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RECEIVED

JUN 4 - 2015

PUBLIC SERVICE
COMMISSION

June 1, 2015

Jeff D. Cline
Annual Report Branch Manager
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 2014. If you have any questions, please call me at 423-628-2121 or e-mail patriece@highlandtel.net

Sincerely,

A handwritten signature in cursive script that reads 'Patriece Brown'.

Patriece Brown
Account Manager

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

December 31, 2014 and 2013



TOTHEROW HAILE & WELCH, PLLC

Certified Public Accountants

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PUBLIC SERVICE
COMMISSION

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

December 31, 2014 and 2013

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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 consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations, 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 fair 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 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. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the 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 audit opinion.

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, 2014 and 2013, 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.

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our report dated March 13, 2015 on our consideration of Highland Telephone Cooperative, Inc. and Subsidiary's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

Sotherow, Spate, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 13, 2015

CONSOLIDATED BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

	2014	2013
<u>ASSETS</u>		
<u>CURRENT ASSETS</u>		
Cash - general	\$ 7,713,321	\$ 9,965,051
Cash - construction fund	509	504
Temporary investments	700,996	1,080,887
Securities available for sale	3,599,520	1,799,922
Telecommunications accounts receivable, less allowances of \$100,000 in 2014 and \$100,000 in 2013	995,354	1,126,545
Other accounts receivable	1,137,357	975,622
Grant receivable	952,553	606,538
Materials and supplies	3,556,366	3,309,568
Prepayments	264,403	223,792
Refundable tax deposits	4,906	4,906
Other current assets	146,904	161,793
	<hr/>	<hr/>
TOTAL CURRENT ASSETS	\$ 19,072,189	\$ 19,255,128
<u>NONCURRENT ASSETS</u>		
Other investments	\$ 898,327	\$ 1,033,266
Nonregulated investments	2,827,321	3,082,395
Deferred tax asset	23,572	26,266
Deposits	4,173	4,173
	<hr/>	<hr/>
TOTAL NONCURRENT ASSETS	\$ 3,753,393	\$ 4,146,100
<u>PROPERTY, PLANT AND EQUIPMENT</u>		
Telecommunications plant in service	\$ 119,507,170	\$ 116,875,403
Telecommunications plant under construction	19,621,308	12,844,223
	<hr/>	<hr/>
	\$ 139,128,478	\$ 129,719,626
Less accumulated depreciation	92,448,396	87,579,706
	<hr/>	<hr/>
TOTAL PROPERTY, PLANT AND EQUIPMENT	\$ 46,680,082	\$ 42,139,920
	<hr/>	<hr/>
	\$ 69,505,664	\$ 65,541,148
	<hr/>	<hr/>

See the accompanying notes and independent auditors' report.

CONSOLIDATED BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

	2014	2013
<u>LIABILITIES AND MEMBERS' EQUITY</u>		
<u>CURRENT LIABILITIES</u>		
Accounts payable	\$ 2,865,446	\$ 4,597,382
Advance billings and payments	848,664	764,660
Customer deposits	1,096	196
Current maturities on long-term debt	502,759	320,579
Accrued taxes	475,478	546,223
Accrued rents	837,680	791,629
Accrued salaries and wages	225,478	209,425
Accrued compensated absences	1,179,676	1,111,947
Accrued federal and state income taxes	3,435	27,363
Other current liabilities	225,868	158,278
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	\$ 7,165,580	\$ 8,527,682
 <u>LONG-TERM DEBT</u>		
Rural Utilities Service - mortgage notes	13,847,547	8,700,742
 <u>OTHER LIABILITIES</u>		
Postretirement benefits other than pension	5,415,136	3,925,052
Deferred taxes	85,269	100,915
	<hr/>	<hr/>
TOTAL LIABILITIES	\$ 26,513,532	\$ 21,254,391
 <u>MEMBERS' EQUITY</u>		
Patronage equity	\$ 43,967,317	\$ 44,162,075
Accumulated other comprehensive income	(975,185)	124,682
	<hr/>	<hr/>
TOTAL EQUITY	\$ 42,992,132	\$ 44,286,757
	<hr/>	<hr/>
	<u>\$ 69,505,664</u>	<u>\$ 65,541,148</u>

CONSOLIDATED STATEMENTS OF OPERATIONS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
Operating revenues:		
Local network services revenue	\$ 6,849,762	\$ 6,770,867
Long distance services revenue	753,284	869,090
Network access services revenue	7,156,191	7,507,223
Miscellaneous revenues	2,879,966	3,501,514
Less uncollectible revenue	<u>(128,164)</u>	<u>(214,985)</u>
TOTAL OPERATING REVENUES	\$ 17,511,039	\$ 18,433,709
Operating expenses:		
Plant specific operations expense	\$ 6,190,555	\$ 6,084,907
Plant nonspecific operations expense	1,826,427	1,600,280
Provision for depreciation	3,840,596	4,031,335
Customer operations expense	1,949,757	2,052,428
Corporate operations expense	2,796,646	3,239,538
Operating taxes	<u>423,059</u>	<u>431,295</u>
TOTAL OPERATING EXPENSES	<u>\$ 17,027,040</u>	<u>\$ 17,439,783</u>
OPERATING INCOME	\$ 483,999	\$ 993,926
Other income (expense):		
Interest income	\$ 45,546	\$ 88,106
Nonregulated (expense) income	(718,812)	(986,009)
Gain from sale of fixed asset	<u>0</u>	<u>15,556</u>
TOTAL OTHER INCOME (EXPENSE)	\$ (673,266)	\$ (882,347)

See the accompanying notes and independent auditors' report.

CONSOLIDATED STATEMENTS OF OPERATIONS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
Fixed charges:		
Interest on long-term debt	\$ 368,571	\$ 281,999
Interest charged to construction - credit	(368,571)	(280,148)
Interest on customer deposits	347	51
	<u>347</u>	<u>1,902</u>
TOTAL FIXED CHARGES	\$ 347	\$ 1,902
NET INCOME (LOSS)	\$ (189,614)	\$ 109,677

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
Net income (loss)	\$ (189,614)	\$ 109,677
Other comprehensive income:		
Unrealized gain from securities available for sale	(167)	160
Postretirement benefits other than pension:		
Unrecognized gain (loss)	<u>(1,099,700)</u>	<u>602,446</u>
COMPREHENSIVE INCOME (LOSS)	<u>\$ (1,289,481)</u>	<u>\$ 712,283</u>

See the accompanying notes and independent auditors' report.

CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	Memberships	Patronage Capital	Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
Balance at December 31, 2012	\$ 235,087	\$ 43,827,371	\$ (477,924)	\$ 43,584,534
Net income for 2013	0	109,677	0	109,677
Unrealized gain on investment of securities available for sale	0	0	160	160
Memberships refunded	(10,060)	0	0	(10,060)
Postretirement benefits other than pension:				
Unrecognized loss	0	0	602,446	602,446
Balance at December 31, 2013	\$ 225,027	\$ 43,937,048	\$ 124,682	\$ 44,286,757
Net loss for 2014	0	(189,614)	0	(189,614)
Unrealized loss on investment of securities available for sale	0	0	(167)	(167)
Memberships refunded	(5,144)	0	0	(5,144)
Postretirement benefits other than pension:				
Unrecognized gain	0	0	(1,099,700)	(1,099,700)
Balance at December 31, 2014	<u>\$ 219,883</u>	<u>\$ 43,747,434</u>	<u>\$ (975,185)</u>	<u>\$ 42,992,132</u>

See the accompanying notes and independent auditors' report.

CONSOLIDATED STATEMENTS OF CASH FLOWS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
<hr/>		
Cash flows from operating activities:		
Cash received from customers	\$ 17,564,499	\$ 18,738,072
Cash paid to suppliers and employees	(14,323,620)	(11,301,274)
Interest and dividends received	26,977	70,384
Interest paid	(347)	(12,543)
Taxes paid	(530,684)	(321,382)
	<hr/>	<hr/>
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 2,736,825	\$ 7,173,257
Cash flows from investing activities:		
Construction and acquisition of plant	\$ (8,385,366)	\$ (6,461,761)
Plant removal cost	(9,292)	(4,816)
Salvage	13,900	16,308
(Increase) Decrease in nonregulated assets	255,074	(326,818)
Decrease in other investments	153,508	36,003
(Increase) Decrease in securities available for sale	(1,799,598)	1,799,340
(Increase) Decrease in temporary investments	379,891	(100,760)
Proceeds from sale of fixed assets	0	16,625
Increase (Decrease) in reserve for market valuation of securities	(167)	160
(Increase) Decrease in:		
Materials and supplies	(246,798)	(624,318)
Nonregulated income	(718,812)	(986,009)
	<hr/>	<hr/>
NET CASH USED BY INVESTING ACTIVITIES	\$ (10,357,660)	\$ (6,636,046)

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
Cash flows from financing activities:		
Payments on long-term borrowings	\$ (384,978)	\$ (2,647,986)
Debt proceeds	5,713,963	3,088,440
Postretirement benefits other than pension	390,384	201,376
(Increase) Decrease in grant receivable	(346,015)	65,128
Increase (Decrease) in:		
Customer deposits	900	(1,900)
Memberships	(5,144)	(10,060)
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>\$ 5,369,110</u>	<u>\$ 694,998</u>
NET INCREASE (DECREASE) IN CASH	\$ (2,251,725)	\$ 1,232,209
CASH AT BEGINNING OF YEAR	<u>9,965,555</u>	<u>8,733,346</u>
CASH AT END OF YEAR	<u>\$ 7,713,830</u>	<u>\$ 9,965,555</u>

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2014 and 2013

	2014	2013
Net income (loss)	\$ (189,614)	\$ 109,677
Nonregulated expense (income)	718,812	986,009
Non cash patronage dividend	(18,569)	(17,722)
Gain from sale of asset	0	(15,556)
Deferred tax benefit	(12,952)	(1,440)
 Net income from regulated operations	 \$ 497,677	 \$ 1,060,968
Adjustments to reconcile net income from regulated operations to net cash provided by operating activities:		
Depreciation	\$ 3,840,596	\$ 4,031,335
Decrease (Increase) in:		
Customer and other accounts receivable	(30,544)	296,274
Refundable tax deposit	0	(1,823)
Current and accrued assets - other	14,889	121,660
Prepaid expenses	(40,611)	(5,947)
Increase (Decrease) in:		
Accounts payable	(1,731,936)	1,562,631
Advance billings and payments	84,004	8,089
Accrued taxes	(70,745)	93,490
Accrued interest	0	(10,641)
Accrued rents	46,051	73,774
Accrued salaries and compensated absences	83,782	(16,964)
Accrued federal and state income taxes	(23,928)	19,686
Other current liabilities	67,590	(59,275)
 TOTAL ADJUSTMENTS	 \$ 2,239,148	 \$ 6,112,289
 NET CASH PROVIDED BY OPERATING ACTIVITIES	 \$ 2,736,825	 \$ 7,173,257

See the accompanying notes and independent auditors' report.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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 Subsidiary (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 Subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

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 2014 reflect the results of operations from January 1 through December 31 for the Cooperative, and October 1, 2013 through September 30, 2014 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.
- (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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

Note A – (Cont'd):

- (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 \$1,314 and \$2,835 at December 31, 2014 and 2013, 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.
- (9) Advertising costs are expensed as incurred and included in customer operations. Advertising expense amounted to \$120,961 in 2014 and \$106,567 in 2013.
- (10) Various items in the financial statements have been reclassified for comparative purposes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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 accounts. \$1,552,888 was uninsured at December 31, 2014.

The Companies also have cash maintained by an investment firm totaling \$1,248,579 and \$3,047,583 as of December 31, 2014 and 2013, respectively. Accounts are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At December 31, 2014 \$998,579 was uninsured.

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, 2014, the Cooperative has received \$15,100,909 in loan proceeds and \$45,302,723 of the grant portion.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

Note D – Investments in Debt and Equity Securities:

Investments in debt and equity securities consist of the following:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains (Losses)</u>	<u>Estimated Market Value</u>
December 31, 2014			
Available for sale:			
U.S. Treasury Notes	<u>\$3,599,553</u>	<u>\$ (33)</u>	<u>\$3,599,520</u>
December 31, 2013			
Available for sale:			
U.S. Treasury Notes	<u>\$1,799,817</u>	<u>\$ 105</u>	<u>\$1,799,922</u>
	<u>Less than 12 months</u>		
	<u>Fair Value</u>	<u>Unrealized Loss</u>	
Description of Securities:			
U.S. Treasury Notes	<u>\$3,599,553</u>	<u>\$ (33)</u>	

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, 2014, 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, 2014, 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:

	<u>2014</u>	<u>2013</u>
Proceeds from sales and redemptions	<u>\$8,999,098</u>	<u>\$5,398,881</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

Note D – (Cont'd):

	<u>Fair Value</u>	Quoted Prices In Active Markets for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2014</u>				
Treasury Notes:				
Available for sale	\$3,599,520	\$3,599,520	\$ 0	\$ 0
Total	<u>\$3,599,520</u>	<u>\$3,599,520</u>	<u>\$ 0</u>	<u>\$ 0</u>
<u>December 31, 2013</u>				
Treasury Notes:				
Available for sale	\$1,799,922	\$1,799,922	\$ 0	\$ 0
Total	<u>\$1,799,922</u>	<u>\$1,799,922</u>	<u>\$ 0</u>	<u>\$ 0</u>

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:

	<u>2014</u>	<u>2013</u>
Tennessee Independent Telecom Group (IRIS Networks) (10.556%)	\$861,414	\$1,013,280
National Rural Telecommunications Cooperative (NRTC)	<u>\$ 36,913</u>	<u>19,986</u>
	<u>\$898,327</u>	<u>\$1,033,266</u>

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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:

	<u>2014</u>	<u>2013</u>
Nonregulated customer premises equipment, paystations, and key systems	\$4,452,963	\$ 4,320,729
Less accumulated depreciation	<u>(2,217,620)</u>	<u>(1,961,622)</u>
Net nonregulated customer premises equipment, paystations, and key systems	\$2,235,343	\$2,359,107
Nonregulated materials and supplies	<u>591,978</u>	<u>723,288</u>
TOTAL	<u>\$2,827,321</u>	<u>\$3,082,395</u>

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:

	<u>2014</u>	<u>2013</u>
Land	\$ 324,225	\$ 324,225
Buildings	3,862,407	3,870,167
Central office equipment	31,834,517	31,345,030
Poles, cables, and wire	69,094,579	67,569,193
Furniture and office equipment	1,811,615	1,680,033
Vehicles and other work equipment	2,941,132	2,858,934
Intangibles	<u>2,422</u>	<u>2,422</u>
Telecommunications plant in service as contained on the Cooperative's records	<u>\$109,870,897</u>	<u>\$107,650,004</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

Note G – (Cont'd):

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

	<u>2014</u>	<u>2013</u>
Land	\$ 248,539	\$ 248,539
Buildings and improvements	1,542,354	1,542,354
Furniture	278,021	272,326
Vehicles	84,563	84,563
Tools and work equipment	11,626	32,666
Central office transmission equipment	<u>7,471,170</u>	<u>7,044,951</u>
Telecommunications plant in service as contained on Highland Holdings, Inc. records	<u>\$9,636,273</u>	<u>\$9,225,399</u>

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 3.49% in 2014 and 3.73% in 2013. Individual depreciation rates are as follows:

Buildings	3.2%
Central office	8.6 – 13.9%
Poles, cables and wire	5.6% – 7.32%
Furniture and office equipment	7.92 – 19%
Vehicles and other work equipment	15%

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 \$1,079,557 in 2014 and \$996,553 in 2013.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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:

	<u>2014</u>	<u>2013</u>
2.268% - 4.474% Rural Development Utilities Programs notes	\$14,350,306	\$9,021,321
Less current maturities	<u>502,759</u>	<u>320,579</u>
TOTAL	<u>\$13,847,547</u>	<u>\$8,700,742</u>

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:

<u>Year</u>	<u>Amount</u>
2015	\$ 502,759
2016	513,444
2017	529,691
2018	546,464
2019	563,781
Beyond 5 years	<u>11,694,167</u>
TOTAL	<u>\$14,350,306</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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:

	<u>2014</u>	<u>2013</u>
Accumulated postretirement obligation attributable to:		
Retirees	\$ 166,300	\$ 197,900
Other active plan participants	<u>5,248,836</u>	<u>3,727,152</u>
Total accumulated postretirement benefit obligation	\$5,415,136	\$3,925,052
Fair value of plan assets	<u>0</u>	<u>0</u>
Net unfunded status	<u>\$5,415,136</u>	<u>\$3,925,052</u>
Amounts recognized in other comprehensive income:		
Unrecognized net (gain)/losses	<u>\$ 976,800</u>	<u>\$ (122,900)</u>
Total included in other comprehensive income	<u>\$ 976,800</u>	<u>\$ (122,900)</u>

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

	<u>2014</u>	<u>2013</u>
Benefits earned during the year	\$225,200	\$166,300
Interest on accumulated postretirement benefit obligation	<u>274,500</u>	<u>192,700</u>
Postretirement benefit cost	<u>\$499,700</u>	<u>\$359,000</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

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 2014, 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:

	<u>2014</u>	<u>2013</u>
Discount rate	5.50%	5.25%
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 2013 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 2014 net periodic postretirement benefit cost by \$75,700 and would have increased the postretirement benefit obligation as of December 31, 2014 by \$631,800.

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

<u>Year</u>	<u>Amount</u>
2015	\$ 153,815
2016	157,661
2017	161,602
2018	165,642
2019	169,783
Years 2020 – 2024	<u>892,432</u>
TOTAL	<u>\$1,700,935</u>

The Company generally does not make an annual contribution to the plan and a contribution is not anticipated in 2015.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 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 \$591,468 in 2014 and \$580,208 in 2013.

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 \$17,500 for 2014 and \$17,000 for 2013. The Company matches the entire amount that each employee contributes to the plan. Retirement expense related to this plan amounted to \$31,725 in 2014 and \$25,074 in 2013.

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.

	<u>2014</u>	<u>2013</u>
Current income tax expense:		
Federal	\$ 10,900	\$1,442
State	2,050	0
Deferred income tax expense (benefit):		
Federal	(10,900)	(1,267)
State	<u>(2,050)</u>	<u>(175)</u>
Income tax	<u>\$ 0</u>	<u>\$ 0</u>

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

	<u>2014</u>	<u>2013</u>
Deferred tax asset	\$ 23,752	\$ 26,266
Deferred tax liability	<u>(85,269)</u>	<u>(100,915)</u>
	<u>\$(61,517)</u>	<u>\$ (74,649)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014 and 2013

Note K – (Cont'd):

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 carryforward of approximately \$1,718,000 which is available to offset future taxable income. This carryforward will expire in 6 to 15 years.

The Companies are no longer subject to federal or state income tax examinations for years beyond the statute of limitations of the respective taxing authorities. Penalties and interest, if any, that are assessed by income tax authorities are included in operating expenses. No interest or penalties were recognized during the years ending December 31, 2014 and 2013.

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, 2014 to September 30, 2017 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, 2014 and before the date these financial statements were available to be issued, March 13, 2015, and determined that no additional disclosures are necessary.

CONSOLIDATING INFORMATION

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, 2014 and 2013, and our report thereon dated March 13, 2015, 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 13, 2015

CONSOLIDATING BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
<u>ASSETS</u>				
<u>CURRENT ASSETS</u>				
Cash - general	\$ 3,447,027	\$ 4,266,294	\$ 0	\$ 7,713,321
Cash - construction funds	509	0	0	509
Temporary investments	600,000	100,996	0	700,996
Securities available for sale	3,599,520	0	0	3,599,520
Telecommunications accounts receivable	994,687	454,098	(453,431)	995,354
Other accounts receivable	1,137,357	0	0	1,137,357
Grant receivable	952,553	0	0	952,553
Materials and supplies	3,556,366	0	0	3,556,366
Prepayments	213,682	50,721	0	264,403
Due from affiliate	1,122,121	0	(1,122,121)	0
Refundable tax deposits	4,906	0	0	4,906
Other current assets	146,904	0	0	146,904
TOTAL CURRENT ASSETS	\$ 15,775,632	\$ 4,872,109	\$ (1,575,552)	\$ 19,072,189
<u>NONCURRENT ASSETS</u>				
Investment in subsidiaries	\$ 7,319,929	\$ 0	\$ (7,319,929)	\$ 0
Other investments	861,414	36,913	0	898,327
Nonregulated investments	2,827,321	0	0	2,827,321
Deferred tax asset	0	23,572	0	23,572
Deposits	2,573	1,600	0	4,173
TOTAL NONCURRENT ASSETS	\$ 11,011,237	\$ 62,085	\$ (7,319,929)	\$ 3,753,393
<u>PROPERTY, PLANT AND EQUIPMENT</u>				
Telecommunications plant in service	\$ 109,870,897	\$ 9,636,273	\$ 0	\$ 119,507,170
Telecommunications plant under construction	19,621,308	0	0	19,621,308
	\$ 129,492,205	\$ 9,636,273	\$ 0	\$ 139,128,478
Less accumulated depreciation	86,789,666	5,658,730	0	92,448,396
TOTAL PROPERTY, PLANT AND EQUIPMENT	\$ 42,702,539	\$ 3,977,543	\$ 0	\$ 46,680,082
	\$ 69,489,408	\$ 8,911,737	\$ (8,895,481)	\$ 69,505,664

CONSOLIDATING BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2014

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
<u>LIABILITIES AND MEMBERS' EQUITY</u>				
<u>CURRENT LIABILITIES</u>				
Accounts payable	\$ 3,038,545	\$ 151,506	\$ (324,605)	\$ 2,865,446
Advance billings and payments	804,377	44,287	0	848,664
Customer deposits	1,096	0	0	1,096
Current maturities on long-term debt	502,759	0	0	502,759
Accrued taxes	449,478	26,000	0	475,478
Accrued rent	837,680	0	0	837,680
Accrued salaries and wages	225,478	0	0	225,478
Accrued compensated absences	1,179,676	0	0	1,179,676
Accrued federal and state income taxes	0	3,435	0	3,435
Advance from related company	0	1,250,946	(1,250,946)	0
Other current liabilities	195,504	30,364	0	225,868
TOTAL CURRENT LIABILITIES	\$ 7,234,593	\$ 1,506,538	\$ (1,575,551)	\$ 7,165,580
<u>LONG-TERM DEBT</u>				
Rural Utilities Service	13,847,547	0	0	13,847,547
<u>OTHER LIABILITIES</u>				
Postretirement benefits other than pension	5,415,136	0	0	5,415,136
Deferred taxes	0	85,269	0	85,269
TOTAL LIABILITIES	\$ 26,497,276	\$ 1,591,807	\$ (1,575,551)	\$ 26,513,532
<u>MEMBERS' EQUITY</u>				
Memberships	\$ 219,883		\$ 0	\$ 219,883
Patronage capital	43,747,432		0	43,747,432
Accumulated other comprehensive loss	(975,183)		0	(975,183)
Capital stock	0	200,000	(200,000)	0
Paid-in capital	0	8,553,642	(8,553,642)	0
Retained earnings	0	(1,433,712)	1,433,712	0
TOTAL MEMBERS' EQUITY	\$ 42,992,132	\$ 7,319,930	\$ (7,319,930)	\$ 42,992,132
	<u>\$ 69,489,408</u>	<u>\$ 8,911,737</u>	<u>\$ (8,895,481)</u>	<u>\$ 69,505,664</u>

CONSOLIDATING STATEMENTS OF OPERATIONS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2014

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Operating revenues:				
Local network services revenue	\$ 6,849,762	\$ 0	\$ 0	\$ 6,849,762
Long distance services revenue	35,436	717,848	0	753,284
Network access services revenue	7,156,191	0	0	7,156,191
Broadband revenue	0	5,092,351	(5,092,351)	0
Video revenue	0	1,220,791	(1,220,791)	0
Miscellaneous revenues	3,263,716	175,110	(558,860)	2,879,966
Less uncollectible revenue	<u>(45,475)</u>	<u>(82,689)</u>	<u>0</u>	<u>(128,164)</u>
TOTAL OPERATING REVENUES	\$ 17,259,630	\$ 7,123,411	\$ (6,872,002)	\$ 17,511,039
Operating expenses:				
Plant specific operations expense	\$ 6,190,555	\$ 205,369	\$ (205,369)	\$ 6,190,555
Plant nonspecific operations expense	1,826,427	114,446	(114,446)	1,826,427
Provision for depreciation	3,791,286	1,079,557	(1,030,247)	3,840,596
Customer operations expense	1,949,757	3,456,695	(3,456,695)	1,949,757
Corporate operations expense	3,180,396	1,082,449	(1,466,199)	2,796,646
Operating taxes	<u>423,059</u>	<u>65,283</u>	<u>(65,283)</u>	<u>423,059</u>
TOTAL OPERATING EXPENSES	\$ 17,361,480	\$ 6,003,799	\$ (6,338,239)	\$ 17,027,040
OPERATING INCOME (LOSS)	\$ (101,850)	\$ 1,119,612	\$ (533,763)	\$ 483,999
Other income (expense):				
Interest and dividend income	\$ 23,572	\$ 21,974	\$ 0	\$ 45,546
Nonregulated income	(362,689)	(889,886)	533,763	(718,812)
Gain from sale of equipment	0	0	0	0
Income from subsidiaries	251,700	0	(251,700)	0
Income from investment	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
TOTAL OTHER INCOME (EXPENSE)	\$ (87,417)	\$ (867,912)	\$ 282,063	\$ (673,266)

CONSOLIDATING STATEMENTS OF OPERATIONS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2014

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Fixed charges:				
Interest on long-term debt	\$ 368,571	\$ 0	\$ 0	\$ 368,571
Interest charged to construction - credit	(368,571)	0	0	(368,571)
Interest on customer deposits	<u>347</u>	<u>0</u>	<u>0</u>	<u>347</u>
TOTAL FIXED CHARGES	<u>\$ 347</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 347</u>
NET INCOME (LOSS)	<u>\$ (189,614)</u>	<u>\$ 251,700</u>	<u>\$ (251,700)</u>	<u>\$ (189,614)</u>

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2014

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Net income (loss)	\$ (189,614)	\$ 251,700	\$ (251,700)	\$ (189,614)
Other comprehensive income:				
Unrealized gain on investment securities available for sale	(167)	0	0	(167)
Postretirement benefits other than pension:				
Unrecognized loss	<u>(1,099,700)</u>	<u>0</u>	<u>0</u>	<u>(1,099,700)</u>
COMPREHENSIVE INCOME (LOSS)	<u>\$ (1,289,481)</u>	<u>\$ 251,700</u>	<u>\$ (251,700)</u>	<u>\$ (1,289,481)</u>

Independent Auditor's Report on Compliance with Aspects of Contractual
Agreements and Regulatory Requirements

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

We have audited, 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, the financial statements of Highland Telephone Cooperative, Inc., which comprise the balance sheet as of December 31, 2014, and the related statements of operations, comprehensive income, changes in members' equity and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 16, 2015. In accordance with *Government Auditing Standards*, we have also issued our report dated March 16, 2015, on our consideration of Highland Telephone Cooperative, Inc.'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above have been furnished to management.

In connection with our audit, nothing came to our attention that caused us to believe that Highland Telephone Cooperative, Inc. failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers*, Sec. 1773.33 and clarified in the RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding Highland Telephone Cooperative, Inc.'s noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with our audit, we noted no matters regarding Highland Telephone Cooperative, Inc.'s accounting and records to indicate that Highland Telephone Cooperative, Inc. did not:

Maintain adequate and effective accounting procedures;

Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts;

Reconcile continuing property records to the controlling general ledger plant accounts;

Clear construction accounts and accrue depreciation on completed construction;

Record and properly price the retirement of plant;

Seek approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap;

Maintain adequate control over materials and supplies;

Prepare accurate and timely Financial and Operating Reports;

Obtain written RUS approval to enter into any contract agreement of lease with an affiliate as defined in Sec. 1773.33(e)(2)(i);

Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles; and

Comply with the requirements for the detailed schedule of investments.

This report is intended solely for the information and use of the board of directors, management, and RUS and supplemental lenders and is not intended to be and should be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Jotherow, Faile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 13, 2015

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

We have audited the financial statements of Highland Telephone Cooperative, Inc. and Subsidiary as of December 31, 2014 and 2013 and for the years ended December 31, 2014 and 2013 and have issued our report thereon dated March 13, 2015. 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.

Internal Control Over Financial Reporting

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'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.

Board of Directors
Highland Telephone
Cooperative, Inc
Sunbright, Tennessee
Page 2

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 communications 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.

Sotheron, Paile, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 16, 2015

March 13, 2015

To the Board of Directors of
Highland Telephone Cooperative, Inc.

We have audited the consolidated financial statements of Highland Telephone Cooperative, Inc. for the year ended December 31, 2014, and have issued our report thereon dated March 13, 2015. 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 December 1, 2014. 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 2014. 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 and liabilities 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.

We evaluated the key factors and assumptions used to develop the above described accounting estimates in determining that if it is reasonable in relation to the financial statements taken as a whole.

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 known and likely 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 as 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 13, 2015.

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 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, Spate, & Welch, PLLC

Certified Public Accountants
McMinnville, Tennessee
March 16, 2015