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South Kentucky Rural Electric Cooperative

Audited Financial Statements

August 31, 2013 and 2012

South Kentucky Rural Electric Cooperative

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August 31, 2013 and 2012

CPAs & Advisors

Independent Auditor's Report

To the Board of Directors
South Kentucky Rural Electric Cooperative
Somerset, Kentucky

We have audited the accompanying financial statements of South Kentucky RECC ("the Cooperative") which comprise the balance sheet as of August 31, 2013 and the related statement of income and comprehensive (loss) income, changes in members' and patrons' equities and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Cooperative as of August 31, 2013, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report (Continued)

Other Matter

The financial statements of the Cooperative, as of August 31, 2012, were audited by other auditors whose report dated October 24, 2012, expressed an unmodified opinion on those statements.

Emphasis of Matter

As discussed in Note K to the financial statements, the 2012 financial statements have been restated to correct a misstatement. Our opinion is not modified with respect to this matter.

Other-Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our reported dated December 6, 2013, on our consideration of the Cooperative'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 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 our audit.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
December 6, 2013

South Kentucky Rural Electric Cooperative
Balance Sheet
August 31, 2013 and 2012

	2013	2012 Restated
Assets		
Electric Plant in Service, net	$ 167,123,861	$ 168,216,840
Investments		
Investments in associated organizations	8,043,955	9,217,279
Investment in East Kentucky Power Cooperative	39,274,997	33,249,925
Total Investments	47,318,952	42,467,204
Current Assets		
Cash and equivalents	8,527,660	8,520,022
Accounts receivable - customers (net of allowance for doubtful accounts of $506,681 in 2013 and $461,677 in 2012)	5,075,421	4,423,810
Other receivables	432,119	683,107
Materials and supplies	1,818,759	1,671,706
Prepayments and other	2,348,128	2,223,489
Total Current Assets	18,202,087	17,522,134
Regualtory Asset		
Deferred meter retirement, net	2,685,599	1,405,374
Total Assets	$ 235,330,499	$ 229,611,552
Members' and Patrons' Equities and Liabilities		
Members' and Patrons' Equities		
Memberships	$ 1,281,361	$ 1,277,297
Patronage capital	81,934,035	70,991,088
Other equities	3,724,101	3,655,403
Accumulated other comprehensive loss	(3,226,143)	(3,461,343)
Total Members' and Patrons' Equities	83,713,354	72,462,445
Long-term Debt and Other Liabilities		
Long-term debt, less current maturities	125,058,090	131,244,711
Accrued compensated absences	350,701	166,590
Postretirement benefits obligation	7,962,193	8,186,641
Total Long-term Debt and Other Liabilities	133,370,984	139,597,942
Current Liabilities		
Current portion of long-term debt	5,487,181	5,025,000
Accounts payable	9,028,459	8,435,998
Accrued interest	397,986	368,255
Customer guaranty deposits	1,165,473	1,129,050
Other current liabilities	1,362,251	1,843,045
Total Current Liabilities	17,441,350	16,801,348
Deferred Credits		
Consumer advances for construction	804,811	749,817
Total Members' and Patrons' Equities and Liabilities	$ 235,330,499	$ 229,611,552

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Income and Comprehensive Income
Years Ended August 31, 2013 and 2012

	2013	%	2012 Restated	%
Operating Revenue				
Sale of electric energy				
Residential	$ 85,726,013	65.14 %	$ 78,859,611	64.43 %
Commercial	40,985,862	31.14	38,795,232	31.70
Public authorities and outdoor lighting	1,517,359	1.15	1,397,902	1.14
Total Sale of Electric Energy	128,229,234	97.43	119,052,745	97.27
Other Revenue	3,380,451	2.57	3,345,844	2.73
Total Operating Revenue	131,609,685	100.00	122,398,589	100.00
Operating Expenses				
Cost of power	95,547,220	72.60	89,691,536	73.28
Distribution expense	10,783,237	8.19	10,260,596	8.38
Customer accounts expense	3,579,599	2.72	3,861,634	3.15
Customer services and information expense	512,780	0.39	683,225	0.56
Administrative and general expense	3,344,660	2.54	3,701,573	3.02
Depreciation	7,532,228	5.72	6,826,002	5.58
Taxes	-	-	143,213	0.12
Total Operating Expenses	121,299,724	92.16	115,167,779	94.09
Net Operating Income	10,309,961	7.84	7,230,810	5.91
Non-operating Income (Expense)				
Interest expense	(5,958,065)	(4.53)	(5,860,012)	(4.79)
Other margins	648,495	0.49	129,822	0.11
Patronage capital	6,152,342	4.67	6,726,850	5.50
Total Non-operating Income	842,772	0.63	996,660	0.82
Net Margins	11,152,733	8.47	8,227,470	6.73
Other Comprehensive Income				
Change in post-retirement benefit obligation	235,200	0.18	235,200	0.19
	$ 11,387,933	8.65 %	$ 8,462,670	6.92 %

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Changes in Members' and Patrons' Equities
Years Ended August 31, 2013 and 2012

	Memberships	Patronage Capital	Other Equities	Accumulated Other Comprehensive Loss	Total Members' and Patrons' Equities
Balance, August 31, 2011 (Restated)	$ 1,287,846	$ 62,924,245	$ 7,548,151	$ (3,696,543)	68,063,699
Comprehensive Income:					
Net Margins	-	8,227,470	-	-	8,227,470
Post Retirement Benefit Obligation	-	-	-	235,200	235,200
Total Comprehensive Income					8,462,670
Net Change in Memberships	(10,549)	-	-	-	(10,549)
Refunds to Estates	-	(188,292)	-	-	(188,292)
Transfers to Other Equity and Prior Year's Deficits	-	27,665	-	-	27,665
Other Equities	-	-	(3,892,748)	-	(3,892,748)
Balance, August 31, 2012	1,277,297	70,991,088	3,655,403	(3,461,343)	72,462,445
Comprehensive Income:					
Net Margins	-	11,152,733	-	-	11,152,733
Post Retirement Benefit Obligation	-	-	-	235,200	235,200
Total Comprehensive Income					11,387,933
Net Change in Memberships	4,064	-	-	-	4,064
Refunds to Estates	-	(216,849)	-	-	(216,849)
Transfers to Other Equity and Prior Year's Deficits	-	7,063	-	-	7,063
Other Equities	-	-	68,698	-	68,698
Balance, August 31, 2013	$ 1,281,361	$ 81,934,035	$ 3,724,101	$ (3,226,143)	$83,713,354

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Cash Flows
Years Ended August 31, 2013 and 2012

	2013	2012 Restated
Cash Flows from Operating Activities		
Net Margins	$ 11,152,733	$ 8,227,470
Non-cash expenses included in net margins		
Patronage capital assigned but not paid by associated organizations	(6,152,342)	(6,726,850)
Depreciation and amortization	7,657,047	6,826,002
Bad debt expense	669,708	639,347
Gain on disposition of electric plant in service	(123,032)	(40,098)
Changes in current and non-current assets and liabilities:		
Accounts receivable	(1,321,319)	2,662,130
Other receivables	250,988	735,345
Materials and supplies	(147,053)	1,618,813
Prepayments and other	(124,639)	(633,920)
Accounts payable	592,461	(1,810,110)
Customer guaranty deposits	36,423	101,651
Accrued interest and other current liabilities	(451,063)	1,484,543
Accrued compensated absences	184,111	(1,821,244)
Postretirement benefits obligation	10,752	56,070
Net Cash Provided by Operating Activities	12,234,775	11,319,149
Cash Flows from Investing Activities		
Increase in deferred meter retirement	(1,405,044)	(155,912)
Increase/decrease in consumer advances	54,994	(12,781)
Proceeds from sale of electric plant in service	128,258	78,314
Additions to electric plant in service	(5,505,247)	(2,597,455)
Removal cost, net	(939,228)	(963,516)
Patronage capital received from associated organizations	1,300,594	1,297,072
Net Cash Used in Investing Activities	(6,365,673)	(2,354,278)
Cash Flows from Financing Activities		
Proceeds from long-term notes payable	15,000,000	-
Payment of principal on long-term notes payable	(20,724,440)	(4,791,570)
Membership fees (reimbursement), net	4,064	(10,549)
Refund of patronage capital to members	(216,849)	(188,292)
Changes in other patronage capital and equities	75,761	(3,865,083)
Net Cash Used in Financing Activities	(5,861,464)	(8,855,494)
Increase in Cash and Equivalents During the Year	7,638	109,377
Cash and Equivalents, Beginning of Year	8,520,022	8,410,645
Cash and Equivalents, End of Year	$ 8,527,660	$ 8,520,022
Supplemental Disclosures of Cash Flow Information		
Interest paid	$ 5,987,796	$ 5,943,313

See accompanying notes.

Note A - Nature of Operations

South Kentucky Rural Electric Cooperative Corporation (the Cooperative) is engaged in distributing power to its member consumers throughout eleven south central Kentucky counties and two northern Tennessee counties. The audited financial statements are prepared in accordance with policies prescribed or permitted by the Kentucky Public Service Commission (PSC) and the United States Department of Agriculture Rural Utilities Services (RUS), which conform with generally accepted accounting principles as applied to regulated enterprises. The more significant of these policies are as follows.

Note B - Summary of Significant Accounting Policies

1. Basis of Accounting: The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") is the sole source of authoritative accounting technical literature for nongovernmental entities. The significant accounting policies are described below to enhance the usefulness of the financial statements to the reader.

2. Electric Plant in Service: Electric plant is stated at original cost, which is the cost when first dedicated to public service. Maintenance and repairs, including the cost of renewals of minor items of property, are charged to maintenance expense accounts. Replacements of property, exclusive of minor items, are charged to the electric plant accounts.

   Depreciation is provided using the straight-line method at rates which are designed to amortize the cost of depreciable plant, net of estimated salvage value, over its estimated useful life. The composite depreciation rate for distribution plant was approximately 3.25% for 2013 and 3.00% for 2012. General plant is being depreciated using specific identification straight-line method over the following estimated useful lives:

Structures and improvements	5 - 50
Miscellaneous equipment	5 - 20
Office, stores and lab equipment	5 - 20
Communication equipment	12
Transportation equipment	4 - 10
Power-operated equipment	7

   When distribution plant is retired or otherwise disposed of in the normal course of business, an estimate of its cost, together with the cost of removal less salvage, is charged to the accumulated provision for depreciation. Gains and losses resulting from the sale or disposal of general plant are recognized in income currently.

Note B - Summary of Significant Accounting Policies (Continued)

The major classifications of electric plant in service were as follows:

	2013	2012
Distribution plant	$ 191,695,925	$ 188,686,114
General plant	27,451,255	27,048,518
Construction in progress	131,971	551,189
	219,279,151	216,285,821
Accumulated Depreciation	52,155,290	48,068,981
Electric Plant in Service, net	$ 167,123,861	$ 168,216,840

3. Cash and Equivalents: For purposes of the statements of cash flows, the Cooperative considers short-term investments having maturities of three months or less at time of purchase to be cash equivalents. The Cooperative has implemented a policy whereby it sweeps non-interest bearing funds from its district accounts to it general funds to maintain balances below the FDIC insured limit of $250,000. The local bank provides additional FDIC insurance on deposits and repurchase agreements in excess of the FDIC limits in the general fund up to an amount of $4,000,000. The Cooperative's management estimates that deposits will not exceed this amount. An additional $1,500,000 of coverage is provided for funds held in the economic development grant fund.

4. Fair Value Measurements: Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a framework for measuring fair value. The ASC establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

   The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

   Level 1: inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

   Level 2: inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

   Level 3: inputs to the valuation methodology are unobservable and significant to the fair value measurement.

   A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. At August 31, 2013 and 2012, financial instruments consisted of cash and equivalents whose carrying values approximate fair value due to the short-term nature of the instruments, all measured using the Level 1.

Note B - Summary of Significant Accounting Policies (Continued)

5. Accounts Receivable: Accounts receivable-customers consists of amounts due for sales of electric energy, which were not received by the Cooperative at year-end. Based on management's evaluation of uncollected accounts receivable at the end of each year, bad debts are provided for on the allowance method.

   Additionally, regulatory requirements authorized by the Kentucky Public Service Commission allow the electric supplier to impose a fuel adjustment surcharge upon the Cooperative. In turn, the Cooperative is required to pass on the fuel surcharge to the consumer. Due to the regulatory requirements in calculating the surcharge the Cooperative may experience an over or under recovery of the fuel adjustment surcharge.

   Similarly, the Kentucky Public Service Commission has an environmental cost recovery mechanism that allows the electric supplier to recover certain costs incurred in complying with the Federal Clean Air Act as amended and those federal, state, and local environmental requirements which apply to coal combustion wastes and byproducts from facilities utilized for the production of energy from coal. In turn, the Cooperative is required to pass on this environmental cost recovery mechanism to the consumer.

   The Cooperative records the under or over recovery of the fuel adjustment surcharge and the environmental surcharge on the financial statements as a debit to the accounts receivable account or as a credit to the accounts receivable account, respectively.

6. Materials and Supplies: The Cooperative values materials and supplies at the lower of cost or market.

7. Deferred Meter Retirement: Deferred meter retirement is considered a regulatory asset in accordance with RUS Bulletin 1767B-1. RUS Bulletin 1767B-1 indicates that a regulatory asset results from a rate action of regulatory agencies. Regulatory assets arise from specific expenses or losses that would have been included in net income determinations in one period under the general requirements of the Uniform System of accounts but for it being probable that such items will be included in a different period for purposes of developing the rates the utility is authorized to charge for its utility services.

   The deferred meter retirement expense was incurred by the Cooperative through a project to update its meters in conjunction with the Smart Grid Investment Grant provided by the Department of Energy. Per the guidance of the PSC, as mandated in its order dated May 11, 2012 in conjunction with Case No. 2011-00096, the Cooperative has placed the loss on the retirement of the old mechanical meters on its financial statements as a regulatory asset. This loss is to be amortized over a 15 year period. The amount of the loss at August 31, 2013 and 2012 was $2,865,599 and $1,405,374, respectively. Amortization expense for the year ended August 31, 2013 was $124,819; deferred meter retirement is displayed on the balance sheet net of the accumulated amortization.

Note B - Summary of Significant Accounting Policies (Continued)

8. Revenue and Cost of Purchased Power: The Cooperative records revenue as billed to its consumers based on monthly meter reading cycles. Consumers are required to pay a refundable customer deposit, which may be waived under certain circumstances. The Cooperative's sales are concentrated in an eleven county area of south central Kentucky and two northern Tennessee counties. 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.

   The Cooperative is required to collect, on behalf of the State of Kentucky, sales taxes based on 6 percent of gross sales from non-residential consumers, a 3 percent school tax from certain counties on most gross sales, and franchise fees in certain cities. The Cooperative's policy is to exclude sales tax from revenue when collected and expenses when paid and instead, record collection and payment of sales taxes through a liability account.

   The Cooperative is one of sixteen members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, the Cooperative 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.

9. Advertising Costs: The Cooperative records advertising expenses as they are incurred. Advertising expense amounted to $39,559 and $42,978 for the years ended August 31, 2013 and 2012, respectively.

10. Investments in Associated Organizations: The Cooperative follows the method of accounting as prescribed by the RUS Uniform System of Accounts in accounting for its investment in associated organizations. This accounting method results in the Cooperative recognizing in income its pro rata share of the associated organization's net margins in the year such margins are assigned. This accounting method does not provide for similar treatment for any losses of the associated organizations. Rather, such losses would not be assigned to member organizations and no additional margins are assigned until subsequent cumulative margins exceed prior cumulative losses.

11. Accrued Compensated Absences: The Cooperative has a policy to pay available but untaken compensated absences to employees who leave service. Accrued compensated absences presented in the financial statements represent available sick leave at August 31, 2013 and 2012. Sick leave is valued at the rate it is earned and the unpaid balance is paid out in full upon termination of employment.

12. Comprehensive Income (Loss): The Cooperative accounts for comprehensive income (loss) in accordance with the relative provisions of the ASC.

    In June 2011, the FASB issued updated guidance to increase the prominence of items reported in other comprehensive income (loss) by eliminating the option of solely presenting components of comprehensive income (loss) as part of the statements of changes in members' and patrons' equities. The updated guidance became effective for the year ending August 31, 2013 and was applied retrospectively. The Cooperative has elected to present the required information on the accompanying statements of income and comprehensive income for the years ended August 31, 2013 and 2012.

Note B - Summary of Significant Accounting Policies (Continued)

13. Use of Estimates: Management uses estimates and assumptions in preparing these financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, disclosure 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.

14. Subsequent Events: Subsequent events for the Cooperative have been considered through the date of the Independent Auditor's Report which represents the date the financial statements were available to be issued.

15. New Accounting Pronouncement: In September 2011, the FASB issued Accounting Standards Update (ASU) 2011-09, *Disclosures about an Employer's Participation in a Multiemployer Plan*, which amends FASB ASC 715-80, *Compensation – Retirement Benefits: Multiemployer Plans*, by requiring employers participating in multiemployer pension plans to provide additional quantitative and qualitative disclosures in order to provide more detailed information about the employer's involvement in multiemployer pension plans. In addition, this amendment also includes changes in the disclosures required for multiemployer plans that provide postretirement benefits other than pensions. This guidance is effective for non-public companies for the fiscal years ending after December 15, 2012. This guidance was adopted for the period ended August 31, 2012 and it had no impact on the Cooperative's financial position or results of operations.

Note C - Investments in Associated Organizations

East Kentucky Power Cooperative:

The Cooperative's investment of $39,274,997 in East Kentucky, the sole supplier of power to the Cooperative, represents the Cooperative's equity ownership interest (approximately 11%) in East Kentucky. The Cooperative owed East Kentucky $7,657,644 and $7,508,479 at August 31, 2013 and 2012, respectively. These amounts are included in accounts payable on the balance sheet.

Investments in other associated organizations consisted of:

	August 31, 2013	August 31, 2012
Cooperative Finance Corporation, Capital Term Certificates	$ 1,628,724	$ 1,636,308
Cooperative Finance Corporation, patronage capital	560,220	524,233
United Utility Supply	827,195	827,195
Southeastern Data Cooperative, Inc.	294,812	258,922
Other associated organizations	337,594	273,251
Economic development loans	4,250,289	5,548,429
Non utility property	79,851	82,934
Wholly owned subsidiary	65,270	66,007
	$ 8,043,955	$ 9,217,279

Note C - Investments in Associated Organizations (Continued)

Substantially all of such investments, which consist mainly of patronage capital in the associated organization and capital term certificates are restricted by the respective organization and are not currently available for distribution. The patronage capital will be available to the Cooperative if the Cooperative should terminate its investment in the associated organization. The capital term certificates are not available until the related debt is paid off, currently expected to be between the years 2020 and 2080.

The Capital Term Certificates ("CTC's") were purchased from CFC as a condition of obtaining long-term financing and are recorded at cost. The CTC's bear interest at varying rates between 0% and 5% per annum and are scheduled to mature at varying times from 2020 to 2080. These certificates are required to be maintained under the note agreement with the National Rural Utilities Cooperative Finance Corporation (NRUCFC) in an amount at least equal to 5% of the original debt issued or guaranteed by NRUCFC until maturity.

United Supply Cooperative (United) is a primary supplier of transformers and overhead line materials and supplies. The Cooperative's purchases from United amounted to $1,339,840 and $1,570,026 for the years ended August 31, 2013 and 2012, respectively. The Cooperative owed United $163,223 at August 31, 2013. This amount is included in accounts payable on the balance sheet.

Southeastern Data Cooperative, Inc., (Southeastern) is a primary supplier of data processing services and computer hardware and software. The Cooperative's purchases from Southeastern were $804,750 and $840,562 for the years ended August 31, 2013 and 2012, respectively. The Cooperative owed Southeastern $77,966 at August 31, 2013, this amount is included in accounts payable on the balance sheet.

The Cooperative participates in the Rural Economic Development Loan and Grant (REDLG) program through the United States Department of Agriculture (USDA). The USDA via the REDLG program provides zero interest loans and grants to rural communities through Rural Utilities Services (RUS) borrowers. REDLG assistance promotes rural economic development and job creation projects in accordance with section 313 of the RE Act 7 CFR 1703, Subpart. The Cooperative currently sponsors twelve local organizations with loans with a principal amount due of $2,640,229 as of August 31, 2013.

Additionally, the Cooperative has sponsored nine additional organizations with grant funds in the total amount of $3,080,000. The grant funds were funded in part with funds from the Cooperative and from the USDA. The principal amount due as of August 31, 2013 is $1,610,060.

Note D - Income Tax Status

The Cooperative is exempt from federal and state income taxes under §501(c)(12) of the Internal Revenue Code. The Cooperative recognizes uncertain income tax positions using the "more-likely-than-not" approach as defined in the ASC. No liability for uncertain tax positions has been recorded in the accompanying financial statements. The Cooperative's 2009 - 2012 tax years remain open and subject to examination.

Note E - Line-of-credit

At August 31, 2013 and 2012, the Cooperative had an executed line-of-credit of $15,000,000 with CFC. The line-of-credit bears a variable interest rate, determined by CFC at the date of draw, and matures on December 12, 2013. SKRECC has negotiated an extension of the line of credit. As of August 31, 2013 and 2012 there were no outstanding balances due under the line-of-credit.

Note F - Long-term Debt

Long-term debt consisted of the following:

	August 31, 2013	August 31, 2012
RUS, 0.25% to 5.78%	$ 70,872,873	$ 72,550,084
less advance payment	(15,923,942)	(446,985)
	54,948,931	72,103,099
FFB, 3.249% to 3.699%	52,235,141	38,125,434
Economic development loans, 0%	5,184,228	6,190,524
CCF, 3.05% to 6.70%	14,510,304	16,037,321
City of Monticello, 4.75%	3,666,667	3,813,333
	130,545,271	136,269,711
Less Current Maturities	5,487,181	5,025,000
	$ 125,058,090	$ 131,244,711

The aggregate principal maturities of long-term debt as of August 31, 2013 are as follows:

2014	$ 5,487,181
2015	5,431,704
2016	5,634,169
2017	5,785,160
2018	5,762,573
Thereafter	102,444,484
	$ 130,545,271

The long-term debt as described above is payable in quarterly, monthly, and annual installments of varying amounts. Substantially all utility plant is pledged as collateral for the above notes. Under the terms of the loan agreements, the Cooperative is required to meet certain financial performance covenants. The Cooperative is in compliance with these covenants at August 31, 2013.

The Cooperative participates in an RUS sponsored program which provides economic development funds to businesses in South Kentucky's service area. The Cooperative serves as a conduit for these funds and is

Note F - Long-term Debt (Continued)

contingently liable if the recipient fails to repay the loan. As such, these amounts are included in the debt service above. These loans carry a 0% interest rate to the Cooperative and the recipients. The loans are secured with bank letters of credit.

Note G - Members' and Patrons' Equities

Under terms of its long-term debt agreements, return of capital contributions or patronage capital to the Cooperative's members and patrons is restricted to amounts which would not allow total equity to be less than 30% of total assets, except that distributions may be made to estates of deceased members provided that such distributions do not exceed 25% of total patronage capital and margins received in the previous year. Total equity as a percentage of assets can fall below the 30% requirement if the Cooperative has obtained the appropriate waiver from the RUS. The Cooperative is in compliance with these requirements at August 31, 2013.

Note H - Retirement Benefits

Eligible employees of the Cooperative participate in the National Rural Electric Cooperative Association (NRECA) Retirement and Security Plan (RS Plan). The RS Plan is a defined benefit pension plan qualified under Section 401 and tax-exempt under Section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The plan sponsor's Employer Identification Number is 53-0116145 and the Plan Number is 333. Eligible employees include employees hired prior to January 1, 2008. Non-eligible employees are those hired after January 1, 2008.

A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

The Cooperative contributions to the RS Plan in 2013 and in 2012 represented less than 5 percent of the total contributions made to the plan by all participating employers. The Cooperative made contributions to the plan of $1,566,583 and $1,564,498 in 2013 and 2012, respectively. There have been no significant changes that affect the comparability of 2013 and 2012 contributions.

In the RS Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act (PPA) of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the Retirement Security Plan was over 80 percent funded on August 31, 2013 and between 65 percent and 80 percent funded at January 1, 2012 based on the PPA funding target and PPA actuarial value of assets on those dates.

Because the provisions of the PPA do not apply to the RS Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

In addition to the above, the Cooperative participates in the NRECA 401(k) plan. Non- eligible RS plan employees receive a 6% base contribution with an additional 4% match contribution. Contributions were $35,789 and $30,147 for 2013 and 2012, respectively. Eligible RS plan employees can also elect to participate in the 401 (k) plan, with the Cooperative matching a maximum of 2% of base wages. The Cooperative contributed $135,473 and $145,300 for 2013 and 2012, respectively. Participant contributions can be made after one (1) month of employment and vest immediately. The Cooperative makes contributions for participants after one (1) year of employment.

Note I - Postretirement Benefits

The Cooperative provides postretirement medical benefits to its retired employees and their dependents. South Kentucky pays all the premiums for retirees and 70% for dependents. "Employers' Accounting for Postretirement Benefits Other Than Pensions," requires the accrual of the cost of providing certain postretirement benefits over the employees' years of service, rather than on a pay-as-you-go (cash) basis.

In accordance with the provision of "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," the Cooperative has recorded an accrued benefit cost for the full benefit obligation as of August 31, 2013 and 2012.

The following table sets forth the plan's benefit obligation and accrued liability:

	August 31, 2013	August 31, 2012
Benefit obligation	$ 7,962,193	$ 8,186,641
Fair value of plan assets	-	-
Funded Status	$ (7,962,193)	$ (8,186,641)
Accrued benefit cost recognized in the balance sheet	$ (7,962,193)	$ (8,186,641)
Weighted-average assumptions		
Discounted rate	6.50%	6.50%

For measurement purposes, the health care cost trend rate is assumed to be 8.00% and 8.50% in 2013 and 2012, respectively. During 2013 and 2012, the rate was assumed to decrease by 0.5% per year to 5%.

Other information regarding the Cooperative's benefit plans is as follows:

	August 31, 2013	August 31, 2012
Benefit cost	$ 321,600	$ 320,800
Benefits paid	546,048	499,930

Note K - Prior Period Restatement

Management decided to restate the August 31, 2011 patronage capital and August 31, 2011 accounts receivable by $739,052 to properly record the over recovery of environmental cost recovery mechanism in order to correct an error that occurred in the year ended August 31, 2010. Accordingly, patronage capital as of August 31, 2011, was decreased from $63,663,297 to $62,924,245 and accounts receivable as of August 31, 2011 decreased from $8,464,339 to $7,725,287. The restatement had no resulting impact on previously reported 2012 net margins.

Supplementary Information

CPAs & Advisors

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*

To the Board of Directors
South Kentucky Rural Electric Cooperative
Somerset, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Government Auditing Standards issued by the Comptroller General of the United States, the accompanying financial statements and related notes to the financial statements of South Kentucky Rural Electric Cooperative Corporation (the Cooperative) as of and for the year ended August 31, 2013, and have issued our report thereon dated December 6, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Cooperative's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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 Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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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 (Continued)*

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Cooperative, Inc.'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 audit 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.

This report is intended solely for the information and use of the audit committee, management, the Rural Utilities Service, supplemental lenders, others within the Cooperative, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
December 6, 2013

CPAs & Advisors

Independent Auditor's Letter to Management

To the Board of Directors
South Kentucky Rural Electric Cooperative
Somerset, Kentucky

We have audited the financial statements of South Kentucky Rural Electric Cooperative Corporation for the year ended August 31, 2013, and have issued our report thereon dated December 6, 2013. We conducted our 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 Rural Utilities Service (RUS) Borrowers.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Cooperative's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Cooperative'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 entity'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.

Independent Auditor's Letter to Management (Continued)

Section 1773.33 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. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we 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, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.33(e)(1), related party transactions, depreciation rates, and a schedule of deferred debits and credits upon which we express an opinion. In addition, our audit of the financial statements also included the procedures specified in §1773.38 - .45. Our 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, we express no opinion thereon.

No reports other than our independent auditor's report, and our independent auditor's report on compliance and on internal control over financial reporting, all dated December 6, 2013 or summary of recommendations related to our audit have been furnished to management.

Our 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 1773.33 are presented below.

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

We noted no matters regarding South Kentucky Rural Electric Cooperative Corporation's internal control over financial reporting and its operations that we 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 or other expense accounts; and,
- The materials control.

Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we 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 August 31, 2013:

  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 the existence of written RUS (and other mortgagee) approval of each contract listed by the borrower.

Independent Auditor's Letter to Management (Continued)

- Procedure performed with respect to the requirement to submit RUS Form 7 to the RUS:

  1. Agreed amounts reported in Form 7 to South Kentucky Rural Electric Cooperative Corporation's records.

The results of our tests indicate that, with respect to the items tested, South Kentucky Rural Electric Cooperative Corporation complied, except as noted below, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others as defined in §1773.33(e)(1)(i); and

- The borrower has submitted its Form 7 to the RUS and the Form 7, Financial and Statistical Report, as of December 31, 212 represented by the borrower as having been submitted to the RUS appears reasonable based on audit procedures performed.

<u>Comments on Other Additional Matters</u>

In connection with our audit of the financial statements of South Kentucky Rural Electric Cooperative Corporation as of and for the year ended August 31, 2013, nothing came to our attention that caused us to believe that South Kentucky Rural Electric Cooperative Corporation failed to comply with respect to:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33(c)(1);

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 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 1773.33(c)(5);

- There were no related party transactions, in accordance with Accounting Standards Codification, Related Party Transactions, for the year ended August 31, 2013, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR 1773.33(f);

- The depreciation rates addressed at 7 CFR 1773.33(g);

- The detailed schedule of deferred debits and deferred credits addressed at 7 CFR 1773.33(h) ; and

- The detailed schedule of all investments in subsidiary and affiliated companies addressed at 7 CFR 1773.33(i).

Independent Auditor's Letter to Management (Continued)

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Cooperative has implemented the Accounting Standards Codification (ASC) No. 980, Accounting for the Effects of Certain Types of Regulation, in the recording of the described regulatory deferred debits. Similarly, in accordance with RUS Bulletin 1767B-1, section 1767.13(e), the deferral of these regulatory items are recorded without the prior written approval of RUS. However, they have been recorded as such with the approval and direction of the Kentucky Public Services commission. RUS approval of these regulatory assets is in progress. 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 financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report is intended solely for the information and use of the board of directors, management, others within the Cooperative, and 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.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
December 6, 2013