# Report on Audits of Financial Statements

# South Carolina Universal Service Fund

*for the years ended December 31, 2006 and 2005*

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SCOTT McELVEEN L.L.P.

# Independent Auditors' Report

South Carolina Office of Regulatory Staff
Columbia, South Carolina

We have audited the accompanying balance sheets/statements of net deficit of the South Carolina Universal Service Fund (the "Fund") as of December 31, 2006 and 2005, and the related statements of revenues, expenses and changes in fund deficit/statements of activities, which collectively comprise the Fund's basic financial statements for the years then ended December 31, 2006 and 2005. These financial statements are the responsibility of the Fund's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Governmental Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1, the financial statements of the Fund are intended to present the financial position and results of operations of the Fund and do not purport to and do not present fairly the financial position of the State of South Carolina and the changes in its financial position or cash flows for the periods then ended in conformity with accounting principles generally accepted in the United States of America, and do not include any other agencies, divisions or component units of the State of South Carolina.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of December 31, 2006 and 2005, and the results of its operations for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the Fund. The supplementary information included as Management's Discussion and Analysis on pages 3 thru 5 is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

CERTIFIED PUBLIC ACCOUNTANTS

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In accordance with *Government Auditing Standards*, we have also issued a report dated January 25, 2008, on our consideration of the Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Scott McElveen, L.L.P.

Columbia, South Carolina
January 25, 2008

# Required Supplementary Information

## South Carolina Universal Service Fund
## Management's Discussion and Analysis

Management's Discussion and Analysis ("MD&A") is prepared by the South Carolina Office of Regulatory Staff (the "SCORS") management to provide general information on the financial activities of the Fund. The MD&A should be read in conjunction with the Fund's financial statements and accompanying notes. The financial statements, notes, and this discussion are the responsibility of the SCORS's management.

The South Carolina Office of Regulatory Staff is an independent regulatory agency of the State of South Carolina that is responsible for representing the public interest in the regulation of public utilities, including electric, natural gas and telephone. The SCORS receives its authority and responsibilities from the State Legislature. One of the SCORS's responsibilities is to administer the Fund. The Fund was established to ensure the widespread availability of affordable local exchange telephone service.

This section of the Fund's financial report represents our discussion and analysis of the financial performance during the periods presented. It should be read in conjunction with the Fund's financial statements, which follow this section.

### OVERVIEW OF THE FINANCIAL STATEMENTS

The Fund is accounted for as a special revenue fund, which is a governmental fund that uses the flow of current financial resources and the modified accrual basis of accounting. The financial statements provide a detailed view of the Fund's finances that assists in determining whether there will be adequate resources available to meet the needs of the Fund. The Fund's financial statements include two statements:

The Balance Sheets/Statements of Net Deficit present only assets expected to be used and liabilities that come due during the year or soon thereafter. The difference between assets and liabilities is reported as fund deficit/net deficit.

The Statements of Revenues, Expenditures, and Changes in Fund Deficit/Statements of Activities present a comparison of revenues for which cash is received during or soon after the end of the year; expenditures for which payment is due during the year or soon thereafter; and other financing sources and uses, such as transfers to the General Fund. The net of these categories increases or decreases the fund balance.

This annual report consists of two parts – management's discussion and analysis and the basic financial statements. The basic financial statements also include notes that explain key information contained in the financial statements and provide further details on select data.

### FINANCIAL HIGHLIGHTS

The Fund's fund deficit/net deficit as of December 31, 2006 and 2005 were $838,090 and $595,855, respectively. During the Funds inception stage, the Fund was not adjusted for some telecommunication company changes such as bankruptcies, loss of certification, and buyouts. In the current year, the need to refund revenue for international calls and change in some telecommunication company's ability to pay into the Fund added to the deficit. These factors will be taken into consideration in resizing the Fund in the future to recover the amounts needed by the Fund.

## CURRENTLY KNOWN FACTS/ECONOMIC FACTORS

- Ending balances in both Cash and Distributions payable are lower in 2006 due to improvements implemented during the year in the distribution process. Accounts receivable are somewhat higher at the end of the current year due in part to an increase in revenues and improvements implemented in the collection of aged accounts.

- The current year increase in expenditures reflects an increase of more than $440,000 in distributions to telecommunications companies resulting from improvements in both assessment and collection of monies due to the Fund. Additionally, as the Lifeline and Link-up programs were fully staffed and operational in 2006, the Fund recognized an increase in expenditures for those outreach programs of just over $98,000.

- There is "churn" in the telecommunications industry with various companies entering and exiting the market. This churn, along with various mergers and acquisitions, poses challenges for the administrators of the Fund. Several companies that were contributing to the Fund have filed bankruptcy during the past 12 months, while others have effectively removed themselves from the market.

- The current process of resizing the fund results in using revenue data that is more than 18 months old by the time the fund is resized. In a turbulent sector such as telecommunications, 18 months is excessive and does not allow the Fund to respond rapidly to changes in telephone carriers. A request to shorten the time period for resizing the fund is now pending before the South Carolina Public Service Commission.

**Balances Sheets/Statements of Net Deficit as of December 31,**

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | **$ 2,193,952** | $ 5,185,865 |
| Accounts receivable, less allowance for doubtful accounts in 2006 and 2005 of $280,369 and $446,610, respectively | **3,194,079** | 2,768,855 |
| Due from SCORS | — | 19,106 |
| Total assets | **$ 5,388,031** | $ 7,973,826 |
| **Liabilities and Fund Deficit/Net Deficit** | | |
| Distributions payable | **$ 5,637,463** | $ 8,561,711 |
| Accounts payable | **3,742** | — |
| Overpayments/credits payable | **582,178** | — |
| Due to SCORS | **2,738** | — |
| Other liabilities | — | 7,970 |
| Total liabilities | **6,226,121** | 8,569,681 |
| **Fund Deficit/Net Deficit** | | |
| Unreserved fund deficit/net deficit | **(838,090)** | (595,855) |
| Total fund deficit/net deficit | **(838,090)** | (595,855) |
| Total liabilities and fund deficit/net deficit | **$ 5,388,031** | $ 7,973,826 |

**Statements of Revenues, Expenditures and Changes in Fund Deficit/Statements of Activities for the years ended December 31,**

| | 2006 | 2005 |
|---|---|---|
| **Revenues** | | |
| Contributions | **$ 53,306,102** | $ 53,008,785 |
| Late payment assessments | **1,583** | — |
| Total revenues | **53,307,685** | 53,008,785 |
| **Expenditures/Expenses** | | |
| Telecommunication service providers | **53,270,584** | 52,828,165 |
| General and administrative expenditures/expenses | **222,990** | 124,865 |
| Bad debt expenditures/expenses (recoveries) | **56,346** | (210,806) |
| Total expenditures/expenses | **53,549,920** | 52,742,224 |
| (Deficiency) excess of revenues (under) over expenditures/Changes in net deficit | **(242,235)** | 266,561 |
| Fund deficit/net deficit, at beginning of year | **(595,855)** | (862,416) |
| Fund deficit/net deficit, at end of year | **$ (838,090)** | $ (595,855) |

**Request for Information**

The primary purpose of this financial report is to provide a general overview of the fund's finances and to demonstrate the Fund's accountability for the money it receives and spends. Questions concerning any of the information provided in this report or requests for additional information should be addressed to:

South Carolina Office of Regulatory Staff
Attn: Finance Director
1441 Main Street, Suite 300
Columbia, SC 29201

# Financial Statements

South Carolina Universal Service Fund
Balance Sheets/Statements of Net Deficit
as of December 31,

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | **$ 2,193,952** | $ 5,185,865 |
| Accounts receivable, less allowance for doubtful accounts in 2006 and 2005 of $280,369 and $446,610, respectively | **3,194,079** | 2,768,855 |
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| Accounts payable | **3,742** | — |
| Overpayments/credits payable | **582,178** | — |
| Due to SCORS | **2,738** | — |
| Other liabilities | — | 7,970 |
| Total liabilities | **6,226,121** | 8,569,681 |
| **Fund Deficit/Net Deficit** | | |
| Unreserved fund deficit/net deficit | **(838,090)** | (595,855) |
| Total fund deficit/net deficit | **(838,090)** | (595,855) |
| Total liabilities and fund deficit/net deficit | **$ 5,388,031** | $ 7,973,826 |

*The accompanying notes are an integral part of these financial statements.*

South Carolina Universal Service Fund
Statements of Revenues, Expenditures and Changes in Fund Deficit/
Statements of Activities
for the years ended December 31,

| | **2006** | 2005 |
|---|---|---|
| **Revenues** | | |
| Contributions | **$ 53,306,102** | $ 53,008,785 |
| Late payment assessments | **1,583** | — |
| Total revenues | **53,307,685** | 53,008,785 |
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| Fund deficit/net deficit, at end of year | **$ (838,090)** | $ (595,855) |

*The accompanying notes are an integral part of these financial statements.*

**Note 1. Summary of Significant Accounting Policies**

**General and Basis of Accounting** – On October 10, 2001, the South Carolina Public Service Commission (the "SCPSC") issued Order No. 2001-996 at Docket No. 97-239-C which approved the final guidelines for the establishment of the Fund. The Fund was established to provide both universally available basic local exchange telephone service at affordable rates and to assist with the alignment of prices and/or cost recovery.

The Fund is funded by an assessment on all telecommunications service providers, with the exception of wireless providers, that provide intrastate and interstate telecommunications services in the State of South Carolina (the "State") and is paid, via a monthly remittance advice, to the SCORS. Support disbursements from the Fund are made monthly to eligible telecommunication service providers.

The Fund's financial statements have been prepared in conformity with generally accepted accounting principles for governments as prescribed by the Governmental Accounting Standards Board ("GASB"), for the period presented. The Fund's financial statement presentation follows the guidelines of GASB No. 34. GASB No. 34, as amended, establishes standards for financial reporting for state and local governments. The Fund is a special revenue fund of the State of South Carolina. These statements present the financial position and results of operations of only the activity of the Fund, and are not intended to present the financial activity for the State of South Carolina.

The Fund is accounted for using the current financial resources measurement focus. With this measurement focus, only current assets and current liabilities are included on the Balance Sheets. The operating statement presents revenues and expenditures that result in changes in net available financial resources.

The Fund is accounted for on the modified accrual basis of accounting, which recognizes revenues when they become measurable and available to pay current reporting period liabilities. Revenues are considered to be available if received within one year after the fiscal year-end. Expenditures and related liabilities are recognized when obligations are incurred.

For the purposes of the Fund, there are no reconciling items between the fund financial statements and the presentation on an entity-wide basis. Accordingly, the financial statements have been presented in a combined format as permitted under GASB No. 34.

**Cash and Cash Equivalents** – Cash and cash equivalents represent cash on deposit and invested in various instruments by the State Treasurer as part of the South Carolina Local Government Investment Pool (the "Pool"). Because the Pool operates as a demand deposit account, amounts invested in the Pool are classified as cash and cash equivalents.

**Accounts Receivable** – Receivables are payments due under normal terms requiring payment by the 30th of the month. Any accounts not paid by the 30th of the month are assessed a late payment charge of .0493% per day. Late payment charges are recorded as late payment assessments. Late payments assessed for the year ended December 31, 2006 were $1,583.

**Note 1. Summary of Significant Accounting Policies (continued)**

**Allowance for Doubtful Accounts** – An allowance for doubtful accounts is recorded and reduces the carrying value of accounts receivable to its net realizable value. The amount of the allowance is based upon management's estimate of currently uncollectible accounts, historical trends, current economic trends, and other factors. Provisions to increase or decrease the allowance are charged to operations. During the year ended December 31, 2006, the Fund decreased its allowance for doubtful accounts based upon current year recoveries and changes in the management's estimate of the ultimate collectibility of certain accounts receivable balances.

**Accounting Estimates** – The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenditures and affect disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenditures during the reporting period. Accordingly, actual results could differ from those estimates.

**Revenue Recognition** – Telecommunications companies doing business in South Carolina are required to pay to the Fund a fixed monthly amount as determined in accordance with Fund guidelines. It is the Fund's policy to record revenue when the revenue is both measurable and available.

**Reclassifications** – Certain items in the prior period have been reclassified to conform to the current year presentation.

**Note 2. Deposits Held by State Treasurer**

The deposits of the Fund held by the State Treasurer are under the control of the State Treasurer who, by law, has sole authority for investing State funds. State law requires full collateralization of all State Treasurer balances. The State Treasurer must correct any deficiencies in collateral within seven days.

With respect to investments in the State's internal cash management pool, all of the State Treasurer's investments are insured or registered or are investments for which the securities are held by the State or its agent in the State's name. Information pertaining to carrying amounts, fair value, credit and other risks as required by Governmental Accounting Standards Board Statement No. 40 Deposits and Investments – Risk Disclosures, of the State Treasurer's investments are disclosed in the Comprehensive Annual Financial Report of the State of South Carolina.

Deposits at fair value at December 31, 2006 and 2005 held by the State Treasurer are $2,193,952 and $5,185,865, respectively.

**Note 3. Income Taxes**

These financial statements present the activities of the Fund. The activities of the Fund are tax-exempt since the Fund is a special revenue fund of the state of South Carolina; therefore, not subject to federal or state income taxes or sales, use, gross receipts or other taxes. As such, no provisions for such taxes have been reflected in the accompanying financial statements.

**Note 4. Assessments**

Identified carriers that are operating in the State of South Carolina, excluding wireless service providers, provide assessments to the Fund. The SCORS searches publicly available resources to identify carriers operating in the state of South Carolina that are not providing assessments to the Fund. The carriers are assessed based upon the weighted average of their total revenues compared to the total revenues of all telecommunication companies operating in the State. The total assessment for the years then ended December 31, 2006 and 2005 was $53,306,102 and $53,008,785, respectively.

**Note 5. Amounts Paid and Due to Telecommunication Service Providers**

Payments to the qualified recipients are made by South Carolina Treasurer's office as directed by the SCORS. The qualified recipients receive payments in order to neutralize the revenue deficits created by mandated decreases in access charges in addition to high cost support as determined by the SCPSC. For the years ended December 31, 2006 and 2005, the Fund determined that $53,270,584 and $52,828,165, respectively in support payments were due to service providers.

**Note 6. Related Parties**

The Fund is administered by the SCORS as set forth by the State of South Carolina Act 175 of 2004. During the current year, the SCORS incurred general and administration expenditures/expenses totaling $222,990 related to administration of the Fund and Lifeline/Linkup outreach. Related to these expenditures/expenses, the Fund recorded a payable to the SCORS in the amount of $2,738 as of December 31, 2006.

**Note 7. Fund Deficit/Net Deficit**

As of December 31, 2006, the Fund had a deficit of $838,090. The Fund plans to eliminate this deficit through future revenues and collections.

**Note 8. Commitments and Contingencies**

In 2001 and 2002, the Public Service Commission Orders that established and sized the Fund were appealed by two separate parties. Following a decision in favor of the Fund at the Circuit Court level, the cases were then appealed to the South Carolina Supreme Court. The cases were briefed and argued before the Supreme Court in October 2003. On June 25, 2007, the Supreme Court issued an opinion in which they affirmed the decisions of the Commission. The case has ended, and there are no refunds due or changes to the USF related to that case.

Subsequent appeals have also been filed concerning either sizing or requests for additional funds by the Fund. Previously, these cases had been stayed pending the decision from the Supreme Court in the initial cases discussed above. However, the stays will now be lifted and these cases will be placed on the docket of the Circuit Court for hearing.

The Fund has also received notice of claims from telecommunication companies which have filed for bankruptcy protection in various jurisdictions. Judgment against the Fund in these cases could result in an inability to collect assessed revenues of over $60,000.

# Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

SCOTT McELVEEN L.L.P.

# Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

South Carolina Office of Regulatory Staff
Columbia, South Carolina

We have audited the accompanying balance sheets/statements of net deficit of the South Carolina Universal Service Fund (the "Fund") as of and for the years ended December 31, 2006 and 2005, and the related statements of revenues, expenses and changes in fund balance/statements of activities, which collectively comprise the Fund's basic financial statements and have issued our report thereon dated January 25, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Fund's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepting accounting principles such that there is more than a remote likelihood that a misstatement of the Fund's financial statements that is more than inconsequential will not be prevented or detected by the Fund's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Fund's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the South Carolina Office of Regulatory Staff, the South Carolina Public Service Commission and other agencies of the State of South Carolina, and is not intended to be, and should not be used by anyone other than these specified parties.

Scott McElveen, L.L.P.

Columbia, South Carolina
January 25, 2008

## Status of Prior Material Weaknesses and/or Violations of State Laws, Rules, or Regulations

During the current year, we reviewed the status of corrective action taken on the findings reported as material weaknesses for the period from inception (October 10, 2001) to December 31, 2004 and for the year ended December 31, 2005. We determined that the Fund has taken adequate corrective action on each of the findings.