

SOUTHERN TIER NETWORK, INC.

**Communication of Matters Related to Internal Control
Over Financial Reporting and Other Matters
March 2015**

March 2015

To the Board of Directors of
Southern Tier Network, Inc.:

In planning and performing our audit of the financial statements of Southern Tier Network, Inc. (STN) as of and for the year ended December 31, 2014, in accordance with auditing standards generally accepted in the United States, we considered STN's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of STN's internal control. Accordingly, we do not express an opinion on the effectiveness of STN's internal control.

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.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

This communication is intended solely for the information and use of management, the Board of Directors, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

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SOUTHERN TIER NETWORK, INC.

COMMUNICATION OF MATTERS RELATED TO INTERNAL CONTROL OVER FINANCIAL REPORTING AND OTHER MATTERS MARCH 2015

PRIOR YEAR RECOMMENDATIONS

In connection with our audit of the financial statements of STN for the year ended December 31, 2014, we reviewed the status of the suggestions we made in the prior year. We are pleased to report that STN has addressed our recommendations related to:

- **Customer Lateral Build Costs** – Last year, we recommended that STN establish a procedure to evaluate the actual costs of each lateral built against the amount collected from the customer for that lateral. This year, we noted that STN has implemented a system to track costs and revenues on a contract-by-contract basis that will provide margin information for each project going forward.
- **Public Authority Compliance Requirements** – Last year, we recommended that STN ensure that compliance requirements with the New York State Authorities Budget Office (ABO) are met and documented. This matter is repeated in the current year.

INTERNAL CONTROL RELATED MATTERS

Significant Deficiency in Internal Control

We have identified the following control deficiency that we consider to be a significant deficiency in internal control as defined in our cover letter.

1. ORGANIZATIONAL COMMUNICATION

Observation

During 2014, STN's operation transitioned from construction of the fiber-optic cable backbone ring to outreach and customer relations related to connecting users to that ring. As customer volume continues to grow and new customer signings happen with more frequency, communication between the operational, sales, and accounting functions will be more difficult to effectively maintain on an ad-hoc basis.

STN's structure – with outsourced providers conducting essentially all operational and administrative activities – requires a more disciplined approach than that which might be used by a typical hierarchical organization. STN's administrative and accounting functions are heavily reliant on ECC Technologies to provide timely, accurate information on operational activities.

We noted several instances where communication from ECC's resources to STN's administrative and accounting personnel was not effective and where that ineffectiveness had a negative impact on STN's ability to carry out and account for its activities with appropriate timeliness and controls. These include the following:

- A customer was connected and utilizing the fiber ring but was not invoiced for several months because, at least in part, of unclear communication between operational and accounting personnel.
- A number of vendor invoices were received from ECC for services that had occurred months, and in some cases over a year, prior to the date invoices were rendered.

1. ORGANIZATIONAL COMMUNICATION (Continued)

Observation (Continued)

- Work commenced on a major customer project prior to a signed contract being in place for that work.

STN's contract with ECC Technologies does not include specific terms of communication, nor does it establish requirements for timeliness of conveying invoices or other documents.

Recommendation

We recommend STN establish a procedure for communication between ECC Technologies' operational and sales personnel and STN's accounting personnel on a scheduled monthly or quarterly basis. Standing agenda items could be established for these meetings to include a review of the active project roster and update on the status of each listed project, as well as any changes to existing customer relationships.

Further, STN should consider amending its contract with ECC to establish agreed-upon terms of performance specific to invoices, contracts, sales and marketing, project completion, project change orders, etc. If such an amendment were to be pursued, specific financial penalties for non-performance should be considered in conjunction with the terms of performance.

Other Internal Control Items

We have identified the following control deficiencies that we do not consider to be significant deficiencies or material weaknesses in internal control as defined in our cover letter.

2. PARTS AND SUPPLY INVENTORY

Observation

Starting in 2014, STN began purchasing fiber specifically for each installation. Previously, STN purchased fiber in advance to provide to the installation contractor, and excess lengths were returned to STN and recorded in STN's parts and supplies inventory.

Over time, this practice resulted in fiber accumulating in varying lengths. Due to the expense involved in splicing shorter lengths together to span longer distances, the shorter lengths currently held in STN's parts and supplies inventory are of limited usefulness.

There is approximately \$202,000 of parts and supply inventory recorded on STN's balance sheet as of December 31, 2014, all of which is fiber. We requested and received an analysis of this inventory from STN's accountant indicating that some reserve for unrealizable parts and supplies inventory might be warranted. Adjustment to reduce the net recorded value of fiber inventory was not proposed due to the lack of an established policy and procedure to establish an estimated valuation allowance.

Recommendation

We recommend STN explore the options for use or disposal of these varying lengths of fiber. Based on the identification and evaluation of options, STN should establish a policy regarding valuation allowance against the inventory balance, to reflect the estimated net realizable value of parts and supplies inventory.

3. PUBLIC AUTHORITY COMPLIANCE REQUIREMENTS

Observation

As a Local Development Corporation in New York State, STN is required to comply with a number of governance and reporting regulations. Our audit does not include a review of all requirements to which STN is subject. However, we did become aware that STN is not in compliance with regulations that require all STN Board members to “attend” an on-line training from the New York State Authorities Budget Office (ABO) within one year of appointment to the Board and complete the required “Acknowledgement of Fiduciary Duties” form at the start of each term.

STN has an established system to track which Board members have taken the training and signed the “Acknowledgement of Fiduciary Duties” form, and has encouraged all Board members to comply. As of the date of our audit fieldwork, one of STN’s Board of Directors had not attested to taking the training or completed the form.

Recommendation

We recommend that management and the Board of Directors take steps to ensure that these compliance requirements are met and documented.

Informational Item

The following item is informational in nature and does not represent an internal control deficiency.

4. REVISED REVENUE RECOGNITION RULE

Observation

In May, 2014, the Financial Accounting Standards Board issued a comprehensive revenue recognition rule that will replace essentially all elements of generally accepted accounting principles (GAAP) that address revenue. This new standard is designed to establish consistent revenue recognition practices across industries and companies within industries.

The standard is based on a five step model:

1. Identify the contract
2. Identify performance obligations
3. Determine transaction price
4. Allocate transaction price
5. Recognize revenue

The standard itself and accompanying interpretive guidance run hundreds of pages, and the level of complexity is high. The standard is effective for STN’s 2018 calendar year reporting, and may be adopted no earlier than STN’s 2017 calendar year reporting.

Relative to STN’s contracts with customers, the typical contract has multiple performance obligations, potentially including:

- Designing and constructing a connection from the customer’s location to the fiber optic ring.
- Providing access to the fiber optic ring for a contractual period of time.
- Maintaining that connectivity for a contractual period of time.

4. REVISED REVENUE RECOGNITION RULE (Continued)

Observation (Continued)

The transaction price charged to the customer has multiple elements as well, including at least an initial connection charge and on-going lease and maintenance payments. Under the new standard, the total to be received from the customer must be allocated to the performance obligations in proportion to the effort or cost associated with satisfying each performance obligation. With some performance obligations required to be delivered for years into the future, appropriately estimating these amounts will be challenging.

This may differ from STN's current GAAP accounting, where revenue for contracts is deferred and recognized over the term of the contract.

Alternatively, under current GAAP, STN recognized revenue related to the sale of built-out fiber connections to Steuben County. The new revenue standard may require deferral of some of the sales revenue in recognition of STN's performance obligation related to maintaining the fiber for Steuben County for the thirty year term of the contract.

The new standard includes interpretive guidance on many general and specific situations, and FASB has indicated that more interpretive guidance is to be issued throughout 2015.

Recommendation

We recommend that STN consider the performance obligations inherent in its customer contracts. In addition, actual experience related to existing contracts should be tracked and monitored for trends to inform STN regarding future performance.

We stand prepared to assist STN in interpreting the new standard as additional guidance is released.