Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC management directs the Carrier to implement internal controls necessary to review and reconcile source documentation and reported USF data prior to their submittal, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $14,137.

Finding 3
Condition:
The Beneficiary did not allocate Property Taxes related to GSF assets used in the conduct of non-regulated activities in 2004 and 2005 as required. The Beneficiary allocated 3% of GSF Assets and related, Accumulated Depreciation, Depreciation Expense and General Support Expenses to non-regulated activities but failed to allocate related Property Taxes. Property Tax balances in 2004 and 2005 were $81,188 and $91,712, respectively.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes that the Carrier committed to addressing its internal controls related to this finding, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $1,254.

Finding 4
Condition:
The Beneficiary did not record the income tax impacts of Part 64 Cost Study expense adjustments when reporting the respective regulated expense amounts on the USF Forms as required.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes the Carrier has addressed its internal controls related to this finding.

Finding 5
Condition:
The Beneficiary's Federal and State Income Tax expense was overstated in 2004 by $8,568 and understated in 2005 by $2,195 in its accounting records and USF Forms.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes that the Carrier committed to addressing its internal controls related to this finding, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $1,056.

Comment 1
Condition:
The Beneficiary did not maintain CPRs, as of December 31, 2004, and December 31, 2005, in sufficient detail for the following accounts:

- General Support Facilities (Account 2110)
- C&WF (Account 2410)

Management Response:
USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC recognizes that the Carrier committed to addressing its internal controls related to this comment, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

USAC notes that the auditor found no monetary effect so there is no recovery of funds required.

Comment 2
Condition:
One ($11,070) of the 45 assets selected for testing did not have supporting documentation. The sample item related to Digital Electronic Switching equipment (CARD STS-1 Interface) for a COE project.

Management Response:
USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC recognizes that the Carrier committed to addressing its internal controls related to this comment, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

Comment 3
Condition:
The Beneficiary used incorrect expense amounts, by using balances as of December 31, 2004 and December 31, 2005, on the quarterly Part 64 Cost Study to allocate General Support Expenses and Depreciation Expense to the non-regulated activities in 2005-2 and 2006-3 HCL filings instead of using a rolling year balance. The expense adjustments for 2005-2 and 2006-3 HCL filings were overstated by $1,100 and understated by $535, respectively.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes the Carrier has addressed its internal controls related to this comment.

Audit Recovery Total

	HCL	LSS	ICLS	Finding Total
Finding 1	$201,308	34,543	149,461	385,312
Finding 2	-	5,913	8,224	14,137
Finding 3	718	63	473	1,254
Finding 4	(2,750)	(342)	-	(3,092)
Finding 5	1,056	-	-	1,056
Comment 2	(1,194)	731	-	(463)
Comment 3	(79)	-	-	(79)
Mechanism Total	$199,059	40,908	158,158	$398,125

As the auditor has provided a combined monetary effect for all findings and USAC management does not dispute any of the findings, USAC will recover **$398,573** instead of $398,125.

This concludes the USAC management response to the audit.

Per Access Line End User Billing - Sample

	Company A	Company B	Company C	Company D	Company E
	Jan 09	Jan 09	Jan 09	Jan 09	Jan 09
End User Customer Billing					
Monthly Expense	3,724.22	4,968.82	1,078.24	6,158.50	25,135.75
Access Lines	1,250	1,455	305	1,870	7,800
End User per Access Line	**2.98**	**3.41**	**3.54**	**3.29**	**3.22**

*Main billing functions include the following (per line, per month basis)

Postage	$	0.78
Pre-sort	$	0.01
Message Processing	$	0.93
Billing Form	$	0.08
Meet Point Billing Extract	$	0.05
Processing/Computer/Programming Fees	$	0.53
Barcoding	$	0.03
Printing Bills/PDF Bills on CD/Duplicates	$	0.55
Insert & Fold Bills	$	0.13
Envelopes	$	0.09
Sales Tax	$	0.09

Prepared by John Staurulakis, Inc.
on August 24, 2010

CABS Sample

	Company A	Company B	Company C
	12/31/09	12/31/2009	12/31/2009
CABS			
Monthly Expense	19,724	3,518	13,524
Access Lines	8,400	1,690	7,850
Per Access Line	**2.35**	**2.08**	**1.72**

Prepared by John Staurulakis, Inc.
on August 25, 2010

Rec... ...ted
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FCC Mail Room

Fulton Telephone Company
Follow-up Audit Number: HC-2009-FL070
(SAC Number: 280455)

Letter to management in connection with the performance audit for the Universal Service Fund disbursements made during the twelve-month period ended June 30, 2007

Prepared for: Universal Service Administrative Company

As of Date: July 27, 2010

KPMG LLP
1601 Market Street
Philadelphia, PA 19103

Received & Inspected
DEC 02 2010
FCC Mail Room

Fulton Telephone Company
Follow-up Audit Number: HC-2009-FL070
(SAC Number: 280455)

Performance audit for the Universal Service Fund disbursements made during the twelve-month period ended June 30, 2007

Prepared for: Universal Service Administrative Company

As of Date: July 27, 2010

KPMG LLP
1601 Market Street
Philadelphia, PA 19103

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KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

EXECUTIVE SUMMARY

July 27, 2010

Mr. Wayne Scott, Vice President – Internal Audit Division
Universal Service Administrative Company
2000 L Street, N.W., Suite 200
Washington, DC 20036

Dear Mr. Scott:

This report presents the results of our work conducted to address the performance audit objectives relative to the Fulton Telephone Company, Study Area Code ("SAC") No.280455, ("FTC" or "Beneficiary") for disbursements of $887,664, made from the Universal Service Fund ("USF") during the twelve-month period ended June 30, 2007. Our work was performed during the period from April 21, 2010, to July 27, 2010, and our results are as of July 27, 2010.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objective of this performance audit was to evaluate the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the Federal Communications Commission's ("FCC") Rules as well as FCC Orders governing Universal Service Support for the High Cost Program ("HCP") relative to disbursements of $887,664, made from the USF during the twelve-month period ended June 30, 2007.

As our report further describes, KPMG identified the following as a result of the work performed:

1. **HC-2009-FL070-F01: Inaccurate Centralized Cost Allocations** - Centralized cost allocations (Management Fees) charged by the Operating Company to the Beneficiary totaling $2,347,940 per year in 2004 and 2005 were improperly computed; resulting in USF disbursements being $385,312 higher than they would have been had amounts been reported properly.
2. **HC-2009-FL070-F02: Improper Methodology used in Affiliate Pricing of Billing and Collection Services** -The Beneficiary's affiliate did not use a fully distributed cost methodology to determine its charges to the Beneficiary for Billing and Collection services in 2004 and 2005; resulting in USF disbursements being $14,137 higher than they would have been had amounts been reported properly.
3. **HC-2009-FL070-F03: Non-Allocation of Property Taxes** - The Beneficiary did not allocate Property Taxes related to General Support Facilities used in the conduct of non-regulated

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activities in 2004 and 2005; resulting in USF disbursements being $1,254 higher than they would have been had amounts been reported properly.

4. **HC-2009-FL070-F04: Inaccurate Part 64 Cost Study Adjustments** - The Beneficiary did not record the income tax impacts of Part 64 Cost Study expense adjustments when reporting the respective regulated expense amounts on the USF Forms; resulting in USF disbursements being $3,092 lower than they would have been had amounts been reported properly.

5. **HC-2009-FL070-F05: Inaccurate Income Tax Expenses** - The Beneficiary's Federal and State Income Tax expense was overstated in 2004 by $8,568 and understated in 2005 by $2,195; resulting in USF disbursements being $1,056 higher than they would have been had amounts been reported properly.

Based on the above results, we estimate that disbursements made to the Beneficiary from the USF for the HCP for the twelve-month period ended June 30, 2007 were $399,115 higher[1] than they would have been had amounts been reported properly.

In addition, we also noted other matters that we have reported to the management of the Beneficiary in a separate letter dated July 27, 2010.

This performance audit did not constitute an audit of financial statements in accordance with *Government Auditing Standards*. KPMG was not engaged to, and did not render an opinion on the Beneficiary's internal controls over financial reporting or over financial management systems (for purposes of OMB's Circular No. A-127, *Financial Management Systems*, July 23, 1993, as revised). KPMG cautions that projecting the results of our evaluation to future periods is subject to the risks that controls may become inadequate because of changes in conditions or because compliance with controls may deteriorate.

Sincerely,

KPMG LLP

[1] The combined estimated monetary impacts of the findings may not equal the sum of individual findings to the extent that individual findings indirectly impact other findings. For example, certain findings may impact the categorization of certain asset types and/or modify apportionment factors that apply to other individual findings when considered in combination. The individual impact amounts discussed above consider only the direct impact of the noted finding.

List of Acronyms

Acronym	Definition
AFUDC	Allowance for Funds Used During Construction
B&C	Billing and Collection
CABS	Carrier Access Billing System
C&WF	Cable and Wire Facilities
CLEC	Competitive Local Exchange Carrier
COE	Central Office Equipment
CPE	Customer Premise Equipment
CPRs	Continuing Property Records
DSL	Digital Subscriber Line
FCC	Federal Communications Commission
Form 509	Interstate Common Line Support Mechanism Annual Common Line Actual Cost Data Collection Form
FTC	Fulton Telephone Company
G/L	General Ledger
GSF	General Support Facilities
HCL	High Cost Loop
HCL Form	National Exchange Carrier Association Universal Service Fund Data Collection Form
HCP	High Cost Program
HCM	High Cost Model
IAS	Interstate Access Support
ICLS	Interstate Common Line Support
ILEC	Incumbent Local Exchange Carrier
LEC	Local Exchange Carrier
LSS	Local Switching Support
LSS Form	Local Switching Support Data Collection Form – True-up
MSPC	Mississippi Public Service Commission
NECA	National Exchange Carrier Association
PBO	Payroll, Benefits and Overhead
SAC	Study Area Code
SLC	Subscriber Line Charge
SNA	Safety Net Additive
SVS	Safety Valve Support
TPIS	Telecommunications Plant In Service
TPUC	Telecommunications Plant Under Construction
USAC	Universal Service Administrative Company

BACKGROUND

Program Overview

USAC is an independent not-for-profit corporation that operates under the direction of the FCC pursuant to 47 C.F.R. Part 54. The purpose of USAC is to administer the USF through four support mechanisms: High Cost; Low Income; Rural Health Care; and Schools and Libraries. These four support mechanisms ensure that all people regardless of location or income level have affordable access to telecommunications and information services. USAC is the neutral administrator of the USF and may not make policy, interpret regulations or advocate regarding any matter of universal service policy.

The High Cost Support Mechanism, also known as the HCP, ensures that consumers in all regions of the nation have access to and pay rates for telecommunications services that are reasonably comparable to those services provided and rates paid in urban areas, regardless of location or economic strata. Thus, the HCP provides support for telecommunications companies (Beneficiaries) that offer services to consumers in less-populated areas. The HCP consists of the following support mechanisms:

1. HCL: HCL support is available for rural companies operating in service areas where the cost to provide service exceeds 115% of the national average cost per line. HCL support includes the following two sub-components:
    a. SNA: SNA support is available for carriers that make significant investment in rural infrastructure in years when HCL support is capped and is intended to provide carriers with additional incentives to invest in their networks.
    b. SVS: SVS support is available to rural carriers that acquire high cost exchanges and make substantial post-transaction investments to enhance network infrastructure.
2. HCM: HCM support is available to carriers serving wire centers in certain states where the forward-looking costs to provide service exceed the national benchmark.
3. LSS: LSS is available to rural incumbent carriers serving 50,000 or fewer lines and is designed to help carriers recoup some of the high fixed switching costs of providing service to fewer customers.
4. ICLS: ICLS is available to rate-of-return incumbent carriers and competitive carriers, and is designed to help carriers offset interstate access charges and to permit each rate-of-return carrier to recover its common line revenue requirement, while ensuring that its SLCs remain affordable to its customers.
5. IAS: IAS is available to price-cap incumbent carriers and competitive carriers, and is designed to offset interstate access charges for price cap carriers.

USAC engaged KPMG to conduct a performance audit relating to the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements of $887,664, made from the USF during the twelve-month period ended June 30, 2007.

Beneficiary Overview

Fulton Telephone Company, Inc. (SAC No. 280455), the subject of this performance audit, is an ILEC, Rural, Cost Company with competition in its study area and received LSS, ICLS, SNA and HCL support for the twelve-month period ended June 30, 2007. The Beneficiary is located in Fulton, Mississippi and has its corporate offices in Bay Springs, Mississippi. The Beneficiary is subject to regulation by the MSPC with respect to intrastate services and the FCC with respect to interstate services.

The Beneficiary is 100% owned by Fail Inc. (the "Operating Company"), a wholly owned subsidiary of the Fail Telecommunications Inc. (the "Parent"). The Parent is controlled by the Fail family. The Beneficiary's Affiliates, also owned by the Parent, include Chickamauga Telephone Corporation, Mound Bayou Telephone Corporation, both ILECs and GulfPines Communications, a CLEC.

In addition to these affiliates, the Beneficiary is also related to NexBand, a provider of non-regulated services to the Beneficiary's customers. NexBand also provides B&C services to the Beneficiary and its affiliates and is owned by a member of the Fail family. Accordingly, transactions between the Beneficiary and its affiliates were reviewed as part of this performance audit.

The following table illustrates the High Cost support disbursed by USAC to the Beneficiary for each quarter during the twelve-month period ended June 30, 2007 by fund type:

Quarter Ended	Total Disbursements	HCL	LSS	ICLS	SNA
September 30, 2006	$176,517	$123,972	$111,600	$(59,055)	$ -
December 31, 2006	176,865	124,320	111,600	(59,055)	-
March 31, 2007	267,000	78,036	76,569	92,880	19,515
June 30, 2007	267,282	128,886	15,657	92,880	29,859
Total	$887,664	$455,214	$315,426	$67,650	$49,374

Source: USAC

Performance Audit Approach

The High Cost support received by the Beneficiary during the twelve-month period ended June 30, 2007, was based on the following annual financial and operational data submitted by the Beneficiary to NECA and USAC:

- 2005-1 and 2006-2 HCL Forms, based on calendar year 2004 and 2005 data, respectively, as well as subsequent updated dash filings submitted via the 2005-2 and 2006-3 HCL Forms based on data for the twelve-month periods ended March 31, 2006 and June 30, 2007, respectively.
- 2005 LSS Form, based on calendar year 2005 data.
- 2004 FCC Form 509, based on calendar year 2004 data.
- Written notice of eligibility for SNA based on calendar years 2001 and 2002.

These Forms capture the totals of certain pre-designated G/L Accounts including all asset accounts that make up TPIS as well as certain deferred liabilities and operating expenses, subject to the allocation between regulated and non-regulated activities (Part 64 Cost Allocations), the separation between interstate and intrastate operations (Part 36 Cost Separations) and the separation between access and non-access elements (Part 69 Cost Separations). In addition, the Beneficiary is required to submit certain annual investment data, including the categorization of COE and C&WF on the USF Forms.

Prior to this performance audit, USAC had engaged KPMG to perform a compliance attestation examination of the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements of $887,664, made

from the USF during the twelve-month period ended June 30, 2007. KPMG noted during the planning phase of the compliance attestation engagement that the Beneficiary lacked supporting documentation for the following:

- Asset balances reported on USF Forms
- Affiliate Transactions between the Beneficiary and its non-regulated affiliates

In connection with the compliance attestation engagement, KPMG had inspected the Assets and Affiliate Transactions and noted that support for a significant portion of the information subject to examination was not available. Based on this circumstance, KPMG was unable to perform test procedures related to various assets and expenses, involving affiliate transactions, reported on the USF Forms and withdrew from the engagement, as it was unable to ascertain management's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing USF for the HCP with respect to disbursements made from the USF for the twelve-month period ended June 30, 2007.

For this performance audit, KPMG conducted test procedures relative to assets and affiliate transactions as noted below:

CPRs / Assets

The Beneficiary was able to provide CPR data for COE assets but did not maintain CPRs for GSF and C&WF assets. As underlying documentation supporting assets (CPRs) was not available for GSF and C&WF assets, KPMG performed alternative procedures based on G/L details of these asset accounts between 1999 and 2005, along with COE balances reflected on December 21, 2005 CPRs, to assess the reasonableness and accuracy of the assets recorded as of December 31, 2005.

KPMG utilized the asset account history (1999 – 2005) to make a sample selection. The asset account history covered 50% (GSF – 34%, COE – 100% and C&WF – 14%) of Gross Asset balances. KPMG selected a statistical sample of GSF, COE and C&WF assets in service during the performance audit period that were less than 100% depreciated. KPMG's procedures to evaluate the Beneficiary's asset balances as of December 31, 2004 and 2005 included an evaluation of the Beneficiary's methodology to support the asset account balances and categorizations, physical inspection of Beneficiary assets and statistical sample testing of the actual/estimated historical costs of the assets in service during the performance audit period. In order to determine the reasonableness of the asset cost estimates on the CPRs, the Beneficiary provided third-party invoices where available, work orders, and other supporting documentation.

Affiliate Transactions

Significant affiliate transactions were identified per review of the audited financial statements and through inquiry of the Beneficiary. Affiliate transactions included services provided by the Beneficiary to its affiliates as well as services received from affiliate companies.

KPMG's procedures to evaluate the reasonableness of the affiliate transactions included sample testing of the affiliate transactions by reviewing the intercompany receivables and payables accounts recorded in the Beneficiary's trial balance and testing of support behind recorded transactions.

OBJECTIVES, SCOPE AND METHODOLOGY

Objectives

The objective of this performance audit was to evaluate the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements of $887,664, made from the USF during the twelve-month period ended June 30, 2007.

Scope

The scope of this performance audit includes, but is not limited to, reviewing USF Forms or other correspondence and supporting documentation provided by the Beneficiary, assessing the methodology used to prepare or support the USF Forms or other correspondence, and evaluating disbursement amounts made or potentially due based on filings of USF Forms or other correspondence relative to disbursements made from the USF during the twelve-month period ended June 30, 2007. To the extent required, our procedures were extended to activities of the Beneficiary's affiliates and other related-parties to obtain sufficient information upon which to make our assessment.

KPMG identified the following areas of focus for this performance audit based upon our risk assessment:

1. Materiality Analysis
2. Assets
3. COE Categorization
4. C&WF Categorization
5. Taxes
6. Part 64 Cost Allocations
7. Related-Parties/Affiliate Transactions

Methodology

This performance audit includes procedures related to the high cost support mechanisms for which funds were received by the Beneficiary during the disbursement period July 1, 2006 through June 30, 2007. The procedures conducted during this performance audit include an analysis of the following:

1. Prior period engagements (e.g., audits, studies, etc.) that are significant within the context of the current audit objectives related to assessing risk, determining the nature, timing and extent of current audit work, and evaluating corrective actions taken to address findings and recommendations,

2. Material accounts included in the 2005-2 and 2006-3 HCL and 2005 LSS Forms, and the 2004 Form 509 selected for sample testing in the Asset[2] test procedures,
3. Framework and approach established by the Beneficiary to support the CPRs from 2004 and 2005,
4. Asset balances and categorization to evaluate the reasonableness of the asset valuation, underlying G/L balances of assets and asset-related accounts, and classification and categorization of assets,
5. Methodologies and procedures used to perform the COE and C&WF asset categorizations,
6. Tax expense and related asset and liability balances in specific tax accounts recorded in the G/L,
7. Part 64 Cost Allocation methodologies including the appropriateness of allocation factors, evaluation of data sources and the frequency of the updates to the cost apportionment studies,
8. Affiliate transactions to determine the appropriateness of affiliate transaction pricing and management fee allocations.

[2] KPMG used a stratified random sampling methodology to select 45 asset samples from the material accounts identified in the 2005-2 and 2006-3 HCL and 2005 LSS Forms, and the 2004 Form 509. For the performance audit purposes, KPMG created four strata. Stratum one consisted of 16 assets with acquisition values between $79,026 and $210,374, and was sampled at 100%. Stratum two consisted of 33 assets with acquisition values between $27,115 and $79,025, and 7 samples were selected from this stratum. Stratum three consisted of 75 assets with acquisition values between $17,003 and $27,114, and 5 samples were selected from this stratum. Stratum four consisted of 109 assets with acquisition values between $0 and $17,002, and 17 samples were selected from this stratum.

RESULTS

KPMG's performance audit results include a listing of findings, recommendations and management's responses with respect to the Beneficiary's compliance with FCC requirements, and an estimate of the monetary impact of such findings relative to 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, applicable to the disbursements made from the USF during the twelve-month period ended June 30, 2007. KPMG also noted other matters that we have reported to the management of the Beneficiary in a separate letter dated July 27, 2010.

Findings, Recommendations and Beneficiary Responses

KPMG's performance audit procedures identified five significant findings. The findings along with the criteria, cause, effect, recommendation, and the Beneficiary response are as follows:

1. HC-2009-FL070-F01: Inaccurate Centralized Cost Allocations

Condition

Centralized cost allocations (Management Fees) charged by the Operating Company to the Beneficiary totaling $2,347,940 per year in 2004 and 2005 were improperly computed. The Operating Company utilized a fully distributed cost methodology to arrive at estimated centralized costs to be allocated to the Beneficiary and its affiliates, based on the Operating Company's 2003 financial statements.

- The Operating Company included Bad Debts of $511,398 in centralized costs which were allocated to the Beneficiary. These allocations were made in error as the Parent's bad debts should not have been included as part of the fully distributed cost allocations to Fulton.
- The Operating Company included taxes of $665,321 in centralized costs which were allocated to the Beneficiary; however, the Beneficiary had already recorded a tax liability in its accounting records based on its annual operating results.
- The Operating Company utilized a 12% Rate of Return on the net assets in determining fully distributed cost methodology instead of using the FCC's authorized rate of 11.25%.
- The Operating Company determined Cash Working Capital[3] based on total operating expenses required for 30 days instead of 15 days as prescribed by the FCC.
- The estimated centralized costs were not trued-up for 2004's and 2005's actual results.

[3] Calculation of cash working capital is guided by - 47 C.F.R. Part 65, Subpart G which prescribes a specific methodology in calculating working capital based on full lead-lag study. NECA suggests a simplified calculation where Total Amount for Allowances is multiplied by a factor of 0.041096.

Criteria

According to 47 C.F.R. § 32.27(c)(2), "When services are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and fully distributed cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive."

In addition, according to 47 C.F.R.§ 32.27(c)(3), "All services received by a carrier from its affiliate(s) that exist solely to provide to members of the carrier's corporate family shall be recorded at fully distributed cost."

Further, according to 47 C.F.R. § 32.27(e), "Income taxes shall be allocated among the regulated activities of the carrier, its non-regulated divisions, and members of an affiliated group. Under circumstances in which income taxes are determined on a consolidated basis by the carrier and other members of the affiliated group, the income tax expense to be recorded by the carrier shall be the same as would result if determined for the carrier separately for all time periods, except that the tax effect of carry-back and carry-forward operating losses, investment tax credits, or other tax credits generated by operations of the carrier shall be recorded by the carrier during the period in which applied in settlement of the taxes otherwise attributable to any member, or combination of members, of the affiliated group."

Cause

The Beneficiary incorrectly included certain Operating Company expenses in the calculation of centralized costs. Additionally, the Beneficiary used an incorrect rate of return and an incorrect cash working capital factor in its calculation of centralized costs. The Beneficiary did not have adequate processes and controls in place to review the fully distributed cost components used in calculation of centralized costs or to utilize the correct rate of return and working capital factors.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $201,308 higher than they would have been had amounts been reported properly.
- LSS disbursements calculated in the 2005 data submission were approximately $34,543 higher than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $149,461 higher than they would have been had amounts been reported properly.

Recommendation The Beneficiary should enhance policies and procedures governing the determination of centralized costs using a fully distributed cost methodology in accordance with the affiliate transaction rules.

Beneficiary Response Fulton Telephone Company (Fulton) has already taken steps to implement policies and procedures to assure that its Centralized Costs are in compliance with 47 C.F.R. §32.27 Affiliate Transaction Rules.

2. HC-2009-FL070-F02: Improper Methodology used in Affiliate Pricing of B&C Services

Condition NexBand did not utilize a fully distributed cost methodology to calculate B&C charges to the Beneficiary for 2004 and 2005.

The Beneficiary incurred B&C costs of $360,919 and $309,475 for customer and CABS billing, respectively, in 2004 and $328,555 and $286,921 for customer and CABS billing, respectively, in 2005.

The Beneficiary provided KPMG with example customer bills which indicated charges of $3.00 for customer B&C service and $2.55 for CABS B&C services.

KPMG was unable to obtain supporting documentation from the Beneficiary for these costs. Accordingly, to assess the reasonableness of the B&C costs, KPMG obtained a comparable contract for a beneficiary with a similar B&C arrangement with its affiliate. In this instance the affiliate charged $1.50 per customer bill under a fully distributed cost methodology, representing 50% of amount charged by NexBand to the Beneficiary.

We were unable to identify a similar contract for CABS billing. Accordingly, we utilized the ratio noted above to create an estimated fully distributed cost amount for CABS billing. Using the 50% factor, NexBand CABs billing would be approximately $1.28 per invoice.

Criteria According to 47 C.F.R. § 32.27(c)(2), "When services are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and fully distributed cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive."

In addition, according to 47 C.F.R.§ 32.27(c)(3), "All services received by a carrier from its affiliate(s) that exist solely to provide to members of the carrier's corporate family shall be recorded at fully distributed cost."

Cause The Beneficiary's Affiliate did not utilize a fully distributed cost methodology in determining B&C costs charged to and recorded by the

Beneficiary. In addition, the Beneficiary did not have adequate processes and controls in place to review the fully distributed cost components used in calculation of B&C charges.

Effect

The exception identified above has an impact on LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- LSS disbursements calculated in the 2005 data submission were approximately $5,913 higher than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $8,224 higher than they would have been had amounts been reported properly.

Recommendation

The Beneficiary's affiliate should perform a comprehensive analysis to determine the fully distributed cost of providing customer and CABS B&C services to the Beneficiary, in accordance with the affiliate transaction rules.

Beneficiary Response

Fulton does not agree with KPMG's assertion that there is an affiliate arrangement between Fulton and the billing company, NexBand. As defined by the Communications Act of 1934 Sec. 3. [47 U.S.C. 153(1)], the term "affiliate" means a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person. There is neither common ownership nor control between Fulton and NexBand.

The rates that Fulton is being charged by NexBand are based on historical data from a prior billing company. Therefore, Fulton does not agree with KPMG's finding that NexBand's billing charges constitute overcharges.

KPMG Response:

We believe that NexBand's B&C services to the Beneficiary should be evaluated under the affiliate transaction rules due to the close business and familial relationships between the owners of Fail Inc. (Operating Company) and NexBand. More specifically, the owner of NexBand is an employee of the Operating Company and is also the daughter of the owner of Fail Telecommunications, Inc. (Parent Company).

3. HC-2009-FL070-F03: Non-Allocation of Property Taxes

Condition

The Beneficiary did not allocate Property Taxes related to GSF assets used in the conduct of non-regulated activities in 2004 and 2005 as required. The Beneficiary allocated 3% of GSF Assets and related, Accumulated Depreciation, Depreciation Expense and General Support

Expenses to non-regulated activities but failed to allocate related Property Taxes. Property Tax balances in 2004 and 2005 were $81,188 and $91,712, respectively.

Criteria

According to 47 C.F.R. § 32.12(b), "The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts. The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission."

According to 47 C.F.R. § 32.14(c), "In the application of detailed accounting requirements contained in this part, when a regulated activity involves the common or joint use of assets and resources in the provision of regulated and non-regulated products and services, companies shall account for these activities within the accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to non-regulated activities, amounts solely assignable to regulated activities, and amounts related to assets used and expenses incurred jointly or in common, which will be allocated between regulated and non-regulated activities."

According to 47 C.F.R. § 64.901(a), "Carriers required to separate their regulated costs from non-regulated costs shall use the attributable cost method of cost allocation for such purpose."

According to 47 C.F.R. § 64.902(b)(iii), "When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and non-regulated activities."

Cause

The Beneficiary did not have adequate procedures and controls over the review and approval of Part 64 Cost Allocations of common or joint costs between regulated and non-regulated activities to ensure that all costs related to non-regulated activities were properly allocated.

Effect

The exception identified above has an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $718 higher than the disbursements would have been had amounts been reported properly.
- LSS disbursements calculated in the 2005 data submission were approximately $63 higher than the disbursements would have been had amounts been reported properly.

- ICLS disbursements calculated in the 2004 data submission were approximately $473 higher than the disbursements would have been had amounts been reported properly.

Recommendation

The Beneficiary should establish, document and implement procedures to address the preparation, review and approval processes related to the Part 64 Cost Allocations of common or joint costs. In addition, the Beneficiary should directly assign costs to regulated and non-regulated activities to the extent possible. In instances where direct assignment is not possible, the Beneficiary should perform an appropriate study for the assets and expenses to allocate common or joint costs between regulated and non-regulated activities.

Beneficiary's Response

Fulton will establish procedures for allocating corresponding Property Tax adjustments related to the Part 64 Cost Allocations of common or joint costs between regulated and non-regulated activities for compliance with 47 C.F.R. § 64.901(a) and § 64.902(b)(iii).

4. **HC-2009-FL070-F04: Inaccurate Part 64 Cost Study Adjustments**

Condition

The Beneficiary did not record the income tax impacts of Part 64 Cost Study expense adjustments when reporting the respective regulated expense amounts on the USF Forms as required.

Criteria

According to 47 C.F.R. § 32.12(a),"The company's financial records shall be kept in accordance with generally accepted accounting principles to the extent permitted by this system of accounts."

According to 47 C.F.R. § 32.12(b), "The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts. The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission."

Cause

The Beneficiary did not have appropriate oversight controls in-place to identify that its part 64 Cost Study expense adjustments were not tax affected in its HCL and LSS form submissions, as required. .

Effect

The exceptions noted above impact the Beneficiary's HCL, and LSS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $2,750 lower than the disbursements would have been had amounts been reported properly.

- LSS disbursements calculated in the 2005 data submission were approximately $342 lower than the disbursements would have been had amounts been reported properly.

Recommendation The Beneficiary should tax-affect Part 64 Cost Study expense adjustments prior to reporting on the USF Forms, using the effective income tax rate.

Beneficiary's Response Fulton's Cost Consultant, John Staurulakis, Inc. (JSI) has instituted additional procedures to comply with the need to tax-affect Part 64 Cost Study expense adjustments, reflective of effective income tax rates, prior to reporting on the USF Forms.

5. **HC-2009-FL070-F05: Inaccurate Income Tax Expenses**

Condition The Beneficiary's Federal and State Income Tax expense was overstated in 2004 by $8,568 and understated in 2005 by $2,195 in its accounting records and USF Forms.

Criteria According to 47 C.F.R. § 32.12(a),"The company's financial records shall be kept in accordance with generally accepted accounting principles to the extent permitted by this system of accounts."

According to 47 C.F.R. § 32.12(b), "The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts. The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission."

Cause The Beneficiary's accumulated depreciation calculated on final tax forms differed from source data for asset disposals and transfers. The accumulated depreciation amounts reflected for asset disposals and transfers on tax filings were adjusted to reflect accurate transaction amounts; however, the book balances were not adjusted to reflect the same.

Effect The exceptions identified above have an impact on HCL disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $1,056 higher than the disbursements would have been had amounts been reported properly.

Recommendation The Beneficiary should enhance processes governing calculation of income tax amounts to ensure compliance with FCC Rules and Orders.

Beneficiary Response Fulton Telephone Company, along with their tax accountant, will implement procedures to ensure that future income tax amounts are calculated in compliance with FCC Rules and Orders.

Conclusion

KPMG's evaluation of the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, based on revised USF Forms or other correspondence identified Part 64 Cost Study allocations, property and income taxes, and affiliate transaction findings relative to the disbursements made from the USF during the twelve-month period ended June 30, 2007. Detailed information relative to the findings is described in the Findings, Recommendations and Beneficiary Response section above.

KPMG evaluated the USF disbursements made based on earlier filings of USF Forms, as compared to those which would have been made based on the revised filings or other correspondence. The combined estimated monetary impact[4] of these findings as follows:

Disbursement Mechanism	Monetary Impact Overpayment
HCL	$200,332
LSS	$40,626
ICLS	$158,157
Total Impact	**$399,115**

[4] The combined estimated monetary impacts of the findings may not equal the sum of individual findings to the extent that individual findings indirectly impact other findings. For example, certain findings may impact the categorization of certain asset types and/or modify apportionment factors that apply to other individual findings when considered in combination. The individual impact amounts discussed above consider only the direct impact of the noted finding.