BKD Telecommunications

IMPACTS OF NEW LEASE ACCOUNTING STANDARD – WHAT DOES IT MEAN TO ME?

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AGENDA

- ASC 842 – Leases, ASU 2016-02
  - What's new
  - Comparison with today's rules
  - Details of standard
- Financial Impacts
  - Possible debt covenant impacts
- Regulatory Effects of Standard
  - FCC Part 32 pending rules
  - Potential NECA Settlement Impacts

WHAT CHANGES?

- All leases will be recognized on the balance sheet of lessees
- Operating leases
  - Lease liability
  - Right of Use Asset
  - Don’t appear anywhere under today’s rules
- Finance leases (formerly capital leases)
  - Lease liability
  - Lease assets
  - Similar to today’s rules

WHAT CHANGES?

Lessee Accounting – Comparison of Accounting for Financing Leases			
		Legacy GAAP (Capital Leases)	**ASU 2016-02 (Finance Leases)**
Balance Sheet			
Recognition	Lease assets and liabilities on balance sheet	Yes	Yes
	Exemption for short-term leases	No	Yes
Measurement	Lease liabilities measured on a discounted basis	Yes	Yes*
	Initial lease asset = lease liability	Yes	Yes
	Amortization of lease asset	Generally on a straight-line basis	Generally on a straight-line basis
Presentation	Lease assets	Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the capital lease assets and their amounts	Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the finance lease ROU assets and their amounts
	Lease liabilities	Presented separately from other liabilities, or together with other liabilities with disclosure of the balance sheet line items that include the capital lease liabilities and their amounts	Presented separately from other liabilities, or together with other liabilities with disclosure of the balance sheet line items that include the finance lease liabilities and their amounts
Income Statement			
	Lease-related costs	Amortization of lease assets and lease-related interest expense presented separately	Amortization of finance lease ROU assets and lease-related interest expense presented separately
Cash Flows			
	Operating activities	Cash payment for the interest portion of the lease liability	
	Financing activities	Cash payments for principal portion of the lease liability	

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WHAT CHANGES?

Lessee Accounting – Comparison of Accounting for Operating Leases

		Legacy GAAP	ASU 2016-02
Balance Sheet			
Recognition	Lease asset and liabilities on the balance sheet	No	Yes
	Exemption for short-term leases	N/A	Yes
Measurement	Lease liabilities measured on a discounted basis*	N/A	Yes*
	Initial lease asset = lease liability	N/A	Yes
	Subsequent measurement of lease asset	N/A	Periodic amortization of the asset typically increases with time**
Presentation	Operating lease ROU assets	N/A	Presented separately from finance lease ROU assets with disclosure of related balance sheet line items that include the operating lease assets
	Lease liabilities		Presented separately from finance lease liabilities
Income Statement			
	Lease-related costs	Single lease or rent expense, generally straight line	
Cash Flow Statement			
	Operating activities	Cash payments for lease payments	

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WHY THE CHANGE?

- Increase comparability and transparency among entities
- Decade-long joint project between FASB & IASB
- Eliminate off-balance sheet risk and improve comparability
- More reflective of true substance of leasing transactions
- Lessor accounting remained relatively unchanged

EFFECTIVE DATES

- Early adoption is permitted

Effective Dates Leases ASC 842 ASU 2016-02	Public Entities[1]	All Others
	Annual and interim reporting periods beginning after December 15, 2018	Annual reporting periods beginning after December 15, 2019

[1] A Public entity is defined as any one of these:

- A public business entity
- A not-for-profit entity that has issued – or is a conduit debt obligor for – securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC

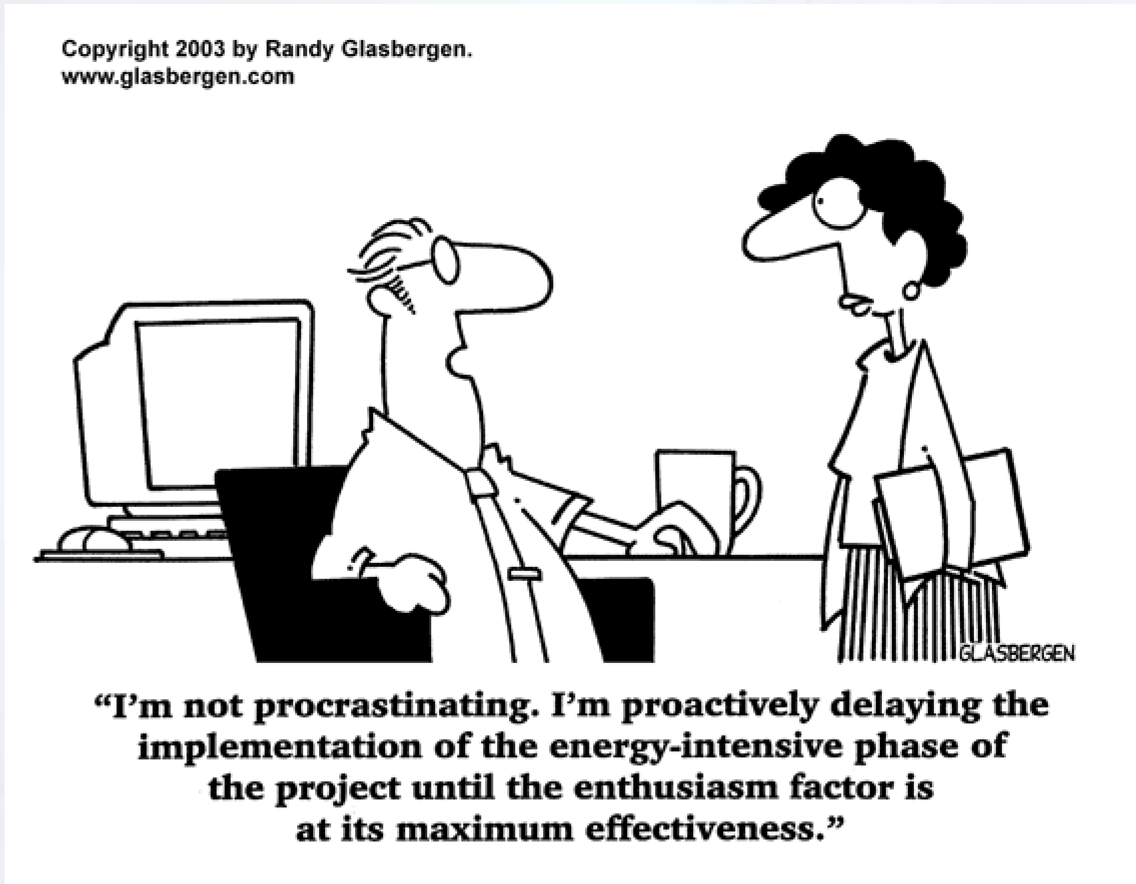
TRANSITION – PRACTICAL EXPEDIENTS

- Modified retrospective transition approach
  - Essentially allows companies to continue to use previous GAAP until existing leases expire or are modified
  - EXCEPT – still have to record the right of use asset and lease liability for all periods presented
    - ✓ Proposal to allow for only in period adopted

TRANSITION – PRACTICAL EXPEDIENTS

- Practical expedients (All three or none)
  - Lessee need not reassess whether any expired or existing **contracts are or contain a lease**
  - Lessee need not reassess **lease classification** for any expired or existing leases
  - Lessee need not reassess **initial direct costs** for any existing lease
- Practical expedient – hindsight in evaluating lessee options to extend or terminate a lease or to purchase underlying asset

WHEN SHOULD WE START?



WHERE DO WE START?

- Identify & educate
- Develop timeline & key milestones
- Identify and collect **ALL** leases and relevant data
- Analyze data – key elements
- Implementation – accounting & reporting
- **Ongoing** accounting – centralization, new leases, modifications, monitoring…and much more

KEY ELEMENTS TO EVALUATING CONTRACTS FOR LEASE

- Counter-party
- Identifiable asset
- Lease commencement date
- Lease term and renewal options
- Interest rate
- Lease payment
  - Fixed
  - Incentives paid by lessee
  - Variable (CPI, market interest rate or other)
  - Frequency
- Exercise price of purchase option
- Penalties for termination, if any
- Residual value guarantees
- Initial direct costs
- Non-lease components

WHAT IS A LEASE?

- Right to control use of identified property, plant or equipment for a period of time in exchange for consideration
- “Control” means the customer has both
  - The right to obtain substantially all of the economic benefits from use of the asset
  - Right to direct use of the asset

WHAT IS A LEASE?

- Portions of assets
  - A capacity portion of an asset can be an “identified asset” if it is physically distinct
    - ✓ E.g. floor of a building, segment of a fiber cable connecting a single customer to a larger network
  - Capacity of a portion of an asset that isn’t physically distinct is not an “identified asset” (not a lease)
    - ✓ E.g. capacity of a fiber cable **unless** it represents substantially all of the capacity of the asset and gives the customer right to obtain substantially all the economic benefits from use of the asset

WHAT IS A LEASE?

- For a lease with a term of 12 months or less, a lessee is permitted to make an **accounting policy** election not to recognize lease assets and lease liabilities.
- If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.
- Consideration of renewal options…
  - Don’t continually renew one-year leases to avoid the Finance Lease accounting
- Does require some disclosure
- Leases with *RELATED PARTIES* should be recognized consistently with the classification criteria above on the basis of legally enforceable terms.

WHAT IS A LEASE?

- EXAMPLE # 1
  - Entered a 15-year contract for fiber-optic cable
  - Right to use two specified, physically distinct dark fibers
  - Customer decides how to use the fibers
    - ✓ What equipment to connect to
    - ✓ What data and how much data fiber will transport
  - Telco (supplier) is responsible for repairs and maintenance of fiber
  - Do we have a lease?

WHAT IS A LEASE?

- EXAMPLE # 2
  - Entered a 15-year contract for fiber-optic cable
  - Right to use specified amount of capacity (equivalent of 2 strands of 24 strand fiber)
  - Telco (supplier) makes decisions about transmission of data
  - Telco (supplier) is responsible for repairs and maintenance of fiber
  - Do we have a lease?

LEASE TERM

- Defined as the **non-cancellable** period for which a lessee has the right to use an underlying asset, including:
  - Periods covered by an option to extend that the **lessee** is reasonably certain to exercise
  - Periods covered by an option to terminate if lessee is reasonably certain **not** to exercise
  - Periods to extend or terminate in which the option is controlled by the **lessor**
- “Reasonably Certain” is similar to “Reasonably Assured” (a high threshold)

LEASE PAYMENTS

- Determine at the commencement date and include (initial measurement):
  - Fixed payments, including in substance payments, less any lease incentives
  - Variable lease payments that depend on an index or rate
  - Exercise price of an option to purchase the underlying asset
  - Payments for penalties for terminating the lease
  - Fees paid by lessee to entity for structuring the transaction. (Such fees are not included in the fair value of the underlying asset.)
  - Residual value guarantees – amounts probable of being owed by lessee

LEASE PAYMENTS EXAMPLE

Key Factors of Lease

- 10-year lease of building
- Annual lease payments of $100,000
- Lease payments increase each year by CPI
- CPI is 125 at commencement date
- 0% (for ease of example)
- Year 2 – CPI to 128

Solution

- Fixed payments $1M
- ROU Asset/Lease Liability $1M
- Year 2 payment - $102,400
- No adjustment to ROU Asset/Lease liability for CPI*
- $2,400 – variable lease cost

**unless lease modification occurs*

LEASE CLASSIFICATION

- **Finance Lease**, if the lease meets any of the following:
  - (a) Transfer of ownership of asset at end of lease term
  - (b) Option to purchase asset that is reasonably certain to be exercised
  - (c) Lease term is the **major part** of the economic life*
  - (d) PV of sum of lease payments and residual guarantee amount to at least **substantially all** of the fair value
  - (e) Underlying asset is of specialized nature, with **no alternative value** to lessor at end of lease term.
- If none of the above criteria are met, it's an **Operating Lease**

* If lease entered into with less than 25% remaining economic life – It's a financing lease.

ACCOUNTING TREATMENT SUMMARY

Finance Lease		Operating Lease	
Balance Sheet		**Balance Sheet**	
	Right of Use (ROU) Asset		Right of Use (ROU) Asset
	Lease Liability		Lease Liability
Income Statement		**Income Statement**	
	Interest expense (on lease liability)		Lease/Rent expense (straight-line)
	Amortization expense (on ROU Asset)		
Cash Flow Statement		**Cash Flow Statement**	
	Operating Activities – interest payments		*Operating Activities* – cash paid for lease payments
	Financing Activities – Cash paid for principal payments		

ACCOUNTING – INITIAL MEASUREMENT

- ROU asset & lease liability
  - Same process for operating or finance lease
- Lease liability = PV of future lease payments
  - Discounted rate in lease OR
  - Incremental borrowing rate
- ROU assets = Lease liability

  + Initial direct costs
  + Payments made at or before lease commencement

INITIAL MEASUREMENT - EXAMPLE

<u>Key Factors of Lease</u>

- 5-year lease of Cell Tower
- Annual lease payments of $100,000
- 3.5% discount rate
- Initial direct costs of $15,000

Years		Annual Payment	
Year 1	$	100,000	
Year 2		100,000	
Year 3		100,000	
Year 4		100,000	
Year 5		100,000	
	$	500,000	
NPV at 3.5%		$451,505	*Lease liability*
		15,000	*Initial direct costs*
	$	466,505	*ROU asset*

IMPLEMENTATION – FINANCING LEASE

Financing leases

- Each payment has two components (interest and principal).
  - ✓ Part I –
    - o Lease liability $XXX
    - o Interest expense XXX
      - ➢ Cash XXX
- Amortization of the right-to-use asset (similar to how depreciation on a capital lease is currently reported)*
  - ✓ Part II –
    - o Amortization of ROU $XXX
      - ➢ ROU asset XXX
- Variable lease payments not in lease liability recorded as expense when incurred

**Short of useful life or lease term, unless ownership transfers or reasonably certain to exercise purchase option – requires useful life of underlying asset.*

IMPLEMENTATION OF FINANCING LEASE

Assumption - Right to use Cell Tower asset transfers at the end of the lease term – **Financing lease**

	Annual Payments	Lease Liability NPV @ 3.5%	Cash	Interest Expense	Lease Liability	ROU Asset	Amortization of ROU Asset
Year 1	100,000	451,505	(100,000)	15,803	84,197	(66,644)	66,644
Year 2	100,000	367,308	(100,000)	12,856	87,144	(66,644)	66,644
Year 3	100,000	280,164	(100,000)	9,806	90,194	(66,644)	66,644
Year 4	100,000	189,969	(100,000)	6,649	93,351	(66,644)	66,644
Year 5	100,000	96,618	(100,000)	3,381	96,619	(66,644)	66,644
Year 6	-	-	-	-	-	(66,644)	66,644
Year 7	-	-	-	-	-	(66,641)	66,641
	500,000		(500,000)	48,495	451,505	(466,505)	466,505

IMPLEMENTATION – OPERATING LEASE

Operating leases

- Single lease expense is recognized that runs through operating expenses for the current year
- Part I -
  - Amortization of ROU Asset $XXX
    - Cash XXX
- Part II -
  - Lease liability XXX
    - ROU asset XXX
- Overall cost of the lease is allocated over the lease term on a straight-line basis.*
- Variable lease payments not in lease liability recorded as expense when incurred

**Escalating rent may cause deferred rent*

IMPLEMENTATION – OPERATING LEASE

Assumption – No purchase option or transfer of rights at the end of the lease term – **Operating lease**

	Annual Payments	Lease Liability NPV @ 3.5%	Cash	Lease Expense	ROU Asset	Lease Liability
Year 1	100,000	$451,505	(100,000)	100,000	(84,197)	84,197
Year 2	100,000	$367,308	(100,000)	100,000	(87,144)	87,144
Year 3	100,000	$280,164	(100,000)	100,000	(90,195)	90,195
Year 4	100,000	$189,969	(100,000)	100,000	(93,351)	93,351
Year 5	100,000	$96,618	(100,000)	100,000	(96,618)	96,618
	500,000		(500,000)	500,000	(451,505)	451,505

REPORTING AND DISCLOSURES

- Operating and financing leases
  - Right-to-use asset and lease liabilities should be presented separate from one another and from other assets and liabilities.
  - No netting of assets and liabilities
  - Split between current and long-term
  - Separate maturity analysis of undiscounted cash flows
- Short-term lease costs, policy disclosure, and if significant short-term lease commitments.
- Variable lease costs, not included in lease liabilities
- Lease transactions with related parties

IMPACTS

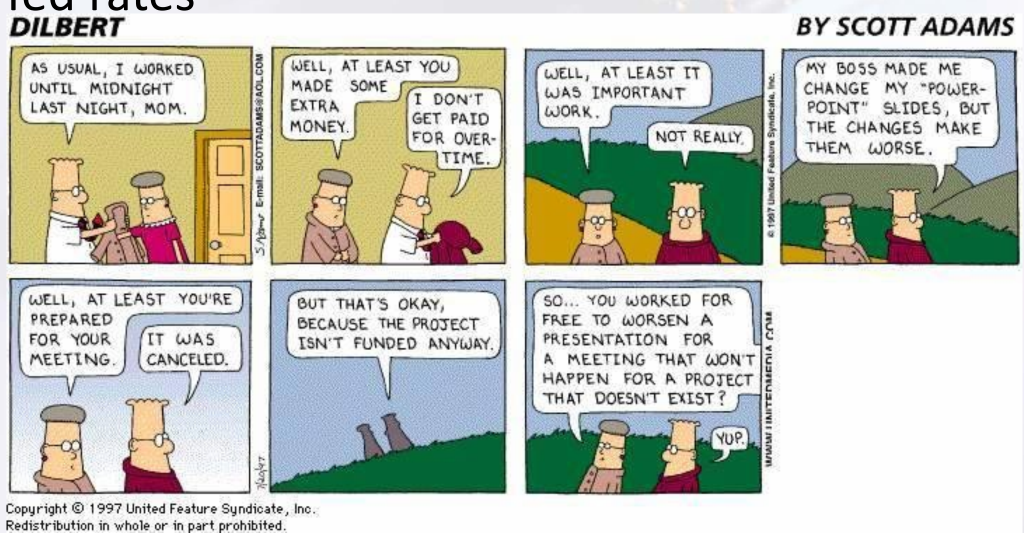
- Loan covenants
- Financial statement ratios
- Borrowing capacity
- Implementation time and resources
- Regulatory
- Settlements

REGULATORY IMPACTS

- FCC Part 32 Accounting Rules
  - Don’t currently provide for how to record the ROU asset and related liability
  - FNPRM 18-29 currently has several options proposed
    - ✓ Should the FCC concur and adopt ASC 842 or should they diverge?
      - o Implications of additional record keeping for Part 32 vs GAAP
    - ✓ If concur – where to record ROU asset and lease liability
    - ✓ If concur –
      - o Does the ROU asset go into rate base? Would need to remove amortization of ROU asset from expense if this happened
      - o ROU as a 1410.xx and not part of rate base. Leave lease expense

SETTLEMENT IMPACTS

- Average Schedule Companies
  - Settlements (if participating in NECA's pools and tariffs)
    - ✓ Eventually impacts to cost companies would flow through average schedule formulas
  - Individual or non-NECA group tariffed rates
    - ✓ Possibly no impact, depends how closely you are basing rates off of NECA's tariffed rates



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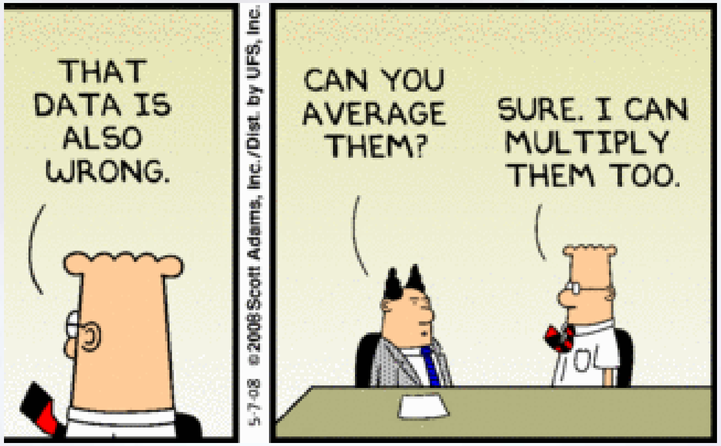
SETTLEMENT IMPACTS

- Average Schedule Companies
  - Model-Based USF
    - ✓ No impact
      - o USF is paid on model's cost estimates for locations built out to, not actual costs
  - Legacy (Traditional) USF
    - ✓ Eventually impacts to cost companies should flow through average schedule formulas



SETTLEMENT IMPACTS

- Model-Based Support/ACAM Cost Companies & Legacy Cost Companies
  - Settlements (if participating in NECA's pools and tariffs)
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Then it depends on the FCC's treatment of asset
          - Include in Rate Base
            - Could be higher or lower than excluding from Rate Base, depends on circumstances
            - Most cases higher than excluding from Rate Base

SETTLEMENT IMPACTS

- Model-Based Support/ACAM Cost Companies & Legacy Cost Companies
  - Settlements (if participating in NECA's pools and tariffs)
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Then it depends on the FCC's treatment of asset
          - Exclude from Rate Base
            - Same results as status quo
      - o Keep status quo and diverge from GAAP
        - ➢ No change to current rules/settlements

SETTLEMENT IMPACTS

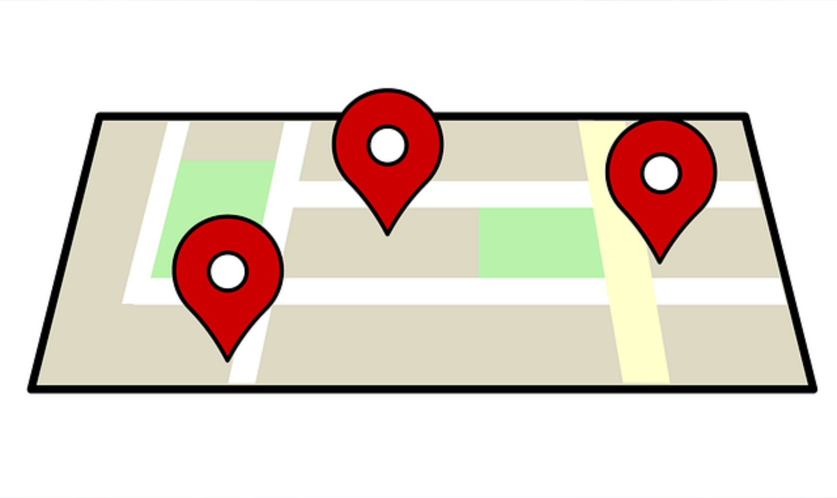
- Model-Based Support/ACAM Cost Companies & Legacy Cost Companies
  - Individual or non-NECA group tariffed access rates
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Then it depends on the FCC's treatment of asset
          - Include in Rate Base
            - Could be higher or lower than excluding from Rate Base, depends on circumstances
            - Most cases higher than excluding from Rate Base

SETTLEMENT IMPACTS

- Model-Based Support/ACAM Cost Companies & Legacy Cost Companies
  - Individual or non-NECA group tariffed access rates
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Then it depends on the FCC's treatment of asset
          - Exclude from Rate Base
            - Same results as status quo
        - ➢ Also depends on how closely your company is following rules to set Cost-Based rates and following NECA guidelines
      - o Keep status quo and diverge from GAAP
        - ➢ No change to current rules/settlements

SETTLEMENT IMPACTS

- Model-Based Support/ACAM Cost Companies
  - Model-Based USF
    - ✓ No impact
      - o Paid on model's cost estimates for locations built out to, not actual costs



SETTLEMENT IMPACTS

- Legacy (Traditional) Cost Companies
  - Cost-Based USF
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Treatment of asset- include in Rate Base or exclude?
          - Include in Rate Base
            - Could be higher or lower than excluding from Rate Base, depends on circumstances
            - Most cases lower than excluding from Rate Base

SETTLEMENT IMPACTS

- Legacy (Traditional) Cost Companies
  - Cost-Based USF
    - ✓ Depends on FCC
      - o Concur with and adopt ASC 842
        - ➢ Treatment of asset- include in Rate Base or exclude?
          - Exclude from Rate Base
            - Same results as status quo
      - o Keep status quo and diverge from GAAP
        - ➢ No change to current rules/Cost-Based USF

SETTLEMENT IMPACTS

- Legacy (Traditional) Cost Companies
  - Net Settlements and Cost-Based USF
    - ✓ Operating Lease with Right of Use Asset in Rate Base
      - In most scenarios produced highest increase in total RRQ and USF
    - ✓ Operating Lease with Right of Use Asset in non-regulated
      - In most scenarios produced second highest increase in total RRQ and USF
    - ✓ Purchase asset instead of leasing or Finance Lease
      - In most scenarios, lowest overall increase in total RRQ and USF

SETTLEMENT IMPACTS

- Final Thoughts:
  - Average Schedule – Operating leases are an option, but does not specifically impact your company's revenues
    - ✓ More of a case by case basis
    - ✓ Evaluate overall on financial and non-financial costs and benefits
  - Cost Companies – Operating leases may still be viable even after rule changes
    - ✓ Need to work directly with your cost consultant as each company can be different

QUESTIONS?

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THANK YOU!

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