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May 7, 2014

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 2013. If you have any questions, please call me at 423-628-2121 or e-mail [patriece@highlandtel.net](mailto:patriece@highlandtel.net)

Sincerely,

Patriece Brown  
Account Manager

RECEIVED

MAY - 9 2014

PUBLIC SERVICE  
COMMISSION

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

December 31, 2013 and 2012

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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, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in members' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

**Management's Responsibility for the Financial Statements**

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

**Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We 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 audits opinion.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audits 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, 2013 and 2012, 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 21, 2014 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.

*Jotherow, Faye, & Welch, PLLC*

Certified Public Accountants  
McMinnville, Tennessee  
March 21, 2014

CONSOLIDATED BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

	2013	2012
<u>ASSETS</u>		
<u>CURRENT ASSETS</u>		
Cash - general	\$ 9,965,051	\$ 8,732,845
Cash - construction fund	504	501
Temporary investments	1,080,887	980,127
Securities available for sale	1,799,922	3,599,262
Telecommunications accounts receivable, less allowances of \$100,000 in 2013 and \$165,811 in 2012	1,126,545	1,195,798
Other accounts receivable	975,622	1,202,643
Grant receivable	606,538	671,666
Materials and supplies	3,309,568	2,685,250
Prepayments	223,792	217,845
Refundable tax deposits	4,906	3,083
Other current assets	161,793	283,453
	<hr/>	<hr/>
TOTAL CURRENT ASSETS	\$ 19,255,128	\$ 19,572,473
 <u>NONCURRENT ASSETS</u>		
Other investments	\$ 1,033,266	\$ 1,051,547
Nonregulated investments	3,082,395	2,755,577
Deferred tax asset	26,266	31,153
Deposits	4,173	4,173
	<hr/>	<hr/>
TOTAL NONCURRENT ASSETS	\$ 4,146,100	\$ 3,842,450
 <u>PROPERTY, PLANT AND EQUIPMENT</u>		
Telecommunications plant in service	\$ 116,875,403	\$ 113,730,579
Telecommunications plant under construction	12,844,223	8,781,528
	<hr/>	<hr/>
	\$ 129,719,626	\$ 122,512,107
Less accumulated depreciation	87,579,706	82,790,052
	<hr/>	<hr/>
TOTAL PROPERTY, PLANT AND EQUIPMENT	\$ 42,139,920	\$ 39,722,055
	<hr/>	<hr/>
	\$ 65,541,148	\$ 63,136,978
	<hr/>	<hr/>

See the accompanying notes and independent auditors' report.

CONSOLIDATED BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

	2013	2012
<u>LIABILITIES AND MEMBERS' EQUITY</u>		
<u>CURRENT LIABILITIES</u>		
Accounts payable	\$ 4,597,382	\$ 3,034,751
Advance billings and payments	764,660	756,571
Customer deposits	196	2,096
Current maturities on long-term debt	320,579	2,200,429
Accrued taxes	546,223	452,733
Accrued interest	0	10,641
Accrued rents	791,629	717,855
Accrued salaries and wages	209,425	181,020
Accrued compensated absences	1,111,947	1,157,316
Accrued federal and state income taxes	27,363	7,677
Other current liabilities	158,278	217,553
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	\$ 8,527,682	\$ 8,738,642
 <u>LONG-TERM DEBT</u>		
Rural Utilities Service - mortgage notes	8,700,742	6,380,438
 <u>OTHER LIABILITIES</u>		
Postretirement benefits other than pension	3,925,052	4,326,122
Deferred taxes	100,915	107,242
	<hr/>	<hr/>
TOTAL LIABILITIES	\$ 21,254,391	\$ 19,552,444
 <u>MEMBERS' EQUITY</u>		
Patronage equity	\$ 44,162,075	\$ 44,062,458
Accumulated other comprehensive income	124,682	(477,924)
	<hr/>	<hr/>
TOTAL EQUITY	\$ 44,286,757	\$ 43,584,534
	<hr/>	<hr/>
	<u>\$ 65,541,148</u>	<u>\$ 63,136,978</u>

CONSOLIDATED STATEMENTS OF INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2013 and 2012

	2013	2012
Operating revenues:		
Local network services revenue	\$ 6,770,867	\$ 6,834,959
Long distance services revenue	869,090	993,851
Network access services revenue	7,507,223	8,113,598
Miscellaneous revenues	3,501,514	3,189,662
Less uncollectible revenue	<u>(214,985)</u>	<u>(274,680)</u>
TOTAL OPERATING REVENUES	\$ 18,433,709	\$ 18,857,390
Operating expenses:		
Plant specific operations expense	\$ 6,084,907	\$ 6,238,038
Plant nonspecific operations expense	1,600,280	1,700,419
Provision for depreciation	4,978,060	5,474,046
Customer operations expense	2,052,428	1,949,680
Corporate operations expense	3,239,538	3,370,971
Operating taxes	<u>431,295</u>	<u>445,149</u>
TOTAL OPERATING EXPENSES	<u>\$ 18,386,508</u>	<u>\$ 19,178,303</u>
OPERATING INCOME (LOSS)	\$ 47,201	\$ (320,913)
Other income (expense):		
Interest income	\$ 88,106	\$ 111,942
Nonregulated (expense) income	(39,284)	387,273
Income from investment	0	37,885
Gain (loss) from sale of fixed asset	<u>15,556</u>	<u>(781)</u>
TOTAL OTHER INCOME	\$ 64,378	\$ 536,319

See the accompanying notes and independent auditors' report.



CONSOLIDATED STATEMENTS OF INCOME (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2013 and 2012

	2013	2012
Fixed charges:		
Interest on long-term debt	\$ 281,999	\$ 312,789
Interest charged to construction - credit	(280,148)	(288,565)
Interest on customer deposits	<u>51</u>	<u>167</u>
TOTAL FIXED CHARGES	<u>\$ 1,902</u>	<u>\$ 24,391</u>
INCOME BEFORE TAXES ON INCOME	\$ 109,677	\$ 191,015
Taxes on income	<u>0</u>	<u>8,512</u>
NET INCOME	<u><u>\$ 109,677</u></u>	<u><u>\$ 182,503</u></u>

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2013 and 2012

	2013	2012
Net income	\$ 109,677	\$ 182,503
Other comprehensive income:		
Unrealized gain from securities available for sale	160	154
Postretirement benefits other than pension:		
Prior service costs	0	5,672
Unrecognized gain	<u>602,446</u>	<u>335,452</u>
COMPREHENSIVE INCOME	<u>\$ 712,283</u>	<u>\$ 523,781</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, 2013 and 2012

	Memberships	Patronage Capital	Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
Balance at December 31, 2011	\$ 241,542	\$ 43,644,868	\$ (819,202)	\$ 43,067,208
Net income for 2012	0	182,503	0	182,503
Unrealized gain on investment of securities available for sale	0	0	154	154
Memberships refunded	(6,455)	0	0	(6,455)
Postretirement benefits other than pension:				
Prior service costs	0	0	5,672	5,672
Unrecognized gain	0	0	335,452	335,452
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 gain	0	0	602,446	602,446
Balance at December 31, 2013	<u>\$ 225,027</u>	<u>\$ 43,937,048</u>	<u>\$ 124,682</u>	<u>\$ 44,286,757</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, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Cash received from customers	\$ 18,738,072	\$ 19,010,475
Cash paid to suppliers and employees	(11,301,274)	(12,492,164)
Interest and dividends received	70,384	108,592
Interest paid	(12,543)	(28,404)
Taxes paid	(321,382)	(473,216)
	<hr/>	<hr/>
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 7,173,257	\$ 6,125,283
Cash flows from investing activities:		
Construction and acquisition of plant	\$ (7,408,486)	\$ (9,134,994)
Plant removal cost	(4,816)	(446)
Salvage	16,308	30,132
Increase in nonregulated assets	(326,818)	(98,977)
Decrease in other investments	36,003	1,708
(Increase) Decrease in securities available for sale	1,799,340	(600,006)
Increase in temporary investments	(100,760)	(718)
Proceeds from sale of fixed assets	16,625	0
Increase in reserve for market valuation of securities	160	154
Decrease (Increase) in:		
Materials and supplies	(624,318)	(48,840)
Nonregulated income	(39,284)	387,273
	<hr/>	<hr/>
NET CASH USED BY INVESTING ACTIVITIES	\$ (6,636,046)	\$ (9,464,714)

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2013 and 2012

	2013	2012
Cash flows from financing activities:		
Payments on long-term borrowings	\$ (2,647,986)	\$ (1,879,933)
Debt proceeds	3,088,440	4,099,032
Postretirement benefits other than pension	201,376	299,790
Decrease in grant receivable	65,128	641,830
(Decrease) Increase in:		
Customer deposits	(1,900)	1,151
Memberships	(10,060)	(6,455)
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>\$ 694,998</u>	<u>\$ 3,155,415</u>
NET INCREASE (DECREASE) IN CASH	\$ 1,232,209	\$ (184,016)
CASH AT BEGINNING OF YEAR	<u>8,733,346</u>	<u>8,917,362</u>
CASH AT END OF YEAR	<u><u>\$ 9,965,555</u></u>	<u><u>\$ 8,733,346</u></u>

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the years ended December 31, 2013 and 2012

	2013	2012
Net income	\$ 109,677	\$ 182,503
Nonregulated expense (income)	39,284	(387,273)
Non cash patronage dividend	(17,722)	(3,350)
Income from investment	0	(37,885)
(Gain) Loss from sale of asset	(15,556)	781
Deferred tax (benefit) expense	(1,440)	36,213
	<hr/>	<hr/>
Net income (loss) from regulated operations	\$ 114,243	\$ (209,011)
Adjustments to reconcile net income (loss) from regulated operations to net cash provided by operating activities:		
Depreciation	\$ 4,978,060	\$ 5,875,770
Decrease (Increase) in:		
Customer and other accounts receivable	296,274	178,822
Refundable tax deposit	(1,823)	0
Current and accrued assets - other	121,660	(169,486)
Prepaid expenses	(5,947)	126,183
Increase (Decrease) in:		
Accounts payable	1,562,631	323,566
Advance billings and payments	8,089	(25,737)
Accrued taxes	93,490	(53,662)
Accrued interest	(10,641)	(4,013)
Accrued rents	73,774	35,513
Accrued salaries and compensated absences	(16,964)	82,338
Accrued federal and state income taxes	19,686	(2,106)
Other current liabilities	(59,275)	(32,894)
	<hr/>	<hr/>
TOTAL ADJUSTMENTS	\$ 7,059,014	\$ 6,334,294
	<hr/>	<hr/>
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 7,173,257	\$ 6,125,283
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See the accompanying notes and independent auditors' report.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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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 2013 reflect the results of operations from January 1 through December 31 for the Cooperative, and October 1, 2012 through September 30, 2013 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, 2013 and 2012

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 \$2,835 and \$22,537 at December 31, 2013 and 2012, 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 \$106,567 in 2013 and \$172,763 in 2012.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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. \$1,974,980 was uninsured at December 31, 2013.

The Companies also have cash maintained by an investment firm totaling \$3,047,583 and \$1,626,519 as of December 31, 2013 and 2012, respectively. Accounts are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At December 31, 2013 \$2,797,583 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, 2013, the Cooperative has received \$9,386,950 in loan proceeds and \$28,730,287 of the grant portion.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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, 2013			
Available for sale:			
U.S. Treasury Notes	<u>\$1,799,817</u>	<u>\$ 105</u>	<u>\$1,799,922</u>
December 31, 2012			
Available for sale:			
U.S. Treasury Notes	<u>\$3,597,638</u>	<u>\$1,624</u>	<u>\$3,599,262</u>
	<u>Less than 12 months</u>		
	<u>Fair Value</u>	<u>Unrealized Gain</u>	
Description of Securities:			
U.S. Treasury Notes	<u>\$1,799,922</u>	<u>\$ 105</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, 2013, 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, 2013, 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>2013</u>	<u>2012</u>
Proceeds from sales and redemptions	<u>\$5,398,881</u>	<u>\$5,997,764</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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, 2013 and 2012

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, 2013</u>				
Treasury Notes:				
Available for sale	<u>\$1,799,922</u>	<u>\$1,799,922</u>	<u>\$ 0</u>	<u>\$ 0</u>
Total	<u>\$1,799,922</u>	<u>\$1,799,922</u>	<u>\$ 0</u>	<u>\$ 0</u>
<u>December 31, 2012</u>				
Treasury Notes:				
Available for sale	<u>\$3,599,262</u>	<u>\$3,599,262</u>	<u>\$ 0</u>	<u>\$ 0</u>
Total	<u>\$3,599,262</u>	<u>\$3,599,262</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>2013</u>	<u>2012</u>
Tennessee Independent Telecom Group (IRIS Networks) (10.556%)	\$1,013,280	\$1,041,688
National Rural Telecommunications Cooperative (NRTC)	<u>19,986</u>	<u>9,859</u>
	<u>\$1,033,266</u>	<u>\$1,051,547</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, 2013 and 2012

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>2013</u>	<u>2012</u>
Nonregulated customer premises equipment, paystations, and key systems	\$ 4,320,729	\$ 4,493,295
Less accumulated depreciation	<u>(1,961,622)</u>	<u>(2,054,973)</u>
Net nonregulated customer premises equipment, paystations, and key systems	\$2,359,107	\$2,438,322
Nonregulated materials and supplies	<u>723,288</u>	<u>317,255</u>
TOTAL	<u>\$3,082,395</u>	<u>\$2,755,577</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>2013</u>	<u>2012</u>
Land	\$ 324,225	\$ 296,225
Buildings	3,870,167	3,807,821
Central office equipment	31,345,030	31,289,637
Poles, cables, and wire	67,569,193	66,230,863
Furniture and office equipment	1,680,033	1,600,703
Vehicles and other work equipment	2,858,934	2,585,901
Intangibles	<u>2,422</u>	<u>2,422</u>
Telecommunications plant in service as contained on the Cooperative's records	<u>\$107,650,004</u>	<u>\$105,813,572</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

Note G – (Cont'd):

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

	<u>2013</u>	<u>2012</u>
Land	\$ 248,539	\$ 248,539
Buildings and improvements	1,542,354	1,541,938
Furniture	272,326	217,936
Vehicles	84,563	123,793
Tools and work equipment	32,666	32,666
Central office transmission equipment	<u>7,044,951</u>	<u>5,752,135</u>
Telecommunications plant in service as contained on Highland Holdings, Inc. records	<u>\$9,225,399</u>	<u>\$7,917,007</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 3.73% in 2013 and 4.72% in 2012. 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 \$996,553 in 2013 and \$920,171 in 2012.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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>2013</u>	<u>2012</u>
5% Rural Development Utilities Program notes	\$ 0	\$2,407,609
2.268% - 4.474% Rural Development Utilities Programs notes	<u>9,021,321</u>	<u>6,173,258</u>
	\$9,021,321	\$8,580,867
Less current maturities	<u>320,579</u>	<u>2,200,429</u>
TOTAL	<u>\$8,700,742</u>	<u>\$6,380,438</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>
2014	\$320,579
2015	309,160
2016	312,723
2017	322,529
2018	332,654
Beyond 5 years	<u>7,423,676</u>
TOTAL	<u>\$9,021,321</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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>2013</u>	<u>2012</u>
Accumulated postretirement obligation attributable to:		
Retirees	\$ 197,900	\$ 402,935
Other active plan participants	<u>3,727,152</u>	<u>3,923,187</u>
Total accumulated postretirement benefit obligation	\$3,925,052	\$4,326,122
Fair value of plan assets	<u>0</u>	<u>0</u>
Net unfunded status	<u>\$3,925,052</u>	<u>\$4,326,122</u>
Amounts recognized in other comprehensive income:		
Unrecognized net (gain)/losses	\$ (122,900)	\$ 473,871
Prior service costs	<u>0</u>	<u>5,673</u>
Total included in other comprehensive income	<u>\$ (122,900)</u>	<u>\$ 479,544</u>

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

	<u>2013</u>	<u>2012</u>
Benefits earned during the year	\$166,300	\$184,015
Interest on accumulated postretirement benefit obligation	<u>192,700</u>	<u>218,399</u>
Postretirement benefit cost	<u>\$359,000</u>	<u>\$402,414</u>



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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 2013, 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>2013</u>	<u>2012</u>
Discount rate	5.25%	5.50%
Expected return on plan assets	0.00%	0.00%

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

The medical cost trend rate in 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 2013 net periodic postretirement benefit cost by \$47,200 and would have increased the postretirement benefit obligation as of December 31, 2013 by \$423,500.

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>
2014	\$ 165,697
2015	168,182
2016	170,705
2017	173,266
2018	175,865
Years 2019 – 2021	<u>919,693</u>
TOTAL	<u>\$1,773,408</u>

The Company generally does not make an annual contribution to the plan and a contribution is not anticipated in 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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 \$580,208 in 2013 and \$563,495 in 2012.

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 \$17,000 for 2013 and \$16,500 for 2012. The Company matches the entire amount that each employee contributes to the plan. Retirement expense related to this plan amounted to \$25,074 in 2013 and \$29,211 in 2012.

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>2013</u>	<u>2012</u>
Current income tax expense:		
Federal	\$1,442	\$(25,688)
State	0	(2,013)
Deferred income tax expense (benefit):		
Federal	(1,267)	30,058
State	<u>(175)</u>	<u>6,155</u>
Income tax	<u>\$ 0</u>	<u>\$ 8,512</u>

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

	<u>2013</u>	<u>2012</u>
Deferred tax asset	\$ 26,266	\$ 31,153
Deferred tax liability	<u>(100,915)</u>	<u>(107,242)</u>
	<u>\$ (74,649)</u>	<u>\$ (76,089)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013 and 2012

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 \$1,814,000 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, 2013 and 2012.

Note L – Labor Force:

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

Note M – Commitments and Contingencies:

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

Note N – Subsequent Events:

Subsequent events are transactions or events that occur subsequent to the date of the financial statements and before the issuance of those financial statements. Management has evaluated transactions and events that occurred subsequent to December 31, 2013 and before the date these financial statements were available to be issued, March 21, 2014, 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, 2013 and 2012, and our report thereon dated March 21, 2014, 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 21, 2014

CONSOLIDATING BALANCE SHEETS

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
	<u>ASSETS</u>			
<u>CURRENT ASSETS</u>				
Cash - general	\$ 5,927,624	\$ 4,037,427	\$ 0	\$ 9,965,051
Cash - construction funds	504	0	0	504
Temporary investments	600,000	480,887	0	1,080,887
Securities available for sale	1,799,922	0	0	1,799,922
Telecommunications accounts receivable	956,871	457,716	(288,042)	1,126,545
Other accounts receivable	975,622	0	0	975,622
Grant receivable	606,538	0	0	606,538
Materials and supplies	3,309,568	0	0	3,309,568
Prepayments	166,011	57,781	0	223,792
Due from affiliate	2,047,547	0	(2,047,547)	0
Refundable tax deposits	4,906	0	0	4,906
Other current assets	161,793	0	0	161,793
	<u>\$ 16,556,906</u>	<u>\$ 5,033,811</u>	<u>\$ (2,335,589)</u>	<u>\$ 19,255,128</u>
<u>NONCURRENT ASSETS</u>				
Investment in subsidiaries	\$ 7,068,230	\$ 0	\$ (7,068,230)	\$ 0
Other investments	1,013,280	19,986	0	1,033,266
Nonregulated investments	3,082,395	0	0	3,082,395
Deferred tax asset	0	26,266	0	26,266
Deposits	2,573	1,600	0	4,173
	<u>\$ 11,166,478</u>	<u>\$ 47,852</u>	<u>\$ (7,068,230)</u>	<u>\$ 4,146,100</u>
<u>PROPERTY, PLANT AND EQUIPMENT</u>				
Telecommunications plant in service	\$ 107,650,004	\$ 9,225,399	\$ 0	\$ 116,875,403
Telecommunications plant under construction	12,844,223	0	0	12,844,223
	<u>\$ 120,494,227</u>	<u>\$ 9,225,399</u>	<u>\$ 0</u>	<u>\$ 129,719,626</u>
Less accumulated depreciation	82,993,583	4,586,123	0	87,579,706
	<u>\$ 37,500,644</u>	<u>\$ 4,639,276</u>	<u>\$ 0</u>	<u>\$ 42,139,920</u>
	<u>\$ 65,224,028</u>	<u>\$ 9,720,939</u>	<u>\$ (9,403,819)</u>	<u>\$ 65,541,148</u>

CONSOLIDATING BALANCE SHEETS (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

December 31, 2013

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
<u>LIABILITIES AND MEMBERS' EQUITY</u>				
<u>CURRENT LIABILITIES</u>				
Accounts payable	\$ 4,494,377	\$ 209,010	\$ (106,005)	\$ 4,597,382
Advance billings and payments	745,709	18,951	0	764,660
Customer deposits	196	0	0	196
Current maturities on long-term debt	320,579	0	0	320,579
Accrued taxes	493,219	53,004	0	546,223
Accrued rent	791,629	0	0	791,629
Accrued salaries and wages	209,425	0	0	209,425
Accrued compensated absences	1,111,947	0	0	1,111,947
Accrued federal and state income taxes	0	27,363	0	27,363
Advance from related company	0	2,229,584	(2,229,584)	0
Other current liabilities	144,396	13,882	0	158,278
<b>TOTAL CURRENT LIABILITIES</b>	<b>\$ 8,311,477</b>	<b>\$ 2,551,794</b>	<b>\$ (2,335,589)</b>	<b>\$ 8,527,682</b>
<u>LONG-TERM DEBT</u>				
Rural Utilities Service	8,700,742	0	0	8,700,742
<u>OTHER LIABILITIES</u>				
Postretirement benefits other than pension	3,925,052	0	0	3,925,052
Deferred taxes	0	100,915	0	100,915
<b>TOTAL LIABILITIES</b>	<b>\$ 20,937,271</b>	<b>\$ 2,652,709</b>	<b>\$ (2,335,589)</b>	<b>\$ 21,254,391</b>
<u>MEMBERS' EQUITY</u>				
Memberships	\$ 225,027	\$ 0	\$ 0	\$ 225,027
Patronage capital	43,937,046	0	0	43,937,046
Accumulated other comprehensive loss	124,684	0	0	124,684
Capital stock	0	200,000	(200,000)	0
Paid-in capital	0	8,553,642	(8,553,642)	0
Retained earnings	0	(1,685,412)	1,685,412	0
<b>TOTAL MEMBERS' EQUITY</b>	<b>\$ 44,286,757</b>	<b>\$ 7,068,230</b>	<b>\$ (7,068,230)</b>	<b>\$ 44,286,757</b>
	<u><u>\$ 65,224,028</u></u>	<u><u>\$ 9,720,939</u></u>	<u><u>\$ (9,403,819)</u></u>	<u><u>\$ 65,541,148</u></u>

CONSOLIDATING STATEMENTS OF INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2013

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Operating revenues:				
Local network services revenue	\$ 6,770,867	\$ 0	\$ 0	\$ 6,770,867
Long distance services revenue	50,081	819,009	0	869,090
Network access services revenue	7,507,223	0	0	7,507,223
Broadband revenue	0	4,860,981	(4,860,981)	0
Video revenue	0	909,634	(909,634)	0
Miscellaneous revenues	3,832,109	116,502	(447,097)	3,501,514
Less uncollectible revenue	<u>(147,938)</u>	<u>(67,047)</u>	<u>0</u>	<u>(214,985)</u>
<b>TOTAL OPERATING REVENUES</b>	<b>\$ 18,012,342</b>	<b>\$ 6,639,079</b>	<b>\$ (6,217,712)</b>	<b>\$ 18,433,709</b>
Operating expenses:				
Plant specific operations expense	\$ 6,084,907	\$ 204,958	\$ (204,958)	\$ 6,084,907
Plant nonspecific operations expense	1,600,280	136,696	(136,696)	1,600,280
Provision for depreciation	3,981,507	996,553	0	4,978,060
Customer operations expense	2,052,428	3,340,155	(3,340,155)	2,052,428
Corporate operations expense	3,239,538	1,118,972	(1,118,972)	3,239,538
Operating taxes	<u>431,295</u>	<u>123,441</u>	<u>(123,441)</u>	<u>431,295</u>
<b>TOTAL OPERATING EXPENSES</b>	<b>\$ 17,389,955</b>	<b>\$ 5,920,775</b>	<b>\$ (4,924,222)</b>	<b>\$ 18,386,508</b>
<b>OPERATING INCOME</b>	<b>\$ 622,387</b>	<b>\$ 718,304</b>	<b>\$ (1,293,490)</b>	<b>\$ 47,201</b>
Other income (expense):				
Interest and dividend income	\$ 67,144	\$ 20,962	\$ 0	\$ 88,106
Nonregulated income	(669,446)	(663,327)	1,293,489	(39,284)
Gain from sale of equipment	0	15,556	0	15,556
Income from subsidiaries	91,494	0	(91,494)	0
Income from investment	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>TOTAL OTHER INCOME (EXPENSE)</b>	<b>\$ (510,808)</b>	<b>\$ (626,809)</b>	<b>\$ 1,201,995</b>	<b>\$ 64,378</b>



CONSOLIDATING STATEMENTS OF INCOME (CONT'D)

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2013

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Fixed charges:				
Interest on long-term debt	\$ 281,999	\$ 0	\$ 0	\$ 281,999
Interest charged to construction - credit	(280,148)	0	0	(280,148)
Interest on customer deposits	<u>51</u>	<u>0</u>	<u>0</u>	<u>51</u>
TOTAL FIXED CHARGES	<u>\$ 1,902</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 1,902</u>
INCOME BEFORE TAXES ON INCOME	\$ 109,677	\$ 91,495	\$ (91,495)	\$ 109,677
Taxes on income	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
NET INCOME	<u><u>\$ 109,677</u></u>	<u><u>\$ 91,495</u></u>	<u><u>\$ (91,495)</u></u>	<u><u>\$ 109,677</u></u>

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME

HIGHLAND TELEPHONE COOPERATIVE, INC. AND SUBSIDIARY

For the year ended December 31, 2013

	Highland Telephone Cooperative, Inc.	Highland Holdings, Inc.	Eliminations/ Reclassifications	Total
Net income	\$ 109,677	\$ 91,495	\$ (91,495)	\$ 109,677
Other comprehensive income:				
Unrealized gain on investment securities available for sale	160	0	0	160
Postretirement benefits other than pension:				
Unrecognized loss	<u>602,446</u>	<u>0</u>	<u>0</u>	<u>602,446</u>
COMPREHENSIVE INCOME	<u>\$ 712,283</u>	<u>\$ 91,495</u>	<u>\$ (91,495)</u>	<u>\$ 712,283</u>