Kentucky 57
Cumberland Valley Electric
Gray, Kentucky

Audited Financial Statements
May 31, 2012 and 2011

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Independent Auditor's Report

To the Board of Directors
Cumberland Valley Electric

I have audited the balance sheets of Cumberland Valley Electric, as of May 31, 2012 and 2011, and the related statements of income and patronage capital and cash flows for the years then ended. These financial statements are the responsibility of Cumberland Valley Electric's management. My responsibility is to express an opinion on these financial statements based on my audits.

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

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Cumberland Valley Electric as of May 31, 2012 and 2011, and the results of operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, I have also issued a report dated July 12, 2012, on my consideration of Cumberland Valley Electric's internal control over financial reporting and my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of my audits.

Alan Zumstein

Alan M. Zumstein, CPA
July 12, 2012

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To the Board of Directors
Cumberland Valley Electric

I have audited the financial statements of Cumberland Valley Electric as of and for the years ended May 31, 2012 and 2011, and have issued my report thereon dated July 12, 2012. I conducted my audits in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

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

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

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Cumberland Valley's financial statements are free of material misstatement, I performed test of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the audit committee, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Alan Zumstein

Alan M. Zumstein, CPA
July 12, 2012

Cumberland Valley Electric

Balance Sheets, May 31, 2012 and 2011

Assets	2012	2011
Electric Plant, at original cost:		
In service	$ 88,137,134	$ 85,403,163
Under construction	602,410	400,737
	88,739,544	85,803,900
Less accumulated depreciation	31,667,980	30,525,552
	57,071,564	55,278,348
Investments in Associated Organizations	16,861,441	14,121,045
Current Assets:		
Cash and cash equivalents	2,794,101	1,066,011
Accounts receivable, less allowance for 2012 of $177,175 and 2011 of $224,363	3,541,250	3,325,718
Other receivables	123,131	203,593
Material and supplies, at average cost	692,941	643,002
Other current assets	631,225	611,799
	7,782,648	5,850,123
Past Service Pension Costs	-	68,781
Total	$ 81,715,653	$ 75,318,297

Members' Equities and Liabilities	2012	2011
Members' Equities:		
Memberships	$ 428,615	$ 428,025
Patronage capital	34,276,878	30,502,864
Other equities	1,985,731	1,985,976
Accumulated other comprehensive income	(960,044)	(1,012,664)
	35,731,180	31,904,201
Long Term Debt	34,839,683	32,847,220
Accumulated Postretirement Benefits	3,147,531	3,033,213
Current Liabilities:		
Accounts payable	3,035,281	2,997,945
Current portion of long term debt	2,000,000	2,000,000
Consumer deposits	1,397,010	1,118,585
Accrued expenses	1,481,241	1,378,010
	7,913,532	7,494,540
Consumer Advances	83,727	39,123
Total	$ 81,715,653	$ 75,318,297

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

Statements of Revenue and Patronage Capital

for the years ended May 31, 2012 and 2011

	2012	2011
Operating Revenues	$ 48,180,555	$ 48,706,429
Operating Expenses:		
Cost of power	36,690,158	36,985,517
Distribution - operations	1,398,571	1,250,401
Distribution - maintenance	2,589,412	2,955,425
Consumer accounts	1,852,920	1,784,066
Customer services	122,817	109,566
Administrative and general	1,257,081	1,292,824
Depreciation, excluding $261,699 in 2012 and $245,435 in 2011 charged to clearing account	2,908,404	2,801,544
Taxes	47,235	44,833
	46,866,598	47,224,176
Operating margins before interest charges	1,313,957	1,482,253
Interest Charges:		
Long-term debt	428,906	523,883
Other	78,067	68,756
	506,973	592,639
Operating margins after interest charges	806,984	889,614
Nonoperating Margins		
Interest income	161,975	156,577
Others	48,627	(8,016)
	210,602	148,561
Patronage Capital Credits	2,756,387	1,571,411
Net Margins	3,773,973	2,609,586
Patronage Capital, beginning of year	30,502,864	28,667,128
Refund of capital credits and others	41	(773,850)
Patronage Capital, end of year	$ 34,276,878	$ 30,502,864

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

Statements of Cash Flows

for the years ended May 31, 2012 and 2011

	2012	2011
Cash Flows from Operating Activities:		
Net margins	$ 3,773,973	$ 2,609,586
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	2,908,404	2,801,544
Charged to clearing accounts	261,699	245,435
Patronage capital credits assigned	(2,756,387)	(1,571,411)
Accumulated postretirement benefits	166,938	168,801
Past service pension costs	68,781	117,972
Change in assets and liabilities:		
Receivables	(135,070)	(589,566)
Material and supplies	(49,939)	(11,076)
Other assets	(19,426)	179,393
Payables	37,336	604,923
Consumer deposits and advances	323,029	(46,215)
Accrued expenses	103,231	91,649
	4,682,569	4,601,035
Cash Flows from Investing Activities:		
Plant additions	(4,668,463)	(4,944,805)
Plant removal costs	(434,016)	(544,131)
Salvage recovered from retired plant	139,160	10,422
Receipts from other investments, net	15,991	19,083
	(4,947,328)	(5,459,431)
Cash Flows from Financing Activities:		
Net increase in memberships	590	3,135
Increase in other equities	(245)	365,457
Refund of capital credits	41	(773,850)
Advances of long term debt	4,000,000	-
Payments on long term debt	(1,920,004)	(1,932,989)
Advance payments on long term debt	(87,533)	(27,833)
	1,992,849	(2,366,080)
Net increase in cash	1,728,090	(3,224,476)
Cash and cash equivalents, beginning of year	1,066,011	4,290,487
Cash and cash equivalents, end of year	$ 2,794,101	$ 1,066,011
Supplemental cash flows information:		
Interest paid on long-term debt	$ 432,073	$ 521,795

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

Note 1. Summary of Significant Accounting Policies

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

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

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expense. The cost of replacement of depreciable property units, as distinguished from minor items, is charged to electric plant. The units of property replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation for distribution plant. Gain or loss is recognized on disposition of general plant items.

Electric plant consists of:

	2012	2011
Distribution plant	$81,411,114	$78,859,656
General plant	6,726,020	6,543,507
Total	$88,137,134	$85,403,163

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. Depreciation rates range from 2.33% to 5.44%, with a composite rate of 3.37% for distribution plant. General plant rates are as follows:

Structures and improvements	2.5%
Transportation equipment	11.3%
Office furniture and equipment	5.0%
Other general plant	4.0% - 6.0%

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

Off Balance Sheet Risk Cumberland Valley has off-balance sheet risk in that they maintain cash deposits in financial institutions in excess of the amounts insured by the Federal Deposit Insurance Corporation (FDIC) at various time during the month. Cumberland Valley's primary bank deposits in excess of the FDIC limits are 100% secured with collateral from the financial institution.

Revenue Cumberland Valley records revenue as billed to its consumers based on monthly meter-reading cycles. All consumers are required to pay a refundable deposit, however, it may be waived under certain circumstances. Cumberland Valley's sales are concentrated in a six county area of southeastern Kentucky. Consumers must pay their bill within 20 days of billing, then are subject to disconnect after another 10 days. Accounts are written off when they are deemed to be uncollectible. The allowance for uncollectible accounts is based on the aging of receivables. There were no customers whose individual account balance exceeded 10% of outstanding accounts receivable at May 31, 2012 or 2011.

Note 1. Summary of Significant Accounting Policies, continued

Cost of Power Cumberland Valley is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Cumberland Valley 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.

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

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

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

Cumberland Valley may, and also does, invest idle funds in local banks and in National Rural Utilities Cooperative Finance Corporation ("CFC") commercial paper. These investments are classified as held-to-maturity in accordance with provisions of the *Financial Instruments Topic* of FASB ASC 320. Held-to-maturity securities are presented at amortized cost. The fair value of held-to-maturity securities approximates cost at 2012 and 2011.

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

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

Advertising Cumberland Valley expenses advertising costs as incurred.

Note 1. Summary of Significant Accounting Policies, continued

Income Tax Status Cumberland Valley is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements for Cumberland Valley include no provision for income taxes. Cumberland Valley's accounting policy provides that a tax expense/benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Management believes Cumberland Valley has no uncertain tax positions resulting in an accrual of tax expense or benefit. Cumberland Valley recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Cumberland Valley did not recognize any interest or penalties during the years ended May 31, 2012 and 2011.

Subsequent Events Management has evaluated subsequent events through July 12, 2012, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investments in Associated Organizations

Investments in associated organizations consist of:

	2012	2011
East Kentucky, patronage capital	$15,255,770	$12,555,708
CFC, patronage capital	183,560	175,478
CFC, CTC's	851,836	852,692
Others	570,275	537,167
Total	$16,861,441	$14,121,045

Cumberland Valley records patronage capital assigned by associated organizations in the year in which such assignments are received. The Capital Term Certificates ("CTCs") of CFC are recorded at cost. The CTCs were purchased from CFC as a condition of obtaining long-term financing. The CTCs bear interest at 3% and 5% and are scheduled to mature at varying times from 2020 to 2080.

Note 3. Patronage Capital

Patronage capital consisted of:

	2012	2011
Assigned to date	$36,281,915	$32,593,943
Assignable margins	1,058,222	972,220
Retirements to date	(3,063,259)	(3,063,299)
Total	$34,276,878	$30,502,864

Under provisions of the long-term debt agreement, return to patrons of capital contributed by them is limited to amounts which would not allow the total equities and margins to be less than 30% of total assets, except that distributions may be made to estates of deceased patrons. The debt agreement provides, however, that should such distributions to estates not exceed 25% of the net margins for the next preceding year, Cumberland Valley may distribute the difference between 25% and the payments made to such estates. At May 31, 2012, the equities and margins were 44% of total assets.

Note 4. Accumulated Other Comprehensive Income

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

	2012	2011
Balance, beginning of period	($1,012,664)	($1,060,899)
Amortization	52,620	48,235
Adjustments	-	-
Total	($960,044)	($1,012,664)

Note 5. Long Term Debt

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

	2012	2011
RUS, 0.375% to 5.375%	$3,645,106	$3,761,705
Advance payments	(1,218,512)	(1,130,979)
	2,426,594	2,630,726
FFB, 0.073% (0.102% in 2011)	28,519,394	25,511,453
CFC, 4.50% to 6.45%	3,025,939	3,309,856
NCSC, 1.85% to 4.30%	2,867,756	3,395,185
	36,839,683	34,847,220
Less current portion	2,000,000	2,000,000
Long term portion	$34,839,683	$32,847,220

The interest rates on the notes payable to CFC are subject to change approximately every seven years. The long term debt payable to RUS and CFC are due in quarterly and monthly installments of varying amounts through 2039. During November 2010, $3,839,834 of RUS loans were refinanced with lower interest rate notes from NCSC. Cumberland Valley has loan funds available from FFB in the amount of $2,340,000 and an additional $17,608,000 for a new loan at May 31, 2012. These funds will be used for future plant additions.

As of May 31, 2012, annual current principal due for the next five years are as follows: 2013 - $2,000,000; 2014 - $2,000,000; 2015 - $2,100,000; 2016 - $2,150,000; 2017 - $2,200,000.

Note 6. Short Term Borrowings

Cumberland Valley has executed a short term line of credit agreement with CFC in the amount of $5,000,000. At May 31, 2012 Cumberland Valley had repaid all advances against this line of credit.

Note 7. Pension Plan

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

Cumberland Valley also sponsors a Retirement Savings Plan available to all eligible employees. The plan allows participants to make contributions by salary reduction, pursuant to Section 401(k) of the Internal Revenue Code. Cumberland Valley makes contributions of 10% for non salaried employees and 5% for salaried employees of the participant's base compensation. Contributions for both plans were $548,984 for 2011 and $506,406 for 2011.

Effective July 1, 1993, Cumberland Valley adopted the NRECA Retirement and Security Program to recognize salaried employees' prior service. The cost to provide this benefit was $1,568,591. During 2002, Cumberland Valley included additional employees as salaried. The cost to recognize the past service benefits for these employees was an additional $395,389. The past service benefits have been recorded as a deferred asset and are being amortized over a 20 year period. The past service cost was fully-amortized during 2012. RUS approval has been granted for this deferred treatment.

Note 8. Postretirement Benefits

Cumberland Valley sponsors a defined benefit plan that provides medical insurance coverage for retired employees and their spouses. Cumberland Valley pays all the premiums for retirees and their dependents. For measurement purposes, an annual rate of increase of 8.0% in 2009, then decreasing by 0.5% per year until 5% per year, in the per capita cost of covered health care benefit was assumed. The discount rate used in determining the accumulated postretirement benefit obligation was 6.0% in 2012 and 2011.

The funded status of the plan is as follows:

	2012	2011
Projected benefit obligation	($3,147,531)	($3,033,213)
Plan assets at fair value	-	-
Total	($3,147,531)	($3,033,213)

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

	2012	2011
Benefit obligation at beginning of year	$3,033,213	$2,912,647
Components of net periodic benefit cost:		
Service cost	37,958	49,389
Interest cost	185,422	178,376
Amortization of actuarial gain/loss	-	52,611
Net periodic benefit cost	223,380	280,376
Benefits paid	(109,062)	(159,810)
Actuarial gain/loss		
Benefit obligation at end of year	$3,147,531	$3,033,213

Projected retiree benefit payments for the next five years are expected to be as follows: 2013 - $117,480; 2014 - $112,895; 2015 - $127,070; 2016 - $82,080; 2017 - $73,710.

Note 9. Related Party Transactions

Several of the Directors of Cumberland Valley and its President & CEO are on the Boards of Directors of various associated organizations.

Note 10. Commitments and Contingencies

Cumberland Valley is contingently liable as guarantor for approximately $46,000 of long term obligations of East Kentucky to RUS and CFC. Substantially all assets of Cumberland Valley are pledged as collateral for this guarantee, in addition to the pledge in the mortgage agreement referred to in Note 5. This contingent liability was part of an overall financing plan for the construction of generating facilities near Maysville, Kentucky.

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

Note 11. Environmental Contingency

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

Note 12. Rate Matters

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

Note 13. Contingencies

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

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