RECEIVED

APR 15 2013

PUBLIC SERVICE
COMMISSION

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

TENNESSEE 554
HIGHLAND TELEPHONE COOPERATIVE, INC.
AND SUBSIDIARY
SUNBRIGHT, TENNESSEE

December 31, 2012 and 2011

TOTHEROW, HAILE & WELCH, PLLC
Certified Public Accountants

HTC Technology For You

7840 Morgan County Hwy.
P.O. Box 119
Sunbright, TN 37872

EMAIL
highland@highland.net

voice 423/628 2121
423/663 3939
606/376 5311

Fax 423/628 2409

April 11, 2013

RECEIVED

APR 15 2013

PUBLIC SERVICE
COMMISSION

Jeff D. Cline
Annual Report Branch
Commonwealth of Kentucky
Public Service Commission
211 Sower Boulevard P. O. Box 615
Frankfort, Kentucky 40602-0615

Dear Jeff Cline:

Please find enclosed a copy of the Audited Consolidated Financial Statements from Totherow, Haile & Welch for period ending December 2012. If you have any questions, please call me at 423-628-2121.

Sincerely,

Patriece Brown

Patriece Brown
Account Manager

RECEIVED

APR 15 2013

PUBLIC SERVICE
COMMISSION

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

TENNESSEE 554
HIGHLAND TELEPHONE COOPERATIVE, INC.
AND SUBSIDIARY
SUNBRIGHT, TENNESSEE

December 31, 2012 and 2011

--oo0oo--

CONTENTS

--oo0oo--

TOTHEROWHAILE&WELCH, PLLC
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Directors
Highland Telephone Cooperative, Inc.
Sunbright, Tennessee

We have audited the accompanying consolidated financial statements of Highland Telephone Cooperative, Inc. and Subsidiary which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of income, comprehensive income, changes in members' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Highland Communications, LLC, a wholly owned subsidiary of Highland Holdings, Inc. (Subsidiary), which statements reflect total assets of $4,673,185 and $4,139,259 as of September 30, 2012 and 2011, respectively, and total revenues of $5,654,454 and $5,578,566, respectively, for the years then ended. Those statements were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for Highland communications, LLC, is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audits opinion.

2355 South Chancery St., McMinnville, TN 37110 tel: 931-668-1272 fax: 931-668-2752
1418 Kensington Square Ct. Bldg. D, Murfreesboro, TN 37130 tel: 615-848-1072 fax: 615-848-1772
www.thwcpa.com / TIN: 62-0693408

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Highland Telephone Cooperative, Inc. and Subsidiary as of December 31, 2012 and 2011, and the results of its operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Jotherow, Haile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 8, 2013

CONSOLIDATED BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2012 and 2011

	2012	2011
ASSETS		
CURRENT ASSETS		
Cash - general	$ 8,732,845	$ 8,084,701
Cash - construction fund	501	832,661
Temporary investments	980,127	979,409
Securities available for sale	3,599,262	2,999,256
Telecommunications accounts receivable, less allowances of $165,811 in 2012 and $62,932 in 2011	1,195,798	1,448,955
Other accounts receivable	1,202,643	1,128,308
Grant receivable	671,666	1,313,496
Materials and supplies	2,685,250	2,636,410
Prepayments	217,845	344,028
Refundable tax deposits	3,083	3,083
Other current assets	283,453	113,967
TOTAL CURRENT ASSETS	$ 19,572,473	$ 19,884,274
NONCURRENT ASSETS		
Other investments	$ 1,051,547	$ 1,012,020
Nonregulated investments	2,755,577	2,656,600
Deferred tax asset	31,153	37,136
Deposits	4,173	4,173
TOTAL NONCURRENT ASSETS	$ 3,842,450	$ 3,709,929
PROPERTY, PLANT AND EQUIPMENT		
Telecommunications plant in service	$ 113,730,579	$ 111,881,768
Telecommunications plant under construction	8,781,528	2,584,876
	$ 122,512,107	$ 114,466,644
Less accumulated depreciation	82,790,052	77,973,346
TOTAL PROPERTY, PLANT AND EQUIPMENT	$ 39,722,055	$ 36,493,298
	$ 63,136,978	$ 60,087,501

See the notes to financial statements.

CONSOLIDATED BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2012 and 2011

	2012	2011
LIABILITIES AND MEMBERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 3,034,751	$ 2,711,185
Advance billings and payments	756,571	782,308
Customer deposits	2,096	945
Current maturities on long-term debt	2,200,429	2,063,488
Accrued taxes	452,733	506,395
Accrued interest	10,641	14,654
Accrued rents	717,855	682,342
Accrued salaries and wages	181,020	162,082
Accrued compensated absences	1,157,316	1,093,916
Accrued federal and state income taxes	7,677	9,783
Other current liabilities	217,553	250,447
TOTAL CURRENT LIABILITIES	$ 8,738,642	$ 8,277,545
LONG-TERM DEBT		
Rural Utilities Service - mortgage notes	6,380,438	4,298,280
OTHER LIABILITIES		
Postretirement benefits other than pension	4,326,122	4,367,456
Deferred taxes	107,242	77,012
TOTAL LIABILITIES	$ 19,552,444	$ 17,020,293
MEMBERS' EQUITY		
Patronage equity	$ 44,062,458	$ 43,886,410
Accumulated other comprehensive income	(477,924)	(819,202)
TOTAL EQUITY	$ 43,584,534	$ 43,067,208
	$ 63,136,978	$ 60,087,501

CONSOLIDATED STATEMENTS OF INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Operating revenues:		
Local network services revenue	$ 6,834,959	$ 7,115,505
Long distance services revenue	993,851	1,049,489
Network access services revenue	8,113,598	8,432,286
Miscellaneous revenues	3,189,662	2,657,627
Less uncollectible revenue	(274,680)	(225,475)
TOTAL OPERATING REVENUES	$ 18,857,390	$ 19,029,432
Operating expenses:		
Plant specific operations expense	$ 6,238,038	$ 6,427,912
Plant nonspecific operations expense	1,700,419	1,655,190
Provision for depreciation	5,474,046	5,606,223
Customer operations expense	1,949,680	1,898,974
Corporate operations expense	3,370,971	3,190,375
Operating taxes	445,149	467,722
TOTAL OPERATING EXPENSES	$ 19,178,303	$ 19,246,396
OPERATING LOSS	$ (320,913)	$ (216,964)
Other income (expense):		
Interest income	$ 111,942	$ 115,958
Nonregulated income	387,273	436,290
Income from investment	37,885	38,457
Loss from sale of fixed asset	(781)	0
TOTAL OTHER INCOME	$ 536,319	$ 590,705

See the notes to financial statements.

CONSOLIDATED STATEMENTS OF INCOME (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Fixed charges:		
Interest on long-term debt	$ 312,789	$ 298,644
Interest charged to construction - credit	(288,565)	(179,958)
Interest on customer deposits	167	389
TOTAL FIXED CHARGES	$ 24,391	$ 119,075
INCOME BEFORE TAXES ON INCOME	$ 191,015	$ 254,666
Taxes on income	8,512	6,203
NET INCOME	$ 182,503	$ 248,463

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Net income	$ 182,503	$ 248,463
Other comprehensive income:		
Unrealized gain (loss) from securities available for sale	154	(170)
Postretirement benefits other than pension:		
Prior service costs	5,672	5,667
Unrecognized gain (loss)	335,452	(202,544)
COMPREHENSIVE INCOME	$ 523,781	$ 51,416

See the notes to financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	Memberships	Patronage Capital	Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
Balance at December 31, 2010	$ 253,327	$ 43,397,026	$ (622,155)	$ 43,028,198
Net income for 2011	0	248,463	0	248,463
Unrealized loss on investment of securities available for sale	0	0	(170)	(170)
Capital credits paid	0	(621)	0	(621)
Memberships refunded	(11,785)	0	0	(11,785)
Postretirement benefits other than pension:				
Prior service costs	0	0	5,667	5,667
Unrecognized gain	0	0	(202,544)	(202,544)
Balance at December 31, 2011	$ 241,542	$ 43,644,868	$ (819,202)	$ 43,067,208
Net income for 2012	0	182,503	0	182,503
Unrealized gain on investment of securities available for sale	0	0	154	154
Memberships refunded	(6,455)	0	0	(6,455)
Postretirement benefits other than pension:				
Prior service costs	0	0	5,672	5,672
Unrecognized loss	0	0	335,452	335,452
Balance at December 31, 2012	$ 235,087	$ 43,827,371	$ (477,924)	$ 43,584,534

See the notes to financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	$ 19,010,475	$ 18,352,321
Cash paid to suppliers and employees	(12,492,164)	(10,595,870)
Interest and dividends received	108,592	112,296
Interest paid	(28,404)	(123,673)
Taxes paid	(473,216)	(489,924)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 6,125,283	$ 7,255,150
Cash flows from investing activities:		
Construction and acquisition of plant	$ (9,134,994)	$ (4,685,391)
Plant removal cost	(446)	(1,061)
Salvage	30,132	0
Increase in nonregulated assets	(98,977)	71,003
Decrease in other investments	1,708	3,084
Securities available for sale	(600,006)	799,292
Increase in temporary investments	(718)	(1,238)
Increase (Decrease) in reserve for market valuation of securities	154	(170)
Decrease (Increase) in:		
Materials and supplies	(48,840)	(1,102,954)
Nonregulated income	387,273	436,290
NET CASH USED BY INVESTING ACTIVITIES	$ (9,464,714)	$ (4,481,145)

<u>CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)</u>

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Cash flows from financing activities:		
Payments on long-term borrowings	$ (1,879,933)	$ (1,921,634)
Debt proceeds	4,099,032	2,032,715
Postretirement benefits other than pension	299,790	271,369
(Increase) Decrease in grant receivable	641,830	(1,313,496)
Decrease in:		
Customer deposits	1,151	546
Capital credits paid	0	(621)
Memberships	(6,455)	(11,785)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	$ 3,155,415	$ (942,906)
NET INCREASE (DECREASE) IN CASH	$ (184,016)	$ 1,831,099
CASH AT BEGINNING OF YEAR	8,917,362	7,086,263
CASH AT END OF YEAR	$ 8,733,346	$ 8,917,362

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2012 and 2011

	2012	2011
Net income	$ 182,503	$ 248,463
Nonregulated income	(387,273)	(436,290)
Non cash patronage dividend	(3,350)	(5,143)
Income from investment	(37,885)	(38,457)
Loss from sale of asset	781	0
Deferred tax expense (benefit)	36,213	(6,005)
Net loss from regulated operations	$ (209,011)	$ (237,432)
Adjustments to reconcile net loss from regulated operations to net cash provided by operating activities:		
Depreciation	$ 5,875,770	$ 5,690,243
Decrease (Increase) in:		
Customer and other accounts receivable	178,822	(673,356)
Refundable tax deposit	0	12,173
Current and accrued assets - other	(169,486)	(8,024)
Prepaid expenses	126,183	(37,182)
Increase (Decrease) in:		
Accounts payable	323,566	2,526,420
Advance billings and payments	(25,737)	(3,755)
Accrued taxes	(53,662)	(25,614)
Accrued interest	(4,013)	(4,598)
Accrued rents	35,513	60,590
Accrued salaries and compensated absences	82,338	(105,081)
Accrued federal and state income taxes	(2,106)	3,447
Other current liabilities	(32,894)	57,319
TOTAL ADJUSTMENTS	$ 6,334,294	$ 7,492,582
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 6,125,283	$ 7,255,150

See the notes to financial statements.

Note A – Highland Telephone Cooperative, Inc. provides telecommunications services to customers in Morgan County and Scott County, Tennessee and McCreary County, Kentucky. The Cooperative has adopted the following accounting policies:

(1) Principles of Consolidation:

Highland Telephone Cooperative, Inc. (Cooperative) owns 100% of the outstanding common stock of Highland Holdings, Inc. and Subsidiaries (Subsidiary). The Subsidiary was formed for the purpose of providing long distance services, internet, and video services. Both the Cooperative and Subsidiary provide telecommunication services to a portion of east Tennessee. The consolidated financial statements include the accounts of Highland Holdings, Inc. and Subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

On October 1, 2010, Highland Telephone Cooperative, Inc. exchanged its shares of common stock in Highland Communications Corporation for shares of Highland Media Corporation in a tax free stock merger. Immediately following the stock merger, Highland Media Corporation changed its name to Highland Holdings, Inc. and transferred the assets and liabilities of Highland Communications Corporation to Highland Communications, LLC. The Company also transferred assets and liabilities to form a new entity, Highland Media, LLC. The newly formed entities are single member limited liability companies. The stock merger and subsequent transfer of assets and liabilities did not disrupt the daily operations of the companies.

The Cooperative operates on a fiscal year ending December 31. Highland Holdings, Inc. and Subsidiaries operate on a fiscal year ending September 30. The consolidated financial statements of 2012 reflect the results of operations from January 1 through December 31 for the Cooperative, and October 1, 2011 through September 30, 2012 for Highland Holdings, Inc. and its subsidiaries.

(2) The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Note A – (Cont'd):

(3) For purposes of financial statement presentation, the Cooperative and Subsidiary consider all highly-liquid investments with a maturity of three months or less to be cash equivalents. Cash equivalents consist primarily of treasury bills and notes and commercial paper with original maturities of 90 days or less. Certificates of deposit and other securities with original maturities over 90 days are classified as temporary investments.

(4) Accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a charge to earnings and a credit to the allowance for doubtful accounts based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the allowance for doubtful accounts and a credit to accounts receivable. No interest is charged on accounts receivable balances that are past due. Past due accounts receivable are based upon contractual terms as defined on customer invoices. Accounts receivable past due 90 days or more amounted to $22,537 and $18,684 at December 31, 2012 and 2011, respectively.

The allowance for doubtful accounts is based upon a credit review of the accounts receivable, past bad debt experience, current economic conditions and other pertinent factors which form a basis for determining the adequacy of the allowance. The allowance represents an estimate based upon these and other factors and, it is at least reasonably possible that a change in the estimate will occur in the near term.

(5) Materials and supplies are valued at average cost accumulated in perpetual inventory records, which are periodically adjusted to physical counts.

(6) Compensated absences are accrued as the benefits are earned by employees according to an established policy.

(7) Revenue is recorded upon the billing of telecommunications services net of sales tax.

(8) Expenditures for maintenance and repairs are charged to operations as they are incurred and betterments are capitalized. Original costs of properties retired are eliminated from property accounts and removal costs are charged to the allowance for depreciation. Salvage value of retired property is credited to the allowance for depreciation.

Note A – (Cont'd):

(9) Advertising costs are expensed as incurred and included in customer operations. Advertising expense amounted to $172,763 in 2012 and $165,787 in 2011.

Note B – Concentrations of Credit Risks:

Deposits

The Cooperative and Subsidiary maintains its cash in several commercial banks located within its trade area. Accounts are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $250,000 on interest bearing accounts and unlimited coverage on non-interest bearing accounts. All cash was insured at December 31, 2012.

The Companies also have cash maintained by an investment firm totaling $1,626,519 and $2,222,837 as of December 31, 2012 and 2011, respectively. The investment firm is a member of Securities Investors Protection Corporation (SIPC). SIPC provides limited protection for cash and investments held directly by the firm in the event of the failure of the investment firm.

Accounts receivable

Telecommunications services are provided to the customers within its trade area on a credit basis in the ordinary course of business. Generally, the accounts receivable generated by the sale of these services are unsecured.

Note C – Broadband Initiatives Program:

During 2010, the Cooperative applied for, and was awarded, a loan and grant combination to construct an updated broadband network in its service area under the Broadband Initiatives Program (the Program). The total amount awarded to the Cooperative was $66,489,162, of which $16,622,291 represents eligible loan proceeds and $49,866,871 of which will be awarded as a grant. Under the Program, the Cooperative will be reimbursed for eligible costs associated with the construction of the broadband facilities over a three year period. As of December 31, 2012, the Cooperative has received $6,298,510 in loan proceeds and $19,530,104 of the grant portion.

Note D – Investments in Debt and Equity Securities:

Investments in debt and equity securities consist of the following:

	Amortized Cost	Gross Unrealized Gains (Losses)	Estimated Market Value
December 31, 2012:			
Available for sale:			
U.S. Treasury Notes	$3,597,638	$1,624	$3,599,262
December 31, 2011:			
Available for sale:			
U.S. Treasury Notes	$2,997,788	$1,468	$2,999,256

	Less than 12 months	
Description of Securities	Fair Value	Unrealized Gain
U.S. Treasury Notes	$3,599,262	$1,624

Management evaluates securities for other-than-temporary impairment at least on an annual basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the intent and ability of the Cooperative to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery. At December 31, 2012, management believes there are no other-than-temporary impairments in the debt and equity securities.

The amortized cost and estimated market value of debt securities at December 31, 2012, by contractual maturities, are shown above. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from the sale of investments in debt securities were as follows:

	2012	2011
Proceeds from sales and redemptions	$5,997,764	$6,598,615

Note D – (Cont'd):

The Cooperative's investments are reported at fair value. The methods used to measure fair value may produce an amount that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Cooperative believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The fair value measurement accounting literature establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. This hierarchy consists of three broad based levels. A description of the three levels follows:

Level 1 – Uses prices and other relevant information generated by active market transactions involving identical or comparable assets that the Cooperative has the ability to access at the measurement date;

Level 2 – Uses inputs other than quoted market prices included within Level 1 that are observable for valuing the asset, either directly or indirectly. This level of the hierarchy may use quoted prices for similar assets in an active or non-active market and may also include insignificant adjustments to market observable inputs;

Level 3 – Uses unobservable inputs used for valuing assets. Unobservable inputs are those that use valuation techniques to convert future amounts to a single present amount based on current market expectations about the future amounts.

The Cooperative's investments are grouped and measured at fair value and use the aforementioned fair value hierarchy in the following manner:

Note D – (Cont'd):

	Fair Value	Quoted Prices In Active Markets for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2012				
Treasury Notes:				
Available for sale	$3,599,262	$3,599,262	$ 0	$ 0
Total	$3,599,262	$3,599,262	$ 0	$ 0
December 31, 2011				
Treasury Notes:				
Available for sale	$2,999,256	$2,999,256	$ 0	$ 0
Total	$2,999,256	$2,999,256	$ 0	$ 0

Financial instruments are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation.

Note E – Other Investments:

	2012	2011
Tennessee Independent Telecom Group (IRIS Networks) (10.556%)	$1,041,688	$1,003,803
National Rural Telecommunications Cooperative (NRTC)	9,859	8,217
	$1,051,547	$1,012,020

Ownership percentages are in parentheses for investments in which Highland Telephone Cooperative Corporation, Inc. owns a significant portion of the investment. All other investments are carried at cost.

Note E – (Cont'd):

Investments carried at cost are not normally evaluated for impairment because it is not practical to estimate fair value due to insufficient information being available. An evaluation is performed, however, if economic or market concerns warrant such an evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent or ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value.

Management has not identified any events or circumstances that may have a significant adverse effect on the fair value of any cost method investment.

Note F – Nonregulated Investments:

	2012	2011
Nonregulated customer premises equipment, paystations, and key systems	$ 4,493,295	$ 4,358,093
Less accumulated depreciation	(2,054,973)	(1,902,453)
Net nonregulated customer premises equipment, paystations, and key systems	$ 2,438,322	$ 2,455,640
Nonregulated materials and supplies	317,255	200,960
TOTAL	$ 2,755,577	$ 2,656,600

Note G – Investment in Telecommunications Plant in Service:

Telecommunications plant in service and under construction is stated at cost. Listed below are the major classes of the telecommunications plant in the accounts of the Cooperative as of December 31:

	2012	2011
Land	$ 296,225	$ 264,586
Buildings	3,807,821	3,745,320
Central office equipment	31,289,637	30,912,700
Poles, cables, and wire	66,230,863	64,837,800
Furniture and office equipment	1,600,703	1,457,879
Vehicles and other work equipment	2,585,901	2,877,093
Intangibles	2,422	2,422
Telecommunications plant in service as contained on the Cooperative's records	$105,813,572	$104,097,800

Note G – (Cont'd):

Investment in property and equipment included in the accounts of Highland Holdings, Inc and Subsidiaries:

	2012	2011
Land	$ 248,539	$ 248,539
Buildings and improvements	1,541,938	1,541,938
Furniture	217,936	206,530
Vehicles	123,793	123,209
Tools and work equipment	32,666	33,250
Central office transmission equipment	5,752,135	5,630,502
Telecommunications plant in service as contained on Highland Holdings, Inc. records	$7,917,007	$7,783,968

The Cooperative provides for depreciation on a straight-line basis at annual rates, which will amortize the depreciable property over its estimated useful life. Such provision, as a percentage of the average balance of telecommunications plant in service, was 4.72 % in 2012 and 4.72% in 2011. Individual depreciation rates are as follows:

Buildings	2.7%
Central office	8.9 – 11.6%
Poles, cables and wire	5.2%
Furniture and office equipment	6.6 – 15.8%
Vehicles and other work equipment	6.5 – 12.1%

Note G – (Cont'd):

Highland Holdings, Inc. and Subsidiaries provide for depreciation on a straight-line basis at annual rates, which will amortize the depreciable property over its useful life. Depreciation charged to expense on Highland Holdings, Inc.'s records amounted to $920,171 in 2012 and $862,851 in 2011.

Note H – Mortgage Notes:

Long-term debt is represented by mortgage notes payable to the United States of America. Substantially all assets are pledged as security for the long-term debt. Following is a summary of the outstanding long-term debt:

	2012	2011
5% Rural Development Utilities Program notes	$2,407,609	$4,329,053
2.458% - 4.474% Rural Development Utilities Programs notes	6,173,258	2,032,715
	$8,580,867	$6,361,768
Less current maturities	2,200,429	2,063,488
TOTAL	$6,380,438	$4,298,280

Principal and interest installments on the above notes are due periodically. The maturities of long-term debt for each of the five years succeeding the balance sheet date are as follows:

Year	Amount
2013	$2,200,429
2014	613,280
2015	208,566
2016	208,817
2017	215,201
Beyond 5 years	5,134,573
TOTAL	$8,580,866

Note I – The Cooperative accrues all postretirement benefits other than pensions. Under the prescribed accrual method, the Cooperative's obligation for these postretirement benefits is to be fully accrued by the date employees attain full eligibility for such benefits. The cost of medical benefits for current and future associate retirees was recognized as determined under the projected united credit cost method.

Substantially all of the Cooperative's employees are covered under postretirement medical plans. The determination of postretirement benefit cost for postretirement medical benefit plan is based on comprehensive hospital, medical and surgical benefit provisions.

The following table sets forth the plan's funded status and the amounts recognized in the Cooperative's Consolidated Balance Sheet as of December 31:

	2012	2011
Accumulated postretirement obligation attributable to:		
Retirees	$ 402,935	$ 480,420
Other active plan participants	3,923,187	3,887,036
Total accumulated postretirement benefit obligation	$4,326,122	$4,367,456
Fair value of plan assets	0	0
Net unfunded status	$4,326,122	$4,367,456
Amounts recognized in other comprehensive income:		
Unrecognized net losses	$ 473,871	$ 809,329
Prior service costs	5,673	11,340
Total included in other comprehensive income	$ 479,544	$ 820,669

Postretirement benefit cost is composed of the following for the year ended December 31:

	2012	2011
Benefits earned during the year	$184,015	$166,600
Interest on accumulated postretirement benefit obligation	218,399	221,894
Postretirement benefit cost	$402,414	$388,494

Note I – (Cont'd):

The Medicare and Prescription Drug, Improvement and Modernization Act of 2003 provides for a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the benefit established by the law. Currently, for the plan, the Medicare Part D Subsidy is a reduction to premiums paid for by participants that are at least 65 years old. For 2012, premiums for this group of participants were approximately $50 less than it would have been without the adjustment.

Weighted average assumptions to determine benefit obligations and net periodic cost for the years ended December 31:

	2012	2011
Discount rate	5.50%	5.50%
Expected return on plan assets	0.00%	0.00%

The Company's expected rate of return on plan assets is determined by the plan's historical long-term investment performance, current asset allocation, and estimates of future long-term return by asset class. To date the Company has chosen not to fund the liability.

The medical cost trend rate in 2012 was approximately 9.5% grading down to an ultimate rate in 2029 of 6.5%. A one percentage point increase in the assumed medical cost trend rates for each future year would have increased the aggregate of the service and the interest components of the 2012 net periodic postretirement benefit cost by $63,999 and would have increased the postretirement benefit obligation as of December 31, 2012 by $528,566.

Note I – (Cont'd)

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid from the plan:

Year		Amount
2013		$ 115,717
2014		118,032
2015		120,392
2016		122,799
2017		125,256
Years 2018 – 2021		664,874
	TOTAL	$1,267,070

The Company generally does not make an annual contribution to the plan and a contribution is not anticipated in 2013.

Note J – Pension Plan:

The Cooperative sponsors a 401(k) savings plan in which both union and non-union employees can participate. The company matches employees' contributions based on a percentage of salary contributed by participants. Employer matches amounted to $563,495 in 2012 and $574,093 in 2011.

Highland Communications, LLC established a 401(k) plan effective May 19, 1997. The plan covers all full time employees. Employees have the option to contribute up to 10% of their pay up to a maximum of $16,500 for 2012 and 2011. The Company matches the entire amount that each employee contributes to the plan. Retirement expense related to this plan amounted to $29,211 in 2012 and $33,026 in 2011.

Note K – Income Taxes:

The Company recognizes deferred tax assets and liabilities for future tax consequences of events that have been previously recognized in the Company's financial statements and tax returns. The measurement of deferred tax assets and liabilities is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. Measurement is computed using applicable current tax rates.

	2012	2011
Current income tax expense:		
Federal	$(25,688)	$ 9,164
State	(2,013)	3,044
Deferred income tax expense (benefit):		
Federal	30,058	(4,984)
State	6,155	(1,021)
Income tax	$ 8,512	$ 6,203

The Company's total deferred tax assets and liabilities at December 31 are as follows:

	2012	2011
Deferred tax asset	$ 31,153	$ 37,136
Deferred tax liability	(107,242)	(77,012)
	$ (76,089)	$(39,876)

The deferred tax asset is the result of amortizing organizational costs for tax purposes. The deferred tax liability is the result of timing differences in depreciation.

The individual companies included in the consolidation are responsible for their own tax liabilities. All companies are no longer subject to Internal Revenue or state taxing authority examinations beyond the statute of limitations of the respective tax authorities.

Highland Holdings, Inc. has a net operating loss carryfoward of approximately $2,159,000 which is available to offset future taxable income. This carryfoward will expire in 6 to 15 years.

Note L – Labor Force:

Approximately 80% of the Cooperative's labor force is subject to a collective bargaining agreement. A three-year agreement was negotiated and approved for the period October 1, 2011 to September 30, 2014 between the Cooperative and the Communications Workers of America.

Note M – Commitments and Contingencies:

The Cooperative is a guarantor for loans in the amount of approximately $550,000. These loans are the obligation of TN Independent Telecommunications Group d/b/a Iris Networks, a related party.

Note N – Subsequent Events:

Subsequent events are transactions or events that occur subsequent to the date of the financial statements and before the issuance of those financial statements. Management has evaluated transactions and events that occurred subsequent to December 31, 2012 and before the date these financial statements were available to be issued, March 8, 2013, and determined that no additional disclosures are necessary.

CONSOLIDATING INFORMATION

TOTHEROWHAILE&WELCH, PLLC
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT ON CONSOLIDATING INFORMATION

Board of Directors
Highland Telephone Cooperative, Inc.
Sunbright, Tennessee

We have audited the consolidated financial statements of Highland Telephone Cooperative, Inc., and Subsidiary as of and for the years ended December 31, 2012 and 2011, and our report thereon dated March 8, 2013, which expresses an unmodified opinion on those financial statements, appears on page 5. Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information on pages 38 through 43 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and it is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements, themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Totherow, Haile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 8, 2013

2355 South Chancery St., McMinnville, TN 37110 tel: 931-668-1272 fax: 931-668-2752
1418 Kensington Square Ct. Bldg. D, Murfreesboro, TN 37130 tel: 615-848-1072 fax: 615-848-1772
www.thwcpa.com / TIN: 62-0693408

CONSOLIDATING BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2012

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
ASSETS				
CURRENT ASSETS				
Cash - general	$ 5,173,694	$ 3,559,151	$ 0	$ 8,732,845
Cash - construction funds	501	0	0	501
Temporary investments	600,000	380,127	0	980,127
Securities available for sale	3,599,262	0	0	3,599,262
Telecommunications accounts receivable	958,603	475,231	(238,036)	1,195,798
Other accounts receivable	1,202,643	0	0	1,202,643
Grant receivable	671,666	0	0	671,666
Materials and supplies	2,685,250	0	0	2,685,250
Prepayments	164,504	53,341	0	217,845
Due from affiliate	1,482,042	25,001	(1,507,043)	0
Refundable tax deposits	3,083	0	0	3,083
Other current assets	283,453	0	0	283,453
TOTAL CURRENT ASSETS	$ 16,824,701	$ 4,492,851	$ (1,745,079)	$ 19,572,473
NONCURRENT ASSETS				
Investment in subsidiaries	$ 6,976,735	$ 0	$ (6,976,735)	$ 0
Other investments	1,041,688	9,859	0	1,051,547
Nonregulated investments	2,755,577	0	0	2,755,577
Deferred tax asset	0	31,153	0	31,153
Deposits	2,573	1,600	0	4,173
TOTAL NONCURRENT ASSETS	$ 10,776,573	$ 42,612	$ (6,976,735)	$ 3,842,450
PROPERTY, PLANT AND EQUIPMENT				
Telecommunications plant in service	$ 105,813,572	$ 7,917,007	$ 0	$ 113,730,579
Telecommunications plant under construction	8,781,528	0	0	8,781,528
	$ 114,595,100	$ 7,917,007	$ 0	$ 122,512,107
Less accumulated depreciation	79,117,084	3,672,968	0	82,790,052
TOTAL PROPERTY, PLANT AND EQUIPMENT	$ 35,478,016	$ 4,244,039	$ 0	$ 39,722,055
	$ 63,079,290	$ 8,779,502	$ (8,721,814)	$ 63,136,978

CONSOLIDATING BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2012

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
	LIABILITIES AND MEMBERS' EQUITY			
CURRENT LIABILITIES				
Accounts payable	$ 3,178,652	$ 164,838	$ (308,739)	$ 3,034,751
Advance billings and payments	733,759	22,812	0	756,571
Customer deposits	2,096	0	0	2,096
Current maturities on long-term debt	2,200,429	0	0	2,200,429
Accrued taxes	402,851	49,882	0	452,733
Accrued interest	10,641	0	0	10,641
Accrued rent	717,855	0	0	717,855
Accrued salaries and wages	181,020	0	0	181,020
Accrued compensated absences	1,157,316	0	0	1,157,316
Accrued federal and state income taxes	7,677	0	0	7,677
Advance from related company	0	1,436,340	(1,436,340)	0
Other current liabilities	195,900	21,653	0	217,553
TOTAL CURRENT LIABILITIES	$ 8,788,196	$ 1,695,525	$ (1,745,079)	$ 8,738,642
LONG-TERM DEBT				
Rural Utilities Service	6,380,438	0	0	6,380,438
OTHER LIABILITIES				
Postretirement benefits other than pension	4,326,122	0	0	4,326,122
Deferred taxes	0	107,242	0	107,242
TOTAL LIABILITIES	$ 19,494,756	$ 1,802,767	$ (1,745,079)	$ 19,552,444
MEMBERS' EQUITY				
Memberships	$ 235,087	$ 0	$ 0	$ 235,087
Patronage capital	43,827,371	0	0	43,827,371
Accumulated other comprehensive loss	(477,924)	0	0	(477,924)
Capital stock	0	200,000	(200,000)	0
Paid-in capital	0	8,553,642	(8,553,642)	0
Retained earnings	0	(1,776,907)	1,776,907	0
TOTAL MEMBERS' EQUITY	$ 43,584,534	$ 6,976,735	$ (6,976,735)	$ 43,584,534
	$ 63,079,290	$ 8,779,502	$ (8,721,814)	$ 63,136,978

CONSOLIDATING STATEMENTS OF INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2012

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Operating revenues:				
Local network services revenue	$ 6,834,959	$ 0	$ 0	$ 6,834,959
Long distance services revenue	55,059	938,792	0	993,851
Network access services revenue	8,113,598	0	0	8,113,598
Broadband revenue	0	4,697,602	(4,697,602)	0
Video revenue	0	799,577	(799,577)	0
Miscellaneous revenues	3,516,412	87,779	(414,529)	3,189,662
Less uncollectible revenue	(173,371)	(101,309)	0	(274,680)
TOTAL OPERATING REVENUES	$ 18,346,657	$ 6,422,441	$ (5,911,708)	$ 18,857,390
Operating expenses:				
Plant specific operations expense	$ 6,238,038	$ 152,367	$ (152,367)	$ 6,238,038
Plant nonspecific operations expense	1,700,419	113,481	(113,481)	1,700,419
Provision for depreciation	4,553,875	920,171	0	5,474,046
Customer operations expense	1,949,680	3,113,302	(3,113,302)	1,949,680
Corporate operations expense	3,370,971	1,055,404	(1,055,404)	3,370,971
Operating taxes	445,149	101,073	(101,073)	445,149
TOTAL OPERATING EXPENSES	$ 18,258,132	$ 5,455,798	$ (4,535,627)	$ 19,178,303
OPERATING INCOME (LOSS)	$ 88,525	$ 966,643	$ (1,376,081)	$ (320,913)
Other income (expense):				
Interest and dividend income	$ 105,445	$ 6,497	$ 0	$ 111,942
Nonregulated income	(427,768)	(561,040)	1,376,081	387,273
Loss from sale of equipment	0	(781)	0	(781)
Income from subsidiaries	411,319	0	(411,319)	0
Income from investment	37,885	0	0	37,885
TOTAL OTHER INCOME (LOSS)	$ 126,881	$ (555,324)	$ 964,762	$ 536,319

CONSOLIDATING STATEMENTS OF INCOME (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2012

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Fixed charges:				
Interest on long-term debt	$ 312,789	$ 0	$ 0	$ 312,789
Interest charged to construction - credit	(288,565)	0	0	(288,565)
Interest on customer deposits	167	0	0	167
TOTAL FIXED CHARGES	$ 24,391	$ 0	$ 0	$ 24,391
INCOME BEFORE TAXES ON INCOME	$ 191,015	$ 411,319	$ (411,319)	$ 191,015
Taxes on income	8,512	0	0	8,512
NET INCOME	$ 182,503	$ 411,319	$ (411,319)	$ 182,503

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2012

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Net income	$ 182,503	$ 411,319	$ (411,319)	$ 182,503
Other comprehensive income (loss):				
Unrealized gain on investment securities available for sale	154	0	0	154
Postretirement benefits other than pension:				
Prior service costs	5,672	0	0	5,672
Unrecognized loss	335,452	0	0	335,452
COMPREHENSIVE INCOME	$ 523,781	$ 411,319	$ (411,319)	$ 523,781

TH&W TOTHEROWHAILE&WELCH, PLLC
Certified Public Accountants

Board of Directors
Highland Telephone
Cooperative, Inc.
Sunbright, Tennessee 37012

We have audited the financial statements of Highland Telephone Cooperative, Inc. and Subsidiary as of December 31, 2012 and 2011 and for the years ended December 31, 2012 and 2011 and have issued our report thereon dated March 8, 2013. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

<u>Internal Control Over Financial Reporting</u>

In planning and performing our audit, we considered Highland Telephone Cooperative, Inc.'s internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Highland Telephone Cooperative, Inc.'s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Highland Telephone Cooperative, Inc.'s internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Cooperative's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Cooperative's financial statements that is more than inconsequential will not be prevented or detected by the Cooperative's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Cooperative's internal control.

Our consideration of the internal control was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies that we consider to be material weaknesses, as defined above.

2355 South Chancery St., McMinnville, TN 37110 tel: 931-668-1272 fax: 931-668-2752
1418 Kensington Square Ct. Bldg. D, Murfreesboro, TN 37130 tel: 615-848-1072 fax: 615-848-1772
www.thwcpa.com / TIN: 62-0693408

Compliance

As part of obtaining reasonable assurance about whether Highland Telephone Cooperative, Inc. and Subsidiary's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

This communication is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Jatherow, Haile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 8, 2013

TH&W TOTHEROWHAILE&WELCH, PLLC
Certified Public Accountants

To the Board of Directors of
Highland Telephone Cooperative, Inc.
Sunbright, Tennessee 37012

We have audited the consolidated financial statements of Highland Telephone Cooperative, Inc. for the year ended December 31, 2012, and have issued our report thereon dated March 8, 2013. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated October 29, 2012. Professional standards also require that we communicate to you the following information related to our audit.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by Highland Telephone Cooperative, Inc. are described in Note A to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during 2012. We noted no transactions entered into by the Company during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

Management's estimate of the allowance for doubtful accounts is based on historical sales, historical loss levels, and an analysis of the collectability of the individual accounts.

Management's estimate of the deferred tax asset encompasses the temporary differences in tax reporting and financial statement presentation based on future expected financial trends of the Company.

Management's estimate of the accrued postretirement benefits is based on the actuarial findings of an independent actuary for the cost of medical benefits for current and future associate retirees.

The financial statement disclosures are neutral, consistent, and clear.

2355 South Chancery St., McMinnville, TN 37110 tel: 931-668-1272 fax: 931-668-2752
1418 Kensington Square Ct. Bldg. D, Murfreesboro, TN 37130 tel: 615-848-1072 fax: 615-848-1772
www.thwcpa.com / TIN: 62-0693408

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

Disagreements with management

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditors' report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated March 8, 2013.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Company's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Company's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Other Matters

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with U.S. generally accepted accounting principles, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

This information is intended solely for the use of the Board of Directors and management of Highland Telephone Cooperative, Inc. and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

Jotherow, Haile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 13, 2013

TOTHEROW HAILE & WELCH, PLLC
Certified Public Accountants

Board of Directors
Highland Telephone
Cooperative, Inc.
Sunbright, Tennessee 37012

We have audited the financial statements of Highland Telephone Cooperative, Inc. for the year ended December 31, 2012, and have issued our report thereon dated March 8, 2013. We conducted our audit in accordance with generally accepted auditing standards, the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, and 7 CFR part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of Highland Telephone Cooperative, Inc. for the year ended December 31, 2012, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting that we consider to be material weaknesses.

2355 South Chancery St., McMinnville, TN 37110 tel: 931-668-1272 fax: 931-668-2752
1418 Kensington Square Ct. Bldg. D, Murfreesboro, TN 37130 tel: 615-848-1072 fax: 615-848-1772
www.thwcpa.com / TIN: 62-0693408

7 CFR 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.33(e)(2), and related party transactions and investments. In addition, our audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38 - .45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports (other than our independent auditors' report, and our independent auditors' report on compliance and on internal control over financial reporting, all dated March 13, 2013) or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR Part 1773.33 are presented below.

COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted no matters regarding Highland Telephone Cooperative, Inc.'s internal control over financial reporting and its operation that we consider to be a material weakness as previously defined with respect to:

<u>ACCOUNTING RECORDS</u> - In addition to our observation of the effectiveness of internal control, it appears that the bookkeeping and accounting records, including the many supplementary files and ledgers are well kept and adequately maintained. From tests made by us, it appeared that the methods used in accumulating costs for material, transportation, labor and overhead and the distribution of these costs to the various accounts were in accordance with proper procedures.

MATERIAL CONTROL – Materials and supplies are stated at average cost. Inventory quantities of outside plant materials and supplies were ascertained by physical count, weight or other measure as of December 31, 2012, by employees of the Cooperative. We were present during the time of taking the physical inventories to observe the procedures used to determine inventory quantities. We made test counts of quantities on hand and subsequently traced these counts to the perpetual inventory records. We reviewed the basis of pricing and tested the clerical accuracy of the extensions and footings. We tested the accuracy of perpetual inventory records. Our review indicated only minor differences between the counts reflected by the tests and those accumulated on the books.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts and grants. The procedures we performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement or lease between the borrower and an affiliate for the year ended December 31, 2012, of Highland Telephone Cooperative, Inc.

    1. No contracts for management, operations or billing services were in effect during the year ended December 31, 2012 as defined in 1773.33(e)(2)(i).

    2. Reviewed Board of Directors minutes to ascertain whether board-approved written contracts should have been included in a borrower-prepared schedule.

- Procedure performed with respect to the requirement to submit RUS Form 479 to the RUS:

    Financial statements as of December 31, 2012, included in copies of RUS Form 479 were compared with the Cooperative's books and found to be in agreement in all material respects.

The results of our tests indicate that, with respect to the items tested, Highland Telephone Cooperative, Inc. complied in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract, agreement, or lease with an affiliate as defined in 1773.33(e)(2)(i);

- The borrower has submitted its Form 479 to the RUS and the Form 479, Financial and Statistical Report, as of December 31, 2012, represented by the borrower as having been submitted to RUS is in agreement with the Highland Telephone Cooperative, Inc.'s audited records in all material respects as of December 31, 2012, appears reasonable based upon the audit procedures performed.

COMMENTS ON OTHER ADDITIONAL MATTERS

In connection with our audit of the financial statements of Highland Telephone Cooperative, Inc., nothing came to our attention that caused us to believe that Highland Telephone Cooperative, Inc. failed to comply with respect to:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33 (c)(1);

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.33 (c)(2);

- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4);

- The approval of the sale and disposition of proceeds for the sale of plant, material, or scrap addressed at 7 CFR 1773.33 (c)(5); and

- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards No. 57, Related Party Transactions, for the year ended December 31, 2012, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR 1773.33 (e).

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of investments in affiliated companies required by 7 CFR 1773.33(i) and provided below, is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Board of Directors
Highland Telephone
Cooperative, Inc.
Sunbright, Tennessee 37012
Page 5

Detailed schedule of investments:

	Highland Communications Corporation	TN Independent Telecommunications Group d/b/a/ Iris Networks	Highland Holdings, Inc.	Total
Original investment	$ 3,766,403	$ 965,350	$ 200,000	$4,931,753
Additional investments as of 12/31/11	0	0	5,681,739	5,681,739
Transactions due to stock merger	(3,466,403)	0	3,466,403	0
Distribution	(300,00)	0	(500,000)	(800,000)
Undistributed earnings (losses) as of 12/31/11	0	38,453	(2,188,226)	(2,149,773)
Book value of investments as of 12/31/11	$ 0	$1,003,803	$6,659,916	$7,663,719
Additional earnings	0	37,885	411,319	449,204
Distribution	0	0	(94,500)	(94,500)
Book value of investments as of 12/31/12	$ 0	$1,041,688	$6,976,735	$8,018,423

This report is intended solely for the information and use of the board of directors, management, and the RUS and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties.

Jotherow, Haile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 8, 2013