Kentucky 21

Salt River Electric Cooperative Corporation
Bardstown, Kentucky

Audited Financial Statements
December 31, 2011 and 2010

ALAN ZUMSTEIN

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CONTENTS

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- TENNESSEE STATE BOARD OF ACCOUNTANCY

Independent Auditor's Report

To the Board of Directors
Salt River Electric Cooperative Corporation

I have audited the balance sheets of Salt River Electric Cooperative Corporation, as of December 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 Salt River 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 Salt River Electric Cooperative Corporation as of December 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 February 22, 2012, on my consideration of Salt River 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 M. Zumstein

Alan M. Zumstein, CPA
February 22, 2012

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To the Board of Directors
Salt River Electric Cooperative Corporation

I have audited the financial statements of Salt River Electric Cooperative Corporation as of and for the years ended December 31, 2011 and 2010, and have issued my report thereon dated February 22, 2012. 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 Salt River'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 Salt River's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of Salt River'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 Salt River'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

Alan M. Zumstein, CPA
February 22, 2012

Salt River Electric Cooperative Corporation

Balance Sheets, December 31, 2011 and 2010

Assets	2011	2010
Electric Plant, at original cost:		
In service	$ 128,108,393	$ 124,499,327
Under construction	1,875,890	2,075,352
	129,984,283	126,574,679
Less accumulated depreciation	55,049,691	50,840,917
	74,934,592	75,733,762
Investments and Other Assets:		
Associated organizations	30,593,507	24,862,980
Others	4,253,637	3,815,205
	34,847,144	28,678,185
Current Assets:		
Cash and cash equivalents	7,225,769	11,282,185
Accounts receivable, less allowance for 2011 of $375,000 and 2010 of $350,000	11,058,702	10,888,873
Material and supplies, at average cost	784,075	637,207
Regulatory asset	699,537	-
Prepayments	237,558	274,758
	20,005,641	23,083,023
Total	$ 129,787,377	$ 127,494,970

Members Equities and Liabilities	2011	2010
Members' Equities:		
Memberships	$ 1,832,765	$ 1,822,220
Patronage capital	61,820,897	55,782,197
Other equities	3,398,972	3,154,229
Accumulated other comprehensive income	(5,151,454)	(6,322,111)
	61,901,180	54,436,535
Long Term Debt	51,693,242	54,236,721
Accumulated Operating Provisions	1,447,612	3,276,422
Current Liabilities:		
Accounts payable	8,006,548	9,326,593
Current portion of long term debt	3,030,000	2,900,000
Consumer deposits	2,076,664	1,655,308
Accrued expenses	1,289,749	1,132,198
	14,402,961	15,014,099
Regulatory Liability	-	191,676
Consumer Advances for Construction	342,382	339,517
Total	$ 129,787,377	$ 127,494,970

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

Statements of Revenue and Patronage Capital

for the years ended December 31, 2011 and 2010

	2011	2010
Operating Revenues	$ 98,515,417	$ 95,004,572
Operating Expenses:		
Cost of power	78,451,169	73,959,784
Distribution - operations	2,562,532	2,340,000
Distribution - maintenance	2,752,489	2,632,950
Consumer accounts	2,068,047	2,049,958
Customer service and information	204,189	206,236
Sales	195,416	237,093
Administrative and general	2,977,154	2,818,038
Depreciation, excluding $320,163 in 2011 and $294,079 in 2010 charged to clearing accounts	5,174,860	4,978,297
Taxes, other than income	88,720	84,730
Other deductions	115,192	101,987
	94,589,768	89,409,073
Operating margins before interest charges	3,925,649	5,595,499
Interest Charges:		
Interest on long-term debt	2,798,028	2,930,838
Operating margins after interest charges	1,127,621	2,664,661
Patronage Capital assigned from:		
East Kentucky Power Cooperative	5,546,539	2,988,680
Other organizations	247,650	287,215
	5,794,189	3,275,895
Net operating margins	6,921,810	5,940,556
Nonoperating Margins:		
Interest income	568,592	467,870
Others	210,813	168,616
	779,405	636,486
Net Margins	7,701,215	6,577,042
Patronage Capital - beginning of year	55,782,197	50,845,082
General retirement of capital credits	(1,503,306)	(1,501,111)
Retirements to estates of deceased members	(159,209)	(138,816)
Patronage Capital - end of year	$ 61,820,897	$ 55,782,197

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

Statements of Cash Flows

for the years ended December 31, 2011 and 2010

	2011	2010
Cash Flows from Operating Activities:		
Net margins	$ 7,701,215	$ 6,577,042
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation		
Charged to expense	5,174,860	4,978,297
Charged to clearing accounts	320,163	294,079
Patronage capital credits	(5,794,189)	(3,275,895)
Accumulated operating provisions	(658,153)	(412,230)
Change in assets and liabilities:		
Receivables	(1,061,042)	(2,557,013)
Material and supplies	(146,868)	126,063
Prepayments	37,200	59,897
Payables	(1,320,045)	2,030,966
Consumer deposits	421,356	(34,032)
Accrued expenses and advances	160,416	79,009
	4,834,913	7,866,183
Cash Flows from Investing Activities:		
Construction of plant	(4,464,794)	(5,196,279)
Salvage, net of removal costs	(231,059)	(264,416)
Purchase of other investments, net of receipts	(374,770)	789,351
	(5,070,623)	(4,671,344)
Cash Flows from Financing Activities:		
Net increase in memberships	10,545	66,950
Retirements of capital credits	(1,662,515)	(1,639,927)
Other equities	244,743	199,552
Additional borrowings	2,500,000	2,500,000
Payments on long-term debt	(2,913,479)	(2,835,703)
Cushion of credit applied (payment)	(2,000,000)	-
	(3,820,706)	(1,709,128)
Net increase in cash	(4,056,416)	1,485,711
Cash and cash equivalents - beginning of period	11,282,185	9,796,474
Cash and cash equivalents - end of period	$ 7,225,769	$ 11,282,185
Supplemental cash flows information:		
Interest paid on long-term debt	$ 2,805,641	$ 2,938,210

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

Note 1. Summary of Significant Accounting Policies

Salt River Electric Cooperative Corporation ("Salt River") 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. Electric plant consists of:

	2011	2010
Distribution plant	$116,583,899	$112,998,360
General plant	11,524,494	11,500,967
Total	$128,108,393	$124,499,327

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. Depreciation rates range from 2.2% to 5.0%, with a composite rate of 4.28% for distribution plant. General plant rates are as follows:

Structures and improvements	2.5%
Transportation equipment	16%
Other general plant	6% - 16%

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

Off Balance Sheet Risk Salt River 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 Salt River (FDIC). At December 31, 2011, the financial institutions reported deposits in excess of the $250,000 FDIC insured limit several times during the audit period.

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.

Revenue Salt River records revenue as billed to its consumers based on monthly meter-reading cycles. Consumers may be required to pay a refundable deposit which can be waived under certain circumstances. Salt River's sales are concentrated in a ten county area of central 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 December 31, 2011 or 2010.

Note 1. Summary of Significant Accounting Policies, continued

Cost of Power Salt River is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Salt River 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 the energy is consumed, based upon billings from East Kentucky.

Regulatory Asset/Liability Included on the current power bill from East Kentucky are amounts for fuel adjustment and environmental surcharge. These amounts are passed on to Salt River's consumers using the methodology prescribed by the PSC. There is a billing lag between the time Salt River pays East Kentucky and the time Salt River bills its consumers. When the net is a credit, it creates a regulatory liability, when there is a net charge, a regulatory assets is created.

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 Salt River'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 are not considered financial instruments because they represent activities specifically related to Salt River. 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.

Salt River may, and also does, invest idle funds in local banks and in National Rural Utilities Cooperative Finance Corporation ("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 2011 and 2010.

Environmental Contingency Salt River 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 Salt River 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 Salt River's financial position or its future cash flows.

Note 1. Summary of Significant Accounting Policies, continued

Risk Management Salt River 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.

Income Tax Status Salt River 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, Salt River adopted the provisions of the *Income Taxes Topic* of the FASB ASC that pertains to accounting for uncertainty in income taxes. Salt River 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. Salt River recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Salt River did not recognize any interest or penalties during the years ended December 31, 2011 or 2010.

Advertising Salt River expenses advertising costs as incurred.

Subsequent Events Management has evaluated subsequent events through February 22, 2012, 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	$26,389,691	$20,843,151
National Bank for Cooperatives (CoBank)		
Patronage capital	1,147,881	1,111,444
CFC, CTC's and patronage capital	1,003,462	1,005,288
CFC, Member Capital Security	1,000,000	1,000,000
Other associated organizations	1,052,473	903,097
	$30,593,507	$24,862,980

Salt River records patronage capital assigned by associated organizations in the year in which such assignments are received. The Capital Term Certificates ("CTCs") of CFC are recorded at cost. The CTCs were purchased from CFC as a condition of obtaining long-term financing. The CTCs bear interest at 3% and 5% and are scheduled to mature at varying times from 2020 to 2080. Member Capital Securities have a 7.5% fixed interest rate and mature 35 years from the issuance date. Interest is paid each April1 and October 1.

Note 3. Other Assets

The economic development loans are secured by either/or a portion of the assets pledged by Salt River's consumers, or guarantees from local banks. The note to Nelson County is secured by land at an industrial site. Payments will be made to Salt River at the time real estate, or a portion thereof, is sold or leased, at which time, based on the value of the property sold or leased, in proportion to the contribution value of the entire property. The note to Spencer-Washington Economic Development Authority has been set up as a 30 year amortization, with a 15 year balloon; however, it is SWEDA goal to pay off the loan in less than 15 years.

Note 3. Other Assets, continued

Other assets consist of:

	2011	2010
Non utility property, net of depreciation	$162,919	$183,848
Economic development loans, no interest, various due in 108 months, from date of loan	461,574	487,037
Spencer-Washington Economic Development Authority note dated October 7, 1999, interest rate of 3.75%	771,487	286,663
County of Nelson, Kentucky note dated July 26, 2004 due on or before 5 years, interest rate 1% over US Treasury rate, currently 1.18%	2,857,657	2,857,657
	$4,253,637	$3,815,205

Note 4. Patronage Capital

Patronage capital consisted of:

	2011	2010
Assigned to date	$77,080,015	$70,502,974
Assignable	7,701,215	6,577,042
Retirements to date	(23,237,928)	(21,575,414)
Unassigned	277,595	277,595
	$61,820,897	$55,782,197

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, Salt River may distribute the difference between 25% and the payments made to such estates. At December 31, 2011, the equities and margins were 48% of total assets.

Note 5. Accumulated Other Comprehensive Income

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

	2011	2010
Balance, beginning of year	($6,322,111)	($6,785,395)
Amortize pension plan	338,600	366,009
Adjust pension plan	638,808	64,302
Amortize postretirement benefits	24,734	32,973
Adjust postretirement benefits	168,515	-
Balance, end of year	($5,151,454)	($6,322,111)

Note 5. Accumulated Other Comprehensive Income, continued

The balance is comprised of the following:

	2011	2010
Pension plan	($4,916,056)	($5,893,464)
Accumulated postretirement benefits	(235,398)	(428,647)
	($5,151,454)	($6,322,111)

Note 6. Long Term Debt

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

	2011	2010
First mortgage notes due RUS:		
3.68% to 5.75%	$39,068,027	$39,917,249
Advance payment	(6,665,727)	(4,421,825)
	32,402,300	35,495,424
First mortgage notes due FFB:		
0.22% (0.164% in 2010)	5,000,000	2,500,000
First mortgage notes due CoBank:		
3.18% to 7.40%	14,298,246	14,646,604
First mortgage notes due CFC:		
5.25% to 5.50%	2,888,437	4,332,656
Economic development loans, no interest	134,259	162,037
	54,723,242	57,136,721
less current portion of debt	3,030,000	2,900,000
	$51,693,242	$54,236,721

The long term debt payable to RUS and CoBank is due in quarterly and monthly installments of varying amounts through 2039. During 2003, Salt River refinanced $14,442,183 of 5% RUS loans with funds advanced from CFC. The principal portion of long term debt payable to CFC is due in ten (10) annual installments of $1,444,218 each until 2013. RUS assesses 1.25 basis points to administer the FFB loans. Salt River has loan funds available from FFB in the amount of $15,873,000, which will be used for plant additions.

Salt River is participating in a RUS sponsored program which provides economic development funds to businesses in Salt River's service area. Salt River serves as a conduit for these funds and is contingently liable if the recipient fails to repay the loan.

As of December 31, 2011, annual current principal due for the next five years are as follows: 2012 - $3,030,000; 2013 - $3,100,000; 2014 - $1,750,000; 2015 - $1,825,000; 2016 - $2,000,000.

Note 7. Short Term Borrowings

At December 31, 2011, Salt River had a short term line of credit of $4,000,000 available from CoBank. There were no advances against either line of credit during the year.

Note 8. Pension Plan

Salt River has a noncontributory defined benefit pension plan covering substantially all employees who meet minimum age and service requirements. The plan has pay-related pension benefit formula. Salt River's policy is to fund such plans in accordance with the requirements of the Employee Retirement Income Security Act ("ERISA"). The plan is measured as of December 31, 2011 and 2010.

The following is an assessment of the noncontributory defined benefit plan:

	2011	2010
Projected benefit obligation	($14,558,363)	($14,504,159)
Fair value of plan assets	13,935,394	12,176,885
Funded status	($622,969)	($2,327,274)
Accumulated benefit obligation included in plan	$12,436,001	$11,607,353
Amount recognized as accrued benefit liability	($622,969)	($2,327,274)

The calculation of net periodic benefit cost, change in projected benefit obligation, and change in fair value of plan assets are as follows:

	2011	2010
Net Periodic Benefit Cost		
Service cost	$704,753	$721,475
Interest cost	696,105	721,462
Expected return on assets	(966,356)	(844,127)
Amortization (gain) loss	338,600	366,009
Net periodic benefit cost	$773,102	$964,819
Change in Projected Benefit Obligation		
Projected benefit obligation at beginning of year	$14,504,159	$13,387,831
Service cost	634,753	659,475
Interest cost	696,105	721,462
Disbursements	(277,955)	(319,888)
Actuarial (gain) loss	(998,699)	55,279
Projected benefit obligation at end of year	$14,558,363	$14,504,159
Change in Fair Value of Plan Assets		
Fair value of plan assets, beginning of year	$12,176,885	$10,145,065
Actual return on plan assets	598,378	991,675
Employer contributions	1,500,000	1,450,000
Benefits paid	(277,955)	(319,888)
Administrative costs	(61,914)	(89,967)
Projected benefit obligation at end of year	$13,935,394	$12,176,885

Note 8. Pension Plan, continued

Assumptions used to develop the projected benefit obligation were as follows:

	2011	2010
Discount rate	5.50%	6.00%
Rate of increase in compensation level	3.50%	3.50%
Expected long-term rate of return on assets	8.50%	8.50%

The expected long term rate of return on plan assets for determining net periodic pension cost for each fiscal year is chosen from the best range determined by applying anticipated long term returns for various asset categories to the target asset allocation of the plan, as well as taking into account historical returns.

The general investment objectives are to invest in a diversified portfolio, comprised of debt investments, equity investments, and fixed income investments. The diversification is designed to minimize the risk of large losses while maximizing total return within reasonable and prudent levels of risk. The investment objectives specify a targeted investment allocation for the pension plan of approximately 50% equities. The remaining may be allocated amount fixed income or cash equivalent investments.

Expected retiree pension benefit payments are projected to be as follows: 2012 - $236,000; 2013 - $475,000; 2014 - $1,033,000; 2015 - $873,000; 2016 - $1,443,000.

Contributions for 2012 are expected to be approximately $1,500,000.

Note 9. Savings Plan

Salt River sponsors a savings plan covering all employees who are covered by a collective bargaining agreement and who meet certain length of service requirements. This salary deferral plan provides a 2.50% contribution by Salt River based on eligible employee wages. Salt River contributed $86,642 in 2011 and $76,570 in 2010 to this plan.

Salt River also sponsors a plan covering all eligible employees not covered by a collective bargaining agreement which allows an employee salary deferral and also provides a 6% Salt River contribution based on eligible employee wages. Salt River's contribution is made on behalf of the employee regardless of their decision to participate with elective salary deferral contributions. Salt River contributed $107,672 in 2011 and $102,636 in 2010.

Note 10. Postretirement Benefits

Salt River sponsors a defined benefit plan that provides medical insurance coverage for retired employees under age 65, and have worked 30 or more years for Salt River. The plan for retirees is a continuation of the fully insured program now in place for active employees.

The funded status of the plan is as follows:

	2011	2010
Projected benefit obligation	($824,644)	($949,148)
Fair value of plan assets	-	-
Funded status	($824,644)	($949,148)

Note 10. Postretirement Benefits, continued

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

	2011	2010
Benefit obligation at beginning of year	$949,148	$909,170
Components of net periodic benefit cost:		
Service cost	38,046	34,994
Interest cost	44,345	52,033
Net periodic benefit cost	82,391	87,027
Actuarial (gain) loss	(168,515)	-
Benefits paid	(38,380)	(47,049)
Benefit obligation at end of year	$824,644	$949,148

For measurement purposes, an annual rate of increase of 8% in 2011, 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 6.0% in 2011 and 6.50% in 2010.

Projected retiree benefit payments for the next five years are expected to be as follows: 2012 - $26,000; 2013 - $17,000; 2014 - $17,000; 2015 - $12,000; 2016 - $12,000.

Note 11. Leases

Salt River leases tower space at its non utility property to an unrelated party. The monthly tower lease is $500 per month. The lease may be cancelled by either party.

Salt River leases space for one of its branch office from an unrelated party. The lease, dated January 1, 2004, is for a period of 5 years, with an option to renew for 2 successive 5 year periods. The lease is an operating lease with monthly payments of $931 per month, with 3% increases each year of the lease.

Salt River exercised the option to lease space for another of its branch offices from an unrelated part. The lease option, dated July 1, 2005, is for a three year period, with options for additional three year lease terms. The lease is an operating lease with monthly payments of $896 per month.

Note 12. Commitments

Salt River is contingently liable as guarantor for approximately $169,000 of long term obligations of East Kentucky to RUS and CFC. Substantially all assets of Salt River 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.

Salt River 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 three years.

Note 13. Related Party Transactions

Several of the Directors of Salt River and its President & CEO are on the Boards of Directors of various associated organizations. The President & CEO is also on the Board of Directors of one of the local banks where Salt River routinely performs its banking functions.

Note 14. Labor Force

Approximately 75% of Salt River's labor force is subject to a collective bargaining agreement. An eight (8) year agreement was negotiated and approved for the period starting June, 2012 between Salt River and the International Brotherhood of Electric Workers ("IBEW").

Note 15. Rate Matters

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

Note 16. Contingencies

Salt River is involved in litigation arising in the normal course of business. While the results of such litigation cannot be predicted with certainty, management, based upon advice of counsel, believes that the final outcome will not have a material adverse effect on the financial statements.

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• TENNESSEE STATE BOARD OF ACCOUNTANCY

To the Board of Directors
Salt River Electric Cooperative Corporation

I have audited the financial statements of Salt River Electric Cooperative Corporation for the year ended December 31, 2011, and have issued my report thereon dated February 22, 2012. 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 Salt River for the year ended December 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 February 22, 2012, 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 Salt River'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 December 31, 2011, of Salt River.
    1. Salt River has not entered into any contract 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).
- 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 Salt River's records as of December 31, 2011.

The results of my tests indicate that, with respect to the items tested, Salt River 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 Salt River 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 submitted its RUS Financial and Operating Report Electric Distribution to RUS and the Financial and Operating Report Electric Distribution, Financial and Statistical Report, 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.
- During the period of this review, Salt River received no long term advances from CFC on loans controlled by the RUS/CFC Mortgage and Loan Agreement.

Comments on Other Additional Matters

In connection with my audit of Salt River, nothing came to my attention that caused me to believe that Salt River 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 December 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	$342,382

Salt River is a one-half (1/2) owner of a subsidiary, Lock 7 Hydro Partners, LLC, which generates electricity through hydro methods on the Kentucky River. The investment is accounted for using the equity method of accounting. The original investment was $100,000. The investment is as follows:

	Investment	Profits
Beginning balance	$120,000	$100,045
Income for 2011	-	219,416
Return of earnings	-	(100,000)
Ending balance	$120,000	$219,461

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

Alan M. Zumstein, CPA
February 22, 2012