



OFFICE OF INSPECTOR GENERAL

MEMORANDUM

DATE: September 27, 2012

TO: Chairman Julius Genachowski
Commissioner Robert McDowell
Commissioner Mignon Clyburn
Commissioner Jessica Rosenworcel
Commissioner Ajit Pai

CC: General Counsel Sean Lev
Kris Monteith, Acting Bureau Chief, CGB

FROM: David Hunt, Inspector General 

SUBJECT: Report on the Audit of the Use of Funds Disbursed to and Received by Telecommunications Relay Service Providers

The Office of Inspector General is providing the audit report for Sorenson Communications, Inc.'s (Sorenson) use of Telecommunications Relay Service (TRS) funds. This audit report is one in a series of reports to determine if TRS funds were used in accordance with TRS program requirements.

We engaged Clifton Larson Allen LLP to conduct the audit. The scope of the audit was limited to the use of TRS funds received by TRS providers in calendar year 2011. The audit objectives were to:

1. Determine if federal funds disbursed to and received by TRS providers were applied in accordance with TRS program requirements and supported by adequate documentation.
2. Follow-up on the audit findings of prior year audits of Relay Service Data Requests (TRS provider annual cost data submissions).

The audit concluded that:

1. TRS funds received by Sorenson for VRS did not compensate for only the reasonable costs of providing access to VRS.
2. Sorenson's costs that were, and were not included in the RSDR for the year ending December 31, 2011 were supported by adequate documentation.

3. Sorenson has instituted measures to address the prior year's FCC-OIG audit findings, but has not yet fully implemented all the corrective measures because they did not receive the audit report from the FCC-OIG until late in 2011.

Sorenson's management did not concur with the Auditor's findings and recommendations and stated that the draft audit report was flawed and misleading. The Auditors considered Sorenson's management comments in preparing the final audit report.

Clifton Larson Allen LLP is wholly responsible for the audit, the attached report and the conclusions expressed therein.

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If you have any questions, please contact William Garay at (202) 418-7899.

Attachment

**PERFORMANCE AUDIT REPORT
OF
SORENSEN COMMUNICATIONS, INC.'S
VIDEO RELAY SERVICE
OF THE
TELECOMMUNICATIONS RELAY SERVICE FUND**

**Conducted for the
Federal Communications Commission
Office of Inspector General**

For The Year Ending December 31, 2011



CliftonLarsonAllen

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PERFORMANCE AUDIT REPORT

EXECUTIVE SUMMARY

CliftonLarsonAllen LLP (formerly Clifton Gunderson LLP) was engaged by the Federal Communications Commission (FCC or the Commission) Office of Inspector General (OIG) to conduct a performance audit of the application of funds received from the Telecommunications Relay Service (TRS) Fund (the Fund) by Sorenson Communications, Inc. (SCI or Sorenson), a service provider of Video Relay Service (VRS). VRS is a form of TRS provided to persons with hearing and speech disabilities in the United States.

The TRS Fund is financed by interstate telecommunications providers on the basis of their interstate end-user telecommunication revenues. TRS providers are compensated by the TRS Fund at a rate determined by the FCC. Commission rules provide that rates for the provision of TRS should reflect the "reasonable costs of providing interstate" VRS service, including a reasonable rate of return for capital investment, see 47 C.F.R. §§ 64.604(c)(5)(iii) (C), (E). In recent rate orders, the FCC has found "a 'substantial disparity' between the providers' actual cost of providing VRS and the projected costs which had been used to calculate compensation rates." *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, 25 FCC Rcd. 8689 at 8694 (2010). The Commission also determined that there exists "substantial evidence that [VRS] providers are receiving far more in compensation than it costs them to provide service." *Id.* ¶12 at 8695.

The objectives of this performance audit were:

1. To determine if VRS-related federal funds disbursed to, and received by, SCI in calendar year (CY) 2011, were applied in accordance with TRS program requirements and supported by adequate documentation. The specific TRS program requirements we audited relate to FCC rules and orders, and other policies that require that:
 - a. TRS payments be designed to compensate TRS providers for only the reasonable costs of providing access to VRS. The Commission defines "reasonable costs" to be those direct and indirect costs necessary to provide the service consistent with TRS mandatory minimum standards.
 - b. Costs on the Relay Services Data Request (RSDR) data collection report, submitted to the TRS Fund Administrator are supported by adequate documentation. Other costs not reported on the RSDR but deemed by the service provider to be incurred in providing VRS services were also supported by adequate documentation.
2. To follow up on the audit findings of the recent FCC OIG audit of SCI's costs on the RSDR Schedule I forms submitted to the TRS Fund Administrator.

Our audit concluded that:

1. TRS funds received by SCI for VRS did not compensate for only the reasonable costs of providing access to VRS.

2. SCI costs that were and were not included in the RSDR for the year ending December 31, 2011 were supported by adequate documentation.
3. SCI has instituted measures to address the prior year FCC audit findings, but has not yet fully implemented all the corrective measures because it did not receive the audit report from FCC until late in 2011.

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 the audit objectives. Because of inherent limitations, a study and evaluation made for the limited purposes of our review would not necessarily disclose all weaknesses related to the application of VRS program funds received by SCI.

BACKGROUND

Section 225 of the *Communications Act*, 47 U.S.C. Section 225, requires the FCC to ensure that interstate and intrastate TRS is available, to the extent possible and in the most efficient manner, to persons with hearing and speech disabilities in the United States.

VRS is a form of TRS that allows a person with a hearing or speech disability to communicate with voice telephone users through video equipment. The person with a hearing or speech disability communicates with a communications assistant (CA) using American Sign Language. The CA then conveys that communication to the voice telephone user, thereby serving as an interpreter.

The TRS program is implemented through Title 47, Code of Federal Regulations (C.F.R.), Part 64, Subpart F – *Telecommunications Relay Services and Related Customer Premises Equipment for Persons with Disabilities*. Specifically, 47 C.F.R. Section 64.604 addresses Mandatory Minimum Standards (MMS) for TRS providers, including their processes for collecting and reporting minutes of service to the TRS Fund Administrator. The MMS specifies three standards – operational standard, technical standard and functional standard.

Through its rules, the Commission established a shared-funding mechanism that compensates TRS providers for their reasonable costs of providing interstate TRS. The TRS Fund Administrator receives contributions to the TRS fund from providers of interstate telecommunications services and makes disbursements to TRS providers from the fund. Over the last two funding years (FY) approved by FCC, the funding (revenue) requirements specific for VRS program contributed by about 2,800 telecommunication providers were \$523 million and \$563 million for FY 2010-2011 and FY 2011-2012, respectively. The FY is from July to June.

TRS providers receive compensation for providing interstate TRS based on FCC established formulas that are designed to ensure that TRS is provided "in the most efficient manner, which ... necessitates adopting reasonable compensation rates that do not over compensate entities that provide TRS." *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, 25 FCC Rcd. 8689 at 8698 (2010).

The Commission has defined "reasonable costs" to mean "those direct and indirect costs necessary to provide the service consistent with all applicable regulations governing the provision of the service, i.e., the TRS mandatory minimum standards." *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities, Report and Order, Order on Reconsideration, and Further Notice of Proposed Rulemaking*, 19 FCC Rcd 12475, 12543-544 at para. 181.

By Commission rule, TRS providers seeking compensation from the TRS fund must provide the Fund Administrator with true and adequate data, and other historical, projected and state related information reasonably requested to determine the TRS Fund revenue requirements and payments. 47 C.F.R. § 64.604(c)(5)(iii)(C). In a series of prior FCC orders, the FCC designated which categories of costs incurred by VRS providers are allowed and which categories of costs are disallowed from compensation. The cost data collected by the Fund Administrator are reported by TRS providers in the RSDR.

Under 47 C.F.R §§ 64.604,(c)(5)(iii)(D)(6), the FCC OIG has the authority to examine and verify TRS provider data as necessary to assure the accuracy and integrity of TRS Fund payments.

FCC, as the steward of the TRS Fund, has a fiduciary duty to ensure that the TRS Fund operates efficiently and to guard against waste, fraud, and abuse.

AUDIT OBJECTIVES

The objectives of this performance audit were:

1. To determine if VRS-related federal funds disbursed to, and received by, SCI in CY 2011, were applied in accordance with TRS program requirements and supported by adequate documentation. The specific TRS program requirements we audited relate to FCC rules and orders, and other policies that require that:
 - a. TRS payments be designed to compensate TRS providers for only the reasonable costs of providing access to VRS. The Commission defines "reasonable costs" to be those direct and indirect costs necessary to provide the service consistent with TRS mandatory minimum standards.
 - b. Costs on the RSDR, submitted to the TRS Fund Administrator are supported by adequate documentation. Other costs not reported on the RSDR but deemed by the service provider to be incurred in providing VRS services were also supported by adequate documentation.
2. To follow up on the audit findings of the recent FCC OIG audit of SCI's costs on the RSDR Schedule I forms submitted to the TRS Fund Administrator.

SCOPE AND METHODOLOGY

We audited the VRS funds earned (used interchangeably with received) by SCI from January 1, 2011 through December 31, 2011 (CY 2011). Table A below shows the total VRS funds received by SCI, funds received for costs related to VRS that were reported in the RSDR form, and the remaining VRS funds received by SCI.

Table A – Breakout of VRS Funds Received by SCI in CY 2011

VRS Funds	Amount	Percentage
VRS Funds Received (based on FCC approved minutes-of-use rates)	\$ [REDACTED]	100%
Costs reported on the RSDR form	\$ [REDACTED]	[REDACTED]
Excess of VRS Funds Received and Costs Reported on RSDR	\$ [REDACTED]	[REDACTED]

The RSDR form, submitted annually, is designed to ensure that TRS providers comply with the TRS rules requiring providers to “provide the administrator with true and adequate data, and other historical, projected and state rate related information reasonably requested by the administrator, necessary to determine TRS Fund revenue requirements and payments.” 47 C.F.R. § 64.604(c)(5)(iii)(C). The Commission noted in FCC 07-186, paragraph 13, that the data collection form (RSDR) sets forth the categories of costs related to the provision of TRS for which providers may seek compensation, and the United States Court of Appeals for the 10th Circuit acknowledged this also in its opinion denying Sorenson’s challenge to the FCC’s 2010 interim TRS rates. *Sorenson v. FCC*, 659 F.3d 1035, 1040 (10th Cir. 2011).

A high level summary of our audit methodology is set forth in Appendix A.

AUDIT RESULTS

Our audit concluded that:

1. TRS funds received by SCI for VRS did not compensate for only the reasonable costs of providing access to VRS .
2. SCI costs that were and were not included in the RSDR for the year ending December 31, 2011 were supported by adequate documentation.
3. SCI has instituted measures to address the prior year audit findings but has not fully implemented all the corrective measures, having received the RSDR audit report from FCC late in 2011.

Conclusion 1: TRS Funds Received by SCI Did Not Compensate for Only the Reasonable Costs of Providing Access to VRS

VRS payments are based on FCC approved minutes-of-use rates. FCC established these minutes-of-use rates based on a variety of, largely unaudited, information including the consideration of costs identified by service providers. Accordingly, FCC rules require service providers to submit annual cost data to assist the FCC in the rate setting process. The RSDR

requests category cost data that FCC determines to be reasonable, and therefore allowable or "compensable" costs. The RSDR instructions include descriptions of allowable costs and unallowable costs as explained in the FCC rules and orders. FCC rules and orders also consider an 11.25 percent rate of return on capital investments as "reasonable" compensation.

Our audit found that TRS payments for VRS received by SCI did not compensate for only the reasonable costs of providing access to VRS. The VRS payments to SCI exceeded the actual costs it reported on the RSDR by [REDACTED] or [REDACTED]. A substantial cost not reported in the RSDR was SCI's interest expense or debt service costs of [REDACTED]. The discussion below provides additional information relative to SCI's financial operations

SCI's total revenue in CY 2011 was earned from the following services:

- TRS-VRS, that is, VRS service compensable from the TRS Fund.
- TRS-IP Relay, that is, IP-Relay service compensable from the TRS Fund.
- TRS-IPCTS (Caption Telephone Service)] compensable from the TRS Fund.
- VRI (video remote interpreting), which is not reimbursed through the TRS Fund.
- VRS services for Canadian users through SCI's Canadian subsidiary. This service is not compensable from the TRS Fund. It has been discontinued in 2012.

Based on the CY 2011 trial balance (unaudited) provided to us by SCI, VRS-related revenue of [REDACTED] (rounded to [REDACTED]) represents approximately [REDACTED] percent of SCI's total revenue for the CY 2011.

Based on information provided by the TRS Fund Administrator, total cash payments to all VRS providers for CY 2011 is approximately \$531 million. Also, total cash payments to all TRS providers for CY 2011 is approximately \$681 million. The VRS revenue received by SCI is approximately [REDACTED] percent of the total VRS cash payments and [REDACTED] percent of total TRS cash payments from the TRS Fund in CY 2011.

As explained in FCC rules and orders, FCC collects in the RSDR form only the categories of costs that are deemed allowable as compensable costs for providing VRS. FCC has also designated costs that are allowed and disallowed from VRS compensation. Correspondingly, Table A above shows approximately [REDACTED] or [REDACTED], of the funds received by SCI are either (1) not deemed to be compensable as reasonable costs of providing VRS or (2) are costs the reasonableness of which has not been examined by the Commission.

In SCI's written response to our questionnaire asking how the [REDACTED] revenue above was applied, SCI provided an approximate accounting of the costs incurred. SCI's response is presented in italicized font below. Throughout this report, italicized fonts represent excerpts of SCI's written responses to our questionnaire. Non-italicized font, presented parenthetically, represents CLA's comments.

- *Interest expenses of [REDACTED] on the long-term debt of [REDACTED].* (See our discussion on the long-term debt below).
- *Amortized costs of approximately [REDACTED] for intangible assets, including especially video phones.*
- *Engineering costs of [REDACTED] for the development of new VRS equipment.*

- Equipment costs of roughly [REDACTED] related to the installation of customer-premised equipment, aside from the cost of the videophone itself, including costs such as TVs, cables, routers, repair components, and so on.
- Unreportable depreciation of [REDACTED] on intangible assets, such as customer relations and non-compete agreements.
- Costs of approximately [REDACTED] to procure ten-digit numbers for customers as required by FCC regulators.
- Income taxes of approximately [REDACTED].
- Management fees of [REDACTED] paid to SCI's parent companies [REDACTED] (see our discussion below on related parties)
- Net income attributable to VRS, from a total net income of [REDACTED].
- The remaining balance relates to all other costs not reportable on the RSDR forms but related to VRS, as well as costs of other lines of business.

Our review of the trial balance (unaudited) showed interest expense as of December 31, 2011 was [REDACTED]. The [REDACTED] described by SCI above represents interest expense computed on a cash basis. Also, the [REDACTED] is the total of short term debt of [REDACTED] and long-term debt of [REDACTED]. The interest expense of [REDACTED], which was approximately [REDACTED] percent of [REDACTED], is the debt service cost of the [REDACTED] debt (See Debt discussion below). The [REDACTED] is the excess between the SCI VRS funds received and the costs reported on the RSDR as shown in Table A above.

Debt

In our review of the [REDACTED] debt as of December 31, 2011, we asked SCI "What is the composition of the long-term debt currently in the SCI's books and what were the uses of the proceeds of those debt?" SCI's response is shown below:

The balance of the long-term debt as of December 31, 2011 is made up of [REDACTED]
 [REDACTED]
 [REDACTED] The interest on the debt is not reportable for VRS reimbursement purposes, but the loans were used in VRS related operations. The proceeds from the debt were used in the following manner:

- Initial acquisition of the Company by owners
- Pay off and refinance existing loans
- Payment of financing fees
- Operations of Sorenson Communications
- Payment of dividends. To date, Sorenson has paid approximately [REDACTED]

[REDACTED] (See our discussion on Financial Ratios below)

Using the CY 2011 trial balance (unaudited) and prior years audited financial statements, we analyzed SCI's equity in reviewing the response above. Our review showed that SCI has a stockholder's deficit as of December 31, 2011, primarily due to the accumulated dividends paid exceeding the equity contributions and accumulated earnings as shown in Table B below. The

equity contributions (Capital Stock and Additional Paid-in Capital), Retained Earnings and Net Income of SCI as of December 31, 2011 are also shown in Table B.

Table B - Stockholders' Deficit

Description	Balance as of December 31, 2011
Capital Stock	\$ [REDACTED]
Additional Paid-in Capital	[REDACTED]
Retained Earnings as of December 31, 2011	[REDACTED]
Net Income – CY 2011	[REDACTED]
Total Stockholders' Equity Before Dividends Payments	[REDACTED]
Accumulated Dividends Payments (See Table C)	[REDACTED]
Immaterial Difference	[REDACTED]
Stockholders' Deficit per Trial Balance at December 31, 2011	\$ [REDACTED]

Table C – Accumulated Dividends Payments

Dividends Payments	Amount
Balance of Dividends Payments at December 31, 2007	\$ [REDACTED]
Dividends Paid in 2008	[REDACTED]
Dividends Paid in 2009	[REDACTED]
Dividends Paid in 2010	[REDACTED]
Dividends Paid in 2011	[REDACTED]
Accumulated Dividends Payments per Trial Balance as of December 31, 2011	\$ [REDACTED]

We also asked SCI "to describe how the long-debt of [REDACTED] will be paid and the sources of funds for those payments." SCI response is as follows:

SCI may pay for the [REDACTED] [short and] long-term loans through any of the following means:

- *Use of TRS funds*
- *Capital contribution from shareholders*
- *Revenue from Non-TRS sources*
- *Refinancing*

Financial Ratios

We reviewed SCI's CY 2011 trial balance (unaudited) and analyzed key financial ratios to evaluate its overall financial condition. The ratios presented in Tables E and F measure key aspects of SCI's business operations.

Table D - Balance Sheet Ratios

Balance Sheet Accounts	Ratio
Property and Equipment net to Total Assets	█%
Goodwill to Total Assets	█%
Goodwill and Other Intangibles to Total Assets	█%
Debt to Property and Equipment	█%
Debt to Total Assets	█%
Debt to Equity	Note 1
Dividends to Other Stockholder's Equity and Additional Paid-In Capital	█%
Dividends to Retained Earnings	█%

A substantial portion of the property and equipment, net, was comprised of VRS related phones, routers, and capitalized installations costs. The goodwill and other intangibles resulted from business acquisitions and combinations that occurred prior to CY 2011 (see also discussion on Related Party Transactions below). Debt includes the short-term and the long-term portions.

Note 1 - Debt to Equity Ratio is a leverage ratio that measures how much the company is financed by its debtholders compared with its owners. A lower percentage of the debt - equity ratio means that a company is using less leverage and has a stronger equity position. Conversely, a higher ratio means that a company is using more leverage and has a weaker equity position. We could not calculate the debt-equity ratio because SCI has a negative equity or stockholders' deficit of █ as of December 31, 2011. The negative equity was primarily due to dividends payments totaling █, which exceeded the equity contributions and retained earnings as shown in Table B above.

Table E - Income Statement Ratios

Income Statement Accounts	Ratio
VRS Revenue to Total Revenue	█%
RSDR Cost to Total VRS Revenue	█%
RSDR Cost to Total Cost	█%
Non-RSDR Cost to Total Cost	█%
Interest Expenses to Total Cost	█%
Total Compensation to Total Cost	█%

Total Compensation includes total salaries paid including executive pay and bonuses.

Related Party Transactions:

The following information was provided by SCI in their response to our questionnaire:

SCI is a wholly-owned subsidiary of SCI Holdings, Inc. SCI Holdings, Inc is a wholly-owned subsidiary of Sorenson Holdings, Inc. Sorenson Holdings, Inc is a wholly-owned subsidiary of Sorenson Communications Holdings, LLC, which is majority owned by

SCI started as Sorenson Media, Inc. in 2000 and merged with Sorenson Laboratories on May 1, 2005 to become Sorenson Communications, Inc. SCI has 100% ownership in Allied Communications, Inc. which owns Sorenson Communications of Canada (SCC).

During our interviews, we were told that the four affiliates of SCI, namely: SCI Holdings, Inc.; Sorenson Holdings, Inc.; Sorenson Communications Holdings, LLC; and Allied Communications, Inc. do not have operations. Also, SCC is set up as an extension of SCI's operations in Canada. SCI and all of its affiliates are substantially owned by

Below is a list of payments in 2011 to [related] parties reported as related in Sorenson's financial statements:

[REDACTED]	Management Fees	[REDACTED]
[REDACTED]	Other Fees	[REDACTED]
[REDACTED]	Management Fees	[REDACTED]
[REDACTED]	Other Fees	[REDACTED]
[REDACTED]	Other Fees	[REDACTED]
[REDACTED]	SRP IX, LLC (Rent)	[REDACTED]

[REDACTED] are the majority owners of Sorenson Communications, LLC, a parent company of SCI. [REDACTED] provide the following management services to SCI:

- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

[REDACTED]

SRP IX, is owned by a former member of Sorenson's Board. The owner of SRP IX left the Board in 2010 and was not an affiliated party in 2011. SRP IX owns buildings leased by Sorenson.

Conclusion 2: SCI costs that were and were not included in the data collection report (RSDR) for the year ending December 31, 2011 were supported by adequate documentation.

We tested samples of all costs incurred by SCI for CY 2011 – both those included and not included in the RSDR data collection report – to determine if the costs were supported by adequate documentation. We found no exception in the results of our tests.

Conclusion 3: SCI has instituted, but not yet fully implemented, corrective measures to address prior year audit findings.

SCI received FCC OIG's most recent audit report of its RSDR cost data late in 2011 and recently instituted measures to address the report's findings shown in Table F below. Some of the measures include [REDACTED]

[REDACTED] SCI has also created [REDACTED]. However, since the measures are newly implemented, we did not review the implementation or the effectiveness of the implementation. Table F shows a summary of the prior year audit findings.

Table F - Prior Year Audit of RSDR Findings

PY Finding No.	Topic	Years Reported	Finding
Finding 1	[REDACTED]	2008 to 2010	[REDACTED]
Finding 2	[REDACTED]	2008 to 2010	[REDACTED]

We provided a draft of our report to Sorenson and to the Commission. We considered any comments received from the Commission prior to finalizing this report.

CliftonLarsonAllen LLP performed its work between January 10, 2012 and March 31, 2012.

CLIFTONLARSONALLEN LLP

Arlington, Virginia
April 6, 2012

APPENDIX A
High Level Summary of the Audit Methodology

Our audit methodology included the following:

- Assessing audit risk and significance within the context of the audit objectives.
- Obtaining an understanding of internal control that is significant to the administration of the TRS/VRS funds through review of prior year's audit reports and management inquiries.
- Understanding relevant information systems controls as applicable.
- Identifying sources of evidence and the amount and type of evidence required.

To implement our audit methodology, below are some of the audit procedures we performed:

- Inquired from Sorenson management, through the use of a management questionnaire and interviews, about the organization and operations of the TRS/VRS program.
- Reviewed policies, procedures and regulations for the SCI's management and accounting systems as they relate to the administration of TRS/VRS programs.
- Reviewed the operations of SCI in relation to the corporate structure and governance.
- Reviewed the TRS/VRS funds received in 2011 and related supporting documentation.
- Tested randomly selected expense items such as payroll, interest expenses and other expenses and related supporting documentation.
- Reviewed expenses against FCC rules of allowable and unallowable costs.
- Reviewed relevant contracts and agreements.
- Reviewed fixed assets schedule.
- Performed analytical reviews such as financial ratios analyses relevant to the audit objectives.
- Inquired with SCI concerning the status of the findings reported in the latest FCC audit of costs reported in RSDR.

APPENDIX B
Auditor's Comments on Sorenson's Response
to the Draft Performance Audit Report

CliftonLarsonAllen's (CLA) Response

CLA reviewed Sorenson Communications Inc. (SCI) response, attached as Appendix C, to our draft performance audit report. CLA disagreed with SCI's conclusion regarding the faulty findings and stands by the findings and conclusions reached in our report.

Summary of SCI's Response

SCI disagreed with the first conclusion stating that ***"TRS funds received by SCI for VRS did not compensate for only the reasonable costs of providing access to VRS."***

In its disagreement, SCI stated that CLA's report wades into a policy matter – the proper compensation rate for VRS. The SCI response also:

1. Stated that "The stated objectives of the audit were improper and misguided."
2. Questioned the OIG's authority to audit how providers spend TRS funds or for this type of audit to be conducted.
3. Stated that "The Report's Conclusion No. 1 is wrong as a Matter of Law."
4. Stated that "the report repeatedly states and otherwise implies that the categories for which providers are instructed to submit cost data on the RSDR forms are the only costs of providing VRS that are "allowable" and therefore that are "compensable.""

Brief Discussion of CLA's Response

The CLA's report does not recommend or advocate for any policy matter, including the compensation rate for VRS. The report presents the results of the audit that "TRS payments be designed to compensate TRS providers with only reasonable costs of providing access to VRS." As mentioned in our audit report, "the data collection form sets forth the categories of costs related to the provision of TRS for which providers may seek compensation. See *FCC 07-186, paragraph 13, and Sorenson v FCC, 659 F.3d 1035, 1040 (10th Cir. 2011)*. In various FCC rules and orders, "the FCC has sensibly adopted an approach that compensates only the reasonable costs of providing access to VRS, by limiting compensation to certain "allowable costs." See *2010 Order, 25 FCC Rcd. 10 at 8694* ("We are therefore compelled ... to ensure that providers recover only the reasonable costs caused by their provision of VRS."); See *2004 Order, 19 FCC Rcd. 181 at 12543-44* ("[W]e believe 'reasonable costs' must be construed to be those direct and indirect costs necessary to provide the service consistent with all applicable regulations ... i.e., the TRS mandatory minimum standards.").

Also, contrary to SCI's response, the audit report described the VRS compensation methodology as based on FCC approved minutes-of-rates used (Page 5). The report also presented that SCI funds received are based on FCC approved minutes-of-use rates (Table A Page 4). Moreover, the report also provides the FCC OIG's authority to examine and verify TRS provider data as necessary to assure the accuracy and integrity of TRS payments (Page 3).

**Response of Sorenson Communications, Inc. to
2012 Performance Audit Report conducted by CliftonLarsonAllen
for FCC OIG
June 8, 2012**

Sorenson Communications, Inc. is extremely concerned by the draft audit report prepared for the Federal Communications Commission (FCC) Office of Inspector General (OIG) by CliftonLarsonAllen LLP (CliftonLarson). At root, the report wades into a policy matter—the proper compensation rate for video relay service (VRS)—that is well outside the purview of OIG. Indeed, that is the subject of an ongoing FCC rulemaking proceeding in which Sorenson is actively participating.

The draft report is also so flawed and misleading that the OIG and FCC must disregard it entirely. Specifically:

- The audit was not designed to test compliance with any law, rule, or regulation;
- The report belies a misunderstanding of the basics of how VRS providers are compensated;
- The report fails to recognize that the FCC deliberately set the current rate higher than providers' "reportable" costs; and
- The report reveals no new facts.

Sorenson has great respect for the FCC and OIG. However, this audit process seems to have been an attempt to validate preconceived and erroneous assumptions about the VRS compensation system using Sorenson as "Exhibit A." The unfortunate result is that anyone reading this report would think that Sorenson has done something wrong when it has not. The following comments provide context and explain why the report should be disregarded.

I. INTRODUCTION

A. About Sorenson Communications, Inc.

Sorenson Communication, Inc. is a privately held company based in Salt Lake City, Utah. It employs more than 5,400 people in 49 states, D.C., and Puerto Rico, including 4,000 people at its 95 VRS call centers. Sorenson is the nation's leading provider of innovative video communications services for deaf and hard-of-hearing Americans, particularly Video Relay Service. For many deaf Americans, VRS has become an essential lifeline, enabling them to communicate by phone comfortably and easily in their native language, American Sign Language, regardless of whether the person with whom they are communicating is deaf or hearing.

Although Sorenson did not invent VRS, without Sorenson's ingenuity and innovation in both the videophone platform and its premier VRS interpreting services, VRS would not have grown as quickly – or even at all – to become the predominant way in which deaf Americans communicate with the hearing

[REDACTED]

public. In this way, Sorenson has led the way in *delivering* on the Americans with Disabilities Act's promise of functionally equivalent telecommunications for the deaf and hard of hearing.

Sorenson is committed to this mission as well as to being an honest and efficient steward of public funds. Indeed, we do not just serve the deaf community—we are part of it, as the nation's largest private employer of deaf individuals. In our more than seven years of providing VRS, we have consistently been in compliance with the rules and requirements of the TRS (Telecommunications Relay Service) Fund. While other companies have been found guilty of fraud and abuse of the system, Sorenson has operated with integrity.

Sorenson has also worked to drive down the costs associated with VRS and is today the nation's lowest-cost provider of VRS and the nation's least-compensated VRS provider on a per-minute basis.¹ According to the FCC, more than \$24 million could be saved each year if all VRS providers were paid the same rate that Sorenson receives for the bulk of its minutes.

B. The Problems with the CliftonLarson Report

The CliftonLarson audit report is based on faulty assumptions and a misunderstanding of the legal and regulatory basis by which VRS providers are paid for their service. As a result, it would lead people to believe that Sorenson has done something wrong, when it has done nothing of the kind.

- **The audit was not designed to test compliance with any actual law, rule, or regulation** – The audit sought to determine whether VRS funds disbursed to Sorenson were spent appropriately. Yet, there is no FCC rule that regulates how companies spend the money they receive for providing video relay services. To the contrary, the 10th Circuit made clear that the FCC's compensation system "allows providers to spend revenue from the TRS Fund however they choose." According to the court, "The FCC has chosen to reward efficient providers by allowing them to retain the savings generated by providing TRS at a low cost. It does this by compensating providers regardless of their actual costs in providing TRS. This reward mechanism is only effective if providers are permitted to decide how to spend those savings." In short, the very premise of the audit was misguided.
- **The Report belies a misunderstanding of the basics regarding VRS compensation** – The report seeks to draw a connection between Sorenson's compensation and its costs, but this shows a complete misunderstanding of the way VRS compensation works. The TRS Fund, which covers VRS, pays providers at a pre-determined rate per minute for service provided. It is decidedly not a cost reimbursement system, which would pay each provider according to that provider's costs. Instead, the same tiered rate is paid to all VRS providers. Under this system, it pays to be efficient, because more efficient providers earn a larger margin than less efficient ones.

¹ As explained below, all VRS providers are compensated according to the same tiered rate structure. Each additional tier of minutes is compensated at a lower rate. Because Sorenson provides so many more minutes than other providers, it is the only provider that is compensated for the majority of its minutes at the lowest-paying tier. Because of its success, therefore, Sorenson is effectively compensated at a significantly lower average rate.

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- **The Report fails to recognize that the FCC deliberately set the current rate higher than providers' "reportable" costs** – In the case of VRS, the FCC explicitly set the current rates at a level lower than its previous rates, but higher than the average of costs that CliftonLarson erroneously implies either are or ought to be the sole basis for the rate. Thus, for CliftonLarson to conclude in its report that payments to Sorenson exceeded those costs is irrelevant and self-evident. It is analogous to deliberately pouring two cups of water into a glass, and then having an auditor verify that the amount of water exceeded one cup. More fundamentally, the auditor's conclusion implies either a fundamental misunderstanding of the rate-setting process or an improper attempt to arrogate the Commission's statutory authority to set rates.
 - **The report reveals no new facts** – Moreover, it was hardly necessary to conduct an audit to conclude that Sorenson, like all other providers, receives compensation in excess of the subset of costs on which CliftonLarson erroneously fixates. Every provider has such additional costs, and Sorenson and others have been telling the Commission as much for years. The audit was, in the end, a poorly executed waste of both Sorenson's and the government's resources.

It is well known by the Commission that Sorenson is the lowest cost VRS provider. It is similarly irrelevant for the audit to examine Sorenson's financial structure. Most fundamentally, it is entirely inappropriate and completely misleading for CliftonLarson to look at Sorenson's costs of conducting business and its financial structure and conclude, somehow, that its costs or compensation for providing VRS are unreasonable.

II. DETAILED RESPONSE TO THE REPORT

A. The Stated Objectives of the Audit Were Improper and Misguided

The audit report's first stated objective was to determine whether VRS-related funds received by Sorenson "were applied in accordance with TRS program requirements." This objective was misguided from the outset for two reasons.

First, OIG's stated authority is "to examine and verify TRS provider data as necessary to ensure the accuracy and integrity of TRS Fund payments." (Report at 3, citing 47 C.F.R. § 64.604(c)(5)(iii)(D)(6)). As discussed below, nothing in the FCC's TRS rules limits or restricts how funds earned by providing VRS may be used once they are earned. Instead, because providers are compensated at a per-minute rate set by the FCC, the only TRS provider data that could affect the accuracy and integrity of the TRS Fund are the number of minutes of bona fide service provided, and, to the extent the FCC relied on Relay Service Data Request (RSDR) cost reports in setting VRS rates, whether those reported costs were actually incurred.

CliftonLarson did not, in this audit, review Sorenson's reports with respect to the number of conversation minutes served. With respect to both RSDR and non-RSDR costs reported to the Administrator or reflected in the company's books, CliftonLarson concluded that all such data was adequately supported and documented. (Report at 4, 10). The report, however, cites no authority for

[REDACTED]

OIG to audit and examine how a provider has spent or “applied” the revenue it received from the Fund. That information is not reported to the Fund Administrator and there exists no authority for OIG or its outside designees to audit it.

Second, it would make no sense for OIG to have the authority to audit how providers spend TRS funds, or for such an audit to be conducted, because *there are no requirements – none – governing or in any way limiting how providers may spend revenue received from the TRS fund*. To the contrary, in a federal court decision that the report fails to cite, the United States Court of Appeals for the 10th Circuit held that the FCC’s compensation regime “allows providers to spend revenue from the TRS Fund however they choose.” *Sorenson Communications, Inc. v. FCC*, 567 F.3d 1215, 1222 (10th Cir. 2009). The court thus rejected the same argument that the report implies here, namely that “any expenditure apart from the actual cost of providing TRS is inconsistent with the purpose of the Fund.” *Id.* Rather, the court explained that,

The FCC has chosen to reward efficient providers by allowing them to retain the savings generated by providing TRS at a low cost. It does this by compensating providers regardless of their actual costs in providing TRS. This reward mechanism is only effective if providers are permitted to decide how to spend those savings.

Id. As with the rates considered by the 10th Circuit and consistent with its practice across all TRS programs, the FCC sets a fixed per-minute VRS compensation rate, without a reconciliation to company-specific costs incurred. Accordingly, CliftonLarson’s objective of determining whether the funds received by Sorenson “were applied in accordance with TRS program requirements” is nonsensical because there are no requirements on expenditures and nothing limiting compensation to provider-specific costs incurred. VRS compensation is not a “cost plus” contract in which the level of provider-specific costs incurred determines the amount of compensation and profit received. CliftonLarson’s audit objective thus reflects an utter lack of understanding of how the governing compensation regime operates.

Moreover, CliftonLarson’s audit objective reflects a wholly inappropriate exercise in second-guessing the company’s reasoned business judgments – judgments, it should be noted, that have enabled Sorenson to become the country’s most innovative, successful, and efficient provider of VRS. While courts across the country routinely decline to pass judgment on the soundness of private corporate business judgments, CliftonLarson’s auditors have charged ahead undeterred, suggesting in the report’s conclusions that Sorenson’s business decisions – including decisions on how to allocate its revenues among various costs – were faulty.

B. The Report’s Conclusion No. 1 is Wrong as a Matter of Law

Conclusion No. 1 in the report states that “TRS funds received by SCI for VRS did not compensate for only the reasonable costs of providing VRS.” (Report at 4). This conclusion is simply wrong and again reveals a misconception by CliftonLarson about the very basics of how the TRS compensation system operates. The misconception stems from two misstatements of the law contained in the report.

[REDACTED]

First, the report states that “Commission rules provide that rates for the provision of TRS should reflect the ‘reasonable costs of providing interstate’ VRS service.” (Report at 1, citing 47 C.F.R. § 64.604(c)(5)(iii)(C) and (E)). CliftonLarson has failed to quote the actual rule. In reality, the cited regulation states:

Payments to TRS providers. TRS Fund payments shall be distributed to TRS providers based on formulas approved or modified by the Commission. The administrator shall file schedules of payment formulas with the Commission. Such formulas shall be designed to compensate TRS providers for reasonable costs of providing interstate TRS, and shall be subject to Commission approval. Such formulas shall be based on total monthly interstate TRS minutes of use. TRS minutes of use for purposes of interstate cost recovery under the TRS Fund are defined as the minutes of use for completed interstate TRS calls placed through the TRS center beginning after call set-up and concluding after the last message call unit.

47 C.F.R. § 64.604(c)(5)(iii)(E). Thus, what CliftonLarson misstates as a requirement applicable to the FCC’s rate-setting for a particular provider is in fact a provision that describes the formulas to be submitted by the Administrator with respect to TRS providers as a whole. The regulation makes clear that the Commission is free to adopt or modify those formulas as it sees fit. That is precisely what the Commission did in 2010 when it adopted the rates currently in effect.

Second, the report repeatedly states and otherwise implies that the categories for which providers are instructed to submit cost data on the RSDR form are the only costs of providing VRS that are “allowable” and therefore that are “compensable.” The report states, for example, that “[t]he RSDR requests category cost data that FCC determines to be reasonable, and therefore allowable or ‘compensable’ costs.” (Report at 5). Elsewhere the report states that “the FCC designated which category of costs incurred by VRS providers are allowed and which categories of costs are disallowed from compensation.” (Report at 3). That is not at all how the system works.

As an initial matter, these misstatements of the law suggest that each provider is reimbursed directly for its unique costs that are submitted on the RSDR form. Yet the VRS and TRS compensation regimes have never worked that way. Indeed, it is not a cost-reimbursement system at all. Rather, the Commission considers the company-specific costs submitted by all carriers on their individual RSDR forms along with other inputs and considerations, and then sets a per-minute rate structure that provides a compensation rate for each minute of service performed and that applies to all providers in the industry, regardless of any particular carrier’s unique costs. In other words, the Commission considers the costs submitted on the RSDRs (but is not means limited to those costs) in devising the industry-wide per-minute rate structure. Once that rate structure is set, carriers are compensated at those per-minute rates regardless of their actual or reported costs.

The rates currently in effect were established by the Commission in 2010. In the order setting those rates, the Commission employed a two-step methodology that intentionally and explicitly ensured that the rates would be set **above** the costs reported by Sorenson on its RSDR form. CliftonLarson misses

[REDACTED]

this point entirely. In 2010, the Commission first took a weighted average of the RSDR costs reported by all providers. Thus, it necessarily would be the case that the rates would exceed the RSDR reported costs for providers like Sorenson, with costs well below the industry average. As the Commission explained:

To the extent that one provider commands a substantial share of the VRS market, we find that NECA's use of a weighted average is appropriate, and properly balances, on one side, the greater relative costs incurred by smaller providers with, on the other, not penalizing providers operating at lower costs for their greater efficiency.

Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities, Order, 25 F.C.C. Rcd. 8689, 8695 (2010) ("2010 Order").

In turn, the Commission took that industry average and averaged it again with the previous, much higher, rates that had been set in 2007 and were then in effect. Here again, the Commission intentionally and wisely wanted to **avoid** adopting new "rates based on actual costs that would represent a significant and sudden cut to providers' compensation." *Id.* The Commission thus expressly made clear that the **"the rates we adopt herein exceed the VRS providers' average actual costs as reported by them."** *Id.* Accordingly, it is entirely unremarkable that – as CliftonLarson concluded only after an audit that has dragged on for over six months at considerable expense to both Sorenson and the Commission – Sorenson's compensation under the 2010 rates exceeded the costs reported by it on its RSDR forms. Moreover, it most certainly does **not** follow that the funds received by Sorenson "did not compensate only for the reasonable costs of providing VRS." (Report at 5, Conclusion No. 1). Sorenson was compensated at the rates set by the Commission—rates deliberately set to exceed the RSDR reported costs of Sorenson, as the industry's lowest cost provider. *2010 Order* at ¶ 11-12.

In fact, no labor-intensive service-based business could survive on just the RSDR-reportable cost that the auditors used to define "reasonable costs." As Sorenson has presented to the Commission in its comments to the Notice of Proposed Rulemaking, the current definition of RSDR-reportable or "allowable" costs is woefully incomplete – failing to include actual taxes paid, numbering costs, actual financing costs, actual depreciation on intangibles, and actual costs of designing and providing the equipment that makes VRS a usable and useful service for deaf Americans. The definition of "reasonable costs" used by the auditors also allows for no profit on expenses, with the only return being to booked capital investment. This is like saying that the only profit a temp agency could earn would be on its investment in office furniture, that it could not mark-up the hourly wages of its workers, and that it could not charge a rate that covered its anticipated taxes or the loans it took out to purchase the business.

It is not the role of CliftonLarson to opine on whether the rates set by the Commission in 2010 are reasonable or unreasonable simply because, as the Commission fully intended, they exceeded the limited subset of actual costs reported on the RSDR form by the industry's lowest cost provider. Indeed, the Commission judged those rates to strike a "reasonable balance" among the Commission's objectives. *2010 Order* ¶ 12. CliftonLarson's implication that Sorenson's having received compensation

[REDACTED]

that exceeded its RSDR reported costs was somehow the result of improper conduct by Sorenson is inappropriate, unfair, and misleading.

C. Sorenson's Financial Structure Is Irrelevant; The Costs Not Reported on the RSDR are Reasonable

The remainder of the report's discussion of Conclusion No. 1 is entirely unrelated to any Commission regulations or VRS program requirements and should not be included in the report. (Report at 6-10). Here again, there are simply no regulations or other program requirements – certainly CliftonLarson cites none – addressing a provider's costs and expenditures in categories not included on the RSDR forms, a provider's debt and related interest payments, its financial ratios, its payment of dividends to investors, or other related party transactions. (Report at 6-10). It thus makes no sense for CliftonLarson's objective to have been to "audit" or otherwise examine these things for compliance with program requirements. No such requirements exist.

The report purports to find that Sorenson's [REDACTED] non-reportable costs are not "reasonable" costs of providing VRS. (Report at 5-6). The report itself provides a breakdown of those costs, (Report at 6), which actually shows that Sorenson's costs were very much directly and indirectly necessary to its provision of VRS. It includes, for example, the cost of video phones, of engineering new VRS equipment, of installing VRS equipment at customer premises, of complying with Commission orders related to the provision of VRS, and of paying income taxes on VRS revenue. (Report at 6). The interest expense is also directly, or at least indirectly, related to VRS. Sorenson's interest obligation services long term debt, [REDACTED] of which was assumed to purchase the company. Because providing VRS and TRS is virtually the entirety of Sorenson's business, the purchase of the company, and the related financing, was unquestionably necessary in order for the current owners to provide VRS. No VRS provider could survive if it were not compensated for all of these costs, and there exist no Commission rules or regulations deeming them per se unreasonable. To the contrary, there currently is an open and active proceeding before the Commission in which it is considering many of these very same cost categories. (2010 Order at 8697).

To the extent the report implies that Sorenson improperly spent [REDACTED] of VRS revenue on dividends to investors over the past seven years (Report at 7), it is both wrong and misleading. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] The remaining dividends represented reasonable returns to investors who, at significant risk, invested over [REDACTED] in Sorenson since 2005. It is normal with any start-up company like Sorenson that investor risks are the highest in the early years. That risk must be compensated or the company will no longer be able to continue attracting necessary investment. These payments were reasonable, and there are no Commission rules or regulations that suggest otherwise or that place any restrictions on the manner in which a VRS provider might structure its finances.

[REDACTED]

Indeed, the reasonableness of the dividends is further illustrated by the auditor's other conclusions. [REDACTED]

[REDACTED] Although VRS is not operated on a cost-plus basis, if it were the audit report shows that Sorenson would have had [REDACTED] [REDACTED] in documented expenditures relating to VRS in 2011 and the additional [REDACTED] would represent a 15% mark-up, which hardly represents an extraordinary profit. Moreover, as stated above, no other provider can offer VRS at a lower rate than Sorenson – so no company other than Sorenson could have provided the millions of minutes of video relay service to deaf Americans that Sorenson provided in 2011 at a lower cost than Sorenson was paid.

III. CONCLUSION

Sorenson Communications, Inc. leads the VRS industry because it provides innovative technology, the highest quality interpretation services, and the best customer service. And it does this at the lowest cost in the industry.

Rather than burdening Sorenson with irrelevant audits and faulty findings, the FCC should recognize that Sorenson is its partner and is integral to the continued success of the program designed by Congress to ensure access for all deaf Americans to high quality, efficiently-provided communication services.