Kentucky 522

Foothills Rural Telephone Cooperative and Subsidiary

Staffordsville, Kentucky

Audited Financial Statements
December 31, 2016 and 2015

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Independent Auditor's Report

To the Board of Directors
Foothills Rural Telephone Cooperative

I have audited the accompanying consolidated financial statements of Foothills Rural Telephone Cooperative Corporation and Subsidiary ("Cooperative"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of revenue and comprehensive income, changes in members' equities, 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 consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

My responsibility is to express an opinion on these consolidated financial statements based on my audits. I did not audit the financial statements of East Kentucky Network, LLC. As discussed in Note 3, these consolidated financial statements account for an investment in East Kentucky Network, LLC under the equity method. The investment was $27,278,499 and $23,907,978 at December 31, 2016 and 2015 respectively, and the equity in its net margins was $12,802,011 and $5,802,853 for the years then ended. The financial statements of East Kentucky Network, LLC were audited by other auditors, whose report has been furnished to me, and my opinion, insofar as it relates to amounts for East Kentucky Network, LLC is based solely on the report of the other auditors. I conducted my 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 I plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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, I express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of

To the Board of Directors
Foothills Rural Telephone Cooperative

significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

I believe the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Opinion

In my opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Cooperative as of December 31, 2016 and 2015, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplemental Information

My audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information on pages 15 - 16 are 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 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 my opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, I have also issued a report dated March 3, 2017, on my consideration of the Cooperative's internal control over financial reporting and my 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 my 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* in considering internal control over financial reporting and compliance.

Alan Zumstein
Alan M. Zumstein, CPA
March 3, 2017

Foothills Rural Telephone Cooperative and Subsidiary

Consolidated Balance Sheets, December 31, 2016 and 2015

Assets	2016	2015
Current Assets:		
Cash and cash equivalents	$ 11,131,046	$ 15,798,166
Accounts receivable, less allowance for 2016 of $78,175 and 2015 of $50,307	651,605	668,976
Other accounts receivable	1,358,528	1,655,309
Materials and supplies, at average cost	1,471,407	1,187,672
Prepayments	574,066	487,776
	15,186,652	19,797,899
Other Assets:		
Investment securities available for sale	2,785,395	5,076,587
Investment in limited liability company	27,278,499	23,907,978
Pesnion plan prefunding	2,078,772	-
Nonregulated investments	1,229,680	1,515,046
	33,372,346	30,499,611
Utility Plant, at original cost:		
In service	130,014,014	131,894,748
Under construction	5,075,195	2,228,209
	135,089,209	134,122,957
Less accumulated depreciation	76,252,830	77,709,373
	58,836,379	56,413,584
Total	$ 107,395,377	$ 106,711,094
Liabilities and Member's Equities		
Current Liabilities:		
Accounts payable	$ 1,410,782	$ 1,135,629
Current portion of long term debt	2,620,000	4,150,000
Customer deposits	192,451	200,806
Other current and accrued expenses	2,126,588	2,047,029
	6,349,821	7,533,464
Long Term Debt	2,375,621	8,041,117
Accrued Postretirement Benefits	4,173,960	4,109,878
Members' Equities:		
Memberships and capital investment	626,566	608,476
Patronage capital and retained earnings	95,928,729	88,627,647
Donated capital	124,537	124,537
Accumulated other comprehensive income	(2,183,857)	(2,334,025)
	94,495,975	87,026,635
Total	$ 107,395,377	$ 106,711,094

The accompanying notes are an integral part of the financial statements.

Foothills Rural Telephone Cooperative and Subsidiary

Consolidated Statements of Revenue and Comprehensive Income

for the years ended December 31, 2016 and 2015

	2016	2015
Operating Revenue:		
Basic local network services	$ 3,674,854	$ 7,830,024
Network access services	15,732,662	12,918,868
Billing and collection	412,167	450,711
Miscellaneous	841,250	1,042,965
Less provision for uncollectibles	(90,000)	(84,000)
	20,570,933	22,158,568
Operating Expenses:		
Plant specific operations	6,647,696	6,055,460
Plant nonspecific operations	2,366,282	2,551,165
Depreciation	6,318,126	5,932,046
Customer operations	2,060,455	1,895,967
Corporate operations	1,821,809	1,820,660
Taxes	1,311,743	1,297,819
	20,526,111	19,553,117
Operating margins	44,822	2,605,451
Nonoperating Margins		
Other nonoperating income	13,062,505	6,109,275
Less related income taxes	(4,029,338)	(1,958,711)
Non regulated activities	42,098	(1,140,670)
	9,075,265	3,009,894
Margins before interest charges	9,120,087	5,615,345
Interest Charges:		
Interest on long-term debt	313,664	505,310
Other	9,489	9,643
	323,153	514,953
Net Margins	8,796,934	5,100,392
Other Comprehensive Income:		
Postretirement benefits	150,168	150,168
Total Comprehensive Income	$8,947,102	$5,250,560

The accompanying notes are an integral part of the financial statements.

Foothills Rural Telephone Cooperative and Subsidiary
Statement of Changes in Consolidated Members' Equity
for the years ended December 31, 2015 and 2016

		Patronage Capital							Accumulated Other	Total
	Memberships	Assigned	Assignable	Unassigned	Unlocated	Retirements	Total	Other Equity	Comprehensive Income	Members' Equity
Balance-December 31, 2014	$ 628,314	$ 83,676,787	$ 5,513,402	$ 21,090,733	$ 1,079,800	$ (26,493,781)	$ 84,866,941	$124,537	$ (2,484,193)	$ 83,135,599
Allocate margins		5,210,526	(5,513,402)	272,224	30,652		-			-
Comprehensive income:										
Net margins			5,100,392				5,100,392			5,100,392
Postretirement benefit obligation										
Amortization									150,168	
Adjustment										150,168
Total comprehensive income										5,250,560
Net change in memberships	(19,838)									(19,838)
Refunds of capital credits						(1,273,306)	(1,273,306)			(1,273,306)
Other equities		79,900	21,587	(150,695)	(17,172)		(66,380)	-		(66,380)
Balance-December 31, 2015	608,476	88,967,213	5,121,979	21,212,262	1,093,280	(27,767,087)	88,627,647	124,537	(2,334,025)	87,026,635
Allocate margins		1,965,590	(5,100,392)	3,134,802			-			-
Comprehensive income:										
Net margins			8,796,934				8,796,934			8,796,934
Postretirement benefit obligation										
Amortization									150,168	
Adjustment										150,168
Total comprehensive income										8,947,102
Net change in memberships	18,090									18,090
Refunds of capital credits						(1,499,966)	(1,499,966)			(1,499,966)
Other equities					4,114		4,114	-		4,114
Balance-December 31, 2016	$ 626,566	$ 90,932,803	$ 8,818,521	$ 24,347,064	$ 1,097,394	$ (29,267,053)	$ 95,928,729	$124,537	$ (2,183,857)	$ 94,495,975

The accompanying notes are an integral part of the financial statements.

Foothills Rural Telephone Cooperative and Subsidiary

Consolidated Statements of Cash Flows

for the years ended December 31, 2016 and 2015

	2016	2015
Cash Flows from Operating Activities:		
Net margins	$ 8,796,934	$ 5,100,392
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation	6,318,126	5,932,046
Accrued postretirement benefits	214,250	194,262
Income from subsidiary	(12,802,011)	(5,805,549)
Net change in current assets and liabilities:		
Receivables	(999,560)	(210,802)
Materials	(283,735)	26,135
Prepayments	(86,290)	71,520
Payables	1,588,865	(2,081)
Customer deposits	(8,355)	(6,700)
Other current and accrued liabilities	79,559	526,070
	2,817,783	5,825,293
Cash Flows from Investing Activities:		
Construction of plant	(8,640,147)	(4,568,563)
Salvage recovered from plant	(100,774)	(15,824)
Nonregulated investments	285,366	295,963
Investment in associated organizations	9,431,490	2,761,812
Change in investment securities	2,291,192	(15,945)
	3,267,127	(1,542,557)
Cash Flows from Financing Activities:		
Net increase in memberships and other equities	22,204	(19,838)
Retirements of capital credits	(1,499,966)	(1,481,417)
Prefund pension plan	(2,078,772)	-
Advances on long term debt	-	1,023,225
Payments on long term debt	(7,195,496)	(4,179,692)
	(10,752,030)	(4,657,722)
Net increase in cash balances	(4,667,120)	(374,986)
Cash and cash equivalents - beginning	15,798,166	16,173,152
Cash and cash equivalents - end	$ 11,131,046	$ 15,798,166
Supplemental disclosures of cash flows information:		
Interest on long-term debt	$ 313,664	$ 505,310
Income taxes paid	$ 4,029,338	$ 1,958,711

The accompanying notes are an integral part of the financial statements.

Note 1 Summary of Significant Accounting Policies

Foothills Rural Telephone Cooperative (the Cooperative) maintains its records in accordance with policies prescribed or permitted by the Kentucky Public Service Commission (PSC) and the United States Department of Agriculture, Rural Utilities Service (RUS) Uniform System of Accounts, which conform in all material respects with generally accepted accounting principles in all material respects. The more significant of these policies are as follows:

Principles of Consolidation The consolidated financial statements include the accounts of the Cooperative and its wholly-owned subsidiary, Cellular Services, LLC (Cellular Services). All significant inter-company accounts and transactions have been eliminated.

Cash and Cash Equivalents The Cooperative considers all short-term, highly liquid investments with original maturities of three months or less to be cash equivalents.

Off Balance Sheet Risk The Corporation has off-balance sheet risk in that they maintain cash deposits in financial institutions in excess of the amounts insured by the Federal Deposit Insurance Corporation (FDIC). At December 31, 2016, the financial institutions reported deposits in excess of the $250,000 FDIC insured limit on several of the accounts. Deposits and repurchase agreements in excess of the FDIC limits are 100% secured with collateral from each of the respective financial institutions.

Telecommunications Revenue Recognition Revenues are recognized when earned regardless of the period in which they are billed. Bills are sent to customers on credit based on three (3) monthly billing cycles, with local service being billed a month in advance of service. Sales are concentrated in portions of five (5) southeastern Kentucky counties. Payments are due 20 days from the date of billing, at which time a disconnect notice is sent with payment to be within 10 days. The allowance for uncollectible accounts is based on the aging of accounts receivable. Accounts are written off when they are deemed to be uncollectible. There were no customers whose individual account balance exceeded 10% of outstanding accounts receivable at December 31, 2016 or 2015. The number of access lines was 12,891 at 2016 and 12,612 at 2015.

Interstate revenues are recognized on the cost basis recovery method. Compensation for intrastate/interlata service is received through tariffed access charges as filed with the FCC. These access charges are billed to the interlata long distance carrier and retained by the Cooperative.

Video Revenue Recognition Cellular Services' headend equipment will allow the Cooperative with the capabilities to provide expanded video services with over 200 channels, high definition television, and Video on Demand. The monthly charge will be based on the capacity utilized by Foothills Telephone and other unrelated companies.

Fiber to the Home Activities The Cooperative has launched an expanded services network. This network establishes the Cooperative as a full service network (FSN) provider allowing it to provide expanded video services with over 200 channels, high definition television and Video on Demand. It also is able to provide high speed internet, virtual private networks and voice on internet protocol (VoIP). This is accomplished through Fiber to the Home (FTTH) technology. The Cooperative purchases cable transmissions from networks at various amounts based on the number of customers receiving the service.

Utility Taxes Foothills Telephone and Cellular Services' is required to collect, on behalf of taxing authorities, excise taxes, sales, school taxes, and franchise fees. Foothills Telephone and Foothills Telecom's policy is to exclude taxes from revenue when collected and expenses when paid and instead, record collection and payment of taxes through a liability account.

Note 1 Summary of Significant Accounting Policies, continued

Fair Value Measurements The Fair Value Measurements and Disclosures Topic of the FASB ASC 820, *Fair Value Measurements and Disclosures,* defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal, or most advantageous, market for the asset or liability in an orderly transaction between market participants at the measurement date. The Fair Values Measurements Topic establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs when possible. The three levels of inputs used to measure fair value are as follows:

> Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities
>
> Level 2: Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly.
>
> Level 3: Prices or valuations that require inputs that are both significant to the fair value measure and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The carrying amounts of the Cooperative's cash and cash equivalents, other receivables, investment securities, accounts payable and other current liabilities approximate fair value due to their short maturity. Investments in associated organizations are not considered a financial instrument because they represent nontransferable interests in associated organizations. Other assets and liabilities are not considered financial instruments because they represent activities specifically related to the Cooperative. Long term debt can not be traded in the market, and is specifically for telecommunications companies and, therefore, a value other than its outstanding principal cannot be determined.

The Cooperative may, and also does, invest idle funds in local banks money market accounts and CD's. The inputs used to measure idle funds are Level 1 measurements, as these funds are exchange traded funds in an active market.

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

Utility Plant Telecommunications and video plant are stated at original cost, which is the cost when first dedicated to public service. Such amount includes applicable supervisory and overhead cost including any construction period interest and taxes. Interest capitalized during the year was $109,165 for 2016 and $119,796 for 2015.

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expenses. The cost of replacement of depreciable property units, as distinguished from minor items, is charged to plant. The units of property replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation.

Note 1 Summary of Significant Accounting Policies, continued

The major classification of plant in service is:

	2016	2015
General support	$16,564,854	$14,847,022
Central office switching	1,374,008	2,291,234
Central office transmission	22,994,146	26,372,285
Cable and wire facilities	81,601,376	81,542,108
General plant	3,453	3,453
Subtotal telecommunications plant	122,537,837	125,056,102
Headend equipment	5,815,790	5,355,171
Cable and other video plant	1,660,387	1,483,475
Subtotal video plant	7,476,177	6,838,646
	$130,014,014	$131,894,748

Depreciation Provision has been made for depreciation on the basis of estimated lives of assets, using the straight-line method. Rates are as follows:

	Foothills	Cellular
General support	2.7% - 15.8%	
Central office switching and headend	7.5%	5.0%
Central office transmission	11.9%	
Cable and wire facilities	5.1% - 9.4%	5.1% - 6.6%

Advertising Advertising costs are expensed as incurred.

Income Taxes The Cooperative is exempt from federal and state income taxes under IRS Code Section 501(c)(12). Certain unrelated business activities are subject to federal income taxes. Cellular Services is a "C" corporation for federal and state income tax purposes.

The Cooperative's accounting policy provides that a tax expense/benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Management believes the Cooperative has no uncertain tax positions resulting in an accrual of tax expense or benefit. The Cooperative recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. The Cooperative did not recognize any interest or penalties during the years ended December 31, 2016 and 2015. The Cooperative's income tax return is subject to possible examination by taxing authorities until the expiration of related statues of limitations on the return, which is generally three years.

Comprehensive Income Comprehensive income includes both net margin and other comprehensive income. Other comprehensive income represents the change in funded status of the accumulated postretirement benefit obligation.

Subsequent Events Management has evaluated subsequent events through March 3, 2017, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investment Securities

The Cooperative classifies its investment in securities as held to maturity, available for sale, or trading categories in accordance with provisions of the *Financial Instruments Topic* of the Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC"). Investment securities are classified as held to maturity when the Cooperative has the positive intent and ability to hold the securities until maturity. Held to maturity securities are stated at amortized cost. Investment securities not classified as held to maturity are classified as available for sale and are carried at fair market value, with unrealized gains and losses, net of tax, reported as a separate component in stockholders' equity.

Investments securities are all considered held to maturity and consist of Certificates of Deposits in local banks.

Note 3 Investment in Limited Liability Company

Cellular Services is a partner in East Kentucky Network, LLC (EKN). EKN provides cellular service, fiber connections, paging, and other services in eastern Kentucky. EKN is comprised of Cellular Services and four (4) other independent telephone companies. The investment is accounted for using the equity method of accounting and includes capital investments.

Note 3 Non Regulated Activities

Deregulated customer premises equipment is stated at cost; material held for lease or resale is stated at average cost. CPE also includes inside wire revenues and expenses. Depreciation is provided on a straight-line basis at 11.9% per year. The Cooperative provides long distance telephone service under the name of Foothills Long Distance (FLD). FLD revenues are billed and collected through Foothills Telephone. A monthly fee is recorded based on telephone usage. FLD purchases minutes of long distance to resell to its customers from an unrelated party. Non regulated investments also include amounts that the Cooperative has invested to provide internet services to its customers. The Cooperative pays an unrelated party for the help desk and access to the internet system.

The following is a summary of non-regulated activities:

	Income	Expenses	Net
Customer premises equipment	$232,266	$238,998	($6,732)
Internet activities	4,797,832	4,351,566	446,266
Long distance services	834,761	748,426	86,335
Fiber to the home video	4,700,008	5,183,779	(483,771)
Total - 2016	$10,564,867	$10,522,769	$42,098

	Income	Expenses	Net
Customer premises equipment	$234,060	$251,486	($17,426)
Internet activities	4,895,321	5,333,554	(438,233)
Long distance services	464,014	318,887	145,127
Fiber to the home video	4,530,613	5,360,751	(830,138)
Total - 2015	$10,124,008	$11,264,678	($1,140,670)

Note 4 Long Term Debt

All telecommunications assets, except motor vehicles, are pledged as collateral on the long term debt due RUS and National Bank for Cooperatives ("CoBank"). During 2012 the long term debt payable to RUS was refinanced with proceeds from CoBank and are included with the debt due from CoBank.

Long term debt is as follows:

	2016	2015
RUS, Broadband, 2.132% - 3.426%	$1,875,042	$5,075,380
CoBank, 2.47% and 6.25%	3,120,579	7,115,737
	4,995,621	12,191,117
Less current portion	2,620,000	4,150,000
Long term portion	$2,375,621	$8,041,117

Principal payments for the next five years are as follows: 2017 - $2,620,000; 2018 - $780,000; 2019 - $150,000; 2020 - $155,000; 2021 - $160,000.

Note 5 Patronage Capital

The long term debt agreement contains restrictions on the return to patrons of capital contributed by them. The restrictions relate in general to the Cooperative's net worth and assets, as defined. The net worth of the Cooperative at December 31, 2016, was 88%.

Note 6 Pension Plan

All eligible employees of the Cooperative participate in the NTCA Retirement and Security Plan ("R&S Plan"), a defined benefit pension plan qualified under section 401 and tax exempt under section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The Plan sponsor's identification number is 52-0741336 and the Plan Number is 333. A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

The Cooperative's contributions to the R&S Plan in 2016 and 2015 represent less than 5 percent of the total contributions made to the plan by all participating employers. The Cooperative made contributions to the plan of $616,965 in 2016 and $532,390 in 2015. There have been no significant changes that affect the comparability of 2016 and 2015.

In the R&S Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act ("PPA") of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the R&S Plan was between 88 percent and 80 percent funded at January 1, 2016 and 2015 based on the PPA funding target and PPA actuarial value of assets on those dates. Because the provisions of the PPA do not apply to the R&S Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

Note 6 Pension Plan, continued

The NTCA Board of Directors amended the 2017 R&S Program specifications at the recommendation of the Plan Trust Committee to include the following changes:

- Basic contribution rates will increase by 19%.
- The program's current surcharge will expire at the end of 2017, and a new surcharge contribution of 50% of the member's elected contribution rate will begin in 2018. This surcharge is expected to continue for approximately 12 years.
- A prefunding option was added to allow members the option to prefund their future surcharge contributions in a single payment prior to the start of the new surcharge effective in 2018.
- Beginning January 1, 2017, for members that have adopted the Rule-of-85 ("ROE") provision, the ROE charge will apply to both the member's elected employer contribution rate and any required employee contribution rate.

Over the past several years, various actions have been taken to sustain the reserve of funds available to help meet the program's legally required minimum contribution amount. However, adverse economic conditions and regulatory changes have negatively affected all pension plans, including the R&S Program. Despite prudent decision-making by the program's trust committee, the R&S Program's minimum contribution amount is projected to exceed the current reserve and member contributions alone will not meet the minimum requirement. This expectation has led the program's actuary to recommend the new surcharge contribution beginning in 2018. The R&S Program is offering prefunding to give members flexibility in addressing this situation at their company.

The prefunding contribution is expected to fund the member's surcharge contribution for approximately 12 years.

- Each member's prefunding contribution will be maintained in a notional account within the R&S Program and used to pay that member's surcharge contributions.
- Each member's prefunding account is maintained separately from other member's prefunding accounts.
- Account funds will be invested with other R&S Program assets and grow at the same rate as the program's overall investment returns.
- An annual statement will be provided to each member showing their specific prefunding account activity.

During 2016, the Cooperative prefunded the surcharge in an amount of $2,078,772. This amount will be amortized over the 12 year period the surcharge is expected to continue.

Note 7 Accumulated Postretirement Benefits

The Cooperative sponsors a noncontributory defined benefit plan that provides medical insurance coverage to retirees and their dependents until they reach age 65. Participating retirees and dependents do not contribute to the projected cost of coverage. Employees qualify with a minimum age of 55 and meeting the Rule of 85. There have been no significant changes that affect the comparability of 2016 and 2015.

Note 7 Accumulated Postretirement Benefits, continued

The funded status of the plan was as follows:

	2016	2015
Projected benefit obligation	($7,312,617)	($6,981,080)
Plan assets at fair value	3,138,657	2,871,202
Total	($4,173,960)	($4,109,878)

The components of net periodic postretirement benefit costs are as follows:

	2016	2015
Benefit obligation at beginning of year	$4,109,878	$4,065,784
Components of net periodic benefit cost:		
Service cost	239,945	55,242
Interest cost	357,342	346,976
Expected return on assets	(267,455)	(72,386)
Net periodic benefit cost	329,832	329,832
Contributions to plan	-	-
Benefits paid from general funds	(265,750)	(285,738)
Adjust comprehensive income	-	-
Benefit obligation at end of year	$4,173,960	$4,109,878
Change in plan assets:		
Fair value of plan assets-beginning of year	$2,871,202	$2,832,179
Employer contributions	-	-
Change in fair value of plan assets	267,455	39,023
Benefits paid from plan	-	-
Fair value of plan assets-end of year	$3,138,657	$2,871,202
Amounts recognized in the balance sheet consists of:		
Noncurrent assets (liabilities)	($4,173,960)	($4,109,878)
Amounts included in other comprehensive income:		
Unrecognized actuarial gain (loss)	($2,183,857)	($2,334,025)
Effect of 1% increase in the health care trend:		
Projected benefit obligation	$7,872,000	
Net periodic benefit cost	355,000	

Note 7 Accumulated Postretirement Benefits, continued

For measurement purposes, an 8.5% annual rate of increase, decreasing by 0.5% per year until 5.5% per year, in the per capita cost of covered health care benefits was assumed. The discount rate used in determining the accumulated benefit obligation was 4.5% for 2016 and 2015.The projected retiree benefit payments are expected to be as follows: 2017 - $271,000; 2018 - $262,000; 2019 – $258,000; 2020 - $267,000; 2021 - $260,000.

Note 8 Risk Management

The Cooperative is exposed to various forms of losses of assets associated with, but not limited to, fire, personal liability, theft, vehicular accidents, errors and omissions, fiduciary responsibility, workers compensation, etc. Each of these areas is covered through the purchase of commercial insurance.

Note 9 Commitments

The Cooperative has various agreements outstanding with local contractors. Under these agreements, the contractors will perform certain construction, maintenance, and other work at specified hourly rates or unit cost, or on an as needed basis. The duration of these contracts are one to three years.

* * * * * *

Foothills Rural Telephone Cooperative Corporation and Subsidiary

Consolidating Balance Sheet, December 31, 2016

Assets	Foothills Telephone	Cellular Services	Eliminations	Consolidated
Current Assets:				
Cash and cash equivalents	$7,936,111	$3,194,935		$11,131,046
Accounts receivable, less allowance for 2016 of $78,175	651,605			651,605
Other accounts receivable	2,133,407		(774,879)	1,358,528
Materials and supplies, at average cost	1,471,407			1,471,407
Prepayments	574,066			574,066
	12,766,596	3,194,935	(774,879)	15,186,652
Other Assets:				
Investment securities available for sale	2,685,395	100,000		2,785,395
Investment in limited liability company	34,071,700	27,278,499	(34,071,700)	27,278,499
Pension plan prefunding	2,078,772			2,078,772
Nonregulated investments	1,229,680			1,229,680
	40,065,547	27,378,499	(34,071,700)	33,372,346
Telecommunications Plant, at original cost:				
In service	122,537,837	7,476,177		130,014,014
Under construction	4,297,087	778,108		5,075,195
	126,834,924	8,254,285		135,089,209
Less accumulated depreciation	72,376,154	3,876,676		76,252,830
	54,458,770	4,377,609		58,836,379
Total	$107,290,913	$34,951,043	($34,846,579)	$107,395,377

Liabilities and Member's Equities	Foothills Telephone	Cellular Services	Eliminations	Consolidated
Current Liabilities:				
Accounts payable	$1,411,602	$774,059	($774,879)	$1,410,782
Current portion of long term debt	2,620,000			2,620,000
Customer deposits	192,451			192,451
Other current and accrued expenses	2,021,304	105,284		2,126,588
	6,245,357	879,343	(774,879)	6,349,821
Long Term Debt	2,375,621			2,375,621
Accrued Postretirement Benefits	4,173,960			4,173,960
Members' Equities:				
Memberships and capital investment	626,566	8,257,826	(8,257,826)	626,566
Patronage capital and retained earnings	95,928,729	25,813,874	(25,813,874)	95,928,729
Donated capital	124,537			124,537
Accum other comprehensive income	(2,183,857)			(2,183,857)
	94,495,975	34,071,700	(34,071,700)	94,495,975
Total	$107,290,913	$34,951,043	($34,846,579)	$107,395,377

The accompanying notes are an integral part of the financial statements.

Foothills Rural Telephone Cooperative Corporation and Subsidiary

Consolidating Statement of Revenue and Comprehensive Income

for the year ended December 31, 2016

	Foothills Telephone	Cellular Services	Eliminations	Consolidated
Operating Revenue:				
Basic local network services	$3,411,001	$332,862	($69,009)	$3,674,854
Network access services	15,666,928	65,734		15,732,662
Billing and collection	412,167			412,167
Miscellaneous	841,250			841,250
Less provision for uncollectibles	(90,000)			(90,000)
	20,241,346	398,596	(69,009)	20,570,933
Operating Expenses:				
Plant specific operations	6,098,913	617,792	(69,009)	6,647,696
Plant nonspecific operations	2,366,177	105		2,366,282
Depreciation	5,821,202	496,924		6,318,126
Customer operations	2,057,030	3,425		2,060,455
Corporate operations	1,744,744	77,065		1,821,809
Taxes, other than income	1,271,319	40,424		1,311,743
	19,359,385	1,235,735	(69,009)	20,526,111
Operating margins	881,961	(837,139)		44,822
Nonoperating Margins				
Other nonoperating income	8,196,028	12,802,011	(7,935,534)	13,062,505
Less related income taxes		(4,029,338)		(4,029,338)
Non regulated activities	42,098			42,098
	8,238,126	8,772,673	(7,935,534)	9,075,265
Margins before interest charges	9,120,087	7,935,534	(7,935,534)	9,120,087
Interest Charges:				
Interest on long-term debt	313,664			313,664
Other	9,489			9,489
	323,153			323,153
Net Margins	8,796,934	7,935,534	(7,935,534)	8,796,934
Other Comprehensive Income:				
Accumulated postretirement benefits	150,168			150,168
Net Comprehensive Income	$8,947,102	$7,935,534	($7,935,534)	$8,947,102

The accompanying notes are an integral part of the financial statements.

ALAN M. ZUMSTEIN
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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

To the Board of Directors
Foothills Rural Telephone Cooperative Corporation

I have audited, in accordance with the 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 Foothills Rural Telephone Cooperative Corporation (the "Cooperative"), which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of revenue and comprehensive income, members' equities and cash flows for the years then ended, and related notes to the financial statements, and have issued my report thereon dated March 3, 2017. My report includes a reference to other auditors who audited the financial statements of East Kentucky Network, LLC, as described in my report on Cooperative's financial statements. This report does not include the results of the other auditor's testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing my audit of the financial statements, I considered the Cooperative's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

My consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during my audit I did not identify any deficiencies in internal control that I consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

To the Board of Directors
Foothills Rural Telephone Cooperative Corporation

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Cooperative's financial statements are free of material misstatement, I 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 my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of my testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the organization's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the organization's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Alan Zumstein

Alan M. Zumstein, CPA
March 3, 2017

ALAN M. ZUMSTEIN
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Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Telephone Borrowers

Board of Directors
Foothills Rural Telephone Cooperative Corporation

Independent Auditor's Report

I 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 Foothills Rural Telephone Cooperative Corporation ("the Cooperative"), which comprise the balance sheet as of December 31, 2016, and the related statements of revenue and comprehensive income, patronage capital, and changes in cash flows for the year then ended, and the related notes to the financial statements, and have issued my report thereon dated March 3, 2017. In accordance with *Government Auditing Standards*, we have also issued my report dated March 3, 2017, on my consideration of the Cooperative's internal control over financial reporting and on my 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 related to my audit have been furnished to management.

In connection with my audit, nothing came to my attention that caused me to believe that the Cooperative 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*, §1773.33 and clarified in the RUS policy memorandum dated February 7, 2013, insofar as they relate to accounting matters as enumerated below. However, my audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had I performed additional procedures, other matters may have come to my attention regarding the Cooperative'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 my audit, I noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative 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 material and supplies;
- Prepare accurate and timely Financial and Operating Reports;
- Obtain written approval of the RUS to enter into any contract, agreement, or lease with an affiliate as defined in Part 1773 (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, which are listed below.

Foothills Telephone formed a wholly-owned subsidiary, Cellular Services, LLC, which communications and video service and also is a one-fifth (1/5) owner of a limited liability company that provides cellular and other communications services. The initial investment was $820,000. The investment is comprised of the following:

	Investment	Profits (less Dividends)
Balance, beginning of year	$8,257,826	$21,378,340
Activity for 2016	-	4,435,534
Balance, end of year	$8,257,826	$25,813,874

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

Alan Zumstein

Alan M. Zumstein, CPA
March 3, 2017