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June 15, 1999

VIA OVERNIGHT DELIVERY

Blanca S. Bayó
Director, Division of Records & Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0870

990776-TI

Re: Application for Approval of Proposed Transfer of Control of S.J. Investments, Inc. d/b/a Access Long Distance of Florida, Inc. to McLeodUSA Incorporated

Dear Ms. Bayó:

McLeodUSA Incorporated ("McLeodUSA") and S.J. Investments, Inc. d/b/a Access Long Distance of Florida, Inc. ("Access") (collectively, "Applicants"), pursuant to Section 364.33 of the Florida Statutes, hereby request Commission approval of a transaction whereby McLeodUSA will acquire ownership and control of Access. Access is a nondominant carrier authorized by this Commission to provide intrastate interexchange telecommunications services within the State of Florida. McLeodUSA is the parent company of McLeodUSA Telecommunications Services, Inc., a nondominant carrier that is authorized to provide intrastate interexchange services in Florida. Neither McLeodUSA nor any of its subsidiaries is currently affiliated with Access.

As described below, McLeodUSA will acquire control of Access through a transaction whereby Access's corporate parent will be merged with and into a new subsidiary of McLeodUSA formed specifically for purposes of accomplishing the acquisition. Following consummation of the merger, Access will be an indirect, wholly owned subsidiary of McLeodUSA. Attached hereto as Exhibit A is a chart that illustrates the corporate structure of the parties prior to and immediately following consummation of the proposed transfer of control.

Applicants respectfully request expedited treatment of this Application to permit them to consummate the transfer of control as soon as possible, but no later than July 31, 1999. An original and twelve (12) copies of this letter are enclosed. Please date-stamp the enclosed extra copy of this filing and return it in the self-addressed, postage prepaid envelope provided.

Applicants submit the following information in support of this Application.

I. THE PARTIES

A. S.J. Investments, Inc. d/b/a Access Long Distance of Florida, Inc.

Access is a privately held Utah corporation whose principal offices are located in Salt Lake City, Utah. Access is a wholly owned subsidiary of S.J. Investments Holdings, Inc. ("S.J. Holdings"). S.J. Holdings is a holding company whose principal business is telecommunications. Access provides interexchange telecommunications services in Florida pursuant to Certificate No. 4802.[1] Further information regarding Access's legal, technical, managerial, and financial qualifications to provide service was filed with its application for certification, filed in Docket No. 961311-TI. That information is, therefore, already a matter of public record at the Commission, and Applicants respectfully request that it be incorporated by reference herein.

B. McLeodUSA Incorporated

McLeodUSA is a publicly traded Delaware corporation (NASDAQ symbol: MCLD) whose principal offices are located in Cedar Rapids, Iowa. McLeodUSA is a provider of integrated telecommunications services to primarily small- and medium-sized business and residential customers. McLeodUSA's services include primarily competitive local and long distance telecommunications services, competitive access services, including special access and private line services, and maintenance and installation of fiber optic telecommunications networks. McLeodUSA is the parent of McLeodUSA Telecommunications Services, Inc., a nondominant carrier that is authorized to provide resold intrastate long distance telecommunications services in Florida pursuant to certification issued by this Commission in Docket No. 961457-TI, on March 11, 1997, as amended on March 24, 1997, effective April 2, 1997.

McLeodUSA has the technical, managerial, and financial qualifications to acquire control of Access. Attached hereto as Exhibit B are the consolidated financial statements of McLeodUSA and its subsidiaries for the year ended December 31, 1998, as filed with the Securities and Exchange Commission on Form 10K. With its financial resources, and by virtue of its extensive experience in the provision of telecommunications services, McLeodUSA is well qualified to acquire control of Access.

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[1] *See Application of S.J. Investments, Inc. d/b/a Access Long Distance of Florida, Inc. for certificate to provide interexchange telecommunications service*, Docket No. 961311-TI, Order No. PSC-97-0221-FOF-TI (issued Feb. 24, 1997).

II. REQUEST FOR APPROVAL TO TRANSFER CONTROL OF ACCESS TO McLEODUSA

McLeodUSA and S.J. Holdings, the corporate parent of Access, have determined that they will realize significant economic and marketing efficiencies by establishing Access as an indirect wholly owned subsidiary of McLeodUSA. The proposed transaction is structured as a merger of S.J. Holdings and Morton Acquisition Corporation ("Morton"), a newly created Delaware subsidiary of McLeodUSA, formed specifically for purposes of consummating the transaction. S.J. Holdings will merge with and into Morton, with Morton being the surviving entity. Following the merger, Access will be an indirect wholly owned subsidiary of McLeodUSA.

Although the proposed transaction will transfer ownership and control of Access to McLeodUSA, it will not involve a change in the manner in which Access provides service to its Florida customers. Access will continue to provide high quality, affordable resold services to its Florida subscribers pursuant to its certification with no change in the rates or terms and conditions of service currently enjoyed by its existing customers.[2/] As such, the transaction will not cause inconvenience or confusion to Access's customers nor otherwise have a negative impact on the operations of Access. The transaction will be virtually transparent to Access's customers in terms of the services that they receive.

III. PUBLIC INTEREST CONSIDERATIONS

Consummation of the proposed transaction will serve the public interest in promoting competition among Florida providers of intrastate telecommunications services by combining the financial resources and complementary managerial skills and experience of McLeodUSA and Access Holdings, the parent of Access, in providing telecommunications services to the public. Applicants anticipate that the contemplated business combination will result in a company better equipped to accelerate its growth as a competitive telecommunications service provider. The transfer of control will allow Access to benefit from McLeodUSA's considerable financial, managerial, and technical resources and experience. Applicants expect that the transaction will enhance significantly Access's operational flexibility and efficiency, as well as its long term financial viability. These enhancements will directly benefit Florida customers, who will also benefit from the expanded array of services offered by Access. The proposed transaction, therefore, will ensure the continued

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[2/] Similarly, McLeodUSA Telecommunications Services, Inc. will continue to provide services to Florida customers under its existing service agreements, pursuant to its own grant of certification.

provision of high quality, affordable telecommunications services to Access's existing customers and should promote competition in the Florida telecommunications service market.

Please do not hesitate to contact us if you have any questions regarding this transaction.

Respectfully submitted,

Grace Chiu

Counsel for McLeodUSA Incorporated

Enclosures

cc: Tom Williams (FL PSC)
William Haas (McLeodUSA)
Jeffrey M. Vincent (Access)
Andrew D. Lipman, Esq.
Brett P. Ferenchak, Esq.

EXHIBITS

EXHIBIT A

Illustrative Chart of Proposed Transfer of Control

Proposed Transfer of Control of S.J. Investments, Inc. d/b/a Access Long Distance of Florida, Inc. to McLeodUSA Incorporated

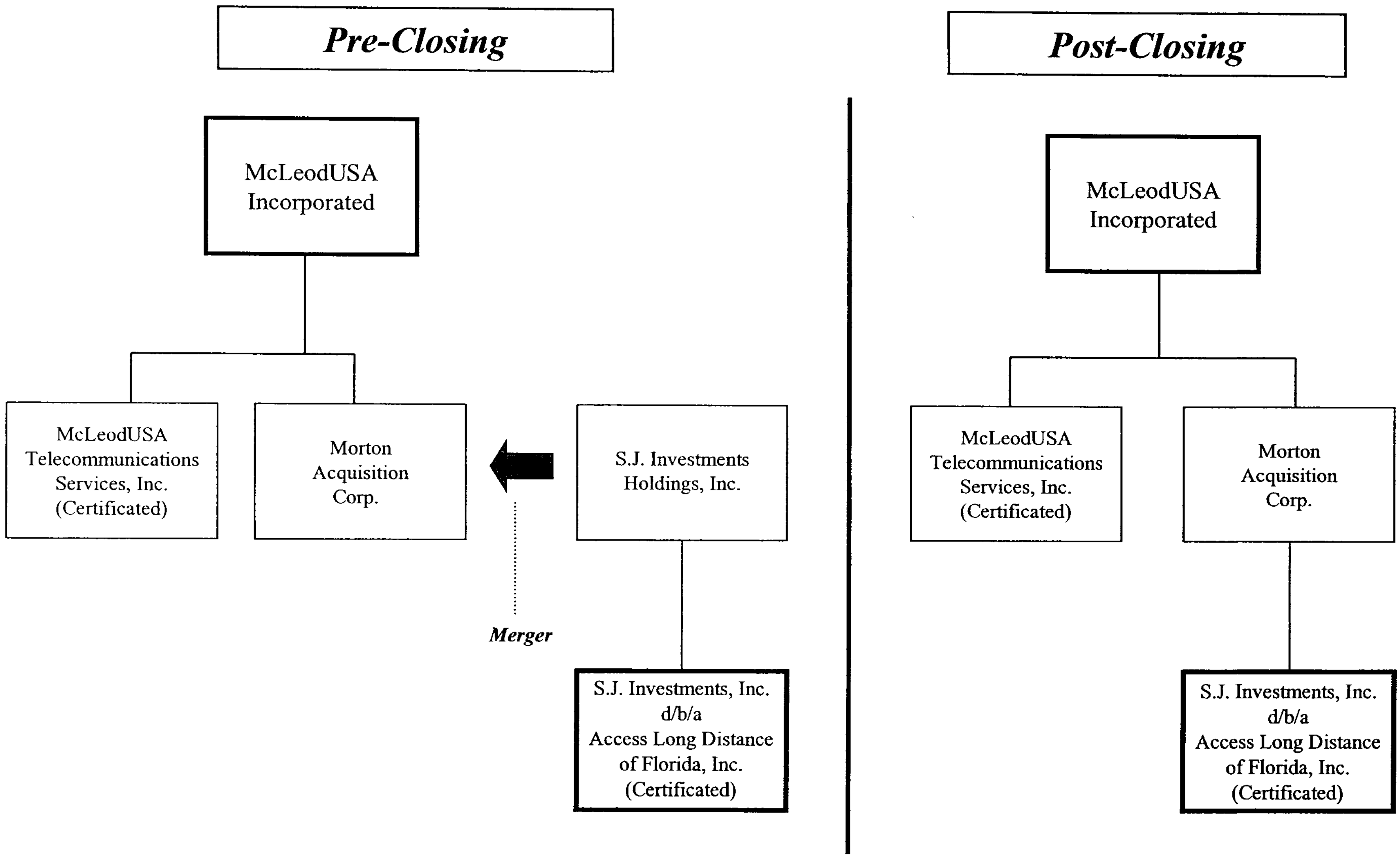

EXHIBIT B

McLeodUSA's Financial Statements

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

MCLEODUSA INCORPORATED AND SUBSIDIARIES

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of
McLeodUSA Incorporated:

We have audited the accompanying consolidated balance sheets of McLeodUSA Incorporated (a Delaware corporation) and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of McLeodUSA Incorporated's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of McLeodUSA Incorporated and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Chicago, Illinois
January 27, 1999 (except with respect to the matters discussed in Note 16, as to which the date is March 5, 1999)

MCLEODUSA INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In thousands, except shares)

	December 31, 1998	December 31, 1997
ASSETS		
Current Assets		
Cash and cash equivalents	$ 455,067	$ 331,941
Investment in available-for-sale securities	136,585	34,696
Trade receivables, net	116,369	108,472
Inventory	12,824	3,992
Deferred expenses	26,693	27,641
Prepaid expenses and other	45,654	11,127
Total current assets	793,192	517,869
Property and Equipment		
Land and building	60,325	35,420
Telecommunications networks	307,310	198,046
Furniture, fixtures and equipment	138,349	70,579
Networks in progress	185,505	81,432
Building in progress	12,567	10,002
	704,056	395,479
Less accumulated depreciation	74,310	21,675
	629,746	373,804
Investments, Intangibles and Other Assets		
Other investments	35,870	30,189
Goodwill, net	289,639	273,359
Other intangibles, net	112,379	97,935
Other	64,371	52,496
	502,259	453,979
	$1,925,197	$1,345,652
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Current maturities of long-term debt	$ 8,236	$ 6,004
Contracts and notes payable	4,508	6,556
Accounts payable	62,000	45,354
Accrued payroll and payroll related expenses	13,579	21,454
Other accrued liabilities	63,849	36,793
Deferred revenue, current portion	10,995	10,381
Customer deposits	16,789	12,710
Total current liabilities	179,956	139,252
Long-Term Debt, less current maturities	1,245,170	613,384
Deferred Revenue, less current portion	16,798	12,664
Other Long-term liabilities	20,467	20,973
Stockholders' Equity		
Capital stock:		
Common, Class A, $.01 par value; authorized 250,000,000 shares; issued and outstanding 1998 63,679,175 shares and 1997 61,799,412 shares	637	618
Common, Class B, convertible, $.01 par value; authorized 22,000,000 shares; issued and outstanding 1998 none; 1997 none	—	—
Additional paid-in capital	716,475	688,964
Accumulated deficit	(252,647)	(127,735)
Accumulated other comprehensive income	(1,659)	(2,468)
	462,806	559,379
	$1,925,197	$1,345,652

The accompanying notes are an integral part of these consolidated financial statements.

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Year Ended December 31,		
	1998	1997	1996
Revenue:			
Telecommunications:			
Local and long distance	$ 267,435	$ 110,023	$ 41,399
Local exchange services	67,785	16,117	—
Private line and data	43,892	17,174	10,272
Network maintenance and equipment	32,885	20,965	5,936
Other telecommunications	27,794	9,907	—
Total telecommunications revenue	439,791	174,186	57,607
Directory	144,876	81,055	15,152
Telemarketing	19,479	12,645	8,564
Total revenue	604,146	267,886	81,323
Operating expenses:			
Cost of service	323,208	151,190	52,624
Selling, general and administrative	260,931	148,158	46,044
Depreciation and amortization	89,107	33,275	8,485
Other	5,575	4,632	2,380
Total operating expenses	678,821	337,255	109,533
Operating loss	(74,675)	(69,369)	(28,210)
Nonoperating income (expense):			
Interest income	26,000	22,660	6,034
Interest (expense)	(78,234)	(34,627)	(665)
Other income	1,997	1,426	495
Total nonoperating income (expense)	(50,237)	(10,541)	5,864
Loss before income taxes	(124,912)	(79,910)	(22,346)
Income taxes	—	—	—
Net loss	$ (124,912)	$ (79,910)	$ (22,346)
Loss per common share	$ (1.99)	$ (1.45)	$ (0.55)
Weighted average common shares outstanding	62,807	54,974	40,506
Other comprehensive income (loss):			
Unrealized gains on securities:			
Unrealized holding gains (losses) arising during the period	3,020	(2,468)	—
Less: reclassification adjustment for gains included in net income	(2,211)	—	—
Total Other Comprehensive Income (Loss)	809	(2,468)	—
Comprehensive Loss	$ (124,103)	$ (82,378)	$ (22,346)

The accompanying notes are an integral part of these consolidated financial statements.

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Years Ended December 31, 1998, 1997 and 1996
(In thousands, except shares)

	Common Stock Class A	Common Stock Class B	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balance, December 31, 1995	$ 164	$ 156	$ 40,117	$ (25,479)	$ —	$ 14,958
Net loss	—	—	—	(22,346)	—	(22,346)
Issuance of 19,424,316 shares of Class A common stock	194	—	396,020	—	—	396,214
Issuance of 361,420 shares of Class A common stock in connection with the acquisition of Ruffalo, Cody & Associates, Inc.	4	—	8,941	—	—	8,945
Options to purchase 158,009 shares of Class A common stock granted in connection with the acquisition of Ruffalo, Cody & Associates, Inc., less cash to be received upon exercise of options	—	—	3,301	—	—	3,301
Amortization of fair value of stock options issued to nonemployees	—	—	341	—	—	341
Amortization of compensation expense related to stock options	—	—	2,016	—	—	2,016
Balance, December 31, 1996	362	156	450,736	(47,825)	—	403,429
Net loss	—	—	—	(79,910)	—	(79,910)
Issuance of 1,137,883 shares of Class A common stock	11	—	881	—	—	892
Release of 56,177 shares of Class A common stock from escrow	1	—	1,346	—	—	1,347
Issuance of 84,430 shares of Class A common stock in connection with the acquisition of Digital Communications of Iowa, Inc.	1	—	2,249	—	—	2,250
Issuance of 8,488,596 shares of Class A common stock in connection with the acquisition of CCI	85	—	223,590	—	—	223,675
Issuance of 55,500 shares of Class A common stock in connection with the acquisition of certain assets of OneTEL Corp.	1	—	1,962	—	—	1,963
Issuance of 140,000 shares of Class A common stock in connection with the acquisition of ownership interests of Colorado Directory Company LLC	1	—	4,479	—	—	4,480
Issuance of 38,080 shares of Class A common stock to participants in the Employee Stock Purchase Plan	—	—	728	—	—	728
Conversion of 15,625,929 shares of Class B common stock to 15,625,929 shares of Class A common stock	156	(156)	—	—	—	—
Amortization of compensation expense related to stock options	—	—	2,993	—	—	2,993
Other comprehensive income	—	—	—	—	(2,468)	(2,468)
Balance, December 31, 1997	618	—	688,964	(127,735)	(2,468)	559,379
Net loss	—	—	—	(124,912)	—	(124,912)
Issuance of 1,353,785 shares of Class A common stock	13	—	3,755	—	—	3,768
Issuance of 70,508 shares of Class A common stock in connection with the acquisition of NewCom Technologies, Inc. and NewCom OSP Services, Inc.	1	—	3,216	—	—	3,217
Issuance of 151,019 shares of Class A common stock in connection with the acquisition of certain assets of Communications Cable-Laying Company, Inc.	1	—	5,964	—	—	5,965
Issuance of 70,672 shares of Class A common stock in connection with the acquisition of of Inlet, Inc.	1	—	2,387	—	—	2,388
Issuance of 82,602 shares of Class A common stock to participants in the 401(k) profit-sharing plans	1	—	2,611	—	—	2,612
Issuance of 132,893 shares of Class A common stock to participants in the Employee Stock Purchase Plan	2	—	3,707	—	—	3,709
Amortization of compensation expense related to stock options	—	—	5,871	—	—	5,871
Other comprehensive income	—	—	—	—	809	809
Balance, December 31, 1998	$ 637	$ —	$ 716,475	$ (252,647)	$ (1,659)	$ 462,806

The accompanying notes are an integral part of these consolidated financial statements.

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31, 1998	1997	1996
Cash Flows from Operating Activities			
Net loss	$(124,912)	$ (79,910)	$ (22,346)
Adjustments to reconcile net loss to net cash (used in) operating activities:			
Depreciation	53,343	17,622	3,944
Amortization	34,693	15,653	4,882
Accretion of interest on senior discount notes	35,145	26,754	—
Changes in assets and liabilities, net of effects of acquisitions:			
(Increase) in trade receivables	(6,409)	(15,937)	(9,317)
(Increase) in inventory	(8,242)	(773)	(2)
Decrease in deferred expenses	948	1,218	1,966
(Increase) in prepaid expenses and other	(34,288)	(1,041)	(3,703)
(Increase) in deferred line installation costs	(13,630)	(9,669)	(1,289)
Increase in accounts payable and accrued expenses	32,178	27,117	3,192
Increase in deferred revenue	4,597	7,186	9,505
Increase in customer deposits	4,077	3,024	1,366
Net cash (used in) operating activities	(22,500)	(8,756)	(11,802)
Cash Flows from Investing Activities			
Purchase of property and equipment	(289,923)	(151,280)	(70,290)
Available-for-sale securities:			
Purchases	(607,440)	(115,985)	(207,681)
Sales	264,383	102,368	17,577
Maturities	241,977	133,817	62,389
Business acquisitions	(27,812)	(181,892)	(80,081)
Deposits on PCS licenses	—	(27,975)	(4,889)
Other	(5,175)	(1,863)	(133)
Net cash (used in) investing activities	(423,990)	(242,810)	(283,108)
Cash Flows from Financing Activities			
Proceeds from line of credit agreements	—	—	55,925
Payments on line of credit agreements	—	—	(59,825)
Payments on contracts and notes payable	(11,082)	(18,967)	—
Proceeds from long-term debt	583,923	506,626	2,060
Payments on long-term debt	(10,895)	(2,252)	(2,065)
Net proceeds from issuance of common stock	7,670	1,620	396,214
Other	—	—	(919)
Net cash provided by financing activities	569,616	487,027	391,390
Net increase in cash and cash equivalents	123,126	235,461	96,480
Cash and cash equivalents:			
Beginning	331,941	96,480	—
Ending	$ 455,067	$ 331,941	$ 96,480
Supplemental Disclosure of Cash Flow Information			
Cash payment for interest, net of interest capitalized 1998 $10,616; 1997 $4,440; 1996 $204	$ 26,992	$ 1,764	$ 300
Supplemental Schedule of Noncash Investing and Financing Activities			
Release of 56,177 shares of Class A common stock from escrow		$ 1,347	
Capital leases incurred for the acquisition of property and equipment	$ 5,914	$ 3,367	

The accompanying notes are an integral part of these consolidated financial statements.

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Nature of Business and Significant Accounting Policies

Nature of business: McLeodUSA Incorporated and subsidiaries (the "Company") is a diversified telecommunications company, incorporated in Delaware, that provides a broad range of products and services to business customers in Iowa, Illinois, North Dakota, South Dakota, Minnesota, Indiana, Colorado and Wyoming and residential customers in Iowa, Illinois, North Dakota, South Dakota, Wisconsin and Colorado. The Company's services primarily include local and long-distance telecommunications services, telecommunications network maintenance services and telephone equipment sales, service and installation, private line and data services, the sale of advertising space in telephone directories, the operation of an independent local exchange company, and telemarketing services. The Company's business is highly competitive and is subject to various federal, state and local regulations. In 1997, the Company's stockholders approved a change in its name to McLeodUSA Incorporated from McLeod, Inc.

Accounting estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

A summary of the Company's significant accounting policies is as follows:

Principles of consolidation: The accompanying financial statements include those of the Company and its subsidiaries, substantially all of which are wholly owned. All significant intercompany items and transactions have been eliminated in consolidation.

Regulatory accounting: Illinois Consolidated Telephone Company ("ICTC"), an independent local exchange carrier and a wholly owned subsidiary of the Company, prepares its financial statements in accordance with the provisions of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" ("SFAS No. 71"). The provisions of SFAS No. 71 require, among other things, that regulated enterprises reflect rate actions of regulators in their financial statements, when appropriate. These rate actions can provide reasonable assurance of the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise. SFAS No. 71 also specifies that the actions of a regulator can eliminate only liabilities imposed by the regulator.

Cash and cash equivalents: For purposes of reporting cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less and all certificates of deposit, regardless of maturity, to be cash equivalents.

Investments: Management determines the appropriate classification of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. The Company has classified its securities as available-for-sale. Available-for-sale securities are stated at fair value, and unrealized holding gains and losses are reported as a component of stockholders' equity. Realized gains and losses are determined on the basis of the specific securities sold.

Trade receivables: In accordance with the industry practice for the publication of telephone directories, trade receivables include certain unbilled revenue from installment contracts. It is anticipated that a substantial portion of all such amounts at December 31, 1997 and 1998 will be collected within one year (see Note 2).

Note 1. Nature of Business and Significant Accounting Policies— (Continued)

Inventory: Inventory is carried principally at the lower of average cost or market and consists primarily of new and reusable parts to maintain fiber optic networks and parts and equipment used in the maintenance and installation of telephone systems. All inventory is classified as raw materials.

Property and equipment: Property and equipment is stated at cost. Construction costs, including interest, are capitalized during the installation of fiber optic telecommunications networks. Interest expense was also capitalized as part of the construction of the Company's headquarters buildings and the development of the Company's software.

ICTC's property and equipment for its regulated operations is summarized as follows at December 31, 1998 (In thousands):

Telephone plant:	
In service	$101,126
Under construction	902
	102,028
Less accumulated depreciation	(10,576)
	$ 91,452

When regulated property and equipment are retired, the original cost, net of salvage, is charged against accumulated depreciation. The cost of maintenance and repairs of property and equipment including the cost of replacing minor items not constituting substantial betterments is charged to operating expense.

The provision for depreciation of regulated property and equipment is based upon remaining life rates for property placed in service through 1980 and equal life rates for property additions placed in service after 1980. The regulated provision is equivalent to an annual composite rate of 5.58% for 1998.

The provision for depreciation of nonregulated property and equipment is recorded using the straight-line method based on the following estimated useful lives:

	Years
Buildings	20-39
Telecommunications networks	5-15
Furniture, fixtures and equipment	2-10

The Company's telecommunications networks are subject to technological risks and rapid market changes due to new products and services and changing customer demand. These changes may result in changes in the estimated economic lives of these assets.

Other investments: Other investments primarily includes $26,195,000 for a minority interest in a limited partnership which provides cellular services to customers in east central Illinois. The Company follows the equity method of accounting for this investment, which recognizes the Company's proportionate share of the income and losses accruing to it under the terms of its partnership agreement.

Note 1. Nature of Business and Significant Accounting Policies— (Continued)

Goodwill: Goodwill resulting from the Company's acquisitions is being amortized over a range of 15 to 30 years using the straight-line method and the acquisitions are periodically reviewed for impairment based upon an assessment of future operations to ensure that it is appropriately valued. Accumulated amortization on goodwill totaled $16,356,000 and $5,834,000 at December 31, 1998 and 1997, respectively.

Other intangibles: Other intangibles consist of customer lists and noncompete agreements related to the Company's acquisitions, deferred line installation costs incurred in the establishment of local access lines for customers and franchise rights to provide cable services to customers in three Illinois counties and in a Michigan city. The customer lists and noncompete agreements are being amortized using the straight-line method over periods ranging from 3 to 15 years. The deferred line installation costs are being amortized using the straight-line method over 36 to 60 months, which approximates the average lives of residential and business customer contracts. The franchise rights are being amortized using the straight-line method over periods ranging from 10 to 15 years. Accumulated amortization on the other intangibles totaled $25,066,000 and $9,158,000 at December 31, 1998 and 1997, respectively.

Income tax matters: The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Net deferred tax assets are reduced by a valuation allowance when appropriate (see Note 6). Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Deferred revenue: Amounts received in advance under long-term leases of fiber optic telecommunications networks are recognized as revenue on a straight-line basis over the life of the leases.

Revenue recognition: Revenues for local and long-distance services are recognized when subscribers use telecommunications services. The revenue from long-term leases of fiber optic telecommunications networks is recognized over the term of the lease. Base annual revenue for telecommunications network maintenance is recognized on a straight-line basis over the term of the contract. Additional services provided under these contracts are recognized as the services are performed.

ICTC's toll revenue is provided through a combination of billed carrier access charges, traditional end-user billed toll revenues, interstate tariffed subscriber line charges and ICTC's share of revenues and expenses from the non-traffic sensitive pool administered by the National Exchange Carrier Association.

As allowed by the FCC, ICTC's presubscribed rate of return on interstate access revenues for 1998 was 11.25%. The FCC further restricted overall interstate revenues to a maximum 11.50% rate of return on related investments, or to a maximum of 11.65% rate of return on related investments per any individual rate element.

Fees from telemarketing contracts are recognized as revenue in the period the services are performed.

Revenues from directories are recorded upon publication.

Note 1. Nature of Business and Significant Accounting Policies— (Continued)

Customer deposits consist of cash received from customers at the time a sales contract is signed. They are recorded as revenue when the related directory is published or when the related service is performed.

Cost of service and deferred expenses: Cost of service includes local and long-distance services purchased from certain Regional Bell Operating Companies and interexchange carriers, the cost of providing local exchange services to customers in ICTC's service area and the cost of operating the Company's fiber optic telecommunications networks. Cost of service also includes production costs associated with the publication of directories and direct costs associated with telemarketing services and the sale and installation of telephone systems.

Deferred expenses consist of production and selling costs on unpublished directory advertising orders. They are expensed when the related directory is published and the related revenue of the directory is recognized.

Key business suppliers: U S WEST, Ameritech and Southwestern Bell Company are the Company's primary suppliers of local central office switching and local lines.

Stock options issued to employees: In fiscal year 1996, the Company adopted the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, which establishes a fair value based method for the financial reporting of its stock-based employee compensation plans. The Company measures compensation using the intrinsic value based method as prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. Under this method, compensation is measured as the difference between the market value of the stock on the grant date, less the amount required to be paid for the stock. The difference, if any, is charged to expense over the vesting period of the options.

The estimated market value used for the stock options granted was determined on a periodic basis by the Company's Board of Directors prior to the Company's initial public offering on June 10, 1996. Subsequent to the Company's initial public offering, the market value used for stock options granted is based upon the closing price of the Class A common stock on the day before the grant date.

Stock options issued to nonemployees: The Company uses the Black-Scholes model to determine the fair value of the stock options issued to nonemployees at the date of grant. This amount is amortized to expense over the vesting period of the options.

Loss per common share: Loss per common share has been computed using the weighted average number of shares of common stock outstanding after giving effect to the recapitalization in 1996. All stock options granted are anti-dilutive, and therefore excluded from the computation of earnings per share. In the future, these stock options may become dilutive.

Note 1. Nature of Business and Significant Accounting Policies— (Continued)

Fair value of financial instruments: The carrying amount of cash and cash equivalents approximates fair value due to the short maturity of the instruments. For other investments for which there are no quoted market prices, a reasonable estimate of fair value could not be made without incurring excessive cost. The $29.9 million carrying amount of unquoted investments at December 31, 1998, represents the original cost of the investments, which management believes is not impaired. The fair value of the Company's long-term debt is estimated to be $1.3 billion based on the quoted market rates for the same or similar issues or the current rates offered to the Company for debt with similar maturities.

Reclassifications: Certain items in the 1997 consolidated financial statements have been reclassified to be consistent with the classification in the 1998 consolidated financial statements.

Note 2. Trade Receivables

The composition of trade receivables, net is as follows:

	December 31, 1998	December 31, 1997
	(In thousands)	
Billed	$110,587	$ 86,309
Unbilled	21,350	34,114
	131,937	120,423
Less allowance for doubtful accounts and discounts	(15,568)	(11,951)
	$116,369	$108,472

Note 3. Investments

At December 31, 1998, the Company held $187,136,000, $30,298,000 and $30,614,000 in corporate debt securities, United States Government and governmental agency securities and marketable equity securities, respectively. At December 31, 1997, the Company held $4,493,000, $94,341,000 and $27,491,000 in repurchase agreements, corporate debt securities and marketable equity securities, respectively. The Company has classified these securities as available-for-sale, and at December 31, 1998 and 1997, the debt securities' amortized cost approximates fair value. The marketable equity securities have been recorded at their fair market value at December 31, 1998. The available-for-sale securities have been classified as cash and cash equivalents, and investment in available-for-sale securities-current, with $111,463,000 and $136,585,000, respectively, being recorded in each classification at December 31, 1998. At December 31, 1997, $91,629,000 and $34,696,000, respectively, were recorded in each classification.

The contractual maturities of the available-for-sale securities of $248,048,000 and $126,325,000 in 1998 and 1997, respectively, are due within one year.

Expected maturities will differ from contractual maturities because the issuers of certain debt securities have the right to call or prepay their obligations without any penalties. The amount classified as current assets on the accompanying balance sheets represent the expected maturities of the debt securities during the next year.

Note 4. Pledged Assets and Debt

Debt offerings: On March 4, 1997, the Company completed a private offering of 10½% Senior Discount Notes (the "Senior Discount Notes") due March 1, 2007 at an original issue discount in which the Company received approximately $288.9 million in net proceeds. The Company filed a registration statement with the Securities and Exchange Commission ("SEC") for the registration of $500 million principal amount at maturity of 10½% Senior Discount Notes due March 1, 2007 (the "Senior Discount Exchange Notes") to be offered in exchange for the Senior Discount Notes (the "Senior Discount Exchange Offer"). The registration statement was declared effective by the SEC on July 28, 1997 and the Senior Discount Exchange Offer was commenced. The Senior Discount Exchange Offer expired on August 24, 1997, at which time all of the Senior Discount Notes were exchanged for the Senior Discount Exchange Notes. The form and terms of the Senior Discount Exchange Notes are identical in all material respects to the form and terms of the Senior Discount Notes except that (i) the Senior Discount Exchange Notes have been registered under the Securities Act of 1933 (the "Securities Act") and (ii) holders of the Senior Discount Exchange Notes are not entitled to certain rights under a registration agreement relating to the Senior Discount Notes. The Senior Discount Exchange Notes rank *pari passu* in right of payment with all existing and future senior unsecured indebtedness of the Company and rank senior in right of payment to all existing and future subordinated indebtedness of the Company. The Senior Discount Exchange Notes accrete interest at a rate of 10½% per year, compounded semi-annually, to an aggregate principal amount of $500 million by March 1, 2002. Interest will not accrue on the Senior Discount Exchange Notes for five years, after which time the Senior Discount Exchange Notes will accrue interest at 10½%, payable semi-annually. The indenture related to the Senior Discount Exchange Notes contains certain covenants which, among other things, restrict the ability of the Company to incur additional indebtedness, pay dividends or make distributions of the Company's or its subsidiaries' stock, enter into sale and leaseback transactions, create liens, enter into transactions with affiliates or related persons, or consolidate, merge or sell all of its assets.

On July 21, 1997, the Company completed a private offering of $225 million aggregate principal amount of 9¼% Senior Notes due July 15, 2007 (the "Senior Notes"). The Company received net proceeds of approximately $217.6 million from the Senior Note offering. Interest on the Senior Notes is payable in cash semi-annually in arrears on July 15 and January 15 of each year at a rate of 9¼% per annum, starting January 15, 1998. The Senior Notes rank *pari passu* in right of payment with all existing and future senior unsecured indebtedness of the Company and rank senior in right of payment to all existing and future subordinated indebtedness of the Company. As of December 31, 1997, the Senior Notes had not been registered under the Securities Act and therefore cannot be offered for resale, resold or otherwise transferred unless so registered or unless an applicable exemption from the registration requirements of the Securities Act is available. The Company has filed a registration statement with the SEC for the registration of $225 million aggregate principal amount of 9¼% Senior Notes due July 15, 2007 (the "Exchange Notes") to be offered in exchange for the Senior Notes (the "Exchange Offer"). The registration statement was declared effective by the SEC on December 1, 1997, and the Exchange Offer was commenced on December 2, 1997. The Exchange Offer expired on January 9, 1998, at which time all of the Senior Notes were exchanged for the Exchange Notes. The form and terms of the Exchange Notes are identical in all material respects to the form and terms of the Senior Notes except that (i) the Exchange Notes have been registered under the Securities Act and (ii) holders of the Exchange Notes will not be entitled to certain rights under a registration agreement relating to the Senior Notes. The indentures relating to the Senior Notes and the Exchange Notes contain certain covenants which are materially the same as the covenants relating to the Senior Discount Exchange Notes.

Note 4. Pledged Assets and Debt— (Continued)

On March 16, 1998, the Company completed a private offering of its 8⅜% Senior Notes due March 5, 2008 (the "March 1998 Privately Placed Senior Notes"), for which the Company received net proceeds of approximately $291.9 million. The Company filed a registration statement with the SEC for the registration of $300 million principal amount of 8⅜% Senior Notes due March 15, 2008 (the "March Exchange Notes" together with the March 1998 Privately Placed Senior Notes, the "March 1998 Senior Notes") to be offered in exchange for the March 1998 Privately Placed Senior Notes (the "March Exchange Offer"). The registration statement was declared effective by the SEC on May 15, 1998 and the March Exchange Offer was commenced. The March Exchange Offer expired on June 25, 1998, at which time all of the March 1998 Privately Placed Senior Notes were exchanged for the March Exchange Notes. The form and terms of the March Exchange Notes are identical in all material respects to the form and terms of the March 1998 Privately Placed Senior Notes except that (i) the March Exchange Notes have been registered under the Securities Act of 1933 (the "Securities Act") and (ii) holders of the March Exchange Notes are not entitled to certain rights under a registration agreement related to the March 1998 Privately Placed Senior Notes. Interest on the March 1998 Senior Notes will be payable in cash semi-annually in arrears on March 15 and September 15 of each year at a rate of 8⅜% per annum, starting September 15, 1998. The March 1998 Senior Notes rank *pari passu* in right of payment with all existing and future senior unsecured indebtedness of the Company and rank senior in right of payment to all existing and future subordinated indebtedness. The March 1998 Senior Notes will mature on March 15, 2008. The March 1998 Senior Notes will be redeemable at the option of the Company, in whole or in part, at any time on or after March 15, 2003 at 104.188% of their principal amount at maturity, plus accrued and unpaid interest, declining to 100.000% of their principal amount at maturity, plus accrued and unpaid interest, on or after March 15, 2006. In the event of certain equity investments in the Company by certain strategic investors on or before March 15, 2001, the Company may, at its option, use all or a portion of the net proceeds from such sale to redeem up to 33⅓% of the originally issued principal amount of the March 1998 Senior Notes at a redemption price equal to 108.375% of the principal amount of the March 1998 Senior Notes plus accrued and unpaid interest thereon, if any, to the redemption date, provided that at least 66⅔% of the originally issued principal amount of the March 1998 Senior Notes would remain outstanding immediately after giving effect to such redemption. In addition, in the event of a Change of Control (as defined in the indenture dated as of March 16, 1998 between the Company and the United States Trust Company of New York as trustee, governing the March 1998 Senior Notes (the "March 1998 Senior Note Indenture")) of the Company, each holder of March 1998 Senior Notes will have the right to require the Company to repurchase all or any part of such holder's March 1998 Senior Notes at a purchase price equal to 101% of the principal amount of the March 1998 Senior Notes tendered by such holder plus accrued and unpaid interest, if any, to any Change of Control Payment Date (as defined in the March 1998 Senior Note Indenture).

The March 1998 Senior Note Indenture imposes operating and financial restrictions on the Company and its subsidiaries. These restrictions affect, and in certain cases significantly limit or prohibit, among other things, the ability of the Company and its subsidiaries to incur additional indebtedness, pay dividends or make distributions in respect of the Company's or such subsidiaries' capital stock, make other restricted payments, enter into sale and leaseback transactions, create liens upon assets, enter into transactions with affiliates ore related persons, sell assets, or consolidate, merge or sell all or substantially all of their assets.

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Note 4. Pledged Assets and Debt— (Continued)

On October 30, 1998, the Company completed a private offering of its 9½% Senior Notes due November 1, 2008 (the "October 1998 Privately Placed Senior Notes"), for which the Company received net proceeds of approximately $291.9 million. The Company filed a registration statement with the SEC for the registration of $300 million principal amount of 9½% Senior Notes due November 1, 2008 (the "October Exchange Notes" together with the October 1998 Privately Placed Senior Notes, the "October 1998 Senior Notes") to be offered in exchange for the October 1998 Privately Placed Senior Notes (the "October Exchange Offer"). The registration statement was declared effective by the SEC on January 29, 1999 and the October Exchange Offer was commenced. The October Exchange Offer expired on March 3, 1999, at which time all of the October 1998 Privately Placed Senior Notes were exchanged for the October Exchange Notes. The form and terms of the October Exchange Notes are identical in all material respects to the form and terms of the October 1998 Privately Placed Senior Notes except that (i) the October Exchange Notes have been registered under the Securities Act and (ii) holders of the October Exchange Notes are not entitled to certain rights under a registration agreement related to the October 1998 Privately Placed Senior Notes. Interest on the October 1998 Senior Notes will be payable in cash semi-annually in arrears on May 1 and November 1 of each year at a rate of 9½% per annum, starting May 1, 1999. The October 1998 Senior Notes rank *pari passu* in right of payment with all existing and future senior unsecured indebtedness of the Company and rank senior in right of payment to all existing and future subordinated indebtedness. The October 1998 Senior Notes will mature on November 1, 2008. The October 1998 Senior Notes will be redeemable at the option of the Company, in whole or in part, at any time on or after November 1, 2003 at 106.750% of their principal amount at maturity, plus accrued and unpaid interest, declining to 100.000% of their principal amount at maturity, plus accrued and unpaid interest, on November 1, 2008. In the event of certain equity investments in the Company by certain strategic investors on or before November 1, 2001, the Company may, at its option, use all or a portion of the net proceeds from such sale to redeem up to 33⅓% of the originally issued principal amount of the October 1998 Senior Notes at a redemption price equal to 111.500% of the principal amount of the October 1998 Senior Notes plus accrued and unpaid interest thereon, if any, to the redemption date, provided that at least 66⅔% of the originally issued principal amount of the October 1998 Senior Notes would remain outstanding immediately after giving effect to such redemption. In addition, in the event of a Change of Control (as defined in the indenture dated as of October 30, 1998 between the Company and the United States Trust Company of New York as trustee, governing the October 1998 Senior Notes (the "October 1998 Senior Note Indenture")) of the Company, each holder of October 1998 Senior Notes will have the right to require the Company to repurchase all or any part of such holder's October 1998 Senior Notes at a purchase price equal to 101% of the principal amount of the October 1998 Senior Notes tendered by such holder plus accrued and unpaid interest, if any, to any Change of Control Payment Date (as defined in the October 1998 Senior Note Indenture).

The October 1998 Senior Note Indenture imposes operating and financial restrictions on the Company and its subsidiaries. These restrictions affect, and in certain cases significantly limit or prohibit, among other things, the ability of the Company and its subsidiaries to incur additional indebtedness, pay dividends or make distributions in respect of the Company's or such subsidiaries' capital stock, make other restricted payments, enter into sale and leaseback transactions, create liens upon assets, enter into transactions with affiliates ore related persons, sell assets, or consolidate, merge or sell all or substantially all of their assets.

Note 4. Pledged Assets and Debt— (Continued)

The Company's debt consisted of the following at December 31, 1998 and 1997:

	1998	1997
	(In thousands)	
Contracts payable, unsecured, non-interest bearing, due in various installments With the final payment to be made in 1999	$ 4,400	$ 1,056
Notes payable, banks, bearing interest at 6.1875% due in various installments Through October 1997 (A)	—	5,500
Other long-term borrowings, due in various installments Bearing interest at rates ranging from 0% to 8.625%	108	—
	$ 4,508	$ 6,556
10½% Senior Discount Notes	$ 361,902	$326,754
9¼% Senior Notes	225,000	225,000
8⅜% Senior Notes	300,000	—
9½% Senior Notes	300,000	—
CCI unsecured senior notes payable, with semiannual interest payments at 7.75% payable April 1 and October 1. Annual principal payments of $1,428,571 are due beginning October 1, 1998 until maturity in October 2004	8,571	10,000
CCI Series A Senior Unsecured Notes, with semiannual interest payments at 6.83% payable June 1 and December 1. Annual principal payments of $909,091 are due beginning December 1, 2001 until maturity in December 2010	10,000	10,000
CCI Series B Senior Unsecured Notes, with semiannual interest payments at 6.71% payable June 1 and December 1. Annual principal payments of $454,546 are due beginning December 1, 2001 until maturity in December 2010	5,000	5,000
Greene County Partners, Inc. senior notes due in quarterly payments of $450,000 bearing interest at 6.35% and maturing in April 2001	13,500	15,300
ICTC Series K, 8.620% First Mortgage Bonds due September 2022 (B)	10,000	10,000
ICTC Series L, 7.050% First Mortgage Bonds due October 2013 (B)	10,000	10,000
Contracts payable, to finance company, due in various monthly Payments, including interest at 3.90%, through March 2000, Collateralized by equipment with a depreciated cost of $4,173,000 at December 31, 1998	2,204	2,637
Note payable due in various annual installments, including Interest at 8.25%, through 2006. Collateralized by publishing Rights to purchased directories	606	995
Other long-term borrowings, due in various installments Bearing interest at rates ranging from 0% to 8.625% Through March 2004	5,429	2,092
Incentive compensation agreements, due in various Estimated amounts plus interest at 6.0% through January 2001 (See Note 11)	1,194	1,610
	1,253,406	619,388
Less current maturities	8,236	6,004
	$1,245,170	$613,384

(A) CCI and ICTC have various short-term line of credit agreements with certain financial institutions totaling $30,000,000 of which no borrowings were outstanding at December 31, 1998 and $5,500,000 in borrowings were outstanding at December 31, 1997.

(B) ICTC's first mortgage bonds are collateralized by substantially all real and personal property of the subsidiary. The bond indenture contains various provisions restricting, among other things, the payment of dividends and repurchase of its own stock. Early redemption of the Series K and Series L Bonds is permitted.

Note 4. Pledged Assets and Debt— (Continued)

In 1996, the Company used a portion of the proceeds from the Company's initial public offering (see Note 8) to pay off all existing indebtedness under three line of credit facilities, which were then canceled. Options to purchase Class B common stock were granted to a stockholder which had guaranteed borrowings under two of the facilities. The Company used the Black-Scholes model to determine the value of the options, which was approximately $3,400,000, at the date of grant. This value was being amortized over the vesting period of the options. Upon cancellation of the credit facilities, the options' vesting schedule and amortization of the fair value of the options were terminated. A total of 1,300,688 Class B common stock options were outstanding at December 31, 1998 and December 31, 1997.

Principal payments required on the outstanding debt at December 31, 1998 are as follows (In thousands):

1999	$ 8,236
2000	6,643
2001	13,414
2002	3,256
2003	3,203
Later years	1,218,654
	$1,253,406

Note 5. Leases and Commitments

Leases: The Company leases certain of its office and network facilities under noncancelable agreements which expire at various times through September 2022. These agreements require various monthly rentals plus the payment of applicable property taxes, maintenance and insurance. The Company also leases vehicles and equipment under agreements which expire at various times through December 2003 and require various monthly rentals.

The total minimum rental commitment at December 31, 1998 under the leases mentioned above is as follows (In thousands):

1999	$17,786
2000	10,908
2001	6,090
2002	3,877
2003	3,026
Thereafter	4,398
	$46,085

The total rental expense included in the consolidated statements of operations for 1998, 1997 and 1996 is approximately $19,824,000, $8,060,000 and $3,640,000, respectively, which also includes short-term rentals for office facilities.

Network construction: During 1995, the Company was awarded contracts from the State of Iowa to build fiber optic telecommunications network segments throughout the State of Iowa. As of December 31, 1998, the contracts call for the construction of 235 network segments. Upon completion of each segment, the Company will receive approximately $115,000 for a seven-year lease for certain capacity on that segment. The Company will recognize this revenue of approximately $27,025,000 on a straight-line basis

Note 5. Leases and Commitments — (Continued)

over the term of the lease based on the relationship of individual segment costs to total projected costs. For the years ended December 31, 1998, 1997 and 1996, revenue of $2,763,000, $1,794,000 and $445,000, respectively, had been recognized under these contracts.

The Company estimates that minimum future construction costs required to fulfill its obligations under the 1995 contract with the State of Iowa would be approximately $5,393,000. The Company, however, expects that its actual construction costs will be higher with respect to such network segments, because the Company is adding more fiber and route miles than is contractually required with respect to such construction, in order to optimize the design of its network. The Company anticipates that the minimum costs to complete this project will be incurred in 1999.

Buildings: In August 1996, the Company purchased approximately 194 acres of land on which the Company constructed its headquarters and associated buildings. Of the land purchased, approximately 75 acres was purchased from a subsidiary of a stockholder for approximately $692,000. At December 31, 1998, the total remaining contracted commitments on the building in progress is approximately $8 million.

Alcatel: In January 1999 the Company entered into an agreement with Alcatel USA Marketing, Inc. to purchase equipment, software and services for a total commitment of $200,000,000 over a six (6) year period. If McLeodUSA does not meet the committed purchases on a cumulative annual basis, Alcatel retains the right to renegotiate the applicable prices. If regulatory conditions substantially prevent the Company from continuing to implement its current network deployment plans, the Company has the option to request renegotiation of unit prices based on revised quantities of products or to renegotiate unit prices based on the quantities of products purchased to that time and cease any further purchases of products.

Note 6. Income Tax Matters

Net deferred taxes consist of the following components as of December 31, 1998 and 1997:

	1998	1997
	(In thousands)	
Deferred tax assets:		
Net operating loss carryforwards	$106,498	$60,335
Accruals and reserves not currently deductible	24,485	15,910
Deferred revenues	8,149	7,093
Intangibles and other assets	7,605	3,669
Other	2,144	2,125
	148,881	89,132
Less valuation allowance	78,556	29,532
	70,325	59,600
Deferred tax liabilities:		
Property and equipment	39,549	24,620
Other investments	11,395	15,333
Differences in revenue recognition	10,900	12,140
Deferred line installation cost	7,952	3,945
Other intangibles	—	3,318
Other	529	244
	70,325	59,600
	$ —	$ —

Note 6. Income Tax Matters — (Continued)

A valuation allowance has been recognized to offset the related net deferred tax assets due to the uncertainty of realizing the benefit of the loss carryforwards. The Company has available net operating loss carryforwards totaling approximately $262.5 million which expire in various amounts in the years 2008 to 2018.

The income tax rate differs from the U. S. Federal income tax rate for 1998, 1997 and 1996 due to the following:

	1998	1997	1996
"Expected" tax (benefit) rate	(35)%	(35)%	(35)%
Percent increase (decrease) in income taxes resulting from:			
Change in valuation allowance	34	15	35
Tax deductions due to exercises of incentive stock options	(2)	(2)	(9)
Goodwill amortization for stock purchases	6	—	—
Net deferred liability balance purchased in CCI transaction (see Note 11)	—	21	—
Other	(3)	1	9
	—%	—%	—%

Note 7. Stock-based Compensation Plans

At December 31, 1998, the Company has various stock-based compensation plans which are described below. Grants under the Company's stock option plans are accounted for in accordance with Accounting Principles Board (APB) Opinion No. 25 and related Interpretations. The Company granted a total of 1,653,688 stock options in January and February 1996 at an exercise price of $2.67 per share. The estimated aggregate fair market value of these options at the date of grant was later determined to exceed the aggregate exercise price by approximately $9,190,000. Additionally, in September 1997, the Company granted a total of 1,468,945 stock options at an exercise price of $24.50 per share. The aggregate fair market value of these options at the date of grant exceeded the aggregate exercise price by approximately $15,790,000. As a result, the Company is amortizing these amounts over the four-year vesting period of the options. Compensation cost of $5,820,000 and $2,993,000 has been charged to income for the year ended December 31, 1998 and 1997, respectively, using the intrinsic value based method as prescribed by APB No. 25. Had compensation cost for all of the stock-based compensation plans been determined based on the grant date fair values of awards granted during 1998, 1997 and 1996, as prescribed by SFAS No. 123, reported net loss and loss per common share would have been as follows (in thousands, except per share data):

	December 31,		
	1998	1997	1996
Pro forma net loss	$(151,227)	$(93,855)	$(24,776)
Pro forma loss per common share	(2.41)	(1.71)	(0.61)

1992, 1993 and 1995 Incentive Stock Option Plans: The Company has reserved 2,903,243 shares of Class A common stock for issuance to employees under the 1992, 1993 and 1995 Incentive Stock Option Plans. Options outstanding under these plans were granted at prices equal to the estimated fair market value on the dates of grant as determined by the Company's Board of Directors. Under the 1992

Note 7. Stock-based Compensation Plans — (Continued)

and 1993 plans, all options granted become exercisable at a rate of 25% per year, on a cumulative basis, and expire seven years after the date of grant. Under the 1995 plan, all options, except for options granted to the Company's chairman and chief executive officer, become exercisable at a rate of 25% per year, on a cumulative basis, beginning five years from the date of grant. The options granted to the Company's chairman and chief executive officer vest at a rate of 20% per year on a cumulative basis. All options granted under the 1995 plan expire ten years after the date of grant. These plans have been superseded by the 1996 Employee Stock Option Plan, and no future grants of options will be made under these plans.

1996 Employee Stock Option Plan: In 1997, the Company's stockholders approved an amendment to the 1996 Employee Stock Option Plan to increase the number of Class A common shares available under the plan to 37,500,000 shares from 4,525,000 shares. At December 31, 1998, after adjusting for option exercises, the Company has reserved 37,277,305 shares of Class A common stock for issuance to employees under the plan, which supersedes the 1992, 1993 and 1995 Incentive Stock Option Plans. The exercise price for options granted under this plan is the fair market value of the Company's Class A common stock on the day before the grant date (or 110% of the fair market value if the grantee beneficially owns more than 10% of the outstanding Class A common stock). The options granted expire ten years after the grant date (or five years after the grant date if the grantee beneficially owns more than 10% of the outstanding Class A common stock), and vest over periods determined by the Compensation Committee; however, no more than $100,000 worth of stock covered by the options may become exercisable in any calendar year by an individual employee. The 1996 Plan will terminate in March 2006, unless terminated earlier by the Board of Directors.

Directors' Stock Option Plan: The Company has reserved 397,686 shares of Class A common stock for issuance under the Directors' Plan to directors who are not officers or employees of the Company. The Director's Plan was adopted and approved by the stockholders in 1993 and amended and restated on March 28, 1996 to be a "formula" plan providing for an automatic grant of options to eligible directors. Each eligible director who commences service on the Board of Directors after the amendment and restatement of the plan will be granted an initial option to purchase 10,000 shares of Class A common stock. An additional option to purchase 5,000 shares of Class A common stock will be granted after each of the next two annual meetings to each eligible director who remains for the two-year period. Options granted under the Directors' Plan vest at a rate of 25% per year, on a cumulative basis, and expire seven years after the date of grant (ten years after the date of grant for options granted under the amended and restated plan). However, upon a change in control of the Company as defined in the Directors' Plan, all options will become fully exercisable. The Company has the right to repurchase any Class A common stock issued pursuant to the exercise of an option granted under this plan that is offered for sale to an individual who is not an employee or director of the Company. The Directors' Plan will terminate in March 2006, unless terminated earlier by the Board of Directors.

The fair value of each grant under the Company's stock option plans is estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants in 1998, 1997 and 1996, respectively: no expected dividends, risk-free interest rates of 4.65%, 5.48%, and 6.08%; price volatility of 59.39% in 1998, 48.63% in 1997 and 40% in 1996 and expected lives of 4 years for all three years.

Employee Stock Purchase Plan: Under the stock purchase plan, employees may purchase up to an aggregate of 1,000,000 shares of Class A common stock through payroll deductions. Employees of the Company who have been employed more than six months and who are regularly scheduled to work more than 20 hours per week are eligible to participate in the plan, provided that they own less than five percent of the total combined voting power of all classes of stock of the Company. The purchase price for each

Note 7. Stock-based Compensation Plans — (Continued)

share will be determined by the Compensation Committee, but may not be less than 90% of the closing price of the Class A common stock on the first or last trading day of the payroll deduction period, whichever is lower. No employee may purchase in any calendar year Class A common stock having an aggregate fair value in excess of $25,000. Upon termination of employment, an employee other than a participating employee who is subject to Section 16(b) under the Securities Exchange Act of 1934, as amended, will be refunded all moneys in his or her account and the employee's option to purchase shares will terminate. The plan will terminate in March 2006, unless terminated earlier by the Board of Directors. The Company has implemented this plan effective February 1, 1997. Under the plan, the Company sold 132,893 shares of Class A common stock in 1998 and 38,080 shares in 1997. The fair value of the employees' purchase rights was calculated for disclosure purposes using the Black-Scholes model with the following assumptions: an expected life of 12 months in 1998 and 11 months in 1997; a risk-free interest rate of 4.65% in 1998 and 5.40% in 1997; expected volatility of 59.39% in 1998 and 48.63% in 1997; and no expected dividends. The fair value of each purchase right granted in 1998 was $10.76 and in 1997 was $6.35.

A summary of the status of the Company's stock option plans as of and for the years ended December 31, 1998, 1997 and 1996 is as follows (In thousands, except price data):

	Shares	Weighted-Average Exercise Price
Outstanding at January 1, 1996	4,869	$ 1.33
Granted	3,502	13.14
Exercised	(491)	1.30
Forfeited	(336)	7.64
Outstanding at December 31, 1996	7,544	6.54
Granted	6,674	26.72
Exercised	(1,138)	1.15
Forfeited	(2,472)	29.74
Outstanding at December 31, 1997	10,608	14.40
Granted	6,273	31.28
Exercised	(1,373)	2.72
Forfeited	(3,237)	35.85
Outstanding at December 31, 1998	12,271	18.69

	Number of Options		
	1998	1997	1996
Exercisable, end of year	2,776	2,397	2,324
Weighted-average fair value per option of options granted during the year	$18.18	$12.24	$ 5.74

Note 7. Stock-based Compensation Plans — (Continued)

Other pertinent information related to the options outstanding at December 31, 1998 is as follows:

	Options Outstanding			Options Exercisable	
Range Of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$0.27 to $2.27	1,926,362	3.14	$ 1.68	1,373,212	$ 1.49
$2.49 to $2.93	1,275,525	4.20	2.68	569,491	2.67
$4.29 to $9.30	43,073	5.81	7.63	30,917	7.08
$17.75 to $17.75	2,145,639	8.07	17.75	186,408	17.75
$18.63 to $23.50	242,566	7.70	20.14	41,333	20.01
$24.25 to $24.25	2,678,612	9.77	24.25	80	24.25
$24.50 to $24.50	1,639,730	8.66	24.50	399,926	24.50
$24.75 to $29.61	112,511	8.49	29.38	24,093	29.16
$29.75 to $29.75	1,316,560	10.00	29.75	--	--
$31.56 to $46.63	889,956	9.06	35.77	150,066	34.31
	12,270,534	7.61	$ 18.69	2,775,526	$ 8.49

In addition, options to purchase shares of Class B common stock were granted to a stockholder which had guaranteed borrowings under certain credit facilities which were paid off with a portion of the proceeds from the Company's initial public offering and subsequently canceled. These options have a weighted-average exercise price of $1.79 and are fully vested at December 31, 1998.

Note 8. Capital Stock Information and Investor Agreement

Public offerings: On June 10, 1996, the Company undertook an initial public offering of Class A common stock which yielded net proceeds of approximately $258 million. On November 20, 1996, the Company completed an additional public offering of Class A common stock which yielded net proceeds of approximately $138 million in additional capital.

Recapitalization: In May 1997, the Company's stockholders approved an increase in the authorized Class A common stock from 75,000,000 shares of $.01 par value stock to 250,000,000 shares of $.01 par value stock. In March 1996, the Company's Board of Directors had authorized an increase in the authorized Class A common stock to 75,000,000 shares of $.01 par value stock from 15,000,000 shares of $.01 par value stock and an increase in the authorized Class B common stock to 22,000,000 shares of $.01 par value stock from 15,000,000 shares of $.01 par value stock. All Class B common stock has rights identical to Class A common stock other than their voting rights, which are equal to .40 vote per share. Each share of Class B common stock is convertible into one share of Class A common stock at the option of the holder. The restated Articles of Incorporation also authorizes the Board of Directors to issue up to 2,000,000 shares of $.01 par value preferred stock. The terms of the preferred stock are determined at the time of issuance. No preferred shares were issued or outstanding at December 31, 1998. Also in March 1996, the Board of Directors declared a 3.75 to 1 stock split for both the Class A and Class B common stock which was effected in the form of a stock dividend. All references to share and per share amounts give retroactive effect to this stock split and recapitalization.

Stockholders' Agreement: Certain of the Company's principal stockholders have entered into a Stockholders' Agreement, which amended and restated a prior Investor Agreement, and became effective on September 24, 1997. This agreement provides for the election of directors designated by certain principal stockholders and prevents certain principal stockholders from disposing of any equity securities

Note 8. Capital Stock Information and Investor Agreement — (Continued)

of the Company for a period of one year unless consented to by the Board of Directors. In addition, certain principal stockholders agreed that for a period of two years they will not acquire any securities or options issued by the Company, except as allowed by previous agreements or by the Board of Directors.

On November 18, 1998, the Company entered into a stockholders' agreement (the "November 1998 Stockholders' Agreement") with Alliant Energy, Clark E. and Mary E. McLeod, and Richard A. Lumpkin, Gail G. Lumpkin and several other parties affiliated or related to Richard A. Lumpkin (collectively, the "Lumpkins," and together with Alliant Energy and Clark E. and Mary E. McLeod, the "Principal Stockholders").

The November 1998 Stockholders' Agreement provides, among other things, that:

- until December 31, 2001, the Principal Stockholders will not sell or otherwise dispose of any of our equity securities, or any other securities convertible into or exercisable for such equity securities, beneficially owned by such Principal Stockholder without receiving the prior written consent of the Company's board of directors, except for permitted transfers as provided in the November 1998 Stockholders' Agreement
- the Company's board of directors will determine on a quarterly basis starting with the quarter ending December 31, 1998 and ending on December 31, 2001, the aggregate number, if any, of shares of Class A common stock (not to exceed in the aggregate 150,000 shares per quarter) that the Principal Stockholders may sell or otherwise dispose of during designated trading periods following the release of the Company's quarterly or annual financial results
- to the extent the Company's board of directors grants registration rights to a Principal Stockholder in connection with a sale or other disposition of the Company's securities by such Principal Stockholder, it will grant similar registration rights to the other parties
- the Company's board of directors will determine on an annual basis starting with the year ending December 31, 1999 and ending on December 31, 2001 (each such year, an "Annual Period"), the aggregate number, if any, of shares of Class A common stock (not to exceed in the aggregate on an annual basis a number of shares equal to 15% of the total number of shares of Class A common stock beneficially owned by the Principal Stockholders as of December 31, 1998) (the "Registrable Amount"), to be registered by the Company under the Securities Act, for sale or other disposition by the Principal Stockholders
- in any underwritten offering of shares of Class A common stock by the Company, other than an offering registering shares of our Class A common stock on a registration statement on Form S-4 or Form S-8 or other form which would not permit the inclusion of shares of Class A common **Note 8. Capital Stock Information and Investor Agreement** stock of the Principal Stockholders, the Company will give written notice of such offering to the Principal Stockholders and will undertake to register the shares of Class A common stock of such parties up to the Registrable Amount, if any, as determined by the Company's board of directors
- the Company may subsequently determine not to register any shares of the Principal Stockholders under the Securities Act and may either not file a registration statement or otherwise withdraw or abandon a registration statement previously filed

The November 1998 Stockholders' Agreement terminates on December 31, 2001.

Note 9. Change-of-Control Agreements

Change-of-Control Agreements: The Company has entered into change-of-control agreements with certain executive employees, which provide for certain payments in connection with termination of employment after a change of control (as defined within the agreements) of the Company. The change-of-control agreements terminate on December 31, 2006 unless a change of control occurs during the six-month period prior to December 31, 2006, in which case the agreements terminate on December 31, 2007. The agreements provide that if an executive terminates his or her employment within six months after a change of control or if the executive's employment is terminated within 24 months after a change of control in accordance with the terms and conditions set forth in the agreements, the executive will be entitled to certain benefits. The benefits include cash compensation, immediate vesting of outstanding stock options and coverage under the Company's group health plan.

Note 10. Retirement Plans and Postretirement Benefits

CCI, a wholly owned subsidiary of the Company, maintains noncontributory defined pension and death benefit plans covering substantially all of its salaried and hourly employees. The pension benefit formula used in the determination of pension cost is based on the highest five consecutive calendar years' base earnings within the last ten calendar years immediately preceding retirement or termination. It is CCI's policy to fund pension costs as they accrue subject to any applicable Internal Revenue Code limitations.

In 1997, the Company offered salaried plan participants a choice between transferring their plan assets to the hourly defined benefit plan or participating in the 1996 Employee Stock Option Plan, as the salaried defined benefit plan was terminated effective April 1, 1998. This plan change substantially reduced the expected future benefits under the defined benefits pension plans and has been reflected in the tables below. As a result of the termination of the salaried plan, the Company recognized a gain of $2.2 million. The Company continues to maintain the defined benefit pension plan for substantially all hourly employees of CCI.

In addition to providing pension benefits, CCI provides an optional retiree medical program to its salaried and union retirees and spouses under age 65 and life insurance coverage for the salaried retirees. All retirees are required to contribute to the cost of their medical coverage while the salaried life insurance coverage is provided at no cost to the retiree.

Note 10. Retirement Plans and Postretirement Benefits— (Continued)

The change in benefit obligations and the change in plan assets for 1998 and 1997, and the components of net periodic benefit costs and the weighted-average assumption for 1998, 1997 and 1996, are as follows (in thousands):

	Pension Benefits		Postretirement Benefits	
	1998	1997	1998	1997
Change in benefit obligations				
Benefit obligation at beginning of year	$ 52,120	$ 59,495	$ 4,998	$ 9,905
Service cost	788	2,440	114	606
Interest cost	3,904	3,517	337	581
Plan amendments	—	—	—	(2,389)
Curtailment gain	—	(4,067)	—	—
Special termination benefits and other	6,544	—	—	—
Benefits paid	(20,319)	(2,580)	(367)	(297)
Actuarial gains	2,013	(6,685)	(493)	(3,408)
Benefit obligation at end of year	$ 45,050	$ 52,120	$ 4,589	$ 4,998
Change in plan assets				
Fair value of plan assets at beginning of year	$ 65,694	$ 55,257	$ —	$ —
Actual return on plan assets	6,835	7,767	—	—
Employer contributions	—	5,250	367	297
Benefits paid	(20,319)	(2,580)	(367)	(297)
Fair value of plan assets at end of year	$ 52,210	$ 65,694	$ —	$ —
Funded status	$ 7,160	$ 13,574	$ (4,589)	$ (4,998)
Unrecognized net actuarial gain	(13,829)	(22,963)	(3,742)	(3,463)
Unrecognized prior service cost	4,464	3,425	(2,215)	(2,389)
Unrecognized transition (asset) or obligation	(118)	(157)	4,346	4,733
Accrued benefit cost	$ (2,323)	$ (6,121)	$ (6,200)	$ (6,117)

	Pension Benefits			Postretirement Benefits		
	1998	1997	1996	1998	1997	1996
Components of net periodic benefit costs						
Service cost	$ 788	$ 2,440	$ 2,195	$ 114	$ 606	$ 572
Interest cost	3,904	3,517	3,327	337	581	540
Expected return on plan assets	(5,043)	(3,877)	(3,417)	–	—	—
Amortization of prior service costs	482	496	496	(174)	—	—
Amortization of transitional (asset) or obligation	(39)	12	12	387	387	387
Recognized actuarial (gain) or loss	(1,708)	(543)	(373)	(215)	(26)	(14)
Net periodic benefit cost	$ (1,616)	$ 2,045	$ 2,240	$ 449	$ 1,548	$ 1,485
Weighted-average assumption as of December 31						
Discount rate	7%	7%	7%	7%	7%	6%
Expected return on plan assets	8%	8%	8%	—	—	—
Rate of compensation increase	5%	5%	5%	5%	5%	5%

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Note 10. Retirement Plans and Postretirement Benefits— (Continued)

The postretirement benefit obligation is calculated assuming that health-care costs increased by 8% in 1998 and 7.5% in 1999, and that the rate of increase thereafter (the health-care cost trend rate) will decline to 5% in 2004 and subsequent years. The health-care cost trend rate has a significant effect on the amounts reported for costs each year as well as on the accumulated postretirement benefit obligation. For example, a one percentage point increase each year in the health-care trend rate would have the following effects:

	One Percentage Point Increase	One Percentage Point Decrease
Effect on total of service and interest cost components in 1998	$ 40,565	$ (35,853)
Effect on year-end 1998 postretirement benefit obligations	$370,825	$(333,297)

The weighted average discount rate used in determining the benefit obligation was 7% in 1998.

The postretirement medical and life insurance benefit plans have been modified effective January 1, 1998 to provide benefits only to employees meeting certain age and years of service requirements as of January 1, 1998.

CCI also has a nonqualified deferred compensation plan, which allows selected employees to defer a portion of any compensation received. Those deferred amounts are invested in various funds at December 31, 1998 to provide assets and accumulated earnings to offset the deferred compensation amounts due to the participating employees.

In addition, the Company has various 401(k) profit-sharing plans available to eligible employees. The Company contributed approximately $2,007,000, $1,252,000 and $242,000 for the years ended December 31, 1998, 1997 and 1996, respectively. An additional discretionary 1998 contribution of $1,500,000 was also made.

Note 11. Acquisitions

Ruffalo, Cody & Associates, Inc. (Ruffalo Cody): On July 15, 1996, the Company acquired Ruffalo Cody for a total purchase price of approximately $17.3 million, which consisted of approximately $5.1 million in cash (including approximately $243,000 in direct acquisition costs), 361,420 shares of Class A common stock and 158,009 options to purchase shares of Class A common stock granted to the holders of Ruffalo Cody options. An additional $50,782 in cash and 56,177 shares of Class A common stock were delivered to certain stockholders of Ruffalo Cody upon fulfillment certain conditions relating to ongoing revenues from an agreement with a major long distance carrier to provide telemarketing services. The long distance carrier terminated this contract effective December 31, 1996.

Note 11. Acquisitions— (Continued)

Telecom★USA Publishing Group, Inc. (McLeodUSA Media Group): On September 20, 1996, the Company acquired Telecom★USA Publishing Group, Inc. (now known as McLeodUSA Media Group, Inc.) for a total purchase price of approximately $76.1 million, which consisted of approximately $74.5 million in cash (including approximately $436,000 in direct acquisition costs) and $1.6 million resulting from the Company entering into an incentive compensation program with all holders of nonvested McLeodUSA Media Group options, which provides for payments to be made to these individuals on January 1 of the year following the year in which the corresponding options would have vested.

Total Communications Systems, Inc. (TCSI): On December 9, 1996, the Company purchased the customer base and certain other assets of TCSI for a cash purchase price of approximately $534,000.

Digital Communications of Iowa, Inc. (DCI): In January 1997, the Company issued 84,430 shares of Class A common stock in exchange for all the outstanding shares of DCI, in a transaction accounted for as a purchase. The total purchase price was approximately $2.3 million based on the average closing market price of the Company's Class A common stock at the time of the acquisition.

Fronteer Financial Holdings, Ltd. (Fronteer): In January 1997, McLeodUSA Media Group exercised its option to acquire six directories from Fronteer for a total cash purchase price of approximately $3.9 million.

Indiana Directories, Inc. (Indiana Directories): On March 31, 1997, McLeodUSA Media Group acquired 26 telephone directories published by Indiana Directories for a total cash purchase price of approximately $10 million.

ESI Communications, Inc. (ESI): On June 10, 1997, the Company acquired substantially all of the assets of ESI and related entities for a total cash purchase price of approximately $15.2 million.

Smart Pages, Inc. and Yellow Pages Publishers, Inc. (Smart Pages): On September 22, 1997, McLeodUSA Media Group acquired two telephone directories published by Smart Pages for a total cash purchase price of approximately $2 million.

CCI: On September 24, 1997, pursuant to the terms and conditions of an Agreement and Plan of Reorganization dated June 14, 1997 (the "Merger Agreement"), the Company issued 8,488,586 shares of Class A common stock and paid approximately $155 million in cash to the shareholders of CCI in exchange for all of the outstanding shares of CCI in a transaction accounted for using the purchase method of accounting. The total purchase price was approximately $382.1 million based on the average closing price of the Company's Class A common stock five days before and after the date of the Merger Agreement. The purchase price includes approximately $3.4 million of direct acquisition costs.

OneTEL Corp. (OneTEL): On October 15, 1997, the Company issued 55,500 shares of Class A common stock as consideration for certain assets of OneTEL. The total purchase price was approximately $2 million based on the closing price of the Company's Class A common stock on the purchase date.

Colorado Directory Company LLC (Colorado Directory): On December 31, 1997, the Company issued 140,000 shares of Class A common stock as consideration for all of the outstanding membership and ownership interests of Colorado Directory. The total purchase price was approximately $4.5 million based on the closing price of the Company's Class A common stock on the purchase date.

Note 11. Acquisitions— (Continued)

F.D.S.D. Rapid City Directories, Inc. (F.D.S.D.): On March 17, 1998, McLeodUSA Media Group acquired a telephone directory published by F.D.S.D. for a cash purchase price of approximately $2.2 million.

Bi-Rite Directories, Inc. (Bi-Rite): On March 20, 1998, McLeodUSA Media Group acquired a telephone directory published by Bi-Rite for a cash purchase price of approximately $3.7 million.

Smart Pages, Inc. and Yellow Page Publishers, Inc. (Smart Pages): On April 8, 1998, McLeodUSA Media Group acquired a telephone directory published by Smart Pages for a cash purchase price of approximately $1.3 million.

NewCom Technologies, Inc. and NewCom OSP Services, Inc. (collectively, NewCom): On April 24, 1998, the Company issued 70,508 shares of Class A common stock and paid approximately $1 million cash for all of the outstanding shares of NewCom, in a transaction accounted for using the purchase method of accounting. The total purchase price was approximately $4.2 million based on the average closing market price of the Class A common stock at the time of the acquisition.

Communications Cable-Laying Company, Inc. (CCC): On June 29, 1998, the Company issued 151,019 shares of Class A common stock to acquire certain of the assets of CCC. The total purchase price was approximately $6 million based on the average closing market price of the Class A common stock at the time of the acquisition and including $78,000 of cash acquisition costs.

QST Communications, Inc. (QST): On August 21, 1998, the Company acquired all the outstanding shares of QST for approximately $20 million cash and an option to purchase 245,536 shares of the Company's Class A common stock at an exercise price of the lower of $40.00 or the closing price of the Class A common stock on the day prior to the closing date of the acquisition ($37.25). This transaction is accounted for using the purchase method of accounting. The purchase price includes approximately $151,000 of cash acquisition costs.

ADCO Publishing Co., Inc. (ADCO): On September 15, 1998, McLeodUSA Media Group acquired two telephone directories published by ADCO for a cash purchase price of approximately $8.9 million.

Rivers Directories, Inc. (Mozarks): On November 19, 1998, McLeodUSA Media Group acquired three telephone directories published by Mozarks for a total cash purchase price of $216,000.

Inlet, Inc. (Inlet): On November 25, 1998, the Company acquired substantially all of the assets of Inlet for a total purchase price of approximately $2.4 million, which consisted of 70,672 shares of Class A common stock and an option to purchase 10,414 shares of Class A common stock. The total purchase price was based on the average closing market price of the Class A common stock on the five days prior to and after the closing date of the acquisition ($31.76). This transaction is accounted for using the purchase method of accounting.

Mo-Ark Directories, Inc. (Mo-Ark): On December 3, 1998, McLeodUSA Media Group acquired two telephone directories published by Mo-Ark for a total cash purchase price of $606,000.

Note 11. Acquisitions— (Continued)

The following table summarizes the purchase price allocations for the Company's business acquisitions (in thousands):

Transaction Year:	1998	1997	1996
Cash purchase price	$27,583	$178,477	$79,402
Acquisition costs	229	3,415	679
Incentive agreements	—	—	1,610
Contracts payable	9,540	7,022	—
Option agreements	—	500	—
Promissory notes	815	100	—
Stock issued	11,427	232,368	8,945
Options to purchase Class A common stock	143	—	3,911
Less cash to be received upon option exercised	—	—	(610)
	$49,737	$421,882	$93,937
Working capital acquired, net	$ (118)	$ 41,797	$ 9,138
Fair value of other assets acquired	13,480	174,401	5,817
Intangibles	38,742	288,038	79,966
Liabilities assumed	(2,367)	(82,354)	(984)
	$49,737	$421,882	$93,937

These acquisitions have been accounted for as purchases and the results of operations are included in the consolidated financial statements since the dates of acquisition.

The unaudited consolidated results of operations for the years ended December 31, 1998 and 1997 on a pro forma basis as though the above entities had been acquired as of the beginning of the respective periods are as follows:

	1998	1997
	(In thousands, except per share data)	
Revenue	$612,703	$484,376
Net loss	(127,006)	(86,996)
Loss per common share	(2.02)	(1.42)

The pro forma financial information is presented for informational purposes only and is not necessarily indicative of the operating results that would have occurred had the acquisitions been consummated as of the above dates, nor are such operating results necessarily indicative of future operating results.

On October 27, 1998, the Company entered into an Agreement and Plan of Reorganization with Dakota Telecommunications Group, Inc., a Delaware corporation (DTG), pursuant to which the Company agreed, subject to certain conditions, to acquire DTG for an aggregate of 1,375,000 shares of Class A common stock and the assumption of $31 million in debt. The DTG transaction was consummated on March 5, 1999 (see Note 16).

Note 12. Related Party Transactions

The Company has entered into agreements with two stockholders that gives certain rights-of-way to the Company for the construction of its telecommunications network in exchange for capacity on the network.

The Company provided and purchased services from various companies, the principals of which are stockholders or directors of McLeodUSA Incorporated or are affiliates. Revenues from services provided totaled $3,698,000, $1,018,000 and $254,000 and services purchased, primarily rent, legal services and database verification services, totaled $3,065,000, $2,030,000 and $934,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

In December 1998, the Company entered into a split dollar arrangement for life insurance policies owned by the McLeod Family 1998 Special Trust on the joint lives of Clark and Mary McLeod. The McLeod Family 1998 Special Trust agreed to assign the policies to the Company as collateral for the premium payments. No loans have been taken against these policies. In 1998, the premium payments paid by the Company totaled $1,880,000. The aggregate face amount of the policies is $113,000,000. The McLeod Family 1998 Special Trust is sole owner and beneficiary of each policy. The Company has agreed with Clark and Mary McLeod that one of the principle reasons for entering into this arrangement is to avoid any need for their heirs to liquidate their holdings of Class A common stock at or soon after the death of one or both of them. Clark and Mary McLeod have agreed to restrictions on their ability to sell or otherwise dispose of their shares of Class A common stock. The Company also paid premiums of $138,257 for a universal life policy on Clark and Mary McLeod with a face value of $13,500,000. The Company is the beneficiary of this policy.

During 1997, the Company also acquired two condominium units from a Company director for a total purchase price of $171,000 and purchased a 15,000 square foot building, which is used as a support facility for its fiber optic network, from a stockholder for a cash purchase price of $500,000.

In addition, at December 31, 1998 the Company has two $75,000 notes receivable from officers. The notes bear interest at the applicable federal interest rate for mid-term loans. One note requires interest-only payments for one year and then annual $25,000 payments plus interest until paid in full. The other note requires annual $25,000 payments plus interest until paid in full.

Note 13. Quarterly Data— (Unaudited)

The following tables include summarized quarterly financial data for the years ended December 31:

	Quarters			
	First	Second	Third	Fourth (1)
	(In thousands, except per share data)			
1998:				
Revenue	$134,331	$155,695	$148,616	$165,504
Operating loss	(20,813)	(17,300)	(21,257)	(15,305)
Net loss	(30,267)	(29,791)	(33,042)	(31,812)
Loss per common share	(0.49)	(0.48)	(0.52)	(0.50)
1997:				
Revenue	$ 35,747	$ 46,523	$ 49,325	$136,291
Operating loss	(15,168)	(15,668)	(20,074)	(18,459)
Net loss	(13,355)	(16,496)	(23,705)	(26,354)
Loss per common share	(0.26)	(0.31)	(0.45)	(0.43)
1996:				
Revenue	$ 12,488	$ 13,918	$ 19,091	$ 35,826
Operating loss	(4,076)	(4,791)	(7,689)	(11,654)
Net loss	(4,340)	(4,543)	(4,535)	(8,928)
Loss per common share	(0.14)	(0.13)	(0.10)	(0.18)

(1) The fourth quarter 1997 results include the operations of CCI, which was acquired on September 24, 1997.

Note 14: Information by Business Segment

The Company operates predominantly in the business of providing local, long distance and related communications services to end users and the sale of advertising space in telephone directories. The two business segments have separate management teams and infrastructures that offer different products and services. The principal elements of these segments are to provide integrated communications services, provide outstanding customer service, expand fiber optic network, expand intra-city fiber network build, and publish and distribute directories to local area subscribers.

The Company evaluates the performance of its operating segments based on earnings before interest, taxes, depreciation and amortization, excluding general corporate expenses ("EBITDA"). The accounting policies of the reportable segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements. Intersegment transfers are accounted for on an arm's length pricing basis.

Identifiable assets (excluding intersegment receivables) are the Company's assets that are identified in each business segment. Corporate assets primarily include cash and cash equivalents, investments in available-for-sale securities, administrative headquarters and goodwill recorded primarily as a result of the CCI merger in 1997.

In 1998, 1997 and 1996, no single customer or group under common control represented 10% or more of the Company's sales.

Note 14: Information by Business Segment— (Continued)

Segment information for the years 1998, 1997 and 1996 was as follows (in thousands):

	Telecommunications	Media	Corporate	Total
1998				
Revenues	$ 459,270	$144,876	$ —	$604,146
EBITDA	13,139	18,829	(11,961)	20,007
Depreciation and amortization	(56,136)	(9,814)	(23,157)	(89,107)
Interest Revenue	941	41	25,018	26,000
Interest Expense	(5,256)	—	(72,978)	(78,234)
Taxes and Other	(4,014)	(42)	478	(3,578)
Net Income (Loss)	(51,326)	9,014	(82,600)	(124,912)
Total assets	684,730	199,734	1,040,733	1,925,197
Capital expenditures	251,401	26,395	61,864	339,660
1997				
Revenues	$ 218,245	$ 49,641	$ —	$ 267,886
EBITDA	(29,954)	11,914	(13,422)	(31,462)
Depreciation and amortization	(18,302)	(5,814)	(9,159)	(33,275)
Interest Revenue	290	21	22,349	22,660
Interest Expense	(1,415)	(27)	(33,185)	(34,627)
Taxes and Other	1,366	(2,547)	(2,025)	(3,206)
Net Income (Loss)	(48,015)	3,547	(35,442)	(79,910)
Total assets	351,990	172,424	821,238	1,345,652
Capital expenditures	121,618	34,204	445,315	601,137
1996				
Revenues	$ 66,171	$ 15,152	$ —	$ 81,323
EBITDA	(10,490)	1,141	(7,996)	(17,345)
Depreciation and amortization	(4,327)	(1,346)	(2,812)	(8,485)
Interest Revenue	—	87	5,947	6,034
Interest Expense	(1)	(133)	(531)	(665)
Other	—	(2,162)	277	(1,885)
Net Income (Loss)	(14,818)	(2,413)	(5,115)	(22,346)
Total assets	110,302	94,270	248,422	452,994
Capital expenditures	66,507	528	106,747	173,782

Note 15: Effects of New Accounting Standards

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. This statement provides guidance on accounting for the costs of computer software developed or obtained for internal use and is required to be adopted no later than our 1999 fiscal year. The Company plans to modify its method of capitalization of such costs by adopting this statement prospectively on January 1, 1999. The Company is currently evaluating this statement but does not expect it to have a material impact on its financial condition or results of operations.

In June 1998, the FASB issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards requiring that every derivative instrument (including derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. SFAS 133 requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the income statement, and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

SFAS 133 is effective for fiscal years beginning after June 15, 1999. A company may also implement SFAS 133 as of the beginning of any fiscal quarter after issuance (that is, fiscal quarters beginning June 16, 1998 and thereafter). SFAS 133 cannot be applied retroactively. SFAS 133 must be applied to (a) derivative instruments and (b) derivative instruments embedded in hybrid contracts that were issued, acquired or substantively modified after December 31, 1997 (and, at the company's election, before January 1, 1998).

The Company does not expect the impact of the adoption of SFAS 133 to be material to its results of operations as it does not currently hold any derivative instruments or engage in hedging activities.

Note 16: Subsequent Events

The Ovation Merger Agreement. On January 6, 1999, the Company entered into an Agreement and Plan of Merger (the "Ovation Merger Agreement") with Ovation Communications, Inc., a Delaware corporation ("Ovation"), and certain stockholders of Ovation pursuant to which Ovation will be merged with and into a newly formed wholly owned subsidiary of the Company (the "Ovation Merger"). As a result of the Ovation Merger, (i) each share of Ovation's preferred stock will be converted into the right to receive cash, and (ii) each share of Ovation's common stock will be converted, at the election of the stockholder, into the right to receive cash or shares of Class A common stock. The amount of cash into which each share of Ovation's preferred stock will be converted and the amount of cash or number of shares of Class A common stock into which each share of Ovation's common stock will be converted will be determined immediately prior to consummation of the Ovation Merger in accordance with formulas specified in the Ovation Merger Agreement. The Company estimates that it will be required to issue approximately 5.1 million shares of Class A common stock and to pay approximately $141 million cash to effect the Ovation Merger. The Company will also assume approximately $95 million in Ovation debt. In addition, under the terms of the Ovation Merger Agreement, each option to purchase Ovation common stock issued under Ovation's stock option plan will become or be replaced by an option to purchase a number of shares of Class A common stock equal to the number of shares of Ovation common stock that could have been purchased (assuming full vesting) under the Ovation stock option multiplied by the exchange ratio used to convert Ovation common stock into Class A common stock.

Note 16: Subsequent Events— (Continued)

Consummation of the Ovation Merger is subject to the satisfaction of certain conditions, including (i) approval of the Ovation Merger Agreement and the Ovation Merger by the stockholders of Ovation, (ii) effectiveness of the registration statement registering the shares of Class A common stock to be issued in the Ovation Merger, (iii) compliance with the applicable provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and the related waiting periods thereunder, (iv) receipt of specified regulatory approvals, and (v) certain other customary conditions. Both the Company and Ovation may terminate the Ovation Merger Agreement if the Ovation Merger has not been consummated by May 1, 1999. Certain stockholders of Ovation holding in the aggregate approximately 94% of the voting power attributable to Ovation's common stock and preferred stock have agreed to vote all of their shares in favor of the Ovation Merger at a meeting of the stockholders of Ovation.

In connection with the execution of the Ovation Merger Agreement, the Company entered into a Revolving Credit Agreement with Ovation pursuant to which the Company agreed to lend Ovation up to $20 million on a senior subordinated unsecured basis. In addition, pursuant to a stockholders' agreement, certain Ovation stockholders agreed through December 31, 2001 to certain restrictions on their ability to transfer the shares of Class A common stock that they will receive in the Ovation Merger.

Acquisition of Talking Directories, Inc. and Info America Phone Books, Inc. On February 10, 1999, the Company acquired Talking Directories, Inc., a Michigan corporation ("Talking Directories"), in exchange for 2.6 million shares of its Class A common stock. In a related and concurrent transaction, on February 10, 1999, the Company acquired Info America Phone Books, Inc., a Michigan corporation ("Info America"), in exchange for 1.2 million shares of Class A common stock. The Company also paid outstanding obligations of Talking Directories and Info America of approximately $27 million.

1999 Senior Note Offering. In February 1999, the Company completed a private offering of $500 million aggregate principal amount of our 8⅛% Senior Notes due February 15, 2009 (the "1999 Senior Notes"), yielding net proceeds of approximately $487.8 million. The 1999 Senior Notes accrue interest at a rate of 8⅛% per annum payable in cash semi-annually in arrears on February 15 and August 15 of each year, starting August 15, 1999.

Acquisition of Dakota Telecommunications Group, Inc. On March 5, 1999, the Company acquired Dakota Telecommunications Group, Inc. in exchange for 1,375,000 shares of its Class A common stock and the assumption of approximately $31 million in Dakota Telecommunications Group, Inc. debt.