City of New York

OFFICE OF THE COMPTROLLER

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FINANCIAL AUDIT

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Audit Report on the Compliance of Verizon New York, Inc. with Its Cable Franchise Agreement

FM12-085A

December 09, 2013

http://comptroller.nyc.gov

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

John C. Liu
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December 9, 2013

To the Residents of the City of New York:

My office has audited the compliance of Verizon New York, Inc. (Verizon) with its cable franchise agreement with the Department of Information Technology and Telecommunications (DoITT). We audit entities such as Verizon to ensure that they accurately report all gross receipts, properly calculate franchise fees due the City, and comply with certain non-revenue terms of the franchise agreement.

Under the franchise agreement, Verizon is to operate and maintain a cable system and deliver cable service throughout New York City. The agreement also requires Verizon to pay the City a franchise fee equal to five percent of gross revenue, which includes all subscriber revenues net of bad debts plus late fee charges, advertising revenues, commissions on subscriber home shopping purchases, and other miscellaneous items.

The audit found that from July 2008 to June 2013, Verizon understated advertising revenue on the quarterly franchise fee reports it submits to the City by approximately $28.2 million, resulting in approximately $1.41 million in franchise fees owed to the City. Specifically, Verizon understated $17.1 million in advertising commissions that should have been included in gross revenue and did not report $11.1 million in foregone revenue from the value of advertising availabilities retained for its own use, resulting in $855,000 and $555,000 in franchise fees due to the City, respectively.

The audit made eight recommendations, including that Verizon immediately remit $1.41 million in additional franchise fees due to the City, report all advertising revenues at gross and the value of its internal marketing advertising availabilities in the quarterly franchise fee reports it submits to the City, and pay the appropriate franchise fees. The audit also recommends that as per the franchise agreement, DoITT should assess a nine percent late fee on the amount due if Verizon has not paid the $1.41 million in additional franchise fees due to the City and ensure that Verizon accurately reports all revenue on its quarterly franchise fee reports and pays the appropriate franchise fees as required by the franchise agreement.

The results of the audit have been discussed with Verizon and DoITT officials, and their comments have been considered in preparing this report. Their complete written responses are attached to this report. If you have any questions concerning this report, please e-mail my audit bureau at audit@comptroller.nyc.gov.

Sincerely,

John C. Liu

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FM12-085A

AUDIT REPORT IN BRIEF

On May 29, 2008, the City of New York (City), through the Department of Information Technology and Telecommunications (DoITT), entered into a non-exclusive 12-year cable franchise agreement ("agreement") with Verizon New York, Inc. (Verizon) to operate and maintain a cable system and deliver cable service throughout New York City.

The agreement requires Verizon to pay the City a franchise fee equal to five percent of gross revenue, which includes all subscriber revenues net of bad debts plus late fee charges, advertising revenues, commissions on subscriber home shopping purchases, and other miscellaneous items. Additionally, Verizon is obligated to make certain payments to Community Access Organizations (CAOs) designated by the City.[1] Verizon is permitted to partially offset this cost by charging its customers Public, Educational, and Governmental (PEG) fees. Verizon is also required to submit quarterly franchise fee reports with its franchise fee payments no later than 45 days after the end of each calendar quarter. Following at least 30 days written notice that the franchise fee has not been paid, Verizon is required to pay interest at the applicable interest rate (nine percent annually).

Verizon outsources its advertising sales business to three third parties, Time Warner Cable Media Sales (Time Warner), Viamedia, Inc. (Viamedia), and National Cable Communications LLC (NCC). Of the total advertising slots (availabilities) offered to Verizon, a portion is retained for its own marketing purposes, and a portion is allocated to Viamedia and Time Warner to sell. In addition, each of the respective parties receives a percentage of the gross sale for the various functions performed.

Audit Findings and Conclusion

From July 2008 to June 2013, Verizon understated advertising revenue on the quarterly franchise fee reports it submits to the City by approximately $28.2 million, resulting in approximately $1.41 million in franchise fees owed to the City. Specifically, Verizon

[1] CAOs are non-profit corporations promoting charitable and educational purposes

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understated $17.1 million in advertising commissions that should have been included in gross revenue and did not report $11.1 million in foregone revenue from the value of advertising availabilities retained for its own use, resulting in $855,000 and $555,000 in franchise fees due to the City, respectively.

Except for advertising revenue, our review of Verizon's gross revenue was based on Ernst & Young LLP's (E&Y) audit of Verizon's Statement of Gross Revenues for the year ended December 31, 2012. Accordingly, nothing came to our attention that suggests that Verizon's Statement of Gross Revenues was not presented fairly, in all material respects, on the basis of the franchise agreement.

Moreover, Verizon did comply with certain non-revenue-related requirements of its agreement with the City, such as maintaining the required insurance.

On another issue, the Comptroller's Office and DoITT both faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions. Some of these difficulties were due to limitations or complicating factors inherent to Verizon's internal processes that may not have been anticipated when the franchise agreement was written. Other limitations were due to non-disclosure clauses within the agreements entered into by Verizon with third parties, which do not grant the City access rights to records that are deemed confidential.

Audit Recommendations

Verizon should:

- Immediately remit $1.41 million in additional franchise fees due to the City.
- Report all advertising revenues at gross (including all advertising commissions) in the quarterly franchise fee reports it submits to the City, as required by the franchise agreement, and pay the appropriate franchise fees.
- Track the value of its internal marketing advertising availabilities, report the value of such advertisements in its quarterly franchise fee reports submitted to the City, and pay the appropriate franchise fees.
- Modify existing third-party agreements to allow the Comptroller's Office and DoITT to obtain the records necessary to properly determine Verizon's compliance with the terms of the franchise agreement.
- Provide DoITT with access to all records necessary to oversee Verizon's compliance with the terms of the franchise agreement, including records that are considered confidential but are required to determine the accurate reporting of gross revenue.

DoITT should:

- Ensure that Verizon pays the $1.41 million in additional franchise fees due to the City. As per the franchise agreement, if Verizon has not paid the franchise fees following at least 30 days written notice, DoITT should assess a nine percent late fee on the amount due.
- Ensure that Verizon accurately reports all revenue on its quarterly franchise fee reports and pays the appropriate franchise fees, as required by the franchise

agreement.

- Ensure that Verizon complies with all of the recommendations in this report.

Verizon Response

Verizon officials disagreed with the audit's findings and conclusions in their response. As such, they did not address the recommendations in the report. In their response, Verizon officials wrote, "Verizon reported and paid franchise fees on all advertising revenue in a manner fully consistent with the requirements of the Franchise and therefore does not owe the City $1.41 million in additional franchise fees…Verizon provided all books and records 'reasonably necessary to ensure compliance with the terms of [the] Franchise.'"

DoITT Response

In their response, DoITT officials stated that they were in agreement with the report's recommendations.

INTRODUCTION

Background

On May 29, 2008, the City, through DoITT, entered into a non-exclusive 12-year cable franchise agreement with Verizon to operate and maintain a cable system and deliver cable service throughout New York City. The agreement, which became effective on July 18, 2008, after approval by the New York State Public Service Commission, permits Verizon to use public rights-of-way to install fiber-optic equipment for the purpose of selling FiOS television service throughout the City.

The agreement requires Verizon to pay the City a franchise fee equal to five percent of gross revenue, which includes all subscriber revenues (e.g., monthly recurring cable charges, equipment rentals, and usage-based charges) net of bad debts plus late fee charges, advertising revenues, commissions on subscriber home shopping purchases, and other miscellaneous items.

Additionally, Verizon is obligated to make certain payments to CAOs designated by the City. Verizon is permitted to partially offset this cost by charging its customers PEG fees. Verizon is also required to submit quarterly franchise fee reports with its franchise fee payments no later than 45 days after the end of each calendar quarter (March, June, September, and December). Following at least 30 days written notice that the franchise fee has not been paid, Verizon is required to pay interest at the applicable interest rate (nine percent annually).

Verizon outsources its advertising sales business to three third parties. Time Warner sells regional advertisements on an interconnect.[2] In addition, Viamedia sells local advertisements (within the five boroughs), and NCC sells on behalf of both Time Warner and Viamedia to advertisers located outside the New York area. NCC's sales are included in Time Warner's and Viamedia's reporting. Of the total advertising availabilities offered to Verizon, a portion is retained for its own marketing purposes, and a portion is allocated to Viamedia and Time Warner to sell. In addition, each of the respective parties receives a percentage of the gross sale for the various functions performed.

For Calendar Year 2012 (January 1, 2012, through December 31, 2012), Verizon reported gross revenues to the City totaling nearly $427 million and paid related franchise fees totaling $21.3 million, as shown in Table I.

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[2] The interconnect, which is operated by Time Warner, is a large group of cable systems within a particular geographic market that are "connected" together, giving advertisers the option to reach all cable households within a given market with one purchase and one point of contact.

Table I

Total Revenue for Calendar Year 2012

Subscriber Revenue:	$389,532,485
Advertising:	$10,499,744
Home Shopping:	$2,329,969
Late Payment:	$581,453
Other Misc. (Leased Access and Other Misc.)	$7,975,880
Franchise Fee Billed:	$20,571,655
PEG Fee Billed:	$6,287,298
Less Bad Debt:	$(10,894,580)
Total Receipts Subject to Franchise Fee Calculation	$426,883,904
Franchise Fee Due (5%)	$21,344,195

Objectives

The objectives of this audit were to determine whether Verizon:

- properly and accurately reported gross revenues on its quarterly franchise fee reports and correctly calculated and paid its franchise fees to the City on time, and
- complied with certain non-revenue terms of the franchise agreement (e.g., maintain the required insurance, a performance bond, letter of credit, and cash security fund).

Scope and Methodology Statement

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

The scope of this audit covers Calendar Year 2012. Our scope was expanded to the period July 2008 to June 2013 with regard to the additional procedures related to our review of advertising revenue. Please refer to the Detailed Scope and Methodology at the end of this report for the specific procedures and tests that were conducted.

Discussion of Audit Results

On January 3, 2013, a preliminary draft report was sent to Verizon and discussed at an exit conference on January 17, 2013. The preliminary draft report concluded that we could not determine whether Verizon properly and accurately reported its gross revenues and correctly calculated and paid its franchise fees to the City because Verizon did not provide documentation that was sufficient and appropriate.

Following the issuance of the January 3, 2013, preliminary draft report, Verizon entered into an agreement with the Comptroller's Office on February 28, 2013, to provide the auditors with access to records necessary to continue the audit. Further, at Verizon's request, the Comptroller's Office issued a subpoena on March 7, 2013, for all advertising records that were deemed confidential or were subject to non-disclosure clauses.

Subsequent to the issuance of the preliminary draft report, Verizon engaged E&Y to conduct an audit and report on the special purpose Statement of Gross Revenues derived by Verizon from the operations of its video cable system within the City for the year ended December 31, 2012, in accordance with the franchise agreement. On March 22, 2013, E&Y issued an opinion stating "the schedule referred to above [within E&Y's report] present[s] fairly, in all material respects, the Statement of Gross Revenues derived by Verizon New York from the operation of the Cable System within the City of New York, for the year ended December 31, 2012, on the basis of the Franchise agreement." On April 23, 2013, we met with E&Y and reviewed its work papers.

E&Y did not identify any material findings in Verizon's Statement of Gross Revenues. However, based on our review of E&Y's audit testing, audit risk for advertising revenue was not mitigated. Consequently, we conducted additional audits tests on Verizon's reporting of advertising revenue.

The matters covered in this report were discussed with Verizon and DoITT officials during and at the conclusion of this audit. A new preliminary draft report was sent to Verizon and DoITT officials based on the events that occurred subsequent to the prior audit report and was discussed at an exit conference held on November 6, 2013. On November 14, 2013, we submitted a draft report to Verizon and DoITT officials with a request for comments. We received written responses from Verizon and DoITT officials on November 27, 2013. [Note: Page 3 of Verizon's response makes reference to an attachment titled "Statement of Gross Revenues for the City for 2012" that was not included with its formal response and, therefore, is not attached to this report.]

In its response, Verizon said, "the Draft Report's primary findings rely on severely flawed interpretations and analyses that lead to patently incorrect conclusions…The Draft Report contains four specific findings, each of which Verizon disputes, that: (1) Verizon understated advertising commissions paid to Time Warner; (2) Verizon understated advertising commissions paid by Viamedia to third party advertising agencies; (3) Verizon did not report the advertising availabilities retained for its own marketing purposes; and (4) '[t]he Comptroller's Office and DoITT faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions….'"

Further, Verizon officials stated, "[t]he first three of these claims are wrong because the Draft Report relies upon phantom revenues never received by Verizon in order to claim unpaid franchise fees. In reality, Verizon fully paid franchise fees on all of its revenues, as determined in accordance with GAAP, consistent with the requirements of the Franchise. The final claim is wrong because Verizon never agreed that the Franchise could override standard confidentiality provisions in third party contracts. Moreover, the Comptroller has subpoena power - which it exercised here - to obtain all of the records that it wished to see."

In their response, DoITT officials stated that they were in agreement with the report's recommendations.

We disagree entirely with Verizon's response, as Verizon did not provide any documentation or evidence that was sufficient to support its position on these matters.

The full texts of Verizon's and DoITT's responses are included as addenda to this report.

FINDINGS AND RECOMMENDATIONS

From July 2008 to June 2013, Verizon understated advertising revenue on the quarterly franchise fee reports it submits to the City by approximately $28.2 million. As a result, Verizon owes the City approximately $1.41 million in franchise fees. Specifically, Verizon understated $17.1 million in advertising commissions that should have been included in gross revenue, resulting in $855,000 in franchise fees due to the City. In addition, Verizon did not report the value of advertising availabilities it retained for its own use, resulting in $11.1 million in foregone revenue and an additional $555,000 in franchise fees due to the City.

Except for advertising revenue, our review of Verizon's gross revenue was based on E&Y's audit of Verizon's Statement of Gross Revenues for the year ended December 31, 2012. Accordingly, nothing came to our attention that suggests that Verizon's Statement of Gross Revenues was not presented fairly, in all material respects, on the basis of the franchise agreement.

Moreover, Verizon did comply with certain non-revenue-related requirements of its agreement with the City, such as maintaining the required insurance.

On another issue, the Comptroller's Office and DoITT both faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions. Some of these difficulties were due to limitations or complicating factors inherent to Verizon's internal processes that may not have been anticipated when the franchise agreement was written. Other limitations were due to non-disclosure clauses within the agreements entered into by Verizon with third parties, which do not grant the City access rights to records that are deemed confidential.

These matters are discussed in more detail in the following sections of this report.

Understated Approximately $17.1 Million in Advertising Commissions

Between July 2008 and June 2013, Verizon understated on its quarterly franchise fee reports approximately $17.1 million in advertising commissions paid to its third-party advertising sales representative firms and advertising agencies, resulting in approximately $855,000 in additional franchise fees due to the City. Specifically, Verizon understated approximately $15.4 million and $1.7 million in advertising commissions from Time Warner and Viamedia's advertising sales, respectively. Section 1.27.1 of the franchise agreement explicitly states, "Gross Revenue shall also include all advertising revenue which is received directly or indirectly by the Franchisee or any Affiliate from or in connection with the distribution of any service over the System…Advertising commissions paid to third parties shall not be netted against advertising revenue included in Gross Revenue."

Understated Approximately $15.4 Million from Time Warner's Advertising Sales

For revenue generated between November 2010 and June 2013 through Verizon's agreement with Time Warner, Verizon understated approximately $15.4 million in advertising commissions paid to third parties because it only reports to the City the net amount it receives, rather than the gross sale. As a result of understating the approximately $15.4 million in commissions paid, Verizon owes the City approximately $770,000 in additional franchise fees (see Table II for a breakdown and the Appendix for further details).

Table II

Total Time Warner Advertising Commissions Understated and Franchise Fees Due

Year	Total Revenue Understated in Quarterly Franchise Fee Reports	Franchise Fee Due (5%)
2010	$310,610	$15,531
2011	$4,738,368	$236,918
2012	$6,766,278	$338,314
2013	$3,577,891	$178,895
Total:	**$15,393,147**	**$769,657**

Verizon Response: "The Draft Report claims that Verizon understated 'advertising commissions' paid to Time Warner Cable, Inc. ('TWC'), because Verizon 'only reports to the City the net amount it receives, rather than the gross sale.' This finding misstates Verizon's obligations in its Franchise Agreement with the City. Verizon is required to include as Gross Revenue '[a]ll revenue, ***as determined in accordance with generally accepted accounting principles***, which is derived by [Verizon] from the operation of the Cable System to provide Cable Service in the [City].' (Emphasis added). Thus, the relevant inquiry is not simply to distinguish between the 'net amount received' and the 'gross sale amount' and conclude that Verizon should treat the 'gross sale amount' as revenue. Such a simplistic inquiry ignores the plain language of the Franchise Agreement, which requires that a determination be made in accordance with GAAP in order to calculate the amount that should be included in Verizon's Gross Revenues."

"Verizon's arrangement with TWC is a 'Purchase and Sale Agreement' for the purpose of fostering more efficient sales of advertising availabilities in multiple markets. TWC, as part of an interconnect arrangement with other cable systems, purchases advertising availability from Verizon, and resells those advertising slots throughout the region. TWC is not Verizon's agent and does not sell the ads on behalf of Verizon. Instead, Verizon 'sells and conveys' ad avails to TWC, and TWC sells the ad avails to third parties. In effect, TWC is buying the ads wholesale from Verizon, selling the ads on a retail basis, and retaining the difference as its revenue."

"There are published accounting standards that provide guidance on this specific issue (codified in EITF 99-19 and FASB ASC 605-45). EITF 99-19 states that the issue of whether a company should report revenue based on 'gross sales' vs. 'net amount' may arise in 'transactions related to advertisements' and is 'a matter of judgment that depends on the relevant facts and circumstances' and in consideration of a number of 'indicators.' The enumerated indicators are to determine which entity: (i) is the primary obligor, (ii) has general inventory risk, (iii) has latitude in establishing price, (iv) performs part of the service, (v) has discretion in supplier selection, (vi) is involved in the determination of service specifications, and (vi) has credit risk. Verizon's finance and accounting teams reviewed the arrangement with TWC and determined that TWC is the answer for most of these factors; most significantly that TWC is the ‘primary obligor’ in the arrangement. Verizon consulted with its outside auditor, Ernst & Young, who confirmed that Verizon's treatment of the ‘net amount’ as revenue is consistent with GAAP and industry practice.”

Auditor Comment: Contrary to Verizon’s response, the plain language of the franchise agreement states, “Advertising commissions paid to third parties shall not be netted against advertising revenue included in Gross Revenue.” Verizon is being cited for the advertising commissions it did not include in gross revenue. However, Verizon is discounting the explicit term of the contract and relying on a subjective interpretation of the accounting of this revenue to justify its exclusion.

Verizon cites several indicators in its response to justify its decision. However, Verizon omits the fact that nearly all of these indicators, most importantly primary obligor, are used to determine whether an entity has the risks and rewards of a principal. Verizon falsely portrays itself as a wholesaler of advertisements to Time Warner when it actually has a retail interest. Verizon’s interest in all advertisements, subject to its agreement with Time Warner, is ongoing throughout the entire revenue cycle. Verizon’s revenue is directly correlated to the amounts charged to the customers. If customers fail to pay, then Verizon does not get paid. Verizon shares in risk and reward. Furthermore, each entity involved in the process, including Time Warner, receives a percentage of Verizon’s gross revenue. Verizon retains what remains. These indicators could easily be interpreted to mean Verizon should be recording advertising revenue on the gross and not on the net as it contends.

If Verizon’s intent was to report on net advertising revenues, then it should have included specific language within the franchise agreement. Subjective interpretation of the accounting policy should not be the determining factor regarding whether advertising commissions should be reported when the contract clearly states that advertising commissions should be not be netted. Therefore, Verizon should pay the City what it is due.

Understated Approximately $1.7 Million from Viamedia’s Advertising Sales

Although Verizon properly reported the commissions paid to certain third parties (NCC and Viamedia) in its quarterly franchise fee reports, it understated approximately $1.7 million in advertising commissions paid to advertising agencies for revenue generated between July 2008 and June 2013 through Verizon’s agreement with Viamedia. Therefore, this finding only pertains to advertising agency commissions. As previously mentioned, the franchise agreement requires that advertising commissions paid to third parties be included as part of the gross revenue reported to the City. Therefore, Verizon owes the City approximately $85,000 in additional franchise fees. For December 2012 to June 2013, we were able to calculate the agency commissions. However, prior to December 2012, all commissions paid were estimated because the documentation required to make actual calculations was not provided. See Table III for a breakdown and the Appendix for further details.

Table III

Total Viamedia Advertising Commissions Understated and Franchise Fees Due

Year	Total Revenue Understated in Quarterly Franchise Fee Reports	Franchise Fee Due (5%)
2008	$15,221	$761
2009	$159,820	$7,991
2010	$341,245	$17,062
2011	$344,904	$17,245
2012	$544,549	$27,227
2013	$296,852	$14,843
Total:	**$1,702,591**	**$85,129**

Verizon Response: "The Draft Report claims that Verizon understated 'advertising commissions paid to advertising agencies…through Verizon's agreement with Viamedia.' The Draft Report purports to base this claim on the language in the Franchise that says '[a]dvertising commissions paid to third parties shall not be netted against advertising revenue included in Gross Revenue.' It is important to note that the '$1.7 million in advertising commissions' cited in the Draft Report are expenses paid by Viamedia - not Verizon. As explained above, Verizon pays Viamedia a commission for selling advertising on its behalf, and Verizon - in accordance with GAAP - includes the gross receipts in its calculation of 'Gross Revenues.'"

"The Draft Report seems to take the position that the Franchise Agreement also obligates Verizon to include in Gross Revenues the amount of expense that a third party (Viamedia) incurs in the performance of its services to Verizon. That is not a reasonable interpretation of the last sentence of Section 1.27.1. The 'gross receipts' received by Verizon do not include taxes, agency fees, bad debts, refunds and other expenses that are incurred by Viamedia. Those expenses are the cost of Viamedia doing business. It makes no economic difference to Verizon, and should have no impact on Verizon's calculation of gross revenues, whether Viamedia sells advertising through its own employees or through a third party vendor. In any event, Verizon is not netting Viamedia's third party expenses 'against advertising revenue included in Gross Revenue.' In order for that provision even to apply, the advertising revenue must first be 'included in Gross Revenue' (as determined in accordance with GAAP). With respect to its arrangement with Viamedia, Verizon is including the full amount of its gross receipts in Gross Revenues (without netting advertising commissions paid by Verizon, or paid by Viamedia). Thus, Verizon - consistent with the requirements of the Franchise Agreement and in accordance with GAAP - is not including Viamedia's $1.7 million of advertising commission expenses in its calculation of Gross Revenues."

Auditor Comment: The intent of the franchise agreement is to base the payment of franchise fees on gross advertising revenue. Commissions, fees, and/or operating expenses associated with these revenues, whether paid directly by Verizon or indirectly by a third party, are not to be deducted from gross revenue. Once again, if it were Verizon's intention to report advertising revenues at net (gross less expenses), it should have included explicit language in the franchise agreement.

Did Not Report Approximately $11.1 Million from Verizon's Retained Advertising Availabilities

From July 2008 to June 2013, Verizon did not report the value of the advertising availabilities retained for its own marketing purposes on the quarterly franchise fee reports submitted to the City. Therefore, approximately $11.1 million in gross revenues was not reported, resulting in approximately $555,000 in franchise fees due to the City. According to Section 1.27.2 of the franchise agreement, "such foregone revenue which Franchisee chooses not to receive in exchange for trades, barters, services or other items of value shall be included in Gross Revenue." In other words, Verizon should include the value of the advertising availabilities it retains on the quarterly franchise fee reports it submits to the City.

According to Verizon officials, approximately 25 percent of the total advertising availabilities are retained by Verizon to use for its own marketing purposes. This includes advertisements to promote Verizon's own business or to get existing customers to upgrade their current products and services. As part of its agreement with Verizon, Viamedia (the advertising representative discussed in the previous section) is responsible for scheduling Verizon's advertising availabilities along with its own allocated advertising availabilities for placement on Verizon's network.

Verizon does not track the value of the advertising availabilities it uses for its own marketing purposes. Therefore, using other documentation that was provided, we calculated a value for Verizon's advertising availabilities. Based on the total monthly revenue (from July 2008 to June 2013) that Viamedia generated from the advertising availabilities it sold, we determined what the value would have been if Verizon's advertising availabilities were sold. Our results are listed in Table IV. See Appendix for further details.

Table IV

Value of Verizon's Internal Marketing Advertisements

Year	Total Revenue Not Reported in Quarterly Franchise Fee Reports	Franchise Fee Due (5%)
2008	$59,434	$2,972
2009	$622,406	$31,120
2010	$1,509,384	$75,469
2011	$2,591,934	$129,597
2012	$4,105,534	$205,277
2013	$2,205,192	$110,260
Total:	**$11,093,884**	**$554,694**

Verizon Response: "In defining 'Gross Revenues' under the Franchise Agreement, Section 1.27.2 provides, in part, that 'such foregone revenue which Franchisee chooses not to receive *in exchange for trades, barters, services or other items of value* shall be included in Gross Revenue.' (Emphasis added). This is a common provision in cable franchise agreements, the obvious intent of which is to ensure that where a cable operator chooses to forgo receipt of revenue from a third party *in exchange* for consideration of some value from such third party, the foregone revenue should be reported as Gross Revenue subject to the 5% franchise fee. In other words, the provision reflects the principle that a franchisee should not be permitted to circumvent the assessment of franchise fees by agreeing to transactions involving trades, barters, or exchanges with third parties which would be exempt from Gross Revenue.

"In a strained interpretation of Section 1.27.2, the Draft Report claims that certain advertising revenue used by Verizon for its own marketing purposes, rather than being sold, meets the 'foregone revenue' standard under the Franchise and should have been reported as Gross Revenue. While the Draft Report cites the relevant language of Section 1.27.2, it never even attempts to articulate how Verizon's retention of its *own* advertising space for its *own* promotional purposes - involving no third party transaction for any value - constitutes an 'exchange' of value which should be construed as Gross Revenue. Clearly, Section 1.27.2 was never intended to apply to circumstances in which Verizon utilizes its own internal resources to market its business, and even the most generous interpretation of that provision could not reach the conclusion that such a business decision constitutes an exchange for trades, barters, services or other items of value."

Auditor Comment: Verizon states that a third party is required in order for an exchange to occur. However, exchange can certainly be defined as "the act or process of substituting one thing for another." In other words, Verizon used 25 percent of its advertising availabilities without incurring any cost of advertising, a benefit it received without fair compensation to the City. In this case, Verizon substituted marketing for revenue. Marketing clearly has value. Based on Verizon's decision, we estimate Verizon chose to forgo $11.1 million in revenue. Consequently, Verizon should pay the City an additional $555,000 in franchise fees.

Other Issue

Access to Records

The Comptroller's Office and DoITT faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions to ensure the proper reporting of gross revenue and payment of franchise fees in accordance with the franchise agreement. Some of these difficulties were due to limitations or complicating factors inherent to Verizon's internal processes. Other limitations were due to non-disclosure clauses within agreements entered into by Verizon with third parties, which do not grant the City record access rights. GAGAS requires the Comptroller's Office to obtain sufficient and appropriate evidence to form a basis for our findings and conclusions. However, all parties had to expend valuable resources in an effort to work around these limitations, such as preparing preliminary audit reports, entering into agreements, and subpoenaing information to arrive at a consensus where that evidence could be appropriately reviewed.

DoITT should also have full access to records that will allow it to adequately oversee Verizon's compliance with the terms of the franchise agreement. However, it is still unclear whether DoITT can obtain access to the information subpoenaed by the Comptroller's Office, or whether Verizon will allow both parties (Comptroller's Office and DoITT) access to the information in the future.

> ***Verizon Response:*** "The Draft Report, in both the Discussion and Recommendations sections, states that Verizon should: i) '[m]odify existing third-party agreements to allow the Comptroller's Office and DoITT to obtain the records necessary to properly determine Verizon's compliance with the terms of the franchise agreement…;' and ii) Provide DoITT with access to all records necessary to oversee Verizon's compliance with the terms of the franchise agreement, including records that are considered confidential but are required to determine the accurate reporting of gross revenue.' As Verizon has consistently explained, Verizon's agreements with advertising sales vendors and home shopping networks include confidentiality and non-disclosure provisions which Verizon cannot lawfully breach by disclosing them to DoITT or the Comptroller, absent a subpoena. Consistent with industry standards, these advertising and home shopping agreements include such provisions because they contain highly confidential and proprietary information of Verizon's third party advertising sales and home shopping partners, the disclosure of which would cause substantial competitive harm to those third party entities as well as Verizon. Contrary to the Draft Report's assertion, nothing in the Franchise precludes Verizon's acceptance of such provisions in a third party agreement and, indeed, were Verizon to refuse to agree to such terms with advertising sales vendors and home shopping networks, Verizon would suffer significant competitive impairment by inflating costs and/or limiting the number of advertising sales vendors and home shopping networks willing to do business with Verizon.
>
> "Moreover, the Comptroller's review of Verizon's underlying advertising and home shopping contracts is not 'reasonably necessary to ensure compliance with the Franchise' as required under Section 11.1 of the Franchise. While Verizon was not legally permitted to disclose the full text of the advertising and home shopping contracts to the Comptroller and DoITT, Verizon did provide both agencies with vast amounts of financial information necessary to substantiate advertising and home shopping revenues, including: invoices, commission reports, billing reports, payment records, checks, wire transfer records, correspondence and other related documents. Further, following the issuance of the subpoena by the Comptroller, Verizon provided redacted versions of the relevant provisions of these agreements to the Comptroller (with the consent of Verizon's counterparties). Given the nature and scope of information provided by Verizon to the Comptroller and to DoITT with respect to advertising and home shopping, it is clear that review of certain third party proprietary provisions - many of which have no bearing on the instant audit - is not 'reasonably necessary' for the Comptroller or DoITT to accurately conduct its audits."
>
> ***Auditor Comment:*** Verizon, the subject of this audit, appears to believe that it should be able to dictate what records are "reasonably necessary" to perform an audit of its franchise agreement. However, it is the auditors' responsibility, not Verizon's, to determine what is "reasonably necessary" to ensure compliance with its own responsibilities under Generally Accepted Government Auditing Standards

(GAGAS), the standards required by the City Charter.

The fact that the Comptroller's Office was ultimately able to obtain records through a subpoena does not negate our belief that DoITT, as Verizon's oversight agency, should also have access to these records. Verizon's franchise agreement with the City, which was signed before Verizon entered into any agreements with its third parties, clearly allows for access to any records deemed confidential. Section 11.1 states, "Subject to applicable law, including but not limited to New York State Public Officers Law ('FOIL'), any such information disclosed to the City that the Franchisee reasonably identifies as confidential or competitively sensitive (including, without limitation, financial information related to the calculation of Franchise Fees) shall be treated by the City as confidential…" Therefore, Verizon should have taken appropriate measures prior to entering into any third party agreements to ensure that the City was not precluded from accessing any records which may be deemed as confidential.

Recommendations

Verizon should:

1. Immediately remit $1.41 million in additional franchise fees due to the City.

DoITT Response: "While we do not have access to critical documents underlying this recommendation, promptly after receipt of the Comptroller's final audit report, we will send Verizon an invoice for $1.41 million, or such other amount the Comptroller finds to be due in the final report. If payment in full is not made within 30 days of the invoice, we will assess late fees as provided in the franchise agreement."

2. Report all advertising revenues at gross (including all advertising commissions) in the quarterly franchise fee reports it submits to the City, as required by the franchise agreement, and pay the appropriate franchise fees.

DoITT Response: "We agree with this recommendation."

3. Track the value of its internal marketing advertising availabilities, report the value of such advertisements in its quarterly franchise fee reports submitted to the City, and pay the appropriate franchise fees.

DoITT Response: "We agree with this recommendation."

4. Modify existing third-party agreements to allow the Comptroller's Office and DoITT to obtain the records necessary to properly determine Verizon's compliance with the terms of the franchise agreement.

DoITT Response: "We agree with this recommendation. Verizon is in violation of its franchise agreement by entering into advertising contracts that do not allow DoITT to review those contracts. Verizon must ensure that the Comptroller's Office and DoITT have access to these advertising contracts and in the future must enter into advertising contracts that clearly provide for auditing by DoITT and the Comptroller."

5. Provide DoITT with access to all records necessary to oversee Verizon's compliance with the terms of the franchise agreement, including records that are considered confidential but are required to determine the accurate reporting of gross revenue.

DoITT Response: "We agree with this recommendation."

DoITT should:

6. Ensure that Verizon pays the $1.41 million in additional franchise fees due to the City. As per the franchise agreement, if Verizon has not paid the franchise fees following at least 30 days written notice, DoITT should assess a nine percent late fee on the amount due.

DoITT Response: "See response to recommendation 1 above."

7. Ensure that Verizon accurately reports all revenue on its quarterly franchise fee reports and pays the appropriate franchise fees, as required by the franchise agreement.

DoITT Response: "We agree with this recommendation. We have persistently sought to ensure that Verizon accurately reports gross revenue as required by its franchise agreement. We will continue to conduct reviews and audits and will take appropriate action to ensure that Verizon complies with all terms and conditions of the franchise agreement."

8. Ensure that Verizon complies with all of the recommendations in this report.

DoITT Response: "We agree with this recommendation."

DETAILED SCOPE AND METHODOLOGY

We conducted this performance audit in accordance with GAGAS. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

The scope of this audit covers Calendar Year 2012. Our scope was expanded to the period July 2008 to June 2013 with regard to additional procedures related to our review of advertising revenue. To achieve our audit objectives, we reviewed and abstracted the franchise agreement and supporting appendices between Verizon and the City and identified relevant terms and conditions. We reviewed correspondence, Verizon's quarterly franchise fee reports submitted to DoITT, cancelled franchise fee check payments, and other relevant documents to ascertain whether Verizon submitted the required revenue reports and paid the fees due to the City on time.

To obtain an understanding of Verizon's operating procedures, we conducted walk-throughs and held meetings with Verizon officials and familiarized ourselves with the reporting, ordering, installation, billing, disconnection, and change order processes. We documented our understanding through memoranda and flowcharts.

Initially, we attempted to determine whether Verizon accurately reported its gross revenue to the City by judgmentally selecting March 2012, the current month for which we were provided a subscriber list and its supporting files. We conducted tests on the Excel spreadsheets provided to support the gross receipts and franchise fees paid to the City for March 2012 by tracing the amounts to the quarterly franchise fee report submitted to the City.

We also attempted to determine the completeness of the subscriber list by reconciling the customer account numbers from the subscriber list to other files provided by Verizon. These files included lists of customers (by account number) that were charged late fees, ordered pay-per-view programming, and "TAX" files indicating those customers who were charged PEG Grant, Federal Communications Commission Regulatory, and/or franchise fees, or may have had an adjustment made to their account. In addition, a random sample of 50 customer bills was selected to independently verify that the accounts were on the subscriber list.

Subsequent to our initial preliminary draft report and pursuant to our agreement with Verizon, Verizon engaged E&Y to conduct an audit and report on the special purpose Statement of Gross Revenues derived by Verizon from the operations of its video cable system within the City for the year ended December 31, 2012, in accordance with the franchise agreement. On March 22, 2013, E&Y issued an opinion stating, "the schedule referred to above [within E&Y's report] present[s] fairly, in all material respects, the Statement of Gross Revenues derived by Verizon New York from the operation of the Cable System within the City of New York, for the year ended December 31, 2012, on the basis of the Franchise agreement." On April 23, 2013, we met with E&Y and reviewed its work papers.

To obtain a detailed understanding of Verizon's advertising procedures, we conducted walkthroughs and held meetings with Verizon officials to familiarize ourselves with the reporting, ordering, and billing processes. We also met with Verizon's third parties (Time Warner, Viamedia, and NCC) to obtain an understanding of how they earn and report advertising sales to Verizon and receive commissions. We documented our understanding through memoranda and flowcharts. We also reviewed Verizon's agreements with Time Warner and Viamedia.

To determine whether Verizon properly and accurately reported Time Warner's advertising revenue to the City for January 1, 2012, to December 31, 2012, we reviewed Time Warner's monthly sales detail reports and Viamedia's monthly sales and commission summary sheets, and compared them to Verizon's quarterly franchise fee reports submitted to DoITT. To determine what portion of the total advertising revenue reported for New York State pertains to the City, we reviewed Verizon's advertising revenue allocation reports.

To determine whether Verizon properly and accurately reported Viamedia's advertising revenue to the City for January 1, 2012, to December 31, 2012, we reviewed Viamedia's monthly sales and commission summary sheets and dashboards (used to track Viamedia's performance regarding the number of advertising availabilities sold and unsold) , and compared them to Verizon's quarterly franchise fee reports submitted to DoITT. To determine what portion of the total advertising revenue reported for New York State pertains to the City, we reviewed Verizon's advertising revenue allocation reports.

Based on the results of our analysis of advertising documents for January 1, 2012, to December 31, 2012, we expanded our scope period to include July 2008 (effective date of Verizon's franchise agreement) to December 2011 and January 2013 to June 2013 (latest reported period at the time of the fieldwork stage of our audit).

We also attempted to determine whether Verizon accurately reported Viamedia's advertising revenue for the period July 2008 to December 2011 and January 2013 to June 2013 by contacting Viamedia directly to obtain independent verification. However, Viamedia was only able to provide records for December 2012 to June 2013. Since there was no documentation available for the prior months (July 2008 to November 2012), we estimated what the advertising agency commissions would have been to determine what percentage of the total revenue should be charged an agency commission. Therefore, we took the portion of the total monthly invoiced amount where an agency commission was charged and divided it by the total monthly invoiced amount for each zone in the City. We then took the average of all percentages by zone for the seven months (December 2012 to June 2013) and applied that figure to the prior months for which no documentation was provided.

Finally, we also attempted to determine whether Verizon accurately reported the value of the advertising availabilities it used for its own marketing purposes. However, because Verizon does not track the value of these advertising availabilities, we estimated what the value should have been. Specifically, we took Viamedia's portion of the monthly advertising revenue and multiplied it by 25 percent (the percentage of advertising availabilities Verizon maintains for its own marketing purposes). We then took that result and divided it by the applicable percentage of advertising availabilities allocated to Viamedia.

$$\frac{\text{Viamedia's reported revenue X 25\% (Verizon's retained inventory)}}{\text{30\% (total slots allocated to Viamedia)}}$$

Total Understated Time Warner Advertising Commissions and Franchise Fees Due

Month	Year				Total
	2010	2011	2012	2013	
January	N/A	$77,185	$497,036	$597,410	$1,171,631
February	N/A	$110,802	$571,891	$595,092	$1,277,785
March	N/A	$357,396	$484,387	$527,656	$1,369,439
April	N/A	$341,454	$493,205	$628,775	$1,463,434
May	N/A	$368,022	$598,564	$625,554	$1,592,140
June	N/A	$421,188	$496,116	$603,404	$1,520,708
July	N/A	$522,446	$691,991	N/A	$1,214,437
August	N/A	$443,797	$545,239	N/A	$989,036
September	N/A	$354,352	$434,319	N/A	$788,671
October	N/A	$512,789	$760,240	N/A	$1,273,029
November	$222,635	$715,347	$632,312	N/A	$1,570,294
December	$87,975	$513,590	$560,978	N/A	$1,162,543
Total Understated Revenue	$310,610	$4,738,368	$6,766,278	$3,577,891	**$15,393,147**
Franchise Fee Due (5%)	$15,531	$236,918	$338,314	$178,895	**$769,657**

Total Understated Viamedia Advertising Commissions and Franchise Fees Due

Month	Year						Total
	2008	2009	2010	2011	2012	2013	
January	N/A	$4,782	$20,029	$21,021	$32,374	$52,866	$131,072
February	N/A	$4,801	$20,447	$19,369	$35,791	$42,196	$122,604
March	N/A	$6,915	$18,755	$18,390	$34,347	$42,112	$120,519
April	N/A	$10,047	$23,937	$25,226	$34,354	$53,211	$146,775
May	N/A	$7,934	$23,161	$28,617	$46,297	$58,643	$164,652
June	N/A	$11,907	$30,347	$33,355	$43,999	$47,824	$167,432
July	N/A	$13,343	$31,815	$28,570	$43,062	N/A	$116,790
August	$178	$11,973	$26,894	$33,084	$43,437	N/A	$115,566
September	$1,487	$18,031	$37,412	$31,345	$41,883	N/A	$130,158
October	$3,270	$19,300	$39,296	$30,901	$65,678	N/A	$158,445
November	$4,278	$23,313	$47,201	$40,331	$79,704	N/A	$194,827
December	$6,008	$27,474	$21,951	$34,695	$43,623	N/A	$133,751
Total Understated Revenue	**$15,221**	**$159,820**	**$341,245**	**$344,904**	**$544,549**	**$296,852**	**$1,702,591**
Franchise Fee Due (5%)	**$761**	**$7,991**	**$17,062**	**$17,245**	**$27,227**	**$14,843**	**$85,129**

Value of Verizon's Internal Marketing Advertisements

Month	Year						Total
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	
January	N/A	$18,371	$77,405	$159,854	$242,158	$400,911	$898,699
February	N/A	$19,239	$79,853	$143,532	$278,403	$285,825	$806,852
March	N/A	$26,504	$68,323	$123,688	$260,382	$309,868	$788,765
April	N/A	$38,671	$89,396	$189,846	$263,985	$410,320	$992,218
May	N/A	$30,856	$86,087	$216,193	$347,169	$429,394	$1,109,699
June	N/A	$45,995	$113,053	$252,640	$337,130	$368,874	$1,117,692
July	N/A	$51,501	$118,584	$218,890	$314,417	N/A	$703,392
August	$693	$47,543	$94,424	$244,888	$328,797	N/A	$716,345
September	$5,806	$70,349	$137,704	$231,908	$320,427	N/A	$766,194
October	$12,749	$75,339	$144,203	$239,823	$493,067	N/A	$965,181
November	$16,721	$90,947	$338,745	$304,569	$587,961	N/A	$1,338,943
December	$23,465	$107,091	$161,607	$266,103	$331,638	N/A	$889,904
Total Foregone Revenue	**$59,434**	**$622,406**	**$1,509,384**	**$2,591,934**	**$4,105,534**	**$2,205,192**	**$11,093,884**
Franchise Fee Due (5%)	**$2,972**	**$31,120**	**$75,469**	**$129,597**	**$205,277**	**$110,260**	**$554,694**

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November 27, 2013

Re: Verizon's Response to the New York City Comptroller's Draft Audit Report dated November 14, 2013

Verizon New York Inc. ("Verizon") hereby provides its response to the draft "*Audit Report on the Compliance of Verizon New York, Inc. with its Cable Franchise Agreement*" (the "Draft Report") by the New York City Comptroller (the "Comptroller") provided to Verizon on November 14, 2013. While the Draft Report implicitly acknowledges that Verizon has properly paid franchise fees on 94% of revenue due to the City of New York (the "City") in accordance with the Cable Franchise Agreement between Verizon and the City (the "Franchise" or "Franchise Agreement") and maintains appropriate internal accounting controls, the Draft Report's primary findings rely on severely flawed interpretations and analyses that lead to patently incorrect conclusions. Generally, Verizon maintains that: 1) Verizon reported and paid franchise fees on all advertising revenue in a manner fully consistent with the requirements of the Franchise and therefore does not owe the City $1.41 million in additional franchise fees as claimed in the Draft Report; and 2) Verizon provided all books and records "reasonably necessary to ensure compliance with the terms of [the] Franchise" in accordance with Section 11.1 of the Franchise and is not precluded by the Franchise from honoring confidentiality provisions imposed by its third party advertising partners.

Without conceding any issues not addressed herein, this submission specifically responds to the findings in the Draft Report. Consistent with standard Comptroller procedure, and in the interest of establishing a transparent and complete record, Verizon respectfully requests that this response be appended to the Comptroller's Final Report. Nothing set forth herein shall be deemed to constitute a waiver of any rights or remedies that Verizon may have, which are expressly reserved.

Executive Summary

The Draft Report contains four specific findings, each of which Verizon disputes, that: (1) Verizon understated advertising commissions paid to Time Warner; (2) Verizon understated advertising commissions paid by Viamedia to third party advertising agencies; (3) Verizon did not report the advertising availabilities retained for its own marketing purposes; and (4) "[t]he Comptroller's Office and DoITT faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions" because of "non-disclosure clauses within agreements entered into by Verizon with third parties."

The first three of these claims are wrong because the Draft Report relies upon phantom revenues never received by Verizon in order to claim unpaid franchise fees. In reality, Verizon fully paid franchise fees on all of its revenues, as determined in accordance with GAAP, consistent with the requirements of the Franchise. The final claim is wrong because Verizon never agreed that the Franchise could override standard confidentiality provisions in third party contracts. Moreover, the Comptroller has subpoena power – which it exercised here – to obtain all of the records that it wished to see.

Verizon Did Not "Net" Any Advertising Commissions Against Time Warner Advertising Revenues: The Draft Report claims that Verizon underreported $15.4 in advertising revenues from Time Warner resulting in $777,000 in franchise fees being payable. This is incorrect because Verizon did not net any commissions against the Time Warner advertising revenues, since Verizon's arrangement with Time Warner is not an advertising sales agency contract. Rather, it is a resale arrangement, by which Verizon "sold and conveyed" advertising availabilities to Time Warner for resale to third parties. *Verizon fully paid franchise fees on the amount Time Warner paid to Verizon*, which is consistent with accounting standards as mandated by the Franchise Agreement. In other words, nothing was "netted" against the revenues that were properly recorded and reported by Verizon to the City.

Verizon Is Not Required To Pay Franchise Fees On Viamedia's Own Advertising Expenses: The Draft Report claims that Verizon underreported $1.7 million in advertising commissions paid by a third party, Viamedia – not Verizon – resulting in $85,000 in Franchise fees being payable. This is incorrect because Verizon is not required under the franchise Agreement (or permitted under GAAP) to include a third party vendor's operating costs in Verizon's revenues. Verizon properly included the full amount of its gross receipts from Viamedia in its calculation of Gross Revenues (without deducting any advertising commissions paid by Verizon or by Viamedia), and *Verizon fully paid franchise fees on the amount Viamedia paid to Verizon*.

Verizon Did Not Exchange Its Retained Advertising Inventory For Anything Of Value: The Draft Report alleges that Verizon did not report the value of retained advertising availability in the amount (as valued by the Comptroller) of $11.1 million of gross revenue resulting in $555,000 in franchise fees being payable. This is wrong because the provision of the Franchise cited by the Draft Report, Section 1.27.2, only applies to "foregone revenue" which is *exchanged* for trades, barters, services, or other items of value. Verizon's retention of advertising availability for its *own* purposes does not meet this standard because there obviously is *no exchange involved*, as is required under the Franchise.

Industry-Standard Provisions In Third Party Contracts Are Not Overridden By the Franchise, And The Comptroller and DoITT Had Access To All Records "Reasonably Necessary" For Their Audits: The Draft Report alleges that "[t]he Comptroller's Office and DoITT faced significant difficulties in obtaining the sufficient and appropriate documentation necessary to perform their respective oversight functions" because of "non-disclosure clauses within agreements entered into by Verizon with third parties." Despite this claim, nothing in the Franchise precludes Verizon from accepting industry-standard confidentiality provisions with third party ad sales vendors and Verizon provided all books and records to the Comptroller and DoITT that were "reasonably necessary" to fully conduct their respective audits consistent with the Franchise and applicable law.

Discussion

1. Verizon Properly Reported Revenue With Respect to All Time Warner Advertising Sales.

The Draft Report claims that Verizon understated "advertising commissions" paid to Time Warner Cable, Inc. ("TWC"), because Verizon "only reports to the City the net amount it receives, rather than the gross sale." This finding misstates Verizon's obligations in its Franchise Agreement with the City. Verizon is required to include as Gross Revenue "[a]ll revenue, ***as determined in accordance with generally accepted accounting principles***, which is derived by [Verizon] from the operation of the Cable System to provide Cable Service in the [City]." (Emphasis added). Thus, the relevant inquiry is not simply to distinguish between the "net amount received" and the "gross sale amount" and conclude that Verizon should treat the "gross sale amount" as revenue. Such a simplistic inquiry ignores the plain language of the Franchise Agreement, which requires that a determination be made in accordance with GAAP in order to calculate the amount that should be included in Verizon's Gross Revenues.

Verizon's arrangement with TWC is a "Purchase and Sale Agreement" for the purpose of fostering more efficient sales of advertising availabilities in multiple markets. TWC, as part of an interconnect arrangement with other cable systems, purchases advertising availability from Verizon, and resells those advertising slots throughout the region. TWC is not Verizon's agent and does not sell the ads on behalf of Verizon. Instead, Verizon "sells and conveys" ad avails to TWC, and TWC sells the ad avails to third parties. In effect, TWC is buying the ads wholesale from Verizon, selling the ads on a retail basis, and retaining the difference as its revenue.

There are published accounting standards that provide guidance on this specific issue (codified in EITF 99-19 and FASB ASC 605-45). EITF 99-19 states that the issue of whether a company should report revenue based on "gross sales" vs. "net amount" may arise in "transactions related to advertisements" and is "a matter of judgment that depends on the relevant facts and circumstances" and in consideration of a number of "indicators." The enumerated indicators are to determine which entity: (i) is the primary obligor, (ii) has general inventory risk, (iii) has latitude in establishing price, (iv) performs part of the service, (v) has discretion in supplier selection, (vi) is involved in the determination of service specifications, and (vi) has credit risk. Verizon's finance and accounting teams reviewed the arrangement with TWC and determined that TWC is the answer for most of these factors; most significantly that TWC is the "primary obligor" in the arrangement. Verizon consulted with its outside auditor, Ernst & Young, who confirmed that Verizon's treatment of the "net amount" as revenue is consistent with GAAP and industry practice. The attached Statement of Gross Revenues for the City for 2012 was reviewed by E&Y and states that Verizon "has recorded advertising revenue in accordance with generally accepted accounting principles."

As set forth in the last sentence of Section 1.27.1 of the Franchise, advertising commissions may not be deducted from "advertising revenue that is *included in Gross Revenue*." However, if advertising commissions are not "included in Gross Revenue," then the last sentence of Section 1.27.1 does not apply. That is the case here. Verizon earns revenue from the Verizon-TWC arrangement, and properly records its revenue on its financial statements (in accordance with GAAP) and fully pays franchise fees on this revenue, without deduction. However, the Comptroller's tortured interpretation of Section 1.27.1 asks Verizon to <u>increase</u> its own Gross Revenue by the amount of revenue that TWC earns on the ad resales. That interpretation would result in Verizon recording "gross revenue" contrary to GAAP, which is a clear violation of the plain language of the Franchise Agreement.

Thus, Verizon recorded its TWC revenue, and paid its franchise fee to the City, consistent with the requirements set forth in the Franchise Agreement. To do as the City suggests in the Draft Report would require Verizon to maintain separate sets of financial records: a set of "GAAP" records for tax, securities, and other purposes; and a second set of "non-GAAP" records solely for purposes of paying franchise fees to the City. The language in the Franchise – "as determined in accordance with GAAP" – was heavily negotiated and was included precisely to avoid there being separate, and inconsistent, financial records.

The Verizon-TWC arrangement is in contrast to the Verizon-Viamedia arrangement, where Verizon and Viamedia are parties to an "Advertising Availability Representation Agreement," Viamedia is acting as Verizon's agent selling ads on Verizon's behalf, and is paid a commission based on those sales. Verizon's finance and accounting teams reviewed the arrangement with Viamedia and the accounting standards "indicators," just as it did with its TWC arrangement, and determined that GAAP required that Verizon record the Viamedia "gross sales" as its revenue. As such, in accordance with the Franchise Agreement, the advertising commissions paid to Viamedia properly are not, and have not been, netted against the Viamedia advertising revenue.

In both of its advertising arrangements – with TWC and with Viamedia – Verizon complied with its Franchise Agreement obligations, by determining revenue "in accordance with generally accepted accounting standards" to calculate "Gross Revenues" and by paying franchise fees to the City based on that calculation.

2. **Verizon Properly Reported Revenue With Respect to All Viamedia Advertising Sales.**

The Draft Report claims that Verizon understated "advertising commissions paid to advertising agencies … through Verizon's agreement with Viamedia." The Draft Report purports to base this claim on the language in the Franchise that says "[a]dvertising commissions paid to third parties shall not be netted against advertising revenue included in Gross Revenue." It is important to note that the "$1.7 million in advertising commissions" cited in the Draft Report are expenses paid by Viamedia – not Verizon. As explained above, Verizon pays Viamedia a commission for selling advertising on its behalf, and Verizon – in accordance with GAAP – includes the gross receipts in its calculation of "Gross Revenues."

The Draft Report seems to take the position that the Franchise Agreement also obligates Verizon to include in Gross Revenues the amount of expense that a third party (Viamedia) incurs in the performance of its services to Verizon. That is not a reasonable interpretation of the last sentence of Section 1.27.1. The "gross receipts" received by Verizon do not include taxes, agency fees, bad debts, refunds and other expenses that are incurred by Viamedia. Those expenses are the cost of Viamedia doing business. It makes no economic difference to Verizon, and should have no impact on Verizon's calculation of gross revenues, whether Viamedia sells advertising through its own employees or through a third party vendor. In any event, Verizon is not netting Viamedia's third party expenses "against advertising revenue included in Gross Revenue." In order for that provision even to apply, the advertising revenue must first be "included in Gross Revenue" (as determined in accordance with GAAP). With respect to its arrangement with Viamedia, Verizon is including the full amount of its gross receipts in Gross Revenues (without netting advertising commissions paid by Verizon, or paid by Viamedia). Thus, Verizon – consistent with the requirements of the Franchise Agreement and in accordance with GAAP – is not including Viamedia's $1.7 million of advertising commission expenses in its calculation of Gross Revenues.

3. Retained Advertising Availability Does Not Constitute "Foregone Revenue" Under Section 1.27.2 of the Franchise.

In defining "Gross Revenues" under the Franchise Agreement, Section 1.27.2 provides, in part, that "such foregone revenue which Franchisee chooses not to receive *in exchange for trades, barters, services or other items of value* shall be included in Gross Revenue." (Emphasis added). This is a common provision in cable franchise agreements, the obvious intent of which is to ensure that where a cable operator chooses to forgo receipt of revenue from a third party *in exchange* for consideration of some value from such third party, the foregone revenue should be reported as Gross Revenue subject to the 5% franchise fee. In other words, the provision reflects the principle that a franchisee should not be permitted to circumvent the assessment of franchise fees by agreeing to transactions involving trades, barters, or exchanges with third parties which would be exempt from Gross Revenue.

In a strained interpretation of Section 1.27.2, the Draft Report claims that certain advertising revenue used by Verizon for its own marketing purposes, rather than being sold, meets the "foregone revenue" standard under the Franchise and should have been reported as Gross Revenue. While the Draft Report cites the relevant language of Section 1.27.2, it never even attempts to articulate how Verizon's retention of its *own* advertising space for its *own* promotional purposes – involving no third party transaction for any value – constitutes an "exchange" of value which should be construed as Gross Revenue. Clearly, Section 1.27.2 was never intended to apply to circumstances in which Verizon utilizes its own internal resources to market its business, and even the most generous interpretation of that provision could not reach the conclusion that such a business decision constitutes an exchange for trades, barters, services or other items of value.

4. Verizon provided all books and records "reasonably necessary to ensure compliance with the terms of [the] Franchise" in accordance with Section 11.1 of the Franchise.

The Draft Report, in both the Discussion and Recommendations sections, states that Verizon should: i) "[m]odify existing third-party agreements to allow the Comptroller's Office and DoITT to obtain the records necessary to properly determine Verizon's compliance with the terms of the franchise agreement…;" and ii) Provide DoITT with access to all records necessary to oversee Verizon's compliance with the terms of the franchise agreement, including records that are considered confidential but are required to determine the accurate reporting of gross revenue." As Verizon has consistently explained, Verizon's agreements with advertising sales vendors and home shopping networks include confidentiality and non-disclosure provisions which Verizon cannot lawfully breach by disclosing them to DoITT or the Comptroller, absent a subpoena. Consistent with industry standards, these advertising and home shopping agreements include such provisions because they contain highly confidential and proprietary information of Verizon's third party advertising sales and home shopping partners, the disclosure of which would cause substantial competitive harm to those third party entities as well as Verizon. Contrary to the Draft Report's assertion, nothing in the Franchise precludes Verizon's acceptance of such provisions in a third party agreement and, indeed, were Verizon to refuse to agree to such terms with advertising sales vendors and home shopping networks, Verizon would suffer significant competitive impairment by inflating costs and/or limiting the number of advertising sales vendors and home shopping networks willing to do business with Verizon.

Moreover, the Comptroller's review of Verizon's underlying advertising and home shopping contracts is not "reasonably necessary to ensure compliance with the Franchise" as required under Section 11.1 of the Franchise. While Verizon was not legally permitted to disclose the full text of the advertising and home shopping contracts to the Comptroller and DoITT, Verizon did provide both agencies with vast amounts of financial information necessary to substantiate advertising and home shopping revenues, including: invoices, commission reports, billing reports, payment records, checks, wire transfer records, correspondence and other related documents. Further, following the issuance of the subpoena by the Comptroller, Verizon provided redacted versions of the relevant provisions of these agreements to the Comptroller (with the consent of Verizon's counterparties). Given the nature and scope of information provided by Verizon to the Comptroller and to DoITT with respect to advertising and home shopping, it is clear that review of certain third party proprietary provisions – many of which have no bearing on the instant audit – is not "reasonably necessary" for the Comptroller or DoITT to accurately conduct its audits.

As described above, the existing process worked in a manner consistent with the Franchise Agreement and the Comptroller's authority under Section 93(b) of the New York City Charter (the "Charter"). In addition to providing that DoITT shall have access to books and records as "reasonably necessary" to substantiate Verizon's financial obligations – a right DoITT successfully exercised throughout this audit – Section 11.1 of the Franchise also expressly acknowledges the full authority of the Comptroller to perform audits pursuant to the Charter, which it in turn exercised in full, including the issuance of the subpoena of certain agreements. This process allowed both the Comptroller and DoITT to discharge their respective oversight duties with respect to Verizon's performance under the Franchise, with transparent and good faith cooperation by Verizon in effectuating the conclusion of both audits.

Going forward, in an effort to further demonstrate Verizon's good faith and in order to assist the Comptroller and DoITT in their oversight of financial reporting under the Franchise, Verizon intends to engage its third party auditor, Ernst & Young, on an annual basis to conduct internal audits of the New York City Franchise Agreement. While this is obviously not an obligation of Verizon under the Franchise, existing law, or otherwise, Verizon strongly believes that this annual internal third party audit review will constitute an additional reflection of Verizon's already robust system of internal controls, processes, and accurate financial reporting, both as a matter of business practice and Franchise compliance.

Conclusion

Verizon appreciates the opportunity to submit this reply to the Draft Report and to respectfully clarify the glaring factual and logical inaccuracies set forth therein. As discussed above, Verizon unequivocally maintains that: 1) Verizon reported and paid franchise fees on all advertising revenue in a manner fully consistent with the requirements of the Franchise and therefore does not owe the City $1.41 million in additional franchise fees as claimed in the Draft Report; and 2) Verizon provided all books and records "reasonably necessary to ensure compliance with the terms of [the] Franchise" in accordance with Section 11.1 of the Franchise and is not precluded by the Franchise from honoring confidentiality provisions imposed by its third party advertising partners. Verizon remains hopeful that the Final Report will be modified to correct the significant errors in the Draft Report as discussed herein and that, in any event, this reply be appended to the Final Report in the interest of establishing an accurate and transparent record.

Respectfully,

Azare

Monica F. Azare

Information
Technology &
Telecommunications

Rahul Merchant
Chief Information and Innovation Officer
Department of Information Technology and Telecommunications
255 Greenwich Street, 9th Floor
New York, New York 10007

November 27, 2013

The Honorable H. Tina Kim
Deputy Comptroller
Office of Comptroller
Bureau of Audit
One Centre Street, Room 1100
New York, NY 10007-2341

Re: Audit Report on the Compliance of Verizon New York, Inc., FM12-085A

Dear Deputy Comptroller Kim:

Thank you for the opportunity to comment on the above referenced audit report.

The position of the Department of Information Technology and Telecommunications (DoITT) is that our franchise agreement with Verizon New York entitles both the Comptroller and DoITT to audit Verizon's FiOS gross revenues, that such audits must be conducted pursuant to Generally Accepted Government Auditing Standards (GAGAS), and that Verizon is obligated by the franchise agreement to produce all documentation and information to the auditor that is necessary to complete the audit. To the extent that Verizon fails or refuses to produce such documentation or information, it is DoITT's position that Verizon is in breach of the franchise agreement. Our position is not different where Verizon fails or refuses to provide advertising contracts because those contracts contain non-disclosure clauses. The matter is of some importance because, although the Comptroller has statutory subpoena power and therefore was able to obtain copies of the advertising contracts for this audit, DoITT does not have subpoena power yet remains fully entitled under the franchise agreement to gain access to those contracts in order to conduct an audit of Verizon's gross FiOS revenue.

Following are our responses to your recommendations:

<u>Recommendation 1:</u> Verizon should immediately remit $1.41 million in additional franchisee fees due to the City.

DoITT Response: While we do not have access to critical documents underlying this recommendation, promptly after receipt of the Comptroller's final audit report, we will send Verizon an invoice for $1.41 million, or such other amount the Comptroller finds to be due in the final report. If payment in full is not made within 30 days of the invoice, we will assess late fees as provided in the franchise agreement.

Recommendation 2: Verizon should report all advertising revenues at gross (including all advertising commissions) in the quarterly franchise fee reports it submits to the City, as required by the franchise agreement, and pay the appropriate franchise fees.

DoITT Response: We agree with this recommendation.

Recommendation 3: Verizon should track the value of its internal marketing advertising availabilities, report the value of such advertisements in its quarterly franchise fee reports submitted to the City, and pay the appropriate franchise fees.

DoITT Response: We agree with this recommendation.

Recommendation 4: Verizon should modify existing third-party agreements to allow the Comptroller's Office and DoITT to obtain the records necessary to properly determine Verizon's compliance with the terms of the franchise agreement.

DoITT Response: We agree with this recommendation. Verizon is in violation of its franchise agreement by entering into advertising contracts that do not allow DoITT to review those contracts. Verizon must ensure that the Comptroller's Office and DoITT have access to these advertising contracts and in the future must enter into advertising contracts that clearly provide for auditing by DoITT and the Comptroller.

Recommendation 5: Verizon should provide DoITT with access to all records necessary to oversee Verizon's compliance with the terms of the franchise agreement, including records that are considered confidential but are required to determine the accurate reporting of gross revenue.

DoITT Response: We agree with this recommendation.

Recommendation 6: DoITT should ensure that Verizon pays the $1.41 million in additional franchise fees due to the City. As per the franchise agreement, if Verizon has not paid the franchise fees following at least 30 days written notice, DoITT should assess a nine percent late fee on the amount due.

DoITT Response: See response to recommendation 1 above.

Recommendation 7: DoITT should ensure that Verizon accurately reports all revenue on its quarterly franchise fee reports and pays the appropriate franchise fees, as required by the franchise agreement.

DoITT Response: We agree with this recommendation. We have persistently sought to ensure that Verizon accurately reports gross revenue as required by its franchise agreement. We will continue to conduct reviews and audits and will take appropriate action to ensure that Verizon complies with all terms and conditions of the franchise agreement.

Recommendation 8: DoITT should ensure that Verizon complies with all of the recommendations in this report.

DoITT Response: We agree with this recommendation.

If you have any questions regarding our responses, please feel free to contact me at 718-403-8024.

Sincerely,

Stanley Shor
Assistant Commissioner for Franchise Administration

C: Alma Fana, Michael Morgese, George Davis III, Charles R. Fraser, Linda Mercurio, Wayne Kalish