

DEPRECIATION ISSUES AND ALTERNATIVE METHODS

TSTCI 2009 FINANCE, MARKETING, COMMERCIAL CONFERENCE

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Introduction

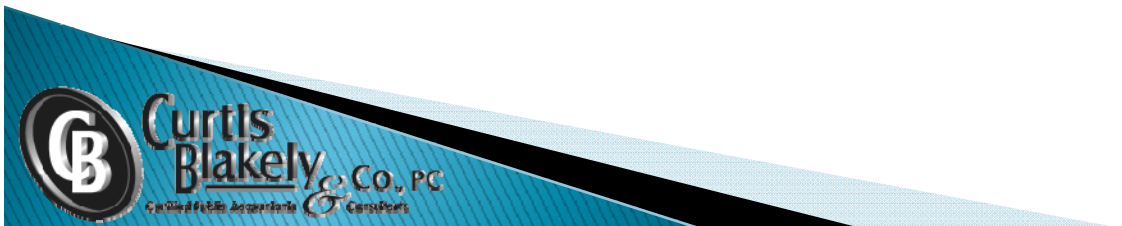
- ▶ Most telcos use group method depreciation, whereby a rate calculated for a group of assets is applied to the group to compute depreciation expense.
- ▶ This method specifies that gains and losses are generally not recognized when retirements are made.
- ▶ Group methods are in accordance with GAAP.

Introduction

- ▶ Many telcos are experiencing a situation where accounts depreciated on a group basis have large balances and are fully depreciated or nearing that point. This is causing a dilemma where a large addition may occur in a month and the entire addition be fully depreciated the next month.

Introduction

- ▶ This does not seem reasonable or logical and is an indication that the approved group depreciation rate is too high or possibly that retirements are not being reported and recorded.



Regulatory Requirements

- ▶ As members of NECA and Federal USF recipients, regulated telcos, including Class B companies with revenues less than \$142 million, are required to comply with Part 32.
- ▶ Part 32.2000 (g) specifies the accounting for depreciation.

Part 32.2000(g)

- ▶ g)(1)(i) “depreciation percentage rates shall be computed in conformity with a group plan of accounting for depreciation.”
- ▶ (g)(2)(i) “A separate annual percentage rate for each depreciation category of telecommunications plant shall be used in computing depreciation charges.”

Part 32.2000(g)

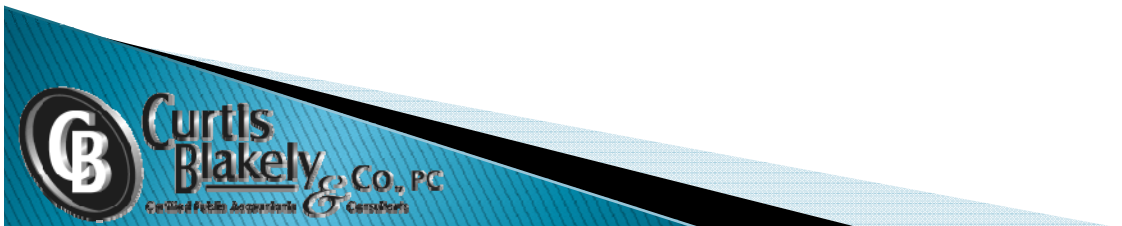
- ▶ (g)(2)(ii) “shall apply such depreciation rate ... as will ratably distribute on a straight line basis the difference between the net book cost of a class or subclass of plant and its estimated net salvage”.
- ▶ (g)(2)(iii) “Current monthly charges shall normally be computed by the application of one-twelfth of the annual depreciation rate to the monthly average balance of the associated category of plant.”

Commission Approval

- ▶ There are several references in section (g) to requirements for approval by the Commission.
- ▶ The Commission is the FCC
- ▶ Small regulated telcos are not required to obtain FCC approval for depreciation rates or extraordinary retirements.
- ▶ Regulated by state commissions

Commission Approval

- ▶ In Texas, all depreciation rates of regulated telcos are subject to Texas PUC approval or were grandfathered upon creation of the PUC and are on file with the PUC.
- ▶ PUC Substantive Rule 26.206 Depreciation Rates describes the PUC rules regarding depreciation.



Sub Rule 26.206

- ▶ (a) **General.** Dominant certificated telecommunications utilities (DCTUs) shall use depreciation rates approved by the commission to determine depreciation expense and provide for accumulated depreciation (also referred to as depreciation reserve). For purposes of this section, depreciation rates used prior to September 1, 1976, and those in effect on September 1, 1976, shall be deemed appropriate for use, unless subsequently modified by the commission.

Sub Rule 26.206

- ▶ (b) Depreciation rate changes for telecommunications utilities subject to regulation of interstate depreciation rates by the Federal Communications Commission. This section is not applicable to small companies.

Sub Rule 26.206

- ▶ (c) Depreciation rate changes for other dominant carriers. Any DCTU, except as covered in subsection (b) of this section, requesting a change in depreciation rates must request commission approval and include in its request the information set out in paragraphs (1) – (3) of this subsection.

Sub Rule 26.206

- ▶ (1) For each property account or subaccount for which a depreciation rate change is proposed:
 - (A) the plant in service and the accumulated depreciation as of the requested effective date for the proposed depreciation rates;
 - (B) the total of accruals, additions, retirements, gross salvage, and cost of removal for each of the preceding 4 years; and
 - (C) detailed justification for the proposed changes.

Sub Rule 26.206

- ▶ (2) The requested effective date of the changes. A request for an effective date that is earlier than January 1st of the year in which the request is filed must be fully justified in order to receive consideration.
- ▶ (3) The change in annual depreciation expense that would result from adoption of the proposed depreciation rates, expressed both as a dollar amount and as a percentage of current total depreciation expense.

Sub Rule 26.206

- ▶ (d) **Methods for figuring depreciation rates.** On application by a utility, the commission shall fix depreciation rates that promote deployment of new technology and infrastructure. In setting depreciation rates, the commission shall consider depreciation practices of nonregulated telecommunications providers. Depreciation rates must be based on reasonable methods of depreciation; however, the commission reserves the right to specifically consider any and all appropriate methods of depreciation in each case.

Sub Rule 26.206

- ▶ (e) **Burden of proof.** A DCTU shall have the burden of proof to show that depreciation or amortization expense is reasonable, necessary and in the public interest. The DCTU shall also be required to show that depreciation rate changes were timely requested in accordance with prudent management practices. The burden of proof shall not be satisfied solely by demonstrating that the depreciation rates or amortization periods used were approved. If the DCTU fails to meet this burden the commission may deny as a cost of service that depreciation or amortization expense.

Sub Rule 26.206

- ▶ (f) **Interim booking.** Unless otherwise ordered by the commission, a DCTU may book depreciation and amortization expense on an interim basis based on proposed depreciation rates from the month of filing until interim or final action by the commission. Interim booking shall be adjusted upon final approval of depreciation rates and records must be maintained showing the interim booking and the adjustments, if any, that were made upon final approval of the rates.

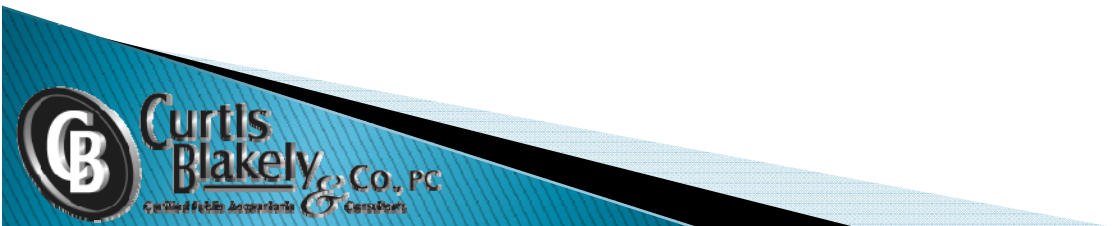


Sub Rule 26.206

- ▶ (g) **Special amortization.** Where all or a substantial portion of a property account or subaccount is retired earlier than anticipated and the reserve for that account is less than the amount to be retired less salvage, or in other instances when an amortization is appropriate, special amortization may be requested.

Sub Rule 26.206

- (1) If the amortization period is two years or less, and the annual amount to be amortized is less than 2.0% of annual revenues, the DCTU shall advise the commission. The commission may review the appropriateness of such amortization during rate cases.
- (2) If the amortization period is more than two years, or the amount to be amortized is more than 2.0% of annual revenues, commission approval is required.



Sub Rule 26.206

- ▶ (h) **New depreciation rates.** When a DCTU determines a need to establish a new depreciation rate for a new class of property, it may adopt a depreciation rate that has been approved by the commission for a similar DCTU for the same property class if similar depreciation parameters and methods are used to determine the rates. The DCTU must notify the commission that it has adopted such rates within 45 days of its adoption. The commission may review and modify such rates upon appropriate motion or in subsequent rate or depreciation proceedings.

Sub Rule 26.206

- ▶ (i) **Public Utility Regulatory Act (PURA), Chapter 58 companies.** A company electing under PURA Chapter 58 may determine its own depreciation rates and amortizations, but shall notify the commission of any subsequent changes to the rates or amortizations. Such company shall notify the commission using the same format required by the Federal Communications Commission for depreciation and amortization filings.

Alternatives

- ▶ File for lower depreciation rates
 - Not an immediate solution because the rate is still applied to a large plant balance
- ▶ Inventory plant or review CPRs for unrecorded retirements
 - Will not change the book value of plant but will reduce depreciation base
- ▶ Vintage year depreciation

Vintage Year Depreciation

- ▶ Regulated telcos are required to use state commission approved rates computed in conformity with a group depreciation method.
- ▶ Section 32.2000 (g)(2)(ii) requires the rate to be applied, on a straight line basis, to classes or subclasses of plant but these are not defined.

Vintage Year Depreciation

- ▶ “Category of plant” as used in 32.2000 (g)(2)(iii) is also undefined.
- ▶ Telcos have historically applied approved rates computed on a group basis to individual items, mainly for vehicles and other support assets.

Vintage Year Depreciation

- ▶ CB&Co's opinion is that group rates could be applied on a vintage year basis to regulated plant accounts and still comply with the group method requirement.
- ▶ This would require maintaining a depreciation schedule by vintage year and applying the group rate for a particular account to each year.

Vintage Year Depreciation

- ▶ Depreciation for the current year could be computed using the average monthly balance or the prior month ending balance as the basis for depreciation.
- ▶ Once a vintage year's book value reaches the salvage or negative salvage value used in computing the group rate, depreciation would cease for that year.
- ▶ If the negative salvage factor used to determine the depreciation rate were -30% , each vintage would be over depreciated by 30% of the cost basis.

Retirements

- ▶ Using a vintage year method would require adopting an assumption for retirements, such as, first-in-first-out (FIFO).
- ▶ Retirements would be removed from the earliest year first.
- ▶ If not completely absorbed, the remaining retirement value would be removed from the next year.

Retirements

- ▶ If a vintage year is not fully depreciated, the amount removed from accumulated depreciation on the depreciation schedule will move forward into subsequent years faster than the reduction of the plant cost.
- ▶ There could be situations where salvage is recorded but the asset and AD have been removed, in which case, the salvage could be recorded in the next vintage.
- ▶ The same could occur for cost of removal (COR).

Retirements

- ▶ For central office equipment, CPRs may identify the year equipment was installed so that FIFO would not be necessary.
- ▶ FIFO would be the most logical assumption for cable and other outside plant.

Effect on Expense

- ▶ Adopting a vintage year group method will effect depreciation expense in the year of adoption and all future years, and the dollar impact of a vintage year method versus applying the rate to an entire account balance will increase as years accumulate.
- ▶ The effect should be a decrease in depreciation expense in the first several years after adoption.

Effect on Revenue

- ▶ The decrease in depreciation expense will slow down the decline in rate base.
- ▶ The effect will probably be a decrease in support revenue for the first few years after adoption.
- ▶ Talk to your cost consultant before changing to vintage year on your regulated companies.

Non-regulated Affiliates

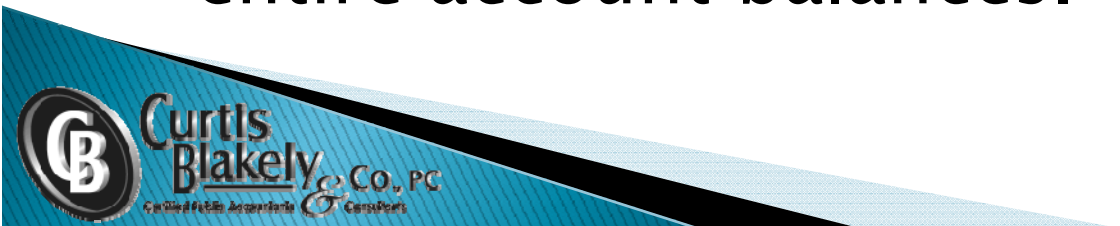
- ▶ The vintage year method can be used for affiliates of telcos that use group method depreciation .
- ▶ Using a vintage year method would not change the accounting for retirements (no gain or loss recognized).
- ▶ No negative impact on revenue.

Software

- ▶ Using a vintage year method will complicate the monthly depreciation calculations.
- ▶ It may be worth purchasing depreciation software to accomplish the vintage year calculations.
- ▶ Software that interfaces with the g/l may not be able to perform calculations in this manner.

Application

- ▶ A company would not be required to adopt a vintage year method for all accounts.
- ▶ Can choose the accounts that are creating the distortion to depreciation expense.
- ▶ The result may be that you use three different methods applying group rates to individual items (common for vehicles and work equipment), applying group rates to vintage years, and applying group rates to entire account balances.



Accounting & Disclosure

- ▶ According to SFAS 154, changing to a vintage year method is considered a change in an estimate and would be recorded in the current and future periods.
- ▶ It is not presented as a cumulative effect adjustment.
- ▶ The nature and reason for the change and the effect on net income in the year of change must be disclosed.
- ▶ Suggest making the disclosure in the PP&E paragraph of Note 1.

Sample Disclosure

- ▶ In 2008, the Cooperative changed its method of computing and recording depreciation expense for certain telephone plant accounts. The change was from applying group method depreciation rates to entire plant account balances to applying these same rates to plant additions on a vintage year basis. The Cooperative made the change because, for certain plant accounts, applying group method rates to the entire plant balance was depreciating additions to plant very rapidly, such as in one month. Changing to a vintage year group method decreased depreciation expense by \$600,000 from what it would have been using the old method for all accounts.

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