 occurs may be adjusted to comply with the provisions of this Opinion.

The Opinion entitled "Interest on Receivables and Payables" was adopted unanimously by the eighteen members of the Board.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

Accounting Principles Board (1971)

Philip L. Defliese, *Chairman*	Robert L. Ferst	Louis M. Kessler
Donald J. Bevis	Newman T. Halvorson	Oral L. Luper
Milton M. Broeker	Robert Hampton, III	David Norr
Leo E. Burger	Emmett S. Harrington	George C. Watt
George R. Catlett	Charles B. Hellerson	Glenn A. Welsch
Joseph P. Cummings	Charles T. Horngren	Frank T. Weston

[8]Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as timing differences in accordance with APB Opinion No. 11, *Accounting for Income Taxes.*

[9]Refer to the Appendix for illustrations of balance sheet presentation.

AUDIT DISCLOSURE NO. 3

SUBJECT: Investment Tax Credit Cost Rate

STATEMENT OF FACT: The Company's Investment Tax Credit (ITC) cost rate is calculated using Long-Term Debt and Common Equity. The Company's ITC cost rate is calculated on the Surveillance Report as follows: [See Audit Report for Table] [The Table indicates using the weighted cost for long-term debt and common equity having a 11.31% weighted Cost Rate.]

RECOMMENDATION: There are times when the ITC cost rate is calculated using Long-Term Debt, Common Equity, and Short-Term Debt. Further analysis may determine that it is appropriate to include short-term debt in BellSouth's ITC cost rate calculation. The ITC cost rate using Short-Term Debt is calculated as follows: [See Audit Report for Table] [The Table indicates a 10.91% weighted Cost Rate.]

COMPANY COMMENTS: It is not appropriate to theorize on an alternate method of computing the ITC cost rate. The Company is using the method as ordered by the PSC in Order No. 16257, Docket No. 850172-GU, dated 6/19/86 (see copy attached). This method has been used consistently since 1986. Furthermore, the Company is bound by the provisions of the Stipulation and Agreement in this docket, approved by Order No. PSC-94-0172-FOF-TL, dated February 11, 1994, as follows:

> "...SOUTHERN BELL shall continue to record its operations for regulatory purposes and to make the reports required of it by the FPSC using the same format, standards and guidelines adopted by the FPSC in the Order [Order No. 20162, issued October 13, 1988] and subsequently used by SOUTHERN BELL in filing its surveillance reports since October of 1988."

Therefore, a change in the method of computing the ITC cost rate is not appropriate.

fractional amount, plus interest, is a reasonable resolution of the interest synchronization dilemma which has gone unresolved for so long.

The parties agree that to implement the one-time depreciation reserve adjustments, the companies shall book the appropriate amounts as set out below prior to June 24, 1986. These entries shall be non-account specific, bottom-line reserve entries. The entries will be made account specific at the next review of the companies' depreciation rates, whether through represcription or a rate case.

6. The second stage of the adjustment is a prospective monthly adjustment. Monthly adjustments, consisting of one-twelfth of the annual revenues avoided by the interest synchronization adjustment, shall be credited to the companies' depreciation reserves for each month beginning January 1, 1986, or the effective date of the respective companies' rate orders, whichever may be later. The calculation of these monthly entries from January 1, 1986 through May 22, 1986 shall be based on the interest synchronization methodology proposed by Public Counsel in the companies' respective rate cases.

After May 22, 1986, the monthly entries shall be consistent with the final IRS regulations specifying the appropriate prospective method of calculating cost of capital for establishing the return on JDIC and for purposes of interest synchronization. The cost of capital assigned to the credit must be at least equal to the overall cost of capital, determined on the basis of a weighted average, that would have been provided by common and preferred shareholders and long-term creditors if the credit were unavailable. These monthly entries shall continue until the companies' respective rates are adjusted to eliminate any revenue excesses in accordance with the interest synchronization methodology set out in the final IRS regulations.

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AUDIT DISCLOSURE NO. 4

SUBJECT: Olympics and Special Olympics Expense

STATEMENT OF FACT: The Company reports a total expense related to the Olympics and Special Olympics of $11,255,293. Since the Olympics were held in Georgia, most of the expenses were charged to Georgia. The Florida portion is $102,198, with $55,207 being included in Florida intrastate expense. Olympic costs to Florida were charged to the following function codes and accounts: [See Audit Report for Table and legend.]

RECOMMENDATION: The $55,207 is a nonregulated expense. The Company should reduce regulated expenses by this amount.

COMPANY COMMENTS: The expense in question is properly allocated to **regulated** operations. The $55,207 is appropriately assigned to intrastate regulated expense. This amount could be disallowed, not as a nonregulated expense, but as a regulated expense which does not benefit the Florida ratepayers, as suggested by the audit disclosure. However, the Company asserts that it would not be appropriate to disallow this amount for the following reasons:

Although the Olympics were held primarily in Georgia, there were venues in other states. Florida had two venues for soccer - the Florida Citrus Bowl in Orlando and the Orange Bowl Stadium in Miami. The Company received regulated revenue for provision of telecommunications services at the venues. Because the revenue is included in Florida operating results, it is not appropriate for the Company to remove the related expense of $55,207.

No adjustment is necessary.

AUDIT DISCLOSURE NO. 5

SUBJECT: Centennial Olympic Park Fund

STATEMENT OF FACT: An invoice dated July 9, 1996 payable to the Atlanta Chamber Foundation in the amount of $50,000 was charged to account 6728.90, Other General and Administrative Expense. The payment was a contribution to the Centennial Olympic Park Fund.

Subsequent to the filing of the 1996 Surveillance Report, the Company discovered a Headquarters payment of $50,000 for the Olympic Centennial Park Fund. The Florida intrastate portion of this payment is $9,303.

RECOMMENDATION: The $9,303 is a nonregulated expense. The Company should reduce regulated expenses by this amount.

COMPANY COMMENT: The Company agrees that the $9,303 should be removed from regulated expense because the expense is related to the Olympic Centennial Park in Atlanta, Georgia. The Company will remove $9,303 from the revised 1996 Surveillance Report.

However, it is important to recognize that the $9,303 is **not nonregulated** expense; it is appropriately booked as a **regulated** expense according to Part 32 account classifications. It is being removed as a disallowed regulated expense pursuant to prior Commission rulings and pursuant to negotiations with the Office of Public Counsel.