STATE OF VERMONT

BEFORE THE

PUBLIC SERVICE BOARD

To amend Condition No. 17 of its Certificate of Public Good, enlarging the date by which it must complete Its system building out	**) Docket No. 7044))**
Investigation into City of Burlington d/b/a/ Burlington Telecom's Non-Compliance with Condition No. 60 of its Certificate of Public Good	**)))**

<u>Submitted to</u>

State of Vermont
Public Service Board

<u>Submitted by</u>

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On Behalf of the Department of Public Service

December 10, 2010

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Larkin & Associates, PLLC

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I. Executive Summary

Burlington Telecom ("BT") was issued a Certificate of Public Good ("CPG") on September 13, 2005. Included within the CPG were a number of "General Provisions" (usually referred to as conditions) that in our opinion were designed to protect customers, provide service at a competitive and fair rate and protect the City and other City operations from bearing any of the costs of building out the system and operating the system. Some specific conditions we identified as concerns and/or potential concerns include Condition Nos. 12, 17, 56, 58 and 60. Condition No. 12 states that the system's service would be priced at a reasonable level with respect to the cost of providing that service. Condition No. 17 states that BT shall build its network to serve all of the City of Burlington within 36 months of the CPG issue date. Condition No. 56 states that in no event shall any losses or costs incurred by BT, in the event of the enterprise being abandoned or curtailed, be borne by the City of Burlington taxpayers. Condition No. 58 states that the accounting system shall be capable of tracking costs from financing, construction, operation and maintenance of BT's facilities. Finally, Condition No. 60 states that the City shall only make payments on behalf of BT for Phase III when specific cash and cash equivalents exceed the sum of payments made plus any current payments owed the City. In addition, Condition No. 60 states that BT may participate in the City's Pooled Cash management provided that BT shall reimburse the City within two months of the City's expenditures for expenses incurred or paid in support of providing services to non-City entities.

Larkin & Associates, PLLC ("Larkin") was contracted by the Department of Public Service ("DPS" or "Department") to investigate the non-compliance by BT with Condition No. 60 of its Certificate of Public Good and related matters. This investigation was to include a review of the financial and accounting records and the controls that existed during the period under review. Our investigation consisted of issuing two official sets of discovery, reviewing the City's responses to that discovery, two on-site visits to BT's offices at 200 Church Street, and a review of BT's (i.e. the City's) outside independent auditor's workpapers for the years ended June 30, 2007, June 30, 2008 and June 30, 2009.

The period under review is from the issue date of the CPG, September 2005, through the unaudited information for the fiscal year ended June 30, 2010. Each section of the report will provide an introduction to the area of investigation. That will be followed by a description of various responses from BT applicable to that section of the report. We will then explain what we did and/or provide our opinion on the issue being discussed.

The report begins with our investigation of BT's violation of Condition No. 60. Sections A-K detail areas of investigation including the nature and timing of the violation, the current debt to the City and whether BT is still borrowing funds from the City. Section L addresses our concerns regarding BT's accounting system and its controls. Part III closes the report with our conclusions and recommendations.

The exhibit list consists of 43 exhibits. Exhibits LA-1 through LA-6 were developed by Larkin & Associates PLLC. Exhibits LA-7 through LA-25 are responses and/or documents received during the review period and are referenced in the footnotes. Exhibits LA-26 through

LA-40 are responses and/or documents received during the review period that were discussed within the body of the report and were included because the full response and/or document was not included in the report discussion. Other responses referenced in the body of the report were not attached if the entire response was included in the report discussion. Exhibits LA-41 through LA-43 are “management letters” from the City’s auditors.

Our conclusions fall into three categories: those that relate to Condition No. 60, going concern issues, and our concerns with BT's accounting system. First, we believe that BT has not been in compliance with Condition No. 60 since September 2005. BT failed to meet the requirement to repay borrowed funds within 60 days. Even after instituting a policy to repay loans within 60 days, it has continued to carry a negative balance, failing to repay over $16 million in loans from the City's Pooled Cash fund. We also believe that BT not only withheld the fact that it was not in compliance from the DPS and the Board, but appears to have been aware of the violation earlier than it has claimed.

We also believe that BT has serious “going concern” issues. BT has incurred losses in each fiscal year from 2005 through 2009. BT has accumulated a $16.9 million obligation to the City and is currently having difficulty meeting its $33.5 million obligation to CitiCapital. We are concerned with the possibility that BT could default on its loans and leave the City and its taxpayers responsible for the debt of $16.9 million and possibly a portion of the debt of $33.5 million.

Finally, we have concerns regarding accounting issues. We have discovered significant internal control weaknesses throughout the system. These deficiencies include controls over the coding of costs and authorization of expenditures. The controls that would properly monitor capital and operational costs appear to be insufficient. Also, the fact that the City has had issues with posting interest in a timely manner and identifying principal and interest payments suggests that BT is not in compliance with Condition No. 58. Evidence also suggests that BT may have violated Condition No. 12 in that the discounted prices charged to some City operations do not appear to be reasonable in relation to the costs of providing the services.

It is our recommendation that the Board require BT to conduct a physical inventory of assets and present it to the Board. We also recommend that the Board require BT to provide a plan for bringing BT into compliance with all violated provisions of its CPG. Further, we recommend that BT be required to provide a report that addresses the going concern issues and includes an operating plan detailing how BT expects to become profitable and cash-flow positive, including details regarding any restructuring of the CitiCapital lease financing. Finally, we recommend that the Board consider revoking BT’s CPG if it is not satisfied that BT has a realistic plan to bring itself into compliance with all violated provisions of its CPG and a viable plan for addressing the going concern issues.

II. Areas of Investigation

The DPS provided Larkin with the areas of investigation that are discussed in sections II-A through II-L of this report. There is some degree of overlap between these areas of investigation because the areas identified within the scope were related to some extent. During the course of the investigation, significant concerns regarding BT's and the City's accounting were discovered. Those concerns are described in detail in section II-M of this report.

A. When BT first violated Condition No. 60 of their CPG

Condition No. 60 of its Certificate of Public Good requires BT to repay any loans from the City of Burlington (City) within 60 days. The specific requirements of Condition No. 60 are as follows:

> 60. The City shall make payments on behalf of Phase III only when and to the extent that Phase III has cash reserves, revenues receivable, or other payments receivable that, collectively, equal or exceed the sum of the payments to be made by the City plus the balance of any other current payments owed to the City. BT may participate in the City's pooled cash management system provided, however, that BT shall reimburse the City within two months of the City's expenditure for any expenses incurred or payments made by the City in support of services that BT provides to non-City entities. The City shall obtain Board approval prior to appropriating any funds other than as described above in the support of BT's Phase III activities.

Condition No. 60 specifically refers to the Phase III build-out. Phase III refers to the build-out by BT to make its service available to residential customers in all areas of the City of Burlington.[1] By way of timing, BT's general ledger[2] shows a Pooled Cash fund draw of $1.7 million as of June 30, 2005 and $4.5 million as of June 30, 2006. BT's general ledger for the fiscal year ending June 30, 2006, shows $8.8 million of plant additions. Of this, $8.4 million is identified in BT's general ledger as Phase III, and approximately $300,000 is construction work in progress ("CWIP"), presumably most of which also relates to Phase III. Consequently, in terms of timing, BT's Phase III construction was significant during the fiscal year ending June 30, 2006 and subsequent years when BT drew heavily on the Pooled Cash Fund. In other words, the funds expended throughout the fiscal year ended June 30, 2006 were primarily related to Phase III, including the amount that was in the Pooled Cash account on September 13, 2005. Based on our interpretation, BT would have been required to be in compliance with the terms of Condition No. 60 on the date that the CPG was issued.

According to the responses by BT, it actually violated the compliance requirement before it was even aware of the violation. In response to DPS 3-3, BT indicated that it had first violated this condition on April 30, 2007. However, BT's response to DPS 3-2 states that it first realized in November 2008 that it was in violation of Condition No. 60.[3]

[1] We note that BT has also admitted violation of Condition No. 17 of its CPG which relates to the build-out of its network to serve every residence, building and institution in the City of Burlington within 36 months of the date of the CPG.
[2] See Exhibit LA-2, attached to this report, for a summary prepared by Larkin of balances from BT's general ledger.
[3] See response to DPS 3-2 (Exhibit LA-7).

BT's response to DPS 3-3 states as follows about the time periods of violation of Condition No. 60:

> According to accounting records, BT first became non-compliant with Condition 60 on April 30, 2007, when it failed to repay cash debited against the pooled cash management system within 60 days. Burlington Telecom received the CitiCapital funds in August 2007 allowing BT to repay the Cash Pool and continue operations with no further non-compliant debits to the Cash Pool until October 2007. Non-compliant debits to the Cash Pool effectively resumed by November 2007 and continued until October 2009.
>
> See attached spreadsheet as BT Exhibit Response DPS 3-3, which is a spreadsheet of the financial and accounting records demonstrating the first violation. For information related to subsequent debits to the Cash Pool see BT Exhibit Response DPS 3-14.

BT amended their response to DPS 3-3 by stating in the response to DPS 4-4 that the correct date of the first non-compliance was March 2007.

When asked if BT had drawn any funds from the City's Pooled Cash during 2005 and 2006 that were not repaid within 60 days, the City replied "No".[4] Based on that response, the City is contending that it was compliant until March of 2007.

From March 1 through April 30, 2007 and beyond, however, BT shows that it had a negative Pooled Cash fund balance. This suggested that BT was borrowing funds from the Pooled Cash fund and possibly not paying the funds back within 60 days as required by Condition No. 60.[5] As indicated in the response to DPS 3-3, BT is of the opinion that its violation of Condition No. 60 persisted until a re-financing was obtained from CitiCapital in August 2007. With the funds obtained from the CitiCapital re-financing, BT indicated that it remained compliant through November 2007. After November 2007, BT admits it was non-compliant up to October 2009.

Even when BT understood that it was in violation, BT did not disclose the non-compliant situation to the DPS or the Board. As explained in BT's response to DPS 3-4:

> In November 2008 when Burlington Telecom learned of the Condition No. 60 violation, BT was engaged in negotiations with the Department of Public Service "DPS" regarding the build out, i.e., Condition No. 17. Burlington Telecom determined at that time to bring itself back into compliance with Condition 60 or have a plan for doing so prior to bringing the violation to the attention of the DPS and the Board.

Apparently, BT also withheld information on its non-compliance from the City Council. BT was asked in DPS 3-122 to confirm that the statement by Mr. Leopold on lines 18-19 of page 66 of the October 5, 2009 Burlington City Council Discussion Re: Burlington Telecom was accurate: "The Council was never asked to authorize going beyond the 60 days."

BT's response to DPS 3-122 states that:

[4] See response to DPS 4-62 (Exhibit LA -8).
[5] See Attachment to DPS 3-3(Exhibit LA -9).

> The statement made on October 5, 2009 to the City Council was accurate. The City Council was never explicitly asked to authorize a debit to pooled cash beyond the 60 days.

The City, in an attempt to address BT's existing Condition No. 60 violation, established a policy for repayment of funds advanced from the City. In November 2009, BT instituted the new policy of repaying any debits from Pooled Cash made after October 1, 2009 within 60 days.[6] BT indicated that after October 2, 2009, it has complied with the policy of repaying any added funds advanced. However, BT acknowledges that it did not pay back the money it had drawn from the Pooled Cash fund as of October 2, 2009.[7]

An additional change to prevent further violations of Condition No. 60 was the establishment of a separate bank account for BT. In BT's Response to DPS 3-15, the City stated:

> Until October 2009, there were no special procedures to govern BT debits from pooled cash. Currently, the City has established a separate bank account for BT and accounts for any transfers from the master account to the BT account.

Based on Larkin's review of responses and documents provided during on-site visits, we do not agree with the City's assertion of when it first failed to comply with Condition No. 60. In addition, there is concern raised with the date that BT stated it first became aware of the violation. If the November 2008 date is accurate, it clearly indicates that BT lacked sufficient monitoring controls to maintain compliance with the CPG.

It was noted in our review of the management letter from the City's auditors Sullivan, Powers & Co. (SPC), that SPC identified in its Schedule of Significant Deficiencies dated June 26, 2008 a specific concern with CPG Compliance. The concern was that the Telecom was operating under a CPG issued by the State of Vermont Public Service Board and there were various provisions that the Telecom was required to adhere to. The concern noted that there were financial-related provisions that require monitoring to ensure compliance. It was further noted that no procedures currently exist to monitor and document compliance with the CPG and it was recommended that procedures be implemented.[8] Based on the recommendation made that summer, it is unclear why it was not until November 2008 that the violation was identified.

Since it was a concern, we looked for any added information during our review of SPC's workpapers for the year ended June 30, 2007. On workpaper PP1203, a planning document, we noted the following statement (emphasis added): **"Cash in Pooled account is very negative which [is] a violation of the CPG. No current plans to fund this negative."** The workpaper is dated 1/08. That suggests that someone at the City should have known that BT was in violation of the CPG prior to November 2008 even if only relying on auditor workpapers.

Exhibit LA-1 shows BT's Pooled Cash fund position by month. As documented in that Exhibit, BT did not comply with a full and literal reading of Condition No. 60 from the date the CPG was issued. Condition No. 60 first provides that payments on behalf of Phase III can only be made if cash receivables collectively equal or exceed money owed to the city. In reviewing the response to DPS 3-3, we believe that BT based its responses regarding compliance and non-compliance on

[6] See response to DPS 3-71, Page 66 (Exhibit LA-10).
[7] See response to DPS 4-40 (Exhibit LA-11).
[8] Management Letter for Year Ended June 30, 2007, Page 19, (Exhibit LA-41).

this section of Condition No. 60. The attachment to DPS 3-3 shows that the City used temporary investments and escrow funds as an offset to the negative Pooled Cash balance suggesting that the Pooled Cash balance is in effect paid off. However there is a separate sentence regarding the City's Pooled Cash advances and repayments that we believe made BT non-compliant in 2005 when the CPG was issued.

The separate sentence that is not addressed by BT states:

> BT may participate in the City's pooled cash management system provided, however, that **BT shall reimburse the City within two months of the City's expenditure for any expenses incurred or payments made by the City in support of services that BT provides to non-City entities.** (Emphasis supplied.)

The sentence is specific that the City is to be <u>reimbursed</u> within sixty days. The sentence does not state that BT can consider funds invested or in escrow as being the equivalent of reimbursements. It would also be inconsistent with accounting standards to treat the investment account and the funds in escrow as an offset to an obligation. This is especially true if there are restrictions on the investment account and/or escrowed funds.

Exhibit LA-1 summarizes the Pooled Cash position of BT from June 30, 2005 through the unaudited June 30, 2010 balance on BT's general ledger. The column labeled "Sixty Day Debits" represents the sum of debits to the Pooled Cash account for the two months subsequent to any respective month end balance listed. There is no Pooled Cash month-end balance shown on Exhibit LA-1 for BT that was exceeded by the "Sixty Day Debits." That would indicate that at no time was the Pooled Cash balance due the City paid within the 60 days as required under Condition No. 60.

For example, on October 31, 2005, BT's Pooled Cash balance due to the City was $4,708,220. The sum of debits posted to the Pooled Cash account in November and December of 2005 totaled $53,324. Even assuming that the October 2005 balance due the City occurred on the last day of that month (i.e., on October 31), at least $4,654,896 of BT's draw on the City's Pooled Cash fund was not repaid by BT to the City within the sixty day time frame.

In addition to BT's failure to reimburse the Pooled Cash balance reflected in the general ledger within sixty days based on the debits shown, it should also be noted that the debits reflected in the analysis do not always represent actual reimbursements by BT of draws on the Pooled Cash fund. Examples of debits that do not reflect actual reimbursements were identified in November 2006, December 2006, January 2007 and February 2007. In November 2006 and December 2006, the total debits for the month were $817,500 and $867,749, respectively. However, in each of these months there was a debit of $752,867 that was reversed in the same month as a correction of a credit posted to the account that month in error. Similar postings were made in January 2007 and February 2007 that were also reversed.

Our investigation reveals, for example, that BT's accounting records have understated the amount of BT's monthly balance in the Pooled Cash account on numerous occasions because of its failure to record in a timely manner costs that it was incurring.

The understatement of the amount of BT's Pooled Cash draws was associated with payroll, which, on a number of occasions, was not posted on a timely basis to BT's accounting records.

In some cases, the interest due the City was not posted in a timely manner. Each week, payroll would be expensed and the disbursement would be recorded in account 21202, "Cash Payroll." The actual payment of the payroll was not posted to the Pooled Cash account until some later date. In December 2005, BT posted the July through September 2005 payroll disbursements. That posting, although done in December 2005, was made on BT's books for the month of September 2005. That means the July 2005 and August 2005 payroll payments were not reflected in the Pooled Cash balance due the City until September 2005. Therefore the July and August 2005 balances due from BT to the City's Pooled Cash fund were understated. The pattern continued as October 2005 and November 2005 payroll disbursements were not recorded as a BT draw on the Pooled Cash account until December 2005. January 2006 through May 2006 payroll charges to BT were not posted until June 2006.

Similar delays in posting payroll to BT's accounting records occurred in 2007, 2008 and 2009, with 2009 having the longest delay. In September of 2009, BT recorded, as of June 30, 2009[9], an entire year's payroll disbursement. As a result of these delayed postings of payroll charges on BT's accounting records for each of the first 11 months of that fiscal year, July 2008 through May 2009, the amount of the Pooled Cash balance due from BT to the City was understated.

As indicated above, the City has acknowledged that it was in violation of Condition No. 60 as early as March 2007. Also, BT claims it did not become aware of the violation until November of 2008. We believe that BT needs to explain how the violation could have continued for so long without recognition.

As recently as September 30, 2009, the City officer responsible for BT's Pooled Cash fund position made the following statements with respect to BT's violation of Condition No. 60:

> "… the use of pooled cash for cash flow for BT … is not a subsidy from the City General Fund or the taxpayer."[10]
>
> "There is neither a direct nor indirect subsidy of BT by the General Fund or any other fund of the City."[11]
>
> "I also appreciate the Board's goal to ensure that taxpayers do not subsidize Burlington Telecom. Proper enterprise fund accounting for the Burlington Telecom operations fully allocates BT's expenses to BT and BT's customers. Currently as a start-up venture yet to achieve full operating maturity, BT has incurred substantial start-up and operating costs beyond the capital improvements which are reflected in BT's financial statements as a deficit. **To the extent that BT remains in operation, the City can cover the cash flow needs of BT through the pooled cash as it progresses to becoming cash flow positive.**"[12]

Then, in response to DPS 3-33, the City stated "Burlington Telecom did not have any loans from the City of Burlington."

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[9] The City's and BT's fiscal year ends on June 30. BT records transactions in each month of the fiscal year (i.e., the monthly entries occur in periods 1 through 12). Year-end closing and adjusting entries are recorded by BT in "period 13." The period 13 entries can occur several months beyond the June 30 fiscal year end.
[10] See, e.g., Testimony of Jonathan P.A. Leopold, Jr. September 30, 2009, page 4, lines 14-15.
[11] Id., at page 5, lines 4-5.
[12] Id, at page 7, lines 15-22 (emphasis supplied).

The above statements and the response to DPS 3-33 suggest that BT is of the opinion that funds advanced and not repaid are neither a subsidy nor a loan and BT firmly believes it will become cash flow positive and be able to repay the funds advanced. Yet all draws on the cash pool do, in fact, require repayment. BT's perspective presents a direct contradiction to the requirements and intent of Condition No. 60. Funds that are not a loan would not require repayment. Therefore, BT's draw of the City's Pooled Cash fund must be viewed as a loan and will ultimately be a subsidy from the City General Fund if BT is unable to repay it. This cash management approach runs counter to the restrictions the Board placed on BT's use of the cash pool. The statement from the City officer that "To the extent that BT remains in operation, the City can cover the cash flow needs of BT through the pooled cash as it progresses to becoming cash flow positive" also suggests an apparent disregard of past performance. This statement suggests the city officer may be questioning whether BT will continue as a going concern, which in turn raises the possibility that a subsidy exists.

It should have been clear to the City officers responsible for BT prior to November 2008 that the City **cannot** and should not cover the cash flow needs of BT through the pooled cash as it did, as this is a clear violation of Condition No. 60. Evidence shows that the auditors informed the City of the violation prior to November 2008. Moreover, this practice of improper use of the City's Pooled Cash fund by BT not only violates Condition No. 60, it places the General Fund and the taxpayers of Burlington at risk.

Whether BT is able to remain in operation without continued subsidies from the City in the form of Pooled Cash fund draws by BT is a serious concern. This subsidization makes the question of when the violation was known to occur more important, because if the violation had been corrected when it was first discovered, the City's and the taxpayers' ultimate liability could have been limited.

Based on the response to DPS 4-4, BT has incurred losses and has consumed net cash every year of its existence. From July 2004 through December 2009, BT's own summary of revenues and expenses by month shows net cash outflows in every month except for July 2007, July 2008 and July 2009, and substantial net cash losses in each fiscal year:

BT's Summary of Revenues and Expenses by Fiscal Year

Fiscal Year	Cash Expenses	Revenue	Net Cash (Outflow)	Cumulative Net Cash (Calculated)
(A)	(B)	(C)	(D)	(E)
FY2005	$ 3,715,438	$ 576,420	$ (3,139,018)	$ (3,139,018)
FY2006	$ 11,517,527	$ 1,128,292	$ (10,389,235)	$ (13,528,253)
FY2007	$ 13,311,175	$ 1,662,098	$ (11,649,077)	$ (25,177,330)
FY2008	$ 16,746,510	$ 3,414,920	$ (13,331,590)	$ (38,508,920)
FY2009	$ 12,072,563	$ 6,310,769	$ (5,761,794)	$ (44,270,714)
Thru Dec2009	$ 4,700,274	$ 3,575,037	$ (1,125,237)	$ (45,395,951)
Totals	$ 62,063,487	$ 16,667,536	$ (45,395,951)	

In 2010, BT has been unable to make debt service payments on the CitiCapital lease purchase financing with operating cash flow, and has other issues that make BT's viability as a going concern under City ownership questionable, as is discussed in additional detail subsequently in this report.

Conclusions

BT has been non-compliant with Condition No. 60 since BT was issued its CPG on September 13, 2005 and it remains non-compliant as of June 30, 2010 due to management's failure to monitor compliance and to develop and execute a successful business plan. BT's claim that it first violated Condition No. 60 in March 2007 is not accurate. BT did receive the CitiCapital funds in August 2007 as stated, but the receipt of the funds did not cure the non-compliance as BT claims. Although BT claims the receipt of such funds allowed BT to repay the Pooled Cash fund and continue operations without further non-compliant debits to Pooled Cash until October 2007, the fund as shown in Exhibit LA-1 clearly indicates that a negative balance remained and the analysis of subsequent debits demonstrates that Condition No. 60 was not complied with. Therefore, BT could not have repaid the Pooled Cash as it stated in the response to DPS 3-3. Even though BT's analysis indicates the non-compliant debits to Pooled Cash effectively resumed by November 2007, the fact remains that BT was non-compliant from when BT was issued its CPG on September 13, 2005 and it remains non-compliant as of June 30, 2010. As BT has not repaid the approximately $16.9 million of Pooled Cash fund draw, the non-compliance with Condition No. 60 is believed to be continuing presently. See Exhibit LA-1.

BT's analysis of when it first violated Condition No. 60 appears to be premised on an unfounded interpretation of the condition, and upon assumptions that cash available to BT via the CitiCapital lease financing could be imputed as repayment of BT's Pooled Cash fund draw. Because funds in escrow are restricted, it is not appropriate to assume the funds could be drawn on to repay the negative balance in the Pooled Cash account. BT has been in continual violation of Condition No. 60, due to its failure to actually reimburse the Pooled Cash fund within sixty days.

BT's claim that it was compliant is further complicated by BT's failure to account for costs in a timely manner. Delays in posting significant accounting entries such as payroll and interest to the monthly Pooled Cash fund balance resulted in a number of months being understated on BT's books. Failure to maintain accurate monthly accounting records during the year is significant since the requirement under Condition No. 60 is that funds advanced must be repaid in two months. Quarterly or year-end adjustments do not correct this deficiency.

BT's failure to identify its non-compliance, even under BT's interpretation of Condition No. 60, prior to November 2008 is troubling. The results of operations, i.e. annual losses, were an obvious indication that BT was being funded by the City. A review of the growing negative balance in the Pooled Cash account would have been an obvious indicator that advances from the City were not being repaid in accordance with the terms of Condition No. 60. There is also an indication that someone did in fact know that BT was in violation of its CPG prior to November 2008. The City's auditor's management letter and workpapers for the year ended June 30, 2007 in our opinion clearly indicate that the City was made aware of, or the City itself made the auditors aware of, the noncompliance. The management of BT failed to fulfill the duty of monitoring the provisions of the CPG.

B. Total amount of money BT has borrowed from the City of Burlington including the current balance owed to the City

Larkin attempted to determine through discovery the amount BT actually borrowed from the City. This determination was complicated by the City's unconventional accounting practices. The first step was to request the City's general ledger for the period under review. The City, in response to DPS 3-14, provided the general ledger for the years ending June 30, 2005; June 30, 2006; June 30, 2007; June 30, 2008; the unaudited June 30, 2009 and the unaudited 4 months ended October 31, 2009. Subsequently, in response to a verbal request, BT provided the audited June 30, 2009 and the unaudited June 30, 2010 general ledgers.

The general ledgers provided showed only year end balances but did not show year to date balances by month, as would be expected in a commercial venture with reasonable and appropriate accounting practices. To develop the monthly balances was a time-consuming undertaking. In reviewing the general ledger detail, there were numerous entries that were recorded as if they were advances of funds that were later reversed and classified as correcting entries. We tested the year ending June 30, 2007 using the response to DPS 3-3 and specifically identified $3,052,309 of credits that were corrected by a like amount of debits. That is significant because there was only $16,906,784 of debits posted during the year. Adding to the problem of identifying what actually was borrowed was the fact that entries for a particular month were posted months later "as of" a specific month end. For example, there may have been a posting made in June that was in effect "as of" March. Further complicating the analysis was the posting of "Period 13" entries. Period 13 entries are adjustments to respective accounts made after the year end that could be related to activity that occurred at any point in time during the year. If one were to assume that all the other entries were actually funds advanced during the year, BT was advanced $14,546,439 over the entire year net of the sum of correcting entries of $3,052,309.

The identification of the most current balance was the final part of the second task in our review.

BT's response to DPS 3-26 states as follows:

> Through February 2007, BT used the remaining balance on the $10 million lease from Koch Financial. Between February 2007 and August 2007, Burlington Telecom utilized pooled cash from the City of Burlington until the funds from the CitiCapital lease for $33.5 million were received. Burlington Telecom effectively exhausted the funds from the CitiCapital lease by November 2007. Since then, BT has debited against the City's pooled cash management system in the amount of $17,388,087.38.

Per the responses to DPS 3-5 and DPS 3-65, the $17,388,087 is BT's Pooled Cash fund advance as of October 30, 2009. According to the responses to DPS 3-10 and DPS 3-73, BT drew an additional amount from the Pooled Cash fund in November 2009. The response provided conflicting amounts. DPS 3-10 indicated the amount to be $265,000 and DPS 3-73 indicated the amount to be $266,500.

BT's Debit Cash Pool Position	Reference	Period
$ 17,388,087	DPS 3-65	at 10/31/2009
$ 266,500	DPS 3-73	November 2009

DPS 3-33 asked BT to provide the following information:

> Please identify, by month, from January 2008 through the present, all loans and advances from the City to BT. (a) For each loan, please identify, quantify and explain the amount borrowed and the terms of such loan. (b) For each advance please identify, quantify and explain the amount advanced by the City to BT and the terms of such advance.

BT's response to this request stated as follows:

> a. Burlington Telecom did not have any loans from the City of Burlington.
>
> b. See BT Exhibit Response DPS 3-24. The debits to pooled cash were used for operational and capital expenses in excess of service revenues. No written terms regarding the debits are in place. See BT's response to DPS 3-58 for the City's policy relative to pooled cash.

The point of the question was to obtain information regarding the level of funds advanced to BT. While sufficient information was not provided to determine the level of funds advanced from January 2008 to date, it is curious that in its response to DPS 3-33a, BT does not consider the funds obtained from the Pooled Cash fund to be a loan. Certainly BT and the City should have realized that BT was under an obligation to repay the City with interest for any funds advanced by the City. The fact that the City is charging interest on the funds owed by BT to the City is a clear indication that the advance constitutes a loan. However, according to the response to DPS 4-82, there are no written procedures or processes regarding how the interest on the Pooled Cash is derived.

As of June 30, 2010, the unaudited general ledger of BT, as summarized for the Pooled Cash account in Exhibit L&A-1, shows a total amount owed to the Pooled Cash fund of $16,936,492 million.

In reviewing the additional general ledger detail provided, it was noted that BT's unaudited general ledger for the fiscal year ending June 30, 2010 does reflect a liability of $64,162 identified as "Due to G.F. Telecom."[13] This appears to represent funds advanced to BT in a similar manner as the funds that were advanced through the Pooled Cash account. This was confirmed by reviewing various entries posted to each of the accounts. Since BT has owed the City at least $16.9 million for BT's unpaid Pooled Cash draws from October 2009 through June 30, 2010, it was noted that interest on this amount had not continued to be posted to the Pooled Cash account beyond October 2009. The interest on Pooled Cash for July through September 2009 was posted to the Pooled Cash account on October 16, 2009, but that entry was "as of" September 30, 2009. Subsequently, the interest was being accrued to account 33002, "Due to G.F. Telecom." Based on that review, we believe that the account 33002, "Due to G.F.

[13] "G.F." in this context presumably means the City of Burlington General Fund.

Telecom" is essentially a replacement for the Pooled Cash account. The difference appears to be that this new account has been paid back in the two month period required under Condition No. 60.

BT has a balance due to the Pooled Cash fund of approximately $16.9 million, and shows no realistic prospects of having the operational cash flow to be able to repay it.

Conclusion

The amount due from BT to the City related to BT's Pooled Cash fund draws is at a minimum $16,936,492. The total amount as of any particular date since September 25, 2005 cannot be readily determined due to the manner in which the City and BT record transactions. It is evident from the analysis in Exhibit LA-1 that transactions continue to flow through the Pooled Cash account, but it does appear that any new postings are in effect repaid within two months because the balance due the City continues to remain at $16.9 million.

We believe that a separate liability account should be reflected on BT's books for its obligation to repay its cumulative Pooled Cash fund draws. BT should also refrain from recording any further adjustments to this account unless an actual payment is made.

Continued use of the account "Due to G.F. Telecom" for recording cash activities associated with the City could be appropriate as long as BT makes the required repayment in the 60 day time period allowed. A separate report should be filed monthly with the Department and the Board by BT that identifies the advances and the repayments.

Finally, with the number of corrections identified in the fiscal year 2007 and the City's failure to provide adequate detail on the amount of funds advanced we believe that a concern exists as to whether BT is in full compliance with Condition No. 58. As indicated earlier Condition No. 58 states that the accounting system shall be capable of tracking BTs costs including financing in a transparent and auditable manner. Although the City could argue that the detail is there, the transparency is questionable.

C. Source of City or other City Department funds used to support BT

BT specifically stated in response to DPS 3-33 that "operational" expenses were supported by the Pooled Cash fund. BT has also stated that the source of the advanced funds cannot be determined from the City's accounting records. BT's response to DPS 3-6 states as follows:

> All of the funds within the Cash Pool are commingled; therefore Burlington Telecom is unable to determine the exact source of funds the City provided to BT in 2007, 2008 and 2009. See Response to DPS Question No. 13 below for the source of the funds.

The response to DPS 3-13 states as follows:

> The pooled cash account is the general bank account for the City. It is the ultimate depository for all receipts from and pays all accounts payable for all City departments and operations except for the Electric and School Departments and minor accounts dictated by federal regulation. In addition, "pooled cash" debits and credits reflect payroll

charges and journal entry debits and credits for internal charges between accounting entities and departments.

The response does not specify that interest charges or credits are also flowing through the Pooled Cash account for the use or provision of pooled funds, respectively. Departments providing cash to the Pooled Cash fund receive interest; the departments that have drawn on the Pooled Cash fund owe interest. Additionally, the City maintains information on the Pooled Cash fund balances by department, from which one can identify which departments and funds have provided funds into Pooled Cash and which funds and departments have drawn from Pooled Cash.

The interest rate that BT pays on the funds obtained from the Pooled Cash fund was explained in response to DPS 3-58 as follows:

> a. The interest rate for a credit balance in pooled cash is based on the rate of interest paid on City money by the City's bank, TD Bank. Similarly the rate of interest charged is based on the rate of interest from TD Bank for money borrowed by the City. Currently, the annualized rate for credit balances is approximately .3%. The current annualized rate for debit balances is approximately 1.9%
>
> b. … the City believes that it is a reasonable proxy since it is based on the actual rates of the City's bank for money on deposit and/or borrowed. The rate represents a short term interest rate.

Additionally, BT's response to DPS 3-15 states as follows:

> The "pooled cash" is the master bank account of the City. City departments and enterprises covered by this master account do not "withdraw" money per se. The City uses this master account to pay all accounts payable for all departments and enterprises which do not have separate bank accounts, which included Burlington Telecom until October 2009. Each month the City calculates the net of revenues and expenditures for each department or enterprise which is accounted separately from the General Fund of the City. This "net" is credited or debited as appropriate from the balance from the prior month to determine the current net credit or debit for each separate accounting entity.
>
> City departments or enterprises which in effect do "withdraw money" are those entities which have separate bank accounts such as the Electric and Schools Departments.
>
> The actual use of pooled cash is the result of the processing and payment of accounts payable. The City usually runs accounts payable twice a month for all departments except Burlington Electric and Schools which process their own payables. Each department or enterprise prepares a voucher of all invoices to be processed. The voucher must be approved by the appropriate department head or other authorized managers. The vouchers are then submitted to the Clerk/Treasurer's Office for processing. Departments are responsible for reviewing invoices and vouchers for consistency with budgets and the appropriateness of the actual charges. For BT, the voucher is approved by the General Manager or his designee and all reviews and approvals of the actual invoices are performed by BT staff.

> Separate from the above process for accounts payable, the calculation of the credit and/or debit in pooled cash for each accounting entity is also affected by processing of weekly payroll and journal entries for transactions internal to the City, such as accounting for the cost of FICA, personnel benefits and administrative charges. These transactions are accounted for through "journal entries" by the accounting staff of the Clerk/Treasurer's Office. Such journal entries are reviewed by appropriate department staff for accuracy and appropriateness and are also reviewed by the city's auditors at year end.
>
> Until October 2009, there were no special procedures to govern BT debits from pooled cash. Currently, the City has established a separate bank account for BT and accounts for any transfers from the master account to the BT account. BT debits must be approved by the General Manager or his designee and the Clerk/Treasurer's Office and are based on a review of the current cash position and forecast.

At any point in time during which BT was drawing on the Pooled Cash fund, other departments had draws or surpluses. For example, during December 2006, when BT's Pooled Cash balance due to the City increased $1,277,029[14], the Pooled Cash fund due from the City for December 2006 for the Airport[15] decreased by $1,063,100 From that information one might be tempted to conclude that the Airport had funded BT's Pooled Cash fund draw. However, the balances of draws or surpluses for individual City departments, while discernible at particular points in time, can fluctuate significantly over time.

In our review of the July 7, 2010 communication between the City and Moody's[16], we observed that from January 2005 through June 2010 there were only two funds that maintained a sufficiently positive balance in most months to have supported BT's draws from the Pooled Cash fund. The spreadsheet provided by the City to Moody's shows the General Fund and the Airport being primary positive providers of cash into the Pooled Cash fund from January 2005 through June 2010. In the case of the Airport's provision of cash into the Pooled Cash fund during the 2005 through June 2010 period, we are informed by BT and by the City's independent auditor that the Airport has used such cash and has become a net draw on the Pooled Cash fund, yet BT continues to carry a net draw of approximately $16.9 million.

Another communication from the City to Moody's, dated July 6, 2010, relates to the future for BT and the potential impact on City finances. The email attachment indicated that BT's finances and cash flows continue to improve. The attachment explains that a consultant was retained to assist in restructuring the debt and implementing recommendations to improve BT's operations. It then discussed what would happen if BT was unable to secure repayment of the Pooled Cash obligation within a reasonable time. The indicated result is that the Pooled Cash obligation would become a liability of the General Fund if BT ceases to be a City venture. According to the memo, in that event the City would have the authority to issue general obligation bonds to convert the Pooled Cash obligation to long term debt. That financing would be 20 years with annual debt services of $1.2 million. The cost to taxpayers would be a tax rate increase of less than 3.4 cents or 4.7%. The communication then states that a "4.7% increase, if it becomes necessary, represents a reasonable and not overly burdensome tax rate."[17]

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[14] See Exhibit LA-1.
[15] Email entitled "Pooled Cash" from Jonathon Leopold to Moody's dated July 7, 2010 (Exhibit LA-12).
[16] Id.
[17] Email entitled "Burlington Telecom" from Jonathon Leopold to Moody's dated July 6, 2010 (Exhibit LA-13). The DPS has been advised that the legal opinion referred to was never issued.

Conclusions

At any point in time, City departments have positions in the Pooled Cash fund that are either a surplus, where the department has provided cash to the Pooled Cash fund, or a draw, where the department, such as BT, has drawn cash from the Pooled Cash fund. BT operations have been supported by the Pooled Cash fund during the entire period that BT has operated under the CPG. The actual source of the $16.9 million accumulated by BT through June 2010 varied during the period under review. As noted above, during portions of the period of review it appears the General Fund and the Airport's surplus cash provided the primary funding source for BT's cash draws from the Pooled Cash fund. Due to the fluctuations in the sources of cash supplied to the Pooled Cash fund, which can be significant, and the manner in which the Pooled Cash fund operates, it would, in our opinion, be inaccurate to conclude that the Airport will be out the amount of cash that it had deposited in the Pooled Cash fund. It appears that if BT is unable to repay the full $16.9 million and default occurs, the default will fall upon the City's general fund and ultimately the taxpayers of the City of Burlington.

D. Amount of money BT has repaid the City, and interest or principal payments

BT was requested, in DPS 3-8, to provide financial and accounting records showing the total amount BT has repaid the City distinguishing between interest and principal payments.

BT's response to DPS 3-8 stated as follows:

> The amount of the debit fluctuates depending upon cash receipts, disbursements, payroll charges and journal entries. No amounts identified specifically as "repayments" have been made to the City of Burlington. Interest charges are debited monthly to the total amount of BT's debit.

First it should be clarified that the response in referring to debits is addressing the City's accounting entry to BT's obligation to the City. In BT's Pooled Cash account, the entries referred to are in fact credits on BT's books. That being said, the response essentially states that the City's accounting records cannot sufficiently identify the advances made and the repayment of either the principal or the interest.

We analyzed the entries to the Pooled Cash account in an attempt to identify the interest recorded by BT on the outstanding balance by year. For the fiscal year ended June 30, 2006 a period 13 entry was made for $184,616 for interest. It was the only entry in the year identified as interest, which means the monthly balance was understated throughout the year. For the fiscal year ended June 30, 2007 an entry was made in period 10 (as of April 2007) for $264,873 for interest. No posting was found for either May or June. The fact that it was the only entry in the year identified as interest also means the monthly balance was understated throughout the year. The fact that it was posted as of April means that May and June interest may not have been recorded. For the fiscal year ended June 30, 2008, six entries were identified totaling $233,729 of interest. Again, there was lag in recording the interest. For the fiscal year ended June 30, 2009, five entries were identified totaling $392,843 of interest. As with previous years, there was lag in recording the interest, resulting in an understatement of the monthly balance due the City. In the fiscal year ended June 30, 2010, an entry was made in October of 2009 recording the interest for the months of July through September. Interest after September 2009 was recorded in account

33002, “Due to G.F. Telecom” and appears to have been paid to the City.

As of June 30, 2010, BT owed the Pooled Cash fund approximately $16.9 million without repayment.[18] Because of the way that BT and/or the City records the transactions to the Pooled Cash account, we were not able to determine the total amount of principal and/or interest that is included in the $16.9 million. In performing our review, we did not identify any description that would indicate that the interest that was accumulating was paid.

Larkin compiled the amount owed the City on Exhibit LA-1 from BT’s accounting records. However, it should be noted that a number of concerns exist regarding BT’s accounting that make it difficult to accurately identify how much BT owes to the City at any particular point in time. As discussed above, BT did not record its interest obligation to the City in a timely manner. In addition, there are the other accounting concerns discussed in sections II-A and II-M of this report that raise concerns as to the transparency of BTs accounting records.

Conclusions

It cannot be readily determined from either the City's or BT’s books of record how much of the $16.9 million is borrowed funds and how much is interest. The accounting entries make no specific reference to whether a reduction to the Pooled Cash balance is principal or interest. The fact that BT failed to record interest and payroll in a timely manner suggests that the interest calculation itself is understated and the books are in error.

As indicated in the introduction and in Section B, there is a concern regarding BT’s compliance with Condition No. 58 (requiring that the accounting system shall be capable of tracking, in a transparent and auditable manner, BT’s costs including financing). The City has indicated it cannot identify either the principal or the interest payments made. There is also the problem with the untimely posting of interest and the possibility that a full year of interest was not recorded in the 2007 fiscal year. The obligation to the City is the equivalent of short term borrowing and the fact that the payments cannot be identified with any specificity has to be a concern. BT does not view this as debt but the fact remains that it is debt and BT is not operating under the same requirements other City funds departments are operating under, i.e., that borrowed funds will have to be repaid. BT has a CPG with requirements that have to be met and the City’s failure to provide adequate detail on the amount of payments on the funds advanced causes concern as to whether BT is in full compliance with Condition No. 58.

E. Estimated monthly cash flow requirements that BT needs to cover its operating and debt service expenses as compared to its monthly revenue

Throughout its existence, BT has obtained various projections of its cash flow requirements and ability to cover its operating expenses as compared to its monthly revenue. See the statements of Mr. Nulty, the then Director of BT, in a Burlington Telecom Case Study, dated August 2007:

> I’m very familiar with many government owned telecom operations throughout the world, over many years, and across many different forms of government, and I can tell

[18] See the analysis shown in Exhibit LA -1.

> you that governments generally do not subsidize publicly owned telecommunications. They milk telecommunications – these systems generate a lot of revenue.[19]

Additionally, at that time, the investment in BT was also anticipated to generate significant revenue for the City. For example, a statement is made that: "Once the City fully pays off the debt, BT's net income (predicted to be around $15 million/yr) could provide more than 20% of the City's general fund requirements."[20] The City "… now views the telecommunications sector as an important source of new revenues."[21]

As another illustrative example, the following conclusion based on BT recovering the Average Revenue Per User (ARPU) and completion of wiring all aerial neighborhoods, is taken from BT's Exhibit Response DPS 3-35(a):

> These two factors together strongly suggest that revenue will reach the "cash-flow positive" level of approximately $5.5 million per annum by the end of 2008...
>
> ...From the point the Commercial Project Phase II/III goes cash-flow positive in January, 2009 until the end of the Lease 2022 BT is projected to generate a total of between $70 and $80 million dollars in cash for the City. At the end of this period BT is conservatively estimated on the basis of 8 X cash flow to have a fair market value of between $100 and $115 million.

BT's response to DPS 3-111 provided a copy of the "Shanahan Report" a/k/a the Creative Telecom Ventures LLC report dated December 5, 2007. That report has various findings and recommendations, including projections of BT's operations prepared at that time. Notably, the City Council was apparently not informed of the finding on page 8 of the report that BT would exceed its borrowing capacity under the current debt facility in March 2008.[22]

However, there is a pattern of consultants hired by the City or BT making acknowledgement of BT's then-current cash-flow-negative situation and inability to turn a profit, then making rosy projections of BT's becoming profitable in some future period, typically by adding more customers and increasing revenue, and/or by obtaining larger amounts of financing.

Unfortunately, none of those overly optimistic projections for BT have materialized. BT has continued to incur losses each year and has been unable to pay back the amount it has borrowed from the Pooled Cash fund. Further complicating BT's financial future is the lease arrangement which CitiCapital entered into in August 2007, where BT obtained $33.5 million of financing.[23] Recently, BT has experienced difficulty making lease payments due at various points in 2010 under the CitiCapital financing.[24] For BT to continue to operate it must be able to service both its debt to the City and to CitiCapital.

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[19] Tim Nulty, Director of Burlington Telecom quoted in Burlington Telecom Case Study, dated August 2007, by Christopher Mitchell, Director Telecommunications, a publication of the New Rules Project of the Institute for Local Self-Reliance, reproduced as Exhibit LA-40 to this report. The quote from Mr. Nulty appears at Exhibit LA-40, page 2.
[20] Burlington Telecom Case Study, dated August 2007, Exhibit LA-40, page 3.
[21] Id.
[22] See response to DPS 3-111, Shanahan Report, (Exhibit LA-14).
[23] See response to DPS 4-8 (Exhibit LA-15).
[24] See response to DPS 4-46 and Response DPS 4-42a (Exhibit LA16 and Exhibit LA-17).

The question of cash flow required to meet operating expense and debt services has been raised by the City's independent auditors Sullivan, Powers & Co. Specifically the June 30, 2009 audit report states:

> The City is unable to provide an assessment of its ability to refinance its current debt or otherwise provide sufficient cash flow in the Telecom Fund in order to repay all, or a portion of, its interfund loan within a reasonable time.

The June 30, 2010 unaudited general ledger shows a $16.9 million BT Pooled Cash fund draw and a $33.5 million balance due to CitiCapital related to BT's lease financing arrangement. The sum of these two amounts indicates that BT owes $50.4 million. In comparison, the June 30, 2010 unaudited general ledger shows a net plant balance of $31.9 million and a net accounts receivable balance of $1.092 million ($1.569 million of Accounts Receivable less $477,000 Allowance for Doubtful Accounts)[25]. BT's net plant assets and accounts receivable are not sufficient to cover BT's current debt load. The level of the allowance for doubtful accounts is significant since the optimistic view in the response to DPS 3-35(a) is contingent on recovering the necessary ARPU.

BT's June 30, 2010 unaudited general ledger also shows a negative fund balance of $18 million.[26] This negative balance is the result of recurring losses. The response to DPS 1-30 listed losses of $1.1 million in fiscal 2005, $1.6 million in fiscal 2006, $3.7 million in fiscal 2007 and $4.9 million in fiscal 2008. The 2009 audited financial statements indicated a $4.2 million loss. BT as a stand-alone entity would have a significant "going concern" problem and its inability to turn a profit combined with its troubled debt structure are signs that the forecasts have been overly optimistic.

In December 2009, the City Council initiated a Blue Ribbon Committee ("BRC") to investigate BT's financial viability. The BRC's work included reports from Stratum Broadband and Hiawatha Broadband Communications ("HBC"). Those reports included additional projections of BT's cash flow requirements and expenses compared to its monthly revenue.

The Blue Ribbon Committee's report dated February 11, 2010[27] at page 6 contains the following statements (emphasis added):

> … we have settled on answering the basic question of "is Burlington Telecom able to support the current debt structure based on the current financial situation of BT and the forecasted situation in the 2009 Business Plan?"
>
> ? The Committee has determined that BT is not viable in relationship to its current debt load of $51 million and its ability to generate earnings to pay off this debt. BT cannot meet its principal and interest obligations at this time and the Committee does not feel the current business plan can generate the 'EBITDA' earnings before interest, taxes, depreciation and amortization, to meet its debt obligations in the future.

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[25] The ratio of the Allowance for Doubtful Accounts to Accounts Receivable, which exceeds 30 percent ($477k / $1,569k = 30.4%), suggests that BT may also have problems collecting the revenue that it bills to customers for services.
[26] This was provided by BT in response to a verbal request to update the response to DPS 3-14.
[27] This report is reproduced in Exhibit LA -18.

- ? Refinancing the $51 million of current debt at an interest rate between 4% and 5%, would require an annual debt service of at least $3 million. The committee is not comfortable BT can support this today or in the near future. **In order for BT's EBITDA to cover a debt service level in excess of $3 million, we estimate revenues would need to exceed $25 million compared to current revenue of $7 million.** This is based on an industry average of 19% EBITDA to revenue ratio and BT is currently operating at 14.6%.
- ? BT's business plan does not support covering this debt service by 2014; however, it assumes an EBITDA to revenue ratio of 40% (in low case business plan), that we have determined is not realistic.
- ? The consultants came to the same conclusion.

As an example, the following is taken from Stratum's "Business Analysis" dated January 27, 2010:

> Stratum does not believe that the current business plan, with its current assumptions, is viable or will reach cash flow break-even within a reasonable timeframe. In these circumstances, BT's existing debt exceeds its ability to service it. We therefore do not recommend a maximum 5 year debt capacity for BT under these circumstances.
>
> . . .
>
> Stratum does not believe that BT is a viable business under its current assumptions and with its current strategy and marketing approach.[28]

HBC's "A Report to the Blue Ribbon Committee" dated January 27, 2010 contains the following statement:

> It also was readily apparent that B.T. faces a steep uphill battle to reach a self-sustaining financial performance level. Historic spending levels coupled with the slow rate of customer acquisition have placed the business in a precarious position.[29]

The reports also provided various suggestions for BT's future business strategy. None of these reports, however, provided a clear solution for BT that would ensure that BT could (1) avoid defaulting on the $33.5 million of CitiCapital lease financing, (2) repay the Pooled Cash fund for the approximately $16.9 million that BT owes, or (3) under the current ownership structure become a viable business operation that is profitable and cash flow positive in the near future.

Conclusions

BT continues to believe that it will be able achieve a positive cash flow despite its past performance. There is a pattern of having consultants hired by the City or BT making acknowledgement of BT's then-current cash-flow-negative situation and inability to turn a profit, then making rosy projections of BT's becoming profitable in some future period, typically by adding more customers and increasing revenue, and/or by obtaining larger amounts of financing. The past projections of BT becoming profitable and cash flow positive have not materialized.

[28] A copy of the redacted Stratum report is included for ease of reference as Exhibit LA-19.
[29] A copy of the redacted HBC report is included for ease of reference as Exhibit LA-20.

The Blue Ribbon Committee and the consultants reporting to the BRC, on the other hand, appear to present a more candid and realistic assessment of BT's prospects. The Blue Ribbon Committee concluded that BT is not viable in relationship to its current debt load of $51 million and its ability to generate earnings to pay off this debt.

The Stratum report indicated that Stratum does not believe that the current business plan, with its current assumptions, is viable or will reach cash flow break-even within a reasonable timeframe. In these circumstances, Stratum found that BT's existing debt exceeds its ability to service it. Stratum also indicated that it does not believe that BT is a viable business under its current assumptions and with its current strategy and marketing approach.

HBC's report indicates that BT faces a steep uphill battle to reach a self-sustaining financial performance level and that BT's historic spending levels coupled with the slow rate of customer acquisition have placed the business in a precarious position.

Larkin finds it troubling that BT and officers of the City continue to believe that BT can achieve a positive cash flow and will be able to service its debt. As noted above, the optimism of BT voiced in the response to DPS 3-35(a) hinges on recovering the ARPU and completing the wiring of neighborhoods. BT's allowance for doubtful accounts suggests recovering the ARPU is not occurring and as noted in Section A, BT has violated Condition No. 17 by not completing its build out. BT and the City have not to date presented a credible plan for BT's viability as an ongoing City enterprise fund that would demonstrate how BT will become profitable or how BT will be able to meet its monthly cash flow requirements with its existing revenue and external financing, or how BT will be able to cover its operating and debt service expenses out of its monthly revenues. As discussed in previous sections of this report, BT has incurred repeated losses in its operations. A firm incurring more than 6 years of continuous losses in the private sector would have a significant going concern problem. It is not appropriate for BT and City officials to use the City umbrella to continue to operate at a deficit in hope and anticipation that a profit will eventually come. The blind optimism of BT and some City officials has put the taxpayers of Burlington at tremendous risk.

Finally, as noted, BT has incurred continuous significant losses for the past 6 years. As a start-up business it would be expected to show some improvements. The proverbial light at the end of the tunnel does not seem to exist in BT's near or longer term future. We question whether the continuous losses are an indication that BT has failed to comply with Condition No. 12 which states the system will be priced at a reasonable level with respect to the cost of providing that service. If the price for the installation and/or the service itself were reasonable, BT might have been in a better financial position than it is.

F. Is BT still borrowing money from the City or another entity to cover its operating or debt service expenses?

BT's response to DPS 4-40c states that:

> The debits to the Cash Pool existed as of October 2, 2009 have continued to be present. After that date BT has debited funds from the Cash Pool but has re-paid these funds within 60 days pursuant to Condition 60.

From the issuance of BT's CPG, BT's borrowing from the Pooled Cash fund accumulated to a total draw of approximately $16.9 million. BT's draw from the Pooled Cash fund as recently as

June 2010 continued to be approximately $16.9 million.[30] Subsequent to October 2009 the Pooled Cash account balance did fluctuate but debits were recorded maintaining the balance at $16.9 million.

As mentioned previously, BT has stated that a policy was instituted such that BT would repay any debits from Pooled Cash made after October 1, 2009 within 60 days. During the period from October 2009 through June 30, 2010, the amount owed by BT to the Pooled Cash fund stabilized at $16.9 million. As discussed in Section B, BT has added account 33002, "Due to G.F. Telecom" to its general ledger. This new account provides a conduit for transactions similar to the Pooled Cash fund. As of June 30, 2010, BT owed the General Fund $64,162 as reflected in this account. This is in addition to the $16.9 million Pooled Cash obligation to the City. Based on our review of the activity in this account, it appears that since October 2009, BT has been repaying any advances from the City in accordance with Condition No. 60.

BT has also borrowed $33.5 million from CitiCapital in the form of lease financing. BT has been unable to make its scheduled payments to CitiCapital under the lease in February, May and August 2010 by normal means. BT utilized an escrow reserve that was provided for under the CitiCapital leases to make the February and May 2010 payments.[31] We are advised that BT and the City are in negotiations with CitiCapital wherein the City and BT are attempting to restructure the CitiCapital lease financing.[32]

Conclusions

It appears that the statement that after October 2, 2009, BT has debited (i.e., drawn) funds from the Pooled Cash fund but has re-paid these funds within 60 days is accurate. Based on the available information, since October 2, 2009, BT's Pooled Cash fund draw has stabilized at approximately $16.9 million. However, that amount has not been repaid and the prospects of BT having the ability to repay the $16.9 million Pooled Cash fund draw appear grim.

Similarly, BT has borrowed $33.5 million from CitiCapital in the form of lease financing. BT has experienced difficulties in making debt service payments on the CitiCapital lease financing in 2010. Restructuring of the debt remains uncertain at this time.

BT has appeared to stabilize its combined debt obligation of $50.4 million. However, because BT has yet to establish a positive cash flow sufficient to meet its operating needs, let alone the ability to reduce its debt obligation and cover interest payment requirements, there is concern that the new account "Due to G.F. Telecom" could begin to accumulate an increasing amount of borrowed funds in addition to the $16.9 million already owed to the city.

G. The nature and extent of any commingling of BT funds with City funds

BT's cash has been commingled with the Pooled Cash fund since BT's inception.[33] As discussed in section G of this report, on October 2, 2009, after BT had accumulated a Pooled Cash fund draw of approximately $16.9 million, a policy was instituted that BT would no longer borrow

[30] See Exhibit LA-1.
[31] See Moody's Investor Credit Service Report (Exhibit LA-21).
[32] Id.
[33] See BT's response to DPS 3-6(Exhibit LA-22).

additional funds from the Pooled Cash fund without repayment within 60 days. Since that time, BT's Pooled Cash fund draw has stabilized at approximately $16.9 million. As described in sections II-A and II-M of this report, BT's accounting records make it very difficult to ascertain how much BT owes to the City at any particular point in time.

When BT obtained the Koch and CitiCapital financing, escrow accounts were established for holding such funds before they were expended by BT.[34] Based on the documentation we reviewed, we did not see evidence that funds held in such escrow accounts were commingled with other City funds. As of June 30, 2009, BT had $1 million of CitiCapital financing that was committed to a loan loss reserve fund.[35] During the fiscal year ended June 30, 2010, BT drew on the reserve to meet its obligations to CitiCapital. The unaudited balance as of June 30, 2010 is $226,739[36].

BT has experienced difficulties in paying debt service on its $33.5 million lease financing obligation to CitiCapital. As indicated above, during 2010 BT has used amounts from that escrow account to make payments to CitiCapital that BT was unable to fund from its operational cash flow.[37]

In terms of investigating the degree of commingling of BT and City funds, we note that in the City's presentation of BT's Pooled Cash fund position, the City attempted to count funds held in BT's escrow accounts as an offset to BT's Pooled Cash fund draw.[38]

Conclusions

The Pooled Cash fund represents a commingling of funds between BT and the City. In the City's presentation of BT's Pooled Cash fund position, the City attempted to count funds held in BT's escrow accounts as an offset to BT's Pooled Cash fund draw. This attempt to reflect escrowed funds against the outstanding balance owed the City is inappropriate since the funds were restricted for use in paying its obligation to CitiCapital.

Our investigation did not reveal commingling of BT and City funds beyond the Pooled Cash fund.

H. Has the City used any of BT's capital or operating revenues for City cash needs or operations

BT's response by Mr. Leopold to DPS 3-11 states that:

> To the best of my knowledge, the City has not used any of BT's capital or operating revenues for City cash needs or operations.

The City has charged BT for a number of items, including allocated labor charges, a payment in lieu of taxes or "PILOT", and for other City services used by BT, such as excavation inspections,

[34] See BT Exhibit Response DPS 4-4(Exhibit LA-23).
[35] See BT Exhibit Response DPS 3-37(Exhibit LA-24).
[36] See Exhibit LA-2.
[37] See Exhibit LA21.
[38] See BT's response to DPS 3-3 (Exhibit LA-9).

etc.[39] The Burlington Electric Department "BED" has charged BT for pole attachments and services provided by BED related to BT's construction of the fiber optic network.[40]

We did note that there were excess charges to BT for PILOT but adjustments were subsequently made returning the overcharge. Other than the charges noted above, which relate to services provided to BT and to the PILOT, our review did not reveal instances of the City using BT's capital or operating revenue for City cash needs.

In this context, however, it should be noted that BT is providing services to various City departments at below-market rates that are below BT's cost of service. The low rates charged by BT for provision of services to the City could be viewed as a form of cross-subsidization.[41]

Conclusions

Other than observing City charges to BT for a PILOT and for other City services, such as excavation inspections, etc., and BED charges to BT for pole attachments and other services provided by BED to BT, our review did not reveal instances of the City using BT's capital or operating revenue for City cash needs.

The fact that BT is providing services to various City departments at below-market rates that may be below BT's cost of service, which could be viewed as a form of cross-subsidization, is a problem. The providing of service at below cost and/or below market rates results in BT absorbing either the cost of the service and/or eliminating margin designed to cover administrative costs. BT should not be allowed to provide discounted services to City departments, which, in essence, is a violation of Condition No. 12. Condition No. 12, as discussed earlier, states that the services would be priced at a reasonable level with respect to the cost of providing that service.

I. Amount of BT's accounts payable for invoices 30, 60, 90, and 120+ days overdue

BT's response to DPS 3-12 states:

> See attached internal tracking spreadsheet as BT Exhibit Response DPS 3-12. Burlington Telecom has no invoices that are 30, 60, 90 or 120 + days overdue.

A review of the spreadsheet provided by BT in response to that request indicates that BT had no invoices overdue by the above numbers of days as of the date that spreadsheet was prepared.

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[39] The City's charges to BT for excavation inspections are per invoices that were examined by Larkin during the second on-site visit to BT's offices to review accounting records and related documentation, which occurred in September 2010.

[40] Id.

[41] See response to DPS 4-68, Pages 57-58 of the BT Exhibit Response DPS 3-71 12-11-09.pdf which shows a November 12, 2009 memo from Jonathan Leopold to the Board of Finance and a BT Data Connectivity Billing Comparison to Market Rates chart. BT charges the City "a rate of 50% of the lowest alternative rate". BT has failed to explain why BT chose 50% as opposed to some other percentage, such as 100%, 90% etc. of the lowest available rate. The substantial under-charging below competitive rates creates the appearance, if not the reality, of a subsidy (Exhibit LA-25).

As noted elsewhere in this report, BT has experienced problems making payments due on the $33.5 million lease financing that it had obtained from CitiCapital. Data request DPS 4-41 asked the following concerning the CitiCapital lease financing:

> Please confirm that because the CitiCapital financing of $33.5 million is senior financing, by the terms of such financing, BT would have to pay off the entire $33.5 million before BT could repay the City Cash Pool balance. If this cannot be confirmed, explain fully why not, and please cite specifically to any and all terms of the CitiCapital financing that the City believes would allow BT to first pay off the City Cash Pool balance before repaying the CitiCapital financing.

BT's response to DPS 4-41 (Exhibit LA-38) stated that:

> If the City continues as the lessee and meets its lease payment obligations, there is no term of the lease that would specifically preclude the reimbursement of the debit to pooled cash. Under the terms of the lease, the above question is speculative and cannot be readily addressed.

As described elsewhere in this report, BT has experienced difficulties meeting its payment obligations under the terms of the CitiCapital lease financing. BT appears to be in serious jeopardy of defaulting on that lease, if it is not already in technical default on the lease. We are advised that BT and the City are in negotiations with CitiCapital wherein the City and BT are attempting to restructure the CitiCapital lease financing. We are uncertain regarding the current status or the outcome of such negotiations to restructure such financing.

Conclusions

BT appears to be current on its obligations to vendors. However, it is delinquent on the amount due the City as required under Condition No. 60. In addition, as noted elsewhere in this report, while BT is not "invoiced" for labor charges, BT's recording of labor charges and interest charges on its books has in some instances been delayed by several months. While this may be viewed as an advantage to BT, it means that BT's accounting records are not current.

BT has experienced problems making payments due on the $33.5 million lease financing that it has obtained from CitiCapital. We are advised that BT and the City are in negotiations with CitiCapital wherein the City and BT are attempting to restructure the CitiCapital lease financing. Absent a favorable resolution in restructuring the current obligation due CitiCapital, we believe the City of Burlington and the taxpayers of the City are at significant risk if BT were to default.

J. City of Burlington's Pooled Cash management system and its cash flow funding of BT from BT's inception to current

The funding of BT through the Pooled Cash fund and the management of the City's pooled Cash is discussed in Section A through D and Section G. As part of our investigation we reviewed the audit workpapers of Sullivan, Powers & Co. (SPC), the City's independent auditors. As part of the review we identified certain documents for copying and have included below quotes from and/or summaries of some of those documents. The review of the Sullivan, Powers & Co. financial audit workpapers for fiscal years ending June 30, 2007, 2008 and 2009 reveal that BT's negative Pooled Cash position and the need for BT to have a plan to pay back the negative

Pooled Cash was a significant financial consideration.

The following are observations, statements and/or areas of concern identified on various audit workpapers. The observations are by topic, by year and include excerpts or references from the years reviewed. The number of observations listed in the different audit program and risk assessment areas indicates the significance of the issue identified. In some instances we identified the key point in bold.

1. Negative Pooled Cash

The following are from the year ended June 30, 2007 SPC audit workpapers.[42]

- (PP-1203) which provided the audit planning for the fiscal year ending June 30, 2007:
    - "**Cash in Pooled account is very negative which [is] a violation of the CPG. No current plans to fund this negative. …"**

The following are from the year ended June 30, 2008 SPC audit workpapers.

- (PP-1201) lists significant financial considerations pertaining to the audit relating to BT issues for the fiscal year. For cash, the auditors listed the following as a significant financial issue, among other things: "**determine the plan to pay back the Negative pooled cash. Make sure the city can obtain financing to pay back the negative Pooled Cash**."

- (PP-1208) lists audit inquiries. Among the audit inquiries is item 9: "Refinance debt – **pay off negative pooled cash** – (Jonathon will get a letter from Municipal Leasing Consultants."

- (PP-1259) is part of an audit program that identifies items for consideration by the auditor. Item 11 is to "describe risks related to the entity's financing." The SPC notation for this item states as follows: "**Will financing be available to payoff the negative pooled cash** (Fred to discuss with Jonathon)."

- (PP-1265) is part of the auditor's risk identification. The risk identified on that page is: "**Pooled cash needs to be paid back**." This risk is identified as significant. The response listed for this risk is: "Partner will closely supervise and discuss with management."

- (PP-1266) continues the audit risk assessment summary. The audit area "Cash" is identified as a significant audit area. SPC's comments for this item state: "Only a few cash accounts. Most activity runs through pooled cash which is audited at the city level. (**Document how pooled cash will be paid back**.)"

- (PP-1236) provides the auditor's preliminary analytical review for 6/30/2008. Balance

[42] Emphasis has been added by Larkin & Associates unless stated otherwise.

Sheet item #1 states that: "**Pooled cash is still negative after the refinance? We will need to evaluate the ability to pay back general fund and overall evaluation of any potential going concern issues**." This will be done by the engagement partner (Fred Duplessis)."

- ? (PP-1290) has additional details regarding the control deficiency comment and **management point development related to BT's having unrepaid negative Pooled Cash**. Under "criteria" this workpaper states that: "Internal controls should be in place to ensure that the Burlington Telecom's pooled cash is positive, so the public's funds are not at risk." The "cause of condition" is stated to be that: "**No internal controls [are] in place to ensure that Telecom has a positive pooled cash** by requiring Telecom to get a Revenue Bond instead of using the public's funds." The auditor's recommendation for BT's negative Pooled Cash situation is stated: "We recommend Burlington Telecom implement a policy that requires them to get a Revenue Bond instead of having negative pooled cash and putting the public's funds at risk."

- ? (PP-1328 and 1329) contain a letter dated April 3, 2009 from the SPC audit partner, Fred Duplessis, to Jonathon Leopold, the City Treasurer, expressing the auditor's concerns regarding certain issues at BT. That letter notes, among other things, the following:

  - o "**The CPG also appears to restrict the City's use of its pooled cash account for Burlington Telecom if Burlington Telecom cannot reimburse the City within two months of the City's expenditure of funds for Burlington Telecom. Burlington Telecom has not reimbursed the City within this timeframe**."

  - o "This also has an accounting implication. **If Burlington Telecom cannot reimburse the City's pooled cash account, then, under GASB standards, the negative pooled cash balance would be treated as a transfer from the General Fund. This would have a significant negative impact on the General Fund**."

- ? (A-1211) provides a letter dated June 12, 2009 from Renee M. Piche, President of Municipal Leasing Consultants to Mr. Jonathon Leopold, Chief Administrative Officer, that states as follows:

  - o "This is to confirm that the City of Burlington has engaged Municipal Leasing Consultants for a lease purchase financing for Burlington Telecom's Fiber Optic Project."

  - o "We are confident we can secure financing for this project."

  - o The auditor handwritten notes on this letter state as follows: "**will be used to pay of negative pooled cash and finish the build out**."

The following are from the <u>year ended June 30, 2009</u> SPC audit workpapers.

- ? (GEN-1217) lists "significant financial considerations."
  Under the item "Cash" the work paper states as follows: "**Evaluate the activity of the Escrow funds, make sure to disclose restricted cash**. And **determine the plan to pay**

back the Negative pooled cash. Make sure the city can obtain financing to pay back the negative pooled cash. Also the city subsequent to year end stopped the process of utilizing pooled cash. Evaluate the new process." For the area "Debt" the work paper indicates as a significant policy consideration that there is "no subsequent debt although they are in the process of looking for additional financing to finish the project and payoff the Negative pooled cash."

- (GEN-1218) contains, among other things, the following planning note for the audit of BT areas for the fiscal year ending June 30, 2009: "Evaluate the Payback of negative pooled cash to the city General fund. Document the results in a memo."

- (GEN-1239) listed, among other things, the following items under Audit Inquiries: (9) Refinance debt – **pay off negative pooled cash** - (Jonathon will get a letter from Municipal Leasing consultants)". See PP-1208 above for June 30, 2008.

- (GEN-1246) contains item 11, which is to: "Describe risks related to the entity's financing." Under this item, SPC has noted the following: "Will financing be available to payoff the negative pooled cash (Fred to discuss with Jonathon?)" See PP-1259 above for June 30, 2008.

- (GEN-1253) The risk identified on that page is: "**Pooled cash needs to be paid back**." This risk is identified as significant. The response listed for this risk is: "Partner will closely supervise and discuss with management." See PP-1265 above for June 30, 2008.

- (GEN-1254) The audit area "Cash" is identified as a significant audit area. SPC's comments for this item state: "Only a few cash accounts. Most activity runs through pooled cash which is audited at the city level. (**Document how pooled cash will be paid back**.)" See PP-1266 above for June 30, 2008.

- (GEN-1264 and 1265) contain the auditor's preliminary analytical review, based in part on the comparison of account balances to prior year. Balance Sheet item 1 concerns Pooled Cash and states as follows:

  - "1) Pooled cash is still negative[.] It went from negative $8,655,180 in 2008 to $15,861,906 in 2009. **We will need to evaluate the ability to pay back general fund** and overall evaluation of any potential going concern issues. This will be done by the engagement partner (Fred Duplessis)."

<u>2. Recognition of and Concerns Regarding CPG Compliance.</u>

The following are from the <u>year ended June 30, 2007</u> SPC audit workpapers.

- (PP-1203) which provided the audit planning for the fiscal year ending June 30, 2007:

  - "**Cash in Pooled account is very negative which [is] a violation of the CPG. No current plans to fund this negative. …"**

- ? (PP-1205) has various handwritten notations, including the following:
  - o "Cert of Public Good is in place for years (They believe the violations of CPG could lead to potential fines) (not material to the city F/S)"

The following are from the year ended June 30, 2008 SPC audit workpapers.

- ? (PP-1293) finds that there are "**no internal controls in place to ensure they have monitoring compliance with CPG**" and describes this condition as: "There is no monitoring compliance with CPG."

The following are from the year ended June 30, 2009 SPC audit workpapers.

- ? (GEN-1219) addresses telecom audit planning and has auditor notes from meetings and discussions with BT. The page included, among other things, the following item:
  - o "8) No modifications or Amendments to CPG. (The current CPG violations are to conditions 60 and 17 which have been well documented. Newer concern areas are related to Condition 3 (Catch all) and condition 18 (which is technical in nature and relates to set top boxes and digital testing for Analogue) … (**Subsequent to year end the pooled cash has been frozen and they have been borrowing from General fund but paying it back within a 60 day period as required by the CPG**. There has been no discussions or mention by PSB of fines to BT. …"

- ? (GEN-1243) continues the audit risk identification checklist.
  - o Item 3 is to: "Describe risks related to the regulatory environment." Under this item, SPC has noted that: "Burlington Telecom needs to be in compliance with the certificate of Public Good" and "Many issues with CPG compliance (See electronic file on PSB correspondence and questions)."
  - o Item 4 is to: "Describe risks related to the economic, political, or social environment." Under this item, SPC has noted that: "No Specific Risks were identified other than the negative issues related to viability and PSB compliance."

3. Source of Pooled Cash Funds

The following are from the year ended June 30, 2007 SPC audit workpapers

- ? (A-1200) shows the City of Burlington Pooled Cash Balances on June 30, 2007. On that date BT had negative Pooled Cash of $5,160,353. As of that date, the departments with the three largest cash surpluses were Fund 4400, Airport, with a cash surplus of $8,445,760; Fund 2110, the School Department Fund, with a surplus of $5,449,244; and fund 1001, the General Fund, with a cash surplus of $5,193,948.

The following are from the year ended June 30, 2008 SPC audit workpapers.

- (A-1207) shows the City of Burlington Pooled Cash at 6/30/2008. At that point, BT's net cumulative draw on the Pooled Cash fund is $8,655,180.[43] As of that same point in time the largest two suppliers of cash into the Pooled Cash account are the Airport (fund 4400) for $7,720,823 and the School Department Fund (fund 2100) for $5,438,172.[44]

The following are from the year ended June 30, 2009 SPC audit workpapers.

- (A-1201) (2 pages) summarizes the Pooled Cash fund position as of June 30, 2009. As of that date BT's (i.e., fund 4383) cumulative draw is $15,467,333. The three entities with the largest Pooled Cash surpluses at June 30, 2009 are, the Airport (fund 4400, with a cash surplus of $10,423,292) ; the General Fund (fund 1001) with a cash surplus of $6,049,426); and School (fund 2110, with a cash surplus of $5,146,347).

4. BT as a Going Concern

The following are from the year ended June 30, 2008 SPC audit workpapers.

- (PP-1261) continues the audit checklist. Item 18 for the auditor's consideration is to: "Describe any conditions that may cause doubt about the government unit's ability to continue as a going concern that could affect the risk of material misstatement of the government unit's financial statements." Under this item, SPC's notation states: "Financing issues and cash flow issues but not yet a going concern issue."

The following are from the year ended June 30, 2009 SPC audit workpapers.

- (GEN-1218) contains, among other things, the following planning notes for the audit of BT areas for the fiscal year ending June 30, 2009:

  - "No need to Evaluate the Telecom for going concern (GASB dictates that this is done at the entity level not the separate opinion units). Section 13.15 of the audit guide."

- (GEN-1219) addresses telecom audit planning and has auditor notes from meetings and discussions with BT. The page includes, among other things, the following items:

  - "4) In Governmental Auditing going concern is evaluated on an entity basis not a department basis. For this reason there will be no issues related to going concern."

- (GEN-1242) is part of the audit risk identification form. For structure and governance, item 1 is to: "Describe risks related to the entity's structure and governance." SPC's notation under this item states that:

  - "**Activities are problematic related to entity sustainability**[;] the organization

[43] BT is listed there as Fund 4383.
[44] As noted elsewhere in this report, the specific sourcing of cash into the Pooled Cash account varies over time.

will hire experts to review the business plan [to] determine if telecom can move forward. (According to the audit guide the going concern issue is addressed at the entity level not the department of fund level)."

- ? (GEN-1248) contains item 18, which is to: "Describe any concerns identified that may cause doubt about the governmental unit's ability to continue as a going concern that could affect the risk of material misstatement of the governmental unit's financial statements." Under this item, SPC has noted the following:

  - o "Financing issues and cash flow issues but not yet a going concern issue."

  - o "Audit guide notes the evaluation is at the entity level which for the city of Burlington is not an issue."

- ? The remaining 3 pages of unnumbered workpapers relate to the auditors consultation regarding a possible opinion qualification related to the uncertainty of BT's ability to repay the City's Pooled Cash deficit. The auditors recognized their inability to determine if and when the interfund loan (from Pooled Cash) can be repaid by BT.

5. Vendor and Internal Control Issues

The following are from the year ended June 30, 2008 SPC audit workpapers.

- ? (PP-1294) identifies the following condition: "Burlington Telecom has an outside company named Eustis Cable do their new drops (installations) and repairs. They have **no internal controls in place that require them to review each invoice and capitalize the portion related to installations and expense the portion related to service calls**. During the audit, they reviewed each invoice and capitalized the portion related to installations and expense the portion related to service calls." The recommendation for this item states: "We recommend Burlington Telecom implement internal controls that require they review Eustis Cable bills and code the repairs to an expense account and capitalize the new installations only.

The following are from the year ended June 30, 2009 SPC audit workpapers.

- ? (GEN-1218) contains, among other things, the following planning notes for the audit of BT areas for the fiscal year ending June 30, 2009:

  - o "Make sure PPE is not overstated. (In the past management has had accounting issues for service call being included in the Capitalized PP&E. This needs to be evaluated. Also make sure for new hook ups that are for location already set up that any costs do not get capitalized."

- ? (GEN-1220) The discussion of preliminary analytical results notes that BT's Accounts Receivable ("A/R") general list includes a vendor double payment for $40,000, which is a management letter point and potential risk factor.

- ? (GEN-1239) Under "Revenues" the workpaper notes that in terms of the allowance for doubtful accounts **BT has "not written any one off – allowance is [sic] not been evaluated seriously."**

? (GEN-1245) item 8 is to: "Describe risks related to the entity's major assets and liabilities." Under this item, SPC has noted the following:

  o "Audit Concern that allowance for D/A [doubtful accounts] for A/R [accounts receivable] has not been evaluated in depth."

  o "Some issues related to capitalization (Eustis bills) Etc. (useful lives evaluation)"

  o "Revenue recognition for Hook on fees."

? (PP-1280) describes a management letter point about BT paying an employee as a contractor rather than going through the payroll system.

? (IC-I1200 through IC-I1202) provide the auditor's fixed assets memo for the fiscal year. The workpaper describes how Eustis Cable began in fiscal year ending June 30, 2009, invoicing for service and repair calls separately from installation work at BT's request. Prior to October 2008, Eustis was not invoicing separately and BT staff had to analyze the bills and separate the repairs and capital items, which was done via a journal entry.

? (IC-I1201) under "Depreciation and Impairment" notes concerns with that area including that "**there is no asset inventory schedule by serial number to track accountability** nor is there any means to identify disposals to adjust the asset accounts or depreciation schedule."

? (IC-I1203 through I1207) relate to auditor investigation of the PPE question concerning reconnects and issues relating to accounting for billings from Eustis Cable, including the issue of whether the capitalization of such costs had been overstated. Work paper I-1205a, for example, states that:

  o "An extensive review of contractor invoices from Eustis found errors resulting in a credit of $130,825. This credit was recorded in Accounts Receivable for FY09 and a reduction made to the fixed assets and accumulated depreciation. BT does not currently track, or have an automated process, to track existing services that terminate and reconnect and whether the reconnect initiates a service upgrade. Currently when an installation technician is dispatched the total cost of the installation fee is capitalized. We are reviewing this process and will determine if any 'classification units', or a percentage of such, should be considered as operating expenses. This decision will be made for all applicable expenses in FY10. Beyond FY10, we are in discussions regarding the possibility of bringing future installations in house."

  o "The current process and documentation of existing drop added value work can't be specifically identified from the existing documentation. There is no specific information being generated from the work order that provides for determination of added value. During the course of Eustis Bills evaluation for overpayment the BT staff determined that only $42,700 of that kind of potential adds value was in the invoices. Some of this $42,700 did add value to the drop."

- o "BT staff will perform … several tasks to calculate an estimate of the amount of 2009 in capitalized costs for this issue."

? (I-1211) (2 pages) identifies equipment that BT had purchased that was not in service as of June 30, 2009. The amount of capitalized items not in service at June 30, 2009 was $923,144, and was removed from the depreciation schedule. The auditors determined that the amount not in service of $923,144 "appears reasonable based on the quantities noted … and the per unit cost of these items."

? An unnumbered audit work paper consisting of an email dated 3/24/2010 indicates that BT was creating an expense account for the Eustis "D" units and would be transferring the $101,896 out of the capital program and into account 43004.65812.

6. General Issues

The following are from the year ended June 30, 2008 SPC audit workpapers.

? (PP-1224) presents background on BT.[45] This page states that: "Although we are a City Department, the network is privately financed and **clean of any taxpayer contributions**."

? (PP-1229) is part of a Burlington Telecom Case Study, dated August 2007. This page indicates that the legislation enacted into law on May 29, 2000 **(H.856)** forbade Burlington from supporting any telecommunications network expenses with income from the BED and **required the City to finance BT's network in such a way that taxpayers, the state of Vermont, and Electric Department ratepayers could not be burdened with either debt, or losses arising from the network**. In other words, any risk from building the network must be borne by outside vendors. This page also lists BT's four goals. **BT's fourth goal is to be "financially self-sustaining – financed by users, not taxpayers**."

? (PP-1280) lists a number of management letter points.[46] One of the points concerns negative pooled cash and states: "**they should get a revenue bond instead of using public money**."

? (I-1223) summarizes the CitiCapital acquisition and reserve accounts from August 2007[47] through July 1, 2008. The CitiCapital acquisition account was drawn down from

[45] This information was apparently derived from BT's web site at http://www.burlingtontelecom/net/aboutus/ on 3/26/2009.
[46] Section M-1 of this report discusses a number of significant management letter points identified by the auditors, including significant deficiency items that have recurred year after year.
[47] Workpaper I-1223 lists the opening balance (or "receipts") for each of these accounts as of the date 8/17/2008; however, the 2008 appears to be a typographical error, as the CitiCapital financing commenced in August 2007. Using an opening balance date of 8/17/2007 also makes the date sequence shown on the workpaper consecutive, whereas a date of 8/17/2008 for the initial receipts would be those in the wrong year.

$10,531,514 on August 17, 2007 to $125,803 on July 1, 2008. The CitiCapital reserve account started with receipts of $1 million on August 17, 2007 and, with accrued interest through June 30, 2008 showed a balance of $1,022,671 on July 1, 2008.

? (I-1243) (2 pages) describes the extended procedures applied by the auditors relating to Eustis Cable invoice coding.

? (K-1208) summarizes how the CitiCapital lease purchase financing, totaling $33.5 million was utilized to repay and refinance the previous Koch lease purchase financing.

The following are from the year ended June 30, 2009 SPC audit workpapers.

? (GEN-1239) listed, among other things, the following items under Audit Inquiries: "(8) **Update last year ml [management letter] points (very few changes**)"

? (GEN-1264) Balance sheet item 2 concerning the use of a lease escrow account to reduce a lease interest payment:

  o "2) **Capital escrow cash appears to be restricted** – need to evaluate for presentation and disclosure."

  o "The $125,809 Acquisition escrow account was used to draw down the lease proceeds since inception and this remaining balance was used subsequent to year end to reduce a lease interest payment. **The other Escrow account is required to have a 1 million balance as long as the lease is outstanding.**"

? The workpapers also pose questions raised by the auditors related to the accounting for interfund transfers of the municipality and refinancing of debt and states in part that:

  o "The City's General Fund 'lent' an enterprise fund, through its pooled cash program, a significant amount of money which was to have been 'repaid' when the enterprise fund refinanced, and added to, existing debt."

  o "Because of regulatory issues, questions regarding the enterprise fund's ability to support the total debt and a pending lawsuit, the City cannot refinance at this time. **Under GASB standards, the City would be required to record the interfund loan as a transfer to the extent that it will not be repaid**. The City cannot provide any verifiable evidence, at this time, as to what, if any, that amount will be."

  o "We know that our opinion on the General Fund and governmental activities of the government-wide financial statements would be qualified. Our second opinion is whether we could issue a clean opinion on the enterprise fund, since it does owe the full amount, and the business-type activities of the government-wide financial statements."

? A later page apparently provides the answers to the questions posed above. With respect to the second question, the handwritten note says: "No – should qualify for both as are interrelated – the amount is material for both funds."

As shown in Exhibit LA-1, BT's Pooled Cash fund from July 2005 through June 2010 was negative and there was no payment made during that period that would have put BT in compliance with Condition No. 60. The SPC workpapers noted above identified the fact that the negative balance was a serious concern and that it was identified as a violation of the CPG.

BT's Exhibit Response to DPS 4-4[48], shows BT's cash expenditures and revenue from July 2004 through December 2009. As noted in "BT's Summary of Revenues and Expenses by Fiscal Year" as shown in Section A, page 11, the results of operations continue to reflect losses in each year. The losses should have been a signal to management that revenues were not sufficient to cover both operations and debt coverage.

In Sections A and B, Larkin discussed BT's non-compliance with Condition No. 60 and identified accounting issues that would have impacted the noncompliance had the accounting records been properly maintained. Larkin also questioned whether BT did know about its non-compliance prior to November 2008 as was asserted by BT. Sections C and D above discuss the source of the funds and the repayment, and BT's inability to identify what was paid and whether the payment was principal and/or interest. In Section E, Larkin addresses the concerns with BT and the City's continued optimism that ignored the losses and the growing negative Pooled Cash fund balance. Section E also notes other opinions from various parties investigating the viability of BT. In Section M, Larkin discusses accounting concerns identified and the lack of controls at BT. All the discussions focus on the management of the Pooled Cash fund and the oversight of the build out of the BT system.

Conclusions

BT's draw on the City's Pooled Cash management system has stabilized at approximately $16.9 million through June 30, 2010. However, if BT were not part of and supported by the City there would be going concern issues with respect to BT. Neither BT nor the City has demonstrated that BT has the ability to repay the $16.9 million it has drawn from the Pooled Cash fund in violation of Condition No. 60. BT became noncompliant with Condition No. 60 because there was insufficient oversight and application of controls during the start-up and build out. Despite many warning signs, such as insufficient revenues and excessive expenses that resulted in operating losses, BT continued to forge ahead as if there was no end to the funding for the project. Despite warnings of violations and questioning of expenses the process continued as if there was no need for concern. Despite the growing negative balance in the Pooled Cash account BT just kept on spending. The concerns and issues identified by Larkin have been affirmed by the Blue Ribbon Committee, the consultants hired by the City to review BT's issues, and by the City's independent auditor.

K. Whether BT actually expended the funds drawn from the Pooled Cash fund and the purposes for which such funds were expended

[48] See Exhibit LA-23.

Larkin's review of vendor payments, manual checks, journal entries and the general ledger served as the basis for addressing this question. BT has expended the funds obtained through external financing as well as the funds it has drawn from the Pooled Cash fund on a combination of capital expenditures, operating expenses and financing costs, including interest on externally sourced financing.

Exhibit LA-2 summarizes the activity of BT's general ledger from June 30, 2005 through June 30, 2010. As shown on Exhibit LA-2, BT has used the proceeds from the Pooled Cash fund and the additional debt obligation to finance the plant additions and to pay for operating expenses. BT's unaudited general ledger for the fiscal year ending June 30, 2010 shows that BT has recorded debt to CitiCapital of $33.5 million. That debt, plus BT's Pooled Cash debit of $16.9 million, equals $50.4 million of debt as of June 30, 2010.

BT's audited general ledger for the fiscal year ending June 30, 2005 showed a notes payable balance of $12.6 million and a Pooled Cash balance of $1.7 million equaling $14.3 million of debt as of June 30, 2005. In comparing these balances recorded in BT's general ledger as of the two dates, (1) June 30, 2005 (which represents audited information) and (2) June 30, 2010 (for which there is not yet an audit report), we can observe that BT's debt increased by $36.1 million over 5 years ($50.4 million at June 30, 2010 less $14.3 million at June 30, 2005)[49]. The net increase represents funds utilized by BT during the period under review.

As of June 30, 2005, BT had $8.1 million of temporary investments and as of June 30, 2010, BT had $0.2 million in escrow. During the period under review, BT's investments/escrow funds balances decreased by $7.9 million ($8.1 million to $0.2 million). Between June 30, 2005 and June 30, 2010, BT had a net increase of funds available for investment in plant and operations of $44 million. The $44 million of combined funds is made up of the $36.1 million net increase in debt and the $7.9 million decrease in investments/escrow funds.

As of June 30, 2005, BT had gross plant of $4.5 million and as of June 30, 2010, BT had gross plant of $37.8 million. Based on that comparison, BT's gross plant increased by $33.3 million ($37.8 million at June 30, 2010 less $4.5 million at June 30, 2005).

During the same time period, the changes to the fund balance and the amount of depreciation that BT has recorded were identified to determine the level of funds required for operations. As of June 30, 2005, BT had a negative fund balance of $2.1 million. As of June 30, 2010, BT's unaudited general ledger shows a negative fund balance of $18 million. In comparing the year end amounts, BT's negative fund balance over the five year period increased by $15.9 million. Since depreciation expense increases the annual losses incurred by BT, and depreciation is a non-cash expense, the depreciation must be removed from the change in the negative fund balance to determine the amount of cash required to meet operating expenses. During that time period, the reserve for accumulated depreciation increased $5.5 million from $0.4 million on June 30, 2005 to $5.9 million on June 30, 2010. The result is a negative fund balance increase of $10.4 million ($15.9 million less $5.5 million of depreciation) which is BT's payment of operating expenses in excess of BT's revenues.

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[49] As noted elsewhere in this report, BT has indicated that it does not view the amount of BT draw from the Pooled Cash fund as debt. That BT/City view, however, is not realistic as the BT draw from the Pooled Cash fund, especially when it has not been paid back within 60 days, is clearly an obligation from BT to the City and should therefore be classified as an amount of debt owing from BT to the City.

The $44 million of increased debt and draw down of investments/escrow was used to increase gross plant by $33.3 million and expended on $10.4 million of operating expenses. The remaining difference of approximately $0.3 million ($44 million less the $33.3 million spent on plant and the $10.4 million spent on expenses) represents other changes to the balance sheet.

BT has relied on the $33.5 million of external financing from the CitiCapital lease arrangement and the $16.9 million of borrowing from the Pooled Cash fund to fund the plant additions and pay operating expenses because BT's revenues were not sufficient to meet even the cost of operations during this five year time period.

The following table summarizes BT's net cash outflows for the fiscal years ending June 30, 2007 and 2008:

BT Expenditures in Excess of Revenue

	FYE 6/30/2007	FYE 6/30/2008
BT Accounting Period:	13/07	13/08
REVENUE STATUS REPORT		
43001 Phase I - Municipal	$ 266,510	$ 355,068
43002 Phase II - Commercial	$ 152,460	$ 191,470
43003 Phase III - City-Wide	$ 1,243,128	$ 2,868,383
TOTAL	$ 1,662,098	$ 3,414,921
EXPENDITURE STATUS REPORT		
43001 Phase I - Municipal	$ 586,159	$ 600,893
43002 Phase II - Commercial	$ 81,002	$ 90,704
43003 Phase III - City-Wide	$ 4,711,517	$ 7,598,077
TOTAL	$ 5,378,678	$ 8,289,674
NET REVENUE (LOSS) CALCULATED		
43001 Phase I - Municipal	$ (319,649)	$ (245,825)
43002 Phase II - Commercial	$ 71,458	$ 100,766
43003 Phase III - City-Wide	$ (3,468,389)	$(4,729,694)
TOTAL	$ (3,716,580)	$(4,874,753)

Source:
BT Exhibit Response DPS 3-115

Based on the response to DPS 1-30 and the audited June 30, 2009 financial statements, the following table summarizes the amount of net loss BT has recorded in each year for which audited financial statement information is available:

FY2005	$(1,071,103)
FY2006	(1,639,688)
FY2007	(3,716,581)
FY2008	(4,874,754)
FY2009	(4,195,627)

Conclusions

Based on BT's operating results, the increase in plant as recorded on BT's books and our sampling of invoices, we believe that BT expended the funds obtained from the $33.5 million of CitiCapital lease financing and the $16.9 million cumulative Pooled Cash fund draw on a combination of plant additions, debt restructuring and operating expenses.

In each year of its existence, BT's revenues from the provision of service have been insufficient to cover its costs, and BT has incurred a net loss. The funds to finance those losses were from the cash advances from the Pooled Cash account and/or debt proceeds from financing.

We have serious going concern issues regarding BT's ability to operate viably under its current situation as a City enterprise. If BT were to cease operations, it is questionable whether it would be able to recover the costs it has spent building the system and recoup the operating losses that contributed to the Pooled Cash obligation to the City. Absent some sudden and extreme change in operations and debt restructuring, we believe that the City and its taxpayers are at risk.

L. Concerns regarding BT's accounting

There are a number of concerns regarding BT's accounting. This discussion is organized into three major areas:

1. Management letter issues - material weaknesses and other significant deficiencies in internal control.

2. Issues with lack of controls over vendor contractors and other Plant Build-Out spending.

3. Issues with BT's delayed or erroneous recording of costs.

1. Management letter issues - material weaknesses and other significant deficiencies in internal control

For each of the fiscal years ending June 30, 2007, 2008 and 2009, Sullivan, Powers & Co. (SPC), the City's independent auditors, audited the financial statements of BT and uncovered material weaknesses and other significant deficiencies in internal control, which SPC appropriately reported to the City in SPC's management letters. A copy of SPC's management letters to the City for the fiscal years ending June 30, 2007, 2008 and 2009 are attached to this report as Exhibits LA-41, LA-42 and LA-43.

Below are the recommendations made for the years ended June 30, 2008 and June 30, 2009. Recommendations from the year ended June 30, 2007 were essentially repeated in the years ended June 30, 2008 and June 30, 2009. A number of these issues concerning significant deficiencies in internal control have recurred over a three-year period which is a cause for concern.

The following issues were documented in the Schedule of Significant Deficiencies and Recommendations for the Year Ended June 30, 2008:

? The City's cost allocation plan does not appear to be updated when changes occur. (This was reported in all three years.)

? The City's financial information is distorted during the year because Capital Projects Funds are not reconciled on a timely basis. (This was also reported in the following year.)
? Internal controls are not in place to ensure that each department is following the City's procurement policy. (This was reported in all three years.)
? Interdepartmental activity - The City writes numerous checks to itself to pay interdepartmental invoices and records interdepartmental activity by posting journal entries. To reflect amounts owed to or from other departments at year end, the City records accounts receivable and accounts payable at year end. (This was also reported for the following year.)
? Telecom Fund Salary Allocations - payroll charges were allocated between phases based on predetermined phases instead of actual time spent. (This issue has persisted from the prior year.)
? The Telecom fund is lacking controls regarding monitoring and documenting compliance with the CPG. (This was reported in all three years.)
? The City lacks an accounting and procedures manual for all City Departments. (This was reported in all three years.)
? The City could be unaware of fraudulent activities because it has not performed a fraud risk assessment. (This was reported in all three years.)
? Internal controls relating to all aspects of general journal entries are inadequately designed and inconsistently applied. Several journal entries were either not approved or processed incorrectly. (This was reported in all three years.)
? The potential for errors exists in the Telecom Department's billing master files because internal controls are not sufficient to prevent unauthorized changes. (This problem was also reported in the previous year.)
? Telecom Fund Indebtedness - the amount of borrowed funds invested in capital assets were not tracked by the City. (This issue was reported in all three years.)
? The City lacks a formal investment policy.
? The City's Pooled Cash account did not reconcile as of June 30, 2008.
? The City was not able to explain why certain funds in the Pooled Cash account were not having interest allocated to them.
? The Telecom Fund lacks policies and procedures related to revenue assurance auditing.
? The Telecom Fund operates under a Certificate of Public Good. It is recommended that the City obtain a legal opinion on whether or not the use of Pooled Cash is a violation of the CPG.

The following issues were documented in the Schedule of Significant Deficiencies and Recommendations for the Year Ended June 30, 2009:

? The Telecom Department overpaid vendors for video provisioning services because it lacks controls that ensure that these payments are reconciled to reports that have been verified to be correct.
? Internal controls over the preparation and review of spreadsheets are inadequate. (This was also reported in the previous year.)
? The Telecom Department overpaid installation contractors due to a lack of controls to ensure that invoices are analyzed properly before payment.
? During the year, the reports of the City's financial position are inaccurate because a system is not in place to record all receivables on a timely basis.

- ? At fiscal year-end, BT's deferred revenue was misstated because controls are not in place to ensure that deferred revenue is recorded accurately.
- ? BT has left assets susceptible to the risk of misappropriation due to a lack of controls segregating incompatible duties.
- ? The City needs to explain how BT allocates telephone and data costs across all departments to be in compliance with the Certificate of Public Good.
- ? Internal controls over the reporting of property, plant and equipment were inadequate. (This issue has persisted after being identified in previous years.)
- ? The Telecom Department could reduce the number of outstanding balances by performing credit checks on customers prior to performing services.
- ? Fees for the Telecom Department may not be set in accordance with the City's objectives because they are set and approved by the Department.
- ? There is a lack of internal controls regarding the review of billing adjustments and documentation of the review of service credits performed by the Telecom Department.
- ? The City lacks a centralized system in place to record all receivables on a timely basis.
- ? The Telecom Department lacks controls ensuring that billings are reconciled to the general ledger in a timely manner.
- ? The Telecom Department lacks controls segregating the duties of resolving accounts receivable disputes and posting customer payments to the account if the account number was not known by the service organization and these entries are not reviewed.
- ? The Telecom Department lacks an accounts receivable list for carrier access billings.
- ? An invoice of approximately $40,000 was paid twice due to lack of controls over disbursements.
- ? The Telecom Department staff lack training and resources related to accounting for telecom companies.
- ? The Telecom Department is paying an employee as a subcontractor instead of through the payroll system in violation of IRS regulations.
- ? The Telecom Department is lacking formal capitalization policies and procedures.
- ? The Telecom Department is lacking depreciation software that would allow the disposal of individual assets that may be lost, destroyed or sold.
- ? The Telecom department lacks a policy that would require that useful lives of capital assets be reviewed for depreciation purposes.

<u>2. Issues with Lack of Controls Over Vendor Contracts and Other Plant Build-Out Spending</u>

Larkin performed two on-site reviews to analyze the City's accounting records, and to review supporting documentation. The second on-site review included a review of the work papers of the City's outside auditors relating to the audit of BT and selected City audit aspects that could impact BT. The first review was performed from February 9, 2010 through February 11, 2010. The second review was performed from September 20, 2010 through September 22, 2010.

During the reviews it was noted that the internal controls and oversight of approvals of BT's expenditures were considered to be weak. BT's failure to record information in a timely manner was identified as a significant concern because the lack of timely accounting results in inaccurate accounting during the interim periods of the fiscal year. Inaccurate accounting information can impact financial decisions.

As of June 30, 2005, the audited general ledger had plant and equipment, including construction work in progress, of $4,479,574. The June 30, 2010, unaudited general ledger had plant and equipment, including construction work in progress, of $36,224,622. In a five year period plant increased $31,765,048. There will be other additions from the June 30, 2010 "period 13" entries.[50]

The initial review process began with a selection of vendor payments, journal entries and manual checks to be made available for detailed review. Upon receipt of the lists, specific vendor payments were requested to be available but BT was informed that all payments on the dates selected for review would be subject to analysis. The requested information was provided by the City.

In reviewing the documents on-site, it was noted that costs were being coded to expense control accounts that were for capital project costs. The costs reflected in these accounts would be later transferred to capital accounts. The first concern identified is that a variety of costs that were expense items were being charged to the capital accounts 73970 through 73981 with the majority being charged to account 73973, Capital-Citywide Phase 3. Items such as software license fees that occur annually, computer supplies, minor material purchases (that were expensed in other months) and trash removal were being charged to account 73973. The level of expenditure did not appear to matter. For example the March 13, 2009 payments included $7.80 for PC Parts that were charged to account 73977.

A vendor that was selected by BT for installation services was also providing repair services. The repair services were being capitalized the same as the capital installation work. It should be noted that in the fiscal years ending June 30, 2008 and 2009, BT recorded some adjustments to remove some repair costs that had been improperly capitalized.

An inquiry was made by Larkin as to who was coding the account information for BT's purchases, and it was indicated that an individual from a temporary employment agency was performing this function. The individual recording these costs on BT's books was a temp for an extended period of time.

The next concern was why the person charged with approving the payment of the costs allowed the accounting coding problems noted. The person approving the payments was an outside consultant hired by the City to oversee the project and operations of BT. The consultant was asked about the questionable coding and he replied "I am not an accountant." It was also noted that the consultant used by BT was approving the payment of his own invoices.

Upon further inquiry, it was revealed that, beginning in October of 2008, department managers were to be responsible for account distribution and approval of invoices. Our review noted that this change in fact appeared to have occurred except that the consultant, also BT's general manager, continued to approve his own invoices. The problems noted are considered to be significant internal control issues.

Another concern involved expenditures being made for the system expansion. Oversight and control of such project spending appears to have been limited. BT relied primarily on an independent contractor and various sub-contractors for the installation of the fiber pass lines, and

[50] BT records some of its expenditures monthly, i.e., with the months representing periods 1 through 12 of the fiscal year; adjusting and correcting entries are recorded by BT in "period 13." The "period 13" entries can occur several months after June 30, the ending date for the fiscal year.

this was only a portion of the total system expansion. A summary of the primary contractor's costs as reported in the Final Inventory Telephone Construction Contract is attached in Exhibit LA-3. It should be noted that the actual payments to this vendor, as shown on Exhibit LA-4, exceeded the Final Inventory Telephone Construction Contract. This primary contractor was to be monitored by another contractor that was specifically selected for oversight of the project and approval of payments to the fiber pass line contractor. The pass line contractor, Tel Power, and the contractor providing the oversight, Communications Consulting, accounted for approximately $11.333 million of the $31.765 million of plant additions between June 30, 2005 and June 30, 2010.[51] This represents approximately 36% of the plant additions since June 30, 2005.

Other costs for building BT's fiber-to-the-home system were primarily for improvements to buildings, equipment and customer connections. Monitoring of the customer connection work is a major area of concern. The City utilized one contractor in particular for connections and for repairs that were being charged as capital work. The contractor Eustis Cable received approximately $5.607 million for its services.[52]

As of September 30, 2009, BT had approximately 4,600 customers. Considering the customer base that BT has, the installation cost appears high. The costs charged by the customer connections contractor does not include equipment purchased and supplied by BT and any additional costs incurred for electrical service work performed for customers to be hooked up to the system.

The costs BT has incurred for other equipment purchases are also of concern because one vendor, Calix Networks Inc., provided a significant amount, approximately $4.7 million,[53] of the equipment purchases.

Through December of 2006, the contractor performing customer installations was primarily billing on what was identified as a fixed per-unit or per-install rate. An inquiry was made of BT's then general manager/contractor as of February 2010 as to what the per unit charge or per install charge was and whether there was a contract for this rate. The general manager indicated that he believed it was an hourly rate for both time and material. It was indicated that he did not know of any contract and believed that the rate was agreed on between the vendor and BT's previous general manager.

There were other miscellaneous charges for splicing, naps and various other services but the billing for these additional services was minimal in comparison to the install charges. Review of the supporting documentation attached to the vendor's invoice provided no additional insight into what was determining the number of installs or units being charged for.

Subsequently, BT entered into a contract with this same vendor that established a set fee structure for customer installations. The fee structure effective December 13, 2006 was modified in December 2007. The revised fee structure provided for significantly more service fees and most of the fees were at a higher rate.[54]

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[51] The June 30, 2010 information is from BT's unaudited general ledger and Exhibit LA-4.
[52] Per summary of costs by vendor, provided by BT during Larkin's first on-site visit to BT (Exhibit LA-4).
[53] Per summary of costs by vendor, provided by BT during Larkin's second on-site visit to BT (Exhibit LA-4).
[54] Per contracts provided by BT during Larkin's second on-site visit to BT.

Based on our review, we are concerned that this vendor's contracted fee structure may have resulted in some overlapping of fees and/or excessive fees. In reviewing the billing, we discovered that there is a fee for the connection whether it is an existing nap or a new nap, there is a configuration fee and there is an add on fee per unit equivalent to the hourly repair rate plus additional costs for boring and trenching. We have to question whether it is appropriate that the installation of a TV or a computer or a phone line or even a digital video recorder "DVR" is being charged at the equivalent of one hour of service. This is especially a concern if the cost is not passed on to customers at the time of installation via an installation fee. An additional concern exists regarding the hourly rate for service charged by Eustis. An RFP was issued for the installation services and the contractor selected appeared to have submitted rates that were in between the two other bids reviewed.[55]

The fee structure for Eustis Cable Enterprises as billed prior to December 2006 was at the rate of $125 per install. The billing identified it as installs. An example is a $17,500 billing dated 4/25/2006 listed 32 addresses but the billing was for 140 installs at $125 unit price. The detail listed 30 Nids ONU; 21 power supply; 18 phones; 27 TVs; 20 computers and 4 naps for a total of 120 possible connections. This discrepancy was not unusual in the review of the billings during this time period. Using the number of addresses, this billing averaged $546.88 per connection excluding equipment and any additional charges.

Adding to the concern were billings that had no back-up. An example was a 2/24/2006 billing for $17,937.50 for 143.5 installs at $125 each.

There is also a concern regarding what appeared to be duplicate billing. An invoice dated 3/1/2006 for $16,437.50 was for 131.5 installs at $125 each. The backup consisted of 2 sheets, one in landscape and one in portrait, but they both listed the same addresses, for the same date and the same installer. The total number of addresses was 12 and the actual number of connections was 53. Based on what appears to be a billing for 24 addresses, the average cost per connection was $684.90. However, since it appears that there was a double count, the average cost per address paid by BT was $1,369.80.

Under the new fee structure that applied after December 2007, the bills had a more detailed summary identifying the respective units of service. During this period what was being billed could be identified. The billing structure for December 2006 through 2007 had a number of added fees. The billings from December 2007 and after used the new fee structure also with certain added charges. A comparison of the fee structures is attached as Exhibit LA-6.

An invoice dated 6/14/2007 for $41,531.37 had 64 addresses listed averaging out to $669.90 per visit. An invoice dated 10/16/2008 that capitalized $35,739.00 of an invoice totaling $37,689.00 listed 79 locations with visits for an average cost of $452.39 per visit.

The additional detail on the 10/16/2008 invoices raises another concern. On the 10/16/2008 billing, it was noted that a new service was connected using the C-2 configuration and adding a TV. Based on the fee schedule and billing for that customer, the connection excluding equipment cost BT $895.00 ($575.00+$245.00+$75.00).

The cost to connect a customer, when added to the equipment costs and pass line costs

[55] Id.

apportioned to that customer, are significant on a per customer basis. Adding to the problem of BT having a high installed cost is the customer turnover, or churn, that occurs due to the number of temporary residents, such as college students, in the Burlington area.

Without an adequate margin and/or without BT charging the new customer for installation, and given the difference between the monthly fee charged the customer and the programming cost for that customer, recovery of BT's installation cost becomes problematic.

Another cost that BT incurs for connecting customers is the installation of an electrical outlet for the customer. Peck Electric was found to be a common vendor for this service. While not every new connection required this added cost of approximately $120 per visit, the sample of invoices selected did include a number of billings for this service being capitalized. This increases the installed cost of service that would need to be recouped through rates if BT were to become financially viable.

Some of the other equipment purchases that appear to be associated with customer connections include the NID or ONU attached to the house, power cords, set boxes, remotes and alarms. The purchases for BT's NIDs and ONUs appeared to be primarily from Optical Solutions and Calix.

Depending on the type purchased, the cost ranged from $380 to $437. Advance Media was a source for Set Top Boxes and remotes for approximately $135 each. While the contractor Eustis Cable is to be responsible for premise wiring, there are other components that BT provides that have not been included above.

As shown on Exhibit LA-4, other major cost contributors were the building improvements contracted primarily with David Clemons, approximately $834,000, and other equipment purchases primarily acquired from Advance Media Technology of approximately $1.124 million, and Calix of approximately $4.684 million.

Advance Media Technology was a source for BT's Top Boxes and remotes. A sampling of $207,378 of invoices identified purchases of 2,553 Top Boxes and a number of remotes. Additional invoices sampled totaled $22,034 for other equipment. The fact that much of our sample was specifically Top Boxes and remotes raises a concern regarding the approximately $895,000 not sampled. Considering the customer base of BT, the fact that Top Boxes were purchased from some other vendors and we identified 2,553 Top Box purchases as only being approximately 18% of the total cost paid to this vendor there is a concern as to what the remaining purchases were.

Calix was a source of equipment for making the connections such as ONTs, power cords, fiber drives, alarms and fiber cards. Attached as Exhibit LA-5 is a summary of the $3.506 million of invoices reviewed. Our analysis of these Calix invoices indicates that BT purchased 5,526 ONT 502 units, which is more than the number of customers BT has.

Adding to the concern with the number of identified purchases from Calix, is the fact that there were added purchases from other vendors for the same item. There were also a number of ONT 560 unit purchases made in 2009 from different vendors. Some of the added purchases from Optical Solutions of the same equipment are also listed on Exhibit LA-5.

Other large quantities that are of concern are the 5,305 ONT Enclosures, 6,077 Power Cords and

3,970 UPS Alarms. Also of concern is the number of fiber drives purchased when considering the size of BT's customer base. Our limited sample identified 53 drives priced at various costs per unit ranging from approximately $2,250 to $14,400.

We note that the City's independent auditors also examined the equipment that BT had purchased that was not in service. SPC audit workpaper I-1211 for fiscal year ending June 30, 2009, for example, noted that BT regularly purchases various equipment to be installed at a customer's location, in order to hook them up to the network. Each customer will have a box installed outside (a 560 or 504 module) and inside for cable (a set-top box). Accordingly, BT keeps a supply of these items on hand for setting up new customers. Since this equipment is an asset of BT, BT includes the cost in its fixed asset balance. Since the items are not in service, they are not depreciated. Periodically, BT takes an inventory of the items on hand. Many of these items are supplies and are not included in fixed assets. SPC concluded that the amount that was examined and not in service, $923,144 as of June 30, 2009, appeared reasonable based on the quantities and per unit cost.

During our second on-site we wanted to discuss some of our concerns regarding equipment purchases and asked to observe the equipment at 200 Church Street, but our request was denied. We were told that the individual responsible did not have time to escort us or answer our questions.

3. Issues with BT's delayed or erroneous recording of costs

Other accounting concerns include the delay in posting capital expenditures and costs to the Pooled Cash fund as discussed in Section II-A and the charging of expense items to the capital clearing account also discussed in Section II-L-2.

The issue of charging capital accounts for items that should have been expensed was discussed in part above, however, there were other costs that were identified during the review that were charged to capital accounts instead of being expensed. Some examples of payments that were improperly classified are annual maintenance fees, maintenance or repair work and miscellaneous small material purchases.

We also noted that BT had two individuals who in effect would be considered employees under IRS rules that were paid as independent contractors. Some duplicated payments were identified at least one of which was subsequently corrected.

Conclusions

Larkin is of the opinion that BT exercised only limited oversight of its construction expenditures. This lack of oversight contributed to BT experiencing improper classification of payments and very limited review of expenditures which may have resulted in an overpayment for services during the construction and purchases of equipment that appear to be in excess of the system needs based on the BT customer base. Also this lack of sufficient oversight contributed to BT's purchase of substantial quantities of units in excess of the number of customers.

We recommend that a physical inventory of equipment purchased by BT be prepared and presented to the Vermont Public Service Board. The inventory should identify the equipment purchases that have been installed to date, and the reason and use for extra purchases. BT should also describe its plan for using extra equipment purchased to date that has not been installed.

BT should also explain how the fee structure for customers is justified and how the cost of installation along with equipment costs will be recovered and over what time period.

Concerns were documented by the City's external auditor regarding the lack of internal controls at the City and BT. Our investigation also observed a lack of accounting controls and review procedures for cost coding and approval of invoices, which has impacted the operations of BT. A major area of accounting concern identified is the City's failure to post payroll and interest charges for BT to the Pooled Cash account in a timely manner and BT's failure to post capital acquisitions during the fiscal year.

BT is currently structured as an enterprise business within the City organizational structure. The lack of timely and accurate accounting information can make it difficult for a competitive business like BT to succeed, and can lead to questionable management decisions. BT has invested approximately $33 million over a five-year period and this was done, as far as we can tell, without adequate accounting controls or a realistic plan for cost recovery. This unfortunate situation has left BT unable to service its existing $33.5 million lease financing with CitiCapital and with grim prospects of being able to repay the Pooled Cash fund the $16.9 million that BT has drawn in clear violation of Condition No. 60 of BT's CPG.

III. Conclusions and Recommendations

Conclusions

Condition No. 60

It is our opinion that BT has not been in compliance with Condition No. 60 since it was granted a CPG in September 2005. Our opinion is based on our interpretation of what Condition No. 60 states. We believe that Condition No. 60 as written, first identifies under what parameters BT can expend funds under Phase III. Condition No. 60 then adds to its requirement that if BT uses funds from the City Pooled Cash account those funds are to be repaid within two months (60 days). Even if one were to interpret Condition No. 60 as it appears that BT has interpreted it, it would not be appropriate to offset the obligation to the City with funds that are restricted in nature because those funds are not readily available for payment. If the funds used as an offset by BT were actually available for payment (we do not believe the funds were available) then because of the requirement in Condition No. 60 BT should have made that payment.

We are also of the opinion that someone either at the City and/or BT was aware of the violation of Condition No. 60 prior to November 2008. In Section A of our report we identified a workpaper where the City's and BT's auditor, Sullivan, Powers &Co., noted in the planning for the June 30, 2007 audit that the negative Pooled Cash balance was in violation of the CPG. Based on what is included in the auditors workpapers we believe that discussions between the City and/or BT personnel had to have taken place regarding the compliance issue. Also it was discussed in Section A that the City Council, the Department or the Board were not advised of the noncompliance when it occurred. It is unclear how the City/BT could assert after the fact that the violation was not known until November 2008, and it is inappropriate that notice of the violation, regardless of when it occurred, was withheld from the City Council, the Department and the Board.

The City's failure to comply with Condition No. 60, its failure to promptly and candidly identify and report its non-compliance to the Board or to the City Council, and its failure to maintain accurate and current accounting records raises significant concerns regarding the overall management of BT from September 25, 2005 through June 30, 2010.

Going Concern

If BT were operating as a separate entity it would in fact have a significant going concern issue. As discussed throughout the report there are concerns with the recurring losses, the accumulation of the $16.9 million obligation to the City and the current problem with meeting its $33.5 million obligation to CitiCapital. It is our opinion that despite signs of financial stress the City/BT continued to rely on projections of future operating results that in the past were found to be overly optimistic. Were it not for BT falling under the umbrella of the City as a whole, the recognition of the going concern issue by the City/BT could have possibly limited the financial impact it may ultimately have on the City and its taxpayers. Even the City's auditors, Sullivan, Powers &Co., questioned BT's going concern status. We cannot provide any rationale and/or reasoning as to why the City officers in charge of, or that had oversight of, the operations of BT did not heed the warnings and opted instead to continue to rely on BT's overly optimistic projections to justify the continued spending to build out the system.

The issue of going concern we now believe has been extended to the City. Because BT is currently having problems meeting its $33.5 million obligation to CitiCapital there is a distinct possibility that $16.9 million due the City will not be repaid. BT has provided no supportable evidence that it will be able to repay the City. Absent some significant change in financial results the City and ultimately taxpayers will be responsible for a minimum of $16.9 million of expended funds. While we cannot state from a legal perspective what, if any, responsibility the City will have for the CitiCapital debt of $33.5 million should BT default, the possibility that some responsibility could exist should not be ignored. Because of the current financial condition of BT, it is possible that operations could be abandoned and/or curtailed. If that were to occur, the $16.9 million would presumably become the responsibility of the City and its taxpayers and BT would be in violation of Condition No. 56. Condition No. 56 states "In no event shall any losses or costs, in the event the enterprise is abandoned or curtailed, incurred by BT be borne by the City of Burlington taxpayers, the City of Burlington Electric Department ("BED") ratepayers or the state of Vermont, nor shall the City of Burlington expend any funds received from the State of Vermont to cover any losses or costs, in the event the enterprise is abandoned or curtailed, incurred by BT, as provided in 24V.S.A. App. Section 3-438(c)(1)".

Accounting Issues

According to the financial records reviewed, BT incurred losses in each fiscal year 2005 through 2009. Based on the unaudited information for the fiscal year 2010 BT will again incur a loss. Between fiscal year 2005 and the unaudited fiscal year 2010 BT expended at least $32.8 million for gross plant additions. During this period of time we noted significant internal control weaknesses over the coding of costs and authorization of expenditures. We also observed in our review of the City auditor's workpapers that a number of the same deficiencies were noted repeatedly and brought to the attention of the City official responsible for over-all controls. In our opinion the City failed to implement controls that would properly monitor the project capital and operational costs of Phase III. That lack of oversight and implementation may have contributed to the excessive plant costs and operating expenses that we believe occurred. There is also concern that because the City appears to have ignored the obvious level of expenditures it was incurring and because of the discounted prices charged other City operations, it may have violated Condition No. 12, which state prices are to be reasonable, having regard for the costs of providing such service. The level of losses incurred suggest that the prices for installation and for services were not reasonable, having regard to the costs of providing such service.

As discussed in Sections B and D there is some concern as to whether the City's/BT's accounting records comply with Condition No. 58. The level of corrections observed in the fiscal year 2007 and the City's inability to identify what principal and/or interest was repaid have to raise the question as to whether the accounting system is capable of tracking in a transparent and auditable manner the costs from BT's financing construction and operation and maintenance expenses. The workpapers of the City's auditors identify concerns with controls over spending and detail how specific costs were adjusted in an attempt to correct for the improper capitalization of costs. We believe that a determination of compliance could be subjective but in our opinion, based on the level of review required to verify costs, transparency is an issue.

Recommendations
We recommend the following:

(1) that the Board require BT to conduct a physical inventory of assets (both installed and uninstalled) and to report to the Board concerning this, along with BT's detailed plan to use the equipment purchased through June 30, 2010 that has not yet been installed. This is critical whether BT is able to survive the current financial crisis or not.

(2) that the Board require BT to provide a plan for bringing BT into compliance with all violated provisions of BT's CPG, including Condition No. 60. While we do not believe that BT can continue as a viable operation, because of the risk to the City and taxpayers it would be remiss to ignore any possible solutions should they exist.

(3) that the Board require BT to address the going concern issues and to provide an operating plan detailing how BT expects to become profitable and cash-flow positive, including details on any restructuring of the CitiCapital lease financing that BT has been able to obtain.

(4) that the Board consider revoking BT's CPG if the Board is not satisfied that BT has a realistic plan to bring BT into compliance with all violated provisions of BT's CPG, including Condition No. 60, and a viable plan for addressing the going concern issues.