



WithumSmith+Brown
A Professional Corporation
Certified Public Accountants and Consultants

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and Pennsylvania

To the Pennsylvania Public Utility Commission and the Board of Directors of the National Exchange Carrier Association, Inc.:

In planning and performing our audit of the financial statements of the Pennsylvania Universal Service Fund (PUSF), a special revenue unit of the State of Pennsylvania administered by the National Exchange Carrier Association, Inc. (NECA) for the period August 1, 2001 through December 31, 2002, we considered the Company's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control.

Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

However, during our audit we became aware of one matter that is an opportunity for strengthening internal controls and operating efficiency. The matter, discussed below, summarizes our comments and suggestions. This letter does not affect our report dated May 16, 2003, on the financial statements of Pennsylvania Universal Service Fund.

Observations concerning internal control over financial reporting:

We noted an instance of noncompliance concerning the internal control structure at NECA (the fiscal agent). NECA disbursement procedure control techniques indicate "NECA PUSF staff will constantly monitor fund levels to ensure they do not bill before the level necessary to pay all amounts due. Any shortfall in disbursements will be paid back as soon as funds are once again available. If a shortfall is anticipated to continue for more than two months, NECA will calculate and propose a new assessment rate for adoption by the Commission."

In early September 2001, NECA discovered that the cash balance in the fund was insufficient to meet the required September 2001 carrier support payments. Prior to September 2001, NECA had not identified that, the then current assessment rate, would result in a cash flow shortfall. This situation was communicated to the Commission in early September and resulted in the following events:

- 1) Partial payment of carrier support for September 2001
- 2) A requirement for the USF to borrow the cash to cover the shortfall
- 3) Requirement for an increase in the assessment rate in October 2001 in excess of 20%.

The NECA control technique indicated above was insufficient to meet its objective. NECA has taken the following actions:

1. It has more clearly defined its cash monitoring procedures as follows:
 - a. The manager – treasury operations updates the “Cash Forecast” on a quarterly basis. The manager of treasury operations is responsible for updating interest income projections and entering actual fund results.
 - b. The manager – State USF reviews the “Cash Forecast” on a quarterly basis and provides update projections for settlement receipts, USF support and administrative expenses.
 - c. The manager – treasury operations reviews the “Cash Forecast” on a monthly basis and reports any unusual deviations to the manager – State USF for further review.
 - d. The associate manager – cash management reports the fund’s cash balance on a weekly basis.
 - e. The manager – State USF reviews the fund’s cash balance on a weekly basis.
 - f. If the review of the cash forecast and current fund cash balance indicates the potential inability to make full payment for the remainder of the year, the manager – State USF immediately notifies the PPUC of the pending shortfall. The manager – State USF is responsible for identifying and disclosing the underlying cause of the shortage. A revised assessment calculation and cash projection is provided to the PPUC for approval.
2. In connection with the above – NECA has established a monthly Cash Forecasting – methodology which forecasts cash flow and cash requirements for 36 months. This Cash Forecast is updated as actual monthly results are available.
3. NECA has established additional review functions in connection with the above Cash Forecasting methodology including a mechanism for reporting material fluctuations directly to the Commission.

The above modifications to NECA's Internal Control appear to have appropriately addressed the issue of noncompliance. We will review the status of these comments during our next audit engagement.

The accompanying comments are intended solely for the information and use of the audit committee, management, and others within the organization and should not be used by anyone other than these specified parties.

A handwritten signature in blue ink, appearing to read "Walter Smith & Ben O'K". The signature is written in a cursive style.

May 16, 2003

**PENNSYLVANIA UNIVERSAL
SERVICE FUND**

FINANCIAL STATEMENTS

DECEMBER 31, 2002

**PENNSYLVANIA UNIVERSAL SERVICE FUND
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DECEMBER 31, 2002**

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INDEPENDENT AUDITORS' REPORT

To the Pennsylvania Public Utility Commission and the Board of Directors of the National Exchange Carrier Association, Inc.:

We have audited the accompanying balance sheet as of December 31, 2002, of the Pennsylvania Universal Service Fund (PUSF), a special revenue unit of the Commonwealth of Pennsylvania administered by the National Exchange Carrier Association, Inc. (NECA), and the related statements of revenues, expenses and changes in fund net assets and cash flows for the period August 1, 2001 through December 31, 2002. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the PUSF administered by NECA as of December 31, 2002, and the changes in fund net assets and cash flows for the period then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 16, 2003 on our consideration of NECA as administrator for the PUSF's internal control structure over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

May 16, 2003

PENNSYLVANIA UNIVERSAL SERVICE FUND

MANAGEMENTS DISCUSSION AND ANALYSIS

PERIOD ENDING DECEMBER 31, 2002

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

FINANCIAL HIGHLIGHTS

- The PUSF unrestricted fund net assets as of December 31, 2002 were \$1.6 million
- The PUSF unrestricted fund net assets increased by approximately \$1.3 million during the period August 1, 2001 through December 31, 2002, which can be attributed to a necessary increase in the contingency allowance that was utilized in calculating the 2002 PUSF assessment contribution factor

OVERVIEW OF THE FINANCIAL STATEMENTS

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.

As of December 31, 2002, the PUSF had a net receivable of \$160 thousand comprised of accounts receivables - assessments of \$211 thousand, accounts payable - assessments of \$17 thousand and accounts payable and accrued expenses of \$34 thousand.

During the third quarter of 2001 the PUSF experienced a cash flow shortfall. An increased interim assessment rate was instituted to immediately address this issue. This revised assessment factor allowed the PUSF to subsequently satisfy all 2001 obligations.

The cash flow shortfall was positively addressed for future periods by increasing the fund's contingency allowance from 1% to 5% of the projected annual support requirement. As a result, the PUSF maintained an adequate cash flow and balance of funds to satisfy all obligations during 2002.



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**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL
REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

National Exchange Carrier Association, Inc.
as administrator for the Pennsylvania Universal Service Fund:

We have audited the financial statements of the Pennsylvania Universal Service Fund as of December 31, 2002, and have issued our report thereon dated May 16, 2003. 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.

Compliance

As part of obtaining reasonable assurance whether the Pennsylvania Universal Service Fund's financial statements are free of material misstatement, we performed tests of compliance of the National Exchange Carrier Association, Inc. (NECA) as administrator for the Pennsylvania Universal Service Fund (PUSF) with certain provisions of laws, regulations and contracts, 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 that are required to be reported under *Government Auditing Standards*. However, we noted an immaterial instance of noncompliance, which we have reported to management of the PUSF in a separate letter dated May 16, 2003.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered NECA's internal control, in its role as administrator for the PUSF over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted an immaterial instance of noncompliance, which we have reported to management of the PUSF in a separate letter dated May 16, 2003.

This report is intended solely for the information and use of the Administrator, Contract Administrator, the Pennsylvania Public Utility Commission and State Auditor's Office of the State of Pennsylvania and is not intended to be and should not be used by anyone other than these specified parties.

May 16, 2003

**PENNSYLVANIA UNIVERSAL SERVICE FUND
BALANCE SHEET
DECEMBER 31, 2002
(IN THOUSANDS)**

ASSETS	
Current Assets:	
Cash and cash equivalents	\$ 1,395
Accounts receivable - assessments	<u>211</u>
TOTAL ASSETS	<u>\$ 1,606</u>
LIABILITIES AND FUND NET ASSETS	
Current Liabilities:	
Accounts payable - assessments	\$ 17
Payable to service providers	--
Accounts payable and accrued expenses	<u>34</u>
Total Current Liabilities	51
Fund Net Assets – Unrestricted	<u>1,555</u>
TOTAL LIABILITIES AND FUND NET ASSETS	<u>\$ 1,606</u>

The Notes to Financial Statements are an integral part of this statement.

**PENNSYLVANIA UNIVERSAL SERVICE FUND
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS
FOR THE PERIOD AUGUST 1, 2001 THROUGH DECEMBER 31, 2002
(IN THOUSANDS)**

Operating Revenue:		
Assessments	\$	48,054
Operating Expenses:		
Amounts paid and due to service providers		46,547
Administrative costs		<u>248</u>
Total Operating Expenses		<u>46,795</u>
Operating Income		1,259
Non-Operating Income:		
Interest income		<u>52</u>
Net Increase in Unrestricted Fund Net Assets		1,311
Fund Net Assets – Unrestricted, Beginning of Period		<u>244</u>
Fund Net Assets – Unrestricted, End of Period	\$	<u>1,555</u>

The Notes to Financial Statements are an integral part of this statement.

**PENNSYLVANIA UNIVERSAL SERVICE FUND
STATEMENT OF CASH FLOWS
FOR THE PERIOD AUGUST 1, 2001 THROUGH DECEMBER 31, 2002
(IN THOUSANDS)**

Cash Flows from Operating Activities:	
Receipts from assessments and service providers	\$ 48,003
Cash paid to service providers	(49,037)
Cash paid for administrative costs	<u>(212)</u>
Net Cash Used for Operating Activities	(1,246)
Cash Flows from Investing Activities	
Interest income	57
Cash Flows from Financing Activities	
Proceeds from short-term borrowings	262
Repayment of short-term borrowings	<u>(262)</u>
Net Cash Used for Financing Activities	--
Net Decrease in Cash and Cash Equivalents	(1,189)
Cash and Cash Equivalents, Beginning of Period	<u>2,584</u>
Cash and Cash Equivalents, End of Period	<u>\$ 1,395</u>
Reconciliation of Net Cash Provided by Operating Activities:	
Operating income	\$ 1,259
Changes in assets and liabilities:	
Decrease in accounts receivable - assessments	17
Decrease in prepaid expenses	2
Decrease in deferred revenue	(68)
Increase in accounts payable and accrued expenses	34
Decrease in payable to service providers	(2,463)
Decrease in accounts payable - assessments	<u>(27)</u>
Net Cash Used for Operating Activities	<u>\$ (1,246)</u>

The Notes to Financial Statements are an integral part of this statement.

**PENNSYLVANIA UNIVERSAL SERVICE FUND
NOTES TO FINANCIAL STATEMENTS
(IN THOUSANDS)**

Note 1 - General:

On September 30, 1999 the Pennsylvania Public Utility Commission (PPUC) issued an Order at Docket Nos. P-00991648 and P-00991649 (Global Order), as amended by the Order entered November 5, 1999, and as amended by the Proposed Order in Rulemaking Re: Establishing Universal Service Fund Regulations at 52 Pa.Code §§63.141-63.151, Docket No. L-00000148, (1/27/00), to create the Pennsylvania Universal Service Fund (PUSF). The PUSF was established to both reduce and restructure access charges and further the opportunity for development of local competition. The PUSF is a means to reduce access and toll rates for the ultimate benefit of the end-user and to encourage greater toll competition, while enabling carriers to continue to preserve the affordability of local service rates.

The PUSF is funded by an assessment on all Pennsylvania telecommunications service providers that provide intrastate telecommunications services (excluding wireless carriers) and is paid, via a monthly remittance advice, to the National Exchange Carrier Association, Inc. (NECA), which in February 2000, was selected by the PPUC to act as Administrator of the Fund. Carriers contribute a fixed monthly assessment amount based on company-specific revenues. Eligible recipients receive fixed monthly support payments from the PUSF as approved by the PPUC.

Note 2 - Summary of Significant Accounting Policies:

A. Basis of Presentation

These statements have been prepared on the accrual basis in accordance with the Governmental Accounting Standards Board (GASB), for the period presented. For the period August 1, 2001 through December 31, 2002 the PUSF had accounting transactions in the unrestricted fund net assets only. The PUSF's financial statement presentation follows the recommendation of GASB No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments" and amendments. GASB No. 34, as amended, establishes standards for financial reporting for state and local governments.

B. Cash and Cash Equivalents

All highly liquid securities, purchased with a maturity of three months or less, are considered cash equivalents. Surplus funds of the PUSF are invested in two money market funds maintained by Fidelity Investment and Mellon Bank. Interest is credited to the PUSF when earned and the interest rate for the period August 1, 2001 through December 31, 2002 averaged 1.91%.

C. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

D. Revenue Recognition

All Pennsylvania telecommunications service providers can assess their customers at a statutory rate. Telecommunications companies doing business in the Commonwealth of Pennsylvania are required to pay into the PUSF a fixed monthly amount as determined in accordance with PUC regulations. It is the PUSF's policy to record revenues in the period earned.

E. Receivables and Credit Policies

Accounts receivable – assessments are due under normal terms requiring payment by the 15th of the month. Any accounts not paid by the 15th of the month plus a five day grace period are assessed a late payment charge of 18 percent per annum, adjusted to a daily percent. Late payment charges are recorded as assessments.

**PENNSYLVANIA UNIVERSAL SERVICE FUND
NOTES TO FINANCIAL STATEMENTS
(IN THOUSANDS)**

Note 3 - Assessments:

Identified carriers that are operating in the Commonwealth of Pennsylvania, excluding wireless service providers, provide assessments to the Fund. NECA searches publicly available resources to identify carriers operating in the Commonwealth of Pennsylvania that are not providing assessments to the Fund. In addition, the PPUC notifies NECA when new carriers are certified to offer service in the Commonwealth of Pennsylvania. The carriers are assessed at a flat rate based on the intrastate revenue of two years prior. The assessment rates for August 2001 through September 2001, October 2001 through December 2001 and January 2002 through December 2002, were .75 percent, .92 percent and .90 percent, respectively. The assessment rate changed as of October 1, 2001 when the Fund had reached a shortfall of cash and was unable to make payments to eligible service providers. The gross assessments for the period August 1, 2001 through December 31, 2002 were approximately \$48,054.

Note 4 - Amounts Paid and Due to Service Providers:

Universal Service Support Payments to the qualified recipients are made by NECA as directed by the PPUC. The qualified recipients receive payments in order to neutralize the revenue deficits created by mandated decreases in toll and access charges. For the period August 1, 2001 through December 31, 2002 the PUSF determined that approximately \$46,547 in support payments were due to service providers.

Note 5 - Administrative Costs:

As stated in the Contract, NECA is reimbursed a fixed amount each fiscal year plus any allowable variable costs, as defined. Such variable costs include customary, reasonable and necessary expenses incurred by NECA in performance of services, including payments to an independent accountant for an annual audit, extraordinary legal work provided by external counsel, taxes, application fees, licensing fees, and similar expenses.

The administrative fee from August 1, 2001 through December 31, 2002 was approximately \$215 payable in five monthly installments of approximately \$12 and twelve monthly installments of approximately \$13. NECA is under contract as the administrator of the PUSF through December 31, 2003.

For the period August 1, 2001 through December 31, 2002, the administrative costs were approximately as follows:

NECA administrative fees	\$ 215
External audit fees	<u>33</u>
Total Administrative Costs	<u>\$ 248</u>

Note 6 - Short-Term Borrowings:

During the period August 1, 2001 through December 31, 2002 the PUSF established a line of credit with NECA Services, Inc. The line of credit was established with a maximum borrowing limit of \$1,000. The funds were payable only to service providers if and when the PUSF cash flows were insufficient to meet the required fund disbursements for the year ended December 31, 2001 as stated in the line of credit agreement. The PUSF received proceeds and made repayments of approximately \$262 during the period August 1, 2001 through December 31, 2002. The outstanding balance incurred interest at the prime rate plus 1%. Interest paid during the period August 1, 2001 through December 31, 2002 was \$-0- due to an agreement with NECA, the fund administrator, in which NECA agreed to absorb the interest. The line of credit expired on January 16, 2002.

Note 7 - Income Taxes:

These financial statements present the activities of the PUSF. The activities of the PUSF are tax-exempt since the PUSF is a special revenue unit of the Commonwealth of Pennsylvania, and therefore not subject to federal or state income taxes or sales, use, gross receipts or other taxes. As such, no provision for such taxes has been reflected in the accompanying financial statements.

**PENNSYLVANIA UNIVERSAL SERVICE FUND
NOTES TO FINANCIAL STATEMENTS
(IN THOUSANDS)**

Note 8 - Concentration of Credit Risk:

The Fund maintains its cash balances at a financial institution, which may at times exceed amounts insured by the Federal Deposit Insurance Corporation. Since this is a high quality financial institution, management does not believe the Fund is exposed to any significant credit risk on its cash balances.