Kentucky 506

Mountain Rural Telephone Cooperative and Subsidiary

West Liberty, Kentucky

Audited Financial Statements
December 31, 2016 and 2015

Alan M. Zumstein
Certified Public Accountant
1032 Chetford Drive
Lexington, Kentucky 40509

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ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
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Independent Auditor's Report

To the Board of Directors
Mountain Rural Telephone Cooperative

I have audited the accompanying consolidated financial statements of Mountain 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 $27,309,135 and $23,841,505 at December 31, 2016 and 2015 respectively, and the equity in its net margins was $12,897,323 and $5,736,380 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

To the Board of Directors
Mountain Rural Telephone Cooperative

of 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 February 17, 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
February 17, 2017

Mountain Rural Telephone Cooperative Corporation and Subsidiary
Consolidated Balance Sheets, December 31, 2016 and 2015

	2016	2015
Assets		
Current Assets:		
Cash and cash equivalents	$ 22,197,118	$ 16,926,818
Accounts receivable, less allowance for 2016 of $116,343 and 2015 of $99,792	613,198	1,346,319
Materials and supplies, at average cost	1,083,395	933,964
Prepaid insurance	37,232	13,049
	23,930,943	19,220,150
Other Assets:		
Investment securities	12,500,000	12,000,000
Associated organizations	27,309,135	23,841,505
Pension plan prefunding	2,326,221	-
Accumulated postretirement benefits	49,478	-
Nonregulated property	3,029,183	3,126,956
	45,214,017	38,968,461
Telecommunications Plant, at original cost:		
In service	123,512,012	119,795,053
Under construction	4,245,514	3,885,006
	127,757,526	123,680,059
Less accumulated depreciation	66,989,073	60,678,826
	60,768,453	63,001,233
Total	$ 129,913,413	$ 121,189,844
Liabilities and Members' Equities		
Current Liabilities:		
Accounts payable	$ 1,911,458	$ 1,876,536
Current portion of long term debt	975,000	952,000
Customer deposits	185,069	148,409
Other current and accrued liabilities	2,971,749	3,170,963
	6,043,276	6,147,908
Long Term Debt	18,922,666	19,898,140
Accrued Postretirement Benefits	-	65,081
Members' Equities:		
Memberships and capital investment	132,714	130,661
Patronage capital	107,495,435	97,849,592
Donated capital	1,323,768	1,323,768
Accumulated other comprehensive income	(4,004,446)	(4,225,306)
	104,947,471	95,078,715
Total	$ 129,913,413	$ 121,189,844

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

Mountain Rural Telephone Cooperative Corporation and Subsidiary
Consolidated Statements of Revenue and Comprehensive Income
for the years ended December 31, 2016 and 2015

	2016	2015
Operating Revenue:		
Local network services	$ 4,842,350	$ 4,342,000
Network access services	14,039,818	14,098,768
Carrier billing and collection	287,736	621,898
Miscellaneous	653,615	552,081
Less provision for uncollectibles	(12,000)	(7,864)
	19,811,519	19,606,883
Operating Expenses:		
Plant specific operations	3,003,459	2,991,340
Plant nonspecific operations	1,589,085	1,623,063
Depreciation	6,790,969	6,717,557
Customer operations	1,459,088	1,477,869
Corporate operations	2,006,644	2,338,968
Other deductions	126,001	256,316
Taxes, other than income	1,382,436	1,416,420
	16,357,682	16,821,533
Operating margins	3,453,837	2,785,350
Nonoperating Margins		
Other income, principally interest	479,718	911,020
Income from limited liability company	12,897,323	5,736,380
Less related income taxes	(6,300,248)	(1,650,279)
Non regulated net income	1,707,467	2,167,405
	8,784,260	7,164,526
Margins available for fixed charges	12,238,097	11,600,155
Fixed Charges:		
Interest on long-term debt	537,110	1,006,946
Net margins	11,700,987	8,942,930
Items of comprehensive income:		
Accumulated postretirement benefits	220,860	220,860
Comprehensive Income	$ 11,921,847	$ 9,163,790

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

Statements of Changes in Members' Equity
for the years ended December 31, 2015 and 2016

	Memberships	Patronage Capital	Other Equity	Accumulated Other Comprehensive Income	Total Members' Equity
Balance-December 31, 2014	$ 129,527	$ 90,701,940	$ 1,322,439	$ (4,446,166)	$ 87,707,740
Comprehensive income:					
Net margins		8,942,930			8,942,930
Postretirement benefit obligation					
Amortization				220,860	
Adjustments				-	220,860
Total comprehensive income					9,163,790
Refunds of capital credits		(1,795,278)			(1,795,278)
Memberships issued, net	1,134				1,134
Other equities			1,329		1,329
Balance-December 31, 2015	130,661	97,849,592	1,323,768	(4,225,306)	95,078,715
Comprehensive income:					
Net margins		11,700,987			11,700,987
Postretirement benefit obligation					
Amortization				220,860	
Adjustments				-	220,860
Total comprehensive income					11,921,847
Refunds of capital credits		(2,055,144)			(2,055,144)
Memberships issued, net	2,053				2,053
Other equities			-		-
Balance-December 31, 2016	$ 132,714	$ 107,495,435	$ 1,323,768	$ (4,004,446)	$ 104,947,471

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

Mountain Rural Telephone Cooperative Corporation 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	$ 11,700,987	$ 8,942,930
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation	6,790,969	6,717,557
Net loss (profit) in limited liability company	(12,897,323)	(5,736,380)
Accumulated postretirement benefits	106,301	100,588
Net change in current assets and liabilities:		
Receivables	235,913	43,787
Material and supplies	(149,431)	(31,931)
Prepayments	(24,183)	(11,119)
Payables	532,131	638,356
Advance billings	36,660	37,982
Accrued expenses	(199,214)	453,541
	6,132,810	11,155,311
Cash Flows from Investing Activities:		
Construction of plant	(4,453,054)	(1,162,169)
Salvage, net of removals	(105,136)	3,395
Purchase investment securities	(500,000)	(1,500,000)
Associated organizations	9,429,693	2,759,169
Nonregulated property	97,773	(112,273)
	4,469,276	(11,878)
Cash Flows from Financing Activities:		
Advances of long term debt	-	1,384,614
Payments on long term debt	(952,474)	(17,079,279)
Prefund pension plan	(2,326,221)	-
Memberships and capital investments	2,053	1,134
Retirements of capital credits	(2,055,144)	(1,795,278)
Increase in donated capital	-	1,329
	(5,331,786)	(17,487,480)
Net increase in cash balances	5,270,300	(6,344,047)
Cash and cash equivalents - beginning of period	16,926,818	23,270,865
Cash and cash equivalents - end of period	$ 22,197,118	$ 16,926,818
Supplemental disclosures of cash flows information:		
Interest on long-term debt	$ 537,110	$ 1,016,249
Income taxes paid	6,300,248	1,650,279

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

Note 1. Summary of Significant Accounting Policies

Mountain 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, Mountain Telecommunications, Inc. (Mountain Telecommunications). All significant inter-company accounts and transactions have been eliminated. During 2010 Mountain Telecommunications purchased the assets of the cable television company that operated in parts of the same service territory as the Cooperative.

Nature of Business The Cooperative has substantially completed construction to launch an expanded services network. This network will establish 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 will also be able to provide high speed internet and virtual private networks. It will be able to provide voice over internet protocol (VoIP) in the future. This is accomplished through Fiber to the Home (FTTH) technology.

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 respective financial institution.

Telecommunications Revenue Recognition Revenues are recognized when earned regardless of the period in which they are billed. Bills are sent to customers on credit the first of each month with local service being billed a month in advance of service. Sales are concentrated in a portion of five (5) southeastern Kentucky counties. Payments are due 10 days from the date of billing. If payment has not been made, then customers are subject to disconnect on the 21st day of the month. 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 13,536 at 2016 and 14,408 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 Video revenue is recognized when earned regardless of the period in which they are billed. Programming transmission is purchased from networks at various amounts based on the number of customers receiving the service.

Taxes The Cooperative's policy is to exclude sales tax from revenue when collected and expenses when paid and instead, record collection and payment of sales 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, investments (except investment securities), trade accounts payable, accrued expenses, and other 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 cannot 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 invests idle funds with local banks in money markets, certificates of deposits, and U.S. Treasury Notes. 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.

Advertising Advertising costs are expensed as incurred.

Telecommunications Plant Telecommunications plant is 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 $122,156 for 2016 and $214,312 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
Telecommunications Plant:		
General support	$16,012,871	$15,638,537
Central office switching	1,360,245	1,346,068
Central office transmission	22,708,525	22,187,295
Cable and wire facilities	83,424,937	80,617,719
Intangibles	2,434	2,434
	123,509,012	119,792,053
Telecom Plant:		
General support	3,000	3,000
Total	$123,512,012	$119,795,053

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

	Telephone
General support	2.7%-15.8%
Central office switching	7.5%
Central office transmission	10.0%
Cable and wire facilities	5.1%-9.4%

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. Mountain Telecommunications is a “C” corporation that pays income taxes on its net income.

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.

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.

Subsequent Events Management has evaluated subsequent events through February 17, 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 and U.S. Treasury Notes in local banks.

Note 3. Associated Organizations

The amounts for East Kentucky Network, LLC ("EKN") represents Mountain Telecommunications' investment in a limited liability corporation with other telephone companies in eastern Kentucky for the purpose of providing cellular telephone, paging, and other services. The investment is accounted for using the equity method since Mountain Telecommunications is a one-fifth owner. EKN has been paying approximately 50% of the income allocated in cash during the following year.

Note 4. 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 Mountain Telephone Long Distance ("MTLD"). MTLD revenues are billed and collected through the Cooperative. A monthly fee is recorded based on telephone usage. MTLD 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 nonregulated activities:

	Income	Expenses	Net
Customer premises equipment	$1,125,766	$2,000,839	($875,073)
Internet activities	3,685,127	1,193,613	2,491,514
Long distance services	629,000	495,565	133,435
Video services	1,932,259	1,924,018	8,241
Security	25,240	75,890	(50,650)
Total - 2016	$7,397,392	$5,689,925	$1,707,467

	Income	Expenses	Net
Customer premises equipment	$842,650	$1,716,126	($873,476)
Internet activities	3,622,225	1,058,062	2,564,163
Long distance services	792,811	336,323	456,488
Video services	1,456,510	1,436,280	20,230
Total - 2015	$6,714,196	$4,546,791	$2,167,405

Note 5. Long Term Debt

All telecommunications assets, except motor vehicles, are pledged as collateral on the long term debt due U.S. Department of Agriculture, Rural Development ("USDA"). The debt was incurred for the FSN project as described earlier and is due in monthly installments of varying amounts.

Long term debt is as follows:

	2016	2015
RUS Broadband Loan 2.27%-3.53%	19,897,666	20,850,140
Less current portion	975,000	952,000
Long term portion	$18,922,666	$19,898,140

Principal payments for the next five years are as follows: 2017 - $975,000; 2018 - $980,000; 2019 - $1,000,000; 2020 - $1,020,000; 2021 - $1,030,000.

Note 6. 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 81%.Patronage capital consisted of:

	2016	2015
Assigned	$96,899,290	$92,791,128
Assignable	11,700,987	8,942,930
Unassigned	35,978,703	31,143,935
Retirements to date	(37,083,545)	(35,028,401)
Total	$107,495,435	$97,849,592

Note 7. Pension Plan

All eligible non-union employees of the Cooperative participate in the National Telephone Cooperative Association (NTCA) Pension 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 Corporation'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 Corporation made contributions to the plan of $476,275 in 2016 and $447,822 in 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 over 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 7. 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 $2,326,221. This amount will be amortized over the 12 year period the surcharge is expected to continue.

Note 7. Pension Plan, continued

Employees hired after January 1, 2015 are considered Schedule 2 employees. Contributions rates after the increase in 2017 are as follows:

	2017	2016
Schedule 1 Employees		
Employer contributions	10.70%	8.30%
Employee contributions	4.00%	4.00%
Rule of 85 charges	5.50%	5.50%
Schedule 2 Employees		
Employer contributions	8.70%	6.20%
Employee contributions	6.00%	6.00%
Rule of 85 charges	5.50%	5.50%

Note 8. Accumulated Postretirement Benefits

The Cooperative sponsors a defined benefit plan that provides medical insurance coverage to retirees and their dependents. 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.

The funded status of the plan was as follows:

	2016	2015
Projected benefit obligation	($16,526,937)	($15,271,188)
Plan assets at fair value	16,576,415	15,206,107
Funded status	$49,478	($65,081)

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

	2016	2015
Benefit obligation at beginning of year	$65,081	$185,353
Components of net periodic benefit cost:		
Service cost	602,077	355,551
Interest cost	796,190	738,594
Expected return on assets	(1,064,427)	(760,305)
Net periodic benefit cost	333,840	333,840
Benefits paid from general funds	(448,399)	(454,112)
Contributions to plan	-	-
Adjust comprehensive income	-	-
Benefit obligation (asset) at end of year	($49,478)	$65,081
Change in plan assets:		
Fair value of plan assets-beginning of year	$15,206,107	$14,087,217
Employer contributions	-	-
Change in fair value of plan assets	1,370,308	1,118,890
Benefits paid from plan	-	-
Fair value of plan assets-end of year	$16,576,415	$15,206,107

Note 8. Accumulated Postretirement Benefits, continued

Amounts recognized in the balance sheet consists of:		
Noncurrent assets (liabilities)	$49,478	($65,081)
Amounts included in other comprehensive income:		
Unrecognized actuarial gain (loss)	($4,004,446)	($4,225,306)
Effect of 1% increase in the health care trend:		
Projected benefit obligation	$17,790,000	
Net periodic benefit cost	360,000	

For measurement purposes, an 8% annual rate of increase, decreasing by 0.5% per year until 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 5.0% for 2016 and 2015.

The projected retiree benefit payments are expected to be as follows: 2017 - $440,000; 2018 - $445,000; 2019 – $425,000; 2020 - $420,000; 2021 - $365,000.

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.

Note 10. Contingencies

The Cooperative, occasionally, is involved in litigation arising in the normal course of business. While the results of such litigation cannot be predicted with certainty, management, based upon advice of counsel, believes that the final outcome will not have a material adverse effect on the financial statements.

* * * * * *

Mountain Rural Telephone Cooperative Corporation and Subsidiary
Consolidating Balance Sheet, December 31, 2016

	Telephone	Telecom	Eliminations	Consolidated
Assets				
Current Assets:				
Cash and cash equivalents	$ 15,053,879	$ 7,143,239		$ 22,197,118
Accounts receivable, less allowance for Telephone of $116,343	619,749		(6,551)	613,198
Material and supplies, at average cost	1,083,395			1,083,395
Prepayments	37,232			37,232
	16,794,255	7,143,239	(6,551)	23,930,943
Other Assets:				
Investment securities	12,500,000			12,500,000
Associated organizations	34,448,608	27,309,135	(34,448,608)	27,309,135
Pension plan prefunding	2,326,221			2,326,221
Accumulated postretirement benefits	49,478			49,478
Nonregulated and others	3,029,183			3,029,183
	52,353,490	27,309,135	(34,448,608)	45,214,017
Utility Plant, at original cost:				
In service	123,509,012	3,000		123,512,012
Under construction	4,245,514			4,245,514
	127,754,526	3,000		127,757,526
Less accumulated depreciation	66,988,858	215		66,989,073
	60,765,668	2,785		60,768,453
Total	$129,913,413	$34,455,159	($34,455,159)	$129,913,413
Member's Equities and Liabilities				
Current Liabilities:				
Accounts payable	$ 1,911,458	$ 6,551	$ (6,551)	$ 1,911,458
Current portion of long term debt	975,000			975,000
Customer deposits	185,069			185,069
Accrued expenses	2,971,749			2,971,749
	6,043,276	6,551	(6,551)	6,043,276
Long Term Debt	18,922,666			18,922,666
Accumulated Postretirement Benefits	-			-
Members' Equities:				
Memberships and capital investments	132,714	4,780,000	(4,780,000)	132,714
Patronage capital and retained earnings	107,495,435	29,668,608	(29,668,608)	107,495,435
Donated capital	1,323,768			1,323,768
Accumulated comprehensive income	(4,004,446)			(4,004,446)
	104,947,471	34,448,608	(34,448,608)	104,947,471
Total	$129,913,413	$34,455,159	($34,455,159)	$129,913,413

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

Mountain Rural Telephone Cooperative Corporation and Subsidiary
Consolidating Statement of Revenue and Comprehensive Income
for the year ended December 31, 2016

	Telephone	Telecom	Eliminations	Consolidated
Operating Revenues:				
Local network services	$ 4,842,350			$ 4,842,350
Network access services	14,039,818			14,039,818
Carrier billing and collection	287,736			287,736
Miscellaneous	653,313	302		653,615
Less provision for uncollectibles	(12,000)			(12,000)
	19,811,217	302		19,811,519
Operating Expenses:				
Plant specific operations	3,003,459			3,003,459
Plant non specific operations	1,589,085			1,589,085
Depreciation	6,790,916	53		6,790,969
Customer operations	1,459,088			1,459,088
Corporate operations	1,994,553	12,091		2,006,644
Other deductions	126,001			126,001
Taxes, other than income	1,382,299	137		1,382,436
	16,345,401	12,281		16,357,682
	3,465,816	(11,979)		3,453,837
Nonoperating Margins:				
Other income, principally interest	470,914	8,804		479,718
Income in limited liability company	6,593,900	12,897,323	(6,593,900)	12,897,323
Less related income taxes		(6,300,248)		(6,300,248)
Nonregulated net income and other	1,707,467	-		1,707,467
	8,772,281	6,605,879	(6,593,900)	8,784,260
Margins available for interest charges	12,238,097	6,593,900	(6,593,900)	12,238,097
Interest Charges:				
Long term debt	537,110			537,110
Net Margins	11,700,987	6,593,900	(6,593,900)	11,700,987
Other Comprehensive Income:				
Accumulated postretirement benefits	220,860			220,860
Net Comprehensive Income	$11,921,847	$6,593,900	($6,593,900)	$11,921,847

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

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
- AMERICAN INSTITUTE OF CPA'S
- KENTUCKY SOCIETY OF CPA'S
- INDIANA SOCIETY OF CPA'S
- AICPA DIVISION FOR FIRMS

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
Mountain Rural Telephone Cooperative

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 Mountain Rural Telephone 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 February 17, 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 Mountain Rural Telephone'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 Mountain Rural Telephone'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 Mountain Rural Telephone's internal control. Accordingly, we do not express an opinion on the effectiveness of Mountain Rural Telephone'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
Mountain Rural Telephone Cooperative

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Mountain Telephone'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
February 17, 2017

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
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Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Telephone Borrowers

Board of Directors
Mountain Rural Telephone Cooperative

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 Mountain Rural Telephone Cooperative ("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 February 17, 2017. In accordance with *Government Auditing Standards*, we have also issued my report dated February 17, 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 and my schedule of findings and recommendations (of which there were none) 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;

Board of Directors
Mountain Rural Telephone Cooperative

- 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.

Mountain Telephone formed a wholly-owned subsidiary, Mountain Telecommunications, Inc., which provides cable television services in Mountain Telephone's service territory 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 $830,000. The investment is comprised of the following:

	Investment	Profits
Beginning of year	$4,780,000	$23,074,708
Activity for 2016	-	6,593,900
End of year	$4,780,000	$29,668,608

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
February 17, 2017