

PUBLIC SERVICE COMMISSION
ANNUAL REPORT BRANCH
MAR 27 2012
RECEIVED
EXAMINED BY _____

FARMERS RURAL ELECTRIC
COOPERATIVE CORPORATION
GLASGOW, KENTUCKY

REPORT ON AUDIT OF CONSOLIDATED
FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION

For the Years Ended
December 31, 2011 and 2010

CONTENTS

	<u>Pages</u>
Independent Auditors' Report	1
Consolidated Financial Statements:	
Balance Sheets	2 - 3
Statements of Revenue	4
Statements of Patronage Capital and Memberships	5
Statements of Cash Flows	6 - 7
Notes to Consolidated Financial Statements	8 - 15
Supplementary Information:	
Independent Auditors' Report on Consolidating Information	16
Schedule I – Consolidating Balance Sheet	17
Schedule II – Consolidating Statement of Revenue	18
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>	19 - 20

CAMPBELL, MYERS, & RUTLEDGE, PLLC

Certified Public Accountants

Cindy L. Greer, CPA
L. Joe Rutledge, CPA
Jonathan W. Belcher, CPA
R. Brent Billingsley, CPA

Skip R. Campbell, CPA
Charles E. Rutledge, CPA
Sammie D. Parsley, CPA
Ryan A. Mosier, CPA
Jenna B. Pace, CPA

410 South Broadway
Glasgow, KY 42141
Telephone (270) 651-2163
Fax (270) 651-6677
www.cmr-cpa.com

Independent Auditors' Report

Board of Directors
Farmers Rural Electric
Cooperative Corporation
Glasgow, Kentucky 42141

We have audited the accompanying consolidated balance sheets of Farmers Rural Electric Cooperative Corporation and Subsidiary, as of December 31, 2011 and 2010, and the related consolidated statements of revenue, patronage capital and memberships and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these consolidated 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 opinions.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers Rural Electric Cooperative Corporation and Subsidiary, 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.

As discussed in Note 15 to the financial statements, the Cooperative has elected to change its policy to record unbilled revenue, to better match revenue and expenses.

In accordance with *Government Auditing Standards* we have also issued our report dated February 27, 2012, on our consideration of Farmers Rural Electric Cooperative Corporation's internal control over financial reporting and on 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 considering in assessing the results of our audit.

Campbell, Myers & Rutledge, PLLC

Certified Public Accountants

February 27, 2012

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
BALANCE SHEETS
December 31, 2011 and 2010

ASSETS		<u>2011</u>	<u>Restated 2010</u>
Current assets:			
Cash and cash equivalents	\$	764,903	\$ 2,523,668
Accounts and notes receivable, less allowance for doubtful accounts of \$66,925 in 2011		5,487,019	5,317,433
Materials and supplies, at average cost		455,319	370,476
Prepaid expenses		193,069	181,709
Total current assets		<u>6,900,310</u>	<u>8,393,286</u>
Other assets and investments:			
Investments in subsidiary companies		1,425,102	1,361,172
Investment in associated organizations		15,395,500	12,865,802
Deferred charges		695,513	711,025
Total other assets		<u>17,516,115</u>	<u>14,937,999</u>
Electric plant in service		72,895,115	70,252,414
Construction work in progress		369,223	409,221
		73,264,338	70,661,635
Less accumulated depreciation		<u>(21,096,657)</u>	<u>(20,020,400)</u>
Electric plant, net		<u>52,167,681</u>	<u>50,641,235</u>
Total assets	\$	<u>76,584,106</u>	\$ <u>73,972,520</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
BALANCE SHEETS
December 31, 2011 and 2010

LIABILITIES AND MEMBERS' EQUITIES

	<u>2011</u>	<u>Restated 2010</u>
Current liabilities:		
Accounts payable	\$ 4,472,258	\$ 4,144,544
Accrued expenses	1,258,622	1,387,579
Customer deposits	910,411	1,094,061
Current Portion of capital leases	29,045	29,045
Current Portion of long-term debt	1,289,000	1,200,000
Total current liabilities	<u>7,959,336</u>	<u>7,855,229</u>
Long-term liabilities:		
Capital lease less current maturities	19,364	48,409
Long-term debt less current maturities	39,952,592	40,167,470
Total long-term liabilities	<u>39,971,956</u>	<u>40,215,879</u>
Noncurrent liabilities:		
Post retirement benefit obligations	339,138	199,170
Customer Advances for Construction	360,170	338,357
	<u>699,308</u>	<u>537,527</u>
Members' equities:		
Memberships	534,535	534,690
Patronage capital	25,968,855	23,411,160
Accumulated other comprehensive income	(300,494)	(180,850)
Other equities	1,405,564	1,253,479
Total members' equities	<u>27,608,460</u>	<u>25,018,479</u>
Minority interests	345,046	345,406
Total equities	<u>\$ 27,953,506</u>	<u>\$ 25,363,885</u>
	<u>\$ 76,584,106</u>	<u>\$ 73,972,520</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
STATEMENTS OF REVENUE

For the years ended December 31, 2011 and 2010

	<u>2011</u>	<u>Restated 2010</u>
Operating revenue	\$ 48,400,849	\$ 48,164,511
Operating expenses:		
Cost of power	35,296,777	34,261,984
Distribution - operations	1,409,019	1,323,836
Distributions - maintenance	2,655,097	2,623,774
Consumer accounts	1,089,638	977,325
Customer services and informational expense	124,081	162,408
Administrative and general	2,123,266	1,995,437
Depreciation	2,298,810	2,194,698
Taxes	617,501	542,732
Total Operating expenses	<u>45,614,189</u>	<u>44,082,194</u>
Operating margins	2,786,660	4,082,317
Interest on long-term debt to RUS and CFC	<u>1,987,320</u>	<u>2,036,209</u>
Operating margins after fixed charges	799,340	2,046,108
G & T and other capital credits	<u>2,551,217</u>	<u>1,449,778</u>
Net operating margins	<u>3,350,557</u>	<u>3,495,886</u>
Nonoperating margins:		
Interest income, net of expenses of \$ 60,984 in 2011 and \$67,597 in 2010	21,894	(17,681)
Other net nonoperating income (loss)	176,238	140,245
	<u>198,132</u>	<u>122,564</u>
Net margins	<u>\$ 3,548,689</u>	<u>\$ 3,618,450</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
 STATEMENTS OF PATRONAGE CAPITAL AND MEMBERSHIPS
 For the years ended December 31, 2011 and 2010

	Memberships	Accumulated Other Comprehensive Income	Patronage Capital				Total	
			Unassigned	Assignable	Assigned	Retired		
Balances, January 1, 2010	\$ 532,675	(\$190,894)	\$ (129,816)	\$ 2,350,262	\$ 29,042,359	\$ (433,300)	\$ (10,250,192)	\$ 20,579,313
Increase in memberships, net of terminations	2,015	-	-	-	-	-	-	-
Net margins for the year ended December 31, 2010	-	-	(962,624)	4,581,074	-	-	-	3,618,450
Assignment of patronage capital for the year ended December 31, 2010 and old unassigned margins	-	-	-	(2,350,262)	2,350,262	-	-	-
Retirement of patronage capital of estates of deceased members and adjustments	-	-	-	-	-	-	-	-
Other comprehensive income	-	10,044	-	-	-	-	-	-
Distributions of patronage capital	-	-	-	-	-	-	(786,603)	(786,603)
Balances, December 31, 2010 Restated	534,690	(180,850)	(1,092,440)	4,581,074	31,392,621	(433,300)	(11,036,795)	23,411,160
Increase in memberships, net of terminations	(155)	-	-	-	-	-	-	-
Net margins for the year ended December 31, 2011	-	-	-	3,548,689	-	-	-	3,548,689
Assignment of patronage capital for the year ended December 31, 2011	-	-	-	(4,581,074)	4,581,074	-	-	-
Retirement of patronage capital of estates of deceased members and adjustments	-	-	-	-	-	-	-	-
Other comprehensive income	-	(119,644)	-	-	-	-	-	-
Distributions of patronage capital	-	-	-	-	-	-	(990,994)	(990,994)
Balances, December 31, 2011	<u>\$ 534,535</u>	<u>\$ (300,494)</u>	<u>\$ (1,092,440)</u>	<u>\$ 3,548,689</u>	<u>\$ 35,973,695</u>	<u>\$ (433,300)</u>	<u>\$ (12,027,789)</u>	<u>\$ 25,968,855</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
STATEMENTS OF CASH FLOWS

For the years ended December 31, 2011 and 2010

	<u>2011</u>	<u>Restated 2010</u>
Cash flows from operating activities:		
Net margins	\$ 3,548,689	\$ 3,618,450
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,298,810	2,194,698
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(169,586)	(246,194)
(Increase) decrease in inventory	(84,843)	(65,321)
(Increase) decrease in prepaid expenses	(11,360)	(5,757)
Increase (decrease) in accounts payable	(327,715)	1,068,353
Increase (decrease) in customer deposits	(183,650)	16,119
Increase (decrease) in accrued expenses	(128,957)	(66,067)
Increase (decrease) in customer advances for construction	21,813	(6,920)
(Increase) decrease in deferred charges	<u>15,512</u>	<u>(3,163)</u>
Net cash provided by operating activities	<u>4,978,713</u>	<u>6,504,198</u>
Cash flows from investing activities:		
Purchases of property, plant and equipment	(2,278,936)	(2,748,593)
Plant removal costs	(486,941)	(412,347)
Salvage recovered from retirement of plant	56,474	17,647
Investments in subsidiary companies	(63,930)	(218,028)
(Increase) decrease in investments in associated organizations and other investments	<u>(2,529,698)</u>	<u>(1,424,468)</u>
Net cash used in investing activities	<u>(5,303,031)</u>	<u>(4,785,789)</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
 STATEMENTS OF CASH FLOWS, CONCLUDED
 For the years ended December 31, 2011 and 2010

	<u>2011</u>	<u>Restated 2010</u>
Cash flows from financing activities:		
Memberships issued	\$ (155)	\$ 2,015
Increase in noncurrent liabilities	(139,968)	(17,726)
Distributions of patronage capital	(990,994)	(786,603)
Retired capital credits - gain	(148,409)	116,157
Minority interest - subsidiary	-	37,024
Principal payments under capital lease obligation	(29,045)	(9,680)
Principal payments to RUS	(239,103)	(1,609,969)
Advanced principal payments unapplied	462,200	(912,604)
Principal payments to CFC	(496,290)	(216,291)
Advance line of credit - short-term - CFC	-	1,174,061
Loan advancements from RUS/FFB	750,000	2,000,000
Principal payments to RUS/FFB	<u>(602,683)</u>	<u>(460,178)</u>
Net cash provided (used) by financing activities	<u>(1,434,447)</u>	<u>(683,794)</u>
Increase (decrease) in cash and cash equivalents	(1,758,765)	1,034,615
Cash and cash equivalents at beginning of year	<u>2,523,668</u>	<u>1,489,053</u>
Cash and cash equivalents at end of year	<u>\$ 764,903</u>	<u>\$ 2,523,668</u>
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	<u>\$ 1,987,320</u>	<u>\$ 2,037,701</u>
Income taxes	<u>\$ -</u>	<u>\$ -</u>

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

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL

1. Summary of Significant Accounting Policies:

Principles of Consolidation:

The consolidated financial statements include the accounts of Farmers Rural Electric Cooperative Corporation and its 75% owned subsidiary, Farmers Energy Services Corporation. All material intercompany transactions have been eliminated in consolidation.

General:

The Cooperative maintains its records in accordance with policies prescribed or permitted by Kentucky Public Service Commission and United States Department of Agriculture, Rural Utilities Service, which conform in all material respects with generally accepted accounting principles. The more significant of these policies are as follows:

Nature of Business:

Farmers Rural Electric Cooperative Corporation provides electric service in an eight-county area of south central Kentucky. The Cooperative grants credit to customers, substantially all of whom are local residents and commercial businesses.

Utility Plant:

Utility plant is stated substantially at original cost, net of contributions, which is the cost when first dedicated to public service. Such cost includes applicable supervisory and overhead cost. The Cooperative does not capitalize interest during construction.

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expense. The cost of replacement of depreciable property units, as distinguished from minor items, is charged to utility plant. The cost of units of property replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation. When property is sold, a gain or loss is reflected in income.

The major classifications of electric plant in service at December 31, 2011 and 2010 were:

	<u>2011</u>	<u>2010</u>
Distribution Plant	\$64,460,155	\$62,362,740
General Plant	7,330,517	6,785,231
Other Production Plant	1,100,818	1,100,818
Intangible Plant	<u>3,625</u>	<u>3,625</u>
	<u>\$72,895,115</u>	<u>\$70,252,414</u>

Cash and Cash Equivalents:

For purposes of the statement of cash flows, the Cooperative considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of management estimates and assumptions that affect the reporting amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reporting amounts of the revenues and expenses during the reporting period. Actual results could differ from those estimates.

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

1. Summary of Significant Accounting Policies, Continued:

Depreciation:

Provision has been made for depreciation on the basis of estimated lives of assets, using the straight-line method. Distribution plant depreciation is based on a composite rate of three and twenty-four hundredths percent (3.24%) per annum.

The following depreciation rates for the components of the general plant were in effect as of December 31, 2011 and 2010:

Structures and Improvements	2.5%
Office Furniture and Fixtures	20.0%
Transportation and Communication Equipment	14.0%
Power-Operated Equipment	12.0%
Office Equipment and Computers	20.0%
Telephone Equipment	14.0%
Other General Plant	6.0%

Depreciation for the years ended December 31, 2011 and 2010 was \$2,528,773 and \$2,420,146 respectively, of which \$2,298,810 in 2011 and \$2,194,698 in 2010 was charged to depreciation expense in 2011 \$229,963 and \$225,448 in 2010 was allocated to plant and other operating expenses based on usage.

Revenue and Cost of Power:

Operating revenue and cost of purchased power include increases (decreases) under the fuel clause adjustment of approximately \$(3,357,534) for the year ended December 31, 2011, and \$(7,749,758) for the year ended December 31, 2010.

Income Tax Status:

The Cooperative is exempt from federal and state income taxes under Code Section 501(c)(12) because more than 85% of its revenue is received from members. Accordingly, the financial statements include no provision for income taxes.

Investment in Subsidiary Companies:

This balance represents the Cooperative's investments in affiliates, together with other Cooperatives, for the purpose of providing other energy services and products. These investments are accounted for using the equity method.

Subsequent Events:

Management has evaluated subsequent events through February 27, 2012, the date which the financial statements were available to be issued. The Cooperative has requested a draw of \$1,000,000 on January 10, 2012 from FFB.

Reclassifications

Comparative data for the prior year have been presented in certain sections of the accompanying financial statements in order to provide an understanding of changes in the Corporation's financial position and operations. Also, certain amounts presented in the prior year data have been reclassified in order to be consistent with current year's presentation.

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

2. Investments in Associated Organizations:

Investments in associated organizations as of December 31, 2011 and 2010, are listed as follows:

	<u>2011</u>	<u>2010</u>
East Kentucky Power Cooperative, Inc.	\$ 13,831,209	\$11,351,169
National Rural Utilities Cooperative Finance Corporation	833,150	834,043
Other	<u>731,141</u>	<u>680,590</u>
	<u>\$ 15,395,500</u>	<u>\$12,865,802</u>

Investments in National Rural Utilities Cooperative Finance Corporation consist of a membership fee and capital term certificates. Patronage capital from associated organizations is recorded at the stated amount of the certificate.

3. Long-Term Debt:

All assets, except motor vehicles are pledged as collateral for the long-term debt to the United States of America and National Rural Utilities Cooperative Finance Corporation under a joint mortgage agreement.

Long-term debt at December 31, 2011 and 2010, consisted of:

	<u>2011</u>	<u>2010</u>
Due United States of America:		
5% First Mortgage Notes	\$ 2,143,947	\$ 1,823,393
5.12% First Mortgage Notes-Variable Rate	1,835,240	1,883,040
4.125 to 4.5% First Mortgage Notes-Variable Rate	1,721,210	1,770,867
5.49% Mortgage Note-FFB	3,953,444	4,037,198
5.62% Mortgage Note-FFB	388,681	396,770
2.87 to 4.93%Mortgage Note - FFB - Variable Rate	<u>26,999,330</u>	<u>26,760,171</u>
Total due United States of America	<u>37,041,852</u>	<u>36,671,439</u>
Due National Rural Utilities Cooperative Finance Corporation:		
2.40% to 6.8% First Mortgage Notes	<u>4,199,740</u>	<u>4,696,031</u>
	41,241,592	41,367,470
Less current maturities	<u>(1,289,000)</u>	<u>(1,200,000)</u>
	<u>\$ 39,952,592</u>	<u>\$ 40,167,470</u>

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

3. Long-Term Debt, Continued:

In June, 2000, the Cooperative received approval from the Federal Financing Bank -- Rural Utilities Service for a loan in amount of \$5,053,000. This loan is for a period of thirty-five years and bears interest at the approximate rate of 5.5%. The total amount of this loan was advanced to the Cooperative in January, 2001. Principal payments began June 30, 2002, and are due quarterly.

In May, 2003, the Cooperative received approval from the Federal Financing Bank -- Rural Utilities Service for a loan in the amount of \$18,228,000. This loan is for a period of thirty-five years, is payable quarterly, and currently bearing a variable interest rate of approximately 4.5%. The total amount of this loan was advanced to the Cooperative.

In 2008, the Cooperative received approval from the Federal Financing Bank-Rural Utilities Service for a loan in the amount of \$17,402,000. This loan is for a period of thirty-five years, is payable quarterly, and currently bearing a variable interest rate of approximately 3.63%. The Cooperative has received \$10,000,000 as of December 31, 2011.

The long-term debt payable to the United States of America is due in quarterly and monthly installments of varying amounts through 2040. During the year ending December 31, 2011, installments estimated at \$2,581,000 will include approximately \$809,000 of principal and \$1,795,000 of current interest.

The long-term debt payable to the National Rural Utilities Cooperative Finance Corporation is due in quarterly installments of varying amounts through 2032. During the year ending December 31, 2011, installments estimated at \$703,000 will include approximately \$480,000 of principal and \$223,000 of current interest.

The Cooperative has available a line of credit for short-term loans of up to \$5,000,000 with National Rural Utilities Cooperative Finance Corporation extending to December 31, 2011. The maximum interest rate is to be the prevailing bank prime rate published in the "money rates" column of The Wall Street Journal plus one percent (1%) per annum. At December 31, 2011, the balance of the line-of-credit was \$-0-.

The maturities of long-term debt for each of the five years succeeding the balance sheet are as follows:

2012	\$ 1,289,000
2013	1,900,000
2014	2,000,000
2015	2,000,000
Thereafter	<u>32,763,592</u>
Total	<u>\$39,952,592</u>

4. Leases:

The Corporation is the lessee of office equipment under capital leases expiring September 2013. The asset and liabilities under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. The assets are amortized over their estimated productive lives. Amortization of the asset under capital leases is included in depreciation expense.

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

4. Leases, Continued:

Following is a summary of property held under capital leases:

Office equipment	\$ 87,136
Accumulated amortization	<u>(8,298)</u>
	<u>\$ 78,838</u>

Minimum future lease payments under capital leases as of December 31, 2011, were as follows:

	<u>Amount</u>
2012	\$ 29,045
2013	<u>19,364</u>
Net minimum lease payments	48,409
Amount representing interest	<u>-0-</u>
Present value of net minimum lease payments	<u>\$ 48,409</u>

5. Deferred Charges:

Following is a summary of amounts recorded as deferred charges as of December 31, 2011 and 2010:

	<u>2011</u>	<u>2010</u>
Transportation Expense	\$ 10,176	\$ 32,852
Gis-Field Inventory Cost	614,044	648,316
Long Range Plans	27,470	-
Mapping ESRI	17,663	17,663
EDP Support Agreement/Maintenance	5,587	10,137
Maintenance Agreements	<u>20,573</u>	<u>2,057</u>
	<u>\$ 695,513</u>	<u>\$ 711,025</u>

6. Return of Capital:

Under provisions of the long-term debt agreement, return to patrons of capital contributed by them is limited to amounts which would not allow the total members' equities to be less than forty percent (40%) of total assets, except that distributions may be made to estates of deceased patrons.

The debt agreement provides, however, that should such distributions to estates not exceed twenty-five percent (25%) of net margins for the next preceding year, the Cooperative may distribute the difference between twenty-five percent (25%) and the payments made to such estates.

Capital credit retirements in the amount of \$990,994 and \$786,603 were paid for the years ended December 31, 2011 and 2010.

7. Other Equities:

At December 31, 2011 and 2010 other equities consisted of retired capital credits – gain, in amounts of \$1,405,564 and \$1,253,479, respectively.

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

8. Pension Plan:

Pension benefits for substantially all employees are provided through participation in the NRECA Retirement and Security Program. It is the policy of the Cooperative to fund pension costs accrued. Due to the good investment performance, a moratorium was declared on all employer contributions to the Retirement and Security Program for the period July 1, 1987 through December 31, 1988, in order to keep the program from moving ahead of its funding schedule. This moratorium was then extended through all of 1993. The moratorium on employer contributions ended in June, 1994, with the collection of all past service costs. Beginning in November, 1994, the program accepted contributions from November, 1994 through April, 1995, then contributions were resumed in October, 1996. Pension costs for 2011 and 2010 were \$702,104 and \$657,757, respectively. The NRECA Retirement and Security Program is a master multiple-employer non-contributory defined benefit plan, and it has been approved as a qualified tax-exempt plan by the Internal Revenue Service. As the Cooperative is only one of several employers participating in the Plan, it is not practical to determine if the vested benefits of the Cooperative's employees exceed the Cooperative's portion of the plan assets.

The accumulated plan benefit information using the latest actuarial information applicable for each plan year as follows:

	December 31, 2011	December 31, 2010
Accumulated benefit obligation	\$ Unavailable	\$ Unavailable
Plan assets at fair value	<u>4,637,065,000</u>	<u>4,098,976,000</u>
Plan assets in excess of the accumulated benefit obligation	<u>\$ Unavailable</u>	<u>\$ Unavailable</u>

Additionally, the Cooperative has a 401-(K) Plan. The terms of the Plan call for an elective contribution from employees of 1% or more of their salaries while the Cooperative contributes 1% of their salary. Total pension expenses related to the Plan for 2011 and 2010 were \$28,011 and \$27,423.

9. Self-Funded Health Insurance Plan:

In October, 1995, the Cooperative's Board of Directors approved the establishment of the FRECC Group Medical Program. The Plan is self-funded and is re-insured through Legion Insurance Company. The Plan was designed to duplicate the Cooperative's prior plan. The third-party administrator is North America Administrators. The Cooperative is protected against any individual claim in excess of \$30,000 and any aggregate claims in excess of \$1,140,399 by the re-insurance. The current funding levels are designed to allow for the maximum claim liability that the Cooperative could incur under the Plan. At December 31, 2011, the Cooperative held \$165,728 in cash designated for payment of these claims and included \$55,293 as a liability in accrued expenses.

10. Related Party Transactions:

The Cooperative is a member of the National Rural Utilities Cooperative Finance Corporation, which furnishes a portion of the Cooperative's financing.

The Cooperative is a member of East Kentucky Power Cooperative which is a generating and transmission cooperative. The Cooperative has entered into an agreement with East Kentucky Power Cooperative to supply substantially all of the Cooperative's future power needs. Under its wholesale power agreement, the Cooperative has agreed to purchase the majority of its electric power and energy requirements from East Kentucky Power Cooperative until January, 2040. Changes in rates are refunded to or recovered from the Cooperative's customers through a cost of power adjustment.

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

11. Cash and Cash Equivalents:

All deposits are in various financial institutions and are carried at cost.

	2011		2010	
	<u>Carrying Amount</u>	<u>Bank Balance</u>	<u>Carrying Amount</u>	<u>Bank Balance</u>
Insured (FDIC)	\$ 764,903	\$ 694,674	\$ 2,523,668	\$ 2,744,719
Uninsured:				
Uncollateralized	-	-	-	-
Total deposits	<u>\$ 764,903</u>	<u>\$ 694,674</u>	<u>\$ 2,523,668</u>	<u>\$ 1,370,024</u>

12. Litigation:

The Cooperative is subject to claims and investigations that arise in the ordinary course of business. One legal investigation is ongoing, and the Cooperative intends to vigorously contest any alleged violations. Management and the Cooperative's legal counsel do not anticipate any material effect on the Cooperative's financial statements as a result of these actions.

13. Postretirement Benefit Plans:

The Company provides postretirement life insurance benefits to all current employees and provides certain retired and active employees with postretirement health care benefits.

The annual measurement date is December 31 for other postretirement benefits. The following tables provide information about changes in the benefit obligation and plan assets and the funded status of the Company's postretirement benefit plan:

	2011	2010
Funded status		
Projected benefit obligation at end of year	\$ 339,138	\$ 199,170
Fair value of plan assets at end of year	-	-
Funded (unfunded) status at end of year	<u>\$ (339,138)</u>	<u>\$ (199,170)</u>
Amounts recognized in the balance sheet		
Non-current assets	\$ -	\$ -
Current liabilities	-	-
Non-current liabilities	<u>339,138</u>	<u>(199,170)</u>
	<u>\$ 339,138</u>	<u>\$ (199,170)</u>
Amounts recognized in accumulated other comprehensive income		
Actuarial gain/loss	\$ 133,954	\$ -
Prior service cost	<u>166,540</u>	<u>180,850</u>
	<u>\$ 300,494</u>	<u>\$ 180,850</u>

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL, CONTINUED

13. Postretirement Benefit Plans, Continued:

	2011	2010
Changes in plan assets and benefit obligations recognized in other comprehensive income		.
Balance at beginning of year	\$ 180,850	\$ 190,894
Actuarial gain/loss	133,954	-
Amortization of prior service cost and actuarial gain/loss	(14,310)	(10,044)
Balance at end of year	\$ 300,494	\$ 180,850
Net benefit cost consisted of the following:		
Service cost	\$ 30,420	\$ 8,811
Interest cost	20,646	13,796
Amortization of prior service cost	10,044	10,044
Amortization of actuarial gain/loss	4,266	-
	\$ 65,376	\$ 32,651

The estimated amount that will be amortized from accumulated other comprehensive income into net pension cost in 2012 is as follows:

Net actuarial gain/loss	\$ 5,700
Prior service cost	10,044
	\$ 15,744

14. Provision for Income Taxes

The Cooperative follows the recognition requirements for uncertain income tax positions as required by generally accepted accounting principles. The Company has no tax position at December 31, 2011 for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. The Cooperative's policy is to classify income tax related interest and penalties in interest expense and other expenses, respectively. No such interest or penalties were recognized during the periods presented.

The Company files income tax returns in the U.S. federal jurisdiction, and various state and local jurisdictions. The Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years before 2008.

15. Accounting Change

As a result of technological changes increasing the reliability in its assessment of unbilled revenue, the Corporation has changed its policy for recording unbilled revenue and accounts receivable as well as the cost of associated power with this unbilled revenue. The approximate effect of this change for the year ended December 31, 2010 was to increase accounts receivable by approximately \$2.7 million, to increase accounts payable by approximately \$3.8 million, to decrease beginning patronage capital by approximately \$100,000 and decrease prior year net margins by approximately \$1 million.

CAMPBELL, MYERS, & RUTLEDGE, PLLC

Certified Public Accountants

Cindy L. Greer, CPA
L. Joe Rutledge, CPA
Jonathan W. Belcher, CPA
R. Brent Billingsley, CPA

Skip R. Campbell, CPA
Charles E. Rutledge, CPA
Sammie D. Parsley, CPA
Ryan A. Mosier, CPA
Jenna B. Pace, CPA

410 South Broadway
Glasgow, KY 42141
Telephone (270) 651-2163
Fax (270) 651-6677
www.cmr-cpa.com

Independent Auditors' Report on Consolidating Information

Board of Directors
Farmers Rural Electric Cooperative Corporation
Glasgow, Kentucky 42141

We have audited the consolidated financial statements of Farmers Rural Electric Cooperative Corporation and subsidiaries as of and for the years ended 2011 and 2010, and our report thereon dated February 27, 2012, which expressed an unqualified opinion on those financial statements, appears on page one. Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information in Schedules I and II is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual companies, and it is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Campbell, Myers & Rutledge, PLLC

Certified Public Accountants

February 27, 2012

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION
SCHEDULE I – CONSOLIDATING BALANCE SHEET
December 31, 2011

ASSETS	Farmers Rural Electric Cooperative Corporation, Inc.	Farmers Energy Services Corporation	Consolidating Entries	Consolidated Totals
Current assets:				
Cash	\$ 708,612	\$ 56,291	\$ -	\$ 764,903
Accounts and notes receivable, less allowance for doubtful accounts of \$66,925 in 2011	-	-	-	5,487,019
Materials and supplies, at average cost	5,487,019	-	-	455,319
Prepaid expenses	455,319	-	-	193,069
	193,069	-	-	6,900,310
Total current assets	6,844,019	56,291	-	6,900,310
Other assets and investments:			(1)(833,026)	
Investments in subsidiary companies	1,136,347	1,399,456	(2)(277,675)	1,425,102
Investments in associated organizations	15,395,500	-	-	15,395,500
Deferred Charges	695,513	-	-	695,513
	17,227,360	1,399,456	1,110,701	17,516,115
Electric plant, at cost				72,895,115
Electric plant in service	72,895,115	-	-	369,223
Construction work in progress	369,223	-	-	73,264,338
	73,264,338	-	-	21,096,657
Less accumulated depreciation	21,096,657	-	-	52,167,681
Electric plant, net	52,167,681	-	-	76,584,106
	\$ 76,239,060	\$ 1,455,747	\$ 1,110,701	\$ 76,584,106
LIABILITIES AND MEMBERS' EQUITIES				
Current liabilities:				
Accounts payable	\$ 4,472,258	\$ -	\$ -	\$ 4,472,258
Accrued expenses	1,258,622	-	-	1,258,622
Customer deposits	910,411	-	-	910,411
Current portion of capital leases	29,045	-	-	29,045
Current portion of long-term debt	1,289,000	-	-	1,289,000
	7,959,336	-	-	7,959,336
Total current liabilities	7,959,336	-	-	7,959,336
Long-term liabilities				19,364
Capital lease less current maturities	19,364	-	-	39,952,592
Current portion of long-term debt	39,952,592	-	-	39,971,956
	39,971,956	-	-	-
Total long-term liabilities	39,971,956	-	-	39,971,956
Noncurrent liabilities:				339,138
Post retirement benefit obligations	339,138	-	-	360,170
Customer advances for construction	360,170	-	-	699,308
	699,308	-	-	-
Total noncurrent liabilities	699,308	-	-	699,308
Members' equities:				534,535
Memberships	534,535	-	-	25,968,855
Patronage capital	25,968,855	-	-	(300,494)
Accumulated other comprehensive income	(300,494)	-	-	1,405,564
Other equities	1,405,564	-	-	206,974
Capital stock	-	1,040,000	(1)(833,026)	138,072
Retained earnings	-	415,747	(2)(277,675)	27,953,506
	27,608,460	1,455,747	(1,110,701)	27,953,506
	\$ 76,239,060	\$ 1,455,747	\$ 1,110,701	\$ 76,584,106

FARMERS RURAL ELECTRIC COOPERATIVE CORPORATION
SCHEDULE II – CONSOLIDATING STATEMENT OF REVENUE
For the Year Ended December 31, 2011

	Farmers Rural Electric Cooperative Corporation, Inc.	Farmers Energy Services Corporation	Consolidating Entries	Consolidated Totals
Operating revenues	\$ 48,400,849	\$ -0-	\$ -0-	\$ 48,400,849
Operating expenses:				35,296,777
Cost of power	35,296,777	-	-	1,409,019
Distribution - operations	1,409,019	-	-	2,655,097
Distribution - maintenance	2,655,097	-	-	1,089,638
Consumer accounts	1,089,638	-	-	124,081
Customer services and Informational expense	124,081	-	-	2,123,266
Administrative and general	2,122,371	895	-	2,298,810
Depreciation	2,298,810	-	-	617,501
Taxes	532,676	84,825	-	
Total operating expenses	45,528,469	85,720	-	45,614,189
Operating margins	2,872,380	(85,720)	-	2,786,660
Interest on long-term debt to RUS and CFC	1,987,320	-	-	1,987,320
Operating margins after fixed charges	885,060	(85,720)	-	799,340
G & T and other capital credits	2,551,217	-	-	2,551,217
Net operating margins	3,436,277	(85,720)	-	3,350,557
Nonoperating margins:				21,894
Interest income, net of interest expense of \$60,984	21,530	364	-	16,835
Other net nonoperating income (loss)	16,835	-	(2) (24,828)	
Income (loss) from equity investments	74,047	184,668	(1) (74,484)	159,403
	112,412	185,032	(99,312)	198,132
Net margins	\$ 3,548,689	\$ 99,312	\$ (99,312)	\$ 3,548,689

CAMPBELL, MYERS, & RUTLEDGE, PLLC

Certified Public Accountants

Cindy L. Greer, CPA
L. Joe Rutledge, CPA
Jonathan W. Belcher, CPA
R. Brent Billingsley, CPA

Skip R. Campbell, CPA
Charles E. Rutledge, CPA
Sammie D. Parsley, CPA
Ryan A. Mosier, CPA
Jenna B. Pace, CPA

410 South Broadway
Glasgow, KY 42141
Telephone (270) 651-2163
Fax (270) 651-6677
www.cmr-cpa.com

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
Farmers Rural Electric Cooperative Corporation
Glasgow, Kentucky 42141

We have audited the consolidated financial statements of Farmers Rural Electric Cooperative Corporation, as of and for the years ended December 31, 2011 and 2010, and have issued our report thereon dated February 27, 2012. 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.

Internal Control Over Financial Reporting

In planning and performing our audits, we considered Farmers Rural Electric Cooperative Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Corporation'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 Corporation's financial statements will not be prevented, or detected and corrected on a timely basis.

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. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Farmers Rural Electric Cooperative Corporation's financial statements are free of 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. However, providing an opinion on compliance with those provisions was not an objective of our audits, 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*.

We noted no matters that we reported to management in a separate letter dated February 27, 2012.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Campbell, Myers & Rathledge, PLLC

Certified Public Accountants

February 27, 2012