SOUTHERN MONTANA TELEPHONE COMPANY

Financial Statements

Years Ended December 31, 2011 and 2010

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Table of Contents

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Southern Montana Telephone Company
Wisdom, Montana

We have audited the accompanying balance sheets of Southern Montana Telephone Company (the Company) as of December 31, 2011 and 2010, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. 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 of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Southern Montana Telephone Company as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated March 2, 2012 on our consideration of Southern Montana Telephone Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grants agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

AKT LLP

Salem, Oregon
March 2, 2012

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SOUTHERN MONTANA TELEPHONE COMPANY

Balance Sheets

December 31, 2011 and 2010

	2011	2010
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,054,230	$ 1,021,638
Accounts receivable, less allowance for doubtful accounts of zero in 2011 and 2010	397,507	471,167
Materials and supplies	133,556	131,031
Prepaid expenses	41,314	43,918
Total Current Assets	1,626,607	1,667,754
Other Investments	382,310	350,514
Property, Plant, and Equipment:		
Telecommunications	23,034,899	19,420,128
Nonregulated	157,976	-
Under construction	52,191	228,147
	23,245,066	19,648,275
Less accumulated depreciation	8,418,811	8,075,656
Property, Plant, and Equipment, net	14,826,255	11,572,619
	$ 16,835,172	$ 13,590,887
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 688,790	$ 530,351
Accounts payable	154,645	222,366
Advance billing and customer deposits	20,444	14,576
Accrued expenses	358,279	287,990
Total Current Liabilities	1,222,158	1,055,283
Long-Term Debt	11,180,713	8,410,572
Stockholders' Equity:		
Common stock, $10 par value, 2,703 shares authorized and 610 shares issued and outstanding	6,100	6,100
Paid-in capital	3,290	3,290
Retained earnings	4,422,911	4,115,642
Total Stockholders' Equity	4,432,301	4,125,032
	$ 16,835,172	$ 13,590,887

See accompanying notes to financial statements.

SOUTHERN MONTANA TELEPHONE COMPANY

Statements of Income

Years Ended December 31, 2011 and 2010

	2011	2010
Operating Revenues:		
Local network	$ 206,340	$ 190,615
Interstate access	3,250,622	2,929,065
Intrastate access	330,179	346,845
Nonregulated	455,720	420,371
Miscellaneous	5,380	(4,699)
Total Operating Revenues	4,248,241	3,882,197
Operating Expenses:		
Plant specific operations	492,620	472,522
Plant nonspecific operations	337,257	322,316
Customer	156,411	137,000
Corporate	677,522	725,948
Depreciation and amortization	1,208,678	1,082,693
Other operating taxes	126,128	114,715
Nonregulated	380,984	353,032
Total Operating Expenses	3,379,600	3,208,226
Operating Income	868,641	673,971
Other Income:		
Other income	3,650	9,361
Allowance for funds used during construction	18,771	33,212
Total Other Income	22,421	42,573
Income Available for Fixed Charges	891,062	716,544
Fixed Charges - Interest on Long-Term Debt	385,331	319,620
Net Income	$ 505,731	$ 396,924

See accompanying notes to financial statements.

SOUTHERN MONTANA TELEPHONE COMPANY

Statements of Changes in Stockholders' Equity

Years Ended December 31, 2011 and 2010

	Capital Stock				
	Shares Issued	Amount	Paid-in Capital	Retained Earnings	Total
Balance, December 31, 2009	610	$ 6,100	$ 3,290	$ 3,867,582	$ 3,876,972
Distributions	-	-	-	(148,864)	(148,864)
Net income	-	-	-	396,924	396,924
Balance, December 31, 2010	610	6,100	3,290	4,115,642	4,125,032
Distributions	-	-	-	(198,462)	(198,462)
Net income	-	-	-	505,731	505,731
Balance, December 31, 2011	610	$ 6,100	$ 3,290	$ 4,422,911	$ 4,432,301

See accompanying notes to financial statements.

SOUTHERN MONTANA TELEPHONE COMPANY

Statements of Cash Flows

Years Ended December 31, 2011 and 2010

	2011	2010
Cash Flows from Operating Activities:		
Net income	$ 505,731	$ 396,924
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,208,678	1,082,693
Depreciation, IPTV	7,916	-
Patronage capital credits, noncash	(1,459)	(7,236)
Changes in assets and liabilities:		
Accounts receivable	73,660	(89,808)
Materials and supplies	(2,525)	(57,071)
Prepaid expenses	2,604	(43,918)
Accounts payable	(229,517)	(639,420)
Advance billing and customer deposits	5,868	(1,771)
Accrued expenses	70,288	(136,269)
Net Cash Provided by Operating Activities	1,641,244	504,124
Cash Flows from Investing Activities:		
Capital expenditures	(4,308,435)	(2,005,732)
Purchase of other investments	(30,337)	-
Proceeds from sale of marketable securities and investments	-	3,389
Net Cash Used by Investing Activities	(4,338,772)	(2,002,343)
Cash Flows from Financing Activities:		
Proceeds from long-term debt	3,540,957	2,272,475
Payments on long-term debt	(612,375)	(517,230)
Equity distributions	(198,462)	(148,864)
Net Cash Provided by Financing Activities	2,730,120	1,606,381
Net Increase in Cash and Cash Equivalents	32,592	108,162
Cash and Cash Equivalents, beginning	1,021,638	913,476
Cash and Cash Equivalents, ending	$ 1,054,230	$ 1,021,638
Cash Paid During the Year for Interest, net of amount capitalized	$ 366,560	$ 286,408
Non-cash Property, Plant, and Equipment Additions	$ 161,796	$ 88,755

See accompanying notes to financial statements.

Note 1 - Organization and Summary of Significant Accounting Policies

Organization
Southern Montana Telephone Company (the Company) is a local exchange carrier (LEC) providing local telephone service, internet access, and long-distance telecommunications services. The Company serves commercial and residential customers in the southwestern Montana exchanges of Divide, Grant, Jackson, Wisdom, and Wise River.

Regulation
The Company is subject to limited regulation by the Public Service Commission of Montana (PSC). 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 PSC. 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 nonregulated entities. Such differences primarily concern the time at which certain items enter into the determination of net income. Pending and future regulatory and legislative actions, including the FCC's National Broadband Plan and Report and Order and Further Notice of Proposed Rule Making, may have a significant impact on the Company's future operations and financial condition.

Cash and Cash Equivalents
The Company considers cash investments with an original maturity of 3 months or less to be cash equivalents. The Company maintains its cash 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. At December 31, 2011 and 2010 the company had no uninsured funds. The Company has not experienced any losses in its bank deposit accounts and believes it is not exposed to any significant credit risk on cash.

Accounts Receivable
The Company extends credit to its customers. Receivables are written off when the Company determines an account is uncollectible. Past due status is determined based on how recently the payment has been received. Credit risk associated with receivables is periodically reviewed by management and, if required, an allowance for doubtful accounts is established.

Fair Value of Financial Instruments
The Company's financial instruments, none of which are held for trading purposes, include cash and cash equivalents, receivables, accounts payable, mortgage and notes payable. The Company estimates that the fair value of all of these non-derivative financial instruments at December 31, 2011 and 2010 does not differ materially from the aggregate carrying value of its financial instruments recorded in the accompanying balance sheets.

Property, Plant, and Equipment
Telecommunications plant in service and under construction is stated at cost, including estimated overhead expense. Depreciation is calculated on a straight-line basis over the estimated life of the classes of buildings and equipment in accordance with rates consistent with industry standards. Depreciation rates range from 4.2% to 33.3%. Costs of plant retired are eliminated from telecommunications plant accounts and such costs plus removal expenses, less salvage, are charged to accumulated depreciation in accordance with industry practice.

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 2011, total interest incurred was $385,331 ($319,620 in 2010), $18,771 of which was capitalized ($33,212 in 2010).

Nonregulated Services
The Company accounts for its nonregulated activities as follows:

Nonregulated activities involving the joint use of regulated assets are accounted for within the prescribed regulated system of accounts for telephone company operations. These activities include directory services, long distance services, and other income items incidental to the provision of regulated telephone services.

Note 1 - Organization and Summary of Significant Accounting Policies, continued

Nonregulated Services, continued

Nonregulated activities not involving the joint use of regulated assets are accounted for separately from regulated activities. Operating revenues and the related expenses are separately presented as nonregulated revenues and expenses. These activities include internet, TV, and payphone services.

Network Access Revenues

Network access revenue for 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 follows access tariffs filed with the PSC 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 investment maintained. The Company participates in pooling arrangements with the National Exchange Carrier Association (NECA).

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 after the close of the related calendar years (NECA only), are recorded in the year in which such adjustments become determinable, based upon studies by an outside consultant.

In addition to recoveries from NECA, the Company also receives revenues from the Universal Service High Cost Loop Fund and other support mechanisms administered by the Universal Service Administration Company (USAC). Amounts received from the USAC High Cost Loop Fund is 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 2011, the Company received $1,456,681 from the USAC High Cost Loop Fund ($840,626 in 2010) and $1,793,941 in interstate access revenues administered through the NECA pool ($2,088,439 in 2010).

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.

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. The Order includes the adoption of a monthly Access Recovery Charge as a transitional recovery mechanism to mitigate the impact of reduced intercarrier revenues.

Note 1 - Organization and Summary of Significant Accounting Policies, continued

National Broadband Plan and FCC Order, continued
The Order was effective December 29, 2011. However, the reform process will take place in phases and will take several years to complete. Furthermore the Order includes a Further Notice of Proposed Rulemaking and seeks comments on various items including potentially reducing the interstate rate of return from its current level of 11.25%. As the ultimate outcome of these proceedings is uncertain the full impacts of the Order on the Company cannot be determined or reasonably estimated at this time.

Estimates
The Company uses estimates and assumptions in preparing financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses.

Income Taxes
The Company is designated as an S corporation under the Internal Revenue Code. As an S corporation, earnings and losses are included in the income tax returns of the stockholders and taxed at the stockholder level.

The Company may incur income tax related to passive income and built-in gains.

The Company follows the accounting standard for uncertain tax positions. This accounting standard provides detailed guidance for financial statement recognition, measurement, and disclosure of uncertain tax positions. It requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position would not be substantiated under examination. The Company recognizes accrued interest and penalties associated with uncertain tax positions as part of the income tax provision when applicable. There are no amounts accrued in the financial statements related to uncertain tax positions.

The Company files income tax returns in the United States and various state and local jurisdictions. The Company's Federal income tax returns for the years ended December 31, 2010, 2009, and 2008 are subject to examination by the Internal Revenue Service, generally for 3 years after the returns were filed. State and local jurisdictions have statutes of limitation that generally range from 3 to 5 years.

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

Subsequent Events
The Company has evaluated subsequent events through March 2, 2012, which is the date the financial statements were issued.

Note 2 - Property, Plant, and Equipment

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

	2011	2010
Telecommunications:		
Land and support	$ 1,556,470	$ 1,546,734
Central office	4,262,976	4,018,948
Cable and wire facilities	17,040,453	13,679,446
Capital Lease Assets	175,000	175,000
Total Telecommunications:	23,034,899	19,420,128
Non-regulated	157,976	-
Under Construction	52,191	228,147
Total Property, Plant, and Equipment In Service	$ 23,245,066	$ 19,648,275

In 2009, the Company entered into a lease for an Indefeasible Right of Use (IRU) for fiber, which will last through 2029. The Company paid the entire amount of the lease at inception and the lease is being amortized over the life of the asset.

Note 3 - Investments in Nonaffiliates

Investments in nonaffiliates consist of the following assets at December 31:

	2011	2010
Vision Net, Inc.	$ 279,861	$ 279,861
Other investments	33,947	32,488
RTFC	828	828
Artwork	31,547	31,547
Other Office Décor	5,790	5,790
RUS Cushion of Credit	30,337	-
	$ 382,310	$ 350,514

The Company has an RUS cushion of credit fund in which it has invested at a return of 5% interest. To recover the investment, the funds can be applied toward debt payments, but not withdrawn. In 2011, the Company invested $105,403 into its RUS cushion of credit fund ($0 in 2010), and $75,066 of these funds were applied toward debt payments ($0 in 2010). Debt payments include principal and interest.

Vision Net, Inc. provides advanced voice, data, and video services, and is owned by Montana's independent telephone companies allowing them to interconnect a digital fiber network serving urban and rural communities throughout the state. The investment is maintained on the cost method of accounting.

Note 4 - Long-Term Debt

Long-term debt consists of the following:

	2011	2010
2.00% notes payable to the Rural Utilities Service, payable in monthly installments of $41,246 principal and interest, collateralized by substantially all real and personal property, due 2016 through 2023.	$ 727,487	$ 884,911
2.692-4.88% notes payable to Rural Utilities Service, payable in monthly installments of $74,172, collateralized by substantially all real and personal property, due in 2026.	9,730,855	8,056,012
0.027-0.028% notes payable to the Rural Utility Services, interest only through September, 2012, then payable in monthly installments of $6,432, collateralized by substantially all real and personal property, due in 2030.	1,411,161	-
	11,869,503	8,940,923
Less current portion	688,790	530,351
	$ 11,180,713	$ 8,410,572

The terms of the debt agreements contain restrictions on the declaration or payment of cash dividends, redemption of capital stock, and the maintenance of a minimum times interest earned ratio. The Company is in compliance with these covenants at December 31, 2011 and 2010.

Future maturities of long-term debt are as follows:

2012	$ 688,790
2013	764,194
2014	788,900
2015	811,231
2016	694,347
Thereafter	8,122,041

At December 31, 2011, the Company had $4,795,358 in unadvanced authorized loan funds from the Rural Utilities Services ($2,792,315 at December 31, 2010).

Note 5 - Retirement Plans

The Company participates in a qualified multi-employer, non contributory, defined benefit plan (the Plan) administered by the Retirement and Security Program of the National Telecommunications Cooperative Association (NTCA), which covers all full-time eligible employees, and contributes 12% of each eligible employee's annual salary to the Plan. Pension costs include current service costs that are accrued and funded on a current basis. Total pension plan charges, including amounts charged to construction, were $112,754 in 2011 ($101,992 in 2010).

The Company also participates in a contributory, multi-employer, defined contribution plan administered by NTCA, which covers all full-time employees. Employees are required to contribute a minimum of 2% of their annual salary to participate in the plan. Employer contributions are 5% of eligible salaries paid. Employer contributions to the plan were $38,078 in 2011 ($37,708 in 2010).

Note 6 - Workers' Compensation

The Company is a member of the Montana Electric and Telephone Systems Self-Insured Workers' Compensation Pool (the Pool). The Pool covers potential liability for workers' compensation and occupational disease to employees and dependents of deceased employees of all members in the Pool. The Company is jointly and severally liable with the other members for the full amount of all known and unknown claims.

Note 7 - Related Party Transactions

The Company leases its office building from Robert G. Helming, stockholder, officer, and director of the Company. The lease calls for monthly payments of $3,100 through April 2014.

Following is a summary of minimum rental payments under the lease for the years subsequent to December 31, 2011:

2012	$ 37,200
2013	37,200
2014	12,400

Total rental expense under the lease listed above was approximately $37,200 for the years ended December 31, 2011 and 2010.

Note 8 - Commitments

The Company has executed several contracts for construction projects. The amounts unpaid against these commitments at December 31, 2011 were $161,796 ($88,755 at December 31, 2010).