CFC Issue brief

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Accounting Considerations for Broadband

CFC is proud to fund electric cooperative broadband initiatives. We also work with our members to ensure their strategic business plans are sound.

Key Takeaways

- Cooperatives face a key strategic decision when choosing a division, subsidiary or hybrid business structure—each with its own unique accounting considerations, advantages and disadvantages.
- It is critical for cooperatives launching a broadband business to adopt accounting and reporting procedures that separate the telecommunications business from the electric business.
- Appropriate revenue and expense allocation is the foundation of sound business planning and decision-making.
- CFC strongly recommends that cooperatives consult their accountants, auditors, FERC consultants and attorneys as they make key decisions regarding establishing a broadband business.

Overview

Electric cooperatives are playing a critical role in making broadband available to rural America. When it comes to launching communications ventures, each cooperative is unique. There is no one-size-fits-all approach to starting up a broadband business.

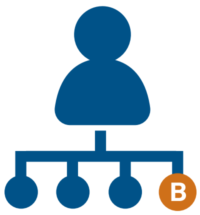
To date, CFC is aware of 35 cooperatives that have completed broadband projects, with another 131 in construction and planning stages. CFC is working with our members as they consider business structure options along with accounting and finance implications. We are seeking to ensure cooperatives are well-positioned to bring the benefits of broadband to their members while mitigating risks inherent in pursuing new ventures.

Early decisions around how to set up a broadband business structure can have downstream implications for cooperatives. Cooperatives are encouraged to evaluate their options, understand the legal and regulatory requirements for their territories and plan for potential long-term tax, financial and patronage capital impacts.

To meet their strategic broadband objectives, CFC encourages its members to follow a phased approach to ensure early business forecasts are meeting expectations and technology and economic risks are effectively mitigated.

Business Structures

Cooperatives are approaching broadband using two primary business structures: the division model and the subsidiary model. To date, most cooperatives using the subsidiary model are building and owning the fiber at the electric cooperative level and leasing it to the subsidiary. Each option has its own advantages, risks and disadvantages, as well as unique accounting considerations.



Division

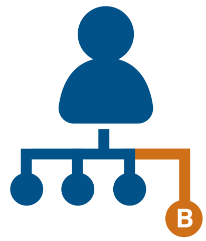
Creating a broadband business as a division of the electric cooperative.

ADVANTAGES

- Broadband is considered a "Like Activity" under section 501(c)(12), which means it may be a tax-exempt activity if structured on a patronage basis.
- Broadband operations are accounted for as a whole.
- Members may benefit from a new service as well as the additional patronage capital it generates.
- Calculation of the 85-15 threshold may be simplified due to increased member income and all operating expense allocations and reimbursements being internal.

CHALLENGES

- It may be more difficult to appropriately allocate expenses across divisions for sound business decision-making.
- Work order accounting can become more complex. Guidance around the treatment of fiber assets is not clear.
- Can be challenging to track construction costs and compare actuals to the feasibility study.
- Tracking of transaction costs can be complicated by pooled accounts including cash, accounts receivable and accounts payable.
- Providing broadband services to non-electric members may pose governance considerations, such as how to provide service and patronage to non-electric members.
- Non-member revenue may pose challenges for cooperatives with respect to the 85-15 test.



Subsidiary

Creating a broadband business as a wholly-owned, "for-profit" subsidiary—often referred to as the "broadband operating entity," or the "fiber entity."

ADVANTAGES

- The structure offers a more distinct separation of costs and avoidance of complications inherent to pooled accounts in the division model.
- This is the required approach in many regulated states.
- It provides a clearer immediate picture of the health of both businesses as the subsidiary works to become cash-flow positive.
- It's easier to serve non-electric members adjacent to the territory.

CHALLENGES

- The subsidiary is taxed as a for-profit entity. Staff will need to understand GAAP and tax accounting for this type of structure.
- Cooperatives must develop a strong controls environment for inventory, cash disbursements, work orders, billing, etc.
- There may be tax considerations with respect to intercompany transactions.
- Need to determine how the co-op will recognize return on its investment once the subsidiary becomes profitable, and to assess if this will impact the 85-15 threshold.

Note: Some cooperatives are pursuing a hybrid model. Often forming a subsidiary with the specific scope of serving non-electric members—simplifying patronage and service considerations. Others, particularly those in dense areas with multiple potential market entrants, are partnering with service providers to minimize risk to the electric business.

CFC does not favor any particular approach. For the subsidiary model, CFC will lend to the parent cooperative, which can in turn lend to the subsidiary as needed.

Accounting for Broadband Apart from the Electric Business

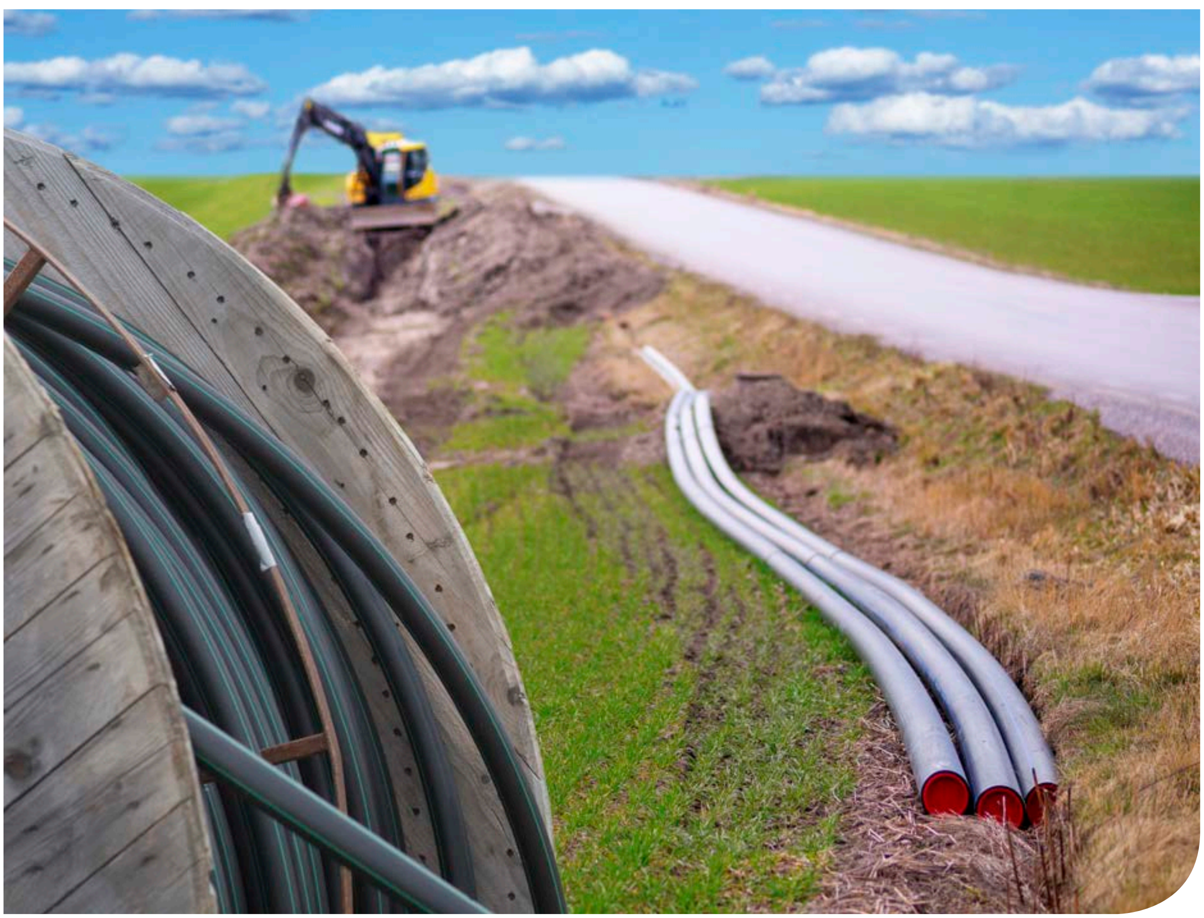
Regardless of structure, cooperatives should adopt accounting and reporting procedures that separate the telecommunications business—including all internet, voice and video offerings—from the electric business.

Separation of the two segments allows for proper planning, analysis and decision-making for each business, minimizing risk to the core electric business and its member-owners. Some states require it to be very transparent that the electric cooperative is not cross-subsidizing its broadband business.

Accordingly, the cooperative will need an accounting and billing system that can accommodate all telecommunications services. These solutions should consider fees, taxes, equipment rental and other facets that are part of a broadband business.

Accounting solutions also need to produce timely and accurate income statements for both businesses. Understanding revenue and expenses for each business is important for key decision-makers.

Regardless of structure, it is a good idea for cooperatives to document how shared costs will be addressed and accounted for in a services agreement. In addition, accountants should consult FERC and FCC charts of accounts to determine how to structure work orders.



Income Statement Considerations

Division

INCOME STATEMENT CONSIDERATIONS FOR THE DIVISION MODEL

In the division model, broadband revenue is recorded on **Line 1: Operating Revenue and Patronage Capital** on the statement of operations. As top line revenue, it is often subject to patronage capital, depending on the cooperative's bylaws.

Cost allocation can be a challenge in the division structure. Care must be taken to properly allocate the costs of the fiber and other operating expenses appropriately to the broadband division. The performance of the broadband division may appear better or worse than forecasted depending on how the fiber depreciation and operating costs are allocated.

Inappropriate expense allocation can also make it challenging to compare the performance with peers.

It is also important to set clear, consistent policy for the appropriate allocation of general and administrative expenses, as well as interest expense allocations.

Subsidiary

INCOME STATEMENT CONSIDERATIONS FOR THE SUBSIDIARY MODEL

In the subsidiary model, assuming the electric cooperative owns the fiber to the home, the broadband business often incurs a major expense: the fiber lease with the parent cooperative. Typically this lease is required to cover principal and interest or debt service for the fiber buildout.

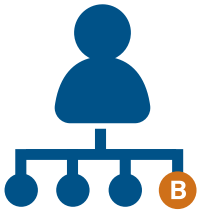
For the subsidiary model, cost allocations for general and administrative expenses are particularly important. Some cooperatives create an "operating agreement" outlining general and administrative services that should be reimbursed.

It is important to consider whether the subsidiary will have any direct employees or if staff will be employed by the member cooperative. This decision may have implications for how benefits are structured.

On the Form 7, net margins for the subsidiary should be reported on **Line 24: Income/(Loss) from Equity Investments** on the statement of operations. Management should note that this means subsidiary revenue will not appear in their MDSC or ODSC KRTA ratios. This is referred to as the equity method. On the audited financial statements, subsidiary and parent financial statements are consolidated.

For more information about KRTA ratios, talk to your RVP. You can also visit nrucfc.coop to enroll in the KRTA Certificate program or speak directly with the Financial Products & Analysis team.

Balance Sheet Considerations

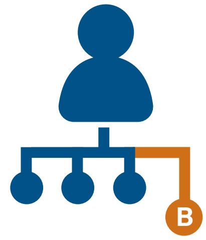


Division

BALANCE SHEET CONSIDERATIONS FOR THE DIVISION MODEL

Best practice encourages cooperatives to consider how they will separate electric and broadband assets and liabilities on the balance sheet. These include fiber assets and related equipment. Related equipment usually includes electronic equipment distributed to individual member-customers, but can also include electronic equipment at the substations and/or the data center infrastructure. This separation is the critical foundation for accurate electric rate and cost-of-service studies.

Broadband assets are likely to become a large percentage of the cooperative's overall assets. In fact, it is common for them to double the cooperative's Total Assets over a 3 to 6 year period. These should be included in **Line 3: Total Utility Plant** and **Line 5: Net Utility Plant**.



Subsidiary

BALANCE SHEET CONSIDERATIONS FOR THE SUBSIDIARY MODEL

Assuming that all of the fiber is owned by the parent cooperative, subsidiary long-term assets will be limited to equipment for broadband, phone and other telecommunications services. Subsidiary assets will also include accounts receivable and accruals.

Liabilities should include short-term debt, or working capital, to the parent cooperative. Many broadband subsidiaries have an internal line of credit with the parent company.

In the audited financial statements, notes receivable and notes payable are eliminated between the parent cooperative and subsidiaries, upon consolidation. Even so, it is advisable to review both a consolidated and consolidating financial statement to assess progress and strategic direction. This allows management and the board to see the related notes receivable and notes payable before they get netted out or eliminated.

In addition, the parent may need to inject longer-term capital into the new subsidiary in the form of debt or equity. This decision should depend on the cooperative's current financial policy and consider tax implications specific to the cooperative.

CFC strongly recommends cooperatives consult their tax accountant, lawyer and RVP as they weigh this decision.

Summary

When investing in broadband and telecommunications services for your membership, there are many finance and accounting factors to consider. It is recommended that cooperatives connect with their peers and lenders during the planning process and become aware of accounting best practices.

CFC strongly recommends that cooperatives consult their accountants, auditors, FERC consultants and attorneys as they make key decisions, specifically around whether to structure their broadband business as a subsidiary or a division. This decision has implications for how the business is financed, as well as accounting, tax, legal and governance implications.

In addition to funding your project, CFC is pleased to provide strategic facilitation services for cooperative boards considering a broadband investment.

Photo courtesy of: Federated Rural Electric Cooperative

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QUESTIONS?

For more Information, contact your RVP or AVP.

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