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Grayson Rural Electric Cooperative Corporation

Grayson, Kentucky

Audited Financial Statements
May 31, 2013

Alan M. Zumstein
Certified Public Accountant
Lexington, Kentucky 40509

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Independent Auditor's Report

To the Board of Directors
Grayson Rural Electric Cooperative
Grayson, Kentucky

Report on the Financial Statements

I have audited the accompanying financial statements of Grayson Rural Electric Cooperative, which comprise the balance sheets as of May 31, 2013, and the related statements of revenue and comprehensive income, changes in equities, and cash flows for the year then ended, and the related notes to the financial statements. The financial statements of Grayson Rural Electric Cooperative Corporation as of May 31, 2012, were audited by other auditors whose report dated August 18, 2012, expressed an unqualified opinion on those 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

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 American 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 I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from 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, I express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made my management, as well as evaluating the overall presentation of the financial statements.

I believe the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Opinion

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Grayson Rural Electric Cooperative as of May 31, 2013, and the results of their operations and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, I have also issued a report dated September 3, 2013, on my consideration of Grayson 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* in considering internal control over financial reporting and compliance.

Alan M. Zumstein

Alan M. Zumstein, CPA
September 3, 2013

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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

To the Board of Directors
Grayson Rural Electric Cooperative

I 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 *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Grayson Rural Electric Cooperative, which comprise the balance sheets as of May 31, 2013, and the related statements of revenue and comprehensive income, members' equities and cash flows for the year then ended, and related notes to the financial statements, and have issued my report thereon dated September 3, 2013.

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 Grayson'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 Grayson's internal control over financial reporting. Accordingly, I do no express an opinion on the effectiveness of Grayson'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 Grayson'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*.

Purpose of this Report

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 M. Zumstein

Alan M. Zumstein, CPA
September 3, 2013

Grayson Rural Electric Cooperative Corporation
Balance Sheets, May 31, 2013 and 2012

Assets	2013	2012
Electric Plant, at original cost:		
In service	$ 65,845,881	$ 63,952,956
Under construction	770,909	601,906
	66,616,790	64,554,862
Less accumulated depreciation	15,220,112	13,806,217
	51,396,678	50,748,645
Investments in Associated Organizations	10,163,500	8,821,511
Current Assets:		
Cash and cash equivalents	148,910	118,519
Accounts receivable, less allowance for 2013 of $133,876 and 2012 of $179,977	4,885,134	4,245,544
Other receivables	308,027	324,871
Material and supplies, at average cost	253,009	264,935
Other current assets	483,598	463,867
	6,078,678	5,417,736
Prepaid Pension Costs	1,701,130	-
Total	$ 69,339,986	$ 64,987,892
Members' Equities and Liabilities		
Members' Equities:		
Memberships	$ 151,440	$ 151,930
Patronage capital	19,339,506	18,410,746
Other equities	171,524	161,571
Accumulated other comprehensive income	(1,178,043)	(1,250,043)
	18,484,427	17,474,204
Long Term Debt	41,576,420	38,629,755
Accumulated Postretirement Benefits	2,896,379	2,884,547
Current Liabilities:		
Short term borrowings	547,000	360,000
Accounts payable	1,887,609	1,777,607
Current portion of long term debt	1,700,000	1,600,000
Consumer deposits	1,331,949	1,294,076
Accrued expenses	771,958	821,988
	6,238,516	5,853,671
Consumer Advances	144,244	145,715
Total	$ 69,339,986	$ 64,987,892

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

Statements of Revenue and Comprehensive Income
for the years ended May 31, 2013 and 2012

	2013	2012
Operating Revenues		
Sale of electric energy	$ 29,957,223	$ 28,256,923
Other electric revenues	1,038,042	1,043,072
	30,995,265	29,299,995
Operating Expenses:		
Cost of power	19,868,274	18,841,544
Distribution - operations	1,120,010	1,145,370
Distribution - maintenance	3,226,845	2,950,336
Consumer accounts	1,066,117	1,057,413
Customer services	233,596	216,591
Sales	23,257	29,527
Administrative and general	1,858,242	1,851,689
Depreciation, excluding $200,089 in 2013 and $181,546 in 2012 charged to clearing accounts	3,045,858	2,944,782
Taxes, other than income	35,079	30,541
Other deductions	9,968	12,065
	30,487,246	29,079,858
Operating margins before interest charges	508,019	220,137
Interest Charges:		
Long-term debt	993,896	1,030,994
Other	79,862	111,711
	1,073,758	1,142,705
Operating margins after interest charges	(565,739)	(922,568)
Nonoperating Margins		
Interest income	29,407	29,873
Others	183,851	(47,666)
	213,258	(17,793)
Patronage Capital Credits	1,437,680	1,525,842
Net Margins	1,085,199	585,481
Accumulated comprehensive income:		
Accumulated postretirement benefits	72,000	80,400
Net Margins and Comprehensive Income	$ 1,157,199	$ 665,881

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

Statement of Changes in Members' Equity
for the years ended May 31, 2013 and 2012

	Memberships	Patronage Capital	Other Equity	Accumulated Other Comprehensive Income	Total Members' Equity
Balance - Beginning of year	$ 151,560	$ 17,984,068	$ 134,728	$ (1,330,443)	$ 16,939,913
Comprehensive income:					
Net margins		585,481			585,481
Postretirement benefit obligation					
Amortization				80,400	
Adjustments					80,400
Total comprehensive income					665,881
Net change in memberships	370				370
Refunds to estates		(158,803)			(158,803)
Other equities			26,843		26,843
Balance - May 31, 2012	151,930	18,410,746	161,571	(1,250,043)	17,474,204
Comprehensive income:					
Net margins		1,085,199			1,085,199
Postretirement benefit obligation					
Amortization				72,000	
Adjustments				-	72,000
Total comprehensive income					1,157,199
Net change in memberships	(490)				(490)
Refunds to estates		(156,439)			(156,439)
Other equities			9,953		9,953
Balance - May 31, 2013	$ 151,440	$ 19,339,506	$ 171,524	$ (1,178,043)	$ 18,484,427

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

Statements of Cash Flows
for the years ended May 31, 2013 and 2012

	2013	2012
Cash Flows from Operating Activities:		
Net margins	$ 1,085,199	$ 585,481
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	3,045,858	2,944,782
Charged to clearing accounts	200,089	181,546
Patronage capital credits assigned	(1,437,680)	(1,525,842)
Accumulated postretirement benefits	83,832	84,074
Change in assets and liabilities:		
Receivables	(622,746)	314,426
Material and supplies	11,926	14,059
Other assets	(19,731)	58,513
Prepaid pension costs	(1,701,130)	-
Payables	110,002	136,980
Consumer deposits and advances	36,402	43,215
Accrued expenses	(50,030)	(39,072)
	741,991	2,798,162
Cash Flows from Investing Activities:		
Plant additions	(3,436,207)	(3,171,605)
Plant removal costs	(516,525)	(382,521)
Salvage recovered from retired plant	58,752	53,251
Receipts from other investments, net	95,691	91,832
	(3,798,289)	(3,409,043)
Cash Flows from Financing Activities:		
Net increase in memberships	(490)	370
Refund of patronage capital to members	(156,439)	(158,803)
Increase in other equities	9,953	26,843
Payments on long term debt	(1,694,427)	(1,509,779)
Advances of long term debt	4,741,092	3,000,000
Short term borrowings	187,000	(711,833)
	3,086,689	646,798
Net increase in cash	30,391	35,917
Cash and cash equivalents, beginning of year	118,519	82,602
Cash and cash equivalents, end of year	$ 148,910	$ 118,519
Supplemental cash flows information:		
Interest paid on long-term debt	$ 994,114	$ 1,031,056

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

Note 1. Summary of Significant Accounting Policies

Grayson Rural Electric Cooperative Corporation ("Grayson") 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:

	2013	2012
Distribution plant	$59,932,116	$58,183,168
General plant	5,913,765	5,769,788
Total	$65,845,881	$63,952,956

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. In Depreciation rates are as follows:

Distribution plant	2.89% - 6.67%
Structures and improvements	2%
Transportation equipment	16%
Other general plant items	6% - 16%

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

Off Balance Sheet Risk Grayson 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.

Revenue Grayson records revenue as billed to its consumers based on meter-readings taken on the 20th of each month using Automated Meter Reading ("AMR") technology. All consumers are required to pay a refundable customer deposit; however, it may be waived under certain circumstances. Grayson's sales are concentrated in a six county area of eastern 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, 2013 or 2012.

Grayson 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. Grayson' 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 Grayson is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Grayson 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 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 Grayson'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 are not considered financial instruments because they represent activities specifically related to Grayson. Long term debt cannot be traded in the market, and is specifically for electric cooperatives and, therefore, a value other than its outstanding principal cannot be determined.

Grayson 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 2013 and 2012.

Risk Management Grayson 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 Grayson expenses advertising costs as incurred.

Note 1. Summary of Significant Accounting Policies, continued

Income Tax Status Grayson is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements for Grayson include no provision for income taxes. Grayson'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 Grayson has no uncertain tax positions resulting in an accrual of tax expense or benefit. Grayson recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Grayson did not recognize any interest or penalties during the years ended May 31, 2013 and 2012.

Reclassifications Comparative data for the prior year have presented in certain sections of the accompanying financial statements in order to provide an understanding of changes in the financial position and operations

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.

Subsequent Events Management has evaluated subsequent events through September 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

Investments in associated organizations consist of:

	2013	2012
East Kentucky, patronage capital	$8,873,470	$7,592,151
CFC, patronage capital	155,848	151,842
CFC, CTC's	630,279	631,683
Others	503,903	445,835
Total	$10,163,500	$8,821,511

Grayson records patronage capital assigned by associated organizations in the year in which such assignments are received. The CTC's from CFC are a condition of borrowing loan funds.

Note 3. Patronage Capital

Patronage capital consisted of:

	2013	2012
Assigned to date	$21,975,803	$21,739,749
Assignable margins	(148,716)	(819,336)
Prior year losses	(385,379)	(540,388)
Retirements to date	(2,102,202)	(1,969,279)
Total	$19,339,506	$18,410,746

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, Grayson may distribute the difference between 25% and the payments made to such estates. At May 31, 2013, the equities and margins were 27% of total assets.

Note 4. Long Term Debt

All assets, except vehicles, are pledged as collateral on the long term debt to RUS, Federal Financing Bank (FFB), National Bank for Cooperative's (CoBank), and CFC under a joint mortgage agreement. First mortgage notes consist of:

	2013	2012
RUS, 0.18% to 4.95%	$10,340,157	$10,568,003
FFB, 0.073% (0.102% in 2011)	19,774,017	17,441,018
CoBank (refinance RUS loans) 3.50%	10,391,722	11,009,447
CFC, 3.45% to 6.80% notes	1,040,562	1,211,287
CFC, 2.20%	1,729,962	-
	13,162,246	12,220,734
	43,276,420	40,229,755
Less current portion	1,700,000	1,600,000
Long term portion	$41,576,420	$38,629,755

The long term debt payable to RUS, FFB, and CFC are due in quarterly and monthly installments of varying amounts through 2039. RUS assess 12.5 basis points to administer the FFB loans. During 2011 Grayson refinanced approximately $12 million of higher interest RUS loans with CoBank. Grayson has loan funds available from FFB in the amount of $4,438,000 at May 31, 2013. These funds will be used for future construction projects. During 2013, Grayson advanced the 2.2% interest rate notes from CFC to finance the accelerated pension payment to NRECA.

As of May 31, 2013, annual current principal due for the next five years are as follows: 2014 - $1,700,000; 2015 - $1,800,000; 2016 - $1,900,000; 2017 - $1,950,000; 2018 - $2,000,000.

Note 5. Short Term Borrowings

Grayson has executed a short term line of credit agreement with CFC in the amount of $6,000,000. The balance against this line of credit was $540,000, at an interest rate of 2.90%. Grayson also has a short term line of credit from CoBank in the amount of $2,000,000. All advances against this line of credit have been repaid.

Note 6. Pension Plan

All eligible employees of Grayson participate in the NRECA Retirement and Security Plan ("R&S Plan"), a defined benefit pension plan qualified under section 401 and tax exempt under section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The Plan sponsor's identification number is 53-0116145 and the Plan Number is 333. A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

Grayson's contributions to the R&S Plan in 2013 and 2012 represent less than 5 percent of the total contributions made to the plan by all participating employers. Grayson made contributions to the plan of $706,927 in 2013 and $750,925 in 2012. There have been no significant changes that affect the comparability of 2013 and 2012.

Note 6. Pension Plan, continued

In the R&S 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 R&S Plan was between 65 percent and 80 percent funded at January 1, 2012 and 2011 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 R&S 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.

Cooperatives participating in the NRECA R&S plan were allowed to make an Accelerated Funding Payment ("prepayment") and receive an immediate reduction in their current contribution requirement equal to approximately 25% of their 2013 billing rate. Although the new (reduced) billing rate can change over time, the relative value of the reduction will continue to benefit prepaying cooperatives in future years, potentially for as many as 10-15 years or longer. During April, 2013, Grayson made an accelerated payment to NRECA in the amount of $1,701,130. The amount was recorded as a deferred debit and is being amortized over 15 years through the benefits matrix.

Note 7. Postretirement Benefits

Grayson sponsors a defined benefit plan that provides medical insurance coverage for retired employees and their spouses. Grayson pays all the premiums for retirees and their dependents. For measurement purposes, an annual rate of increase of 8.9% 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 2013 and 2012.

The funded status of the plan is as follows:

	2013	2012
Projected benefit obligation	($2,896,379)	($2,884,547)
Plan assets at fair value	-	-
Total	($2,896,379)	($2,884,547)

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

	2013	2012
Benefit obligation at beginning of year	$2,884,547	$2,880,873
Components of net periodic benefit cost:		
Service cost	145,055	108,566
Interest cost	158,975	172,963
Net periodic benefit cost	304,030	281,529
Benefits paid	(292,198)	(277,855)
Actuarial gain/loss	-	-
Benefit obligation at end of year	$2,896,379	$2,884,547

Projected retiree benefit payments for the next five years are expected to be as follows: 2014 - $264,876; 2015 - $255,569; 2016 - $236,731; 2017 - $211,246; 2018 - $178,388.

Note 8. Commitments and Contingencies

Grayson 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 9. Related Party Transactions

Several of the Directors of Grayson, its President & CEO, and another employee, are on the Boards of Directors of various associated organizations.

Note 10. Environmental Contingency

Grayson 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 Grayson 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 Grayson's financial position or its future cash flows.

Note 11. Rate Matters

The PSC granted Grayson an increase in rates effective June 2013, in the amount of approximately $1,930,000, or 7%.

Note 12. Contingencies

Grayson 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.

Note 13. Labor Force

Approximately 45% of Grayson's labor force is subject to a collective bargaining agreement. A three (3) year agreement was negotiated and approved for the period starting January 1, 2013 between Grayson and the International Brotherhood of Electric Workers ("IBEW").

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To the Board of Directors
Grayson Rural Electric Cooperative

I have audited the financial statements of Grayson Rural Electric Cooperative for the year ended May 31, 2013, and have issued my report thereon dated September 3, 2013. I conducted my audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and 7 CFR Part 1773, Policy on audits of the Rural Utilities Service (RUS) Borrowers. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing my audit of the financial statements of the Cooperative for the year ended May 31, 2013, I considered its internal control over financial reporting in order to determine my auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

My consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be a material weakness. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. I noted no matters involving the internal control over financial reporting that I consider to be a material weakness.

7 CFR Part 1773.3 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters. I have grouped my comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, I performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, material control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.3(d)(1) related transactions, depreciation rates, a schedule of deferred debits and credits and a schedule of investments, upon which I express an opinion. In addition, my audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38-.45. My Objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, I express no opinion thereon.

No reports, other than my independent auditor's report, and my independent auditor's report on internal control over financial reporting and compliance and other matters, all dated September 3, 2013, or summary of recommendations related to my audit have been furnished to management.

My comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters as required by 7 CFR Part 1773.33 are presented below.

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

I noted no matters regarding the Cooperative's internal control over financial reporting and its operation that I consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records;
- the process for accumulating and recording labor, material and overhead costs, and the distribution of these costs to construction, retirement, and maintenance and other expense accounts, and;
- the material controls.

Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

At your request, I have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, and contracts. The procedures I performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended May 31, 2013, of the Cooperative.
    1. The Cooperative has not entered into any contract during the year for the operation or maintenance of its property, or for the use of its property by others as defined in 1773.33(e)(1)(i).
- Procedures performed with respect to the requirement to submit RUS Financial and Operating Report, Electric Distribution to RUS:
    1. Agreed amounts reported in RUS Financial and Operating Report, Electric Distribution to the Cooperative's records as of December 31, 2012.

The results of my tests indicate that, with respect to the items tested, the Cooperative complied in all material respects, with the specific RUS loan and security instrument provisions referred to below. With respect to items not tested, nothing came to my attention that caused me to believe that the Cooperative had not complied, in all material respects, with those provisions. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has submitted its RUS Financial and Operating Report, Electric Distribution to RUS and the RUS Financial and Operating Report, Electric Distribution, as of December 31, 2012, represented by the borrower as having been submitted to RUS appears to be in agreement with its audited records in all material respects.
- During the period of this review, the Cooperative received no long term advances from CFC on loans controlled by the RUS/CFC Mortgage and Loan Agreement.

Comments on Other Additional Matters

In connection with my audit of the Cooperative, nothing came to my attention that caused me to believe that the Cooperative failed to comply with respect to:

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

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);
- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4);
- Approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standard No. 57, Related party Transactions, for the year ended May 31, 2013, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f);
- The depreciation rates addressed at 7 CFR Part 1773.33(g);
- The detailed schedule of deferred debits and deferred credits; and
- The detailed schedule of investments.

However, I suggest the following:

Grayson has loans with consumers through an agency for the purpose of energy efficiency projects, with Grayson as the conduit. There is potential for a loss when the consumer does not repay the loan. There are several loans that may fall in this category. I suggest Grayson start accruing for potential losses on these loans.

My audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773(h) and 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 my audit of the basic financial statements and, in my opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The deferred debits are as follows:

Prepaid Pension Costs	$1,701,130

The deferred credits are as follows:

Consumer advances for construction	$144,244

This report is intended solely for the information and use of the Board of Directors, management, RUS, 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
September 3, 2013