WISCONSIN 1111-A39
SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

FINANCIAL STATEMENTS
WITH INDEPENDENT AUDITOR'S REPORT
Years ended December 31, 2013 and 2012

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

Contents

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Salem Telephone Company
Salem, Kentucky

Report on the Financial Statements

We have audited the accompanying balance sheets of Salem Telephone Company (a Kentucky corporation) as of December 31, 2013 and 2012, and the related statements of income and comprehensive income, retained earnings and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit 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 estimates made by management as well as evaluating the overall financial statement presentation.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Salem Telephone Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

In accordance with Government Auditing Standards, we have also issued a report dated April 15, 2014, on our consideration of Salem Telephone Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, 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 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 assessing the results of our audit.

Kiesling Associates LLP

Madison, Wisconsin
April 15, 2014

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

BALANCE SHEETS
December 31, 2013 and 2012

	2013	2012
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 66,396	$ 1,393,711
Special construction account - restricted	466,203	412,558
Accounts receivable		
Due from customers		
less allowance of $10,710 and $10,910, respectively	30,881	38,583
Due from RUS	1,167,058	106,713
Due from affiliates	10,742	36,570
Other, principally connecting companies		
less allowance of $5 and $2,911, respectively	117,073	127,003
Interest and dividends receivable	-	218
Materials and supplies	33,730	31,377
Deferred income taxes	4,812	5,377
	1,896,895	2,152,110
OTHER NONCURRENT ASSETS	22,301	10,225
PROPERTY, PLANT AND EQUIPMENT		
Telecommunications plant in service	6,638,816	6,516,351
Less accumulated depreciation	5,910,871	5,714,375
	727,945	801,976
Under construction	496,929	108,948
	1,224,874	910,924
TOTAL ASSETS	$ 3,144,070	$ 3,073,259

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

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

BALANCE SHEETS
December 31, 2013 and 2012

LIABILITIES AND STOCKHOLDER'S EQUITY	2013	2012
CURRENT LIABILITIES		
Accounts payable:		
Due to affiliates	$ 234,677	$ 135,884
Advanced billings and customer deposits	10,300	9,679
Other, principally connecting companies	160,222	137,557
Accrued taxes	40,006	16,491
Accrued compensation	4,341	6,263
Other current liabilities	50,465	40,641
	500,011	346,515
OTHER NONCURRENT LIABILITIES AND DEFERRED CREDITS		
Deferred income taxes	81,188	98,438
Other deferred credits	265,730	297,044
	346,918	395,482
STOCKHOLDER'S EQUITY		
Common stock	15,505	15,505
Accumulated other comprehensive income	14,199	8,696
Retained earnings	2,267,437	2,307,061
	2,297,141	2,331,262
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$ 3,144,070	$ 3,073,259

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

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
Years ended December 31, 2013 and 2012

	2013	2012
OPERATING REVENUES		
Local network services	$ 323,299	$ 320,041
Network access services	751,115	865,438
Nonregulated revenues	314,141	320,254
Miscellaneous revenue	95,703	94,283
Uncollectible, net of recoveries	(7,290)	(5,995)
	1,476,968	1,594,021
OPERATING EXPENSES		
Plant specific operations	380,393	372,073
Plant nonspecific operations	167,253	172,237
Cost of nonregulated services	325,926	311,742
Depreciation and amortization	244,451	260,683
Customer operations	161,426	175,121
Corporate operations	222,724	274,246
Other taxes	37,562	43,291
	1,539,735	1,609,393
OPERATING LOSS	(62,767)	(15,372)
OTHER INCOME (EXPENSE)		
Interest and dividend income	2,187	6,237
Other nonoperating income (deductions)	(635)	(436)
	1,552	5,801
LOSS BEFORE INCOME TAXES	(61,215)	(9,571)
INCOME TAXES (BENEFIT)	(21,591)	(3,581)
NET LOSS	(39,624)	(5,990)
OTHER COMPREHENSIVE INCOME:		
Other defined benefit plan (net of tax of $3,503 and $2,410, respectively)	5,503	3,775
TOTAL COMPREHENSIVE LOSS	$ (34,121)	$ (2,215)

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

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

STATEMENTS OF RETAINED EARNINGS
Years Ended December 31, 2013 and 2012

	2013	2012
Balance at beginning of year	$ 2,307,061	$ 2,313,051
Net loss	(39,624)	(5,990)
Balance at end of year	$ 2,267,437	$ 2,307,061

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

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

STATEMENTS OF CASH FLOWS
Years ended December 31, 2013 and 2012

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (39,624)	$ (5,990)
Adjustments to reconcile net loss		
to net cash provided by operating activities:		
Depreciation and amortization	244,451	260,683
Deferred income taxes	(20,188)	459
Changes in assets and liabilities:		
(Increase) Decrease in:		
Accounts receivable	43,460	11,862
Materials and supplies	(2,353)	3,181
Other	(2,852)	3,902
Increase (Decrease) in:		
Accounts payable	77,015	(134,213)
Accrued taxes	23,515	(14,038)
Accrued compensation	(1,922)	(190)
Other	(21,490)	6,854
Net cash provided by operating activities	300,012	132,510
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(1,669,309)	(416,560)
Proceeds from sale of temporary investments, net	-	245,000
Cost of removing plant, net of salvage	(4,501)	(724)
Proceeds from RUS grant	100,128	207,366
Net cash provided by (used in) investing activities	(1,573,682)	35,082
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in special construction account	(53,645)	(333,624)
Net cash used in financing activities	(53,645)	(333,624)
Net Decrease in Cash and Cash Equivalents	(1,327,315)	(166,032)
Cash and Cash Equivalents at Beginning of Year	1,393,711	1,559,743
Cash and Cash Equivalents at End of Year	$ 66,396	$ 1,393,711
SUPPLEMENTAL DISCLOSURES		
Cash paid for interest and income taxes were as follows:		
Interest	16	-
Income tax payments (refunds), net	(111,711)	9,551
Noncash investing and financing transactions:		
Telecommunications plant acquisition	(1,060,345)	(47,268)
Change in RUS grant receivable	1,060,345	47,268
Intercompany transfer of property and equipment	45,064	57,808
Change in accounts payable	(45,064)	(57,808)
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The accompanying notes are an integral part of these financial statements.

SALEM TELEPHONE COMPANY
SALEM, KENTUCKY

NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

Salem Telephone Company (herein referred to as "the Company") is a wholly owned subsidiary of TDS Telecommunications Corporation (TDS Telecom). TDS Telecom is a wholly owned subsidiary of Telephone and Data Systems, Inc. (TDS). The Company is a provider of local telephone service and access to long-distance service through its local exchange network. The principal market for these telecommunications services are local residential and business customers residing in the exchanges the Company serves, which are located in the state of Kentucky.

The accounting policies of the Company conform to accounting principles generally accepted in the United States of America. Management uses estimates and assumptions in preparing its financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Management has evaluated subsequent events through April 15, 2014, the date the financial statements were available for issue. Telephone operations reflect practices appropriate to the telephone industry. The accounting records of the telephone company are maintained in accordance with the Uniform System of Accounts for Class A and B Telephone Companies prescribed by the Federal Communications Commission (FCC) as modified by the state regulatory authority.

Cash Equivalents

All highly liquid investments with a maturity of three months or less at the time of purchase are considered cash equivalents. The carrying amount approximates fair value because of the short maturity of these instruments.

Accounts Receivable

Accounts receivable are reported net of an allowance for doubtful accounts. The allowance is based on management's estimate of the amount of receivables that will actually be collected.

Temporary Investments

Temporary investments are made up of certificates of deposit and are stated at cost.

Property, Plant and Equipment

Property, plant and equipment is capitalized at original cost including the capitalized cost of salaries and wages, materials, certain payroll taxes, employee benefits and interest incurred during the construction period.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property, Plant and Equipment (Continued)

The Company provides for depreciation for financial reporting purposes on the straight-line method by the application of rates based on the estimated service lives of the various classes of depreciable property as approved by the state regulatory authority. These estimates are subject to change in the near term.

Renewals and betterments of units of telephone property are charged to telephone plant in service. When telephone plant is retired, its cost is removed from the asset account and charged against accumulated depreciation less any salvage realized. No gains or losses are recognized in connection with routine retirements of depreciable telephone property. Repairs and renewals of minor items of telephone property are included in plant specific operations expense.

Repairs of nonregulated assets included in telecommunications plant in service; as well as renewals of minor items, are charged to plant specific operations expense. A gain or loss is recognized when nonregulated assets are sold or retired.

Asset Retirement Obligations

Generally accepted accounting principles require entities to record the fair value of a liability for legal obligations associated with an asset retirement in the period in which the obligations are incurred. When the liability is initially recorded, the entity capitalizes the cost of the asset retirement obligation by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset.

Long-Lived Assets

The Company would provide for impairment losses on long-lived assets when no longer cost of service regulated, indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. Based on current conditions, management does not believe any of its long-lived assets are impaired.

Income Taxes

For federal income taxes, the Company is included in the TDS consolidated federal income tax return. For state income taxes, the Company files a separate tax return. For financial reporting purposes, the Company computes its federal income tax using a statutory rate of 35%.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes (Continued)

Income taxes are accounted for using a liability method and provide for the tax effects of transactions reported in the financial statements including both taxes currently due and deferred. Deferred taxes are adjusted to reflect deferred tax consequences at current enacted tax rates. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred taxes arise from plant and equipment. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible, when the assets and liabilities are recovered or settled.

Revenue Recognition

The Company recognizes revenues when earned regardless of the period in which they are billed. The Company is required to provide telephone service to subscribers within its defined service territory.

Local network service and internet revenues are recognized over the period a subscriber is connected to the network.

Network access revenues are derived from charges for access to the Company's local exchange network. The interstate portion of access revenues is based on an average schedule company settlement formula through December 31, 2012 and on a cost separation procedure settlement formula for 2013 administered by the National Exchange Carrier Association (NECA) which is regulated by the FCC. The intrastate portion of access revenues are billed based on an individual company tariff access charge structure approved by the state regulatory authority. The tariffs developed from this structure are used to charge the connecting carrier and recognize revenues in the period the traffic is transported based on the minutes of traffic carried.

Reported network access revenues are estimates subject to settlement adjustments in the near term resulting from changes in expense and plant investment levels and rate of return experience.

The Company recognizes taxes charged to customers on a net basis.

Advertising Costs

Advertising costs are expensed as incurred.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value Measurements

The Company determines the fair value of its financial assets and liabilities based on the fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following three levels of inputs may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Reclassifications

Certain reclassifications have been made to the 2012 financial statements to conform with the 2013 presentation.

NOTE 2. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment includes the following:

	2013	2012
Telecommunications plant in service:		
General Support Assets	$ 634,012	$ 608,341
Central Office Switching	935,818	948,528
Software	509,718	465,233
Central Office Transmission	1,074,567	1,024,741
Outside Plant	3,462,339	3,447,146
Internet Equipment	22,362	22,362
Total property, plant and equipment	$ 6,638,816	$ 6,516,351

Depreciation on depreciable property resulted in composite rates of 3.72% and 4.05% for 2013 and 2012, respectively.

NOTE 3. INCOME TAXES

Income taxes reflected in the Statements of Income and Comprehensive Income consist of the following:

	2013	2012
Federal income taxes:		
Current tax benefit	$ (1,753)	$ (4,999)
Deferred tax expense (benefit)	(18,224)	1,227
State income taxes:		
Current tax expense	350	953
Deferred tax (benefit)	(1,964)	(762)
Total income tax benefit	$ (21,591)	$ (3,581)

Deferred federal and state tax liabilities and assets reflected in the Balance Sheets are summarized as follows:

	2013	2012
Deferred Tax Liabilities		
Federal	$ 92,309	$ 109,332
State	1,394	854
Total Deferred Tax Liabilities	93,703	110,186
Deferred Tax Assets		
Federal	4,379	6,141
State	12,948	10,984
Total Deferred Tax Assets	17,327	17,125
Net Deferred Tax Liabilities	$ 76,376	$ 93,061
Current Portion	$ (4,812)	$ (5,377)
Long-term Portion	81,188	98,438
Net Deferred Tax Liabilities	$ 76,376	$ 93,061

The tax provision differs from the expense that would result from applying the federal statutory rates to income before income taxes because of the effects of state income taxes.

The Company has evaluated its income tax positions and has determined that there are no uncertain income tax positions that need to be recorded or reported in the financial statements at December 31, 2013 and 2012.

The Company's state and federal income tax returns for years 2010 to present remain subject to examination.

NOTE 3. INCOME TAXES (Continued)

Accounts payable due to affiliates includes federal income taxes due to the parent of $87,297 at December 31, 2013. Accounts receivable other includes state income taxes of $2,750 at December 31, 2013. Accounts receivable due from affiliates includes federal income taxes due from the parent of $22,661 at December 31, 2012.

NOTE 4. EMPLOYEE BENEFIT PLANS

The Company is a member of the TDS Employees' Pension Trust I. This qualified, noncontributory defined contribution pension plan covers substantially all Company employees. Under this plan, pension benefits and costs are calculated separately for each participant and are funded currently. Pension expense for the plan was $2,954 and $2,938 in 2013 and 2012, respectively.

The Company participates in two defined benefit postretirement plans of TDS. One plan provides medical benefits and the other provides life insurance benefits. Under the plans, postretirement benefits and costs are calculated for the plans and allocated to each participant. Amounts allocated to the Company and charged to postretirement benefits expense (benefit) were $(3,170) and $2,876 in 2013 and 2012, respectively. The Company had no cash contributions to the plans in 2013 or 2012. At December 31, 2013 and 2012, the Company's liability for postretirement benefit was $(938) and $(4,108), respectively. The liability is included in other noncurrent assets for 2013 and 2012.

At December 31, 2013 and 2012, the Company recorded an additional asset for its share of the funded status of the postretirement benefits in the amounts of $9,006 and $6,185, respectively. The corresponding offset (net of its tax effect) was an increase to accumulated other comprehensive income in stockholder's equity in the amount of $5,503 and $3,775 at December 31, 2013 and 2012, respectively.

NOTE 5. RELATED PARTIES

Services provided to the Company by TDS Telecom or any of its subsidiaries are charged to the Company primarily based on the Company's access lines relative to the total access lines of all affiliates receiving the benefit of the respective services. These services include centralized management, accounting, commercial, engineering and data processing services aggregating $774,934 and $780,356 in 2013 and 2012, respectively.

A portion of cash and cash equivalents consists of investments in the TDS short-term investment fund (STIF) money market account. The balance in this fund was $60,167 and $405,427 at December 31, 2013 and 2012, respectively.

The STIF account is comprised of the following investments at December 31:

	2013	2012
Money Market Accounts	100 %	95 %
U.S. Treasury Securities	- %	5 %
Total	100 %	100 %

NOTE 6. OPERATING LEASE

The company rents poles, storage space and other items under year-to-year leases. Total rental expense under all leases was $24,585 and $24,256 in 2013 and 2012, respectively.

NOTE 7. CONCENTRATIONS OF CREDIT RISK

The Company grants credit to customers, all of whom are located in the franchised service area, and telecommunications intrastate and interstate long distance carriers and receives revenues from access charges and assistance provided by State and Federal Universal Service Funds.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash equivalents.

The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

NOTE 8. ASSET RETIREMENT OBLIGATIONS

While the Company has determined it has no material asset retirement obligations, it has included in its depreciation rates estimated net removal costs associated with outside plant assets in which estimated cost of removal exceeds gross salvage. These costs have been reflected in the calculation of depreciation expense, which results in greater periodic depreciation expense and the recognition in accumulated depreciation of future removal costs for existing assets. When the assets are actually retired and removal costs are expended, the net removal costs are recorded as a reduction to accumulated depreciation. The Company has determined the accumulated removal cost included in accumulated depreciation is not material to the financial statements.

NOTE 9. REGULATORY ACCOUNTING

For its telephone operations, the Company follows generally accepted accounting principles for regulated enterprises. Accordingly, the Company defers certain cost and obligations and depreciates plant and equipment over lives approved by regulators. While the Company continues to believe the current regulatory and competitive environment supports this accounting treatment, should conditions change the Company would be required to write-off these deferred cost and obligations and evaluate the net carrying value of its plant and equipment for any impairment losses absent the future recovery currently permitted by the regulators.

NOTE 10. BROADBAND INITIATIVES PROGRAM GRANT

In 2010, the Company signed an agreement with the United States Department of Agriculture Rural Utilities Service (RUS) under its Broadband Initiatives Program. In accordance with the Agreement, the Company shall receive grants in the amount of $1,934,474 over a maximum five-year period to finance the construction of a broadband infrastructure project (Project) to serve certain designated areas in Kentucky. The Company recognizes grants receivable when grant approved project costs have been incurred.

Under the grant, the RUS retains a security interest in the property and, accordingly, must provide consent for the sale of the property to a third party or affiliate. In addition, the agreement contains other provisions including an obligation to provide broadband services for the term of the agreement and the composite economic life (21 years) of the facilities financed by the grant; a requirement to achieve a minimum current ratio of one beginning in 2015; and certain restrictions on distributions to stockholders or members and, investment in, or loans to others. The Company is restricted from making any distributions, except as might be specifically authorized in writing in advance by the RUS, unless 75% of the Grant funds have been expended as approved and if after such Distribution, the Grantee's Net Worth is equal to at least twenty percent (20%) of its Total Assets and the amount of all such Distributions during the calendar year does not exceed twenty-five percent (25%) of the Grantee's Net Income or Net Margins for the prior calendar year. Further, Grant funds expended with an affiliate, or other specified related parties, are limited to an amount which is the lower of cost or market rate and the transactions, contracts, or dealings must have received the prior written consent of RUS.

At December 31, 2013, the Company has received funds in the amount of $313,853 related to the Project. Additional costs incurred of $1,167,058 are reflected in accounts receivable with a $1,167,058 reduction in plant under construction or in service at December 31, 2013.

NOTE 11. REGULATORY MATTERS

The Company received 51% of its 2013 revenues from access revenues and assistance provided by the Federal Universal Service Fund (USF). As a result of the National Broadband Plan the manner in which access revenues and Universal Service Funds are determined has been modified by the Federal Communications Commission in an order effective December 29, 2011. Among other things, this order provides for (1) a requirement to provide broadband services; (2) the establishment of a Connect America Fund (CAF) to replace current USF and high cost support mechanisms with a cap on the total fund; (3) modifications to the current rate of return support model including caps on the recovery of certain expenditures; (4) a reduction in the terminating access charges billed by the Company over a nine year period with eventual transition to a bill-and-keep framework for the exchange of traffic between carriers; (5) a new access recovery charge on monthly customer bills; and (6) a national framework for reporting and oversight.

NOTE 11. REGULATORY MATTERS (Continued)

The order calls for further guidelines to be adopted on implementation and other topics. Portions of this order applicable to the Company are being challenged. Accordingly, neither the outcome of these proceedings nor their potential impact on the Company can be predicted at this time.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF THE FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Board of Directors
Salem Telephone Company
Salem, Kentucky

We have audited the accompanying financial statements of Salem Telephone Company as of and for the year ended December 31, 2013, and have issued our report thereon dated April 15, 2014. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

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 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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or 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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Salem Telephone Company's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance 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 our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity'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 entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Kiesling Associates LLP

Madison, Wisconsin
April 15, 2014

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH ASPECTS OF CONTRACTUAL AGREEMENTS AND REGULATORY REQUIREMENTS FOR TELECOMMUNICATIONS BORROWERS AND GRANT RECIPIENTS

To the Board of Directors
Salem Telephone Company
Salem, Kentucky

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, the financial statements of Salem Telephone Company, which comprise the balance sheet as of December 31, 2013, and the related statements of income and comprehensive income, retained earnings and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 15, 2014. In accordance with Government Auditing Standards, we have also issued our report dated April 15, 2014, on our consideration of Salem Telephone Company's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above related to our audit have been furnished to management.

In connection with our audit, nothing came to our attention that caused us to believe that Salem Telephone Company 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 the clarified RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding Salem Telephone Company's noncompliance with the above-referenced terms, covenants, provisions or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with our audit, we noted no matters regarding Salem Telephone Company's accounting and records to indicate that Salem Telephone Company 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 the approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material or scrap;

- Maintain adequate control over materials and supplies;

- Prepare accurate and timely Financial and Operating Reports;

- Obtain written approval to enter into any contract for the management, operation, or maintenance of the grantee's system if the contract covers substantially all of the telecommunications system;

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

- Record depreciation in accordance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures);

This report is intended solely for the information and use of the board of directors and management of the Company and the Rural Development Utilities Program 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 distribution is not limited.

Kiesling Associates LLP

Madison, Wisconsin
April 15, 2014