

South Kentucky Rural Electric Cooperative Corporation

Audited Financial Statements

December 31, 2016 and 2015

South Kentucky Rural Electric Cooperative Corporation

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December 31, 2016 and 2015

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Independent Auditor's Report

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

We have audited the accompanying balance sheets of South Kentucky Rural Electric Cooperative Corporation ("the Cooperative") as of December 31, 2016 and 2015 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, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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.

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Indiana
Ohio

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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, 2016 and 2015, 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.

Emphasis of a Matter

As disclosed in Note M to the financial statements, the January 1, 2015 Members' and Patrons' Equity has been restated. 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 April 13, 2017, 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.

A handwritten signature in black ink that reads "M. C. Chilton, Muddly, LLP". The signature is written in a cursive style.

Lexington, Kentucky
April 13, 2017

South Kentucky Rural Electric Cooperative Corporation
Balance Sheets
December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u> (as restated)
Assets		
Electric Plant in Service, net	\$ 188,374,402	\$ 175,903,214
Investments		
Investments in associated organizations	9,702,563	10,095,530
Investment in East Kentucky Power Cooperative	<u>60,501,635</u>	<u>54,659,753</u>
Total Investments	70,204,198	64,755,283
Current Assets		
Cash and equivalents	9,106,933	15,542,261
Accounts receivable - customers (net of allowance for doubtful accounts of \$347,935 and \$610,680 in 2016 and 2015, respectively)	12,163,036	12,295,149
Other receivables	2,688,911	2,455,602
Materials and supplies	1,458,457	1,385,641
Prepayments and other	<u>262,777</u>	<u>657,156</u>
Total Current Assets	25,680,114	32,335,809
Regulatory Assets, net	2,138,248	2,246,747
Deferred Debits		
Prepayment	<u>3,015,845</u>	<u>3,436,661</u>
Total Assets	<u>\$ 289,412,807</u>	<u>\$ 278,677,714</u>
Members' and Patrons' Equities and Liabilities		
Members' and Patrons' Equities		
Memberships	\$ 1,317,290	\$ 1,307,560
Patronage capital	118,542,025	111,187,275
Equities	5,509,178	4,502,639
Accumulated other comprehensive loss	<u>(4,167,442)</u>	<u>(4,840,194)</u>
Total Members' and Patrons' Equities	121,201,051	112,157,280
Long-term Debt and Other Liabilities		
Long-term debt, less current maturities	135,147,015	137,468,155
Accrued compensated absences	907,977	807,809
Postretirement benefits obligation	<u>9,776,403</u>	<u>10,167,710</u>
Total Long-term Debt and Other Liabilities	145,831,395	148,443,674
Current Liabilities		
Current portion of long-term debt	6,952,950	6,036,235
Accounts payable	11,954,123	9,039,150
Accrued interest	682,363	56,425
Customer guaranty deposits	1,610,522	1,561,236
Other current liabilities	<u>820,245</u>	<u>970,446</u>
Total Current Liabilities	22,020,203	17,663,492
Deferred Credits		
Consumer advances for construction	<u>360,158</u>	<u>413,268</u>
Total Members' and Patrons' Equities and Liabilities	<u>\$ 289,412,807</u>	<u>\$ 278,677,714</u>

See accompanying notes.

South Kentucky Rural Electric Cooperative Corporation
Statements of Income and Comprehensive Income
Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>%</u>	<u>2015</u> <u>(as restated)</u>	<u>%</u>
Operating Revenue				
Sale of electric energy				
Residential	\$ 81,445,788	64.34 %	\$ 83,413,708	64.59 %
Commercial	40,650,508	32.11	41,131,671	31.85
Public authorities and outdoor lighting	<u>1,559,329</u>	<u>1.23</u>	<u>1,578,647</u>	<u>1.22</u>
Total Sale of Electric Energy	123,655,625	97.68	126,124,026	97.66
Other Revenue	<u>2,923,166</u>	<u>2.32</u>	<u>3,021,381</u>	<u>2.34</u>
Total Operating Revenue	126,578,791	100.00	129,145,407	100.00
Operating Expenses				
Cost of power	91,258,444	72.10	93,010,261	72.02
Distribution expense	12,468,985	9.85	12,433,552	9.63
Customer accounts expense	3,466,393	2.74	3,752,677	2.91
Customer services and information expense	127,093	0.10	427,986	0.33
Administrative and general expense	4,273,080	3.38	3,997,163	3.10
Depreciation and amortization	7,848,985	6.20	7,624,271	5.90
Taxes	<u>159,127</u>	<u>0.13</u>	<u>153,807</u>	<u>0.12</u>
Total Operating Expenses	<u>119,602,107</u>	<u>94.50</u>	<u>121,399,717</u>	<u>94.01</u>
Net Operating Income	6,976,684	5.50	7,745,690	5.99
Non-operating Income (Expense)				
Interest expense	(5,603,459)	(4.43)	(6,114,162)	(4.73)
Other margins	1,238,100	0.98	1,125,989	0.87
Patronage capital	<u>5,992,544</u>	<u>4.73</u>	<u>7,644,221</u>	<u>5.92</u>
Total Non-operating Income	<u>1,627,185</u>	<u>1.28</u>	<u>2,656,048</u>	<u>2.06</u>
Net Margins	8,603,869	6.78	10,401,738	8.05
Other Comprehensive Income				
Change in post-retirement benefit obligation	<u>672,752</u>	<u>0.53</u>	<u>254,747</u>	<u>0.20</u>
Comprehensive Income	<u>\$ 9,276,621</u>	<u>7.31 %</u>	<u>\$ 10,656,485</u>	<u>8.25 %</u>

See accompanying notes.

South Kentucky Rural Electric Cooperative Corporation
Statements of Changes in Members' and Patrons' Equities
Years Ended December 31, 2016 and 2015

	<u>Memberships</u>	<u>Patronage Capital</u>	<u>Equities</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Members' and Patrons' Equities</u>
Balance, January 1, 2015 (as restated)	\$ 1,294,692	\$ 102,208,528	\$ 3,289,496	\$ (5,094,941)	101,697,775
Comprehensive Income:					
Net Margins (as restated)	-	9,266,729	1,135,009	-	10,401,738
Post Retirement Benefit Obligation	-	-	-	254,747	254,747
Total Comprehensive Income	-	9,266,729	1,135,009	254,747	10,656,485
Net Change in Memberships	12,868	-	-	-	12,868
Refunds to Estates	-	(286,686)	-	-	(286,686)
Transfers to Other Equity and Prior Year's Income	-	-	78,134	-	78,134
Other Equities	-	(1,296)	-	-	(1,296)
Balance, December 31, 2015 (as restated)	1,307,560	111,187,275	4,502,639	(4,840,194)	112,157,280
Comprehensive Income:					
Net Margins	-	7,365,769	1,238,100	-	8,603,869
Post Retirement Benefit Obligation	-	-	-	672,752	672,752
Total Comprehensive Income	-	7,365,769	1,238,100	672,752	9,276,621
Net Change in Memberships	9,730	-	-	-	9,730
Refunds to Estates	-	(332,849)	90,269	-	(242,580)
Transfers to Other Equity and Prior Year's Income	-	321,830	(321,830)	-	-
Balance, December 31, 2016	<u>\$ 1,317,290</u>	<u>\$ 118,542,025</u>	<u>\$ 5,509,178</u>	<u>\$ (4,167,442)</u>	<u>\$ 121,201,051</u>

See accompanying notes.

South Kentucky Rural Electric Cooperative Corporation
Statements of Cash Flows
Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u> <u>(as restated)</u>
Cash Flows from Operating Activities		
Net Margins	\$ 8,603,869	\$ 10,401,738
Non-cash expenses included in net margins		
Patronage capital assigned but not paid		
by associated organizations	(5,992,544)	(7,644,221)
Depreciation and amortization	7,848,985	7,624,271
Bad debt expense	(170,740)	251,411
Loss/(gain) on disposition of electric plant in service	4,381	(138,942)
Changes in current and non-current assets and liabilities:		
Accounts receivable	302,853	2,366,727
Other receivables	(233,309)	(104,631)
Materials and supplies	(72,816)	192,570
Prepayments and other	394,379	(398,938)
Accounts payable	2,914,973	(1,242,451)
Customer guaranty deposits	49,286	147,159
Accrued interest and other current liabilities	475,737	(359,020)
Accrued compensated absences	100,168	217,535
Postretirement benefits obligation	281,445	298,903
Net Cash Provided by Operating Activities	<u>14,506,667</u>	<u>11,612,111</u>
Cash Flows from Investing Activities		
Increase in deferred debits	342,086	358,950
Decrease in consumer advances	(53,110)	(262,137)
Interest income - other margins	(1,073,746)	(866,138)
Return of investment in associated organization	55,000	-
Investment in CoBank	(1,000)	-
Gain/loss on other investments	506	-
Increase in advance loan payments unapplied	-	(3,000,000)
Increase/decrease in economic development loan funds	1,426,165	(486,327)
Proceeds from sale of electric plant in service	89,189	132,768
Additions to electric plant in service	(19,108,822)	(13,083,080)
Removal cost, net	(1,117,692)	(942,571)
Patronage capital received from associated organizations	62,958	53,795
Net Cash Used in Investing Activities	<u>(19,378,466)</u>	<u>(18,094,740)</u>
Cash Flows from Financing Activities		
Proceeds from long-term notes payable	58,632,798	9,225,000
Payment of principal on long-term notes payable	(59,963,477)	(5,424,776)
Membership fees (reimbursement), net	9,730	12,868
Refund of patronage capital to members	(332,849)	(286,686)
Changes in other patronage capital and equities	90,269	78,134
Net Cash (Used in) Provided by Financing Activities	<u>(1,563,529)</u>	<u>3,604,540</u>
Decrease in Cash and Equivalents During the Year	(6,435,328)	(2,878,089)
Cash and Equivalents, Beginning of Year	<u>15,542,261</u>	<u>18,420,350</u>
Cash and Equivalents, End of Year	<u>\$ 9,106,933</u>	<u>\$ 15,542,261</u>
Supplemental Disclosures of Cash Flow Information		
Interest paid	\$ 6,229,449	\$ 6,109,146

See accompanying notes.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements
December 31, 2016 and 2015

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. Depreciation rates are within the ranges included in Bulletin 183-1 and any rate changes have been approved by RUS for the depreciation rates used by the Cooperative. The depreciation rates have also been approved by the Kentucky Public Service Commission as of March 30, 2012. The composite depreciation rate for distribution plant was approximately 3.33% for 2016 and 2015. Plant is being depreciated using specific identification straight-line method as follows:

Distribution Plant	2.175% - 6.67%
General Plant	2.00% - 15%

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:

	2016	2015
Distribution plant	\$ 212,134,758	\$ 205,512,415
General plant	30,223,012	30,614,142
Construction in progress	13,164,832	2,846,812
	<u>255,522,602</u>	<u>238,973,369</u>
Accumulated Depreciation	67,148,200	63,070,155
Electric Plant in Service, net	<u>\$ 188,374,402</u>	<u>\$ 175,903,214</u>

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

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 (PSC) 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. Regulatory Asset: 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 net amount of the loss at December 31, 2016 and 2015 was \$2,059,518 and \$2,246,747, respectively. Amortization expense for the years ended December 31, 2016 and 2015 was \$187,229; deferred meter retirement is displayed on the balance sheets as a regulatory asset, net of the accumulated amortization.

Additionally, during 2016, the Cooperative began recording the portion of the accounts receivable balance related to the environmental surcharge that had been specifically ordered as an additional recovery amount as a regulatory asset. The amount recorded at December 31, 2016 was \$78,730.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

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 a percentage of the past due receivables at the end of each month.

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 \$54,179 and \$60,154 for the years ended December 31, 2016 and 2015, 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, 2016 and 2015. 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: Comprehensive income is the change in 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 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.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

Note B - Summary of Significant Accounting Policies (Continued)

13. Pronouncements: On May 28, 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. The standard's core principle is that a cooperative will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This standard also includes expanded disclosure requirements that result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity's contracts with customers. This standard will be effective for the calendar year ending December 31, 2019, early adoption is permitted to reporting periods beginning after December 15, 2016.
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. (See Note N.)

Note C - Investments in Associated Organizations

East Kentucky Power Cooperative (East Kentucky):

The Cooperative's investment of \$60,501,635 and \$54,659,753 as of December 31, 2016 and 2015, 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 \$9,697,963 and \$7,715,478 at December 31, 2016 and 2015, respectively. These amounts are included in accounts payable on the balance sheets.

Investments in other associated organizations consisted of:

	December 31,	
	2016	2015
	<u> </u>	<u> </u>
Cooperative Finance Corporation, Capital Term Certificates	\$ 1,602,966	\$ 1,612,084
Cooperative Finance Corporation, patronage capital	691,087	662,737
United Utility Supply	842,767	836,107
Southeastern Data Cooperative, Inc.	332,678	337,068
Other associated organizations	485,649	473,574
Rural Economic Development Loans and Grants	5,672,162	6,098,327
Non utility property	<u>75,254</u>	<u>75,633</u>
	<u>\$ 9,702,563</u>	<u>\$ 10,095,530</u>

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.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

Note C - Investments in Associated Organizations (Continued)

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 Utility Supply (United) is a primary supplier of transformers and overhead line materials and supplies. The Cooperative's purchases from United amounted to \$1,950,213 and \$1,142,417 for the years ended December 31, 2016 and 2015, respectively. The Cooperative owed United \$100,073 and \$45,458 at December 31, 2016 and 2015, 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 \$990,970 and \$936,482 for the years ended December 31, 2016 and 2015, respectively. The Cooperative owed Southeastern \$92,780 and \$72,017 at December 31, 2016 and 2015, respectively, this amount is included in accounts payable on the balance sheets.

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 \$3,210,192 as of December 31, 2016. The Cooperative sponsored thirteen local organizations with loans with a principal amount due of \$3,742,407 as of December 31, 2015.

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 \$542,671 and \$817,226, as December 31, 2016 and 2015, respectively. The Cooperative also has a revolving loan fund in which loans are made from the repaid grant funds. There are 6 organizations that have received loans with a principal amount due of \$1,919,298 and \$1,538,693 as of December 31, 2016 and 2015, respectively. The available cash balance of the rural economic development revolving loan fund was \$637,845 and \$742,095 as of December 31, 2016 and 2015, 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.

Note E - Line of credit

At December 31, 2016 and 2015, 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 October 12, 2017. As of December 31, 2016 and 2015 there were no outstanding balances due under the line-of-credit.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

Note F - Long-term Debt

During 2016, the Cooperative refinanced a portion of its debt with RUS through CoBank. Long-term debt consisted of the following:

	December 31,	
	2016	2015
RUS, 0.375% to .500%	\$ 4,438,726	\$ 63,717,738
less advance payment	<u>(21,954,349)</u>	<u>(20,880,604)</u>
	(17,515,623)	42,837,134
CoBank, 3.55%	57,049,874	-
FFB, 0.05% to 3.699%	83,423,767	79,586,609
Economic development loans, 0%	5,769,748	6,272,226
CFC, 3.35% to 6.70%	10,292,199	11,581,754
City of Monticello, 4.75%	<u>3,080,000</u>	<u>3,226,667</u>
	142,099,965	143,504,390
Less Current Maturities	<u>6,952,950</u>	<u>6,036,235</u>
	<u>\$ 135,147,015</u>	<u>\$ 137,468,155</u>

The aggregate principal maturities of long-term debt as of December 31, 2016 are as follows:

2017	\$ 6,952,950
2018	6,304,595
2019	6,385,619
2020	6,419,941
2021	6,556,077
Thereafter	<u>109,480,783</u>
	<u>\$ 142,099,965</u>

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, 2016.

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.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

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, 2016 and 2015.

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 2016 and in 2015 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 \$1,811,763 in 2016 and \$1,629,522 in 2015.

In 2013, the Cooperative elected 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, 2015 and over 80 percent funded on January 1, 2014 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 \$182,997 and \$174,052 for 2016 and 2015, 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.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

Note I - Deferred Debit - Prepayment

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, 2016 and 2015, the Cooperative's prepayment as reflected on the balance sheets is \$3,015,845 and \$3,436,661, respectively.

Note J - Postretirement Benefits

The Cooperative provides postretirement medical benefits to its retired employees and their dependents. South Kentucky pays the premiums for retirees based upon years of service and a percentage 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, 2016 and 2015.

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

	December 31,	
	2016	2015
Benefit obligation	\$ (9,776,403)	\$ (10,167,710)
Fair value of plan assets	-	-
Funded Status	<u>\$ (9,776,403)</u>	<u>\$ (10,167,710)</u>
Accrued benefit cost recognized in the balance sheet	\$ (9,776,403)	\$ (10,167,710)
Weighted-average assumptions		
Discounted rate	4.30%	4.50%

For measurement purposes, the health care cost trend rate is assumed to be 5.00%, decreasing by .25% until level at 0.0%. It is assumed that employee contributions will be adjusted to mitigate future increases.

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

	December 31,	
	2016	2015
Benefit cost	\$ 716,498	\$ 875,975
Benefits paid	581,141	577,072

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

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, 2016 and 2015, 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.

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 its 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, 2016, 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, 2016 and 2015, financial instruments consisted of patronage capital whose carrying value is determined based on an allocation by a third party. These investments are valued using Level 2.

South Kentucky Rural Electric Cooperative Corporation
Notes to Financial Statements (Continued)
December 31, 2016 and 2015

Note M - Restatement of Prior Period

Accounting Standards Codification (ASC) 605, *Revenue Recognition*, requires the recognition of revenue earned but not yet billed to be recorded on the Cooperative's financial statements. During 2016, a methodology was developed to estimate the amount of revenue related to energy sales not yet billed. Comparative financial statements of prior years have been adjusted to apply the new method retrospectively. The following financial statement line items for fiscal year 2015 were affected by the accounting change.

<u>Balance Sheet</u>	<u>Prior Year Financial Statement</u>	<u>As Restated</u>	<u>Effect of Change</u>
Accounts Receivable	\$ 4,355,590	\$ 12,295,149	\$ 7,939,559
Patronage Capital	103,247,716	111,187,275	7,939,559
 <u>Statement of Income</u>			
Sale of Electric Energy	\$ 125,669,635	\$ 126,124,026	\$ 454,391
Net Margins	9,947,347	10,401,738	454,391

As a result of the accounting change, patronage capital as of January 1, 2015 increased from \$94,723,360 as originally reported using the previous method to \$102,208,528 using the revised method.

Note N - Subsequent Events

In January 2017, The Cooperative completed construction on their new headquarters building. The Cooperative began operating out of their new facility on January 9, 2017. The construction work in progress account will be reduced for the amount relating to the building construction and placed in the appropriate plant accounts during 2017.

Note O - Contingencies

During the course of normal operations the Cooperative may be subject to possible litigation. However, there are currently no amounts which are deemed as contingent liabilities which should be disclosed or accrued in the financial statements.

Supplementary Information



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 Corporation
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, 2016, and have issued our report thereon dated April 13, 2017.

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.

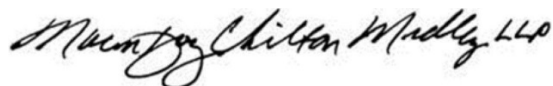
Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards* (Continued)

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.



Lexington, Kentucky
April 13, 2017



**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 Corporation
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, 2016, and the related statements of income and comprehensive income, changes in members' and patrons' equities, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 13, 2017. In accordance with *Government Auditing Standards*, we have also issued our report dated April 13, 2017, 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;

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.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detail schedule of deferred debits and deferred credits required by 7 CFR 1773.33 (h), provided below, is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

South Kentucky RECC
Detailed Schedule of Deferred Debits
December 31, 2016

Description	Amount
Deferred pension prepayment	\$ 3,015,845
	\$ 3,015,845

South Kentucky RECC
Detailed Schedule of Deferred Credits
December 31, 2016

Description	Amount
Customer advances for construction	\$ 360,158
	\$ 360,158

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.



Lexington, Kentucky
April 13, 2017