South Kentucky Rural Electric Cooperative

Audited Financial Statements

December 31, 2014 and 2013

South Kentucky Rural Electric Cooperative

Table of Contents
December 31, 2014 and 2013

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 sheets as of December 31, 2014 and 2013 and the related statements of income and comprehensive income, changes in members' and patrons' equities and cash flows for the years 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 audits. We conducted our audits 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.

Mountjoy Chilton Medley LLP
P 859.514.7800 | F 859.514.7805
1000 Vine Center | 333 West Vine Street | Lexington, KY 40507
www.mcmcpa.com | 888.587.1719
An Independent Member of Baker Tilly International

Independent Auditor's Report (Continued)

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Cooperative as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards,* we have also issued our reported dated April 7, 2015, 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* in considering the Cooperative's internal control over financial reporting and compliance.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
April 7, 2015

South Kentucky Rural Electric Cooperative
Balance Sheets
December 31, 2014 and 2013

	2014	2013
Assets		
Electric Plant in Service, net	$ 169,308,431	$ 167,884,348
Investments		
Investments in associated organizations	9,492,379	7,680,856
Investment in East Kentucky Power Cooperative	47,186,151	39,274,997
Total Investments	56,678,530	46,955,853
Current Assets		
Cash and equivalents	18,420,350	8,495,116
Accounts receivable - customers (net of allowance for doubtful accounts of $626,124 in 2014 and 2013)	7,428,119	7,902,400
Other receivables	2,350,971	2,336,545
Materials and supplies	1,578,211	1,747,991
Prepayments and other	258,218	345,165
Total Current Assets	30,035,869	20,827,217
Regulatory Asset	2,433,976	2,621,205
Deferred Debits	3,795,611	4,208,156
Total Assets	$ 262,252,417	$ 242,496,779
Members' and Patrons' Equities and Liabilities		
Members' and Patrons' Equities		
Memberships	$ 1,294,692	$ 1,283,766
Patronage capital	94,723,360	82,799,342
Other equities	3,289,496	2,112,553
Accumulated other comprehensive loss	(5,094,941)	(4,888,131)
Total Members' and Patrons' Equities	94,212,607	81,307,530
Long-term Debt and Other Liabilities		
Long-term debt, less current maturities	138,109,082	131,054,498
Accrued compensated absences	590,274	412,909
Postretirement benefits obligation	10,123,554	9,627,157
Total Long-term Debt and Other Liabilities	148,822,910	141,094,564
Current Liabilities		
Current portion of long-term debt	5,459,926	5,616,611
Accounts payable	10,281,601	11,286,352
Accrued interest	61,441	66,695
Customer guaranty deposits	1,414,077	1,200,608
Other current liabilities	1,324,450	1,084,744
Total Current Liabilities	18,541,495	19,255,010
Deferred Credits		
Consumer advances for construction	675,405	839,675
Total Members' and Patrons' Equities and Liabilities	$ 262,252,417	$ 242,496,779

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Income and Comprehensive Income
Years Ended December 31, 2014 and 2013

	2014	%	2013	%
Operating Revenue				
Sale of electric energy				
Residential	$ 90,207,014	65.58 %	$ 86,420,326	65.48 %
Commercial	42,452,347	30.86	40,667,735	30.81
Public authorities and outdoor lighting	1,669,464	1.21	1,549,000	1.17
Total Sale of Electric Energy	134,328,825	97.65	128,637,061	97.46
Other Revenue	3,239,392	2.35	3,349,217	2.54
Total Operating Revenue	137,568,217	100.00	131,986,278	100.00
Operating Expenses				
Cost of power	100,431,511	73.00	96,126,053	72.83
Distribution expense	11,599,093	8.43	10,934,670	8.28
Customer accounts expense	3,704,980	2.69	3,688,518	2.79
Customer services and information expense	655,818	0.48	584,609	0.44
Administrative and general expense	3,385,057	2.46	3,621,544	2.74
Depreciation	7,353,851	5.35	7,160,471	5.43
Taxes	209,574	0.15	140,735	0.11
Total Operating Expenses	127,339,884	92.56	122,256,600	92.62
Net Operating Income	10,228,333	7.44	9,729,678	7.38
Non-operating Income (Expense)				
Interest expense	(6,108,925)	(4.44)	(6,081,115)	(4.61)
Other margins	986,754	0.72	911,206	0.69
Patronage capital	8,101,661	5.89	6,162,507	4.67
Total Non-operating Income	2,979,490	2.17	992,598	0.75
Net Margins	13,207,823	9.61	10,722,276	8.13
Other Comprehensive Income				
Change in post-retirement benefit obligation	(206,810)	(0.15)	(1,505,188)	(1.14)
	$ 13,001,013	9.46 %	$ 9,217,088	6.99 %

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Changes in Members' and Patrons' Equities
Years Ended December 31, 2014 and 2013

	Memberships	Patronage Capital	Other Equities	Accumulated Other Comprehensive Loss	Total Members' and Patrons' Equities
Balance, December 31, 2012	$ 1,274,946	$ 73,933,924	$ 1,009,339	$ (3,382,943)	72,835,266
Comprehensive Income:					
Net Margins	-	9,811,070	911,206	-	10,722,276
Post Retirement Benefit Obligation	-	-	-	(1,505,188)	(1,505,188)
Total Comprehensive Income	-	9,811,070	911,206	(1,505,188)	9,217,088
Net Change in Memberships	8,820	-	-	-	8,820
Refunds to Estates	-	(231,212)	-	-	(231,212)
General Retirement to Members	-	(714,440)	-	-	(714,440)
Transfers to Other Equity and Prior Year's Income	-	-	192,008	-	192,008
Other Equities	-	-	-	-	-
Balance, December 31, 2013	1,283,766	82,799,342	2,112,553	(4,888,131)	81,307,530
Comprehensive Income:					
Net Margins	-	12,221,068	986,755	-	13,207,823
Post Retirement Benefit Obligation	-	-	-	(206,810)	(206,810)
Total Comprehensive Income	-	12,221,068	986,755	(206,810)	13,001,013
Net Change in Memberships	10,926	-	-	-	10,926
Refunds to Estates	-	(297,050)	-	-	(297,050)
Transfers to Other Equity and Prior Year's Income	-	-	190,188	-	190,188
Other Equities	-	-	-	-	-
Balance, December 31, 2014	$ 1,294,692	$ 94,723,360	$ 3,289,496	$ (5,094,941)	$ 94,212,607

See accompanying notes.

South Kentucky Rural Electric Cooperative
Statements of Cash Flows
Years Ended December 31, 2014 and 2013

	2014	2013
Cash Flows from Operating Activities		
Net Margins	$ 13,207,823	$ 10,722,276
Non-cash expenses included in net margins		
Patronage capital assigned but not paid		
by associated organizations	(8,101,661)	(6,162,507)
Depreciation and amortization	7,353,851	7,160,471
Bad debt expense	474,720	671,733
Gain on disposition of electric plant in service	(73,197)	(160,270)
Changes in current and non-current assets and liabilities:		
Accounts receivable	(439)	(1,278,261)
Other receivables	(14,426)	295,193
Materials and supplies	169,780	11,453
Prepayments and other	86,947	(166,837)
Accounts payable	(1,004,751)	1,002,242
Customer guaranty deposits	213,469	58,472
Accrued interest and other current liabilities	234,452	244,672
Accrued compensated absences	177,365	188,022
Postretirement benefits obligation	289,587	2,508
Net Cash Provided by Operating Activities	13,013,520	12,589,167
Cash Flows from Investing Activities		
Decrease/increase in deferred debits	412,545	(4,208,156)
Decrease/increase in consumer advances	(164,270)	84,379
Interest income - other margins	(824,851)	(736,452)
Increase in advance loan payments unapplied	-	(15,000,000)
Increase/decrease in economic development loan funds	(1,691,233)	2,936,961
Proceeds from sale of electric plant in service	73,197	163,616
Additions to electric plant in service	(7,695,993)	(7,561,598)
Removal cost, net	(894,712)	(954,042)
Patronage capital received from associated organizations	70,217	69,032
Net Cash Used in Investing Activities	(10,715,100)	(25,206,260)
Cash Flows from Financing Activities		
Proceeds from long-term notes payable	16,000,000	21,200,000
Payment of principal on long-term notes payable	(8,277,250)	(5,024,854)
Membership fees (reimbursement), net	10,926	8,820
Refund of patronage capital to members	(297,050)	(945,652)
Changes in other patronage capital and equities	190,188	192,008
Net Cash Provided by Financing Activities	7,626,814	15,430,322
Increase in Cash and Equivalents During the Year	9,925,234	2,813,229
Cash and Equivalents, Beginning of Year	8,495,116	5,681,887
Cash and Equivalents, End of Year	$ 18,420,350	$ 8,495,116
Supplemental Disclosures of Cash Flow Information		
Interest paid	$ 6,103,671	$ 6,076,812

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 3.33% for 2014 and 2013. 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.

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

	2014	2013
Distribution plant	$ 199,372,570	$ 193,775,426
General plant	27,630,761	27,090,941
Construction in progress	619,898	337,177
	227,623,229	221,203,544
Accumulated Depreciation	58,314,798	53,319,196
Electric Plant in Service, net	$ 169,308,431	$ 167,884,348

Note B - Summary of Significant Accounting Policies (Continued)

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.

4. 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.

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

6. 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 December 31, 2014 and 2013 was $2,433,976 and $2,621,205, respectively. Amortization expense for the year ended December 31, 2014 and 2013 was $187,229; deferred meter retirement is displayed on the balance sheet net of the accumulated amortization.

Note B - Summary of Significant Accounting Policies (Continued)

7. 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.

8. Advertising Costs: The Cooperative records advertising expenses as they are incurred. Advertising expense amounted to $64,569 and $60,611 for the years ended December 31, 2014 and 2013, respectively.

9. 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 income on 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.

10. 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 December 31, 2014 and 2013. Sick leave is valued at the rate it is earned and the unpaid balance is paid out in full upon termination of employment.

11. Comprehensive Income (Loss): Comprehensive income (loss) is the change is equity of an enterprise during the year from transactions and other events and circumstances arising from non-operating sources. The Cooperative's total comprehensive income (loss) includes amounts associated with the change in post-retirement benefits obligation. (See Note J)

12. 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.

13. 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.

Note C - Investments in Associated Organizations

East Kentucky Power Cooperative:

The Cooperative's investment of $47,186,151 and $39,274,997 as of December 31, 2014 and 2013, respectively, 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 $9,320,552 and $9,994,821 at December 31, 2014 and 2013, respectively. These amounts are included in accounts payable on the balance sheets.
Investments in other associated organizations consisted of:

	December 31, 2014	December 31, 2013
Cooperative Finance Corporation, Capital Term Certificates	$ 1,620,659	$ 1,628,724
Cooperative Finance Corporation, patronage capital	632,343	598,984
United Utility Supply	833,937	827,437
Southeastern Data Cooperative, Inc.	314,889	294,812
Other associated organizations	411,627	341,267
Rural Economic Development Loans and Grants	5,601,513	3,910,445
Non utility property	77,411	79,187
	$ 9,492,379	$ 7,680,856

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 $1,379,964 and $1,243,024 for the years ended December 31, 2014 and 2013, respectively. The Cooperative owed United $78,392 and $87,511 at December 31, 2014 and 2013, respectively. This amount is included in accounts payable on the balance sheets.

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 $878,031 and $810,701 for the years ended December 31, 2014 and 2013, respectively. The Cooperative owed Southeastern $74,725 and $64,901 at December 31, 2014 and 2013, respectively, this amount is included in accounts payable on the balance sheets.

Note C - Investments in Associated Organizations (Continued)

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 fifteen local organizations with loans with a principal amount due of $3,790,423 as of December 31, 2014. The Cooperative sponsored thirteen local organizations with loans with a principal amount due of $4,412,979 as of December 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 is $1,097,558 and $1,426,891, as December 31, 2014 and 2013, respectively.

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 2011 - 2013 tax years remain open and subject to examination.

Note E - Line-of-credit

At December 31, 2014 and 2013, 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 November 11, 2015. As of December 31, 2014 and 2013 there were no outstanding balances due under the line-of-credit.

Note F - Long-term Debt

Long-term debt consisted of the following:

	December 31, 2014	December 31, 2013
RUS, 0.125% to 5.78%	$ 65,406,448	$ 70,301,711
less advance payment	(17,015,763)	(16,190,912)
	48,390,685	54,110,799
FFB, 0.03% to 3.699%	72,681,191	57,922,061
Economic development loans, 0%	6,344,711	6,978,979
CFC, 3.05% to 6.70%	12,779,087	14,139,270
City of Monticello, 4.75%	3,373,334	3,520,000
	143,569,008	136,671,109
Less Current Maturities	5,459,926	5,616,611
	$ 138,109,082	$ 131,054,498

Note F - Long-term Debt (Continued)

The aggregate principal maturities of long-term debt as of December 31, 2014 are as follows:

2015	$ 5,459,926
2016	4,890,884
2017	5,013,792
2018	5,087
2019	4,020,265
Thereafter	124,179,054
	$ 143,569,008

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 December 31, 2014.

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 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 provided by the borrower.

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 December 31, 2014.

Note H - Retirement Benefits

Eligible employees of the Cooperative participate in the Retirement Security Plan (RS Plan), sponsored by the National Rural Electric Cooperative Association (NRECA). 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 considered a multi-employer plan under the accounting standards. The Plan sponsor's Employer Identification Number is 53-0116145 and the Plan Number is 333.

A unique characteristic of a multi-employer plan compared to a single employer plan is that all the 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 2014 and in 2013 represented less than 5 percent of the total contributions made to the RS Plan by all participating employers. The Cooperative made contributions to the RS Plan of $1,314,995 in 2014 and $1,737,428 in 2013.

Note H - Retirement Benefits (Continued)

Contributions in 2013 are significantly higher than those in 2014 due to the Cooperative electing to participate in the prepayment option offered to participating employers. See Note I below for more information on the prepayment program. Additionally, beginning in January 2014, all employees regardless of hire date became eligible for the Plan.

For 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 RS Plan was over 80 percent funded on January 1, 2014 and over 80 percent funded on January 1, 2013 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. As all employees are now eligible for the RS plan, the Cooperative transitioned the 401(k) plan employer contributions from a 6% base contribution with an additional 4% match contribution for employees hired after January 1, 2008, to the same plan as previously eligible RS Plan participants. The 401 (k) plan provides for the Cooperative matching a maximum of 2% of base wages. The Cooperative contributed \$187,617 and \$181,234 for 2014 and 2013, 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 - RS Plan Prepayment Option

At the December 2012 meeting of the I&FS Committee of the NRECA Board of Directors, the Committee approved an option to allow participating cooperatives in the RS Plan to make a contribution prepayment and reduce future required contributions. The prepayment amount is a cooperative's share, as of January 1, 2013, of future contributions required to fund the RS Plan's unfunded value of benefits earned to date using RS Plan actuarial valuation assumptions. The prepayment amount will typically equal approximately 2.5 times a cooperative's annual RS Plan required contribution as of January 1, 2013. After making the prepayment, for most cooperatives the billing rate is reduced by approximately 25%, retroactive to the January 1st of the year in which the amount is paid to the RS Plan. The 25% differential in billing rates is expected to continue for approximately 15 years. However changes in interest rates, asset returns and other plan experience different from expected, plan assumption changes and other factors may have an impact on the differential in billing rates and the 15 year period. At December 31, 2014 and 2013, the Cooperative's prepayment as reflected on the balance sheet is \$3,857,476 and \$4,208,156, respectively.

Note J - 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 December 31, 2014 and 2013.

Note J - Postretirement Benefits (Continued)

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

	December 31, 2014	December 31, 2013
Benefit obligation	$ 10,123,554	$ 9,627,157
Fair value of plan assets	-	-
Funded Status	$ (10,123,554)	$ (9,627,157)
Accrued benefit cost recognized in the balance sheet	$ (10,123,554)	$ (9,627,157)
Weighted-average assumptions		
Discounted rate	4.50%	6.00%

For measurement purposes, the health care cost trend rate is assumed to be 5.00% and 6.50% in 2014 and 2013, respectively. During 2014, the discount rate was assumed to decrease by 0.5% per year from 5.0% to 4.5%.

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

	December 31, 2014	December 31, 2013
Benefit cost	$ 832,207	$ 556,800
Benefits paid	542,620	553,759

Note K - Concentrations

All of the Cooperative's sales are made in portions of eleven counties in south central Kentucky and two counties in north central Tennessee, which is primarily an agricultural and rural region. Accounts receivable and customer deposits at December 31, 2014 and 2013, were derived from the various classes of customers in approximately the same proportion as the revenues shown in the accompanying statements of income and other comprehensive income (loss).

The Cooperative maintains its cash balances with banks throughout Kentucky. Effective July 21, 2010, the federal deposit insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC) is $250,000 per depositor. 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. An additional $1,500,000 of coverage is provided for funds held in the economic development grant fund. As of December 31, 2014, there were no uninsured balances.

Note L - 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 December 31, 2014 and 2013, 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.

Supplementary Information

CPAs & ADVISORS

Independent Auditor's 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, Inc. ("the Cooperative") as of and for the year ended December 31, 2014, and have issued our report thereon dated April 7, 2015.

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 opinion 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.

Mountjoy Chilton Medley LLP
P 859.514.7800 | F 859.514.7805
1000 Vine Center | 333 West Vine Street | Lexington, KY 40507
www.mcmcpa.com | 888.587.1719
An Independent Member of Baker Tilly International

Kentucky
Indiana
Ohio

Independent Auditor's 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'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.*

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the organization's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the organization's internal control and compliance. Accordingly, this communication is not suitable for any other purposes.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
April 7, 2015

CPAs & ADVISORS

Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Electric Borrowers

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

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of South Kentucky Rural Electric Cooperative, Inc., ("the Cooperative"), which comprise the balance sheet as of December 31, 2014, and the related statements of revenue and patronage capital, changes in cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 7, 2015. In accordance with *Government Auditing Standards*, we have also issued our report dated April 7, 2015, on our consideration of 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. No reports other than the reports referred to above have been furnished to management.

In connection with our audit, nothing came to our attention that caused us to believe that the Cooperative failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers,* §1773.33 and clarified in the RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Cooperative's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with our audit, we noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative did not:

- Maintain adequate and effective accounting procedures;
- Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts;
- Reconcile continuing property records to the controlling general ledger plant accounts;
- Clear construction accounts and accrue depreciation on completed construction;
- Record and properly price the retirement of plant;
- Seek approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap;
- Maintain adequate control over materials and supplies;
- Prepare accurate and timely Financial and Operating Reports;

Mountjoy Chilton Medley LLP
P 859.514.7800 | F 859.514.7805
1000 Vine Center | 333 West Vine Street | Lexington, KY 40507
www.mcmcpa.com | 888.587.1719
An Independent Member of Baker Tilly International

Kentucky
Indiana
Ohio

Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Electric Borrowers (Continued)

- Obtain written RUS approval to enter into any contract for the management, operation, or maintenance of the borrower's system if the contract covers all or substantially all of the electric system;
- Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles;
- Record depreciation in accordance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures);
- Comply with the requirements for the detailed schedule of deferred debits and deferred credits; and
- Comply with the requirements for the detailed schedule of investments.

This report is intended solely for the information and use of the board of directors, management, and the RUS and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
April 7, 2015