Kentucky 61

Grayson Rural Electric Cooperative Corporation

Grayson, Kentucky

Audited Financial Statements
May 31, 2011 and 2010

Alan M. Zumstein
Certified Public Accountant
1032 Chetford Drive
Lexington, Kentucky 40509

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS
• TENNESSEE STATE BOARD OF ACCOUNTANCY

To the Board of Directors
Grayson Rural Electric Cooperative Corporation

I have audited the financial statements of Grayson Rural Electric Cooperative Corporation for the year ended May 31, 2011, and have issued my report thereon dated August 18, 2011. I conducted my audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and 7 CFR Part 1773, Policy on audits of the Rural Utilities Service (RUS) Borrowers. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing my audit of the financial statements of Grayson Rural Electric Cooperative Corporation for the year ended May 31, 2011, I considered its internal control over financial reporting in order to determine my auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

My consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be a material weakness. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. I noted no matters involving the internal control over financial reporting that I consider to be a material weakness.

7 CFR Part 1773.3 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters. I have grouped my comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, I performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, material control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.3(d)(1) related transactions, depreciation rates, a schedule of deferred debits and credits and a schedule of investments, upon which I express an opinion. In addition, my audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38-.45. My Objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, I express no opinion thereon.

No reports, other than my independent auditor's report, and my independent auditor's report on internal control over financial reporting and compliance and other matters, all dated August 18, 2011, or summary of recommendations related to my audit have been furnished to management.

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

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

I noted no matters regarding Grayson's internal control over financial reporting and its operation that I consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records;
- the process for accumulating and recording labor, material and overhead costs, and the distribution of these costs to construction, retirement, and maintenance and other expense accounts, and;
- the material controls.

Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

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

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended May 31, 2011, of Grayson.
    1. Obtained and read a borrower prepared schedule of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others as defined in 1773.33(e)(1)(i).
    2. Reviewed Board of Director minutes to ascertain whether board-approved written contracts are included in the borrower-prepared schedule.
    3. Noted written RUS approval was not obtained by the borrower for all contracts listed. Grayson's management informed me that RUS approval was not required as the contracts listed related to operation or maintenance entered into during the normal course of business.
- Procedures performed with respect to the requirement to submit RUS Financial and Operating Report Electric Distribution to RUS:
    1. Agreed amounts reported in RUS Financial and Operating Report Electric Distribution to Grayson's records as of December 31, 2010.

The results of my tests indicate that, with respect to the items tested, Grayson complied in all material respects, with the specific RUS loan and security instrument provisions referred to below. With respect to items not tested, nothing came to my attention that caused me to believe that Grayson had not complied, in all material respects, with those provisions. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of RUS to enter into any contract for the operation and maintenance of all or any part of property, for the use of mortgaged property by others as defined in 1773.33(d)(1)(i); and,
- The borrower has submitted its RUS Financial and Operating Report Electric Distribution to RUS and the RUS Financial and Operating Report Electric Distribution, as of December 31, 2010, represented by the borrower as having been submitted to RUS appears to be in agreement with its audited records in all material respects.

Comments on Other Additional Matters

In connection with my audit of Grayson, nothing came to my attention that caused me to believe that Grayson failed to comply with respect to:

- The reconciliation of continuing property records to controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1);
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);
- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4);
- Approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standard No. 57, Related party Transactions, for the year ended May 31, 2011, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f);
- The depreciation rates addressed at 7 CFR Part 1773.33(g);
- The detailed schedule of deferred debits and deferred credits; and
- The detailed schedule of investments, of which there were none.

My audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773(h) and provided below is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in my audit of the basic financial statements and, in my opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The deferred credits are as follows:

Consumer advances for construction	$160,781

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

Alan M. Zumstein, CPA
August 18, 2011

CONTENTS

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS
• TENNESSEE STATE BOARD OF ACCOUNTANCY

Independent Auditor's Report

To the Board of Directors
Grayson Rural Electric Cooperative Corporation

I have audited the balance sheets of Grayson Rural Electric Cooperative Corporation, as of May 31, 2011 and 2010, and the related statements of income and patronage capital and cash flows for the years then ended. These financial statements are the responsibility of Grayson Rural Electric Cooperative Corporation's management. My responsibility is to express an opinion on these financial statements based on my audits.

I conducted my audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and 7 CFR Part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that I plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audits provide a reasonable basis for my opinion.

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Grayson Rural Electric Cooperative Corporation as of May 31, 2011 and 2010, and the results of operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, I have also issued a report dated August 18, 2011, on my consideration of Grayson Rural Electric Cooperative Corporation's internal control over financial reporting and my 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 my 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 considered in assessing the results of my audits.

Alan Zumstein

Alan M. Zumstein, CPA
August 18, 2011

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS
• TENNESSEE STATE BOARD OF ACCOUNTANCY

To the Board of Directors
Grayson Rural Electric Cooperative Corporation

I have audited the financial statements of Grayson Rural Electric Cooperative Corporation as of and for the years ended May 31, 2011 and 2010, and have issued my report thereon dated August 18, 2011. I conducted my audits in accordance with generally accepted auditing standards 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 my audit, I considered Grayson Rural Electric Cooperative Corporation's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Grayson Rural Electric Cooperative Corporation's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of Grayson Rural Electric Cooperative Corporation's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more that a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

My consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. I did not identify any deficiencies in internal control over financial reporting that I consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Grayson Rural Electric Cooperative Corporation's financial statements are free of material misstatement, I performed test 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 my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the audit committee, 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.

Alan M. Zumstein, CPA
August 18, 2011

Grayson Rural Electric Cooperative Corporation

Balance Sheets, May 31, 2011 and 2010

Assets	2011	2010
Electric Plant, at original cost:		
In service	$ 61,900,142	$ 58,925,451
Under construction	611,450	735,379
	62,511,592	59,660,830
Less accumulated depreciation	12,137,494	10,755,861
	50,374,098	48,904,969
Investments in Associated Organizations	7,387,501	6,570,434
Current Assets:		
Cash and cash equivalents	82,602	72,150
Accounts receivable, less allowance for 2011 of $143,595 and 2010 of $130,178	4,589,462	4,271,785
Other receivables	295,379	276,094
Material and supplies, at average cost	278,994	312,550
Other current assets	522,380	481,973
	5,768,817	5,414,552
Total	$ 63,530,416	$ 60,889,955

Members' Equities and Liabilities		
Members' Equities:		
Memberships	$ 151,560	$ 151,945
Patronage capital	18,452,536	17,938,891
Other equities	(333,740)	(390,445)
Accumulated other comprehensive income	(1,330,443)	(1,416,843)
	16,939,913	16,283,548
Long Term Debt	37,314,534	32,685,078
Accumulated Postretirement Benefits	2,880,873	2,855,812
Current Liabilities:		
Short term borrowings	1,064,549	4,017,061
Accounts payable	1,647,911	1,519,810
Current portion of long term debt	1,425,000	1,400,000
Consumer deposits	1,235,795	1,200,629
Accrued expenses	861,060	780,919
	6,234,315	8,918,419
Consumer Advances	160,781	147,098
Total	$ 63,530,416	$ 60,889,955

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

Statements of Revenue and Patronage Capital

for the years ended May 31, 2011 and 2010

	2011	2010
Operating Revenues	$ 30,269,936	$ 28,993,769
Operating Expenses:		
Cost of power	18,856,506	17,508,482
Distribution - operations	1,175,447	1,102,667
Distribution - maintenance	2,800,693	2,500,217
Consumer accounts	1,054,760	843,603
Customer services	250,339	215,693
Sales	37,679	29,210
Administrative and general	1,901,607	1,604,402
Depreciation, excluding $129,910 in 2011 and $130,868 in 2010 charged to clearing account	2,796,766	2,653,433
Taxes, other than income	31,591	27,161
Other deductions	11,670	15,875
	28,917,058	26,500,743
Operating margins before interest charges	1,352,878	2,493,026
Interest Charges:		
Long-term debt	1,080,504	1,190,580
Other	180,813	238,340
	1,261,317	1,428,920
Operating margins after interest charges	91,561	1,064,106
Nonoperating Margins		
Interest income	29,851	29,675
Others	8,320	76,848
	38,171	106,523
Patronage Capital Credits	844,374	875,730
Net Margins	974,106	2,046,359
Patronage Capital, beginning of year	17,938,891	16,238,309
Refunds to estates of deceased members	(414,309)	(251,185)
Transfers to prior year's deficits and other equities	(46,152)	(94,592)
Patronage Capital, end of year	$ 18,452,536	$ 17,938,891

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

Statements of Cash Flows

for the years ended May 31, 2011 and 2010

	2011	2010
Cash Flows from Operating Activities:		
Net margins	$ 974,106	$ 2,046,359
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	2,796,766	2,653,433
Charged to clearing accounts	129,910	130,868
Patronage capital credits assigned	(844,374)	(875,730)
Accumulated postretirement benefits	111,461	143,343
Change in assets and liabilities:		
Receivables	(336,962)	663,781
Material and supplies	33,556	23,321
Other assets	(40,407)	(90,085)
Payables	128,101	(68,403)
Consumer deposits and advances	48,849	469
Accrued expenses	80,141	6,882
	3,081,147	4,634,238
Cash Flows from Investing Activities:		
Plant additions	(4,022,048)	(4,087,889)
Plant removal costs	(416,329)	(394,564)
Salvage recovered from retired plant	42,572	35,197
Receipts from other investments, net	27,307	1,131
	(4,368,498)	(4,446,125)
Cash Flows from Financing Activities:		
Net increase in memberships	(385)	(70)
Refund of patronage capital to members	(414,309)	(251,185)
Increase in other equities	10,553	7,010
Payments on long term debt	(1,345,544)	(1,341,443)
Advances of long term debt	6,000,000	-
Short term borrowings	(2,952,512)	1,424,632
	1,297,803	(161,056)
Net increase in cash	10,452	27,057
Cash and cash equivalents, beginning of year	72,150	45,093
Cash and cash equivalents, end of year	$ 82,602	$ 72,150
Supplemental cash flows information:		
Interest paid on long-term debt	$ 1,101,023	$ 1,192,820

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

Note 1. Summary of Significant Accounting Policies

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

Electric Plant Electric plant is stated at original cost, which is the cost when first dedicated to public service. Such amount includes applicable supervisory and overhead cost including any construction period interest and taxes. There was no interest required to be capitalized during the year.

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 electric plant. The units of property replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation for distribution plant. Gain or loss is recognized on disposition of general plant items.

Electric plant consists of:

	2011	2010
Distribution plant	$56,545,096	$53,917,149
General plant	5,355,046	5,008,302
Total	$61,900,142	$58,925,451

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. In conjunction with a rate application, Grayson had a study performed which increased annual depreciation expense by approximately $800,000. Depreciation rates are as follows:

Distribution plant	2.89% - 6.67%
Structures and improvements	2%
Transportation equipment	16%
Other general plant items	6% - 16%

Cash and Cash Equivalents Grayson considers all short-term, highly liquid investments with original maturities of three months or less to be cash equivalents.

Off Balance Sheet Risk Grayson has off-balance sheet risk in that they maintain cash deposits in financial institutions in excess of the amounts insured by the Federal Deposit Insurance Corporation (FDIC) at various time during the month. Grayson's primary bank participates in a temporary "Transaction Account Guarantee Program" through the FDIC that provides unlimited coverage for noninterest-bearing transaction accounts.

Revenue Grayson records revenue as billed to its consumers based on meter-readings taken on the 20th of each month using Automated Meter Reading ("AMR") technology. All consumers are required to pay a refundable deposit, however, it may be waived under certain circumstances. Grayson's sales are concentrated in a six county area of eastern Kentucky. Consumers must pay their bill within 20 days of billing, then are subject to disconnect after another 10 days. Accounts are written off when they are deemed to be uncollectible. The allowance for uncollectible accounts is based on the aging of receivables. There were no customers whose individual account balance exceeded 10% of outstanding accounts receivable at May 31, 2011 or 2010.

Note 1. Summary of Significant Accounting Policies, continued

Cost of Power Grayson is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Grayson is committed to purchase its electric power and energy requirements from East Kentucky until 2051. The rates charged by East Kentucky are subject to approval of the PSC. The cost of purchased power is recorded monthly during the period in which energy is consumed, based upon billings from East Kentucky.

Fair Value Measurements The Fair Value Measurements and Disclosures Topic of the FASB ASC 820, *Fair Value Measurements and Disclosures,* defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal, or most advantageous, market for the asset or liability in an orderly transaction between market participants at the measurement date. The Fair Values Measurements Topic establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs when possible. The three levels of inputs used to measure fair value are as follows:

> Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
>
> Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices of similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
>
> Level 3: Significant unobservable inputs that reflect an organization's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The carrying amounts of Grayson's cash and cash equivalents, other receivables, investments, inventories, other assets, trade accounts payable, accrued expenses and liabilities, and other liabilities approximate fair value due to their short maturity. Investments in associated organizations are not considered a financial instrument because they represent nontransferable interests in associated organizations. Other assets and liabilities are not considered financial instruments because they represent activities specifically related to Grayson. Long term debt can not be traded in the market, and is specifically for electric cooperatives and, therefore, a value other than its outstanding principal cannot be determined.

Grayson may, and also does, invest idle funds in local banks and in CFC Commercial Paper. These investments are classified as held-to-maturity in accordance with provisions of the *Financial Instruments Topic* of FASB ASC 320. Held-to-maturity securities are presented at amortized cost. The fair value of held-to-maturity securities approximates cost at 2010 and 2009.

Risk Management Grayson is exposed to various forms of losses of assets associated with, but not limited to, fire, personal liability, theft, vehicular accidents, errors and omissions, fiduciary responsibility, workers compensation, etc. Each of these areas is covered through the purchase of commercial insurance.

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

Advertising Grayson expenses advertising costs as incurred.

Note 1. Summary of Significant Accounting Policies, continued

Income Tax Status Grayson is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements include no provision for income taxes.

Effective January 1, 2008, Grayson adopted the provisions of the *Income Taxes Topic* of the FASB ASC that pertains to accounting for uncertainty in income taxes. Grayson had no prior unrecognized tax benefits as a result of the implementation. Management evaluates its potential exposures from tax positions taken that have or could be challenged by taxing authorities. These potential exposures result because taxing authorities may take positions that differ from those taken by management in the interpretation and application of statures, regulations, and rules. There are no tax positions for which the ultimate deductibility is highly uncertain included in the accompanying financial statements. Grayson recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Grayson did not recognize any interest or penalties during the years ended 2011 or 2010.

Subsequent Events Management has evaluated subsequent events through August 18, 2011, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investments in Associated Organizations

Investments in associated organizations consist of:

	2011	2010
East Kentucky, patronage capital	$6,234,911	$5,458,056
CFC, patronage capital	143,080	129,071
CFC, CTC's	634,880	635,979
Others	374,630	347,328
Total	$7,387,501	$6,570,434

Grayson records patronage capital assigned by associated organizations in the year in which such assignments are received. The CTC's from CFC are a condition of borrowing loan funds.

Note 3. Patronage Capital

Patronage capital consisted of:

	2011	2010
Assigned to date	$21,114,967	$19,471,034
Assignable margins	(798,477)	(54,618)
Retirements to date	(1,863,954)	(1,477,525)
Total	$18,452,536	$17,938,891

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 equities and margins to be less than 30% 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 25% of the net margins for the next preceding year, Grayson may distribute the difference between 25% and the payments made to such estates. At May 31, 2011, the equities and margins were 27% of total assets.

Note 4. Accumulated Other Comprehensive Income

The changes in accumulated other comprehensive income, which includes the effects of accumulated postretirement benefits, are as follows:

	2011	2010
Balance, beginning of period	($1,416,843)	($1,488,843)
Amortization	86,400	72,000
Adjustments	-	-
Total	($1,330,443)	($1,416,843)

Note 5. Long Term Debt

All assets, except vehicles, are pledged as collateral on the long term debt to RUS, Federal Financing Bank (FFB), National Bank for Cooperative (CoBank), and CFC under a joint mortgage agreement. First mortgage notes consist of:

	2011	2010
RUS, 0.18 to 4.95% (3.17 to 5.0% in 2010)	$10,786,913	$23,212,650
FFB, 0.102% (0.183% in 2010)	14,924,195	9,309,483
CoBank (refinance RUS loans) 3.50%	11,633,491	-
CFC, 3.45% to 6.80% notes	1,394,935	1,562,945
	13,028,426	1,562,945
	38,739,534	34,085,078
Less current portion	1,425,000	1,400,000
Long term portion	$37,314,534	$32,685,078

The long term debt payable to RUS, FFB, and CFC are due in quarterly and monthly installments of varying amounts through 2039. RUS assess 12.5 basis points to administer the FFB loans. During 2011 Grayson refinanced approximately $11.9 million of higher interest RUS loans with CoBank. Grayson has loan funds available from FFB in the amount of $10,438,000 at May 31, 2011. These funds will be used for future construction projects.

As of May 31, 2011, annual current principal due for the next five years are as follows: 2012 - $1,425,000; 2013 - $1,575,000; 2014 - $1,650,000; 2015 - $1,750,000; 2016 - $1,850,000.

Note 6. Short Term Borrowings

Grayson has executed a short term line of credit agreement with CFC in the amount of $4,200,000. The balance against this line of credit was $1,064,549, at an interest rate of 4.95%. Grayson also has a short term line of credit from National Bank for Cooperative ("CoBank") in the amount of $2,000,000. All advances against this line of credit have been repaid.

Note 7. Pension Plan

All eligible employees of Grayson participate in the NRECA Retirement and Security Program, a defined benefit pension plan qualified under section 401 and tax exempt under section 501(a) of the Internal Revenue Code. Grayson makes annual contributions to the Program equal to the amounts accrued for pension expense. Contributions were $750,925 for 2011 and $510,138 for 2010. In this multiemployer plan, which is available to all member cooperatives of NRECA, the accumulated benefits and plan assets are not determined or allocated separately by individual employer.

Note 8. Postretirement Benefits

Grayson sponsors a defined benefit plan that provides medical insurance coverage for retired employees and their spouses. Grayson pays all the premiums for retirees and their dependents. For measurement purposes, an annual rate of increase of 8.9% in 2009, then decreasing by 0.5% per year until 5% per year, in the per capita cost of covered health care benefit was assumed. The discount rate used in determining the accumulated postretirement benefit obligation was 6.50% in 2011 and 2010.

The funded status of the plan is as follows:

	2011	2010
Projected benefit obligation	($2,880,873)	($2,855,812)
Plan assets at fair value	-	-
Total	($2,880,873)	($2,855,812)

The components of net periodic postretirement benefit cost are as follows:

	2011	2010
Benefit obligation at beginning of year	$2,855,812	$2,784,469
Components of net periodic benefit cost:		
Service cost	141,824	141,824
Interest cost	184,889	184,889
Net periodic benefit cost	326,713	326,713
Benefits paid	(301,652)	(255,370)
Actuarial gain/loss	-	-
Benefit obligation at end of year	$2,880,873	$2,855,812

Projected retiree benefit payments for the next five years are expected to be as follows: 2012 - $210,895; 2013 - $216,070; 2014 - $210,080; 2015 - $199,710; 2016 - $190,753.

Note 9. Commitments and Contingencies

Grayson is contingently liable as guarantor for approximately $58,000 of long term obligations of East Kentucky to RUS and CFC. Substantially all assets of Grayson are pledged as collateral for this guarantee, in addition to the pledge in the mortgage agreement referred to in Note 5. This contingent liability was part of an overall financing plan for the construction of generating facilities near Maysville, Kentucky.

Grayson has various other agreements outstanding with local contractors. Under these agreements, the contractors will perform certain construction and maintenance work at specified hourly rates or unit cost, or on an as needed basis. The duration of these contracts are one to two years.

Note 10. Related Party Transactions

Several of the Directors of Grayson, its President & CEO, and anther employee, are on the Boards of Directors of various associated organizations.

Note 11. Environmental Contingency

Grayson from time to time is required to work with and handle PCBs, herbicides, automotive fluids, lubricants, and other hazardous materials in the normal course of business. As a result, there is the possibility that environmental conditions may arise which would require Grayson to incur cleanup costs. The likelihood of such an event, or the amount of such costs, if any, cannot be determined at this time. However, management does not believe such costs, if any, would materially affect Grayson's financial position or its future cash flows.

Note 12. Labor Force

Approximately 45% of Grayson's labor force is subject to a collective bargaining agreement. A six (6) year agreement was negotiated and approved for the period starting May, 2009 between Grayson and the International Brotherhood of Electric Workers ("IBEW").

Note 13. Rate Matters

East Kentucky increased its base rates to Grayson during August 2007, by 2%, in April 2009, by 7%, and again in January 2011, by 5%. Grayson has passed these increases on to its customers using the methodology prescribed by the PSC.

* * * * * *