# Pend Oreille Telephone Company

## Financial Statements with RUS Letters

*Years Ended December 31, 2012 and 2011*

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CPAs AND BUSINESS CONSULTANTS

**PEND OREILLE TELEPHONE COMPANY**

**Financial Statements with RUS Letters**

Years Ended December 31, 2012 and 2011

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# INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Pend Oreille Telephone Company
Glenns Ferry, Idaho

We have audited the accompanying financial statements of Pend Oreille Telephone Company (the Company) which comprise the balance sheet as of December 31, 2012, and the related statements of operations, changes in stockholders' equity, and cash flows for the year 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 audit. 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

## OPINION

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

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**OTHER REPORTING REQUIRED BY *GOVERNMENT AUDITING STANDARDS***

In accordance with *Government Auditing Standards*, we have also issued a report dated 5/3/2013, on our consideration of Pend Oreille Telephone Company'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 audit.

**OTHER MATTERS**

The financial statements of Pend Oreille Telephone Company as of December 31, 2011, were audited by other auditors whose report dated April 26, 2012 expressed an unmodified opinion on those statements.

*AKT LLP*

Salem, Oregon
5/3/2013

## PEND OREILLE TELEPHONE COMPANY

**Balance Sheets**

December 31, 2012 and 2011

| **ASSETS** | 2012 | 2011 |
|---|---|---|
| Current Assets: | | |
| Cash and cash equivalents | $ 508,612 | $ 79,722 |
| Marketable securities | - | 45,897 |
| Accounts receivable, net of allowance for doubtful accounts of zero | 120,966 | 134,143 |
| Other accounts receivable, net of allowance for doubtful accounts of $90,000 in 2012 and 2011 | 164,770 | 165,271 |
| Materials and supplies | 230,312 | 215,870 |
| Total Current Assets | 1,024,660 | 640,903 |
| Other Assets: | | |
| Marketable securities | 22,674 | - |
| Related party receivables | 231,916 | 332,340 |
| Investments | 392,288 | 435,180 |
| Total Other Assets | 646,878 | 767,520 |
| Property, Plant, and Equipment: | | |
| In service | 16,197,416 | 15,137,949 |
| Under construction | 379,988 | 859,056 |
| Property held for future use | 1,250 | 1,250 |
| | 16,578,654 | 15,998,255 |
| Less accumulated depreciation | 13,697,578 | 13,448,593 |
| | 2,881,076 | 2,549,662 |
| Acquisition adjustment, net | - | 34,125 |
| Property, Plant, and Equipment, net | 2,881,076 | 2,583,787 |
| | $ 4,552,614 | $ 3,992,210 |

See accompanying notes to financial statements.

| LIABILITIES AND STOCKHOLDER'S EQUITY | 2012 | 2011 |
|---|---|---|
| Current Liabilities: | | |
| Current portion of long-term debt | $ - | $ 468,300 |
| Accounts payable | 473,799 | 115,768 |
| Accrued expenses | 125,784 | 134,983 |
| Customer deposits | 4,050 | 4,240 |
| Total Current Liabilities | 603,633 | 723,291 |
| Long-Term Liabilities: | | |
| Related party payables | 389,587 | 260 |
| Long-term debt | 1,390,360 | 1,086,045 |
| Total Long-Term Liabilities | 1,779,947 | 1,086,305 |
| Stockholder's Equity: | | |
| Common stock, authorized 25,000 shares, no par value, issued and outstanding 5,000 shares | 2,666,346 | 2,666,346 |
| Accumulated deficit | (497,312) | (483,732) |
| Total Stockholder's Equity | 2,169,034 | 2,182,614 |
| | $ 4,552,614 | $ 3,992,210 |

See accompanying notes to financial statements.

## PEND OREILLE TELEPHONE COMPANY

**Statements of Operations**

Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| Operating Revenues: | | |
| Local network | $ 407,265 | $ 427,730 |
| Network access | 1,426,806 | 1,559,338 |
| Internet services | 424,462 | 412,085 |
| Miscellaneous | 23,318 | 31,657 |
| Uncollectible | (2,594) | (49,272) |
| Total Operating Revenues | 2,279,257 | 2,381,538 |
| Operating Expenses: | | |
| Plant specific | 544,987 | 645,291 |
| Plant nonspecific | 178,982 | 191,436 |
| Customer | 173,112 | 189,807 |
| Corporate | 765,805 | 772,791 |
| Depreciation and amortization | 283,108 | 399,602 |
| Cost of internet services | 350,295 | 363,480 |
| Other operating taxes | 36,488 | 46,421 |
| Total Operating Expenses | 2,332,777 | 2,608,828 |
| Operating Loss | (53,520) | (227,290) |
| Other Income: | | |
| Investment income, net | 9,663 | 31,924 |
| Other nonregulated services | 22,537 | 19,946 |
| Other income, net | 84,048 | 8,239 |
| Total Other Income | 116,248 | 60,109 |
| Income (Loss) Available for Fixed Charges | 62,728 | (167,181) |
| Fixed charges - interest on long-term debt | 76,308 | 45,858 |
| Net loss | $ (13,580) | $ (213,039) |

See accompanying notes to financial statements.

## PEND OREILLE TELEPHONE COMPANY

**Statements of Changes in Stockholders' Equity**

Years Ended December 31, 2012 and 2011

| | Common Stock | Accumulated Deficit | Total Stockholder's Equity |
|---|---|---|---|
| Balance, December 31, 2010 | $ 2,666,346 | (270,693) | 2,395,653 |
| Net Loss | - | (213,039) | (213,039) |
| Balance, December 31, 2011 | 2,666,346 | (483,732) | 2,182,614 |
| Net Loss | - | (13,580) | (13,580) |
| Balance, December 31, 2012 | $ 2,666,346 | (497,312) | 2,169,034 |

See accompanying notes to financial statements.

**PEND OREILLE TELEPHONE COMPANY**

**Statements of Cash Flows**

Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| Cash Flows from Operating Activities: | | |
| Net income (loss) | $ (13,580) | $ (213,039) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 283,108 | 399,602 |
| Noncash patronage | - | (18,603) |
| Allowance for funds used during construction | (22,406) | (6,949) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 13,177 | (5,507) |
| Accounts receivable, other | 501 | 47,558 |
| Materials and supplies | (14,442) | 8,754 |
| Accounts payable | 358,031 | 19,182 |
| Customer deposits | (190) | (690) |
| Accrued expenses | (9,199) | (29,138) |
| Related party receivables and payables, net | 489,751 | 5,128 |
| Net Cash Provided by Operating Activities | 1,084,751 | 206,298 |
| Cash Flows from Investing Activities: | | |
| Capital expenditures | (557,991) | (803,753) |
| Purchase of investments and marketable securities | (21,935) | - |
| Proceeds from investments and sales of marketable securities | 88,050 | 55,917 |
| Net Cash Used by Investing Activities | (491,876) | (747,836) |
| Cash Flows from Financing Activities: | | |
| Payments on long-term debt | (468,345) | (597,554) |
| Proceeds from long-term debt | 304,360 | 1,086,000 |
| Net Cash Provided (Used) by Financing Activities | (163,985) | 488,446 |
| Net Change in Cash and Cash Equivalents | 428,890 | (53,092) |
| Cash and Cash Equivalents, beginning | 79,722 | 132,814 |
| Cash and Cash Equivalents, ending | $ 508,612 | 79,722 |
| Cash Paid During the Year for Interest, Net of Amount Capitalized | $ 53,902 | $ 38,909 |

See accompanying notes to financial statements.

## Note 1 - Summary of Significant Accounting Policies

Organization

Pend Oreille Telephone Company (the Company) is a Washington S-Corporation providing telecommunications exchange, local access, and internet services in a service area located in northeast Washington. The Company is a wholly-owned subsidiary of Rural Telephone Company (the Parent), which is a wholly-owned subsidiary of Martell Enterprises, Inc., both of which are Idaho corporations.

Regulation

The Company is subject to limited regulation by the Washington Utilities and Transportation Commission (WUTC). The Company maintains its accounting records in accordance with the Uniform System of Accounts, as prescribed by the Federal Communications Commission (FCC), and adopted by the WUTC. As a result, the application of accounting principles generally accepted in the United States of America by the Company differs in certain respects from the application by non-regulated entities. Such differences primarily concern the time at which certain items enter into the determination of net income.

Regulatory and legislative actions, as well as future regulations, could have a significant impact on the Company's future operations and financial condition. See Note 1, National Broadband Plan and FCC Order.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. These estimates involve judgments with respect to numerous factors that are beyond management's control. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investment securities purchased with a maturity of 3 months or less to be cash equivalents. The Company maintains its cash and cash equivalents either in bank deposit accounts that are insured by the Federal Deposit Insurance Corporation (FDIC) up to a limit of $250,000 per depositor or in certain non-interest bearing accounts that are fully insured by the FDIC. As of December 31, 2012 and 2011, the Company had no uninsured cash.

Subsequent to year end, the temporary liquidity guarantee program, which fully insured all non-interest bearing accounts, expired. Therefore, at January 1, 2013, the Company had $55,225 of uninsured cash.

The Company has not experienced any losses on such accounts and believes it is not exposed to any significant credit risk on cash.

Fair Value of Financial Instruments

The Company's financial instruments, none of which are held for trading purposes, include cash and cash equivalents, receivables, marketable securities, accounts payable, and long-term debt. The Company estimates that the fair value of all of these non-derivative financial instruments at December 31, 2012 and 2011 does not differ materially from the aggregate carrying value of its financial instruments recorded in the accompanying balance sheets.

## Note 1 - Summary of Significant Accounting Policies, continued

Marketable Securities
The Company has classified all marketable securities as held to maturity. These investments are stated at amortized cost which approximates fair value.

Materials and Supplies
Materials and supplies are stated at the lower of cost or market. Cost is determined principally by the average cost method.

Property, Plant, and Equipment
Property, plant, and equipment in service and under construction are stated at cost, including direct labor, materials, freight, and indirect overhead costs. Maintenance and repairs are charged to operations when incurred. Renewals and betterments are capitalized. Depreciation is calculated on a straight-line basis over the estimated life of the classes of property and equipment in accordance with rates consistent with industry standards. Depreciation rates range from 4% to 25%. In accordance with composite group depreciation methodology, when a portion of the Company's property, plant, and equipment is retired in the ordinary course of business, the gross book value, plus removal expenses, less salvage, is charged to accumulated depreciation and no gain or loss is recognized in accordance with industry standards.

Telecommunication plant acquisition is being amortized over 15 years and became fully amortized in 2012.

The Company follows the policy of capitalizing interest as a component of the cost of property, plant, and equipment constructed for its own use. In 2012, total interest capitalized to property, plant, and equipment was $22,406 ($6,949 in 2011).

Accounts Receivable
Accounts receivable are recorded at unpaid balances, less an allowance for doubtful accounts of $90,000 at December 31, 2012 and 2011. The Company generally does not require collateral or other security to support accounts receivable. Receivables are considered past due if payments are not received in accordance with invoice terms of net 30 days. Receivables are written off when the Company determines an account is uncollectible.

Network Access Revenues
Network access revenue related to intralata and interlata toll service is received under a system of access charges. Access charges represent a methodology by which local telephone companies, including the Company, charge the long distance carrier for access and interconnection to local facilities. The Company has elected to file access tariffs through the Washington Exchange Carrier Association (WECA) and the National Exchange Carrier Association (NECA). These access tariffs are subject to approval by the WUTC for intrastate charges and FCC for interstate charges.

When network access revenues have been received pursuant to the settlement and access agreements above, they are divided into traffic sensitive, nontraffic sensitive, and billing and collecting portions. The revenues are then either placed into a common pooling arrangement with other exchange carriers for redistribution or kept by the Company. The redistributions are made according to formulas established by the governing boards of the pools and are generally based upon expenses incurred and investments maintained. The Company participates in various pooling arrangements with NECA and WECA.

Settlement, access, and pool distribution revenues are recorded when the amounts become determinable. Related expenses are recorded when incurred. Subsequent true-ups and retroactive adjustments, which are generally allowed for a period of 24 months (NECA pool only) after the close of the related calendar year, are recorded in the year in which such adjustments become determinable, based upon studies prepared by outside consultants.

## Note 1 - Summary of Significant Accounting Policies, continued

Network Access Revenues, continued
In addition to recoveries from the NECA and WECA pools, the Company also receives revenues from the Universal High Cost Loop Fund administered by the Universal Service Administration Company (USAC). Amounts received from USAC are based on the number of customers served and the cost of providing service in that area being in excess of the national average cost per loop, as determined by the FCC, and are included in network access revenues in the accompanying financial statements.

In 2012, the Company received $101,961 ($178,049 in 2011) from the USAC High Cost Loop Fund and $1,073,279 in interstate access revenues administered through the NECA pool ($1,010,040 in 2011).

National Broadband Plan and FCC Order
In 2010, the FCC issued the National Broadband Plan which outlined a long-term plan to increase broadband penetrations and services throughout the United States of America. The plan further outlined a proposed long-term phase-out of access charges (referred to as Intercarrier Compensation) and moved to support mechanisms based on broadband services rather than the current Universal Service High Cost Loop Fund administered by USAC.

In response to the plan, the FCC on October 27, 2011, approved Report and Order 11-161 (the Order), that begins the process of reforming the universal service and intercarrier compensation (ICC) systems and adopts support for broadband-capable networks as an express universal service principle. The Order further creates the Connect America Fund which will ultimately replace all existing high-cost support mechanisms as well as help facilitate ICC reforms. The Order, among other things, caps the federal universal service fund at current levels and reforms the current system by putting various limits on capital and operating spending, requiring minimum levels for local rates and capping the per-line support amount at $250 per month. At December 31, 2012, the Company meets minimum local rate benchmarks and is not subject to the $250 per line support cap.

The Order also reforms the ICC system by adopting a plan to transition from access charges to a bill and keep framework. The transition period for rate-of-return carriers such as the Company is 9 years. Recovery will be calculated initially based on the fiscal year 2011 interstate switched access revenue requirement and will decline annually by 5% during the transition period beginning July 1, 2012. The Order includes the adoption of a monthly Access Recovery Charge as a transitional recovery mechanism to mitigate the impact of reduced intercarrier revenues. The Order was effective December 29, 2011, and implementation began on July 1, 2012.

As of the implementation date, July 1, 2012, the Company is subject to the 5% annual decline in interstate switched access revenue requirement during the 9 year transition period. For the period ended December 31, 2012 the impacts to the Company have not been significant.

The overall reform process takes place in phases and will take several years to implement. Furthermore the Order includes a Further Notice of Proposed Rulemaking and seeks comments on various items and the ultimate outcome of these proceedings and their impact is uncertain at this time.

Income Taxes
The Company and its Parent have elected S Corporation status. Earnings and losses of the Company are included in the income tax returns of the stockholders of Martell Enterprises, Inc. Accordingly, no provision has been made for federal and state income taxes in the accompanying financial statements.

Advertising Costs
Advertising costs are expenses when incurred. Advertising expenses were $77,061 in 2012 ($79,595 in 2011).

Subsequent Events
The Company has evaluated subsequent events through 5/3/2013, which is the date the financial statements were available to be issued.

### Note 2 - Investments

Investments consist of the following at December 31:

| | | 2012 | | 2011 |
|---|---|---|---|---|
| CoBank patronage certificates | $ | 240,253 | $ | 282,300 |
| NECA Independent Services | | 10,000 | | 10,000 |
| NRTC patronage allocations | | 135,486 | | 136,489 |
| Other investments | | 6,549 | | 6,391 |
| | $ | 392,288 | $ | 435,180 |

Investments in other cooperatives are stated at the net realizable value of the patronage and equity allocated to the Company. All other investments are stated at cost.

### Note 3 - Marketable Securities

Marketable securities include U.S. Government and corporate obligations with interest rates ranging from 8.95% to 10.375% in 2012 (3.265% in 2011). The bonds totaled $22,674 at December 31, 2012 and mature in 2015 ($45,897 at December 31, 2011, maturing in 2012). Management has determined that all bonds held at December 31, 2012 and 2011 are held to maturity and cost approximates fair market value.

### Note 4 - Property, Plant, and Equipment

Listed below are the major classes of property, plant, and equipment in service at December 31:

| | | 2012 | | 2011 |
|---|---|---|---|---|
| Land and support | $ | 1,177,256 | $ | 1,173,779 |
| Central office | | 6,235,295 | | 6,211,104 |
| Cable and wire facilities | | 8,784,865 | | 7,753,066 |
| | $ | 16,197,416 | $ | 15,137,949 |

### Note 5 - Long-Term Debt

Long-term debt consists of the following at December 31:

| | | 2012 | | 2011 |
|---|---|---|---|---|
| 5.0% notes payable to the Rural Utilities Service (RUS), payable in equal monthly installments of principal and interest, collateralized by real and personal property, paid in full in 2012. | $ | - | $ | 468,300 |
| 5.0% notes payable to RUS, interest only payments made monthly through December 2013, then monthly payments of $10,211, principal and interest, collateralized by substantially all real and personal property, due December 2029. | $ | 1,390,360 | $ | 1,086,045 |
| | | 1,390,360 | | 1,554,345 |
| Less current portion | | - | | 468,300 |

### Note 5 - Long-Term Debt, continued

Future maturities of long-term debt are as follows:

| | |
|---|---|
| 2013 | $ - |
| 2014 | 48,235 |
| 2015 | 60,248 |
| 2016 | 63,331 |
| 2017 | 66,570 |
| Thereafter | 1,151,976 |

The long-term debt agreement with RUS contains restrictions on the payment of dividends and stipulates certain financial covenants. For the years ended December 31, 2012 and 2011, the Company was not in compliance with the financial covenants of the RUS loan agreement.

At December 31, 2012, the Company had approximately $11,279,640 of unadvanced loan commitments from RUS.

### Note 6 - Pension Plan

The Company participates in a Safe Harbor 401(k) profit sharing plan (the Plan) sponsored by its Parent company. The Plan is available to participants who meet certain eligibility requirements. Eligible participants can contribute a portion of their annual compensation to the Plan subject to Internal Revenue Service limitations. Total pension expense in 2012 was approximately $44,000 ($27,500 in 2011).

### Note 7 - Related Party

The Company and its Parent have a service agreement in which the Parent provides management and operational services to the Company. The Parent also pays for some expenses incurred on behalf of the Company. During 2012, the Parent provided $223,320 of such services, materials, and other expenditures to the Company ($265,144 in 2011).

The Company invoices Nehalem Telecommunications, Inc. (NTI), an affiliated company through common ownership, for any costs incurred on behalf of NTI. Similarly, NTI invoices the Company for any costs incurred on behalf of the Company.

The Company incurs expenses on behalf of Martell Construction, an affiliated company through common ownership. There were no amounts incurred in 2012 or 2011.

### Note 7 - Related Party, continued

The Company leased equipment from Little Valley Elk Ranch, an affiliate company through common ownership, in the amount of $14,526 in 2012 ($115,370 in 2011).

| | | 2012 | | 2011 |
|---|---|---|---|---|
| Accounts receivable, Rural Telephone Company | $ | - | | 102,644.00 |
| Accounts receivable, Nehalem Telecommunications, Inc. | | - | | 2,071 |
| Accounts receivable, Martell Construction, Inc. | | 29,388 | | 28,806 |
| Accounts receivable, Little Valley Elk Ranch | | 125,341 | | 122,861 |
| Notes receivable - shareholders | | 77,187 | | 75,958 |
| | $ | 231,916 | $ | 332,340 |
| | | | | |
| Accounts payable, Rural Telephone Company | $ | 337,839.00 | $ | 260.00 |
| Accounts payable, Nehalem Telecommunications, Inc. | | 51,748.00 | | - |
| | $ | 389,587 | $ | 260 |

### Note 8 - Reclassification

Certain accounts in the 2011 financial statements have been reclassified to conform to the presentation in the 2012 financial statements. Such reclassifications have no effect on net income or stockholder's equity.

# Pend Oreille Telephone Company

## RUS Letters

*Year Ended December 31, 2012*

## INDEPENDENT AUDITORS' MANAGEMENT LETTER

Board of Directors
Pend Oreille Telephone Company
Glenns Ferry, Idaho

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, and 7 CFR 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers, the financial statements of Pend Oreille Telephone Company (the Company), which comprise the balance sheet, and the related statements of operations, changes in stockholder's equity and cash flows for the year ended December 31, 2012, and have issued our report thereon dated 5/3/2013. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of the Company as of and for the year ended December 31, 2012, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements and not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

A description of the responsibility of management for establishing and maintaining the internal control over financial reporting, and the objectives of and inherent limitations in such control, is set forth in our independent auditors' report on compliance and on internal control over financial reporting dated 5/3/2013 and should be read in conjunction with this report.

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, as defined above.

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. We consider the deficiency in the Company's internal control discussed in the independent auditors' report on internal control over financial reporting and other matters to be a significant deficiency.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. However, as discussed in our independent auditors' report on internal control over financial reporting and on compliance and other matters, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

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7 CFR 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.33(e)(2), and related party transactions and investments. In addition, our audit of the financial statements also included the procedures specified in 7 CFR 1773.38-45.

Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports, other than our independent auditors' report, and our independent auditors' report on compliance and on internal control over financial reporting, both dated 5/3/2013, or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters, as required by 7 CFR 1773.33, are presented below.

Comments on Certain Specific Aspects of the Internal Control Over Financial Reporting

We noted no matters regarding the Company's internal control over financial reporting and its operation that we consider to be a material weakness, as previously defined, with respect to the:

- Accounting procedures and records.
- Process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance, or other expense accounts.
- Materials control.

Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- In performing the procedure with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement, or lease between borrower and an affiliate of the Company for the year ended December 31, 2012, we:
    1. Obtained and read a borrower-prepared schedule of new written contracts, agreements, or leases entered into during the year between the borrower and an affiliate as defined in 7 CFR 1773.33(e)(2)(i).
    2. Reviewed Board of Directors minutes to ascertain whether board-approved written contracts are included in the borrower-prepared schedule.
    3. Noted the existence of written RUS approval of each contract listed by the borrower.
- In performing the procedure with respect to the requirement to submit the Operating Report for Telecommunications Borrowers to the RUS, we:
    1. Agreed amounts reported in the Operating Report for Telecommunications Borrowers to the Company's records.

The results of our tests indicate that, with respect to the items tested, the Company complied in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested include the requirements that:

- The borrower has obtained written approval of the RUS and other mortgagees to enter into any contract, agreement, or lease with an affiliate as defined in 7 CFR 1773.33(e)(2)(i).

- The borrower has submitted its Operating Report for Telecommunications Borrowers, as of December 31, 2012, and the report represented by the borrower as having been submitted to RUS, is in agreement with the Company's audited records in all material respects.

Comments on Other Additional Matters
In connection with our audit of the financial statements of the Company, nothing came to our attention, except as noted below, that caused us to believe that the Company failed to comply with respect to:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33(c)(1). The Company's subsidiary plant records have not been updated to agree with the general ledger. The Company is in the process of updating these records to ensure the balances agree to the general ledger going forward.

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.33(c)(2).

- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4).

- 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 addressed at 7 CFR 1773.33(c)(5).

- The disclosure of material related party transactions, in accordance FASB ASC 850-10-50-1, for the year ended December 31, 2012, in the financial statements referenced in the first paragraph of this report, addressed at 7 CFR 1773.33(e).

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of investments required by 7 CFR 1773.33(i) is omitted as the Company does not have investments in affiliated or subsidiary companies.

Other Matters
As a result of current year operating results, the Company is not in compliance with the Times Interest Earned Ratio (TIER) requirement as defined and included in the debt agreement with RUS.

This report is intended solely for the information and use of the Board of Directors, management, Rural Utilities Service, 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 distribution is not limited.

*AKT LLP*

**AKT LLP**
5/3/2013

## 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*

Board of Directors
Pend Oreille Telephone Company
Glenns Ferry, Idaho

We 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 balance sheet of Pend Oreille Telephone Company (the Company) as of December 31, 2012, and the related statements of income, changes in stockholder's equity, and cash flows for the years then ended and the related notes to the financial statements, and have issued our report thereon dated 5/3/2013. The financial statements of the Company as of December 31, 2011 were audited by other auditors.

### Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements we considered the 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 over financial reporting.

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 to those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses, and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we did identify a certain deficiency in internal control, as described below, that we consider to be a significant deficiency.

***Accounting and Financial Reporting*** –

> During the audit we assisted the Company with reconciling certain activities and posting adjustments to the general ledger. While some of these adjustments were identified by the Company, other adjustments would only be identified through our audit process. Further, our expertise is required to report the activity and to draft the financial statements and supporting footnotes in accordance with accounting standards generally accepted in the United States of America. This is considered to be a significant deficiency in internal control over financial reporting. The Board of Directors has considered the cost of staffing the financial expertise to address these issues outweighs the benefit, and as such, has determined to continue outsourcing these matters to external experts.

Management is responsible for the controls over the selection and application of accounting principles in conformity with generally accepted accounting principles, and is also responsible for the controls over the period-end financial reporting process. The period-end financial reporting process includes the controls over procedures used to initiate, authorize, record and process transactions and journal entries into the general ledger; record recurring and nonrecurring adjustments to the financial statements; and prepare the financial statements and related notes. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.

Even though management has requested the auditors' assistance in preparing the financial statements and notes, management is still responsible for the financial information presented. In addition, management is responsible for:

- Making management decisions and performing all management functions.
- Designating an individual with suitable skill, knowledge, or experience to oversee the services provided by the auditors.
- Evaluating the adequacy and results of the services performed by the auditors.
- Accepting responsibility for the results of the services performed by the auditors.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Company's financial statements are free from 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. 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.* However, we noted one instance of noncompliance which we have reported in our independent auditors' management letter in the Other Matters section, as required by 7 CFR 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. As a result of current year operating results, the Company is not in compliance with the Times Interest Earned Ratio (TIER) requirement as defined and included in the debt agreement with RUS.

**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. However, this report is a matter of public record, and its distribution is not limited.

*AKT LLP*

**AKT LLP**
5/3/2013