KENTUCKY HIGHER EDUCATION ASSISTANCE AUTHORITY
KENTUCKY HIGHER EDUCATION STUDENT LOAN CORPORATION

JUNE 30, 2012

Financial Statements

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

June 30, 2012

Mountjoy
Chilton
Medley

INDEPENDENT AUDITOR'S REPORT

Board of Directors
Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation
Frankfort, Kentucky

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Kentucky Higher Education Assistance Authority and the Kentucky Higher Education Student Loan Corporation (the Authority/Corporation), component units of the Commonwealth of Kentucky, as of and for the year ended June 30, 2012, which collectively comprise the Authority/Corporation's basic financial statements as listed in the table of contents. These financial statements are the responsibility of Authority/Corporation's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of Kentucky Education Savings Plan Trust, which statements reflect total assets of $136,977,448 as of June 30, 2012, and increase to fiduciary net assets of $5,975,121 for the year ended June 30, 2012. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Kentucky Education Savings Plan Trust, is solely based on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Authority/Corporation, as of June 30, 2012, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 9, 2012, on our consideration of the Authority/Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Louisville
2000 Meidinger Tower
462 South Fourth Street
Louisville, KY 40202

Lexington
175 East Main Street
Suite 200
Lexington, KY 40507

Frankfort
150 Flynn Avenue, Suite 100
P.O. Box 5630
Frankfort, KY 40602

Cincinnati
1440 PNC Center
201 East Fifth Street
Cincinnati, OH 45202

888.587.1719 | www.mcmcpa.com
An Independent Member of Baker Tilly International

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis (unaudited) on pages 3 through 15 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
October 9, 2012

Description of the Business

The Kentucky Higher Education Assistance Authority (the "Authority" or "KHEAA":) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. The Authority also guarantees, performs default aversion activities and performs collection activities on eligible student loans. The Kentucky Education Savings Plan Trust (the "Trust") and the Commonwealth Postsecondary Education Prepaid Trust Fund, Kentucky's Affordable Prepaid Tuition Plan (the "Plan") offer savings and investment opportunities for Kentuckians to save for higher education. The Kentucky Higher Education Student Loan Corporation (the "Corporation" or "KHESLC") makes student loans directly to parents and students as part of the Kentucky Advantage loan programs, purchases and services eligible Federal and Kentucky Advantage student loans and performs collection activities on eligible Federal student loans. The Authority and the Corporation maintain bundled operations to maximize the efficiency of loan guarantee and servicing operations. Accordingly, all senior management positions have responsibilities related to both the Authority and the Corporation. Additionally, the Plan and the Trust are governed by the Authority and Corporation's combined Board of Directors. Throughout the accompanying financial statements, the "Authority/Corporation" refers to the combined group of operations.

The Authority/Corporation maintains the following operations:

Outreach - Outreach operations provide resources to make higher education accessible to Kentucky's current and future generations. Outreach counselors at the Authority/Corporation are available year-round to provide free college planning and financial aid assistance. They conduct scholarship and other funding searches, help students with the admissions and financial aid application processes and increase motivation for at-risk students. Outreach services are offered through financial aid nights, career fairs, college nights, adult education programs, Kentucky Education Excellence Scholarship ("KEES") workshops, Free Application for Federal Student Aid ("FAFSA") workshops, PTA and other meetings, financial literacy workshops, professional development/staff training, and other programs and camps. Personnel, professional and administrative costs associated with the outreach operation are accounted for as a program benefit in a proprietary fund of the Authority/Corporation.

Student Aid - Student aid operations provide some or all levels of administration of fifteen student aid programs: (1) the Kentucky Tuition Grant ("KTG") program, (2) College Access Program ("CAP") grant, (3) Kentucky Educational Excellence Scholarship program, (4) Teacher Scholarship program, (5) Osteopathic Medicine Scholarship program, (6) the KHEAA Work-Study program, (7) Robert C. Byrd Honors Scholarship program, (8) Early Childhood Development Scholarship program, (9) the Go Higher Grant program, (10) the Coal County Scholarship for Pharmacy Students program, (11) the Mary Jo Young Scholarship program, (12) John R. Justice grant, (13) the Drive the Dream Scholarship program, (14) the Kentucky National Guard Tuition Award program, and (15) the Minority Educator Recruitment and Retention Scholarship program.

Personnel, professional and administrative costs associated with student aid operations are accounted for as a program benefit in a proprietary fund of the Authority/Corporation. Direct benefits to students are accounted for in the governmental fund.

College Savings Plan - The college savings plan operation administers two savings plans for the Commonwealth of Kentucky; (1) the Trust and (2) the Plan.

The Trust was formed on July 15, 1988, by Kentucky law, to help families save for the costs of education after high school. The Trust is administered by the Authority/Corporation's Board of Directors. The Authority/Corporation has contracted with TIAA-CREF Tuition Financing, Inc. ("TFI"), a wholly-owned subsidiary of Teachers Insurance and Annuity Association of America ("TIAA"), for management services for the Trust. The Trust is operated in a manner such that it is exempt from registration as an investment company under the Investment Company Act of 1940. The Trust offers certain federal and state tax advantages to purchasers.

An individual participating in the Trust establishes an account in the name of a beneficiary. Contributions can be made among six investment options: the Managed Allocation Option, the Fixed Income Option, the Balanced Option, the Equity Index Option, the Active Equity Option, and the Guaranteed Option.

Contributions in the Managed Allocation Option are allocated among six age bands, based on the age of the beneficiary. Each age band invests in varying percentages in the Institutional Class of the International Equity, International Equity Index, Large-Cap Value Index, Large-Cap Growth Index, S&P 500 Index, Mid-Cap Growth Fund, Small-Cap Equity, Mid-Cap Value, Short-Term Bond, Bond Index, Large-Cap Growth, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities, Emerging Market Equity, Emerging Market Equity Index and Money Market Funds of the TIAA-CREF Institutional Mutual Funds.

These percentages are determined by the Authority/Corporation's Board of Directors and are subject to change. The assets of the Guaranteed Option are allocated to a funding agreement issued by TIAA-CREF Life Insurance Company, a subsidiary of TIAA, which offers a guarantee of principal and a minimum rate of return to the Trust.

The college savings plan operation also administers the Plan, which was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes ("KRS") 164A.700-709.

The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan offers certain federal and state tax advantages to purchasers.

Participants purchased annual tuition units at current tuition levels, or current tuition levels plus a premium, and receive benefits equal to tuition rates in place at the time that the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan, and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky.

Participants were allowed to elect to spread payments to the Plan over three, five or seven years or until the anticipated year of the student's enrollment in a qualified postsecondary education institution. Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college or university in the United States. If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books, and supplies.

Participants may withdraw from the Plan at any time for any reason. Terminating participants are refunded any contract payments made less benefits received, administrative and cancellation fees. Participants who withdraw after July 1 of the beneficiary's college entrance year receive the tuition payout value of the contract less benefits received, administrative and cancellation fees. Non-qualified withdrawals are subject to a 10% penalty in accordance with Section 529 of the Internal Revenue Code ("IRC") except in cases where the withdrawal is: (1) made on account of the death or disability of the student; (2) made on account of a scholarship received by a student, or (3) a non-taxable transfer to another account or to another IRC Section 529 program for a different student who is a family member of the original student.

As of June 30, 2012, the Plan maintained a present value fund deficit of $54.5 million. Based on actuarial estimates, the Plan's assets will be exhausted in fiscal year 2019, at which time the liability of the Plan becomes a General Obligation of the Commonwealth of Kentucky. Per KRS 164A.708, once a real liability is expected to accrue, the General Assembly shall appropriate the necessary funds to meet the liability. Over the remaining estimated life of the program, through fiscal year 2027, actuarial estimates show the Commonwealth of Kentucky will need to transfer approximately $94 million.

Personnel, professional and administrative costs associated with administering the Trust and the Plan are accounted for in the Student Aid Fund, a governmental fund of the Authority/Corporation. All assets, liabilities and net asset additions and deductions for the Trust are accounted for in the Kentucky Educational Savings Plan Trust fund, a fiduciary fund of the Authority/Corporation. All assets, liabilities and net asset additions and deductions for the Plan are accounted for in the Kentucky Affordable Prepaid Tuition fund, a fiduciary fund of the Authority/Corporation.

Loan Guarantee - Loan guarantee operations maintain loan guarantees for qualified students and parents of qualified students made by approved lenders, under the Federal Family Education Loan Program ("FFELP"). The loan guarantee operation is responsible for providing default aversion assistance to lenders for delinquent loans, reporting loan information to the National Student Loan Data System ("NSLDS"), paying lender claims for loans in default, paying lender claims for death, disability or bankruptcy, and collecting loans on which default claims have been paid

Personnel, professional and administrative costs associated with loan guarantee operations are accounted for in the Agency Operating Fund ("AOF"), a proprietary fund of the Authority/Corporation. All federal program activities related to default aversion, claim payment, claim reinsurance from the U.S. Department of Education ("USDE"), defaulted loan recoveries and other federally mandated program sources and uses of funds are accounted for in the Federal Student Loan Reserve Fund ("FSLRF"), a fiduciary fund of the Authority/Corporation.

Loan Origination and Disbursement – Loan origination and disbursement operations consist of credit underwriting, loan origination, and issuing disbursements directly to schools for the Kentucky Advantage Education Loan ("KAEL") and Kentucky Advantage Parent Loan programs ("KAPL"). KAEL and KAPL are the state based supplemental loans provided by the Authority/Corporation.

Personnel, professional and administrative costs associated with loan origination and disbursement operations are accounted for in the proprietary fund of the Authority/Corporation.

Loan Finance - The Authority/Corporation's loan finance operation is authorized to refinance existing long-term debt and to acquire private supplemental student loans, rehabilitated FFELP loans, and certain other FFELP loans required to be repurchased by the Higher Education Act. The Authority/Corporation may issue bonds and notes not to exceed $5 billion in order to carry out these corporate powers and duties. The FFELP student loans held by the Authority/Corporation include Federal Stafford Loans ("Stafford"), Unsubsidized Stafford Loans ("Unsubsidized Stafford"), Federal Supplemental Loans for Students ("SLS"), Federal Parent Loans for Undergraduate Students ("PLUS"), and Federal Consolidation Loans ("Consolidations"). As of June 30, 2012, the loan finance operation owned approximately $1.5 billion of student loans.

Most FFELP loans held by the Authority/Corporation are insured by the Authority/Corporation's loan guarantee operations. FFELP loans made prior to October 1, 1993, are 100% insured. FFELP loans made between October 1, 1993 and June 30, 2006, are 100% insured against borrowers' death, disability, or bankruptcy and 98% insured against borrowers' default. FFELP loans made after June 30, 2006, are 100% insured against borrowers' death, disability, or bankruptcy and 97% insured against borrowers' default.

The Authority/Corporation's loan finance operation finances all existing FFELP loans with revenue bonds, notes payable, and lines of credit. As of June 30, 2012, the loan finance operation maintained three separate General Bond Resolutions ("GBRs") and related Series Resolutions for issues of revenue bonds, and the Department of Education Conduit Program ("ED Conduit Program"). The GBRs contain provisions establishing funds and accounts for the segregation of assets and provisions restricting the use of the proceeds of bonds and other funds received. As of June 30, 2012, the loan finance operation maintained $947 million of revenue bonds outstanding and $522 million for the ED Conduit Program.

Personnel, professional and administrative costs associated with loan finance operations are accounted for in a proprietary fund of the Authority/Corporation. The state based supplemental loans and a portion of FFELP loans and all related activities are also accounted for in a proprietary fund of the Authority/Corporation. The majority of loans, however, are financed by revenue bonds and the ED Conduit Program Note Payable. These loans, bonds and note payable and all other related assets, liabilities, revenues, and expenses are accounted for in the Education Finance Funds, a proprietary fund of the Authority/Corporation.

Loan Servicing - The loan servicing operation performs servicing and default prevention activities on FFELP and alternative loans held by the Authority/Corporation's loan finance operation and other lenders. Of the loans serviced, approximately $1.5 billion in outstanding principal of loans was held by the loan finance operation. Nearly all of these loans were pledged pursuant to the 1997 GBR, the 2008 Indenture, the 2010 Indenture and the ED Conduit Program. Approximately $23 million of FFELP Loans and other education loans were owned by other holders, including a holder with national lending operations. For loans owned by other holders, the loan servicing operation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities.

Personnel, professional and administrative costs associated with loan servicing operations are accounted for in a proprietary fund of the Authority/Corporation. Student loan remittances and payables to other lenders are also accounted for in a proprietary fund.

Industry Update

The Health Care and Education Reconciliation Act ("HCERA") of 2010 (H.R.4872/Public Law 111-152) was signed into law on March 30, 2010. HCERA eliminated the origination and/or guarantee of FFELP loans, effective July 1, 2010. In accordance with HCERA, the Authority/Corporation continues to provide guarantee services on $3.3 billion of FFELP loans, continues to own $1.5 billion of FFELP loans, and continues to service an additional $23 million of FFELP and other education loans. The Authority/Corporation can no longer originate, guarantee or fund any new FFELP loans.

HCERA provides for servicing opportunities for nonprofit organizations to service an initial allocation of 100,000 Federal loan borrowers. The Authority/Corporation has been pre-approved as an eligible servicer and is preparing operations to accommodate their allotment of Federal loans. The Authority/Corporation is currently scheduled to receive their initial allotment of loans in the fall of 2012.

HCERA created additional funding for the College Access Challenge Grant program ("CACG"). The Authority/Corporation was awarded $2.06 million for the CACG year 2012 award period and $1.99 million for the CACG year 2013 award period.

USDE currently contracts with Private Collection Agencies ("PCAs") to collect student loans, including defaulted Direct Loans that have been assigned or referred to USDE. In March 2012, the Authority/Corporation contracted with one of the PCAs to collect loans on their behalf. The Authority/Corporation plans to leverage this experience, as well as its experience collecting defaulted FFELP loans, in its pursuit to become one of the PCAs selected by USDE as part of the fall 2012 PCA Request for Proposal process. In anticipation of this selection process, the Authority/Corporation sought and received state legislative approval from the Commonwealth of Kentucky to create the Asset Resolution Corporation ("ARC") as the entity that would contract with USDE to become a PCA. On April 11, 2012, House Bill 362 creating ARC was signed.

On July 31, 2012, the Authority/Corporation submitted a request (the "Request") to the Internal Revenue Service (the "IRS") for a voluntary closing agreement (a "VCA") relating to certain tax-exempt obligations issued by the Authority/Corporation ("Tax-Exempt Bonds"), pursuant to IRS

Announcement 2012-14, 2012-14 I.R.B. 721, titled *TEB Voluntary Closing Agreement Program: Relief from Allocation and Accounting Errors for Certain Issuers of Tax-Exempt Student Loan Bonds* (the "Announcement"). See footnote S to the financial statements.

Overview of Financial Statements

This discussion and analysis is intended to serve as an introduction to the Authority/Corporation's combined financial statements. The Authority/Corporation's combined financial statements are comprised of the following three components: 1) combined government-wide financial statements, 2) combined fund financial statements, and 3) notes to combined financial statements.

The combined government-wide statement of net assets and statement of activities include the Governmental Funds and Proprietary Funds. The combined government-wide financial statements can be found on pages 16 and 17 of this report. The combined fund financial statements can be found on pages 18 through 23 of this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the Authority/Corporation. Fiduciary funds are not reflected in the combined government-wide financial statements because the resources are not available to support the Authority/Corporation's programs. The fiduciary fund statement of net assets (deficit) and changes in fiduciary net assets (deficit) can be found on pages 24 and 25 of this report.

The Trust publishes separate financial statements and footnotes.

To obtain a copy of the financial statements and footnotes, please contact the Authority at (502) 696-7421.

The following is a condensed summary of financial information for the years ended June 30, 2012 and 2011, respectively.

Condensed Financial Information - Governmental Fund and Proprietary Funds

Kentucky Higher Education Assistance Authority/Kentucky Higher Education Student Loan Corporation

	Governmental Fund		Proprietary Funds	
	2012	2011	2012	2011
Net Asset Information				
Capital assets	$	$	$ 4,332,499	$ 4,334,067
Other assets	19,409,469	15,001,115	1,748,146,457	1,924,744,367
Total Assets	19,409,469	15,001,115	1,752,478,956	1,929,078,434
Long-term liabilities			1,517,068,808	1,718,438,951
Other liabilities	1,036,388	153,252	22,972,954	22,934,011
Total Liabilities	1,036,388	153,252	1,540,041,762	1,741,372,962
Invested in capital assets, net of expended debt proceeds			4,332,499	4,334,067
Unrestricted			51,704,872	64,279,737
Restricted for program benefits	18,373,081	14,847,863		
Restricted, other			87,695,246	62,401,099
Restricted for student aid and related activities			68,704,577	56,690,569
Total Net Assets	$ 18,373,081	$ 14,847,863	$ 212,437,194	$ 187,705,472
Activity Information				
Interest and investment income fund	$ 279,579	$ 271,582	$ 437,072	$ 525,157
Student aid & advancement fund revenue'	193,585,870	189,937,000		
Tobacco settlement revenue	1,000,000	999,100		
Unclaimed lottery revenue	7,000,000	5,400,000		
Contributions from Agency Operating Fund	3,155,384	3,024,842		
Federal funds revenue	182,835	1,628,179		
Servicing fees from external sources			162,131	694,094
Servicing fees from Education Finance Funds			9,561,870	10,931,907
Deconversion fees				11,506,900
SAFRA revenue			404,677	414,771
Debt recovery commission			25,482,439	20,186,675
Early retirement of debt			3,480,335	4,241,322
Federal fees earned			2,193,241	2,471,570
Federal grant revenue			2,536,854	1,513,679
Default aversion fee income			908,652	1,721,666
Interest income on loans			26,033,086	28,995,951
Amortization of deferred gain on debt retirements			18,465,693	18,465,693
Guarantee fee			98,710	
Gain on the sale of loans			9,146	
Late payment penalties			1,455,242	1,507,824
School services			109,487	
Other Income	279,125	432,972	332,040	320,459
Total Revenue	205,482,793	201,693,675	91,670,675	103,497,668
Kentucky Tuition Grants	31,403,472	32,682,463		
College Access Program Grants	59,044,286	59,947,679		
Robert C. Byrd Scholarship	219,396	631,005		
Mary J Young Scholarships	416,933	405,376		
Early Childhood Development Scholarships	1,245,345	1,243,076		
National Guard Tuition Awards	4,798,881	4,865,270		
Kentucky Education Excellence Scholarships	99,142,626	95,919,021		
Teacher Scholarships	880,971	1,598,653		
Teacher Loan Forgiveness	2,050,000	2,032,800		
Osteopathic Medicine Scholarships	635,862	869,041		
Work Study Benefits	580,481	611,838		
Go Higher Grant Program	206,086	394,991		
Pharmacy Scholarship Program	159,800			
Drive the Dream Scholarship	448,500	500		
John R. Justice Grant	57,544	119,408		
State General Fund expenditure	447,414	535,315		
Loan guarantee operations			3,747,137	4,393,379
Default collections			6,090,275	6,653,593
Default fee expense				65,832
Loan finance and servicing activities			47,246,659	46,014,337
Outreach			3,341,667	3,027,836
Contribution to FSLRF			2,874,310	
Student aid administration			2,358,884	2,704,063
Contribution to student aid programs			796,500	320,779
School services			109,487	
Other activities	219,978	207,434	124,388	284,314
Total Expenditures	201,957,575	202,063,870	66,689,307	63,464,133
Net Operating income (loss) before Operating Transfers	3,525,218	(370,195)	24,981,368	40,033,535
Transfer to State General Fund			(147,000)	
Transfer to KAPT (the "Plan")			(102,646)	(104,476)
Change in Net Assets	$ 3,525,218	$ (370,195)	$ 24,731,722	$ 39,929,059

Financial Analysis – Governmental and Proprietary Funds

As previously noted, the Authority and the Corporation maintain bundled operations to maximize the efficiency of operations. Throughout the financial analysis, the "Authority/Corporation" refers to the combined group of operations for both organizations. Financial results for specific operating activities may be discussed as needed to provide appropriate disclosure.

This section of the annual financial report presents a discussion and analysis of the Authority/Corporation's government-wide performance for the fiscal year ended June 30, 2012. Please read it in conjunction with the Authority/Corporation's combined financial statements and notes to the combined financial statements, which follow this section.

Financial Overview

- The Authority/Corporation's proprietary fund total assets decreased approximately $177 million (9%), from $1.9 billion to $1.7 billion. The decrease was caused primarily by a $199 million decrease in loans, a $7.5 million decrease in accrued interest income, and a $10 million decrease in receivables and deferred assets offset by an increase in cash and investments of $39 million.

- The Authority/Corporation's proprietary fund liabilities decreased by $201 million (11.6%), from $1.7 billion to $1.5 billion. The decrease in liabilities resulted primarily from a decrease in bonds payable and the ED Conduit Program Note Payable combined of $182 million and decreases in deferred gain on early retirement of debt and various payables of $19 million and $5 million, respectively offset by a $4.2 million increase in liabilities due to the accrual for the VCA contingent liability.

- The Authority/Corporation's proprietary fund revenues decreased $11.8 million (11.4%), the majority of which related to decreases in loan deconversion fees and net interest revenues of $11.5 million and $3 million, respectively, and various other decreases offset primarily by increases in debt recovery commissions of $5.3 million.

- The Authority/Corporation's total proprietary fund expenditures increased $3.2 million (.5%), resulting primarily from a contribution to FSLRF of $2.9 million and increases in loan finance and servicing expenses of $1.2 million. All other expenses decreased $900,000.

- The Authority/Corporation's governmental fund assets increased by $4.4 million (29%) resulting primarily from increase in accounts receivable related to student aid programs.

- The Authority/Corporation's governmental fund liabilities increased by $883,000 primarily due to timing differences related to student aid disbursements.

- The Authority/Corporation's governmental fund revenues increased $3.8 million (1.9%), resulting from additional state General Funds for student aid programs of $3.6 million, increases in unclaimed lottery revenue of $1.6 million and net of reductions in federal funds revenue of $1.4 million.

- The Authority/Corporation's governmental fund expenditures remained relatively consistent with the prior year. Expenditure changes included reductions in College Access Program and Kentucky Tuition Grant of $2.1 million, teacher scholarships of $700,000, and Byrd scholarship of $400,000 offset by increases in the Kentucky Education Excellence Scholarships of $3.2 million.

Combined Statement of Net Assets

Total governmental fund net assets increased from $14.8 million to $18.4 million. Total proprietary fund net assets increased $24.7 million (13%) comprised of a $19.3 million increase from default collection operations (compared to $13.5 million in prior year), $313,000 decrease from loan guarantee operations (compared to $113,000 contribution in prior year), $805,000 contribution for outreach activities (compared to $1.5 million loss in prior year), $3.1 million contribution for student aid and administration (compared to $3.0 million in prior year) and a $12.7 million gain in loan finance and servicing activities (compared to a $31 million gain in prior year). Also, the proprietary fund contributed $102,646 to administer the Plan and provided a $147,000 contribution to the State General Fund.

Certain highlights related to the combined statement of net assets as of June 30, 2012, are as follows:

- The Authority/Corporation purchased $46.5 million of its own auction rate securities on the secondary market for a discount, resulting in other income of $3.5 million.

- The Authority/Corporation maintained $3.3 billion of FFELP guarantees outstanding.

- The Authority/Corporation maintained $1.5 billion of FFELP loans.

- The Authority/Corporation maintained $414.5 million of defaulted loans in its collection portfolio.

- Unrestricted net assets decreased from $64.3 million to $51.7 million.

- Net assets, restricted other increased from $62.4 million to $87.7 million.

- Net assets restricted for student aid and related activities increased from $56.7 million to $68.7 million.

Combined Statement of Revenues, Expenses and Changes in Net Assets

In fiscal year 2012, the KEES program was fully funded. However, certain other Student Aid programs, including CAP and KTG, incurred a reduction in General Fund appropriations as a result of the 2010-2012 biennial budget process. In fiscal year 2011, USDE awarded $2,051,545 of CACG funds to the Authority/Corporation, with an award period from August 14, 2010 through August 13, 2011. In fiscal year 2012, USDE awarded another $2,058,032 CACG grant to the Authority/Corporation with an award period from August 14, 2011 through August 13, 2012. The Authority/Corporation is required to provide 1/3rd match for CACG grant, and outreach expenses increased $314,000 during the fiscal year ended June 30, 2012. Outreach activities (including CACG activities) for both fiscal years were accounted for in a proprietary fund of the Authority/Corporation.

The $24.7 million increase in proprietary fund net assets during FY 2012 was $15.2 million less than the $39.9 million increase during FY 2011. The decrease resulted from an approximate $3.1 million increase in the Authority's net assets offset by an approximate $18.3 million decrease in the Corporation's net assets. The Authority's $3.1 million increase was due primarily to increases in net debt recovery commissions of $5.9 million offset by a contribution to the federal student loan reserve fund of $2.87 million. The reduction in the overall increase in net assets of the Corporation in FY 2012 compared to FY 2011 resulted primarily from the net of the following activities: a decrease in deconversion fees of $11.5 million due to HCERA's elimination of FFELP which ended the need for the ECASLA Participation Program, a $3 million decrease in net interest revenues, and a $4.2 million contingent VCA liability.

Certain other highlights related to the combined statement of revenues, expenses and changes in net assets for the year ended June 30, 2012, are as follows:

- The Authority/Corporation provided $19.1 million for program benefits for citizens of the Commonwealth of Kentucky.

- The defaulted loan collection operation received $25.4 million in commissions on the $144 million collected on behalf of the USDE.

Condensed Financial Information - Fiduciary Funds

Kentucky Higher Education Assistance Authority/Kentucky Higher Education Student Loan Corporation

	Federal Student Loan Reserve Fund		**Agency Fund**		**Kentucky's Affordable Prepaid Tuition**		**Kentucky Education Savings Plan Trust**	
	2012	2011	2012	2011	2012	2011	2012	2011
Net Asset Information								
Other assets	$ 21,072,284	$ 27,486,627	$	$ 4,079	$ 121,667,135	$ 127,880,038	$ 136,977,448	$ 130,753,287
Total Assets	**21,072,284**	**27,486,627**		**4,079**	**121,667,135**	**127,880,038**	**136,977,448**	**130,753,287**
Total Liabilities	14,705,359	18,408,393			176,172,487	178,843,631	406,106	157,066
Restricted net asset (deficit)	6,366,925	9,078,234		4,079	(54,505,352)	(50,963,593)	136,571,342	130,596,221
Total Net Assets (Deficit)	**$ 6,366,925**	**$ 9,078,234**	**$**	**$ 4,079**	**(54,505,352)**	**(50,963,593)**	**$ 136,571,342**	**$ 130,596,221**
Changes in Fiduciary Net Asset Information								
Federal reinsurance	$ 121,456,219	$ 122,783,419	$	$	$	$	$	$
Contribution from Agency Operating Fund	2,874,310							
Fee revenue	(1,108)	30,508						
Contributions					649,997	684,285		
Subscriptions							43,420,053	38,855,124
Investment revenue	2,540	3,043			7,740,033	23,028,151	3,520,446	18,436,512
Other Income	2,887,176	2,456,002						
Total Additions	127,219,137	125,272,972			8,390,030	23,712,436	46,940,499	57,291,636
Administrative expenses					500,226	601,846	557,770	524,487
Refunds					632,135	567,022		
Trustee expense					240,268	255,096		
Tuition benefit, net					10,661,806	11,164,076		
Loan claims	129,021,794	125,280,659						
Redemptions							40,407,608	36,235,844
Default aversion	908,652	1,721,666						
Total Deductions	129,930,446	127,002,325			12,034,435	12,588,040	40,965,378	36,760,331
Change in Net Assets Before Operating Transfers	(2,711,309)	(1,729,353)			(3,644,405)	11,124,396	5,975,121	20,531,305
Operating Transfers								
Transfer from Agency Operating Fund					102,646	104,476		
Change in Net Assets After Operating Transfers	**$ (2,711,309)**	**$ (1,729,353)**	**$**	**$**	**$ (3,541,759)**	**$ 11,228,872**	**$ 5,975,121**	**$ 20,531,305**

Financial Analysis – Fiduciary Funds

This section of the annual financial report presents a discussion and analysis of the Authority/Corporation's fiduciary fund performance for the fiscal year ended June 30, 2012. Please read it in conjunction with the Authority/Corporation's combined financial statements and notes to the combined financial statements, which follow this section.

Financial Overview

- Loan claims paid increased from $125.3 million in fiscal year 2011 to $129 million in fiscal year 2012 (3% increase).

- The Plan noted a decrease in tuition benefits payable of $2.7 million in fiscal year 2012, due primarily to a lower than expected tuition rate as well as to the continued maturity of a program that has not been open for new enrollments since fiscal year 2005.

Statement of Fiduciary Net Assets (Deficit)

The FSLRF net assets decreased $2.7 million compared to prior year. Assets decreased approximately 23.3% ($6.4 million), while liabilities decreased 20% ($3.7 million). The decrease in net assets is primarily comprised of a $5.1 million decrease related to higher claim payments and associated federal reinsurance amounts and offset by a $2.87 million contribution from the Agency Operating Fund.

The Plan recognized an increase in the net deficit of $3.5 million for fiscal year 2012 compared to a $11.2 million decrease in net deficit in the prior year. Overall, the current year increase in net deficit is primarily attributable to the inherent compounding effect of the Plan deficit.

The Plan's total assets decreased $6.2 million, from $127.8 million as of June 30, 2011 to $121.6 million as of June 30, 2012. Cash and investments decreased from $121.6 million to $116.8 million, a $4.8 million decrease. The change in tuition and investment return assumptions are as follows:

- 2012-thereafter – investment return decreased from 6.56% to 6.25%

- 2011-2012 academic year – tuition increase assumption was 7.25%, while actual tuition increases were 3.8% for the Value Plan and 6% for the Standard Plan and the Premium Plan

- 2013-thereafter – tuition increase assumption remained at 6.75%

Due to the inherent compounding effect, the Plan deficit was projected to increase by $3.5 million in fiscal year 2012 (without any changes in assumptions). Actual tuition increases in academic year 2011-2012 decreased the deficit by $2.1 million, and changes to other assumptions increased the deficit by $2 million. Projected investment expense for the life of the program is accrued as a liability and was calculated as 20 basis points on all invested assets (consistent with prior year).

The Trust is an Internal Revenue Code 529 plan managed by the Authority and administered on behalf of the Authority by TFI. Trust assets are entirely comprised of cash and pooled investments. Total net assets increased approximately $6.0 million, due to subscriptions received ($43.4 million) and investment gain ($3.5 million), net of expenses and redemptions ($40.9 million).

Statement of Changes in Fiduciary Net Assets (Deficit)

The FSLRF net assets decreased $2.7 million compared to prior year. Assets decreased approximately 23.3% ($6.4 million), while liabilities decreased 20% ($3.7 million). The decrease in net assets is primarily comprised of a $5.1 million decrease related to higher claim payments and associated federal reinsurance amounts and offset by a $2.87 million contribution from the Agency Operating Fund.

The Plan recognized an increase in the net deficit of $3.6 million for fiscal year 2012 compared to a $11.2 million decrease in net deficit in the prior year. Overall, the current year increase in net deficit is primarily attributable to the inherent compounding effect of the Plan deficit.

Combined Government-Wide Statement of Net Assets

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

June 30, 2012

ASSETS	Governmental Activities	Business-Type Activities	Total
Current:			
Cash and cash equivalents	$ 623,276	$ 53,431,329	$ 54,054,605
Accounts receivable and prepaid expenses	9,580,409	2,420,163	12,000,572
Accrued interest income		9,665,505	9,665,505
Investments		2,621,574	2,621,574
Teacher and Osteopathic Medicine scholarship loans	450,000		450,000
Loans, net		188,657,342	188,657,342
Total Current Assets	10,653,685	256,795,913	267,449,598
Noncurrent:			
Restricted cash and cash equivalents		91,169,673	91,169,673
Restricted from Federal Student Loan Reserve Fund		10,223,549	10,223,549
Investments		36,190,298	36,190,298
Fixed assets, net		9,049,686	9,049,686
Loans, net		1,316,549,085	1,316,549,085
Teacher and Osteopathic Medicine scholarship loans, net	4,912,792		4,912,792
Teacher and Osteopathic Medicine scholarship advances	3,842,992		3,842,992
Deferred front end borrower benefits, net		6,498,189	6,498,189
Deferred debt issuance costs, net		5,527,707	5,527,707
Accrued interest income		18,309,569	18,309,569
Deferred lender origination cost, net		2,165,287	2,165,287
Total Noncurrent Assets	8,755,784	1,495,683,043	1,504,438,827
Total Assets	19,409,469	1,752,478,956	1,771,888,425
LIABILITIES			
Current:			
Accounts payable and accrued expenses	1,036,388	9,712,270	10,748,658
Accrued interest expense		3,703,442	3,703,442
Allowance for arbitrage liabilities		120,371	120,371
Payable to US Department of Education		8,936,871	8,936,871
Capital lease payable		500,000	500,000
Total Current Liabilities	1,036,388	22,972,954	24,009,342
Noncurrent:			
Allowance for arbitrage liabilities		94,840	94,840
Deferred gain on bond retirement, net		43,238,314	43,238,314
Capital lease payable		4,285,000	4,285,000
Note payable		522,380,654	522,380,654
Bonds payable		947,070,000	947,070,000
Total Noncurrent Liabilities		1,517,068,808	1,517,068,808
Total Liabilities	1,036,388	1,540,041,762	1,541,078,150
NET ASSETS			
Invested in capital assets, net of expended debt proceeds		4,332,499	4,332,499
Unrestricted		51,704,872	51,704,872
Restricted, other		87,695,246	87,695,246
Restricted for program benefits	18,373,081		18,373,081
Restricted for student aid and related activities		68,704,577	68,704,577
Total Net Assets	$ 18,373,081	$ 212,437,194	$ 230,810,275

See accompanying notes.

Combined Government-Wide Statement of Activities

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

For Year Ending June 30, 2012

	Direct Expenses	Indirect Expenses	Program Revenue: Charges for Services	Program Revenue: Operating Grants and Contributions	Net (Expenses) Revenues and Changes in Net Assets: Governmental Activities	Net (Expenses) Revenues and Changes in Net Assets: Business-Type Activities	Net (Expenses) Revenues and Changes in Net Assets: Total
Governmental activities:							
Kentucky Tuition Grant	$ 31,045,124	$ 358,348	$	$ 32,798,507	$ 1,395,035	$	$ 1,395,035
College Access Program Grant	58,675,586	368,700		60,949,276	1,904,990		1,904,990
Robert C. Byrd Honors Scholarship	161,000	58,396		217,396	(2,000)		(2,000)
Mary Jo Young Scholarship	334,875	82,058		384,662	(32,271)		(32,271)
Early Childhood Development Scholarship	1,167,128	78,217		1,135,414	(109,931)		(109,931)
Kentucky National Guard Tuition Award Program	4,660,447	138,434		5,631,936	833,055		833,055
Kentucky Educational Excellence Scholarship	98,616,514	526,112		99,179,868	37,242		37,242
Teacher Scholarship	578,903	302,068		2,127,887	1,246,916		1,246,916
Teacher Loan Forgiveness	2,050,000				(2,050,000)		(2,050,000)
Osteopathic Medicine Scholarship	509,264	126,598		1,188,158	552,296		552,296
State General Fund expenditure	447,414				(447,414)		(447,414)
KHEAA Work Study Program	507,200	73,281		904,165	323,684		323,684
Go Higher Grant Program	186,861	19,225		243,077	36,991		36,991
Pharmacy Scholarship Program	159,800				(159,800)		(159,800)
Drive the Dream Scholarship	448,500			495,000	46,500		46,500
John R. Justice Grant	50,075	7,469		7,469	(50,075)		(50,075)
Kentucky Education Savings Plan Trust		219,978		219,978			
Total Governmental Activities	199,598,691	2,358,884		205,482,793	3,525,218		3,525,218
Business-Type Activities:							
Loan guarantee operations	3,747,137		3,434,031			(313,106)	(313,106)
Default collections	6,090,275		25,477,902			19,387,627	19,387,627
Loan finance and servicing activities	47,246,659		59,988,013			12,741,354	12,741,354
Outreach	3,341,667		2,536,854			(804,813)	(804,813)
Contribution to student aid programs	796,500					(796,500)	(796,500)
Student aid administration	2,358,884					(2,358,884)	(2,358,884)
Contribution to FSLRF	2,874,310					(2,874,310)	(2,874,310)
School services	109,487		109,487				
Other activities	124,388		124,388				
Total Business-Type Activities	66,689,307		91,670,675			24,981,368	24,981,368
Total Primary Government	$ 266,287,998	$ 2,358,884	$ 91,670,675	$ 205,482,793	3,525,218	24,981,368	28,506,586
Transfers:							
Transfer to KAPT (the "Plan")						(102,646)	(102,646)
Transfer to State General Fund						(147,000)	(147,000)
Total Transfers						(249,646)	(249,646)
Change in Net Assets					3,525,218	24,731,722	28,256,940
Net assets, July 1, 2011					14,847,863	187,705,472	202,553,335
Net assets, June 30, 2012					$ 18,373,081	$ 212,437,194	$ 230,810,275

See accompanying notes.

Combined Statement of Net Assets - Proprietary Funds

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

June 30, 2012

	Authority			Corporation			Combined
ASSETS	**Internal Service Fund**	**Agency Operating Fund**	**Authority Total**	**Education Finance Funds**	**Operating Fund**	**Corporation Total**	**Total**
Current:							
Cash and cash equivalents	$ 2,610,664	$ 22,837,660	$ 25,448,324	$	$ 27,983,005	$ 27,983,005	$ 53,431,329
Investments		2,621,574	2,621,574				2,621,574
Accounts receivable and prepaid expenses	1,928,133	35,619	1,963,752	70,206	386,205	456,411	2,420,163
Accrued interest income		126,403	126,403	9,190,389	348,713	9,539,102	9,665,505
Deferred lender origination cost, net							
Loans, net				183,446,420	5,210,922	188,657,342	188,657,342
Total Current Assets	4,538,797	25,621,256	30,160,053	192,707,015	33,928,845	226,635,860	256,795,913
Noncurrent:							
Restricted cash and cash equivalents	1,000,000		1,000,000	90,169,673		90,169,673	91,169,673
Internal receivable (payable) for Gear Up Scholarships	(1,000,000)	1,000,000					
Receivable from Federal Student Loan Reserve Fund		10,223,549	10,223,549				10,223,549
Investments		28,176,497	28,176,497		8,013,801	8,013,801	36,190,298
Fixed assets, net		8,898,515	8,898,515		151,171	151,171	9,049,686
Loans, net				1,286,383,322	30,165,763	1,316,549,085	1,316,549,085
Deferred front end borrower benefits, net				6,498,189		6,498,189	6,498,189
Deferred debt issuances costs, net		67,813	67,813	5,459,894		5,459,894	5,527,707
Accrued interest income, net				18,011,445	298,124	18,309,569	18,309,569
Deferred lender origination cost, net				2,165,287		2,165,287	2,165,287
Total Noncurrent Assets		48,366,374	48,366,374	1,408,687,810	38,628,859	1,447,316,669	1,495,683,043
Total Assets	4,538,797	73,987,630	78,526,427	1,601,394,825	72,557,704	1,673,952,529	1,752,478,956
LIABILITIES							
Current:							
Accounts payable and accrued expenses	1,103,452	46,139	1,149,591	879,823	7,682,856	8,562,679	9,712,270
Interfund payable (receivable)	3,435,345	(3,270,010)	165,335	(7,345,008)	7,179,673	(165,335)	
Allowance for arbitrage liabilities				120,371		120,371	120,371
Accrued interest expense		40,596	40,596	3,662,846		3,662,846	3,703,442
Payable (receivable) to U.S. Department of Education		(500,000)	(500,000)	9,117,739	319,132	9,436,871	8,936,871
Capital lease payable		500,000	500,000				500,000
Total Current Liabilities	4,538,797	(3,183,275)	1,355,522	6,435,771	15,181,661	21,617,432	22,972,954
Noncurrent:							
Capital lease payable		4,285,000	4,285,000				4,285,000
Allowance for arbitrage liabilities				94,840		94,840	94,840
Deferred gain on bond retirement, net				43,238,314		43,238,314	43,238,314
Note payable				522,380,654		522,380,654	522,380,654
Bonds payable				947,070,000		947,070,000	947,070,000
Total Noncurrent Liabilities		4,285,000	4,285,000	1,512,783,808		1,512,783,808	1,517,068,808
Total Liabilities	4,538,797	1,101,725	5,640,522	1,519,219,579	15,181,661	1,534,401,240	1,540,041,762
NET ASSETS							
Invested in capital assets, net		4,181,328	4,181,328		151,171	151,171	4,332,499
Unrestricted					51,704,872	51,704,872	51,704,872
Restricted, other				82,175,246	5,520,000	87,695,246	87,695,246
Restricted for student aid and related activities		68,704,577	68,704,577				68,704,577
Total Net Assets	$	$ 72,885,905	$ 72,885,905	$ 82,175,246	$ 57,376,043	$ 139,551,289	$ 212,437,194

See accompanying notes.

Combined Statement of Revenues, Expenditures and Changes
in Net Assets - Proprietary Funds

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

For Year Ending June 30, 2012

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total
Operating revenues:							
Interest Revenues:							
Interest on loans	$	$	$	$ 36,308,916	$ 981,414	$ 37,290,330	$ 37,290,330
Interest and investment income		332,138	332,138	36,962	67,972	104,934	437,072
Amortization of deferred gain on debt retirements				18,465,693		18,465,693	18,465,693
Interest expense on bonds				(11,257,244)		(11,257,244)	(11,257,244)
Total net interest revenues		332,138	332,138	43,554,327	1,049,386	44,603,713	44,935,851
Financing Expenses:							
Provision for loan losses				1,128,047	(85,587)	1,042,460	1,042,460
Provision for arbitrage				(51,237)		(51,237)	(51,237)
Variable bond credit facility and remarketing fees				5,372,057		5,372,057	5,372,057
Amortization of origination costs				1,294,363		1,294,363	1,294,363
Amortization and write-off of debt issuance costs				704,086		704,086	704,086
Total financing expenses				8,447,316	(85,587)	8,361,729	8,361,729
Interest revenues net of financing expenses		332,138	332,138	35,107,011	1,134,973	36,241,984	36,574,122
Other Operating Revenues:							
Servicing fees from external sources					162,131	162,131	162,131
Servicing fees from Education Finance Funds					9,561,870	9,561,870	9,561,870
SAFRA revenue					404,677	404,677	404,677
Debt recovery commission		25,477,902	25,477,902		4,537	4,537	25,482,439
Federal fees earned		2,193,241	2,193,241				2,193,241
Federal grant revenue		2,536,854	2,536,854				2,536,854
Default aversion fee income		908,652	908,652				908,652
Guarantee fee					98,710	98,710	98,710
Gain on early retirement of debt				3,480,335		3,480,335	3,480,335
Gain on sale/purchase of loans				9,146		9,146	9,146
Late payment penalties				1,391,914	63,328	1,455,242	1,455,242
School services	109,487		109,487				109,487
Other income	124,388		124,388		207,652	207,652	332,040
Total operating revenues	233,875	31,448,787	31,682,662	39,988,406	11,637,878	51,626,284	83,308,946
Operating expenses:							
Administrative expenses	132,019	9,185,800	9,317,819		14,453,742	14,453,742	23,771,561
Servicing fees for Operating Fund				9,561,870		9,561,870	9,561,870
Depreciation and amortization		588,694	588,694		76,705	76,705	665,399
Other expenses	101,856	62,918	164,774	302,233	4,708,199	5,010,432	5,175,206
Total operating expenses	233,875	9,837,412	10,071,287	9,864,103	19,238,646	29,102,749	39,174,036
Net operating income (loss) before program benefits		21,611,375	21,611,375	30,124,303	(7,600,768)	22,523,535	44,134,910
Program Benefits:							
Amortization of front end borrower benefits				4,348,314		4,348,314	4,348,314
Principal and interest benefits				1,559,860	3,874,007	5,433,867	5,433,867
Outreach		3,341,667	3,341,667				3,341,667
Contribution to FSLRF		2,874,310	2,874,310				2,874,310
Contribution to student aid programs		796,500	796,500				796,500
Student aid administration		2,358,884	2,358,884				2,358,884
Total program benefits		9,371,361	9,371,361	5,908,174	3,874,007	9,782,181	19,153,542
Operating income (loss) before transfers		12,240,014	12,240,014	24,216,129	(11,474,775)	12,741,354	24,981,368
Transfers (to) from other funds							
Interfund transfers				(5,053,091)	5,053,091		
Transfer to State General Fund		(147,000)	(147,000)				(147,000)
Transfer to KAPT (the "Plan")		(102,646)	(102,646)				(102,646)
Increase (decrease) in net assets after transfers		11,990,368	11,990,368	19,163,038	(6,421,684)	12,741,354	24,731,722
Net assets, July 1, 2011		60,895,537	60,895,537	63,012,208	63,797,727	126,809,935	187,705,472
Net assets, June 30, 2012	$	$ 72,885,905	$ 72,885,905	$ 82,175,246	$ 57,376,043	$ 139,551,289	$ 212,437,194

See accompanying notes.

Combined Statement of Cash Flows - Proprietary Fund

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

For Year Ending June 30, 2012

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total
Cash Flows from Operating Activities:							
Principal received on loans	$	$	$	$ 217,240,690	$ 31,835,533	$ 249,076,223	$ 249,076,223
Interest received on loans				54,818,318	881,766	55,700,084	55,700,084
Special allowance paid				(43,923,772)	(727,431)	(44,651,203)	(44,651,203)
Servicing fees received, internal sources	124,388	(35,619)	88,769	(9,561,870)	9,561,870		88,769
School services	109,487		109,487				109,487
Servicing fees received, external sources					158,331	158,331	158,331
Debt recovery commission received		25,477,902	25,477,902				25,477,902
Federal fees received		2,193,241	2,193,241				2,193,241
Federal grant revenue received		2,536,854	2,536,854				2,536,854
Default aversion fees received		908,652	908,652				908,652
Outreach		(3,341,667)	(3,341,667)				(3,341,667)
Internal activity-payments to other funds	(6,538,056)	6,538,056		(1,455,551)	1,455,551		
Loans originated, including costs				2,025	(3,838,246)	(3,836,221)	(3,836,221)
Administrative expenses paid		(10,644,979)	(10,644,979)	(5,684,320)	(18,509,991)	(24,194,311)	(34,839,290)
Contribution to FSLRF		(2,874,310)	(2,874,310)				(2,874,310)
Credit facility fees paid				(5,372,361)		(5,372,361)	(5,372,361)
Loans purchased, including premiums				(15,794,265)	(5,585,688)	(21,379,953)	(21,379,953)
Contribution to student aid programs		(796,500)	(796,500)				(796,500)
Student aid administration		(2,358,884)	(2,358,884)				(2,358,884)
Interfund loan sales and purchases				30,914,030	(30,914,030)		
Client loan receipts					4,337,936	4,337,936	4,337,936
Loan receipts remitted to clients					(4,447,241)	(4,447,241)	(4,447,241)
Net Cash Provided by (Used in) Operating Activities	(6,304,181)	17,602,746	11,298,565	221,182,924	(15,791,640)	205,391,284	216,689,849
Cash Paid from Noncapital Financing Activities:							
Debt principal payments				(182,316,547)		(182,316,547)	(182,316,547)
Principal received on loans PUT to USDE				9,527,365		9,527,365	9,527,365
Interest on debt				(10,740,511)		(10,740,511)	(10,740,511)
Gain on early retirement of debt				3,480,335		3,480,335	3,480,335
Interfund transfers				(4,925,149)	4,925,149		
Transfer to State General Fund		(147,000)	(147,000)				(147,000)
Transfer to KAPT (the "Plan")		(102,646)	(102,646)				(102,646)
Decrease in Federal Student Loan Reserve receivable		3,670,750	3,670,750				3,670,750
Net Cash Provided by (Used in) Noncapital Financing Activities		3,421,104	3,421,104	(184,974,507)	4,925,149	(180,049,358)	(176,628,254)
Cash Flows From Capital and Related Financing Activities:							
Capital expenditures		(276,605)	(276,605)		(98,776)	(98,776)	(375,381)
Interest paid on capital lease		(264,105)	(264,105)				(264,105)
Bond principal payments		(480,000)	(480,000)				(480,000)
Net Cash Used in Capital and Related Financing Activities		(1,020,710)	(1,020,710)		(98,776)	(98,776)	(1,119,486)
Cash Flows From Investing Activities:							
Proceeds from sales/maturities of investments		17,056,829	17,056,829		5,990,033	5,990,033	23,046,862
Purchases of investments		(35,482,747)	(35,482,747)		(5,971,867)	(5,971,867)	(41,454,614)
Investment income		418,759	418,759	36,359	75,778	112,137	530,896
Net Cash Provided by (Used in) Investing Activities		(18,007,159)	(18,007,159)	36,359	93,944	130,303	(17,876,856)
Net Increases (Decrease) in Cash and Cash Equivalents	(6,304,181)	1,995,981	(4,308,200)	36,244,776	(10,871,323)	25,373,453	21,065,253
Cash and Cash Equivalents, July 1, 2011	9,914,845	20,841,679	30,756,524	53,924,897	38,854,328	92,779,225	123,535,749
Cash and Cash Equivalents, June 30, 2012	$ 3,610,664	$ 22,837,660	$ 26,448,324	$ 90,169,673	$ 27,983,005	$ 118,152,678	$ 144,601,002

Continued

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

For Year Ending June 30, 2012

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total
Reconciliation of Operating Income (Loss) to Net Cash Provided by (Used in) Operating Activities							
Operating income (loss) before transfers	$	$ 12,240,014	$ 12,240,014	$ 24,216,129	$ (11,474,775)	$ 12,741,354	$ 24,981,368
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:							
Investment income		(332,138)	(332,138)	(36,359)	(79,361)	(115,720)	(447,858)
Depreciation and amortization		764,962	764,962	6,346,763	76,705	6,423,468	7,188,430
Amortization of deferred gain on debt retirements				(18,465,693)		(18,465,693)	(18,465,693)
Gain on early retirement of debt				(3,480,335)		(3,480,335)	(3,480,335)
Interest expense		264,105	264,105	11,257,244		11,257,244	11,521,349
Provision for loan losses				1,128,047	(85,587)	1,042,460	1,042,460
Borrower interest converted to principal				(35,737,400)	(1,021,148)	(36,758,548)	(36,758,548)
Loan forgiveness				1,559,860		1,559,860	1,559,860
Loss on equipment disposal		166	166				166
(Increases) decreases in assets:							
Accounts receivables and prepaid expenses	(1,916,234)	(89,960)	(2,006,194)	440,322	(67,245)	373,077	(1,633,117)
Accrued interest receivable		54,341	54,341	7,663,185	(68,492)	7,594,693	7,649,034
Principal received on loans				217,240,690	31,835,533	249,076,223	249,076,223
Loans purchased, including premiums				(15,794,265)	(5,585,688)	(21,379,953)	(21,379,953)
Loans originated, including costs				2,025	(3,838,246)	(3,836,221)	(3,836,221)
Interfund loan sales and purchases				30,914,030	(30,914,030)		
Increases (decreases) in liabilities:							
Accounts payable and accrued expenses	44,718	65,125	109,843	122,125	4,095,546	4,217,671	4,327,514
Payable to U.S. Department of Education				(4,307,173)	86,245	(4,220,928)	(4,220,928)
Interfund receivable/payable	(4,432,665)	4,639,313	206,648	(1,455,551)	1,248,903	(206,648)	
Accrued interest payable		(3,182)	(3,182)				(3,182)
Allowance for arbitrage liabilities				(430,720)		(430,720)	(430,720)
Net Cash Provided by (Used in) Operating Activities	$ (6,304,181)	$ 17,602,746	$ 11,298,565	$ 221,182,924	$ (15,791,640)	$ 205,391,284	$ 216,689,849

See accompanying notes

Balance Sheet - Governmental Fund

Kentucky Higher Education Assistance Authority

June 30, 2012

	Governmental Fund Student Aid
ASSETS	
Current:	
Cash and cash equivalents	$ 623,276
Accounts receivable	9,580,409
Teacher and Osteopathic Medicine scholarship loans	450,000
Total Current Assets	10,653,685
Noncurrent:	
Teacher and Osteopathic Medicine scholarship loans, net of allowance of $3,600,000	4,912,792
Teacher and Osteopathic Medicine scholarship advances	3,842,992
Total Noncurrent Assets	8,755,784
Total Assets	19,409,469
LIABILITIES	
Current:	
Accounts payable	1,036,388
Total Liabilities	1,036,388
FUND BALANCE	
Restricted for program benefits	$ 18,373,081

See accompanying notes.

Statement of Revenues, Expenditures and Changes
in Fund Balance - Governmental Fund

Kentucky Higher Education Assistance Authority

June 30, 2012

	Governmental Fund Student Aid
Revenues:	
Interest and investment income fund	$ 279,579
Tobacco settlement revenue	1,000,000
Unclaimed lottery revenue	7,000,000
State General Fund revenue	193,585,870
Federal funds revenue	182,835
Other income	279,125
Contribution from Agency Operating Fund	3,155,384
Total Revenues	205,482,793
Expenditures:	
Kentucky Tuition Grant	31,403,472
College Access Program Grant	59,044,286
Robert C. Byrd Honors Scholarship	219,396
Mary Jo Young Scholarship	416,933
Early Childhood Development Scholarship	1,245,345
Kentucky National Guard Tuition Award Program	4,798,881
Kentucky Educational Excellence Scholarship	99,142,626
Teacher Scholarship	880,971
Teacher Loan Forgiveness	2,050,000
Osteopathic Medicine Scholarship	635,862
State General Fund expenditure	447,414
Pharmacy Scholarship Program	159,800
KHEAA Work Study Program	580,481
Go Higher Grant Program	206,086
Drive the Dream Scholarship	448,500
John R. Justice Grant	57,544
Kentucky Educational Savings Plan Trust	219,978
Total Expenditures	201,957,575
Net Change in Fund Balance	3,525,218
Fund Balance, July 1, 2011	14,847,863
Fund Balance, June 30, 2012	$ 18,373,081

See accompanying notes.

Statement of Fiduciary Net Assets (Deficit)

Kentucky Higher Education Assistance Authority

June 30, 2012

ASSETS	**Federal Student Loan Reserve Fund**	**Kentucky's Affordable Prepaid Tuition**	**Kentucky Education Savings Plan Trust**
Current:			
Cash and cash equivalents	$ 10,479,866	$ 2,889,423	$ 1,580
Contributions receivable		1,172,606	
Fees receivable		190,505	
Receivable from U.S. Department of Education	10,569,533		
Investments		113,911,823	136,618,354
Other current assets	22,885		357,514
Total Current Assets	21,072,284	118,164,357	136,977,448
Noncurrent:			
Contributions receivable		3,502,778	
Total Assets	21,072,284	121,667,135	136,977,448
LIABILITIES			
Current:			
Accounts payable	19,058	68,324	359,038
Accrued expenses			47,068
Current portion of reinsurance reserve	546,196		
Total Current Liabilities	565,254	68,324	406,106
Noncurrent:			
Reinsurance reserve, less current portion	3,916,557		
Payable to Agency Operating Fund	10,223,548		
Tuition benefits payable		176,104,163	
Total Liabilities	14,705,359	176,172,487	406,106
NET ASSETS (DEFICIT)			
Restricted for program benefits		(54,505,352)	136,571,342
Restricted for other purposes	6,366,925		
Total Net Assets (Deficit)	$ 6,366,925	$ (54,505,352)	$ 136,571,342

See accompanying notes.

Statement of Changes in Fiduciary Net Assets (Deficit)

Kentucky Higher Education Assistance Authority

June 30, 2012

	Federal Student Loan Reserve Fund	Kentucky's Affordable Prepaid Tuition	Kentucky Education Savings Plan Trust
Additions:			
Federal reinsurance	$ 121,456,219	$	$
Contribution from Agency Operating Fund	2,874,310		
Fee revenue	(1,108)		
Contract income, net		649,997	
Subscriptions			43,420,053
Investment Revenues:			
Net unrealized gain on investments		3,828,256	820,038
Interest and investment Income	2,540	3,911,777	2,700,408
Other income	2,887,176		
Total Additions	127,219,137	8,390,030	46,940,499
Deductions:			
Program benefits:			
Loan claims	129,021,794		
Default aversion fee expense	908,652		
Redemptions			40,407,608
Administrative expenses		99,510	557,770
Personnel and professional expenses		400,716	
Refunds		632,135	
Trustee fee expense		240,268	
Tuition benefits expense, net		10,661,806	
Total Deductions	129,930,446	12,034,435	40,965,378
Change in Net Assets before Transfers	(2,711,309)	(3,644,405)	5,975,121
Transfer from Agency Operating Fund		102,646	
Change in Net Assets	(2,711,309)	(3,541,759)	5,975,121
Net Assets (Deficit), July 1, 2011	9,078,234	(50,963,593)	130,596,221
Net Assets (Deficit), June 30, 2012	$ 6,366,925	$ (54,505,352)	$ 136,571,342

See accompanying notes.

Note A--Description of Business

The Kentucky Higher Education Assistance Authority (the "Authority") was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. The Authority guarantees loans, performs default aversion activities and performs collection activities on eligible student loans. The Kentucky Education Savings Plan Trust (the "Trust"), and the Commonwealth Postsecondary Education Prepaid Trust Fund, Kentucky's Affordable Prepaid Tuition Plan (the "Plan") offer savings and investment opportunities for Kentuckians to save for higher education. The Kentucky Higher Education Student Loan Corporation (the "Corporation") makes student loans directly to parents and students as part of the Kentucky Advantage Education Loan Program ("KAEL"), which includes the Kentucky Advantage Parent Loan. The Corporation also purchases, services and performs collection activities on eligible education loans. The Authority and the Corporation maintain bundled operations to maximize the efficiency of loan guarantee and servicing operations. Accordingly, all senior management positions have responsibilities related to both the Authority and the Corporation. Additionally, the Plan and the Trust are governed by the Authority and Corporation's combined Board of Directors. Throughout the accompanying financial statements, the "Authority/Corporation" refers to the combined group of operations.

The Health Care and Education Reconciliation Act ("HCERA") of 2010 was signed into law on March 30, 2010. HCERA eliminated the origination and/or guarantee of Federal Family Education Loan Program ("FFELP") loans, effective July 1, 2010. HCERA did allow lenders to make subsequent disbursements on loans originated on or before June 30, 2010. The Authority/Corporation can no longer originate, guarantee or fund any new FFELP loans. However, the Authority/Corporation continues to operate under existing FFELP regulations for loans originated and guaranteed prior to July 1, 2010.

HCERA does provide for servicing opportunities for qualified nonprofit organizations to service an initial allocation of 100,000 federal loan borrowers. The Authority/Corporation has been pre-approved as an eligible servicer and is preparing operations to accommodate their allotment of federal loans. The Authority/Corporation is currently scheduled to receive their initial allotment of loans in the fall of 2012.

Loan Guarantee Operations

The Authority/Corporation's loan guarantee operations guarantees existing FFELP loans to qualified students and parents of qualified students made by approved lenders in Kentucky and Alabama. Commencing in 1969, retroactive to 1965, the federal government agreed to insure 80% of such guarantee student loans. FFELP was established by Congress and is administered by the U.S. Department of Education ("USDE") as a means of making loans available to students attending colleges, universities and vocational institutions. FFELP provides for the Authority/Corporation's loan guarantee operations to guarantee the repayment of principal and accrued interest to lenders for each eligible student loan. The Authority/Corporation's loan guarantee operation is responsible for maintaining loan guarantees, providing default aversion assistance to lenders for delinquent loans, paying lender claims for loans in default, paying lender claims for death, disability or bankruptcy and collecting loans on which default claims have been paid. The Authority/Corporation also educates lenders about FFELP requirements and regulatory changes.

Note A--Description of Business--Continued

Effective January 10, 1977, the Authority/Corporation's loan guarantee operation entered into a supplemental guaranty agreement with the federal government, which provided up to 100% reimbursement, depending upon default experience as specified in the agreement. Subsequently, federal reinsurance on guaranteed loans made from October 1, 1993 to September 30, 1998 was reduced to a maximum of 98% and federal reinsurance on guaranteed loans made on or after October 1, 1998, was reduced to a maximum of 95% (see Note E).

The Higher Education Amendments of 1998 (the "1998 Amendments") which were enacted on October 7, 1998, with an effective date of October 1, 1998, changed the manner in which FFELP is administered. Under the 1998 Amendments, the Authority/Corporation established a Federal Student Loan Reserve Fund (the "FSLRF") and an Agency Operating Fund (the "AOF") to account for all FFELP guarantee activities. The FSLRF assets and all earnings on those assets (except investment income on the 1998 Balance Budget Act set-aside funds) are the property of the federal government.

The guarantee reserves of the Authority/Corporation were required to be deposited in the new Federal Fund no later than 60 days after enactment. The result of this federal legislation was that the Authority/Corporation's guarantee reserve fund equity of approximately $40.6 million was transferred to the newly established FSLRF and the Authority/Corporation's AOF commenced activities with a zero fund equity. The funds in the newly established FSLRF were used to pay for the reimbursements to the lenders for student loan claims and pay the AOF for default aversion fees, Account Maintenance Fee shortfall and any U.S. Treasury recall amounts. Funds used to pay loan claims are mostly replenished from reimbursements from the federal government.

Other sources of revenues to the FSLRF include the federal compliment on collections of defaulted loans and investment income. All of the other sources and uses of funds not related to the FSLRF are recorded in the AOF. The AOF assets and earnings on those assets are the property of the Authority/Corporation and may generally be used for all guaranty agency and other student financial aid related activities.

Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees and account maintenance fees.

Expenditures from the AOF include personnel, professional and other administrative expenses directly related to the loan program operations and outreach activities. The AOF provides funding to the governmental fund to pay administration costs for fifteen student aid programs, administrative costs for the Trust, and direct benefits for the Mary Jo Young Scholarship program. The AOF also transfers funds to the Plan to pay some of the Plan's administration costs. Both the FSLRF and AOF are subject to federal oversight.

Note A--Description of Business--Continued

Loan Finance and Servicing Operations

The Corporation is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky. The Corporation is authorized to finance loans for students attending eligible post-secondary institutions, service and collect education loans, and issue bonds and notes not to exceed $5 billion in order to carry out its corporate powers and duties.

The Authority/Corporation's finance, servicing and collection activities include: (i) the origination and acquisition of education loans; (ii) the financing of FFELP and KAEL loans; (iii) the servicing of FFELP and other education loans; and (iv) the collection of FFELP and other education loans for other holders on a commission or cost reimbursement basis. FFELP student loans held, serviced and collected by the Authority/Corporation include Federal Stafford Loans ("Stafford"), Unsubsidized Stafford Loans ("Unsubsidized Stafford"), Federal Supplemental Loans for Students ("SLS"), Federal Parent Loans for Undergraduate Students ("PLUS") and Federal Consolidation Loans ("Consolidations").

Most FFELP loans held by the Authority/Corporation are insured by a guarantee agency. Loans made prior to October 1, 1993, are 100% insured. Loans made between October 1, 1993 and June 30, 2006, are 100% insured against borrowers' death, disability, or bankruptcy and 98% insured against borrowers' default. Loans made after June 30, 2006, are 100% insured against borrowers' death, disability, or bankruptcy and 97% insured against borrowers' default. KAEL loans are self-insured by the Authority/Corporation. KAEL borrowers are charged a guarantee fee at the time their loan is originated to fund any future losses on defaulted KAEL loans.

The Authority/Corporation's General Bond Resolution ("GBR"), Indentures, and separate series resolutions for issuance of revenue bonds and notes payable contain provisions establishing funds and accounts for the segregation of assets and provisions restricting the use of the proceeds of bonds and other funds received.

Note A--Description of Business--Continued

As of June 30, 2012 the Authority/Corporation held and serviced approximately $1.5 billion outstanding principal amount of FFELP and other education loans. $1.477 billion of loans were pledged pursuant to the 1997 GBR, the 2008 Indenture, the 2010 Indenture and ED Conduit Program Note Payable. The remaining $38 million of loans were funded by the Corporation's Operating Fund. Also, the Authority/Corporation services approximately $23 million of FFELP and other education loans on behalf of other holders, including a holder with national lending operations. The majority of such education loans are serviced by the Authority/Corporation pursuant to servicing agreements which do not provide for the acquisition by the Authority/Corporation of the education loans serviced. As a servicer of FFELP and other education loans, the Authority/Corporation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities. The Authority/Corporation's obligations pursuant to such servicing and collection agreements are without recourse to assets pledged to collateralize any Authority/Corporation financings.

In addition to operations related to FFELP program, the Authority/Corporation administers the Trust, the Plan and fifteen grant and scholarship programs.

Kentucky Education Savings Plan Trust

The Trust was formed on July 15, 1988 by Kentucky law, to help families save for the costs of education after high school. The Trust is administered by the Board of Directors. The Authority/Corporation has contracted with TIAA-CREF Tuition Financing, Inc. ("TFI"), a wholly-owned subsidiary of Teachers Insurance and Annuity Association of America ("TIAA"), for management services over the Trust's operations. The Trust is operated in a manner such that it is exempt from registration as an investment company under the Investment Company Act of 1940.

An individual participating in the Trust establishes an account in the name of a Beneficiary. Contributions can be made among six investment options: the Managed Allocation Option, the Fixed Income Option, the Balanced Option, Equity Index Option, Active Equity Option and the Guaranteed Option.

Contributions in the Managed Allocation Option are allocated among six age bands, based on the age of the beneficiary. Each age band invests in varying percentages in the Institutional Class of the International Equity, International Equity Index, Large-Cap Value Index, Large-Cap Growth Index, S&P 500 Index, Mid-Cap Growth, Small-Cap Equity, Mid-Cap Value, Short-Term Bond, Bond Index, Large-Cap Growth, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities, Emerging Market Equity, Emerging Market Equity Index and Money Market Funds of the TIAA-CREF Institutional Mutual Funds.

The Equity Options invests in varying percentages in the Institutional Class of the International Equity and Growth & Income Funds of the TIAA-CREF Institutional Mutual Funds.

The Guaranteed Option is contractually obligated to pay a minimum rate of return of 1%.

Note A--Description of Business--Continued

All allocation percentages are determined by the Authority/Corporation's Board of Directors and are subject to change. The assets of the Guaranteed Option are allocated to a funding agreement issued by TIAA-CREF Life Insurance Company, a subsidiary of TIAA, which offers a guarantee of principal and a minimum rate of return to the Trust.

Prepaid Tuition Plan

The Authority/Corporation also administers the Plan, which was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes ("KRS") 164A.700-709.

On July 1, 2005, governance of the Plan permanently transferred to the Authority/Corporation. The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan offered enrollment periods in fiscal years 2002, 2003 and 2005, for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers. There have been no enrollment periods since fiscal year 2005 as the Plan currently maintains an accumulated net deficit of approximately $54.5 million.

Participants purchased annual tuition units at current tuition levels, or current tuition levels plus a premium, and receive benefits equal to tuition rates in place at the time that the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky.

Participants were allowed to elect to spread payments to the Plan over three, five or seven years or until the anticipated year of the student's enrollment in a qualified postsecondary education institution.

Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college or university in the United States.

If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books and supplies.

Note A--Description of Business--Continued

Participants may withdraw from the Plan at any time for any reason. Terminating participants are refunded any contract payments made less benefits received, administrative and cancellation fees. Participants who withdraw after July 1 of the beneficiary's college entrance year receive the tuition payout value of the contract less benefits received, administrative and cancellation fees. Non-qualified withdrawals are subject to a 10% penalty in accordance with Section 529 of the Internal Revenue Code ("IRC") except in cases where the withdrawal is: (i) made on account of the death or disability of the student; (ii) made on account of a scholarship received by a student; or (iii) a non-taxable transfer to another account or to another IRC Section 529 program for a different student who is a family member of the original student.

As of June 30, 2012, the Plan maintained an accumulated net deficit of approximately $54.5 million. Based on actuarial estimates, the Plan's assets will be exhausted in fiscal year 2019, at which time the liability of the Plan becomes a General Obligation of the Commonwealth of Kentucky. Per KRS 164A.708, once a real liability is expected to accrue, the General Assembly shall appropriate the necessary funds to meet the liability. Over the remaining estimated life of the program, through fiscal year 2027, actuarial estimates show the Commonwealth of Kentucky will need to transfer approximately $94 million.

Student Aid Programs

The Authority/Corporation provides administration of fifteen student aid programs: (1) the Kentucky Tuition Grant program, (2) College Access Program grant, (3) Kentucky Educational Excellence Scholarship program, (4) Teacher Scholarship program, (5) Osteopathic Medicine Scholarship program, (6) the KHEAA Work-Study program, (7) Robert C. Byrd Honors Scholarship program, (8) Early Childhood Development Scholarship program, (9) the Go Higher Grant program, (10) the Coal County Scholarship for Pharmacy Students program, (11) the Mary Jo Young Scholarship program, (12) John R. Justice grant, (13) the Drive the Dream Scholarship program, (14) the Kentucky National Guard Tuition Award program, and (15) the Minority Educator Recruitment and Retention Scholarship program. Direct benefits for grant, scholarship, and work-study programs are funded by appropriations from the Kentucky General Assembly, federal grants, funding from the Authority/Corporation, allocation of revenues from the Kentucky Lottery Corporation, Coal Severance Tax and Tobacco Settlement funds.

Note B--Summary of Significant Accounting Policies

Basis of Presentation - The Authority/Corporation reports its financial information in accordance with the Government Accounting Standard Board ("GASB") Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis – for State and Local Governments* as amended by GASB No. 37 and modified by GASB No. 38, *Certain Financial Statement Disclosures*, (collectively "GASB No. 34"). The Authority/Corporation's basic financial statements are prepared in accordance with GASB No. 34 and are comprised of the following three components: 1) government-wide financial statements; 2) fund financial statements, and 3) notes to financial statements. The government-wide financial statements are comprised of a statement of net assets and a statement of activities. Prepared using the economic resources measurement focus and the accrual basis of accounting, these statements reflect all of the assets, liabilities, revenues, expenses, gains and losses of the combined Authority/Corporation's governmental and business-type activities. The Authority/Corporation's governmental activities reflect the activities of administering the various student grant, scholarship, advance/loan and work-study programs for the Commonwealth of Kentucky and the Federal Government.

The Authority/Corporation's business-type activities include administering loan guarantees, default collection, borrower assistance, loan finance and servicing, student aid administration and contributions, and other activities.

Also included in the business-type activities are funds related to the Student Aid and Fiscal Responsibility Act ("SAFRA"). SAFRA provides payments to federal student loan servicers operating in FFELP on January 1, 2010 to retain jobs at locations in the United States. Assets related to SAFRA are held by the Authority/Corporation and transferred to the Operating Fund quarterly to offset permissible job retention related costs. All SAFRA funds must be expended on or before September 30, 2012. As of September 30, 2012 all SAFRA funds except for $1,216 were utilized for allowable job retention related costs. The $1,216 was remitted back to the USDE prior to September 30, 2012.

The combined government-wide financial statements do not reflect fiduciary activities whose resources are not available to finance the Authority/Corporation's programs.

The Authority/Corporation's combined fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to state government entities, which provide that accounting systems be organized by funds to account for specific activities consistent with legal and operating requirements. The Authority/Corporation's governmental fund includes the activities of administering grant, scholarship, advance/loan programs and the work-study program for the Commonwealth of Kentucky and the Federal Government.

The Authority/Corporation's loan guarantee, default collection, borrower assistance, loan finance and servicing, student aid administration and contributions, and other business-type activities are presented as proprietary funds. Proprietary funds also include internal service funds, which are used to report activity that provides goods or services on a cost reimbursement basis predominantly to the Authority/Corporation's other business-type activities. The Authority/Corporation follows all applicable GASB pronouncements as well as Financial Accounting Standards Board pronouncements and Accounting Principles Board Opinions, issued on or before November 30, 1989 for its proprietary funds, unless those pronouncements conflict with or contradict GASB pronouncements.

Note B--Summary of Significant Accounting Policies--Continued

Fiduciary activities include private-purpose trust and agency funds administered by the Authority/Corporation pursuant to FFELP, the Trust and the Plan. The fiduciary fund financial statements are comprised of a statement of net assets and a statement of changes of net assets. Prepared using the economic resources measurement focus and the accrual basis of accounting, these statements reflect all of the assets, liabilities, revenues, expenses, gains and losses of the FSLRF, the Trust and the Plan.

The Authority/Corporation's Fiduciary Funds are held in a custodial capacity. Assets of the Trust are held by the Authority/Corporation on behalf of program participants. Assets of the Plan are held by the Authority/Corporation to offset future tuition obligations of participants.

Cash and Cash Equivalents - The Authority/Corporation considers cash and cash equivalents to include highly liquid investments, which mature within one month or less of purchase.

Investments - Investments for all funds consist primarily of securities of the federal government or its agencies, corporate bonds, commercial paper collateralized mortgage obligations and mutual funds, which are stated at fair market value. Fair market value is determined by using quoted market prices as of the last day of the fiscal year.

The Plan maintains a separate investment policy. On June 28, 2012, a change to the target asset allocation was approved and later implemented in August 2012. The target asset allocations in effect as of June 30 and August 2012 are as follows:

	Effective June 30, 2012	Effective August 2012
Large Cap U.S. stocks	45%	37%
Small/Midcap U.S. stocks	10%	
Mid Cap U.S. stocks		6%
Small Cap U.S. stocks		5%
Non-U.S. stocks	5%	9%
Total Equity	60%	57%
Inflation indexed bonds	25%	7%
Corporate bonds	15%	
Domestic fixed income		36%
Total Fixed Income	40%	43%

Note B--Summary of Significant Accounting Policies--Continued

To decrease overall investment risk, the following restrictions apply to the Plan's investments:

i. No more than 5% of the total amount of the equity portion of the investment account in the securities of any one issuer;

ii. No more than 25% of the total amount of the equity portion of the investment account in any one industry, as defined by Standard & Poors;

iii. For portfolios invested in major-market countries, no more than 25% of the total amount of the equity portion of the investment account in any one country with the exception of those countries whose weighting in the Europe, Australia, and Far East ("EAFE") index is greater than 25%, where a maximum weight of the current country weight in the EAFE benchmark plus 10% is permitted;

iv. For portfolios invested in emerging markets, no more than 20% of the equity portion of the investment account shall be invested in one country;

v. A minimum of eight countries shall be represented in each investment account; and

vi. No more than 10% of the total amount of the fixed-income portion of the investment account shall be committed to the securities of any one issuer at the time of purchase, with the exception of securities issued or guaranteed by the full faith and credit of the United States of America or AAA-related securities issued by government agencies as to which there is no limit.

Under the Kentucky Revised Statutes, the Authority/Corporation's Board of Directors is charged with selecting the various options in which the participants of the Trust can invest their funds. An individual participating in the Trust establishes an account in the name of a Beneficiary. Contributions can be made among six investment options: the Managed Allocation Option, the Fixed Income Option, the Balanced Option, Equity Index Option, Active Equity Option and the Guaranteed Option.

Contributions in the Managed Allocation Option are allocated among six age bands, based on the age of the beneficiary. Each age band invests in varying percentages in the Institutional Class of the International Equity, International Equity Index, Large-Cap Value Index, Large-Cap Growth Index, S&P 500 Index, Mid-Cap Growth, Small-Cap Equity, Mid-Cap Value, Short-Term Bond, Bond Index, Large-Cap Growth, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities, Emerging Market Equity, Emerging Market Equity Index and Money Market Funds of the TIAA-CREF Institutional Mutual Funds.

<u>Teacher and Osteopathic Medicine Scholarship Loan and Advances</u> - Teacher Scholarship advances to students may be repaid via eligible service credits granted for specified teaching in primary or secondary schools. The disbursements are recorded as advances and charged to program benefits over the period that the teaching service is performed. If the teaching requirements are not satisfied, the advances are converted to loans, which are repayable with interest.

Note B--Summary of Significant Accounting Policies--Continued

Osteopathic medicine scholarship advances to students may be repaid via eligible service credits granted for working as a doctor in Kentucky. The expenditures are recorded as advances and charged to program benefits over the period that the medical services are provided. If the medical requirements are not satisfied, the advances are converted to loans, which are repayable with interest.

Fixed Assets, Net - Fixed assets are stated at cost, less accumulated depreciation. Fixed assets are depreciated beginning when the assets are placed in service and continuing over the estimated useful lives of the respective asset using the straight-line method.

Defaulted Student Loans - All collections on defaulted loans are recorded as income when received. The portion of collections due to the federal government is treated as a contra-revenue. Federal defaulted loans outstanding are accounted for by the Authority/Corporation but are not presented on the accompanying combined statement of net assets.

Allowance for Uncollectible Loans - As discussed in Note A, most FFELP loans held by the Authority/Corporation are insured by guarantee agencies and the USDE. Management of the Authority/Corporation believes that all of the respective guarantee agencies and the USDE will be able to honor all loan claims submitted. However, the Authority/Corporation records a provision for loan losses based upon its expected default claims with respect to 98% and 97% insured loans and for loans with certain loan servicing violations. The allowance for loan loss on all loans funded through normal operations was $3.6 million for loan principal and $441,000 for accrued interest as of June 30, 2012. Furthermore, the Authority/Corporation is required to purchase loans owned by third party customers with certain loan servicing violations. As of June 30, 2012, the allowance for third party servicing loan losses for loans that have been purchased was $1.5 million for loan principal and $510,000 for accrued interest. In addition, the Authority/Corporation records a provision for loan loss related to Teacher and Osteopathic Medicine advances that have converted to loans. As of June 30, 2012, the allowance for advances converted to loans was $3.6 million.

Interest Income on Loans - The Authority/Corporation earns interest income on loans from the following three sources: (1) subsidized interest from USDE earned while certain students are in school, in grace or in deferment status; (2) special allowance from USDE (discussed in Note G); and (3) borrower interest. All interest is recorded when earned and is shown in the combined financial statements net of the interest related portion of the provision for loan losses.

Servicing Fees - The Authority/Corporation's fees for servicing loans held by third parties are recorded as servicing fee revenue when earned.

Third party loans serviced by the Authority/Corporation are not presented on the combined statement of net assets, as they are not owned by the Authority/Corporation.

Note B--Summary of Significant Accounting Policies--Continued

<u>Deferred Loan Purchase Premium and Deferred Loan Origination Costs</u> - Loan purchase premiums and certain origination costs are deferred and amortized over the estimated life of the loans acquired or originated, based on projected balances outstanding, which approximates the effective interest method.

<u>Deferred Debt Issuance Costs</u> - Debt issuance costs are deferred and amortized over the life of the bonds, utilizing the bonds outstanding method, which approximates the effective interest method.

<u>Deferred Gain on Early Retirement of Debt</u> - In accordance with GASB No. 23, *Accounting and Financial Reporting of Debt Reported by Proprietary Activities*, the Authority/Corporation defers any gains on the early retirement or refinancing of debt over the shorter of the remaining life of the old debt or the life of the new debt.

<u>Income Taxes</u> - The Authority is a state government agency established by the Kentucky General Assembly and the Corporation is an independent *de jure* municipal corporation and political subdivision of the Commonwealth of Kentucky, therefore they are not subject to federal or state income taxes. The Trust and the Plan are state sponsored IRC Section 529 education savings plans and therefore, are also not subject to federal or state income taxes.

<u>Use of Estimates</u> - Generally Accepted Accounting Principles in the United States (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

<u>Interfund Eliminations</u> - Interfund receivables and payables are eliminated in the governmental and business-type activities column of the combined government-wide statement of net assets. Net residual amounts due between governmental and business-type activities are reflected as receivable (payable) for internal balances. Amounts reported in funds as receivable from or payables to fiduciary funds are reflected in the combined government-wide statement of net assets. Eliminations are made in the combined government-wide statement of activities to remove the doubling-up effect of internal service fund activity.

<u>Program Revenues</u> - Program revenues are reported in two categories including (1) charges for services and (2) program-specific operating grants and contributions. Charges for services include revenues received in the form of fees and charges for the Authority/Corporation loan guarantee, default collection, interest income the corporate loan finance and servicing activities, and other activities.

Program-specific operating grants and contributions include revenues from mandatory and voluntary non-exchange transactions with other governments and organizations that are restricted for use in a particular program. Program-specific operating grant and contribution services include the interest earned on scholarship loans.

Note B--Summary of Significant Accounting Policies--Continued

Contribution Receivable - As discussed in Note A, participants in the Plan may elect to make payments on executed tuition contracts over a specific period. Contributions receivable are recorded at their net realizable value in the period in which a tuition contract is purchased. A finance charge of 7.25% per annum of the outstanding balance is charged to participants who enrolled in the Plan during fiscal year 2005.

Tuition Benefits and Other Payable **-** Tuition benefits payable are reported at the actuarial net present value of estimated future benefits to be paid on behalf of participants of the Plan. The reported amount reflects actuarial assumptions, including anticipated tuition and fee increases, expected investment earnings, and refunds and other terminations.

Indirect Costs **-** Indirect costs are allocated among functions/programs utilizing a full cost allocation approach with the objective of allocating all expenses to the Authority/Corporation's various functions and programs.

Risk Management - The Authority/Corporation is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage against various risks of loss is obtained through participation in the State of Kentucky's Risk Management Fund, State Sponsored Group Insurance Fund, and policies purchased from outside insurance corporations.

Restricted Net Assets - Restricted net assets are comprised of net assets with legal or contractual restrictions and thus cannot be used in operations of the Authority/Corporation.

Unrestricted Net Assets - Unrestricted net assets are comprised of net assets available to be used in operations or transfers of the Authority/Corporation.

Subsequent Events - In preparing these combined financial statements, the Authority/Corporation has evaluated events and transactions for potential recognition or disclosure through October 9, 2012, the date the financial statements were available to be issued.

Note C--Cash and Investments

The Authority/Corporation has adopted provisions of GASB Statement No. 40, *Deposits and Investment Risk Disclosures*. This statement adds certain additional disclosures about cash and investments, including common areas of investment risk.

The Authority/Corporation's operating funds and investments comply with the Operating Funds Investment Policy. The policy permits investments in bank time deposits, certificates of deposit, commercial paper, asset-backed commercial paper, bankers acceptance and floating-rate notes with a coupon reset of 30 days or less, direct obligations of the United States of America (which are unconditionally guaranteed by the United States of America), indebtedness issued by certain Federal agencies, U.S. dollar denomination corporate bonds and obligations of foreign governments, asset-backed securities, and taxable and tax-exempt municipal bonds. All securities must have a minimum rating of investment grade BBB or better by a nationally recognized credit rating agency at the time of purchase. Money market instruments must be rated A-1 or P-1 or better at the time of purchase. An average rating of A must be maintained by the total portfolio.

The investments in the Authority/Corporation's Education Finance Funds comply with the underlying bond resolution and indenture requirements, as applicable. In accordance with those requirements, all deposits and investments meet the requirements and approval of bond underwriters and rating agencies. Additionally, such requirements mandate specific classes of investment vehicles including bank time deposits, certificates of deposit, direct obligations of the United States of America (which are unconditionally guaranteed by the United States of America), indebtedness issued by certain Federal agencies, collateralized repurchase agreements or investment funds secured by obligations of the United States of America with collateral held by or at the direction of the trustee.

Note C--Cash and Investments--Continued

Custodial Credit Risk and Interest Rate Risk - Custodial credit risk is the risk that in the event of a bank failure, the Authority/Corporation's deposits may not be returned to it. The Authority/Corporation's investment policy does not contain a requirement for the collateralization of cash and investments nor does it require investments to be maintained in the Authority/Corporation's name. As of June 30, 2012, no custodial credit risk exists for any of the Authority/Corporation's Proprietary Funds, Governmental Fund and Fiduciary Funds. Bank balance cash on deposit is as follows:

Of the $145.8 million of cash and cash equivalents maintained in the Proprietary Funds, $26.6 million was held for guarantee operations and the remaining $119.2 million was held for loan finance and servicing activities.

As of June 30, 2012, the FSLRF maintained money market securities of $2 million held in a trust by Bank of New York Mellon.

	Governmental Fund Bank Balance	Proprietary Fund Bank Balance	Fiduciary Fund Bank Balance
FDIC Insured	$	$ 5,009,166	$ 2,930,477
Collateralized by securities held by the pledging financial institution			10,665,771
Money market demand deposits		238,606	
Money market securities		136,934,032	2,138,554
Cash deposited with Kentucky State Treasurer	623,276	3,610,664	64,550
	$ 623,276	$ 145,792,468	$ 15,799,352

Note C--Cash and Investments--Continued

As of June 30, 2012, all Proprietary Funds investments were registered in the Authority/Corporation's name and maintained by an external trustee. The investment balances as of June 30, 2012 are summarized as follows:

	Fair Value	Weighted Average Maturity (in years)
Corporate bonds	$ 16,834,411	2.87
U.S. Treasury and government agency securities	12,385,057	1.79
Collateralized mortgage obligations	9,592,404	7.68
	$ 38,811,872	

As of June 30, 2012, Trust investments of $136.6 million comprised entirely of TIAA mutual funds.

As of June 30, 2012, Plan investments of $113.9 million comprised primarily of mutual funds held by State Street Global Advisors.

Investments are made based upon prevailing market conditions at the time of the transaction with the intent to hold the instrument until maturity. If the yield of the portfolio can be improved upon sale of an investment, prior to its maturity, with the reinvestment of proceeds, then this provision is also allowed.

Concentration of Credit Risk **-** The Authority/Corporation does not maintain investments in any one issuer that represents 5% or more of the total investment base, excluding investments issued or explicitly guaranteed by the U.S government and investments in mutual funds.

Credit Risk - The Authority/Corporation's investment policy limits the credit risk for securities. Securities must have a credit rating of BBB by a nationally recognized credit rating agency. Money Market Securities must be rated A-1 or P-1 or better at the time of purchase. The investment manager is allowed to hold up to 5% in aggregate market value securities that have been downgraded below BBB, but must maintain an average rating of A for the total portfolio. The following table summarizes the Standard & Poors / Moody's rating (as applicable) for all corporate bonds held by the Authority/Corporation's Proprietary Funds as of June 30, 2012:

Note C--Cash and Investments--Continued

Rating	Fair Value
AAA / Aaa	$ 7,771,747
AA / Aa	1,572,353
A / A	4,929,162
BAA / Baa	2,561,149
	$ 16,834,411

The Plan maintains an investment policy that limits the credit risk for fixed income securities and short-term commercial paper. No more than 10% of the total amount of fixed-income portion of the investment account shall be committed to the securities of any one issuer at the time of purchase, with the exception of securities issued or guaranteed by the full faith and credit of the United States or AAA-rated securities issued by government agencies as to which there is no limit. The Plan may invest in short-term commercial paper of any domestic issuer, maturing within 9 months, with a minimum rating of A-1 by Standard & Poors or Prime 1 by Moody's. As previously noted, at June 30, 2012 the Plan primarily invested in mutual funds.

Note D--Fixed Assets

A summary of fixed assets follows:

	Beginning Balance July 1, 2011	Additions	Disposals	Ending Balance June 30, 2012
Proprietary fund:				
Furniture and equipment	$ 18,922,142	$ 375,381	$ (1,136,961)	$ 18,160,562
Building	11,986,200			11,986,200
System development	55,955			55,955
Student loan servicing	541,131			541,131
Debt recovery system	710,509			710,509
Accumulated depreciation and amortization	(22,709,487)	(831,979)	1,136,795	(22,404,671)
	$ 9,506,450	$ (456,598)	$ (166)	$ 9,049,686
Fiduciary Fund:				
Furniture and equipment	491,922		(4,679)	487,243
Accumulated depreciation	(491,922)		4,679	(487,243)
	$	$	$	$

Depreciation and amortization expense totaled $831,979 for the year ended June 30, 2012, of which $665,233 was allocated to business-type activities, $155,365 allocated to governmental activities, and $11,381 allocated to the fiduciary activities.

Depreciation and amortization expense was allocated to the business-type activities functions as follows:

Loan guarantee operations	$ 384,377
Default collections	204,151
Loan finance and servicing	76,705
	$ 665,233

Note D--Fixed Assets--Continued

The Authority/Corporation has assets under capital lease agreements, as described in Note I, of $11,986,200 with related accumulated amortization of $3,683,921. Amortization of assets under capital lease is included in amortization expense in the accompanying combined financial statements. Amortization expense of assets under capital lease agreements was $399,540 for the year ended June 30, 2012.

Note E--Federal Family Education Loan Programs (Loan Guarantee Operations)

Pursuant to FFELP, the loan guarantee operating unit of Authority/Corporation insures eligible student loans for losses incurred from the default, death, disability, or bankruptcy and also insures for other losses such as school closures and false certifications. As of June 30, 2012, the outstanding balance of aggregate insured student loans was approximately $3.3 billion.

Loans insured by the Authority/Corporation are reinsured under FFELP by the federal government. Death, disability, bankruptcy, lender of last resort, and closed school claims are reinsured at 100%. Default claims are subject to the Authority/Corporation’s default claims rate (reimbursed default claims for the federal fiscal year divided by the original principal amount of loans in repayment at the beginning of the fiscal year).

The Authority/Corporation’s annual default claims rate is within the 5%, which allows for reimbursement rates at the highest level. Due to the reduction of the Federal reimbursement rate for loans made subsequent to October 1, 1993, the Authority/Corporation has recorded a reserve of $4.46 million at June 30, 2012 for losses on federal reinsurance.

The following schedule summarizes the reinsurance rates for guarantee agency paid default claims.

	Reimbursement Rate		
Annual Default Claims Rate	**Through September 30, 1993**	**October 1, 1993 through September 30, 1998**	**October 1, 1998 and After**
0% to 5%	100%	98%	95%
More than 5% up to 9%	90% of claims over 5% up to 9%	88% of claims over 5% up to 9%	85% of claims over 5% up to 9%
Over 9%	80% of claims over 9%	78% of claims over 9%	75% of claims over 9%

Note E--Federal Family Education Loan Programs (Loan Guarantee Operations)—Continued

The Authority/Corporation is entitled to charge certain fees associated with its reinsurance activities. A summary of those fees are as follows:

Rehabilitated Loans - The Authority/Corporation is entitled to retain 18.5% of principal and interest for rehabilitated loans, plus 18.5% of collection costs.

Consolidated Loans - For William D. Ford Consolidation, the Authority/Corporation is entitled to 10% collection costs (18.5% collected, less 8.5% rebate to USDE).

Recoveries Payable to Federal Government - The Authority/Corporation is entitled to retain 16% of defaulted loan collections received after October 1, 2007.

Account Maintenance Fees ("AMF") - The 1998 Amendments established an account maintenance fee based on 0.06% of the original principal amount of outstanding loans as of September 30. AMF is paid to the Authority/Corporation on a quarterly basis by the Federal government.

Default Aversion Fees ("DAF") - Default aversion fees were established under the 1998 Amendments. The Authority/Corporation receives DAF for its aversion activities on delinquent loans at the time lenders request default aversion assistance. DAF's are equal to 1% of principal and interest on the loan at the time the Authority/Corporation receives a request from a lender for preclaim assistance. DAF is recorded monthly and is recognized as a deduction in the FSLRF and as revenue in the AOF.

Note F--Loans (Finance and Servicing Operations)

The Authority/Corporation originates private supplemental loans, purchases loans and holds various types of student loans as described in Note A. The terms of these loans, which vary on an individual basis depending upon loan type and the date the loan was originated, generally provide for repayment in monthly installments of principal and interest over a period of up to thirty years for consolidation loans and generally up to ten years for other loans. The repayment period begins after a grace period of six months following graduation or loss of qualified student status for the Subsidized and Unsubsidized Stafford loans. The repayment period for Consolidation, SLS and PLUS loans begins within 60 days from the date the loan is fully disbursed. Statutory interest rates on student loans ranged from 1.76% to 10% for the fiscal year ended June 30, 2012 depending upon the type and date of origination of the individual loan. Actual rates may be lower due to interest rate reductions associated with payments via electronic funds transfer or for other reasons such as borrowers making a specified number of consecutive on-time payments.

Note F--Loans (Finance and Servicing Operations)--Continued

Loans consist of the following at June 30, 2012:

Stafford - Subsidized	$ 471,908,364
Stafford - Unsubsidized	492,343,205
PLUS/SLS	40,929,666
Consolidation	504,431,864
Other	5,466,347
Total gross loans	1,515,079,446
Allowance for loan losses	(5,106,699)
Loan rebate due to borrowers	(4,000,000)
Unamortized discount on purchase of loans	(766,320)
Loans, net	1,505,206,427
Less amount shown as current assets	188,657,342
Noncurrent loans, net	$ 1,316,549,085

All principal and accrued interest on FFELP student loans is insured against borrower death, disability, bankruptcy or default, as long as the Authority/Corporation performs all required loan servicing due diligence activities. As of June 30, 2012, $2,473,148 of student loans were no longer insured due to violations of due diligence requirements. Loan rebate due to borrowers represents the additional loan forgiveness described in Note H.

Prior to the elimination of FFELP, borrowers were required to pay certain origination fees to USDE, based on a percentage of the gross loan amount. These origination fees were typically withheld from the loan proceeds provided to the borrower and remitted to USDE on a quarterly basis. The Authority/Corporation sometimes elected to pay a portion or all of the origination fees on behalf of the borrower and therefore, would send the borrower an increased amount of loan proceeds, but was still required to remit the full amount of origination fees to USDE. All origination fees paid on behalf of the borrower, totaling $57,293,719, were capitalized as deferred origination costs and amortized over the estimated life of the loan. The remaining unamortized balance at June 30, 2012 is $6,498,189.

The Authority/Corporation was also required to pay to USDE certain lender fees. The amount of the lender fees was based on a certain percentage of the gross loan amount on all FFELP loans originated after October 1, 1993. Lender fees, totaling $22,500,643, were capitalized as deferred origination costs and amortized over the estimated life of the loan. The remaining unamortized balance at June 30, 2012 is $2,165,287.

Generally, all student loans in the Education Finance Funds of the Authority/Corporation are pledged as collateral for the various obligations of the Authority/Corporation.

Note G--Special Allowance

The Higher Education Act of 1965 provides for quarterly Special Allowance Payments to be made by USDE to holders of student loans to the extent necessary to ensure that they receive at least specified market interest rates of return. Certain FFELP loans disbursed during the period from January 1, 2000 through June 30, 2010 received special allowance at a rate based upon the average of the bond equivalent rates of the three-month commercial paper rate as reported by the U.S. Federal Reserve through March 31, 2012. Pursuant to a December 23, 2011, amendment to the Higher Education Act, the Authority/Corporation elected to change the index for special allowance calculations on its FFELP loans disbursed after January 1, 2000, from the three-month commercial paper (CP) rate to the one-month LIBOR index beginning on April 1, 2012. Other eligible loans receive special allowance based on the 91-day Treasury bill rates. The special allowance is accrued as either earned or payable, as applicable.

Note H--Loan and Other Forgiveness

During fiscal year 2012, the Authority/Corporation forgave $3.6 million in loan principal and accrued interest for teachers funded by USDE, and an additional $2.05 million in loan forgiveness for teachers funded by the Commonwealth of Kentucky. Also, during fiscal year 2012, the Authority/Corporation provided additional loan forgiveness of $1,560,462.

The Authority/Corporation's Board of Directors approved $4 million of additional loan forgiveness for teachers, nurses and public service attorneys who were employed in the Commonwealth, which was accrued as of June 30, 2012 and is scheduled to be provided in the fall of 2012.

The Agency Operating Fund of the Authority/Corporation contributed $2,874,310 to the Federal Student Loan Reserve Fund during fiscal year 2012. The contribution was facilitated through a reduction in the receivable/payable between the two funds.

Note I--Capital Lease Payable

On June 22, 2000, the Commonwealth of Kentucky, State Property and Building Commission (the "Commission") issued $8,825,000 in bonds payable on behalf of the Authority/Corporation. The proceeds of the bonds are used to house the Authority/Corporation's operations located in Frankfort, Kentucky. On October 8, 2003, the Commission issued additional bonds payable on behalf of the Authority/Corporation as a partial refunding of original bonds payable.

The original bonds had a final principal payment in May 2010. The new bonds bear interest at fixed rates which vary from 2.0% to 5.25% and have a maturity date of May 2020. The bonds are special and limited obligations of the Commission. The bonds do not constitute a debt, liability or obligation of the Commonwealth of Kentucky or a pledge of the full faith and credit or taxing power of the Commonwealth of Kentucky, but are payable solely from amounts derived from the biennially renewable lease agreement with the Authority/Corporation as described below. The bondholders have no security interest in any properties constituting the project or any amounts derived there from. The scheduled payments of principal and interest on the bonds are guaranteed under an insurance policy.

Note I--Capital Lease Payable--Continued

In connection with the issuance of the bonds, the Authority/Corporation entered into a financing/lease agreement with the Commission whereby the Authority/Corporation agreed to lease the newly constructed building. The Authority/Corporation renewed the lease for the biennium ending June 30, 2014 and has the right to renew for three additional two-year periods.

The Authority/Corporation can cancel the lease on the last business day in May immediately preceding the beginning of any renewal term.

The lease payments are equal to the debt service required by the bond indenture. In connection with the agreements, the Kentucky General Assembly appropriated sufficient spending authorization to the Authority/Corporation to pay the lease payments required through June 30, 2014. There can be no assurance to make rent payments past the two-year lease period.

A summary of the activity for the capital lease for the year ended June 30, 2012 is as follows:

	June 30, 2011	Additions	Payments	June 30, 2012
Capital Lease Payable	$ 5,265,000		$ 480,000	$ 4,785,000

Debt service requirements for the next five fiscal years and thereafter are as follows:

Year Ending June 30,	Principal	Interest
2013	$ 500,000	$ 244,905
2014	525,000	219,905
2015	550,000	192,342
2016	580,000	164,592
2017	610,000	135,268
Three Years Ending June 30,		
2018 - 2020	$ 2,020,000	$ 212,950
	$ 4,785,000	$ 1,169,962

Note J--Revenue Bonds and Notes Payable

The balance of revenue bonds and notes payable at June 30, 2012 and the related activity for the year ended June 30, 2012 is as follows:

Series		Scheduled Maturity	Auction Rate Period	Beginning Balance July 1, 2011	Bond Maturities & Refundings	New Issues	Ending Balance June 30, 2012
1983 General Bond Resolution							
2008A		November 15, 2011	Quarterly	$ 100,000	$ (100,000)	$	$
1997 General Bond Resolution							
1997 A-1		May 1, 2027	Every 35 days	11,950,000			11,950,000
1997 A-2		May 1, 2027	Every 35 days	36,550,000			36,550,000
1997 B	*	May 1, 2027	Every 35 days	23,900,000			23,900,000
1998 A-1		May 1, 2028	Every 28 days	36,400,000			36,400,000
1998 A-2		May 1, 2028	Every 28 days	36,400,000			36,400,000
1998 B	*	May 1, 2028	Every 35 days	42,150,000			42,150,000
1999 A		May 1, 2029	Every 28 days	39,900,000			39,900,000
1999 B	*	May 1, 2029	Every 35 days	23,550,000			23,550,000
2000 A-1		May 1, 2030	Every 28 days	23,500,000			23,500,000
2000 A-2		May 1, 2030	Every 28 days	36,100,000			36,100,000
2000 A-3		May 1, 2030	Every 35 days	38,950,000			38,950,000
2000 B	*	May 1, 2030	Every 35 days	3,750,000			3,750,000
2001A-1		May 1, 2031	Every 35 days	49,100,000	(1,700,000)		47,400,000
2001A-2		May 1, 2031	Every 35 days	47,350,000			47,350,000
2001B	*	May 1, 2031	Every 35 days	28,600,000	(28,600,000)		
2002 A-1		May 1, 2032	Every 28 days	31,600,000			31,600,000
2002 A-2		May 1, 2032	Every 35 days	36,150,000	(16,000,000)		20,150,000
2002 A-3	*	May 1, 2032	Every 35 days	36,600,000			36,600,000
2003 A-1	*	May 1, 2033	Every 35 days	20,650,000	(250,000)		20,400,000
2008 Indenture							
2008 A-1	*	June 1, 2037	Weekly	136,870,000	(12,810,000)		124,060,000
2008 A-2	*	June 1, 2038	Weekly	69,755,000	(6,230,000)		63,525,000
2008 A-3		June 1, 2038	Weekly	37,075,000	(3,090,000)		33,985,000
2010 Indenture							
2010 A-1	*	May 1, 2020	Quarterly	52,600,000	(19,360,000)		33,240,000
2010 A-2	*	May 1, 2034	Quarterly	135,660,000			135,660,000
ED Conduit Program							
		January 19, 2014	Weekly	616,557,201	(94,176,547)		522,380,654
				$ 1,651,767,201	$ (182,316,547)	$	$ 1,469,450,654

*This bond series is tax-exempt.

Continued

Note J--Revenue Bonds and Notes Payable--Continued

The Authority/Corporation's revenue bonds include variable rates of interest based on various index rates. Those variable rates ranged from 0% to 4.02% as of June 30, 2012.

Debt service requirements to maturity or redemption date, assuming interest rates based on variable index rates at June 30, 2012, are as follows:

	Principal Repayment Amount (Thousands)				
	1997 GBR	2008 Indenture	2010 Indenture	ED Conduit Program	Total
Year Ending June 30, 2013	$	$	$	$	$
4 Years Ending June 30, 2017				522,381	522,381
5 Years Ending June 30, 2022			33,240		33,240
5 Years Ending June 30, 2027	72,400				72,400
5 Years Ending June 30, 2032	463,800				463,800
5 Years Ending June 30, 2037	20,400	124,060	135,660		280,120
1 Years Ending June 30, 2038		97,510			97,510
	$ 556,600	$ 221,570	$ 168,900	$ 522,381	$1,469,451

	Interest Payments Amount (Thousands)				
	1997 GBR	2008 Indenture	2010 Indenture	ED Conduit Program	Total
Year Ending June 30, 2013	$ 6,722	$ 534	$ 2,573	$ 1,306	$ 11,135
Year Ending June 30, 2014	6,722	534	2,573	1,306	11,135
Year Ending June 30, 2015	6,722	534	2,573		9,829
Year Ending June 30, 2016	6,722	534	2,573		9,829
Year Ending June 30, 2017	6,722	534	2,573		9,829
5 Years Ending June 30, 2022	33,612	2,672	12,225		48,509
5 Years Ending June 30, 2027	33,612	2,672	11,266		47,550
5 Years Ending June 30, 2032	18,993	2,672	11,266		32,931
5 Years Ending June 30, 2037	106	2,672	4,507		7,285
1 Years Ending June 30, 2038		293			293
	$ 119,933	$ 13,651	$ 52,129	$ 2,612	$ 188,325

Note J--Revenue Bonds and Notes Payable--Continued

The Authority/Corporation entered into an irrevocable direct pay Letter of Credit and Reimbursement Agreement with two banks relating to the Series 2008 Bonds in the amount of $300,000,000 issued on June 18, 2008. The Letter of Credit was issued in an amount (the "Original Stated Amount") equal to the sum of (i) the aggregate principal amount of the outstanding Series 2008A-1 Bonds and the Series 2008A-2 Bonds, plus an amount equal to 202 days of interest thereon at a rate of 14% per annum plus (ii) the aggregate principal amount of the outstanding Series 2008A-3 Bonds, plus an amount equal to 51 days of interest thereon at a rate of 18% per annum. At June 30, 2012, there was no balance nor has there been activity on the letter of credit. The letter of credit had an original maturity date of June 17, 2011. The Authority/Corporation and the banks extended the Stated Expiration Date as defined in the letter of credit to October 14, 2011. On September 8, 2011, the Stated Expiration Date as defined in the letter of credit was extended to September 13, 2013.

All assets of the 1997 General Bond Resolution Fund, the 2008 Indenture, the 2010 Indenture, and the Department of Education ("ED") Conduit Program are pledged for repayment of the specific bond or note issues under each resolution or program.

Note K--Lines of Credit and Other Financing

The Authority/Corporation maintains a line of credit agreement with a commercial bank (the "Bank"). The agreement provides for a commitment amount not to exceed the lesser of $30 million or the combined cash and investments maintained at the Bank, adjusted for asset class factors. The operating cash and investments are pledged as collateral against outstanding balances. The outstanding balance bears interest at the Authority/Corporation's choice of the Bank's prime rate or the London Interbank Offering Rate ("LIBOR") plus .50%. The agreement expires on December 18, 2012. As of June 30, 2012, there was no outstanding balance on the agreement.

Note L--Allowance for Arbitrage Liabilities

Certain of the Authority/Corporation's tax-exempt bond issues are subject to potential arbitrage liabilities under U.S. tax law. Arbitrage liabilities, under current federal income tax law regarding tax-exempt bond issues, consist of three types; (1) yield adjustment payments, (2) forgiveness and (3) arbitrage rebate. At June 30, 2012, the Authority/Corporation is reporting a liability for arbitrage rebate of $215,211.

The determination of excess yield on acquired purpose investments is cumulative over the life of the applicable bond series, as is the determination of arbitrage rebate on non-purpose investments, except for variable rate bonds for which arbitrage rebate is generally determined for each five-year period without retroactivity.

Note L--Allowance for Arbitrage Liabilities--Continued

Yield adjustment payments, which also relate to yield restriction on acquired purpose investments, are applicable to all tax exempt bonds. The allowable yield is 2% above the bond yield (arbitrage yield), with the federal special allowance included in income. The loss of tax-exempt status may be avoided by rebating the excess yield to the U.S. Treasury every 10 years, and upon final maturity of the bonds.

Forgiveness is applicable to all tax exempt bonds. In general, a yield restriction is imposed on acquired purpose investments, designating the allowable yield as 2% above the bond yield (arbitrage yield). The loss of tax-exempt status may be avoided by partial forgiveness of the applicable student loans. Forgiveness can be applied upon maturity of the bonds or as otherwise prescribed by the bond resolutions.

Arbitrage rebate is applicable to all of the Authority/Corporation's tax-exempt bonds. With certain limited exceptions, income earned on non-purpose investments (investments other than student loans) which exceeds the bond yield (arbitrage yield), must be rebated to the U.S. Treasury. Payments of at least 90% are due every five years after the year of issuance, and upon final maturity of bonds.

The estimate of the Authority/Corporation's arbitrage liability is computed by an outside company who specializes in this area.

See the Authority/Corporation's Subsequent Event footnote S disclosure concerning the voluntary closing agreement request relating to certain tax-exempt obligations issued by the Authority/Corporation, pursuant to IRS Announcement 2012-14, 2012-14 I.R.B. 721, titled *TEB Voluntary Closing Agreement Program: Relief from Allocation and Accounting Errors for Certain Issuers of Tax-Exempt Student Loan Bonds* (the "Announcement").

Note M--Deferred Gain on Retirement of Debt

In fiscal year 2010, the Authority/Corporation purchased $1.198 billion of its own auction rate securities, and retired the debt. The resulting $80.2 million of gain was deferred and is being amortized over the life of the new debt. The Authority/Corporation recognized a gain of $18.5 million for the year ended June 30, 2012. The Authority/Corporation retired additional debt during fiscal year 2012 with cash and recognized approximately $3.5 million as income in the current period.

Note N--Retirement Plans

The Authority/Corporation provides retirement benefits to all full-time employees through the Kentucky Employee Retirement System ("KERS"). KERS is a multiple-employer, defined benefit plan sponsored by the Commonwealth of Kentucky, which provides retirement, disability and death benefits. The Authority/Corporation contributed 19.82% of gross wages for the year ended June 30, 2012. The employees contributed up to 6% of their gross wages to the plan for the year ended June 30, 2012. Such rates are intended to provide for normal costs on a current basis, plus an amount equal to the amortization of unfunded past service costs over thirty years, using the level percentage of payroll method. These contribution rates are determined by the Board of Trustees of KERS each biennium. The payroll of employees covered by the retirement plan was $13,643,802 for the year ended June 30, 2012. Total payroll for the year ended June 30, 2012 was $13,938,966. KERS participants have fully vested interests after the completion of sixty months of service, twelve months of which are current service. The KERS contribution requirement for the year ended June 30, 2012 was $3,358,652 which consisted of employer contributions of $2,674,236 and $684,416 from employees. Employer contributions for the years ended June 30, 2011 and 2010 were $2,455,542 and $1,861,656, respectively.

Although separate measurements of assets and pension benefit obligation are not available for individual employers, the Kentucky Retirement Systems' annual financial report (which is a matter of public record) contains this information for the Kentucky Retirement Systems as a whole. It may be obtained from the Kentucky Retirement Systems by writing to them at 1260 Louisville Road, Perimeter Park West, Frankfort, Kentucky 40601.

Note O--Tuition Benefit Payable

The following assumptions developed by management were used in the actuarial valuation of tuition benefits payable as of June 30, 2012. These assumptions are based on historical data for both state and national trends.

Investment Rates - The investment yield assumption is based on estimates of the yields that will be available on the investment portfolio and cash and cash equivalents. The gross investment yield assumption utilized in the calculation of the tuition benefit payable as of June 30, 2012 and June 30, 2011 was 6.25% and 6.56%, respectively.

Investment Expenses - The investment expense is assumed to be 20 basis points on all invested assets.

Note O--Tuition Benefit Payable--Continued

Tuition Increases - Tuition increases are based on the known increases for the next academic year and best estimates of future tuition increases for Kentucky's public colleges and universities. The historical tuition increases are as follows:

- The tuition increases for the 2003-2004 academic year were 23.4% for the Value Plan and 14.4% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2004-2005 academic year were 24.2% for the Value Plan and 16.9% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2005-2006 academic year were 6.5% for the Value Plan and 12.5% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2006-2007 academic year were 11.2% for the Value Plan and 12% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2007-2008 academic year were 5.5% for the Value Plan and 9.0% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2008-2009 academic year were 5.2% for the Value Plan and 9.0% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2009-2010 academic year were 3.3% for the Value Plan and 5.0% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2010-2011 academic year were 4.0% for the Value Plan and 6.0% for the Standard Plan and the Premium Plan.
- The tuition increases for the 2011-2012 academic year were 3.8% for the Value Plan and 6.0% for the Standard Plan and the Premium Plan.
- As of June 30, 2012, the tuition increases for the 2012-2013 academic year were 3.8% for the Value Plan and 6% for the Standard Plan and the Premium Plan. The tuition increase assumption was 6.75% for the 2012-2013 academic year and 6.75% for each year thereafter.

Note O--Tuition Benefit Payable--Continued

For the period from inception to June 30, 2012, the annualized tuition increase for the highest-priced Kentucky public university, as applicable to the tuition benefits payout rate of Kentucky's Affordable Prepaid Tuition Standard Plan, which represents 92.3% of the Plan's enrollments, has been 9.3%. For the Kentucky Community and Technical College System ("KCTCS"), as applicable to the tuition benefits payout rate of the Value Plan, the average annualized tuition increase from inception to June 30, 2012, has been 11.95%. For the University of Kentucky, as applicable to the tuition benefits payout rate of the Premium Plan, the average annualized tuition increase from inception to June 30, 2012 has been 11.11%.

<u>Payment of Tuition and Mandatory Fees</u> - Payments of tuition and mandatory fees are assumed to be 128 credit hours of utilization and payments occur twice annually.

Note P--Restricted Net Assets

The following categories of restricted net assets are included in the combined statement of net assets for the following purposes:

a. **Federal Student Loan Reserve Fund:** Net assets are restricted for certain FFELP activities, primarily the payments of claims.

b. **Agency Operating Fund:** Net assets are restricted for certain FFELP activities and other student aid activities.

c. **Education Finance Funds:** Net assets are restricted as required by the 1997 General Bond Resolution Fund, the 2008 Indenture, the 2010 Indenture and the ("ED") Conduit Program**.**

d. **Corporation Operating Fund:** Net assets are restricted for an estimated amount of mandatory repurchases of loans subject to bankruptcy claims.

e. **Student Aid Funds:** The Student Aid net assets are restricted for the Student Aid Programs.

f. **The Trust:** Net assets are restricted for use by trust participants.

Note Q--Operating Leases

The Authority/Corporation leases office space and equipment under agreements expiring through 2022. Rental expense was $1,930,451 for the year ended June 30, 2012. Minimum future rental payments for real estate and equipment, including common area maintenance commitments, at June 30, 2012 are as follows:

Year Ending June 30,	
2013	$ 1,897,815
2014	1,265,262
2015	647,394
2016	647,394
2017	651,592
Five Years Ending June 30,	
2018 - 2022	3,430,713
	$ 8,540,170

Note R--Commitments and Contingencies

The FSLRF is contingently liable for loans made by financial institutions that qualify for guarantee. The default ratio for loans guaranteed by the Authority/Corporation's loan guarantee operations is below 5% for the fiscal year ended June 30, 2012. The federal government's reinsurance rate for defaults for the fiscal year ending September 30, 2012, is 100% for loans made prior to October 1, 1993, 98% for loans made on or after October 1993 to September 30, 1998, and 95% for loans made after September 30, 1998. In the event of future adverse default experience, the FSLRF could be liable for up to 25% of defaulted loans. At the beginning of each fiscal year, the reinsurance rate returns to baseline (100%, 98% or 95%); management does not expect that all guaranteed loans could default in one year.

While management believes the FSLRF's expected maximum contingent liability is less than 25% of outstanding guaranteed loans, the maximum contingent liability at June 30, 2012 is calculated as follows:

Amount of guaranteed student loans outstanding at lenders	$ 3,323,727,620
Less minimum federal government share - 75%	2,492,795,715
	$ 830,931,905

Kentucky Higher Education Assistance Authority
Kentucky Higher Education Student Loan Corporation

June 30, 2012

Note R--Commitments and Contingencies--Continued

In August of 2009, the Authority/Corporation was served with a copy of a First Amended Complaint in the matter of *Jon H. Oberg v. Nelnet, Inc., et al.,* Civil No. 1:07-cv-960, pending in the United States District Court for the Eastern District of Virginia. This is a Federal False Claims Act ("FCA") case filed by a former employee of USDE. The matter was originally filed under seal in 2007, and the plaintiff was not permitted to serve the defendants until August 2009. USDE elected not to intervene in the prosecution of the action. In short, the plaintiff alleged that the Authority/Corporation and the other named defendants illegally submitted claims for the 9.5% floor loan special allowance payments in violation of applicable law and regulatory guidance.

Separately, on May 28, 2009, the Authority/Corporation received a final audit report from the Office of Inspector General ("OIG") titled "*Special Allowance Payments to the Kentucky Higher Education Student Loan Corporation for Loans Made or Acquired with Proceeds of Tax-Exempt Obligations.*" The Authority/Corporation submitted its comments to Federal Student Aid ("FSA") within 30 days as requested. Subsequently, FSA has requested additional information related to the audit on four separate occasions as recent as May 2012. Regarding the audit, one of the three findings has been resolved. The primary outstanding finding is entitled, "KHESLC Used Ineligible Refunding Obligations to Support Loans Billed Under the 9.5 Percent Floor". The amount that the OIG recommended that the Authority/Corporation repay under this finding was approximately $9 million. While the Authority/Corporation is unable to predict the ultimate outcome of this audit, the Authority/Corporation believes its practices complied with applicable law, including the provisions of the Higher Education Act, the rules and regulations adopted by USDE thereunder, and USDE's guidance regarding those rules and regulations. These practices were reviewed by FSA in October 2005. On May 11, 2006, FSA issued its final "Tax-Exempt Review Report" related to the October 2005 review. That review included an assessment of the Authority/Corporation's 9.5 percent floor billings associated with tax-exempt obligations originally issued before October 1, 1993. The final "Tax-Exempt Review Report" contained no findings related to that specific issue.

As for the lawsuit, on December 1, 2009, the trial court granted to the Authority/Corporation as well as to the three other state-related defendants their motion to dismiss the lawsuit as to all of the state-related defendants. Subsequently, the other, non-state related defendants settled and on November 18, 2010, a Final Order was entered in this matter. Thereafter, the plaintiff filed a Notice of Appeal on November 22, 2010. The previously dismissed state-related defendants filed their briefs with the United States Court of Appeals for the Fourth Circuit on April 12, 2011. The appeal was argued on May 17, 2012. On June 18, 2012, the United States Court of Appeals for the Fourth Circuit vacated the judgment of the lower district court and remanded the case back to the district court to apply the arm-of-the-state analysis in determining whether the Authority/Corporation and other appellees are state agencies subject to suit under the FCA. Management vigorously contests this matter and, as of June 30, 2012, does not believe a loss contingency exists.

Note S--Subsequent Events

On July 31, 2012, the Authority/Corporation submitted a request (the "Request") to the Internal Revenue Service (the "IRS") for a voluntary closing agreement (a "VCA") relating to certain tax-exempt obligations issued by the Authority/Corporation ("Tax-Exempt Bonds"), pursuant to IRS Announcement 2012-14, 2012-14 I.R.B. 721, titled *TEB Voluntary Closing Agreement Program: Relief from Allocation and Accounting Errors for Certain Issuers of Tax-Exempt Student Loan Bonds* (the "Announcement").

In the Request the Authority/Corporation stated that, although it does not intend its submission of the Request or its entry into any resulting VCA, to constitute an agreement or admission by the Authority/Corporation that it has violated federal tax requirements applicable to the Subject Bond Issues, the Authority/Corporation is submitting the Request to remove any doubt that has been raised by the release of the Announcement concerning the status of the Subject Bond Issues and to obtain resolution of any liability under the Code with respect to student loans that are or may be allocated to the Subject Bond Issues.

The settlement provisions proposed in the Request would include a payment to be made by the Authority/Corporation upon entry into the VCA, and the adoption by the Authority/Corporation of certain administrative procedures. The terms of the Announcement provide that such a settlement payment may not be funded from certain proceeds of Tax-Exempt Bonds. Any payments that the Authority/Corporation would be required to make in connection with: (i) the VCA; or (ii) any examination of Tax-Exempt Bonds might reduce funds available to honor student loan forgiveness, debt reduction, repurchase, administration, servicing or other obligations under various agreements relative to Tax-Exempt Bonds or other debt obligations issued by the Authority/Corporation (collectively, "KHESLC Bonds"). However, the Authority/Corporation does not currently expect the resolution of the matters addressed in the Request to materially reduce the amount of assets that are available to fund mandatory payments with respect to KHESLC Bonds or to materially affect its ability to fully discharge its obligations under trust documents securing KHESLC Bonds or to administer its student loan programs. Based on the information available at this time, the Authority/Corporation preliminarily estimates that it may incur costs associated with its VCA of $4.2 million and has accrued a contingent liability for this amount as of June 30, 2012.

Note T--Recent Pronouncements

In December 2010, the GASB issued Statement No. 62, Codification of Accounting and Financial Reporting Guidance in Pre-November 30, 1989 Financial Accounting Standards Board and American Institute of Certified Public Accountants (AICPA) Pronouncements. GASB Statement No. 62 incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance included in the following pronouncements issued on or before November 30, 1989, guidance which does not conflict with or contradict GASB pronouncements: (1) FASB Statements and Interpretations, (2) Accounting Principles Board Opinions, and (3) Accounting Research Bulletins of the AICPA's Committee on Accounting Procedure. GASB Statement No. 62 supersedes GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, thereby eliminating the election provided in GASB Statement No. 20 to enterprise funds and business-type activities to apply post

Note T--Recent Pronouncements--Continued

November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. While the Authority/Corporation has not yet evaluated the impact the provisions of GASB Statement No. 62 will have on its financial statements as of and for the year ended June 30, 2013, the adoption of this standard is not expected to have an impact on the Authority's financial position, results of operations, and/or cash flows.

In June 2011, the GASB issued Statement No. 63, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position. GASB Statement No. 63 provides financial reporting guidance relative to deferred outflows of resources, a consumption of net assets by the entity that is applicable to a future reporting period, and deferred inflows of resources, an acquisition of net assets by the entity that is applicable to a future reporting period. GASB Statement No. 63 incorporates deferred outflows and inflows of resources into the definitions of the required components of the residual measure, renaming such measure as net position, rather than net assets. The provisions of GASB Statement No. 63 are effective for fiscal periods beginning after December 15, 2011 (the fiscal year ended June 30, 2013 for the Authority). While the Authority/Corporation has not yet evaluated the impact the provisions of GASB Statement No. 63 will have on its financial statements as of and for the year ended June 30, 2013, the adoption of this standard is not expected to have an impact on the Authority/Corporation's financial position, results of operations, and/or cash flows.