Performance Audit of
Universal Service Fund
High Cost Program –Interstate Common Line Support

Lani Eko & Company, CPAs, PLLC

TABLE OF CONTENTS

EXECUTIVE SUMMARY

We performed an independent performance audit of the controls over the Universal Service Fund (USF) High Cost Program, Interstate Common Line Support (ICLS) mechanism. The objectives of the performance audit were to: (1) describe the processes and controls, established by National Exchange Carrier Association (NECA) and Universal Service Administrative Company (USAC), to ensure the accuracy and eligibility of the ICLS disbursements, (2) determine whether the controls were effective, and (3) identify any improvements needed to the controls in order to protect the Universal Service Fund from fraud, waste and abuse.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Our audit covered ICLS Program Year 2013.

We determined that internal controls over ICLS payments to Eligible Telecommunication Carriers (ETCs) were not effective. We noted deficiencies in USAC's procedures for validating costs studies; verifying Common Line Revenues; and compiling FCC Forms 509, *Actual Cost and Revenue Data Collection*. We also noted that controls were not adequate to mitigate the inherent risk in the relationships between NECA and the Eligible Telecommunications Carriers. We made seven recommendations to FCC's management that we deemed sufficient to address the deficiencies noted.

FCC management generally concurred with the audit findings and recommendations. The Results of Audit section of this report provides detailed audit findings and recommendations. In Appendix D, we present the results of our work for Objective 1 of this performance audit. FCC's management response is provided in Appendix B and definitions for technical terms are provided in Appendix C.

BACKGROUND

The Communications Act of 1934 (the 1934 Act) created the Federal Communications Commission (FCC) to execute and enforce the provisions of the 1934 Act, organizing federal regulation of telephone, telegraph and radio communications. The 1934 Act expanded under the Telecommunications Act of 1996 (the 1996 Act), which codified the Universal Service Fund (USF) to operate as a program by which interstate telecommunications carriers were assessed tariffs to subsidize telephone service to low-income households and high-cost areas. As part of the 1996 Act, FCC put the Universal Service Administrative Company (USAC) in charge of administering the collection and disbursement of universal service funds.

USAC is an independent, not-for-profit entity designated by FCC as the administrator of the USF. The USF disburses almost $10 billion annually to companies and institutions that make universal service possible. The USF High-Cost Program accounts for about 45 percent (or $4.5 billion) of total USF disbursements. The USF High-Cost Program provides funding to companies working to expand broadband in unserved or underserved areas. USAC is responsible for ensuring the accuracy of the ICLS payments to ETCs.

The National Exchange Carrier Association (NECA) is a non-profit association formed in 1983 by telephone industry representatives to help member companies comply with FCC's access charge rules. The FCC's rules identify NECA's responsibilities and govern how NECA must interact with its member companies, including NECA's responsibility to develop pool tariff rates and interstate access charge tariffs for member companies. NECA is responsible for filing interstate access tariffs with USAC and administrating associated revenue pools on behalf of member companies that choose to submit their regulatory filings through NECA. FCC rules require member companies performing cost studies to submit their cost, demand and access revenue data to NECA. NECA calculates monthly pool revenue distribution and reimburses "cost" companies for access expenses, to the extent their costs exceeded their reported revenues. Instead of employing FCC's Part 36[1] cost allocation manual to develop interstate revenues, expenses, and investments, NECA uses data collected from the population of study areas settling on costs and a sample of Average Schedule study areas to estimate the interstate costs for an average schedule telephone company. Specifically, NECA's services to member companies include:

- Filing interstate access charge tariffs with USAC.
- Collecting and validating cost and revenue data.

[1] Title 47 CFR Part 36 – Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies.

- Ensuring compliance with FCC rules.
- Distributing revenues from access charges among pool members, based on each company's costs of providing interstate access.
- Processing FCC Regulatory Fees.

ICLS is available only to rate-of-return incumbent carriers (mostly rural and some non-rural carriers) and competitive carriers providing service in the areas served by these rate of return incumbent carriers that are designated as eligible telecommunications carriers (ETCs) by the FCC or their state commissions. ICLS helps to offset interstate access charges and is designed to permit each rate-of-return carrier to recover its common line revenue requirement, while ensuring that its subscriber line charges remain affordable to its customers.

The ICLS funding year runs a 12-month period from July 1 through June 30. However, ICLS payments are based on annual projected data submitted by Incumbent Local Exchange Carriers[2] on March 31 each year. ICLS payments are subject to an annual true-up process based on actual data submitted each December 31 for the previous calendar year. In 2013, approximately 1,100 rate-of-return carriers[3] received $852 million in ICLS funds.

In 2017, the Connect America Fund – Broadband Loop Support (CAF BLS) replaced ICLS. CAF BLS provides support for broadband-only lines, as well as voice lines and voice/broadband lines. CAF BLS provides cost recovery for the difference between a carrier's loop costs associated with providing broadband-only service (the "consumer broadband-only loop revenue requirement") and its consumer broadband-only loop revenues. CAF BLS is not provided in areas that are served by a qualifying unsubsidized competitor.

The Results of Audit section of this report provides detailed audit findings and recommendations. Appendix D, presents the results of our work for Objective 1 of this performance audit. The FCC's management response is provided in Appendix B and definitions for technical terms are provided in Appendix C.

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[2] Incumbent Local Exchange Carrier is a dominant telephone company, as determined by the FCC, within a geographic area that was providing local service when the Telecommunications Act of 1996 was enacted.

[3] Rate-of-Return Carrier is any incumbent local exchange carrier not subject to price cap regulation with respect to the geographic area in which it operates as an incumbent local exchange carrier.

RESULTS OF AUDIT

Finding: Internal Control Over ICLS Payments Is Not Effective

I.1 ***<u>Improvement Is Needed In Compilation and Validation of FCC Forms 509</u>***

BACKGROUND

All ETCs designated as rate-of-return carriers must submit their prior year actual cost and revenue data to USAC annually on FCC Form 509, *ICLS Annual Common Line Actual Cost Data Collection Form.* USAC uses data on FCC Form 509 to determine the amount of ICLS each ETC receives from or refunds to the USF.

The ETCs may elect to (a) use NECA's service to complete FCC Form 509 and submit it to USAC, (b) file FCC Form 509 directly with USAC, or (c) designate an agent to complete and submit FCC Form 509 to USAC on its behalf. ETCs that file FCC Form 509 through NECA account for over ninety-nine percent of ICLS funds disbursed annually. The ICLS disbursements for Program Year 2013 were approximately $852 million.

CONDITION

The internal controls over the Cost Study Validation and preparation of FCC Form 509 were not effective to ensure ICLS payments to ETCs who filed FCC Form 509 through NECA were accurate and in compliance with FCC rules. NECA performs a Cost Study Validation to ensure that ICLS payments are computed accurately. However, NECA did not adequately validate the accuracy of the data supporting the ETCs' cost studies and FCC Forms 509 prepared by NECA. NECA performs the Cost Study Validation by comparing the ETC's cost study data to its supporting financial records, such as the financial statements, trial balance, and general ledger. The Cost Study Validation procedures are documented in NECA's IR Analysis & Review Manual, Section 4 (the Manual).

NECA's management asserted that NECA completed the Cost Study Validation using the procedures outlined in the Manual for 100 percent of the 789 cost studies submitted by the ETCs during the year we tested. According to NECA's management, about 50 members of its staff participated in the Cost Study Validation process over a two-month period.

We examined FCC Forms 509 filed through NECA for a sample of 45 Study Area Codes (SAC), and noted eight matters during the audit that support our conclusion that NECA's internal controls over the Cost Study Validation process and preparation of FCC Forms 509 were not effective.

1. USAC's Validation Requirement

USAC did not validate the accuracy or assess the reasonableness of the financial data supporting the amounts reported on FCC Forms 509 before making payments to ETCs. In accordance with the FCC rule, USAC has the ultimate responsibility for calculating and ensuring the accuracy of ICLS payments to ETCs. However, it appears that USAC relied on NECA's validation process, which did not test the accuracy or reasonableness of financial data supporting FCC Forms 509.

2. Cost Study Reconciliations

NECA's reconciliations of the ETCs financial and non-financial data to their cost studies may not be effective in preventing fraud or errors in the ICLS support mechanism. The cost study reconciliations are an important component of the Cost Study Validation. The reconciliation process, if designed and implemented properly, is an effective tool in preventing and detecting fraud or errors. NECA's Cost Study Validation consisted of either a comparison of the ETCs financial data from different records (i.e., financial statements, trial balance, schedules); or tracing and agreeing two sets of financial data from the ETC. Although NECA describes this process as reconciliation, we noted that NECA's analyses were not comprehensive and did not always include comparing financial data from independent third parties or resolving the differences noted among various financial records, schedules, and reports. Such analyses are critical to an effective reconciliation process.

3. Verification of Common Line Revenues

NECA did not perform adequate procedures to ensure Common Line Revenues (CLR) reported on FCC Forms 509 was accurate. The CLR reported on FCC Form 509 were not reconciled to the ETCs' audited or certified financial data, such as general ledger, trial balance, or financial statements. CLR, also known as settlement revenues, include the subscriber line charges and Integrated Services Digital Network (ISDN) Port Revenues. Accurate reporting of CLR is important because it reduces the amount of ICLS payments due to the ETCs. We found that the subscriber line charge Revenues reported on FCC Forms 509 did not agree with amounts reported on the trial balances for 12 of the 45 SACs in our sample. Two of those SACs did not report any subscriber line charge Revenue on their trial balances.

According to NECA's management, their Cost Study Validation process is only a review and reconciliation of the ETCs' investments and expenses, and is not a reconciliation of settlement revenues to audited or certified financial data. NECA's management stated that it relies on the ETCs' officials' certification that CLRs are complete and accurate.

4. Reconciliation of Common Line Revenue Requirements

NECA's reconciliation of the Common Line Revenue Requirements (CLRR) was not effective. NECA did not provide the 2013 Reconciliation forms for two SACs for the auditor's examination. Additionally, for two other SACs, the CLRR reported on the 2013 Reconciliation forms did not agree with NECA's Allocator and the ETC's cost studies. NECA's management told us that ETCs prepared the SACs' cost studies on a fiscal year basis instead of a calendar year. Because the calendar year cost data was not available, NECA calculated the CLRR based on the ETCs' calendar year settlement data. However, we noted instances that settlement data did not agree with the ETC's general ledger, trial balance or financial statements.

5. Variance Review Process Not Aligned with Risk

The variance thresholds (year-over-year comparison of revenue requirements) established by NECA to initiate a further review of the revenue requirements, referred to as a priority review edit, might be too high, and thus ineffective. For example, NECA's variance thresholds for initiating a priority review edit of special access revenue and for common line revenue requirements were equal to or greater than 50 percent and 25 percent, respectively. Under the priority review edit process, accounts that contributed to the threshold variances are identified, researched and resolved to assess the reasonableness of the variances.

The variance thresholds focus on the percentage changes in revenue requirements between the current and prior years, and do not consider the corresponding changes in the dollar amount of the variances. For example, a SAC with a special access revenue requirement variance of 51 percent and a difference of $9,000 would require further analysis. However, a SAC that has a special access revenue requirement variance of 40 percent and a difference of $250,000 would not be flagged for a priority review edit. None of the 45 SACs in our sample met NECA's threshold for a priority review edit.

6. Unsupported Accounting Entries

NECA made accounting entries in the ETCs' cost studies that were not always supported or reflected in the ETCs' accounting records. We also noted two instances of ETCs making accounting entries on their general ledger to agree the general ledger with amounts reported on the cost studies, even though those amounts were not reflected on the ETCs' financial statements.

7. NECA's FCC Form 509 Review

NECA's procedures and controls for approving FCC Forms 509 before submitting them to USAC were not effective to ensure the forms were complete and accurate. We identified deficiencies and errors in the data used to prepare FCC Forms 509 approved by NECA's management.

8. NECA's Monitoring of Controls Over ICLS Is Not Effective

NECA's Internal Audit Division (IAD) did not adequately monitor the effectiveness of NECA's internal controls over processes that support preparation of FCC Forms 508 and 509. The internal audit function is critical for effective monitoring of operations and serves as an essential element of internal controls. Based on the most current audit report provided to us, NECA's IAD had not performed an evaluation of internal controls over NECA's preparation and submission of ICLS data in over five years. Because over ninety-nine percent of ETCs receiving ICLS payments filed their FCC Forms 508 and 509 through NECA, IAD should perform more frequent periodic evaluations of ICLS internal controls. Also, it is important that FCC and USAC's management understand how NECA's internal audits are used to manage and mitigate risks of improper ICLS payments.

CRITERIA

GAO's Standards for Internal Control in the Federal Government[4] *states,*

"…Section OV2.23, "Management conducts activities in accordance with applicable laws and regulations….Section OV 2.24, "…Management designs an internal control system to provide reasonable assurance regarding prevention or prompt detection and correction of unauthorized acquisition, use, or disposition of an entity's assets…"

"…Section 16.04, "Management monitors the internal control system through ongoing monitoring and separate evaluations. Ongoing monitoring is built into the entity's operations, performed continually, and responsive to change. Separate evaluations are used periodically and may provide feedback on the effectiveness of ongoing monitoring."

NECA IR Analysis & Review Manual Section 4, dated July 7, 2015, states:

Paragraph 4.2.2, "The USF Annual Data Submission for all cost study areas should be reconciled to the underlying financial information which is supported by audited or certified financial data, and to the total company amounts utilized in the interstate separation process. NECA's USF Internal Procedures require the managers to compare annual USF Data Collection information to

[4] The Committee of Sponsoring Organizations of the Treadway Commission (COSO)'s 2013 issuance of the revised, Internal Control – Integrated Framework introduced the concept of principles related to the five components of internal control. The GAO Green Book adapts these principles for the government environment.

corresponding cost study/financial information **for all ECs**[5] [emphasis added] settling on cost. The primary purpose of this verification is to validate that cost study data is derived from and reconciles to the same financial source as USF data…..Note: There is no significance margin - *the data must match*."

CAUSES

We identified seven causes for the ineffective validation of the cost studies that support the FCC Forms 509.

(a) USAC did not dedicate adequate resources to validate completeness and accuracy of financial and non-financial data that supports over 700 cost studies and related FCC Forms 509 filed by NECA on behalf of its member ETCs.

(b) USAC and NECA's management did not appropriately align resources to the risks in the ICLS program. For example, significant resources were used to compile FCC Form 508, *ICLS Projected Annual Common Line Revenue Requirement Form*, which did not represent a significant risk to Universal Service Fund.

(c) There is no documented, executed Memorandum of Understanding (MOU) among FCC, USAC, and NECA to define the roles and responsibilities of each party, including expected performance standards (additional details are discussed in Section I.2 below).

(d) NECA did not properly align its resources to mitigate the risks associated with the compilation of FCC Form 509. Examples of areas that might warrant additional resources based on program risks include (a) ETCs receiving significant ICLS, (b) ETCs with a history of erroneous or unsupported cost studies, and (c) ETCs whose costs and revenues are outside the norm.

(e) NECA did not perform an independent verification of CLR reported by ETCs. NECA relies on ETC's official certification that CLR is complete and accurate.

(f) The FCC and USAC have not implemented policies and procedures for performing a periodic review of NECA's operations to evaluate ETCs' compliance with FCC rules that apply to ICLS, and take remedial actions when needed.

(g) The scope and frequency of NECA IAD's evaluations of FCC Forms 509 were not sufficient to detect and mitigate program risks.

[5] Eligible Carriers (EC) and Eligible Telecommunication Carriers (ETC) are interchangeable terms.

EFFECT

The lack of a MOU to define roles and responsibilities, and ineffective policies, procedures and program oversight resulted in an increased risk of improper or fraudulent ICLS payments to ETCs.

RECOMMENDATIONS

We recommend that FCC management:

1.1 Ensure that USAC's management develops and implements a risk-based approach for validating the accuracy of the underlying financial and non-financial data that support the ETCs' FCC Forms 509.

1.2 Execute a MOU with USAC and NECA to define the roles and responsibilities of each party (See Recommendation 2.1 for additional detail).

1.3 Ensure that NECA implements a risk-based approach for its cost study validation process and for selecting ETCs for further examination. .

1.4 Ensure that NECA implements improvements to the cost study validation process to include:

   a. Verifying the accuracy of a sample of the underlying financial data supporting the cost studies,
   b. Validating the financial data supporting the CLR reported by the ETCs,
   c. Implementing changes to the management level reviews of compiled FCC Forms 509 to improve the reviews' effectiveness,
   d. Performing an evaluation to determine whether the thresholds for priority reviews should be set at both a lower dollar amount and percentage, and
   e. Maintaining a record of the changes that have been made to cost studies and other financial data submitted by ETCs to NECA.

1.5 Ensure that USAC management implements a periodic review of NECA's process for compiling FCC Forms 509, validating cost studies, and using NECA IAD to monitor and help to reduce the risk of errors in FCC Forms 509 prepared by NECA.

FCC MANAGEMENT RESPONSE

FCC management generally agreed with the audit findings and recommendations. FCC's management response is provided, in full, in Appendix B of this report.

AUDITOR COMMENT

We commend FCC management for its initial efforts to ensure improvement in the FCC Form 509 process. If adequately implemented, this corrective action should remediate the finding. FCC OIG may review the implementation of the improvements at a future date.

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I.2 Controls Were Not Effective to Mitigate the Inherent Conflict of Interest that Exists Between NECA and the ETCs

BACKGROUND

NECA is a business sector association founded by the telecommunications industry to help member companies comply with FCC regulations, including FCC's Third Report and Order; FCC CC Docket 78-72. NECA manages the distribution of interstate access revenues through revenue pooling. The revenue pool includes ICLS, which is a USF High Cost Program support mechanism. Over 1,300 local telephone companies, or exchange carriers, are members of NECA. NECA's member organizations are also the beneficiaries of ICLS.

NECA is not independent of the ETCs that received ICLS payments, which subsidize interstate access charges and permit ETCs to recover their common line revenue requirements. In its role as a business association, NECA has a responsibility to promote the interests of its members, and thus has an incentive to maximize ICLS payments to ETCs. NECA also has a potentially conflicting responsibility to the FCC to ensure its member ETCs comply with FCC's rules and orders applicable to ICLS.

CONDITION

NECA's lack of independence from its member carriers creates a potential conflict of interest that may increase the risk that errors and irregularities may occur and not be detected timely. NECA acts as an agent of the ETCs when filing FCC Forms 508 and 509 with USAC, and NECA is reimbursed by the ETCs for services it provides. NECA collects and summarizes the ETCs' financial and cost data, calculates ICLS payments, and prepares and files FCC Forms 508 and 509 with USAC on behalf of the ETCs.

However, our audit found that NECA did not certify the completeness and accuracy of FCC Forms 508 and 509 it filed on behalf of the ETCs, as the FCC's rule requires of agents. While NECA calculated the projected and actual ICLS payments on FCC Forms 508 and 509, USAC has the ultimate responsibility for determining the amount of ICLS payments to ETCs. USAC relied solely on NECA to determine the amount of ICLS payments to each ETC that for which NECA filed FCC Form 509.

FCC did not have an agreement documenting and formalizing relationships among the parties with responsibilities for ICLS – the FCC, USAC, and NECA. For example, there was no documented agreement to formalize:

(a) policies for FCC and USAC's oversight over NECA's operations that support the USF,
(b) policies for resolving potential conflicts of interest, and
(c) protocols for communication among parties.

CRITERIA

GAO's Standards For Internal Control in the Federal Government, Principle 3, states, "…Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives…" Principle 6 states, "Management should define objectives clearly to enable the identification of risks and define risk tolerances…" Principle 8 states, "… Management should consider the potential for fraud when identifying, analyzing, and responding to risks…"

CAUSE

FCC management had not executed a MOU among the parties with responsibilities for ICLS – FCC, USAC, and NECA.

EFFECT

The FCC and USAC may be unable to mitigate ICLS program risks to an acceptable level that ensures errors, fraud, waste or abuse of USF funds are detected timely and mitigated.

RECOMMENDATIONS

We recommend that FCC management:

2.1 Execute a MOU among the FCC, USAC and NECA that defines the roles and responsibilities of each party with regard to the ICLS program. Monitor, review and update the MOU on a periodic basis to address changes to FCC's rules applicable to the ICLS program.

2.2 Conduct periodic risk assessments of the ICLS program and review controls over ICLS. Additionally, perform internal control reviews at NECA to ensure that its internal control is effective in mitigating risks of improper ICLS payments to ETCs.

FCC MANAGEMENT RESPONSE

FCC management generally agreed with the audit findings and recommendations. FCC's management response is provided, in full, in Appendix B of this report.

AUDITOR COMMENT

We commend management for its initial efforts to ensure improvement in the FCC Form 509 process. If adequately implemented, this corrective action should remediate the finding. FCC OIG may review the implementation of the improvements at a future date.

APPENDIX A – OBJECTIVES, SCOPE, AND METHODOLOGY

Lani Eko & Company conducted an independent performance audit of the controls over the Universal Service Fund (USF) High Cost Program, Interstate Common Line Support mechanism. The objectives of the performance audit were to: (1) describe the processes and controls, established by NECA and USAC, to ensure the accuracy and eligibility of the ICLS disbursements, (2) determine whether the controls were effective, and (3) identify any improvements needed to the controls in order to protect the Universal Service Fund from fraud, waste and abuse.

We conducted the performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Our audit covered ICLS processes and controls for program year ended June 30, 2015; and process and controls over the compilation of FCC Form 509 for program year ended June 30, 2013.

To achieve the objectives, we performed audit procedures as deemed appropriate, including:

1. Gained an understanding of significant provisions of laws, regulations and FCC's orders applicable to the USF High Cost Program – ICLS.
2. Gained an understanding of NECA and USAC's responsibilities for ICLS, including monitoring activities of FCC's Office of Managing Director and Wireline Competition Bureau.
3. Obtained an understanding of the processes used to prepare and assess the reasonableness of data reported on FCC Forms 508 and FCC Form 509.
4. Obtained an understanding of policies and procedures for ensuring ETCs eligibility to receive ICLS disbursements.
5. Made inquiries of appropriate USAC officials and obtained an understanding of the processes used to maintain the integrity of the Study Area Code (SAC) database including:

   a. Procedures for restricting access to the SAC database, and
   b. Procedures for inputting and editing data in the SAC database.

6. Obtained an understanding of the ICLS fund disbursement processes including procedures for:
   a. Verifying accuracy of ICLS fund disbursements.
   b. Maintaining integrity of the ACH database.
   c. Reconciling ICLS disbursements to the general ledger and bank statements.
   d. Handling and resolving ICLS disbursements inquiries from Carriers.

7. Examined policies and procedures for ensuring that ETCs are eligible to receive ICLS payments.

8. Reviewed FCC Rules and Orders applicable to ICLS to determine ETC's eligibility.

9. Tested USAC's monthly Schedule of ICLS fund disbursements by Study Area Codes for completeness.

10. Identified and obtained explanations from USAC for SACs that had a $500,000 and five percent variance between Projections and 2013 Actual Costs.

11. Assessed the effectiveness of cost study validations in preventing improper ICLS payments to ETCs.

12. Traced amounts on FCC Forms 508 and FCC Forms 509 to underlying financial data.

13. Assessed whether BCAP is an effective internal control monitoring tool for ICLS disbursements.

APPENDIX B – MANAGEMENT'S RESPONSE

Federal Communications Commission
Washington, D.C. 20554

May 25, 2018

Transmitted via E-mail

David L. Hunt, J.D.
Inspector General
Office of Inspector General
Federal Communications Commission

Dear Mr. Hunt:

Thank you for the opportunity to review and comment on the draft report from the Office of Inspector General (OIG) entitled *Performance Audit of Universal Service Fund High Cost Program - Interstate Common Line Support (OIG ICLS Report).* The Commission takes seriously its role as steward of public funds that contribute to the Universal Service Fund (USF or Fund), as well as its duty to exercise responsible programmatic oversight of the Fund. In the draft report, OIG finds that internal control of Interstate Common Line Support (ICLS) payments is not effective.[1] Specifically, OIG finds that improvement is needed in the compilation and validation of FCC Form 509 data by the Universal Service Administrative Company (USAC) and that controls were not sufficient to mitigate the conflict of interest that exists between the National Exchange Carrier Association (NECA) and eligible telecommunications carriers (ETCs). OIG made several recommendations to address these issues.

We agree the Commission must exercise responsible programmatic oversight of the Fund. The importance and size of the USF demands constant scrutiny and assessment of the Commission's oversight efforts.[2] As such, we find valuable your recommendations and intend to use them in working to improve the compilation and validation of FCC Form 509 and to identify better controls to mitigate any conflict of interest that exists between NECA and ETCs.

Concerning issues raised with validation of FCC Form 509, we currently are considering a variety of possible improvements, including ones OIG identified. Some actions may require a notice-and- comment rulemaking or approval under the Paperwork Reduction Act, while others may be achieved by Commission guidance to USAC or NECA, or by executing a Memorandum of Understanding with USAC and NECA. However, we will be working expeditiously to continue to improve and strengthen our procedures in this area.

Regarding the recommendations to mitigate the inherent conflicts of interest between NECA and ETCs, we will also carefully consider actions that can be taken to address concerns. We would also note that carriers are not required to use NECA as a filing agent for ICLS, and that carriers that do not may, in

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[1] In the 2016 *Rate-of-Return Reform Order,* the Commission adopted significant reforms to the rules governing carriers subject to rate-of-return regulation, including the adoption of a new Connect America Fund-Broadband Loop Support (CAF-BLS) mechanism, which replaced ICLS. *Connect America Fund,* Order, 31 FCC Red 3087, 3119-24 (2016).

[2] *Comprehensive Review of the Universal Serv. Fund Mgmt., Admin., & Oversight,* 23 FCC Red 13583, 13583 (2008).

fact, have higher risks than carriers that rely on NECA. Therefore, any action we take to improve the transparency and quality of NECA's validation processes and controls must be carefully tailored not to encourage carriers to use other filing agents that use less robust validation procedures. We will consider improved controls for *all* carriers, regardless of who files their data.

We appreciate the opportunity to respond to this performance audit, and we will continue to develop and improve our oversight and monitoring of ICLS and CAF-BLS. We look forward to continuing to work with OIG in the future.

Sincerely,

Kris Anne Monteith
Chief, Wireline Competition Bureau

Mark Stephens
Managing Director, Office of the Managing Director

CC: USAC

APPENDIX C – GLOSSARY

Average Schedule Companies: Pool revenues (settlements) are determined based on statistical formulas. On December 31 annually, NECA submits adjustments to prior year average schedule formulas to the Federal Communications Commission (FCC) for approval.

Beneficiary and Contributor Audit Program (BCAP): Designed to measure rates of program compliance among universal service beneficiaries and contributors.

Common Line Revenue (CLR): A calculated amount local exchange carriers may recover based on a per-minute carrier common line charge collected on originating access minutes.

Common Line Revenue Requirements (CLRR): CLRR is the minimum revenue required by a rate of return telecommunication carrier to ensure that its subscriber's line charges are affordable to its customers.

Cost Companies: Receive pool revenues (settlements) for interstate telecommunication services based on actual interstate investment and expenses that are calculated annually from detailed cost studies.

Eligible Telecommunication Carriers (ETCs): A designation given to telecommunications service providers by their state public utility commissions or the FCC, enabling them to participate in universal service programs.

File Transfer Protocol (FTP): A standard network protocol used for the transfer of computer files between a client and server on a computer network.

Form 508 – ICLS Projected Annual Common Line Revenue Requirement Form: The rate of return telecommunications carrier uses FCC Form 508 to report project information (i.e., Subscriber Line Charges, Annual Common Line Requirements and Special Access Surcharge Revenues) that is used by USAC to project the amount of ICLS, if any; a carrier is eligible to receive.

Form 509 – ICLS Annual Common Line Actual Cost Data Collection Form: The rate of return carrier that receives ICLS uses FCC Form 509 to report actual cost and revenue data for the prior calendar year to USAC.

Interstate Common Line Support (ICLS): Offsets interstate access charges for rate-of-return companies. ICLS provides support for rate-of-return carriers to the extent that subscriber line charge caps do not permit them to recover their common line revenue requirements. Only rate-of-return carriers or competitive carriers serving in the service area of a rate-of-return carrier are eligible to receive ICLS. The funding year runs from July 1-June 30, annually.

Integrated Services Digital Network (ISDN): A set of communication standards for simultaneous digital transmission of voice, video, data, and other network services over the traditional circuits of the public switched telephone network.

Memorandum of Understanding (MOU): A nonbinding agreement between two or more parties outlining the terms and details of an understanding, including each parties' requirements and responsibilities.

National Exchange Carriers Association (NECA): The **p**arent company of USAC. Formed by the FCC as a not-for-profit corporation, NECA plays an important role in administering the FCC's access charge plan, which helps ensure telephone service remains available and affordable in all parts of the country

Universal Service Administrative Company (USAC): An independent, not-for-profit subsidiary of NECA designated by the FCC to be the permanent Administrator of the Universal Service Fund.

APPENDIX D – AUDIT OBJECTIVE 1

The following summary satisfies the requirements of Audit Objective 1: describe the processes and controls, established by National Exchange Carrier Association (NECA) and Universal Service Administrative Company (USAC), to ensure the accuracy and eligibility of the ICLS disbursements.

NECA and USAC Processes and Controls To Ensure Accuracy and Eligibility of ICLS Disbursements

Interstate Common Line Support (ICLS) helps rate-of-return (ROR) carriers to recover common line revenue requirements, while ensuring that subscribers' line charges remain affordable to their customers.

NECA PROCESSES AND CONTROLS

1. *Form 509 (Annual Common Line Actual Cost Data Collection and Validation)*

ETCs submit cost studies and supporting documentation electronically through NECA's File Transfer Protocol (FTP) site or by email. The Cost Study Validation Process (CSVP) is designed to examine the cost study's key financial elements and to identify significant errors and inconsistencies. For Average Schedule Companies - NECA develops a set of average schedule formulas approved by the FCC that stimulates the disbursements to cost companies that are representative of average schedule companies.

2. *Carrier's Verification and Certification Process for Form 508, and 509*

NECA headquarters (HQ) submits the completed form data through a mass email to ETCs for review and certification before filing the data with USAC. An authorized ETC's official or employee signs the certification page of the form and resubmits with the form file to NECA.

3. *Transmitting Data to USAC*

NECA HQ submits the ICLS file through USAC's [redacted] site. Within seven to fourteen days of filing data with USAC, NECA HQ prepares individual company files and sends a mass e-mail to member ETCs indicating the final ICLS data submitted to USAC.

USAC PROCESSES AND CONTROLS

1. NECA–Filed ICLS Form 507, 508 and 509 Data Upload

NECA uploads ICLS files (e.g., FCC Form 508 or Form 509) to the NECA folder on the USAC-NECA [redacted]. USAC's Subject Matter Expert 1 (SME1) verifies that the NECA uploaded the appropriate ICLS files for the upcoming period and saves the ICLS files to the monthly processing folder on [redacted].

2. Direct-Filed ICLS Forms Data (507, 508 and 509)

USAC receives the Direct-Filed carrier's ICLS data on [redacted]. The SME1 enters ICLS data into an Excel-based template.

3. Peer Review of ICLS Forms Data (507, 508, and 509)

The SME2 verifies that ICLS data in the [redacted] Inbox was entered accurately in the Excel-based template and ICLS data for ineligible carriers was not entered in the template. If there are no issues, the ICLS file is loaded into the HCLI System.

4. Loading Processes for ICLS Forms 507, 508 and 509 Data

The SME1 ensures ICLS data are loaded correctly into HCLI System and committed for calculation of ICLS projections and disbursements. Both the High-Cost Program Manager and Director perform secondary reviews to ensure that the ICLS data (Forms 507, 508, and 509) loaded successfully.

5. ICLS Disbursements

The High-Cost/Low-Income HC/LI division Disbursement Analyst generates the payment files which are then approved by HC/LI officials. The Vice President of HC/LI reviews and signs the Disbursement Authorization Forms (DAF) to authorize the posting of the Disbursement Authorization Electronic Source Files to the secure designated network directory. The source files are subsequently loaded into [redacted] for retrieval by the Disbursements Team.

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[6] [redacted] is an enterprise content management platform that has a Browser-based interface that provides access to the repository and content management services.

[7] [redacted] is the business accounting software package.

6. Process Disbursement File

The Disbursement Analyst verifies that the total amount and the total number of line items on the authorized DAF are consistent with the transactions loaded into [redacted] and posts the Authorization Batch through the General Ledger in [redacted]. The Disbursement Analyst creates a Payment Batch in [redacted] and generates Payment the Electronic Funds Transfer (EFT) file in [redacted]. Upon approval by the USAC Chief Financial Officer, or designee, the Disbursement Analyst transmits the EFT payment file to the Bank of America.

NECA PROCESSES AND CONTROLS

1. Reconciling Variances between Expected and Actual disbursements

NECA's Financial Operations staff performs the reconciliation of variances between the "expected cash receipts from USAC" and "actual cash receipts from USAC." The Accounts Payable office prepares a Post Settlements Payment Reconciliation to reconcile the system calculated disbursement amount to the disbursement authorizations and manual adjustments.

2. Distributing Funds to Carriers

Accounts Payable prepares an "A/P Check/ACH Operation Form" for the check disbursements and generates a Pay Cycle Summary of ACH Disbursement report. Treasury signs the A/P Check/ACH Operation Form and returns a copy of the form to Accounts Payable. Automated Clearing House (ACH) disbursements are made to the ETCs bank accounts on record.