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Licking Valley Rural Electric Cooperative Corporation West Liberty, Kentucky

Audited Financial Statements
October 31, 2012 and 2011

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Independent Auditor's Report

To the Board of Directors
Licking Valley Rural Electric Cooperative

I have audited the balance sheets of Licking Valley Rural Electric Cooperative, as of October 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 Licking Valley Rural Electric Cooperative'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 Licking Valley Rural Electric Cooperative as of October 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 January 3, 2013, on my consideration of Licking Valley Rural Electric Cooperative's internal control over financial reporting and my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of my audits.

Alan M. Zumstein

Alan M. Zumstein, CPA
January 3, 2013

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To the Board of Directors
Licking Valley Rural Electric Cooperative

I have audited the financial statements of Licking Valley Rural Electric as of and for the years ended October 31, 2012 and 2011, and have issued my report thereon dated January 3, 2013. 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

Management is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing my audit, I considered Licking 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 Licking Valley's internal control over financial reporting. Accordingly, I do no express an opinion on the effectiveness of Licking Valley's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Licking Valley's financial statements are free of material misstatement, I 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 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 Board of Directors, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Alan M. Zumstein

Alan M. Zumstein, CPA
January 3, 2013

Licking Valley Rural Electric Cooperative Corporation
Balance Sheets, October 31, 2012 and 2011

Assets	2012	2011
Electric Plant, at original cost:		
In service	$ 61,176,333	$ 59,101,583
Under construction	651,517	1,169,540
	61,827,850	60,271,123
Less accumulated depreciation	21,337,285	20,233,293
	40,490,565	40,037,830
Investments in Associated Organizations	9,717,067	8,269,323
Current Assets:		
Cash and cash equivalents	203,988	367,197
Accounts receivable, less allowance for 2012 of $118,812 and 2011 of $68,141	4,514,760	4,356,596
Other receivables	790,211	86,756
Material and supplies, at average cost	478,252	438,745
Other current assets	22,237	29,330
	6,009,448	5,278,624
Total	$ 56,217,080	$ 53,585,777

Members' Equities and Liabilities	2012	2011
Members' Equities:		
Memberships	$ 214,120	$ 211,930
Patronage capital	26,403,298	24,500,465
Other equities	100,337	88,570
Accumulated other comprehensive income	(1,033,768)	(1,101,808)
	25,683,987	23,699,157
Long Term Debt	19,724,939	20,940,797
Accumulated Postretirement Benefits	2,969,312	3,008,239
Current Liabilities:		
Notes payable	1,383,941	1,068,366
Accounts payable	3,015,615	1,527,634
Current portion of long term debt	1,225,000	1,200,000
Consumer deposits	1,265,754	1,278,972
Accrued expenses	617,523	523,583
	7,507,833	5,598,555
Consumer Advances	331,009	339,029
Total	$ 56,217,080	$ 53,585,777

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

Statements of Revenue and Patronage Capital
for the years ended October 31, 2012 and 2011

	2012	2011
Operating Revenues	$ 27,756,009	$ 28,637,903
Operating Expenses:		
Cost of power	19,072,840	19,760,238
Distribution - operations	1,530,245	1,622,996
Distribution - maintenance	1,850,674	1,901,577
Consumer accounts	972,103	912,464
Customer services	45,597	102,435
Administrative and general	1,238,785	1,155,182
Depreciation, excluding $185,946 in 2012 and $186,367 in 2011 charged to clearing account	1,967,023	1,908,065
Taxes, other than income	37,648	34,317
Other deductions	19,192	20,031
	26,734,107	27,417,305
Operating margins before interest charges	1,021,902	1,220,598
Interest Charges:		
Long-term debt	547,179	593,015
Other	105,115	107,581
	652,294	700,596
Operating margins after interest charges	369,608	520,002
Nonoperating Margins:		
Interest income	30,102	31,631
Others	42,786	-
	72,888	31,631
Patronage Capital Credits	1,460,337	837,131
Net Margins	$ 1,902,833	$ 1,388,764

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

Statements of Cash Flows

for the years ended October 31, 2012 and 2011

	2012	2011
Cash Flows from Operating Activities:		
Net margins	$ 1,902,833	$ 1,388,764
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	1,967,023	1,908,065
Charged to clearing accounts	185,946	186,367
Patronage capital credits assigned	(1,460,337)	(837,131)
Accumulated postretirement benefits	29,113	(8,046)
Change in assets and liabilities:		
Receivables	(861,619)	(234,488)
Material and supplies	(39,507)	(27,975)
Other assets	7,093	2,985
Payables	1,487,981	209,701
Consumer deposits and advances	(21,238)	10,143
Accrued expenses	93,940	92,000
	3,291,228	2,690,385
Cash Flows from Investing Activities:		
Plant additions	(2,408,621)	(2,908,877)
Plant removal costs	(293,491)	(493,803)
Salvage recovered from retired plant	96,408	266,746
Receipts from other investments, net	12,593	15,293
	(2,593,111)	(3,120,641)
Cash Flows from Financing Activities:		
Net increase in memberships	2,190	(310)
Increase in other equities	11,767	-
Short term borrowings	315,575	1,068,366
Payments on long term debt	(1,190,858)	(1,181,349)
Advances of long term debt	-	-
	(861,326)	(113,293)
Net increase in cash	(163,209)	(543,549)
Cash and cash equivalents, beginning of year	367,197	910,746
Cash and cash equivalents, end of year	$ 203,988	$ 367,197
Supplemental cash flows information:		
Interest paid on long-term debt	$ 551,521	$ 598,480

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

Statement of Changes in Members' Equity
for the years ended October 31, 2011 and 2012

	Memberships	Patronage Capital	Other Equity	Accumulated Other Comprehensive Income	Total Members' Equity
Balance - Beginning of year	$212,240	$ 23,111,701	$ 88,570	$(1,169,848)	$ 22,242,663
Comprehensive income:					
Net margins		1,388,764			1,388,764
Postretirement benefit obligation					
Amortization				68,040	
Adjustments				-	68,040
Total comprehensive income					1,456,804
Net change in memberships	(310)				(310)
Refunds of capital credits		-			-
Other equities			-		-
Balance - October 31, 2011	211,930	24,500,465	88,570	(1,101,808)	23,699,157
Comprehensive income:					
Net margins		1,902,833			1,902,833
Postretirement benefit obligation					
Amortization				68,040	
Adjustments				-	68,040
Total comprehensive income					1,970,873
Net change in memberships	2,190				2,190
Refunds to estates		-			-
Other equities			11,767		11,767
Balance - October 31, 2012	$214,120	$ 26,403,298	$ 100,337	$(1,033,768)	$ 25,683,987

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

Note 1. Summary of Significant Accounting Policies

Licking Valley Rural Electric Cooperative Corporation ("Licking 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. Electric plant consists of:

	2012	2011
Distribution plant	$56,238,673	$54,849,803
General plant	4,937,660	4,251,780
Total	$61,176,333	$59,101,583

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. Depreciation rates range from 2.2% to 6.67% for distribution plant and from 3% to 15% for general plant.

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

Off Balance Sheet Risk Licking Valley maintains its cash balances, which may exceed the federally insured limit, with several financial institutions. These financial institutions have strong credit ratings and management believes that the credit risk related to the accounts is minimal.

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

Revenue Licking Valley records revenue as billed to its consumers based through the 20th of each month. All consumers are required to pay a refundable deposit, which may be waived under certain circumstances. Licking Valley's sales are concentrated in an eight county area of eastern Kentucky. There were no consumers whose individual account balance exceeded 10% of outstanding accounts receivable at October 31, 2012 or 2011. Consumers must pay their bill within 20 days of billing, at which time a 5% discount is forfeited, 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.

Licking Valley is required to collect, on behalf of the Commonwealth 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. Licking Valley'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.

Note 1. Summary of Significant Accounting Policies, continued

Cost of Power Licking Valley is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Licking 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: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities
>
> Level 2: Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly.
>
> Level 3: Prices or valuations that require inputs that are both significant to the fair value measure and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The carrying amounts of Licking 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 Licking 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.

Licking Valley may, and also does, invest idle funds in local banks and in National Rural Utilities Cooperative Finance Corporation ("CFC") commercial paper. The inputs used to measure idle funds are Level 1 measurements, as these funds are exchange traded funds in an active market.

Income Tax Status Licking Valley is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements for Licking Valley include no provision for income taxes. Licking 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 Licking Valley has no uncertain tax positions resulting in an accrual of tax expense or benefit. Licking Valley recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Licking Valley did not recognize any interest or penalties during the years ended October 31, 2012 and 2011. Licking Valley's income tax return is subject to possible examination by taxing authorities until the expiration of related statues of limitations on the return, which is generally three years.

Advertising Licking Valley expenses advertising costs as incurred.

Note 1. Summary of Significant Accounting Policies, continued

Comprehensive Income Comprehensive income includes both net margin and other comprehensive income. Other comprehensive income represents the change in funded status of the accumulated postretirement benefit obligation.

Risk Management Licking 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.

Contingencies Licking 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.

Subsequent Events Management has evaluated subsequent events through January 3, 2013, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investments in Associated Organizations

Licking 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 0%, 3%, and 5% and are scheduled to mature at varying times from 2020 to 2080.

Investments in associated organizations consist of:

	2012	2011
East Kentucky, patronage capital	$8,319,439	$6,898,928
CFC, patronage capital	160,043	151,807
CFC, CTC's	661,779	662,663
Others	575,806	555,925
Total	$9,717,067	$8,269,323

Note 3. Patronage Capital

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, Licking Valley may distribute the difference between 25% and the payments made to such estates. The equity at October 31, 2012 was 47% of total assets. Nonoperating margins are used to offset the prior year losses. Patronage capital consists of:

	2012	2011
Assigned to date	$27,185,823	$25,130,991
Assignable margins	(122,678)	60,734
Unassigned	19,739	19,739
Prior year losses	(679,586)	(710,999)
Total	$26,403,298	$24,500,465

Note 4. Long Term Debt

All assets, except vehicles, are pledged as collateral on the long term debt to RUS, Federal Financing Bank ("FFB"), and CFC under a joint mortgage agreement. The long term debt is due in quarterly and monthly installments of varying amounts through 2041. RUS assess 12.5 basis points to administer the FFB loans. The interest rates on notes payable to CFC at 5.50% are subject to change every seven years. The 2.90% interest rate notes to CFC adjusts monthly and may be converted to a fixed rate at any time upon board approval by Licking Valley. Licking Valley has unadvanced loan funds from FFB in the amount of $19,726,000, which can be advanced upon future construction projects. Long term debt consists of:

	2012	2011
RUS, 0.25% to 6.875%	$5,861,457	$6,353,666
FFB, 0.104% (0.22% in 2011) and 6.048%	12,169,341	12,651,609
CFC:		
5.50% fixed rate notes	2,651,340	2,866,889
2.90% (3.20% in 2011) variable rate	267,801	268,633
	2,919,141	3,135,522
	20,949,939	22,140,797
Less current portion	1,225,000	1,200,000
Long term portion	$19,724,939	$20,940,797

As of October 31, 2012, the annual principal portion of long term debt outstanding for the next five years are as follows: 2013 - $1,225,000; 2014 - $1,250,000; 2015 - $1,275,000; 2016 - $1,300,000; 2017 - $1,325,000.

Note 5. Short Term Borrowings

At October 31, 2012, Licking Valley had a short term line of credit of $5,000,000 available from CFC. At October 31, 2012, Licking Valley had advanced $1,383,941 of funds at an interest rate of 2.90%.

Note 6. Savings Plan

All eligible employees of Licking Valley participate in the NRECA Retirement and Security Program, a defined contribution pension plan qualified under section 401(k) and tax-exempt under section 501(a) of the Internal Revenue Code. Licking Valley makes annual contributions to the Program equal to the amounts accrued for pension expense. Contributions to this plan were $239,159 for 2012 and $236,995 for 2011. In this multiemployer plan, which is available to all member corporations of NRECA, the accumulated benefits and plan assets are not determined or allocated separately by individual employer. A portion of this cost is allocated to construction of electric plant.

Note 7. Postretirement Benefits

Licking Valley sponsors a defined benefit plan that provides medical insurance coverage to retirees by contributing 50% of the cost of the policy. For measurement purposes, an annual rate of increase of 8.5%, 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 5.50%. A portion of the net periodic benefit cost is allocated to construction of electric plant.

Note 7. Postretirement Benefits, continued

The funded status of the plan is as follows:

	2012	2011
Projected benefit obligation	($2,969,312)	($3,008,239)
Plan assets at fair value	-	-
Funded status	($2,969,312)	($3,008,239)

The reconciliation of the benefits obligations of postretirement benefits are as follows:

	2012	2011
Benefit obligation - beginning of period	$3,008,239	$3,084,325
Adjust accumulated other comprehensive income	-	-
Net periodic benefit cost:		
Service cost	94,221	54,740
Interest cost	149,439	132,220
Benefit payments to participants	(282,587)	(263,046)
Benefit obligation - end of period	$2,969,312	$3,008,239

Projected retiree benefit payments for the next five years are expected to be as follows: 2013 - $285,500; 2014 - $270,000; 2015 - $270,000; 2016 - $260,000; 2017 - $260,000.

Note 8. Commitments

Licking Valley is contingently liable as guarantor for approximately $40,000 of long term obligations of East Kentucky to RUS and CFC. Substantially all assets of Licking Valley are pledged as collateral for this guarantee, in addition to the pledge in the mortgage agreement referred to in Note 4. This contingent liability was part of an overall financing plan for the construction of generating facilities near Maysville, Kentucky.

Licking 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 three years.

Note 9. Related Party Transactions

Several of the Directors of Licking Valley and its President & General Manager are on the Boards of Directors of various associated organizations.

Note 11. Environmental Contingency

Licking 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 Licking 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 Licking Valley's financial position or its future cash flows.

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