

**Strothman & Company P S C**

Certified Public Accountants & Advisors



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Financial Statements

**Kentucky Higher Education  
Assistance Authority**

June 30, 2005

Financial Statements

**Kentucky Higher Education Assistance Authority**

June 30, 2005

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## Independent Auditors' Report



Board of Directors  
Kentucky Higher Education Assistance Authority  
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 (the "Authority") as of and for the year ended June 30, 2005, which collectively comprise the Authority's basic financial statements as listed in the accompanying table of contents. These financial statements are the responsibility of the Authority'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 \$65,527,551 as of June 30, 2005, and total additions to fiduciary net assets of \$17,097,576 for the year ended June 30, 2005. Those 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 as of June 30, 2005, and the respective changes in financial position and cash flows, where applicable, 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 September 23, 2005 on our consideration of the Authority'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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The management's discussion and analysis on pages 3 through 13 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

*Stout & Company PSC*

Louisville, Kentucky  
September 23, 2005

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Description of the Business**

The financial statements of the Kentucky Higher Education Assistance Authority include the following entities:

- The Kentucky Higher Education Assistance Authority (the "Authority")
- The Kentucky Higher Education Student Loan Corporation (the "Corporation")
- Kentucky's Affordable Prepaid Tuition Plan (the "Plan" or "KAPT")
- The Kentucky Education Savings Plan Trust (the "Trust")

The Authority was established in 1966 as the Commonwealth of Kentucky's (the "Commonwealth") agency for improving higher education opportunities. The Authority guarantees eligible student loans, and through the Corporation, makes student loans directly to parents and students, purchases and services eligible student loans, and performs servicing and collection activities on eligible student loans for third-party lenders, and through the Trust, offers savings and investment opportunities for Kentuckians to save for higher education, and through KAPT offers Kentuckians an opportunity to pay future tuition and related expenses at a reduced present value rate.

In November 1978, the Authority commenced guaranteeing student loans as the designated guarantee agency for the Commonwealth of Kentucky pursuant to the Federal Higher Education Act (the "Act") of 1965, as amended. On July 1, 1996, the Authority was designated by the United States Department of Education ("USDE") as the guarantee agency for the State of Alabama. As such, with regard to eligible student loans originated by the State of Alabama, the Authority is responsible for issuing loan insurance, providing assistance to lenders and lender servicers, paying lender claims and collecting defaulted loans on which claims have been paid.

The Higher Education Amendments of 1998 (the "1998 Amendments") that 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 established a Federal Student Loan Reserve Fund ("FSLRF") and an Agency Operating Fund ("AOF").

The FSLRF assets and all earnings on those assets are the property of the federal government. The funds in the FSLRF are used to pay for the reimbursements to the lenders for defaulted student loan claims, pay the AOF for default aversion fees, and any Account Maintenance Fee ("AMF") and Loan Processing and Issuance Fee ("LPIF") due to from the USDE when federal funds are unavailable. Funds used to pay loan claims are replenished from reimbursements from the federal government. The FSLRF also receives a rebate of default aversion fees paid if a default claim is paid.

The AOF holds and accounts for funds controlled by the Authority, that are restricted for student aid and related activities. Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees, AMF (.10% of original principal outstanding), LPIF (.40% of loans guaranteed and disbursed), and loan and lender servicing fees. Expenditures from the AOF include personnel and professional, administrative expenses, and rebates of default aversion fees paid if a default claim is paid.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Description of the Business--Continued**

In addition to the funds established by the 1998 Amendments to the Act, the Authority administers ten grant and scholarship programs and provides higher education outreach activities. The fund established to administer these programs ("Student Aid Fund") is maintained with the State Treasurer. Sources of monies to the Student Aid Fund include general fund appropriations, federal awards, lottery net revenues, coal severance tax, tobacco settlement funds, and transfers from the AOF and the Corporation. Uses of funds include state grant and scholarship awards, personnel and professional, and other administrative expenses directly related to administration of the student aid programs and outreach activities. In fiscal year 2005, the AOF contributed \$4.6 million to administer the grant and scholarship programs. Additionally, the Corporation contributed \$7.2 million to direct student benefits for the programs.

Also, in 1978, the Kentucky General Assembly created the Corporation as an independent *de jure* municipal corporation. The Corporation functions as a lender of student loans, making loans to parents and students directly; a servicer of student loans; and a secondary market for the purchase of student loans from other lenders. The Corporation funds the origination or acquisition of these student loans by periodically issuing bonds and notes under various debt agreements, including its three general bond resolutions. The Corporation also services education loans and collects defaulted education loans. The Corporation's services and loans are marketed under the registered service mark "The Student Loan People<sup>SM</sup>".

The Authority is also charged with managing the Trust, an Internal Revenue Service Code 529 plan, which was created in 1988 by the Kentucky General Assembly to help families save for the cost of education after high school. The Trust is administered by the Authority's Board of Directors and is being administered by TIAA-CREF Tuition Financing, Inc.

In fiscal year 2004, the Authority had governance control over KAPT. The Plan was created by the 2000 General Assembly and oversight was transferred to the Authority in the 2003 budget bill, House Bill 269. Upon expiration of the 2003 budget bill on June 30, 2004, the Plan was transferred back to a separate board of directors on July 2004. The Plan is an Internal Revenue Service Code 529 plan, which allows participants to purchase future tuition at reduced present value rates.

The FSLRF, the Agency Fund (used to account for loan proceeds handled by the Authority on behalf of lenders and schools), the Trust, and the Plan are accounted for as Fiduciary Funds. The AOF and the internal service fund (an administrative fund held by the State Treasurer) are accounted for as Proprietary Funds. The Governmental Fund is comprised of assets maintained for grant and scholarship program benefits.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Overview of Financial Statements**

This management's discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to financial statements. This report contains other supplementary information in addition to the basic financial statements.

The government-wide statement of net assets and statement of activities include the Governmental Fund and Propriety Funds. The government-wide financial statements can be found on pages 14-15 of this report. The fund financial statements can be found on pages 20-21 of this report.

Fiduciary Funds are used to account for resources held for the benefit of parties outside the Authority. Fiduciary Funds are not reflected in the government-wide financial statements because the resources are not available to support the Authority's programs. The statement of fiduciary net assets (deficit) and statement of changes in fiduciary net assets (deficit) can be found on pages 22-23 of this report.

The Corporation, the Plan, and the Trust each published separate financial statements and footnotes. To obtain a copy of the financial statements, please contact the Authority at (502) 696-7421.

The following is a condensed summary of financial information for the years ended June 30, 2005 and 2004, respectively.

Continued

Condensed Financial Information - Governmental Fund and Proprietary Funds

**Kentucky Higher Education Assistance Authority**

	<u>Governmental Fund</u>		<u>Proprietary Funds</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
<b>Net Asset Information</b>				
Capital assets			\$ 15,031,068	\$ 14,967,294
Other assets	\$ 13,419,346	\$ 14,077,436	1,471,512,438	1,196,121,861
<b>Total Assets</b>	<u>13,419,346</u>	<u>14,077,436</u>	<u>1,486,543,506</u>	<u>1,211,089,155</u>
Long-term liabilities			1,334,511,417	975,477,839
Other liabilities	1,169,222	237,520	17,017,814	108,584,818
<b>Total Liabilities</b>	<u>1,169,222</u>	<u>237,520</u>	<u>1,351,529,231</u>	<u>1,084,062,657</u>
Net assets invested in capital, net of debt			7,558,532	7,221,663
Unrestricted net assets			20,447,257	11,954,893
Restricted net assets	12,250,124	13,839,916	107,008,486	107,849,942
<b>Total Net Assets</b>	<u>\$ 12,250,124</u>	<u>\$ 13,839,916</u>	<u>\$ 135,014,275</u>	<u>\$ 127,026,498</u>
<b>Activity Information</b>				
Interest and investment income fund	\$ 198,593	\$ 222,810	\$ 5,710,141	\$ 1,934,637
State General Fund revenue	71,355,300	70,843,693		
Student Aid and Advancement Fund revenue	71,329,445	72,745,982		
Unclaimed Lottery revenue	9,758,300			
Federal funds revenue	1,516,318	1,157,936		
Tobacco Settlement revenue	900,000	750,000		
Service fees			23,779,356	19,487,790
Debt recovery commission			8,276,124	10,427,041
Federal fees earned			6,466,687	7,086,395
Default aversion fee income			1,550,869	1,450,689
Interest income on loans			97,071,590	61,455,867
Other income	726,887	747,651	408,960	152,463
<b>Total Revenues</b>	<u>155,784,843</u>	<u>146,468,072</u>	<u>143,263,727</u>	<u>101,994,882</u>
Kentucky Tuition Grants	26,470,479	23,640,343		
College Access Program Grants	50,624,331	46,098,392		
Robert S. Byrd Honors Scholarship	664,275			
Early Childhood Development	984,723	833,131		
National Guard Tuition Awards	2,681,518	2,621,895		
Kentucky Educational Excellence Scholarships	82,468,338	73,251,730		
Teacher Scholarships	1,167,096	734,410		
Osteopathic Medicine Scholarships	2,332,395	3,524,248		
Work study	936,748	988,521		
Outreach and other activities	773,411	830,751		
Guarantee operations			5,478,206	5,352,889
Default collection operations			4,189,464	5,392,256
Lender assistance operations			2,929,374	3,274,270
Lending and related activities			102,426,565	62,220,539
Other activities			389,677	120,738
<b>Total Expenditures</b>	<u>169,103,314</u>	<u>152,523,421</u>	<u>115,413,286</u>	<u>76,360,692</u>
<b>Change in Net Assets Before Operating Transfers</b>	(13,318,471)	(6,055,349)	27,850,441	25,634,190
Interfund transfers	4,577,624	2,964,707	(4,577,624)	(2,964,707)
Transfer to KAPT			(188,649)	(119,136)
Transfer to Governmental Fund	7,151,055	3,000,000	(7,151,055)	(3,000,000)
Transfer to the State Treasurer			(7,800,000)	
<b>Change in Net Assets</b>	<u>\$ (1,589,792)</u>	<u>\$ (90,642)</u>	<u>\$ 8,133,113</u>	<u>\$ 19,550,347</u>

Condensed Financial Information - Fiduciary Funds

Kentucky Higher Education Assistance Authority

	Federal Student Loan Reserve Fund		Agency Fund		Kentucky Affordable Prepaid Tuition		Kentucky Education Savings Plan Trust	
	2005	2004	2005	2004	2005	2004	2005	2004
<b>Net Asset Information</b>								
Capital assets				\$ 260,705				
Other assets	\$17,986,421	\$ 21,377,343			\$ 135,382,731	\$ 88,379,750	\$ 65,525,246	\$ 52,472,982
<b>Total Assets</b>	17,986,421	21,377,343		260,705	135,382,731	88,379,750	65,525,246	52,472,982
<b>Total Liabilities</b>	7,250,484	6,306,848		260,705	141,977,631	100,269,073	155,131	76,607
Net assets invested in capital, net of debt					2,517			
Restricted net assets (deficit)	10,735,937	15,070,495			(6,597,417)	(11,889,323)	65,370,115	52,396,375
<b>Total Net Assets</b>	<u>\$10,735,937</u>	<u>\$ 15,070,495</u>		<u>\$ -</u>	<u>\$ (6,594,900)</u>	<u>\$ (11,889,323)</u>	<u>\$ 65,370,115</u>	<u>\$ 52,396,375</u>
<b>Changes in Fiduciary Net Asset Information</b>								
Federal reinsurance	\$50,088,866	\$ 43,821,099						
Contributions					\$ 32,075,577	\$ 2,256,417		
Subscriptions							\$ 12,392,752	\$ 12,700,472
Other income	467,878	409,947			5,456,796	7,972,494	4,704,824	5,344,196
<b>Total Additions</b>	50,556,744	44,231,046			37,532,373	10,228,911	17,097,576	18,044,668
Administrative expenses					1,633,275	728,895	376,891	295,439
Refunds					990,777	354,616		
Trustee expense					257,122	139,901		
Tuition benefits					43,243,458	11,399,497		
Loan claims	52,411,691	45,715,095						
Redemptions							3,746,945	1,895,710
Default aversion	1,550,869	1,450,689						
Other expenses	1,074,078	779,889			2,018	1,094		
<b>Total Deductions</b>	<u>55,036,638</u>	<u>47,945,673</u>			<u>46,126,650</u>	<u>12,624,003</u>	<u>4,123,836</u>	<u>2,191,149</u>
<b>Change in Net Assets Before Operating Transfer</b>	(4,479,894)	(3,714,627)			(8,594,277)	(2,395,092)	12,973,740	15,853,519
<b>Operating Transfers</b>								
Transfer from Agency Operating Fund	145,336				188,649			
Transfer from Internal Service Fund						119,136		
Transfer from Unclaimed Property Fund					13,700,051			
<b>Change in Net Assets After Operating Transfers</b>	<u>\$ (4,334,558)</u>	<u>\$ (3,714,627)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,294,423</u>	<u>\$ (2,275,956)</u>	<u>\$ 12,973,740</u>	<u>\$ 15,853,519</u>

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Financial Analysis – Governmental and Proprietary Funds**

This section of the Authority's annual financial report presents a management's discussion and analysis of the Authority's government-wide performance for the fiscal year ended June 30, 2005. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, that follow.

**Financial Overview**

- The Authority's proprietary total assets increased approximately \$276 million, from \$1.211 billion to \$1.487 billion.
- The Authority's net student loans at year end were approximately \$1.2 billion, which is an increase of approximately \$229 million or 23% over prior year.
- The Authority's proprietary revenue for the fiscal year ended June 30, 2005, was \$143 million, which is an increase of \$41 million or 40% over prior year.
- The Authority's service fee income for the fiscal year ended June 30, 2005, was \$24 million, which is a \$4 million increase or 22% over prior year.
- The Authority's total lending and related activity expense was \$102 million for the fiscal year ended June 30, 2005, which was a \$40 million increase, 65% increase over prior year.
- The Authority provided approximately \$14 million in principal and interest on student loans, \$83.2 million in need based grants and scholarships and an additional \$81.2 million in merit-based scholarships.
- The Authority's change in net assets after operating transfers for the fiscal year ended June 30, 2005, was \$8 million, which is an \$11 million decrease or 58% from prior year.

**Statement of Net Assets**

Total government fund net assets decreased \$1.6 million, due to the net impact of the Authority utilizing grant and scholarship cash more effectively in fiscal year 2005 and reducing the conversion loan value in fiscal year 2005. In fiscal year 2005, the Authority implemented a new approach to better utilize College Access Program ("CAP") and Kentucky Tuition Grant ("KTG") funds; schools receive advanced funding for CAP and KTG and apply those funds to eligible participants. Schools sent unused CAP and KTG funds to the Authority more timely in fiscal year 2005, which allowed the Authority to better utilize these funds. The new approach resulted in a decrease in net assets of \$900,000. In fiscal year 2005, the Authority increased the conversion loan valuation allowance by \$1.5 million (to \$5.4 million), and increased the portfolio by a net \$800,000 (new awards net of payments and service credits), resulting in a net decrease of \$700,000.

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**Kentucky Higher Education Assistance Authority**

June 30, 2005

The increase in Proprietary Fund net assets is primarily due to the Authority's lending activities. Total assets grew from approximately \$1.211 billion at June 30, 2004, to \$1.487 billion at June 30, 2005. Net loans outstanding totaled \$1.2 billion at June 30, 2005, a \$229 million increase over June 30, 2004. This increase included \$430 million in loan acquisitions (both originations and purchases) offset by borrower payments, consolidation loan payments, and principal forgiveness on loans. The remaining \$46 million increase resulted from an increase in cash, cash equivalents and investments from unused bond proceeds as of June 30, 2005, and an increase in deferred loan purchase premium resulting from new loan volume in fiscal year 2005. Total liabilities increased \$267 million. During the fiscal year, the Authority drew down approximately a net \$73 million from its line of credit and issued \$350 million in bonds to acquire student loans. The amount was offset by approximately \$171 million in bond maturities and repayments on the line of credit. The allowance for arbitrage increased approximately \$10 million due to new debt issuances and rising interest rates which were offset by borrower benefit programs. Accounts payable and accrued expenses increased approximately \$5 million, which was consistent with the overall increases in expenses for the fiscal year. These increases were the largest components of the Authority's increase in total liabilities.

**Statement of Revenues, Expenditures, and Changes in Net Assets**

Governmental fund revenues increased 6%, due to increased funding from the Kentucky Lottery Corporation. In 1998, the Kentucky State Legislature created the KEES program and tied state lottery revenue to KEES and need-based grant funding. In fiscal year 2004, the Authority received 80% of lottery net revenue. In fiscal year 2005, the Authority received 90% of lottery net revenue, a 13% increase over prior year. This increase was offset by the overall decrease in available lottery net revenues, which decreased approximately 5% and the elimination of funding for the Kentucky National Guard Tuition Award Program, \$2.7 million, which was funded through an operating transfer from the Authority's lending activities.

Governmental expenditures also increased 11%, which is comprised of an 11% increase in direct benefits to students and 23% increase in administrative costs. Direct benefits increased primarily due to the increase in KEES awards (because the program is in the seventh year of an eight year, phase-in process). The CAP and KTG programs also noted increases in direct benefits (KTG increased 12% and CAP increased 10%). The increases in CAP and KTG resulted from increased lottery funds received. The Teacher Scholarship program did realize a \$432,000 increase in expenses from fiscal year 2005 compared to 2004.

The Authority's Proprietary Fund experienced a 9% increase in changes in net assets before operating transfers, resulting from a 40% increase in revenue and a 51% increase in expenditures. Interest income increased 58% due to certain loans qualifying for the "minimum 9.5% yield" permitted under special allowance rules. The average yield from interest on loans in fiscal year 2005 was 8.64% versus 6.74% in fiscal year 2004. Given the rising interest rate environment, investment yields increased from .81% in fiscal year 2004 to 1.71% in fiscal year 2005. Fee income increased due to the growth of a portfolio for a large client for whom the Authority performs third-party servicing activities. Net assets related to non-lending activities remained relatively constant with prior fiscal year. Defaulted loan collection revenue decreased approximately \$2 million, which was offset by the decrease in expenses; resulting from allocating a greater percentage of expenses to the Governmental Fund to compensate for rising student aid administration costs.

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## **Kentucky Higher Education Assistance Authority**

June 30, 2005

Lender and related activities expense increased 65% or \$40.2 million, due to costs related to the growing loan portfolio as the Authority adds loan volume. Interest on debt more than doubled due to rising interest rates on the variable rate bonds outstanding. Average rates increased from 1.32% in fiscal year 2004 to 2.30% in fiscal year 2005. The remaining expenses decreased approximately \$1.2 million due to reallocation of expenses between the Proprietary Fund and the Governmental Fund, see above.

### **Financial Analysis – Fiduciary Funds**

This section of the Authority's annual financial report presents a management's discussion and analysis of the Authority's fiduciary fund performance for the fiscal year ended June 30, 2005. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, which follow.

#### **Financial Overview**

- Claims expenses in the Federal Student Loan Reserve Fund ("FSLRF") increased from \$46 million in fiscal year 2004 to \$52 million in fiscal year 2005, a 15% increase compared to prior year.
- Contributions to the Kentucky Education Savings Plan Trust (the "Trust") decreased from \$12.7 million in fiscal year 2004 to \$12.4 million in fiscal year 2005, a 3% decrease compared to prior year.
- Interest and investment income in the Trust decreased from \$5.3 million in fiscal year 2004 to \$4.7 million in fiscal year 2005, an 11% decrease compared to prior year.
- The Authority had an open enrollment period for Kentucky's Affordable Prepaid Tuition plan in fiscal year 2005, resulting in \$32.6 million of new contracts (net present value). Accordingly, contributions increased from \$2.2 million in fiscal year 2004 to \$32 million in fiscal year 2005.
- Interest and investment income in the Plan decreased from \$7.9 million to \$5.2 million, a decrease of 34% compared to prior year.

#### **Statement of Fiduciary Net Assets (Deficit)**

The FSLRF assets decreased approximately 16%, while liabilities increased approximately 15%. The decrease in assets is attributed to the decrease in cash, cash equivalents and investments as of June 30, which is due to the overall change in net assets after operating transfer of \$4.3 million (\$1 million of which resulted from non cash activities). The decrease in liabilities resulted from a change to defaulted loan payment posting process, implemented in mid-June 2005. Previously, the Authority utilized a lockbox service and deposited all cash receipts in the AOF and settled with the FSLRF at the end of the month. The new process requires the Authority to deposit all funds in the FSLRF and settled with the AOF at the end of the month.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

The Agency Fund serves as a conduit for loan proceeds transacted between lenders and schools. The Authority usually only maintains Agency Funds for lenders and schools for less than three business days. At June 30, 2004, the Authority maintained \$170,573 on behalf of lenders and borrowed \$419,339 from the AOF to send loan proceeds to schools. At June 30, 2005, the Authority maintained \$595,449 on behalf of lenders and borrowers. Under a new loan disbursement process, the Authority occasionally borrows funds from the AOF to advance money to schools on the same day or next day of origination. All funds are received from lenders within one business day of disbursement.

The Plan's total assets increased \$47 million, which resulted from an increase in cash and investments of \$42.8 million, an increase in contributions receivable of \$3.9 million and an increase in accrued investment income of \$300,000. Investments increased because of \$18.4 million received from new contract participants (sold in fiscal year 2005), \$7 million received from existing contract participants; a transfer from the Commonwealth's Unclaimed Property Fund of \$13.7 million; and investment income of \$5.2 million, net of cash disbursements for contract cancellation, matriculation and operating expenses of \$1.5 million. The contributions receivable increased because of the \$32.6 million of new contracts sold in fiscal year 2005 (net present value), less \$25.4 million cash received from participants and \$3.3 million of cancelled contracts.

The Plan liabilities increased \$41.7 million, almost entirely from the increase in Tuition Benefits Payable. The \$42.6 million increase in Tuition Benefits Payable resulted from the addition of 1,860 new Plan contracts during the fall 2004 enrollment period; current year changes to actuarial assumptions for tuition increases, administrative costs, and investment income expense; and the actual tuition increase experience at Kentucky institutions for the 2005-2006 academic year. The University of Kentucky tuition increase, on which the majority of Plan tuition payouts are based, increased 12.5% for the 2005-2006 academic year. In 2004, the tuition increase assumptions were based on 7.5% increases annually through June 30, 2011, and 7.0% annually thereafter. To reflect higher than anticipated tuition increases, assumptions in 2005 were raised to 7.5% increases annually through June 30, 2011; 7.25% annually through June 20, 2013; and 7.0% annually thereafter. In 2005, the gross investment income projection remained at 7.76%. Projected investment expense remained unchanged; on a sliding scale of costs related to total assets, .49% of the first \$25 million, .28% of the next \$25 million, and .21% of assets in excess of \$50 million. Projected administrative expenses increased from \$2.5 million in 2004 to \$6.2 million in 2005. The Plan retired its note payable to the Unclaimed Property Fund in 2005, decreasing other liabilities by \$900,000.

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 assets increased approximately \$13 million, due to new subscriptions received (\$12.4 million) and investment income (\$4.7 million), net of expenses and redemptions (\$4.1 million). Trust liabilities remained relatively constant during the fiscal year.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Changes in Fiduciary Net Assets**

The FSLRF had a reduction in Fiduciary Net Assets of approximately \$4.3 million for the year ended June 30, 2005, which was a \$600,000 worse than previous year. The reduction resulted from an increase in default claims and an increase in Account Maintenance Fee shortfall. Loan claims expense increased approximately 14.7%, due primarily to the default experience at three large lenders. The federal reinsurance increased approximately 14.3% and has a direct correlation to loan claims expense (since the Authority files for federal reinsurance on all claims paid). Note that the Authority collects AMF based on Original Principal Outstanding as of September 30, 2004. If federal funds in the Section 458 account are unable to meet the demand for AMF, the Authority may transfer the shortfall amount from the FSLRF to the AOF. In fiscal year 2005, the Authority transferred \$400,000 more in AMF shortfall than the amount transferred in fiscal year 2004. As FFELP loan volume at all guarantee agencies increases, the amount of the AMF shortfall increases.

Investment income increased from \$66,000 in fiscal year 2004 to \$251,000 in 2005, because of the improved market conditions for short-term securities. Other expenses increased because operating transfers changed slightly from prior year. In fiscal year 2004, the Authority made no transfers to or from the FSLRF. In fiscal year 2005, the Authority transferred \$145,000 from the AOF to the FSLRF to settle a USDE audit finding.

The Plan recognized a decrease in net deficit of \$5.3 million for fiscal year 2005. The Plan held an enrollment period in fiscal year 2005 and received \$32 million in contract income, a \$30 million increase from 2004. For the first time in its history, the Plan included a 7.5% actuarial premium in the cost of the new contracts sold during the fiscal year 2005 enrollment period, resulting in additional contract revenue of \$2.4 million. The Plan also recognized \$5.2 million of investment income in fiscal year 2005, a \$2.6 million decrease from prior year. Note that the Plan realized a 25.98% gain on equity securities (57% of the portfolio) in fiscal year 2004. In fiscal year 2005, the Plan only realized 7.82% gain on equity securities (and the mix increased to 59% of the portfolio). Fee revenue increased to \$197,000 due to enrollment application fees (associated with the fiscal year 2005 enrollment period) and contract cancellation fees (associated with participants exiting the program primarily due to language in House Bill 267 repealing KRS 393.015 related to the use of the Commonwealth's Unclaimed Property Fund to support the Plan). The Plan recognized other revenue of \$26,000, which is consistent with prior year.

Administrative expenses increased approximately \$900,000, from \$730,000, to \$1.6 million. Administrative expenses increased because the Plan incurred advertising costs in fiscal year 2005 in connection with the enrollment period and incurred almost no advertising costs in fiscal year 2004.

Due to the addition of the 1,860 new contracts sold during the enrollment period and changes in actuarial assumptions discussed above, the tuition benefits expense increased \$31.7 million. Refunds increased approximately \$1.4 million primarily due to language in House Bill 267 as discussed above. Without the explicit backing of the Commonwealth's Unclaimed Property Fund, some account holders became concerned about the Plan and decided to move their funds to a different 529 plan. Trustee expense increased because of the increase in total investments.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

The Plan recorded a transfer from the Unclaimed Property Fund of \$13.7 million in fiscal year 2005. In accordance with KRS 393.015, the board of directors voted to transfer the funds in December 2005 to eliminate the Plan's actuarial deficit as of June 30, 2004. The Plan also recorded a transfer from the Authority in fiscal year 2005 of \$189,000. The Plan maintains two employees for operational functions. In fiscal year 2005, the Authority provided management, accounting, information technology support, legal services, and office space to the Plan at no costs. The Authority allocated certain expenses to the Plan, which were recorded as a permanent transfer.

The trend of improvement for Trust activity ended in fiscal year 2005. In fiscal year 2003, the Trust recognized investment gains of \$960,000 and interest income of \$700,000, totaling income of \$1.66 million. In fiscal year 2004, the Trust recognized investment gains and interest income of \$5.3 million. In fiscal year 2005, investment income slowed to \$4.7 million. The slight decrease in investment income (11%) resulted from market conditions starting in the second quarter of fiscal year 2005. The Trust also experienced a slight decrease (2%) in subscriptions from prior year. Redemptions also increased as the program aged and more participants became eligible for qualified withdrawals.

Government-Wide Statement of Net Assets

**Kentucky Higher Education Assistance Authority**

June 30, 2005

<b>ASSETS</b>	<b>Governmental Activities</b>	<b>Business-Type Activities</b>	<b>Total</b>
<b>Current:</b>			
Cash and cash equivalents	\$ 2,200,187	\$ 174,243,520	\$ 176,443,707
Receivable from Federal Student Loan Reserve Fund		1,090,222	1,090,222
Accounts receivable	1,457,547	3,737,992	5,195,539
Special allowance receivable		13,615,566	13,615,566
Accrued interest income		17,103,329	17,103,329
Default aversion fees receivable		395,748	395,748
Investments		7,917,844	7,917,844
Teacher and Osteopathic Medicine scholarship loans	450,000		450,000
<b>Total Current Assets</b>	<b>4,107,734</b>	<b>218,104,221</b>	<b>222,211,955</b>
<b>Noncurrent:</b>			
Restricted cash and cash equivalents		7,450,389	7,450,389
Investments		11,842,291	11,842,291
Teacher and Osteopathic Medicine scholarship loans, net	2,347,534		2,347,534
Teacher and Osteopathic Medicine scholarship advances	6,964,078		6,964,078
Loans, net		1,207,632,746	1,207,632,746
Deferred loan purchase premiums and originations costs, net		20,433,681	20,433,681
Property and equipment, net		15,031,068	15,031,068
Deferred bond issuance costs, net		6,049,110	6,049,110
<b>Total Noncurrent Assets</b>	<b>9,311,612</b>	<b>1,268,439,285</b>	<b>1,277,750,897</b>
<b>Total Assets</b>	<b>13,419,346</b>	<b>1,486,543,506</b>	<b>1,499,962,852</b>
<b>LIABILITIES</b>			
<b>Current:</b>			
Accounts payable and accrued expenses	1,169,222	13,500,447	14,669,669
Accrued interest expense		3,152,367	3,152,367
Capital lease payable		365,000	365,000
<b>Total Current Liabilities</b>	<b>1,169,222</b>	<b>17,017,814</b>	<b>18,187,036</b>
<b>Noncurrent:</b>			
Allowance for arbitrage liabilities		29,891,417	29,891,417
Bonds/note payable		1,297,250,000	1,297,250,000
Capital lease payable		7,370,000	7,370,000
<b>Total Noncurrent Liabilities</b>		<b>1,334,511,417</b>	<b>1,334,511,417</b>
<b>Total Liabilities</b>	<b>1,169,222</b>	<b>1,351,529,231</b>	<b>1,352,698,453</b>
<b>NET ASSETS</b>			
Invested in capital assets, net of expended debt proceeds		7,558,532	7,558,532
Unrestricted		20,447,257	20,447,257
Restricted, other		91,439,098	91,439,098
Restricted for program benefits	12,250,124		12,250,124
Restricted for student aid and related activities		15,569,388	15,569,388
<b>Total Net Assets</b>	<b>\$ 12,250,124</b>	<b>\$ 135,014,275</b>	<b>\$ 147,264,399</b>

See Notes to Financial Statements

Government-Wide Statements of Activities

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

			Program Revenue		Net (Expenses) Revenues and Changes in Net Assets		Total
	Direct Expenses	Indirect Expenses	Charges for Services	Operating Grants and Contributions	Governmental Activities	Business-Type Activities	
<b>Functions/Programs</b>							
<b>Governmental Activities</b>							
Kentucky Tuition Grants	\$ 25,630,136	\$ 840,343		\$ 23,248,030	\$ (3,222,449)		\$ (3,222,449)
College Access Program Grants	49,755,022	869,309		46,688,720	(3,935,611)		(3,935,611)
Robert S. Byrd Honors Scholarship	516,126	148,149		516,126	(148,149)		(148,149)
Early Childhood Development	900,514	84,209		958,118	(26,605)		(26,605)
National Guard Tuition Awards	2,601,209	80,309		38,989	(2,642,529)		(2,642,529)
Kentucky Educational Excellence Scholarships	81,260,933	1,207,405		81,178,537	(1,289,801)		(1,289,801)
Teacher Scholarships	830,062	337,034		1,790,285	623,189		623,189
Osteopathic Medicine Scholarships	2,172,553	159,842		1,345,208	(987,187)		(987,187)
Work Study	843,330	93,418		830	(935,918)		(935,918)
Outreach and other activities	15,805	757,606		20,000	(753,411)		(753,411)
<b>Total Governmental Activities</b>	<b>164,525,690</b>	<b>4,577,624</b>		<b>155,784,843</b>	<b>(13,318,471)</b>		<b>(13,318,471)</b>
<b>Business-Type Activities</b>							
Loan guarantee operations	5,478,206		\$ 8,507,238			\$ 3,029,032	3,029,032
Default collections	4,189,464		8,221,924			4,032,460	4,032,460
Lender assistance	2,929,374		1,108,436			(1,820,938)	(1,820,938)
Lender operations	102,426,565		125,036,452			22,609,887	22,609,887
Other activities	389,677		389,677				
<b>Total Business-Type Activities</b>	<b>115,413,286</b>		<b>143,263,727</b>			<b>27,850,441</b>	<b>27,850,441</b>
<b>Total Primary Government</b>	<b>\$ 279,938,976</b>	<b>\$ 4,577,624</b>	<b>\$ 143,263,727</b>	<b>\$ 155,784,843</b>	<b>(13,318,471)</b>	<b>27,850,441</b>	<b>14,531,970</b>
<b>Transfers:</b>							
Interfund transfer					4,577,624	(4,577,624)	
Transfer to Federal Student Loan Reserve Fund						(145,336)	(145,336)
Transfer to KAPT						(188,649)	(188,649)
Transfer to the Government Fund					7,151,055	(7,151,055)	
Transfer to the State Treasurer						(7,800,000)	(7,800,000)
<b>Total Transfers</b>					<b>11,728,679</b>	<b>(19,862,664)</b>	<b>(8,133,985)</b>
<b>Change in Net Assets</b>					<b>(1,589,792)</b>	<b>7,987,777</b>	<b>6,397,985</b>
<b>Net Assets, Beginning of Year</b>					<b>13,839,916</b>	<b>127,026,498</b>	<b>140,866,414</b>
<b>Net Assets, End of Year</b>					<b>\$ 12,250,124</b>	<b>\$ 135,014,275</b>	<b>\$ 147,264,399</b>

See Notes to Financial Statements

Statement of Net Assets - Proprietary Funds

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

ASSETS	Authority			Corporation		Combined	
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total
<b>Current:</b>							
Cash and cash equivalents	\$ 7,118,317	\$ 850,481	\$ 7,968,798	\$ 151,532,128	\$ 14,742,594	\$ 166,274,722	\$ 174,243,520
Receivable from Federal Student Loan Reserve Fund		1,090,222	1,090,222				1,090,222
Accounts receivable	240,440	660,521	900,961	4,660	2,832,371	2,837,031	3,737,992
Special allowance receivable				13,615,566		13,615,566	13,615,566
Accrued interest income		70,493	70,493	17,000,358	32,478	17,032,836	17,103,329
Default aversion fees receivable		395,748	395,748				395,748
Investments		1,253,850	1,253,850		6,663,994	6,663,994	7,917,844
<b>Total Current Assets</b>	<b>7,358,757</b>	<b>4,321,315</b>	<b>11,680,072</b>	<b>182,152,712</b>	<b>24,271,437</b>	<b>206,424,149</b>	<b>218,104,221</b>
<b>Noncurrent:</b>							
Restricted cash and cash equivalents	140,389	7,310,000	7,450,389				7,450,389
Investments		11,842,291	11,842,291				11,842,291
Internal receivable (payable) for capital projects	(140,389)	140,389					
Property and equipment, net		11,603,159	11,603,159		3,427,909	3,427,909	15,031,068
Loans, net				1,207,632,746		1,207,632,746	1,207,632,746
Deferred bond issuance costs, net		230,173	230,173	5,818,937		5,818,937	6,049,110
Deferred loan purchase premiums and originations costs, net				20,433,681		20,433,681	20,433,681
<b>Total Noncurrent Assets</b>		<b>31,126,012</b>	<b>31,126,012</b>	<b>1,233,885,364</b>	<b>3,427,909</b>	<b>1,237,313,273</b>	<b>1,268,439,285</b>
<b>Total Assets</b>	<b>7,358,757</b>	<b>35,447,327</b>	<b>42,806,084</b>	<b>1,416,038,076</b>	<b>27,699,346</b>	<b>1,443,737,422</b>	<b>1,486,543,506</b>
<b>LIABILITIES</b>							
<b>Current:</b>							
Accounts payable and accrued expenses	1,932,493	1,240,282	3,172,775	2,492,557	7,835,115	10,327,672	13,500,447
Interfund payable	5,426,264	(600,175)	4,826,089	(815,153)	(4,010,936)	(4,826,089)	
Accrued interest expense		62,210	62,210	3,090,157		3,090,157	3,152,367
Capital lease payable (current portion)		365,000	365,000				365,000
<b>Total Current Liabilities</b>	<b>7,358,757</b>	<b>1,067,317</b>	<b>8,426,074</b>	<b>4,767,561</b>	<b>3,824,179</b>	<b>8,591,740</b>	<b>17,017,814</b>
<b>Noncurrent:</b>							
Allowance for arbitrage liabilities				29,891,417		29,891,417	29,891,417
Bonds/note payable				1,297,250,000		1,297,250,000	1,297,250,000
Capital lease payable		7,370,000	7,370,000				7,370,000
<b>Total Noncurrent liabilities</b>		<b>7,370,000</b>	<b>7,370,000</b>	<b>1,327,141,417</b>		<b>1,327,141,417</b>	<b>1,334,511,417</b>
<b>Total Liabilities</b>	<b>7,358,757</b>	<b>8,437,317</b>	<b>15,796,074</b>	<b>1,331,908,978</b>	<b>3,824,179</b>	<b>1,335,733,157</b>	<b>1,351,529,231</b>
<b>NET ASSETS</b>							
Invested in capital assets, net of expended debt proceeds		4,130,622	4,130,622		3,427,910	3,427,910	7,558,532
Unrestricted					20,447,257	20,447,257	20,447,257
Restricted, other		7,310,000	7,310,000	84,129,098		84,129,098	91,439,098
Restricted for student aid and related activities		15,569,388	15,569,388				15,569,388
<b>Total Net Assets</b>	<b>\$ -</b>	<b>\$ 27,010,010</b>	<b>\$ 27,010,010</b>	<b>\$ 84,129,098</b>	<b>\$ 23,875,167</b>	<b>\$ 108,004,265</b>	<b>\$ 135,014,275</b>

See Notes to Financial Statements

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

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total Funds
<b>Operating Revenues:</b>							
Service fees		\$ 1,108,436	\$ 1,108,436		\$ 7,910,966	\$ 7,910,966	\$ 9,019,402
Debt recovery commission		8,200,814	8,200,814		75,310	75,310	8,276,124
Federal fees earned		6,466,687	6,466,687				6,466,687
Default aversion fee income		1,550,869	1,550,869				1,550,869
Interest and investment income		491,509	491,509	\$ 4,823,969	394,663	5,218,632	5,710,141
Interest on loans				96,653,185	80,802	96,733,987	96,733,987
Late payment penalties				336,703	900	337,603	337,603
EFF service / administration fees					14,759,954	14,759,954	14,759,954
Other Income	\$ 389,677	19,283	408,960				408,960
<b>Total Operating Revenues</b>	<b>389,677</b>	<b>17,837,598</b>	<b>18,227,275</b>	<b>101,813,857</b>	<b>23,222,595</b>	<b>125,036,452</b>	<b>143,263,727</b>
<b>Operating Expenses:</b>							
Personnel and professional services	131,745	8,718,719	8,850,464		13,950,422	13,950,422	22,800,886
Other administrative expenses	242,632	1,865,423	2,108,055	25,357,441	8,071,204	33,428,645	35,536,700
Depreciation and amortization	11,728	930,647	942,375		2,309,382	2,309,382	3,251,757
Default aversion expense		707,626	707,626				707,626
Amortization of bond issuance costs		33,325	33,325	309,260		309,260	342,585
Variable bond credit facility and remarketing fees				3,375,357		3,375,357	3,375,357
Provision for arbitrage liabilities				9,500,006		9,500,006	9,500,006
Amortization of loan purchase premiums and origination costs				4,526,684		4,526,684	4,526,684
Federal consolidation fees				3,237,957		3,237,957	3,237,957
Provision for student loan loss				301,998	103,674	405,672	405,672
Interest expense	3,572	276,391	279,963	30,365,717		30,365,717	30,645,680
Other expenses		64,913	64,913	1,017,463		1,017,463	1,082,376
<b>Total Operating Expenses</b>	<b>389,677</b>	<b>12,597,044</b>	<b>12,986,721</b>	<b>77,991,883</b>	<b>24,434,682</b>	<b>102,426,565</b>	<b>115,413,286</b>
<b>Operating Income (Loss)</b>		<b>5,240,554</b>	<b>5,240,554</b>	<b>23,821,974</b>	<b>(1,212,087)</b>	<b>22,609,887</b>	<b>27,850,441</b>
<b>Transfers In (Out):</b>							
Interfund transfer		(4,577,624)	(4,577,624)	(21,710,055)	21,710,055		(4,577,624)
Transfer to KAPT		(188,649)	(188,649)				(188,649)
Federal Student Loan Reserve Fund transfer		(145,336)	(145,336)				(145,336)
Transfer to the Government Fund				(4,044,200)	(3,106,855)	(7,151,055)	(7,151,055)
Transfer to the State Treasurer					(7,800,000)	(7,800,000)	(7,800,000)
<b>Total Transfers</b>		<b>(4,911,609)</b>	<b>(4,911,609)</b>	<b>(25,754,255)</b>	<b>10,803,200</b>	<b>(14,951,055)</b>	<b>(19,862,664)</b>
<b>Increase (Decrease) in Net Assets after Transfers</b>		<b>328,945</b>	<b>328,945</b>	<b>(1,932,281)</b>	<b>9,591,113</b>	<b>7,658,832</b>	<b>7,987,777</b>
<b>Net Assets, Beginning of Year</b>		<b>26,681,065</b>	<b>26,681,065</b>	<b>86,061,379</b>	<b>14,284,054</b>	<b>100,345,433</b>	<b>127,026,498</b>
<b>Net Assets, End of Year</b>	<b>\$ -</b>	<b>\$27,010,010</b>	<b>\$27,010,010</b>	<b>\$84,129,098</b>	<b>\$23,875,167</b>	<b>\$108,004,265</b>	<b>\$135,014,275</b>

See Notes to Financial Statements

Statement of Cash Flows - Proprietary Funds

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Fund	Operating Fund	Corporation Total	Total Funds
<b>Cash Flows from Operating Activities:</b>							
Service fees	\$ 389,677	\$ 1,627,106	\$ 2,016,783		\$ 7,039,275	\$ 7,039,275	\$ 9,056,058
Debt recovery commission		8,200,814	8,200,814		72,426	72,426	8,273,240
Federal fees		6,466,687	6,466,687				6,466,687
Default aversion fees		816,122	816,122				816,122
Other, net	2,238,849	(7,847,745)	(5,608,896)	\$ (20,288,555)	(9,660,972)	(29,949,527)	(35,558,423)
Principal received on loans				200,631,370	(42,975)	200,588,395	200,588,395
Interest on loans				26,633,477	80,527	26,714,004	26,714,004
Special allowance				59,415,383		59,415,383	59,415,383
Client loan receipts					1,003,347,585	1,003,347,585	1,003,347,585
Loans purchased, including premiums				(16,719,579)	(59,525)	(16,779,104)	(16,779,104)
Loans originated, including costs				(423,615,727)		(423,615,727)	(423,615,727)
Credit facility fees				(3,302,117)		(3,302,117)	(3,302,117)
Loan receipts remitted to clients					(1,000,419,879)	(1,000,419,879)	(1,000,419,879)
<b>Net Cash Provided By (Used In) Operating Activities</b>	2,628,526	9,262,984	11,891,510	(177,245,748)	356,462	(176,889,286)	(164,997,776)
<b>Cash Flows From Noncapital Financing Activities:</b>							
Interfund transfers, net		(188,649)	(188,649)				(188,649)
Increase in federal student loan reserve receivable		(557,494)	(557,494)				(557,494)
Decrease in agency fund receivable		419,339	419,339				419,339
Cash requirements		(4,577,624)	(4,577,624)				(4,577,624)
Federal student loan reserve fund transfer		(145,336)	(145,336)				(145,336)
Proceeds from debt issued				423,000,000		423,000,000	423,000,000
Debt issuance costs				(1,321,511)		(1,321,511)	(1,321,511)
Debt principal payments				(171,200,000)		(171,200,000)	(171,200,000)
Interest on debt				(28,599,834)		(28,599,834)	(28,599,834)
Fund transfers				(21,710,055)	21,710,055	-	
Transfer to the State Treasurer					(7,800,000)	(7,800,000)	(7,800,000)
Transfer to the government fund				(4,044,200)	(3,106,855)	(7,151,055)	(7,151,055)
<b>Net Cash Provided By (Used In) Noncapital Financing Activities</b>		(5,049,764)	(5,049,764)	196,124,400	10,803,200	206,927,600	201,877,836
<b>Cash Flows From Capital and Related Financing Activities</b>							
Interfund transfers, net	64,518	(64,518)					
Capital expenditures		(280,164)	(280,164)		(3,430,835)	(3,430,835)	(3,710,999)
Capital lease payments		(350,000)	(350,000)				(350,000)
Interest paid on capital lease payable		(279,173)	(279,173)				(279,173)
<b>Net Cash Provided By (Used In) Capital and Related Financing Activities</b>	64,518	(973,855)	(909,337)		(3,430,835)	(3,430,835)	(4,340,172)
<b>Cash Flows From Investing Activities</b>							
Purchases of investments		(45,604,590)	(45,604,590)		(13,592,161)	(13,592,161)	(59,196,751)
Proceeds from sales/maturities of investments		45,834,192	45,834,192		14,600,000	14,600,000	60,434,192
Investment income		62,764	62,764	4,560,614	366,795	4,927,409	4,990,173
<b>Net Cash Provided By Investing Activities</b>		292,366	292,366	4,560,614	1,374,634	5,935,248	6,227,614
<b>Net Increase in Cash and Cash Equivalents</b>	2,693,044	3,531,731	6,224,775	23,439,266	9,103,461	32,542,727	38,767,502
<b>Cash and Cash Equivalents Beginning of Year</b>	4,565,662	4,628,750	9,194,412	128,092,862	5,639,133	133,731,995	142,926,407
<b>Cash and Cash Equivalents End of Year</b>	\$ 7,258,706	\$ 8,160,481	\$ 15,419,187	\$ 151,532,128	\$ 14,742,594	\$ 166,274,722	\$ 181,693,909

Continued

Statement of Cash Flows - Proprietary Funds

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Fund	Operating Fund	Corporation Total	Total Funds
Reconciliation of Operating Income (Loss) to Net Cash Provided By (Used In)							
Operating Activities							
Operating income (loss)		\$ 5,240,554	\$ 5,240,554	\$ 23,821,974	\$ (1,212,087)	\$ 22,609,887	\$ 27,850,441
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:							
Investment loss		(491,509)	(491,509)	(4,560,614)	(366,795)	(4,927,409)	(5,418,918)
Depreciation and amortization		1,228,844	1,228,844		2,309,382	2,309,382	3,538,226
Loss on equipment disposal		11,519	11,519		22,704	22,704	34,223
Interest expense		279,173	279,173				279,173
Amortization of bond issuance costs				309,260		309,260	309,260
Amortization of loan purchase premiums and origination costs				4,526,684		4,526,684	4,526,684
Interest on debt				30,365,717		30,365,717	30,365,717
Provision for loan losses				301,998	103,674	405,672	405,672
Borrower interest converted to principal				(14,287,300)	(1,174)	(14,288,474)	(14,288,474)
Principal forgiveness				10,597,487		10,597,487	10,597,487
Interest forgiveness				3,373,475		3,373,475	3,373,475
Net change in fair value of investments					1,192	1,192	1,192
(Increases) decreases in assets							
Receivables	\$ (240,440)	518,670	278,230	2,360	(1,454,348)	(1,451,988)	(1,173,758)
Default aversion fee receivable		(27,121)	(27,121)				(27,121)
Other current assets		553,894	553,894				553,894
Accrued interest				(330,338)	(29,060)	(359,398)	(359,398)
Special allowance receivable				39,778		39,778	39,778
Interfund receivable/payable	3,325,713	1,685,752	5,011,465	(1,683,763)	(3,295,513)	(4,979,276)	32,189
Increases (decreases) in liabilities							
Accounts payable and accrued expenses	(456,747)	265,990	(190,757)	582,892	4,380,987	4,963,879	4,773,122
Interest payable		(2,782)	(2,782)				(2,782)
Allowance for arbitrage liabilities				9,398,578		9,398,578	9,398,578
Items not accounted for as revenues or expenses							
Principal received on loans				200,631,370	(42,975)	200,588,395	200,588,395
Loans purchased, including premiums				(16,719,579)	(59,525)	(16,779,104)	(16,779,104)
Loans originated, including costs				(423,615,727)		(423,615,727)	(423,615,727)
<b>Net Cash Provided By (Used In) Operating Activities</b>	<b>\$ 2,628,526</b>	<b>\$ 9,262,984</b>	<b>\$ 11,891,510</b>	<b>\$ (177,245,748)</b>	<b>\$ 356,462</b>	<b>\$ (176,889,286)</b>	<b>\$ (164,997,776)</b>

See Notes to Financial Statements

Statement of Net Assets - Governmental Fund

**Kentucky Higher Education Assistance Authority**

June 30, 2005

	<b>Governmental Fund Student Aid</b>
<b>ASSETS</b>	
<b>Current:</b>	
Cash and cash equivalents	\$ 2,200,187
Accounts receivable	1,457,547
Teacher and Osteopathic Medicine scholarship loans	<u>450,000</u>
<b>Total Current Assets</b>	<u>4,107,734</u>
<b>Noncurrent:</b>	
Teacher and Osteopathic Medicine scholarship loans, net of allowance of \$5,400,000	2,347,534
Teacher and Osteopathic Medicine scholarship advances	<u>6,964,078</u>
<b>Total Noncurrent Assets</b>	<u>9,311,612</u>
<b>Total Assets</b>	<u>13,419,346</u>
<b>LIABILITIES</b>	
<b>Current:</b>	
Accounts payable and accrued expenses	<u>1,169,222</u>
<b>Total Liabilities</b>	<u>1,169,222</u>
<b>NET ASSETS</b>	
Fund Balance - Restricted for program benefits	<u><u>\$ 12,250,124</u></u>

See Notes to Financial Statements

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

**Kentucky Higher Education Assistance Authority**

For the Year Ended June 30, 2005

	<b>Governmental Fund Student Aid</b>
<b>Revenues:</b>	
Interest and investment income fund	\$ 198,593
Tobacco Settlement revenue	900,000
State General Fund revenue	71,355,300
Student Aid and Advancement Fund revenue	71,329,445
Unclaimed Lottery Revenue	9,758,300
Federal funds revenue	1,516,318
Other income	726,887
	<hr/>
<b>Total Revenues</b>	<b>155,784,843</b>
<b>Expenditures:</b>	
Kentucky Tuition Grants	26,470,479
College Access Program Grants	50,624,331
Byrd Scholarship	664,275
Early Childhood Development Scholarships	984,723
National Guard Tuition Awards	2,681,518
Kentucky Education Excellence Scholarships	82,468,338
Teacher Scholarships	1,167,096
Osteopathic Medicine Scholarships	2,332,395
Work Study	936,748
Outreach and other activities	773,411
	<hr/>
<b>Total Expenditures</b>	<b>169,103,314</b>
	<hr/>
<b>Excess of Expenditures Over Revenues</b>	<b>(13,318,471)</b>
<b>Other Financing Sources and Uses, including Transfers:</b>	
Interfund transfers	4,577,624
Transfer from KHESLC	7,151,055
	<hr/>
<b>Total Other Financing Sources and Uses, including Transfers</b>	<b>11,728,679</b>
	<hr/>
<b>Net Change in Fund Balance</b>	<b>(1,589,792)</b>
	<hr/>
<b>Fund Balance, Beginning of Year</b>	<b>13,839,916</b>
	<hr/>
<b>Fund Balance, End of Year</b>	<b>\$ 12,250,124</b>
	<hr/> <hr/>

See Notes to Financial Statements

Statement of Fiduciary Net Assets (Deficit)

**Kentucky Higher Education Assistance Authority**

June 30, 2005

<b>ASSETS</b>	<b>Federal Student Loan Reserve Fund</b>	<b>Agency Fund</b>	<b>Kentucky's Affordable Prepaid Tuition</b>	<b>Kentucky's Educational Savings Plan Trust</b>
<b>Current:</b>				
Cash and cash equivalents	\$ 5,389,127	\$ 595,449	\$ 9,763,400	\$ 698,510
Contributions receivable			7,619,086	
Fees receivable			188,826	
Investments				64,811,271
Receivables	9,928,235			17,770
Accrued interest income	44,981		458,245	
Other current assets	321,788			
<b>Total Current Assets</b>	<b>15,684,131</b>	<b>595,449</b>	<b>18,029,557</b>	<b>65,527,551</b>
<b>Noncurrent:</b>				
Restricted investments, cash and cash equivalents	2,302,290		96,639,510	
Contributions receivable			20,711,147	
Furniture and equipment, less accumulated depreciation			2,517	
<b>Total Noncurrent Assets</b>	<b>2,302,290</b>		<b>117,353,174</b>	
<b>Total Assets</b>	<b>17,986,421</b>	<b>595,449</b>	<b>135,382,731</b>	<b>65,527,551</b>
<b>LIABILITIES</b>				
<b>Current:</b>				
Accounts payable	3,014,502		28,804	121,330
Accrued expenses	2,750,000			33,012
Origination distribution payable		595,449		
Payable to Agency Operating Fund	1,090,234			
Payable to transfer agent				3,094
Default Aversion fees payable	395,748			
<b>Total Current Liabilities</b>	<b>7,250,484</b>	<b>595,449</b>	<b>28,804</b>	<b>157,436</b>
<b>Noncurrent:</b>				
Tuition benefits payable			141,948,827	
<b>Total Liabilities</b>	<b>7,250,484</b>	<b>595,449</b>	<b>141,977,631</b>	<b>157,436</b>
<b>NET ASSETS</b>				
Invested in capital assets			2,517	
Restricted for program benefits			(6,597,417)	65,370,115
Restricted for USDE recall	2,302,290			
Restricted for other purposes	8,433,647			
<b>Total Net Assets (Deficit)</b>	<b>\$ 10,735,937</b>	<b>\$ -</b>	<b>\$ (6,594,900)</b>	<b>\$ 65,370,115</b>

See Notes to Financial Statements

Statement of Changes in Fiduciary Net Assets (Deficit)

**Kentucky Higher Education Assistance Authority**

June 30, 2005

	<u>Federal Student Loan Reserve Fund</u>	<u>Kentucky's Affordable Prepaid Tuition</u>	<u>Kentucky's Educational Savings Plan Trust</u>
<b>Additions:</b>			
Federal reinsurance	\$ 50,088,866		
Fee revenue		\$ 196,975	
Contract income, net		32,075,577	
Subscriptions			\$ 12,392,752
Other income	216,826	26,244	
<b>Investment Revenue:</b>			
Net unrealized gain on investments		399,932	2,220,449
Interest and investment Income	251,052	4,833,645	2,484,375
<b>Total Investment Revenue</b>	<u>251,052</u>	<u>5,233,577</u>	<u>4,704,824</u>
<b>Total Additions</b>	50,556,744	37,532,373	17,097,576
<b>Deductions:</b>			
Program benefits:			
Loan claims	52,411,691		
Default aversion fee expense	1,550,869		
Redemptions			3,746,945
Administrative expenses		128,077	376,891
Personnel and professional expenses		678,819	
Other administrative expense		826,379	
Refunds		990,777	
Trustee fee expense		257,122	
Tuition benefits expense - payable		42,625,121	
Tuition benefits expense - paid		618,337	
Other expenses	1,074,078	2,018	
<b>Total Deductions</b>	<u>55,036,638</u>	<u>46,126,650</u>	<u>4,123,836</u>
<b>Change in Net Assets Before Transfers</b>	<u>(4,479,894)</u>	<u>(8,594,277)</u>	<u>12,973,740</u>
Transfer from Agency Operating Fund	145,336		
Transfer from Internal Service Fund		188,649	
Transfer from Unclaimed Property Fund		13,700,051	
<b>Change in Net Assets</b>	(4,334,558)	5,294,423	12,973,740
<b>Net Assets (Deficit) Beginning of Year</b>	<u>15,070,495</u>	<u>(11,889,323)</u>	<u>52,396,375</u>
<b>Net Assets (Deficit) End of Year</b>	<u>\$ 10,735,937</u>	<u>\$ (6,594,900)</u>	<u>\$ 65,370,115</u>

See Notes to Financial Statements

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note A--Description of Business**

The financial statements of the Kentucky Higher Education Assistance Authority include the following entities:

- The Kentucky Higher Education Assistance Authority (the "Authority")
- The Kentucky Higher Education Student Loan Corporation (the "Corporation")
- Kentucky's Affordable Prepaid Tuition Plan (the "Plan" or "KAPT")
- The Kentucky Education Savings Plan Trust (the "Trust")

The Authority was established in 1966 as the Commonwealth of Kentucky's (the "Commonwealth") agency for improving higher education opportunities. The Authority guarantees eligible student loans, and through the Corporation, makes student loans directly to parents and students, purchases and services eligible student loans and performs servicing and collection activities on eligible student loans for third-party lenders; and through the Trust, offers savings and investment opportunities for Kentuckians to save for higher education, and through KAPT offers Kentuckians an opportunity to pay future tuition and related expenses at a reduced present value rate.

The Authority--The Authority guarantees 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 guaranteed student loans under the Guaranteed Student Loan Program now known as the Federal Family Education Loan Program ("FFELP"). The FFELP, under which the Authority operates, was established by Congress and is administered by the USDE as a means of making loans available to students attending colleges, universities, and vocational institutions. The FFELP provides for the Authority to guarantee the repayment of principal and accrued interest to lenders for each eligible student loan. The Authority is responsible for processing loans submitted for guarantee, issuing loan guarantees, providing collection assistance to lenders for delinquent loans, paying lender claims for loans in default, and collecting loans on which default claims have been paid. The Authority also educates schools and lenders of FFELP requirements and regulatory changes, and encourages lender participation. Effective January 10, 1977, the Authority 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, 1992 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") that 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 established a Federal Student Loan Reserve Fund ("FSLRF") and an Agency Operating Fund ("AOF") as required to account for FFELP 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 reserves of the Authority 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's fund equity of approximately \$40.6 million was transferred to the newly established FSLRF and the Authority's AOF commenced

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note A--Description of Business--Continued**

activities with a zero fund equity. The funds in the newly established FSLRF were used to pay for the reimbursements to the lenders for defaulted student loan claims and pay the AOF for default aversion fees. Funds used to pay loan claims are 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 and may be used generally for all guaranty agency and other student financial aid related activities.

Sources of funds to the AOF includes investment income, agency retention on collections of defaulted loans, default aversion fees, account maintenance fees (.10% of original principle balance outstanding as of September 30), and loan processing and insurance fees (.40% of loans guaranteed and disbursed during the federal fiscal year).

Expenditures from the AOF include personnel, professional and other administrative expenses directly related to the loan program operations, and commission expense paid to external collection agencies. Both the FSLRF and AOF are subject to federal oversight.

The Corporation--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. Governed by a Board of Directors, 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 Corporation's education finance, servicing and collection activities include: (i) the origination and secondary market acquisition of education loans originated pursuant to the Federal Family Education Loan Program ("FFELP"), (ii) the financing of FFELP Loans, (iii) the servicing of FFELP Loans and of other education loans, and (iv) the collection of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The FFELP student loans held, serviced and collected by the 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").

The FFELP loans held by the Corporation are insured by the Authority, as the state guarantee agency, or the USDE. Loans made prior to October 1, 1993 are 100% insured. Loans made on or after October 1, 1993 are 100% insured against borrowers' death, disability or bankruptcy, and 98% insured against borrowers' default.

The Corporation's General Bond Resolutions ("GBRs") and separate Series Resolutions for issue of revenue bonds 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.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note A--Description of Business--Continued**

As of June 30, 2005 the Corporation serviced approximately \$1.2 billion outstanding principal amount of FFELP Loans which are pledged pursuant to the 1983 GBR, the 1997 GBR, the 2000 Line of Credit Trust Agreement or the 2004 GBR, and approximately \$5.8 billion of FFELP Loans and other education loans on behalf of other holders, including holders with national lending operations. The majority of such education loans are being serviced by the Corporation pursuant to servicing agreements which do not provide for the acquisition by the Corporation of the education loans serviced. As a servicer of FFELP loans, the Corporation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities. In addition, the Corporation currently collects approximately \$162 million of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The Corporation's obligations pursuant to such servicing and collection agreements are without recourse to assets pledged to collateralize any Corporation financings.

The Trust--In addition to operations related to the FFELP program, the Authority administers the Kentucky Education Savings Plan Trust and eight state grant and scholarship programs.

The Trust was formed on July 15, 1988 by Kentucky law, to help people save for the costs of education after high school. The Trust is administered by its Board of Directors, which is the same as the Authority's Board. The Authority 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 three investment options: the Managed Allocation Option, the 100% 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, Growth Equity, Growth & Income, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities, and Money Market Funds of the TIAA-CREF Institutional Mutual Funds. The 100% Equity Option invests in varying percentages in the Institutional Class of the International Equity and Growth & Income Funds of the TIAA-CREF Institutional Mutual Funds. All allocation percentages are determined by the Board 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 Plan--The Authority also administers the Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition, was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes ("KRS") 164A.700-709.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note A--Description of Business--Continued**

Effective July 1, 2003, responsibility for the governance and administration of the Plan was temporarily transferred to the Authority. In connection with the transfer of responsibility, the Plan became a fiduciary fund of the Authority. On July 1, 2004, governance reverted back to the Plan's Board, yet administrative responsibilities remained with the Authority. On July 1, 2005, governance of the Plan permanently transferred to the Authority.

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 typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

The Plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition units at current tuition levels 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 may 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 expenses 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 expenses 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.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note A--Description of Business--Continued**

The Authority administers the Trust, the Plan, College Access Program, Kentucky Tuition Grants, Teacher Scholarships, Osteopathic Medicine Scholarship Program and Work Study, and manages the funds for the Kentucky National Guard Tuition Award Program. The 2000 General Assembly enacted legislation giving the Authority administrative responsibility for a certain portion of the new Early Childhood Development Scholarship Program. The Authority's grant, scholarship and work-study programs are funded by appropriations from the Kentucky General Assembly, grants from the USDE, and allocation of revenues from the Kentucky Lottery Corporation, Coal Severance Tax, Tobacco Settlement funds, and transfers from the AOF.

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

Basis of Presentation--The Authority reports its financial information in accordance with the Government Accounting Standard Board ("GASB") Statement No. 34, "Basic Financial Statements and Management's Discussion Analysis – for State and Local Governments" as amended by GASB No. 37 and modified by GASB No. 38, "Certain Financial Statement Disclosures," (collectively "GASB 34").

The Authority's basic financial statements are prepared in accordance with GASB 34 and are comprised of three components: 1) government-wide financial statements; 2) fund financial statements; and 3) notes to the 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's governmental and business-type activities. The Authority's governmental activities reflect the activities of administering the various student grant, scholarship, and loan programs, and work-study programs for the Commonwealth of Kentucky and the USDE. The Authority's business-type activities include the activities of administering loan guarantee, default collection, lending and related activities, and other lender services.

The government-wide financial statements do not reflect fiduciary activities whose resources are not available to finance the Authority's programs. Fiduciary activities include private-purpose trust and agency funds administered by the Authority pursuant to the FFELP and the Trust.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

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

The Authority's 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 provides that accounting systems be organized by funds to account for specific activities consistent with legal and operating requirements. The Authority's governmental funds include the activities of administering grant, scholarship and loan programs, and work-study programs for the Commonwealth of Kentucky and USDE. Financial activities operated similarly to users of the Authority's loan guarantee, default collection and other lender services are presented as proprietary funds. Propriety 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's other business-type activities. The Authority follows all applicable Accounting Principles Board Opinions issued on or before November 30, 1989 for its proprietary funds, unless those pronouncements conflict with or contradict GASB pronouncements.

The Authority's fiduciary funds include the FSLRF, which is used to account for assets, liabilities, revenues and expenses that the Authority administers for the Federal Government as noted above.

The Authority's fiduciary funds include agency funds, which are held in purely a custodial capacity. Agency Funds include proceeds received from student loan lenders and later remitted to a college or university to pay for tuition assistance for a respective student. The fiduciary fund also includes assets, liabilities, additions, and deductions to net assets related to the Trust and the Plan. Assets of the Trust are held by the Authority on behalf of program participants. Assets of the Plan are held by the Authority to offset future tuition obligations of participants.

The Authority uses the accrual basis of accounting.

Investments--Investments for all funds except the Plan consist primarily of securities of the federal government or its agencies, commercial paper and collateralized mortgage obligations and mutual funds, and 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 invests in certain debt and equity instruments which are reported at fair value. Fair values are determined using quoted market values as of the last day of the reporting period where available. Securities for which quoted market prices are not available are valued using estimates based on similar securities.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

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

To achieve an actuarially determined target rate of gross return of 7.76%, the Plan's investments shall be held in approximately the following composition.

Large cap U.S. stocks	45%
Small/Midcap U.S. stocks	10%
Non-U.S. stocks	<u>5%</u>
<b>Total Equity</b>	<b><u>60%</u></b>
Inflation indexed bonds	25%
Corporate bonds	<u>15%</u>
<b>Total Fixed Income</b>	<b><u>40%</u></b>

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.

Teacher and Osteopathic Medicine Scholarship Loans and Advances--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.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**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.

Property and Equipment--Property and equipment, including construction in progress, is stated at cost less accumulated depreciation. Property and equipment is depreciated beginning when the assets is placed in service and continues over the estimated useful lives of the respective asset using the straight-line method. Net interest cost incurred during the construction period of significant proprietary funds assets is capitalized as part of the respective asset cost.

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 an expense. Federal defaulted loans outstanding are accounted for by the Authority but are not presented on the accompanying statement of net assets.

Allowance for Uncollectible Loans--As discussed in Note A, the Corporation's FFELP loans are guaranteed by the Authority. Management of the Corporation believes that the Authority will be able to honor all default claims submitted by the Corporation. However, the Corporation records a provision for loan losses based upon its expected default claims with respect to 98% insured loans and for loans with certain loan servicing violations. The allowance for loan losses on FFELP loans was \$1,020,207 for loan principal and \$161,765 for accrued interest as of June 30, 2005. Furthermore, the Corporation is required to purchase loans owned by third party customers with certain loan servicing violations. As of June 30, 2005, the allowance for third party servicing loan losses was \$1,690,732 for loan principal and \$176,037 for accrued interest.

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

Commission on Debt Recovery--The Authority fee for collection of defaulted education loans is recorded as commission revenue when earned. Loans for which the Corporation performs debt recovery services are not presented on the statement of net assets, as they are not owned by the Authority.

Servicing Fees--The Corporation's fees for servicing loans held by third parties are recorded as servicing fee revenue when earned. These third party loans are not presented on the statement of net assets, as they are not owned by the Corporation.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

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

Deferred Loan Purchase Premium and Deferred Loan Origination Costs--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.

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

Income Taxes--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.

Statement of Cash Flows--In the statement of cash flows, the Authority considers cash and cash equivalents to include highly liquid investments, which mature within one month of purchase.

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

Interfund Eliminations--Interfund receivables and payables are eliminated in the governmental and business-type activities columns of the 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 statement of net assets. Eliminations are made in the statement of activities to remove the doubling-up effect of internal service fund activity.

Program Revenues--Program revenues are reported in two categories including (1) charges for services and (2) program-specific operating grants and contributions. Charge for services include revenues received in the form of fees and charges for the Authority loan guarantee, default collection and other lender services, and interest income from the corporate lending activities. Program-specific operating grants and contributions include revenues from mandatory and voluntary nonexchange transactions with other governments and organizations that are restricted for use in a particular program. Program-specific operating grants and contributions include the interest earned on scholarship loans.

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 year is charged to participants based on outstanding balance.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

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

Tuition Benefits 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 Cost--Indirect costs are allocated amount functions/programs utilizing a full cost allocation approach with the objective of allocating all expenses to the Authority's various functions and programs.

Operating Revenues and Expenses--The Authority follows a policy of defining proprietary funds operating and nonoperating revenues and expenses utilizing the guidance set forth in GASB Statement No. 9.

Risk Management--The Authority is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage for these various risks of loss are obtained through the Authority's participation in the State of Kentucky's Risk Management Fund and State Sponsored Group Insurance Fund.

**Note C--Cash and Investments**

In March 2003, the GASB issued Statement No. 40 "Deposits and Investment Risk Disclosures," which is effective for periods beginning after June 15, 2004. Risk disclosures in previous financial statements (under the provisions of GASB Statement No. 3) focused only on custodial credit risk. GASB Statement No. 40 not only addresses custodial credit risk but other common areas of investment risk as well, including interest rate risk, credit risk and concentration of credit risk.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**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's deposits may not be returned to it. The Authority'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's name. As of June 30, 2005, the Authority's proprietary fund, governmental fund and fiduciary funds maintained custodial credit risk for cash on deposit as follows:

	<b>Governmental Fund Bank Balance</b>	<b>Proprietary Fund Bank Balance</b>	<b>Fiduciary Fund Bank Balance</b>
Insured (FDIC)		\$ 400,000	\$ 100,000
Uninsured:			
Collateralized by securities held by the pledging financial institution		6,355,102	3,627,981
Cash deposited with Kentucky State Treasurer	<u>\$ 2,200,187</u>	<u>7,258,706</u>	<u>84,626</u>
	<u><u>\$ 2,200,187</u></u>	<u><u>\$ 14,013,808</u></u>	<u><u>\$ 3,812,607</u></u>

As of June 30, 2005, all Proprietary Fund investments were registered in the Authority's name and maintained by an external trustee. The investment balances as of June 30, 2005 are summarized as follows:

	<b>Fair Value</b>	<b>Weighted Average Maturity</b>
Corporate bonds	\$ 5,580,704	5.14 years
U.S. Treasury and government agency securities	3,905,819	2.22 years
Collateralized Mortgage Obligations	10,273,612	5.18 years
Money market securities	<u>4,951,841</u>	
	<u><u>\$ 24,711,976</u></u>	

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note C--Cash and Investments--Continued**

As of June 30, 2005, the investment portfolio maintained by the Trust (\$64,811,271) was comprised entirely of TIAA mutual funds. The investment portfolio maintained by the FSLRF was comprised of the following:

	<u>Fair Value</u>	<u>Weighted Average Maturity</u>
U.S. Treasury and government agency securities	\$ 1,710,132	3.59 years
Collateralized Mortgage Obligations	411,649	7.92 years
Money market securities	<u>3,486,808</u>	
	<u>\$5,608,589</u>	

The investment balances as of June 30, 2005 for the Plan are summarized as follows:

	<u>Fair Value</u>	<u>Weighted Average Maturity</u>
Corporate bonds	\$ 10,295,290	4.59 years
U.S. Treasury and government agency securities	27,425,069	9.39 years
Corporate stock	58,919,151	
Money market securities	<u>9,364,080</u>	
	<u>\$106,003,590</u>	

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 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.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note C--Cash and Investments--Continued**

Credit Risk--The Authority maintains an investment policy that limits the credit risk for securities to investment grade and above by one of the nationally recognized credit rating agencies. As of June 30, 2005, the Authority's Proprietary Fund maintained securities issued by U.S. Treasury and governmental agencies with a Standard & Poor's rating of AAA. The following table summarizes the Standard & Poor's rating for all corporate bonds held by the Authority's Proprietary Fund as of June 30, 2005.

<u>Rating</u>	<u>Fair Value</u>
AAA	\$4,760,927
AA	351,017
AA+	15,718
A+	91,874
A	86,088
A-	45,672
BBB+	229,408
	<u>\$5,580,704</u>

The investment policy for the FSLRF limits the investment type to government back securities. As of June 30, 2005, the U.S. Treasury Notes and U.S. backed collateralized mortgage obligations in the FSLRF contain a Standard and Poor's rating of AAA.

The Plan maintains an investment policy that limits the credit risk for fixed income securities and short-term commercial paper. The Plan invests in AAA-rated securities issued by governmental agencies and long-term commercial paper with an investment grade rating, as long as the overall fixed income portfolio maintains a minimum rating of A by Moody's or Standard & Poor's. The Plan may only invest in short-term commercial paper, maturing within 9 months, with a minimum rating of A-1 by Standard & Poor's or Prime 1 by Moody's.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note C--Cash and Investments--Continued**

As of June 30, 2005, the Plan maintained securities issued by U.S. Treasury and governmental agencies with a Standard & Poor's rating of AAA. The following table summarizes the Standard & Poor's rating for all corporate bonds held by the Plan as of June 30, 2005.

<u>Rating</u>	<u>Fair Value</u>
AAA	\$1,077,780
AA-	1,291,453
A+	1,214,768
A	3,538,257
A-	993,706
BBB+	1,165,634
BBB	1,013,692
	<u>\$10,295,290</u>

**Note D--Property and Equipment**

A summary of property and equipment follows:

	<u>June 30, 2004</u>	<u>Additions</u>	<u>Deletions</u>	<u>June 30, 2005</u>
Proprietary fund:				
Furniture and equipment	\$ 12,635,308	\$3,559,517	\$ (787,099)	\$ 15,407,726
Building	11,841,953	151,482		11,993,435
System development information services	55,955			55,955
Student Loan Servicing System	541,131			541,131
Debt Recovery System	139,350			139,350
Accumulated depreciation	<u>(10,246,403)</u>	<u>(3,613,001)</u>	<u>752,875</u>	<u>(13,106,529)</u>
	<u>\$ 14,967,294</u>	<u>\$ 97,998</u>	<u>\$ (34,224)</u>	<u>\$ 15,031,068</u>
Fiduciary fund:				
Furniture and equipment	\$ 656,446		\$ (32,643)	\$ 623,803
Accumulated depreciation	<u>(651,912)</u>	<u>\$ (2,017)</u>	<u>32,643</u>	<u>(621,286)</u>
	<u>\$ 4,534</u>	<u>\$ (2,017)</u>	<u>\$ 0</u>	<u>\$ 2,517</u>

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note D--Property and Equipment--Continued**

Depreciation expense totaled \$3,613,001 for the year ended June 30, 2005, of which \$3,251,757 was allocated to business-type activities and \$356,662 was allocated to governmental activities and \$4,582 was allocated to the fiduciary activities. Depreciation expense was allocated to the business-type activities functions as follows:

Loan guarantee operations	\$ 494,150
Default collections	248,695
Lending and related activities	2,309,382
Lender assistance	187,802
Other	<u>11,728</u>
	<u><u>\$3,251,757</u></u>

**Note E--Federal Family Education Loan Programs**

Pursuant to the FFELP, the Authority insures eligible student loans for losses incurred from the default, death, disability or bankruptcy of the borrower, and also insures for other losses such as school closures and false certifications. As of June 30, 2005, the outstanding balance of aggregate insured student loans was approximately \$3.3 billion.

Loans insured by the Authority are reinsured under the 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'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).

Reimbursement for default claims is determined according to the following schedule:

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note E--Federal Family Education Loan Programs--Continued**

The Authority'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 has recorded an allowance of \$3.9 million at June 30, 2005 for losses on federal reinsurance.

<u>Through September 30, 1993</u>	<u>September 30, 1998</u>	<u>and After</u>
100%	98%	95%
100% of claims up to 5%, plus 90% of claims over 5% up to 9%	98% of claims up to 5%, plus 88% of claims over 5% up to 9%	90% of claims to 5%, plus 85% of claims over 5% up to 9%
100% of claims up to 5%, plus 90% of claims over 5% up to 9%, plus 80% of claims over 9%	98% of claims to 5%, plus 88% of claims over 5% up to 9%, plus 78% of claims over 9%	95% of claims to 5%, plus 85% of claims over 5% up to 9%, plus 75% of claims over 9%

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

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

Recoveries Payable to Federal Government--The Authority is entitled to retain 24% of collections received for defaulted loans for which federal reinsurance has been received. This amount is recorded as an addition when received. After September 30, 2003, the retention rate decreased to 23% as required by the 1998 Amendments.

Account Maintenance Fees ("AMF")--The 1998 Amendments established an account maintenance fee based on .12% of the original principal amount of outstanding loans. AMF is paid to the Authority on a quarterly bases by the federal government. This fee is recognized as revenue and recorded in the AOF. In fiscal year 2001, the AMF was reduced to .10% of the original principal amount of outstanding loans.

Loan Processing and Issuance Fees ("LPIF")--The 1998 Amendments established a loan processing and issuance fee. The LPIF payments are based on the net guarantee amount, less cancellations, multiplied by .65%. LPIF is paid to the Authority on a quarterly basis by the federal government. This fee is recognized as revenue and recorded in the AOF. Effective on September 30, 2003, LPIF was reduced to .40% of net guarantees, less cancellations.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note E--Federal Family Education Loan Programs--Continued**

Default Aversion Fees ("DAF")--Default aversion fees were established under the 1998 Amendments. The Authority 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 receives a request from a lender for preclaim assistance. DAF is paid monthly from the FSLRF to the AOF and is recognized as a deduction in the FSLRF and as revenue in the AOF.

**Note F--Loans**

The Corporation originates, purchases 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. Interest rates on student loans ranged from 2.77% to 12% for the fiscal year ended June 30, 2005 depending upon the type and date of origination of the individual loan.

Loans consist of the following at June 30, 2005:

Stafford – Subsidized	\$ 477,797,280
Stafford – Unsubsidized	359,444,642
PLUS/SLS	29,051,940
Consolidation	342,483,817
Other	<u>1,566,006</u>
Total gross loans	1,210,343,685
Allowance for loan loss	<u>(2,710,939)</u>
Net loans	1,207,632,746
Net deferred premium and loan cost	<u>20,433,681</u>
	<u><u>\$ 1,228,066,427</u></u>

All student loans are guaranteed as to principal and accrued interest. In order for the loans to be or remain guaranteed, certain due diligence requirements in loan servicing must be met. As of June 30, 2005, \$2,470,548 of student loans were no longer considered guaranteed due to violation of due diligence requirements.

The Corporation withholds certain origination fees from the loan disbursements on FFELP loans to the borrowers and remits these fees to USDE. The amount of the origination fee is based on a percentage of the gross loan amount.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note F--Loans--Continued**

The Corporation is also required to pay to USDE certain Lender and Rebate Fees. The amount of the Lender Fees is based on a certain percentage of the gross loan amount on all FFELP loans originated after October 1, 1993 and a certain percentage of the carrying value of the Consolidation loans.

Generally, student loans of the Corporation are pledged as collateral for the various obligations of the Corporation.

**Note G--Special Allowance**

The USDE pays a special allowance to the Corporation after the end of each quarter representing supplemental interest on outstanding, insured loans. FFELP loans disbursed during the period from January 1, 2000 through June 30, 2005 receive special allowance at a rate based upon the average of the bond equivalent rates of the 3-month commercial paper rate as reported by the U.S. Federal Reserve. Other eligible loans receive special allowance based on the 91-day U.S. Treasury bill rates. Certain loans financed through bonds dated prior to October 1, 1993 receive a 9.5% minimum rate of return based on provisions of the Higher Education Act of 1965, as amended, and related interpretations by the USDE. However, beginning October 1, 2004 and ending on December 31, 2005, any new loans acquired or originated using the proceeds of tax exempt obligations originally issued prior to October 1, 1993, if either the underlying bonds are refunded or loans are refinanced, will no longer receive the 9.5% minimum rate of return. Possible additional changes in legislation and/or USDE interpretations in the future could cause this benefit to be further reduced or eliminated; however, management does not expect any such changes to be retroactive.

**Note H--Principal and Interest Forgiveness**

During fiscal year 2005, the Corporation forgave \$10,597,487 in loan principal and \$3,373,475 in accrued interest for certain borrowers that were teachers and nurses who worked in the Commonwealth and students who completed the academic period for which their loan was made.

**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 on behalf of the Authority. The proceeds of the bonds are used to house the Authority's operations located in Frankfort, Kentucky. On October 8, 2003, the Commission issued additional bonds on behalf of the Authority as a partial refunding of the original bonds.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note I-- Capital Lease Payable --Continued**

The original bonds bear interest at a fixed rate, which varies from 5.00% to 5.30% and have a final maturity date of May 1, 2010. The new bonds bear interest at a fixed rate, which varies 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 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.

In connection with the issuance of the bonds, the Authority entered into a financing/lease agreement with the Commission whereby the Authority agreed to lease the newly constructed building. The lease is for an initial two-year term ending June 30, 2002, with the right to renew for nine additional two-year renewal periods.

The Authority 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 Commonwealth of Kentucky General Assembly appropriated sufficient spending authorization to the Authority to pay the lease payments required for the initial two-year term. There can be no assurance to make rent payments past the initial two-year lease period. The Authority did renew the lease for the biennium ending June 30, 2006.

The Authority has followed consolidation accounting principles as it related to the issuance of the bonds and the related lease agreement. As such, the Authority has recorded the proceeds of the bonds as restricted cash and cash equivalents and recorded the related debt, debt issuance costs and construction in progress incurred to date. The total estimated cost of the building is \$11,993,435 with approximately \$3.2 million of the building costs paid from the Authority's operating reserves. Net interest costs incurred from the tax exempt debt incurred from the date of the issuance of the bonds to the date that the building was available for use by the Authority has been capitalized as part of the building cost.

A summary of the activity for the capital lease for the year ended June 30, 2005 is as follows:

	<u>June 30, 2004</u>	<u>Additions</u>	<u>Payments</u>	<u>June 30, 2005</u>
Capital Lease Payable	\$ 8,085,000	\$ -	\$ 350,000	\$ 7,735,000

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note I-- Capital Lease Payable --Continued**

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

<b>Year Ending June 30,</b>	<b>Principal</b>	<b>Interest</b>
2006	\$ 365,000	\$ 381,554
2007	380,000	363,559
2008	400,000	344,569
2009	420,000	324,259
2010	440,000	302,659
<b>Five Years Ending June 30,</b>		
2011 - 2015	2,520,000	1,201,056
2015 - 2020	<u>3,210,000</u>	<u>512,810</u>
	<u>\$7,735,000</u>	<u>\$ 3,430,466</u>

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Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note J--Revenue Bonds**

The balance of revenue bonds and the related activity for the year ended June 30, 2005 is as follows:

Series	Schedule Maturity	Interest Rate	Beginning Balance @ July 1, 2004	Bond Maturities	New Issues	Ending Balance @ June 30 2005
<b>1983 General Bond Resolution</b>						
1991 E	1-Dec-11	Weekly	\$ 46,000,000			\$ 46,000,000
1993 B	Semi- annually in various amounts					0
	1-Jun-05	4.90% to 5.30%	36,920,000	\$ (36,920,000)		
1996 A	1-Jun-26	Weekly	25,000,000			25,000,000
2003 A	1-Dec-32	Every 35 Days	20,600,000			20,600,000
2003 B	1-Jun-05	1.65%	20,000,000	(20,000,000)		0
<b>1997 General Bond Resolution</b>						
1997 A-1	1-May-27	Every 35 days**	45,250,000			45,250,000
1997 A-2	1-May-27	Every 35 days**	45,200,000			45,200,000
1997 B	1-May-27	Every 35 days**	44,550,000			44,550,000
1998 A-1	1-May-28	Every 28 days**	36,400,000			36,400,000
1998 A-2	1-May-28	Every 28 days**	36,400,000			36,400,000
1998 B	1-May-28	Every 35 days**	42,200,000			42,200,000
1999 A	1-May-29	Every 28 days**	51,350,000			51,350,000
1999 B	1-May-29	Every 35 days**	23,650,000			23,650,000
2000 A-1	1-May-30	Every 28 days**	42,100,000			42,100,000
2000 A-2	1-May-30	Every 28 days**	42,100,000			42,100,000
2000 A-3	1-May-30	Every 35 days**	42,050,000			42,050,000
2000 B	1-May-30	Every 35 days**	23,750,000			23,750,000
2001 A-1	1-May-31	Every 35 days**	59,850,000			59,850,000
2001 A-2	1-May-31	Every 35 days**	59,850,000			59,850,000
2001 B	1-May-31	Every 35 days**	30,300,000			30,300,000
2002 A-1	1-May-32	Every 28 days**	55,450,000			55,450,000
2002 A-2	1-May-32	Every 35 days**	55,450,000			55,450,000
2002 A-3	1-May-32	Every 35 days**	39,100,000			39,100,000
2003 A-1	1-May-33	Every 35 days**	63,700,000			63,700,000
2003 A-2	1-May-33	Every 35 days**	16,950,000			16,950,000

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note J--Revenue Bonds--Continued**

Series	Schedule Maturity	Interest Rate	Beginning Balance @ July 1, 2004	Bond Maturities	New Issues	Ending Balance @ June 30 2005
<b>2004 General Bond Resolution</b>						
2004 A-1	1-Jun-34	Every 35 days**			\$ 18,850,000	18,850,000
2004 A-2	1-Jun-34	Every 35 days**			57,550,000	57,550,000
2004 A-3	1-Jun-34	Every 35 days**			57,600,000	57,600,000
2004 A-4	1-Jun-34	Every 35 days**			57,600,000	57,600,000
2004 A-5	1-Jun-34	Every 28 days**			72,400,000	72,400,000
2004 A-6	1-Jun-34	Every 28 days**			75,000,000	75,000,000
2004 B-1	1-Jun-34	Every 35 days**			11,000,000	11,000,000
			<u>\$ 1,004,170,000</u>	<u>\$ (56,920,000)</u>	<u>\$ 350,000,000</u>	<u>\$ 1,297,250,000</u>

\*\* Variable interest rate changes based on specified indices.

All Revenue Bonds except for the Senior Series 1997A-1 and 1997A-2, Senior Series 1998A-1 and 1998A-2, Senior Series 1999A, and Senior Series 2000A-1, 2000A-2, and Senior Series 2000A-3 and Senior Series 2001A-1 and 2001A-2 and Senior Series 2002A-1 and 2002A-2, and Senior Series 2004A-5 and Senior Series 2004A-6 are tax-exempt issues.

Debt service requirements to maturity or redemption date, assuming interest rates on variable rate debt remains at June 30, 2005 levels, are as follows:

	<b>Principal Repayment Amount (Thousands)</b>			
	<b>83 GBR</b>	<b>97 GBR</b>	<b>04 GBR</b>	<b>Total</b>
Five Years Ending				
June 30, 2014	\$ 46,000			\$ 46,000
June 30, 2029	25,000	\$ 325,000		350,000
June 30, 2034	20,600	530,650	\$ 350,000	901,250
	<u>\$ 91,600</u>	<u>\$ 855,650</u>	<u>\$ 350,000</u>	<u>\$ 1,297,250</u>

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note J--Revenue Bonds--Continued**

	<b>Interest Payment Amount (Thousands)</b>			
	<b>83 GBR</b>	<b>97 GBR</b>	<b>04 GBR</b>	<b>Total</b>
Year Ending June 30, 2006	\$ 3,089	\$ 34,114	\$ 13,177	\$ 50,380
Year Ending June 30, 2007	3,089	34,114	13,177	50,380
Year Ending June 30, 2008	3,089	34,114	13,177	50,380
Year Ending June 30, 2009	3,089	34,114	13,177	50,380
5 Years Ending June 30, 2010	3,089	34,114	13,177	50,380
5 Years Ending June 30, 2015	10,131	170,570	65,886	246,587
5 Years Ending June 30, 2020	7,854	170,570	65,886	244,310
5 Years Ending June 30, 2025	7,854	170,570	65,886	244,310
5 Years Ending June 30, 2030	4,485	138,965	65,886	209,336
5 Years Ending June 30, 2035	1,802	24,001	51,610	77,413
	<u>\$ 47,571</u>	<u>\$ 845,246</u>	<u>\$ 381,039</u>	<u>\$ 1,273,856</u>

All assets of the 1983 General Bond Resolution Fund and 1997 General Bond Resolution Fund and 2004 General Bond Resolution Fund are pledged for repayment of the specific bond issues under each resolution.

**Note K--Line of Credit**

The Corporation is a party to a Line of Credit Agreement with Bank of America, N.A., providing for advances to the Corporation not to exceed an aggregate outstanding principal balance of \$100 million. The borrowing period ends December 31, 2005, and can be extended at the discretion of both parties through December 31, 2006. During the year ended June 30, 2005, the Corporation drew down \$73,000,000 and made principal payments of \$114,280,000 on this line of credit. At June 30, 2005, there were no advances outstanding.

**Note L--Allowance for Arbitrage Liabilities**

Certain of the Corporation's tax-exempt bond issues subject the Corporation 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, 2005, the Corporation is reporting a liability for yield adjustment payments and forgiveness of \$29,829,244 and for arbitrage rebate of \$62,173.

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.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note L--Allowance for Arbitrage Liabilities--Continued**

Yield adjustment payments, which also relate to yield restriction on acquired purpose investments, are applicable to the 1991 Series D & E Bonds, 1996 Series A, Subordinate Series 1997B, Senior Series 1998B, Senior Series 1999B, Senior Series 2000B, Senior Series 2001B and any future issues except certain refunding issues. 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 the 1991 Series B & C, 1993 Series A, B & C, 1994 Series A & B, 1995 Series A, B & C, 1996 Series B, and 1997 Series A, B, C, & D bonds. In general, a yield restriction is imposed on acquired purpose investments, designating the allowable yield as 1.5% or 2.0% 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 Corporation's tax-exempt bonds except the 1985 Series A. 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.

**Note M--Credit and Liquidity Facilities and Bond Remarketing**

The 1991 Series E and 1996 Series A Bonds are collateralized with Standby Bond Purchase Agreements, pursuant to which Landesbank Hessen-Thuringen Girozentrale will purchase any bonds not remarketed. The 1991 Series E Bonds and the 1996 Series A Bonds also have a Municipal Bond Insurance Policy issued by AMBAC Indemnity Corporation and MBIA Insurance Corporation, respectively, which collateralizes payment of principal and interest on the bonds. The Standby Bond Purchase Agreements expires December 1, 2011 for the 1991 Series E Bonds and December 31, 2015 for the 1996 Series A Bonds. The AMBAC Municipal Bond Insurance Policy extends through the term of the 1991 Series E Bonds, December 1, 2011 and the MBIA Municipal Bond Insurance Policy extends through the term of the 1996 Series A Bonds, June 1, 2026.

The Corporation pays certain fees with respect to its variable rate bonds to auction agents, broker dealers, market agents, remarketing agents, and tender agents for remarketing bonds or conducting auctions of bonds. These arrangements are generally cancelable with prior notice by either party.

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note N--Retirement Plans**

The Commonwealth of Kentucky provides retirement benefits to all of the Authority's eligible full-time employees through the Kentucky Employees Retirement System ("KERS"). KERS is a cost-sharing multiple employer defined benefit plan, sponsored by the Commonwealth of Kentucky, which provides retirement, disability and death benefits. The Authority contributed 5.89% in 2005, and the employees contribute 5% of their gross wages to the plan. Such rates were intended to provide for normal costs on a current basis, plus an amount equal to the amortization of past service costs over 30 years, using the level percentage of payroll method. These rates are determined by the Board of Trustees of the Kentucky Retirement System each biennium. The payroll of employees covered by the retirement plan was approximately \$18,096,440 (which approximates total payroll) for the year ended June 30, 2005. KERS participants have a fully vested interest after the completion of sixty months service, twelve months of which are current service. The KERS contribution requirement for the year ended June 30, 2005 was \$1,969,621, which consisted of \$1,065,427 in Authority contributions and \$904,194 from employees. The Authority's contributions to KERS were \$955,711 and \$629,009 for the years ended June 30, 2004 and 2003, respectively. Although separate measurements of assets and pension benefit obligation are not available for individual employers, the annual KERS financial report (which is a matter of public record) contains this information for KERS as a whole. It may be obtained from the KERS by writing to them at 1260 Louisville Road, Perimeter Park West, Frankfort, Kentucky 40601.

Until June 30, 1994, Teachers Insurance and Annuity Association ("TIAA") was offered to eligible employees. TIAA was terminated as of June 30, 1994, and all TIAA participants became covered by KERS effective July 1, 1994. In order to provide coverage equivalent with KERS participants to the Authority's employees who were former TIAA participants regarding retirees' health insurance premiums, the Authority established an allowance for retirees' insurance based on management's projected estimate of future requirements. The portion of retirees' premiums paid by KERS is based on years of service under KERS; the allowance provides for the Authority to fund a portion of premiums, which will result in the same coverage for the 5 employees covered. Plan assets and the accrued liability for the postretirement healthcare plan totaled \$305,503 at June 30, 2005.

**Note O--Note Payable**

The Plan had an interest-free note payable to the Commonwealth's Unclaimed Property Fund in the amount of \$1,000,000. The Plan paid \$100,000 and \$900,000 of principal on the note during the fiscal years ended June 30, 2004 and 2005, respectively.

**Note P--Tuition Benefit Payable**

The following assumptions developed by management were used in the actuarial valuation of tuition benefits payable as of June 30, 2005. These assumptions are based on historical data for both state and national trends.

Continued

Notes to Financial Statements--Continued

## **Kentucky Higher Education Assistance Authority**

June 30, 2005

### **Note P--Tuition Benefit Payable--Continued**

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. Since inception, the gross investment yield assumption has been 7.76% per annum.

Investment Expenses--The investment expense assumption is based on a sliding scale of costs related to total assets. The investment expense is projected as .49% of the first \$25 million of assets, .28% of the next \$25 million of assets and .21 % of assets in excess of \$50 million.

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 two-year colleges and universities. Upon inception of the Plan in fiscal year 2002, the assumption for tuition increases was 6.5% for all future academic years.

As of June 30, 2003, known 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 assumption for tuition increases was adjusted to 7.5% for the next five academic years and 6.5% for all academic years thereafter. As of June 30, 2004, known 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 increase assumption was adjusted to 7.5% annually through the academic year ending June 30, 2011, and increased from 6.5% to 7.00% for each academic year thereafter. As of June 30, 2005, known 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 increase assumption is 7.5% through year ending June 30, 2012, 7.25% annually through year ending June 30, 2014, and 7.0% annually thereafter. For the period from inception to June 30, 2005, the annualized tuition increase for the highest-priced Kentucky public university, as applicable to the tuition benefits payout rate of the KAPT Standard Plan, which represents 90% of KAPT enrollments, has been 10.5%. 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, 2005 has been 26.7%. For the University of Kentucky, as applicable to the tuition benefits payout rate of the KAPT Premium Plan, the average annualized tuition increase from inception to June 30, 2005, has been 12.6%.

Payment of Tuition and Mandatory Fees--Payments of tuition and mandatory fees are based on 128 credit hours of utilization. Payments are assumed to occur twice annually.

### **Note Q--Restricted Net Assets**

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

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

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note Q--Restricted Net Assets--Continued**

Education Finance Funds--Net assets are restricted as required by the 1983, 1997 and 2004 General Bond Resolutions, the separate Series Resolutions, and Line of Credit Agreements.

Student Aid Funds--The Student Aid net assets are restricted for the Student Aid Programs.

**Note R--Operating Leases**

The Corporation leases office space and equipment under agreements expiring through 2010. The following are the approximate minimum lease commitments under operating leases:

Year Ending June 30	
2006	\$814,000
2007	737,000
2008	215,000
2009	183,000
2010	41,000

**Note S--Commitments and Contingencies**

The FSLRF, a fiduciary fund maintained on behalf of the USDE, is contingently liable for loans made by financial institutions that qualify for guaranty. The default ratio for loans guaranteed by the Authority is below 5% for the federal fiscal year ended September 30, 2004. As a result, the federal government's reinsurance rate for defaults for that period is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1993 to September 30, 1998. In the event of future adverse default experience, the Authority could be liable for up to 25% of defaulted loans. At the beginning of each fiscal year, the Authority's reinsurance rate returns to 98%; management does not expect that all guaranteed loans could default in one year.

For loans made on or after October 1, 1998, the reinsurance rate will be 95%. In the event of future adverse default experience, the Authority could be liable for up to 25% of such defaulted loans.

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, 2005 is calculated as follows:

Amount of guaranteed student loans outstanding at lenders	\$ 3,338,746,000
Less minimum federal government share - 75%	<u>2,504,059,500</u>
	<u>\$ 834,686,500</u>

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note S--Commitments and Contingencies--Continued**

The Corporation has entered into loan purchase contracts with various eligible lenders. Subject to the terms and conditions of these agreements, the Corporation on June 30, 2005 had plans to purchase approximately \$33.4 million of loans. These contracts cannot be terminated by either party.

**Note T--The Plan's Relationship with the Commonwealth's Unclaimed Property Fund**

The Kentucky's Constitution and other state laws prohibit the Commonwealth from providing its full faith and credit to obligations of other entities, such as the Plan. As a result, payments from the Plan are not guaranteed in any way by the Commonwealth and are not considered to have created a debt or obligation of the Commonwealth. Such payments are limited obligations, payable from the Plan assets. The Commonwealth does not offer its pledge of the full faith and credit of the Commonwealth. Historically, under KRS 393.015, 75 percent of the balance of the Commonwealth's Unclaimed Property Fund, administered by the Kentucky State Treasurer, was available to meet any unfunded liability of the Plan, as may be determined by the Plan's Board of Directors. In fiscal year 2005, the Commonwealth's Unclaimed Property Fund transferred \$13.7 million to the Plan to address the unfunded actuarial liability as of June 30, 2004. The Plan's Board of Directors acted on its authority provided in KRS 393.015 and approved the transfer.

Subsequent to the transfer, the 2005 Kentucky General Assembly passed the Executive Branch Budget Bill ("House Bill 267"), which repealed KRS 393.015 and required that the \$13.7 million discussed above be transferred to the Commonwealth's General Fund. In response to House Bill 267, the Commonwealth's Attorney General filed a lawsuit and obtained a temporary injunction from a judge. The objective of the lawsuit is to have the court issue a permanent injunction banning the transfer of the \$13.7 million to the General Fund and have the court declare unconstitutional the repeal of KRS 393.015. At June 30, 2005, the \$13.7 million is accounted for as an asset of the Plan in accordance with the provisions of the temporary injunction.

If the above-cited aspects of House Bill 267 are upheld by the courts, the Plan will be required to transfer \$13.7 million to the Commonwealth's General Fund. In addition, the Plan will lose the backing of the Commonwealth's Unclaimed Property Fund. Such actions could impact the Plan's ability to meet its future obligations.

On August 25, 2005, the Plan's Board of Directors passed a resolution stating; "The KAPT Board will work vigorously with the 2006 General Assembly to pass legislation that will ensure that all currently held KAPT contracts will be honored if an unfunded liability arises at the time benefits would be paid on behalf of the contract holders."

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2005

**Note U--Subsequent Events**

On September 8, 2005, the Corporation issued \$400 million of Student Loan Revenue Bonds to continue its student loan finance program. The \$100 million 2005 Series A & B Tax Exempt Bonds are scheduled to mature on June 1, 2035, and bear interest rates that change every 35 days based on specified indices. The \$300 million 2005 Series A Taxable Bonds are scheduled to mature on June 1, 2035, and bear interest rates that change every 28 days based on specified indices.