

**Kentucky Higher Education
Assistance Authority**

**Report on Audit of Financial Statements
for the year ended June 30, 2003**

C O N T E N T S

	Pages
Report of Independent Auditors	1-2
Required Supplementary Information:	
Management's Discussion and Analysis	3-11
Financial Statements:	
Government-Wide Statement of Net Assets	12
Government-Wide Statement of Activities	13
Statement of Net Assets - Proprietary Funds	14
Statement of Revenues, Expenditures and Changes in Net Assets - Proprietary Funds	15
Statement of Cash Flows - Proprietary Fund	16-17
Statement of Net Assets - Governmental Fund	18
Statement of Revenues, Expenditures and Changes in Fund Balance/ Net Assets - Governmental Fund	19
Statement of Fiduciary Net Assets	20
Statement of Changes in Fiduciary Net Assets	21
Notes to Financial Statements	22-46

Report of Independent Auditors

To the Board of Directors of
Kentucky Higher Education Assistance Authority

In our opinion, based on our audit and the report of other auditors, the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of Kentucky Higher Education Assistance Authority (the Authority), a component unit of the Commonwealth of Kentucky, which collectively comprise the Authority's basic financial statements as listed in the table of contents, present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund and aggregate remaining funds of the Authority at June 30, 2003, 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. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of Kentucky Educational Savings Plan Trust, which statements reflect total assets of \$36,643,668 as of June 30, 2003, and total additions to fiduciary net assets of \$12,852,392 for the year ended June 30, 2003. 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 Educational Savings Plan Trust, is solely based on the report of other auditors. We conducted our audit of these financial statements 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, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Management's Discussion and Analysis as set forth on pages 3 to 11 is not a required part of the basic financial statement but is supplementary information required by the Governmental Accounting Standards Board. We have provided certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 23, 2003 on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

As more fully described in Note 1 to the basic financial statements, the financial statements reflect the inclusion of the Kentucky Higher Education Student Loan Corporation as a blended component unit of the Authority and the Kentucky Educational Savings Plan Trust as a fiduciary fund, and therefore, the financial statements as of and for the year ended June 30, 2003 are not comparable in all respects to the financial statements for periods prior to such date.

PricewaterhouseCoopers LLP

September 23, 2003

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Description of the Business

The Kentucky Higher Education Assistance Authority (the Authority) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. The Authority guarantees eligible student loans, and through the Kentucky Higher Education Student Loan Corporation (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 Kentucky Educational Savings Plan Trust (the Trust), offers savings and investment opportunities for Kentuckians to save for higher education. Throughout Management's Discussion and Analysis and the accompanying financial statements, the "Authority" refers to the combined group and its operations.

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 (the U.S.D.E) 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 services, paying lender claims for loans and collecting defaulted loans on which claims have been paid.

The Act amendments of 1998 created a new guarantee agency administrative and financial model. Under the new model, the Authority was required to establish the Federal Student Loan Reserve Fund (the FSLRF) and the Agency Operating Fund (the AOF). All reserves as of October 1, 1998, were accounted for in the FSLRF. Funds in the FSLRF are used to reimburse lenders for defaulted loans, death, disability and bankruptcy claims and to pay the AOF for default aversion activities. The U.S.D.E., through reinsurance, subsequently reimburses the FSLRF for payments to lenders for defaulted loans and death, disability and bankruptcy claims. Other sources of FSLRF additions are federal retention on collections of defaulted loans and investment income. The AOF holds and accounts for funds considered property of the Authority. Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees, account maintenance fees (.10% of original principal outstanding as of September 30), and loan processing and issuance fees (.65% of loans guaranteed and disbursed during the current federal fiscal year). Expenditures from the AOF include personnel and professional and other administrative expenses directly related to loan program operations, and commission expense paid to external collection agencies. Funds in the AOF carry both federal and state imposed restrictions.

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

In addition to the funds established by the 1998 amendments to the Act, the Authority administers nine state sponsored grant and scholarship programs and provides higher education outreach activities in the Student Aid Fund. Funds established to administer these programs are maintained with the State Treasurer. Sources of funds to the student aid fund include, general fund appropriations, federal awards, lottery revenues and transfers from the AOF. Uses of funds include state sponsored grant and scholarship programs, personnel and professional and other administrative expenses directly related to the administration of the student aid programs and outreach activities.

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 parent 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 revenue bonds and notes under various debt agreements, including two 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 PeopleSM".

In July, 2002 an executive order was issued by the Governor of the Commonwealth of Kentucky which made one body responsible for the governance of the Authority and the Corporation. Accordingly, subsequent to the effective date of the order, the Corporation is considered a component unit of the Authority.

The Authority is charged with managing the Trust, an Internal Revenue Service Code Section 529 plan, which was created in 1988 by the Kentucky General Assembly to assist people with saving for the cost of education after high school. The Trust is administered by TIAA-CREF Tuition Financing, Inc. (TFI). The Trust is reported as a fiduciary fund.

The Federal Student Loan Reserve Fund (FSLRF) and the Agency Fund are fiduciary agency funds used to account for loan proceeds handled by the Authority on behalf of lenders and schools.

Overview of Financial Statements

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, 3) notes to financial statements. This report contains other supplementary information in addition to the basic financial statements.

The government-wide statements of net assets and activities include the Governmental Fund and Proprietary Funds. The government-wide financial statements can be found on pages 12-13 of this report. The fund financial statements can be found on pages 14-19 of this report.

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Fiduciary funds are used to account for resources held for the benefit 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 fiduciary fund statements of net assets and changes in fiduciary net assets can be found on pages 20 – 21 of this report.

The following is a condensed summary of financial information for the years ended June 30, 2003 and 2002, respectively.

Kentucky Higher Education Assistance Authority

Management's Discussion and Analysis (Unaudited)

Condensed Financial Information - Governmental Fund and Proprietary Funds

	Governmental Fund		Proprietary Funds	
	2003	2002	2003	2002
Net Asset Information				
Capital assets			\$ 14,705,092	\$ 11,746,467
Other assets	\$ 14,106,342	\$ 22,103,521	1,155,679,875	921,488,797
Total assets	14,106,342	22,103,521	1,170,384,967	933,235,264
Long-term liabilities			1,033,265,782	794,455,871
Other liabilities	175,784	145,176	29,643,034	37,868,700
Total liabilities	175,784	145,176	1,062,908,816	832,324,571
Net assets invested in capital, net of debt			7,190,717	5,336,775
Unrestricted net assets			11,355,470	12,570,205
Restricted net assets	13,930,558	21,958,345	88,929,964	83,003,713
Total net assets	\$ 13,930,558	\$ 21,958,345	\$ 107,476,151	\$ 100,910,693
Activity Information				
Interest and investment income	\$ 205,090	\$ 514,427	\$ 3,953,034	\$ 5,539,827
State General Fund revenue	45,860,000	53,656,960		
Student Aid & Advancement Fund revenue	58,546,800	40,424,708		
Federal funds revenue	817,800	753,617		
Tobacco settlement revenue	570,488	1,052,057		
Service fees			5,475,187	2,643,925
Debt recovery commission			10,090,693	11,644,221
Federal fees earned			6,580,179	5,885,998
Default aversion fee income			863,793	1,234,921
Interest income:				
Loans			33,433,526	43,764,404
Special allowance			5,162,087	3,974,246
Federal Student Loan Reserve Fund transfer			1,473,023	
Other income	537,210	510,136	218,111	642,998
Total revenues	106,537,388	96,911,905	67,249,633	75,330,540
Kentucky Tuition Grants	15,835,333	14,265,831		
College Access Program Grants	36,807,194	35,057,525		
Early Childhood Development	764,460	1,188,274		
National Guard Tuition Awards	2,251,589	2,218,064		
Kentucky Education Excellence Scholarships	58,819,668	38,834,859		
Teacher Scholarships	3,755,771	3,878,814		
Osteopathic Medicine Scholarships	104,470	168,158		
Work study	997,674	843,081		
Outreach and other activities	749,493	437,223	109,852	222,183
Guarantee operations			5,513,436	5,847,231
Default collection operations			6,022,219	4,960,812
Lending and related activities			40,796,039	43,720,637
Lender assistance operations			2,722,152	2,514,449
Federal Student Loan Reserve Fund transfer				1,533,260
Total expenditures	120,085,652	96,891,829	55,163,698	58,798,572
Change in net assets before operating transfers	(13,548,264)	20,076	12,085,935	16,531,968
Interfund transfer	2,520,477	3,320,268	(2,520,477)	(3,320,268)
Transfer to Governmental Fund	3,000,000		(3,000,000)	
Change in net assets	\$ (8,027,787)	\$ 3,340,344	\$ 6,565,458	\$ 13,211,700

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Condensed Financial Information - Fiduciary Funds

	Federal Student Loan		Agency		Kentucky Educational Savings	
	Reserve Fund		Fund		Plan Trust	
	2003	2002	2003	2002	2003	2002
Net Asset Information						
Capital assets	\$ 155,838	\$ 220,090				
Other assets	23,124,345	44,609,010	\$ 260,705	\$ 4,863,585	\$ 36,643,668	\$ 25,575,040
Total assets	23,280,183	44,829,100	260,705	4,863,585	36,643,668	25,575,040
Total liabilities	4,495,061	7,431,386	260,705	4,863,585	100,812	132,413
Net assets invested in capital, net of debt	155,838	220,090				
Restricted net assets	18,629,284	37,177,624			36,542,856	25,442,627
Total net assets	\$ 18,785,122	\$ 37,397,714			\$ 36,542,856	\$ 25,442,627
Changes in Fiduciary						
Net Asset Information						
Federal reinsurance	\$ 52,823,599	\$ 38,777,504				
Subscriptions					\$ 11,167,545	\$ 13,650,366
Other income	1,146,465	1,920,940			1,664,847	
Total additions	53,970,064	40,698,444			12,832,392	13,650,366
Loan claims	54,386,453	40,879,350				
Redemptions					1,732,163	1,729,298
Default aversion	863,793	1,234,921				
Other expenses	498,172	342,970				1,225,770
Total deductions	55,748,418	42,457,241			1,732,163	2,955,068
Change in net assets before operating transfers	(1,778,354)	(1,758,797)			11,100,229	10,695,298
Operating Transfers						
Transfer from (to) Agency Operating Fund	(1,473,023)	1,533,260				
Transfer to USDE for recall	(15,361,215)					
Change in net assets after operating transfers	\$ (18,612,592)	\$ (225,537)			\$ 11,100,229	\$ 10,695,298

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Financial Analysis – Governmental Fund and Proprietary Funds

Statement of Net Assets

The Authority's total governmental fund net assets decreased due to the expenditure of available funds designated for need-based grant and scholarship programs. In fiscal year 2002, the Authority utilized 9% of available funds to build a reserve of available general funds (carryforward) to offset projected revenue shortfalls in fiscal year 2003. In fiscal year 2003, the Authority expended the available fund carryforward and implemented an improved grant and scholarship delivery system resulting in the Authority disbursing 99.5% of available funds. There was no significant change in the government fund liabilities.

The increase in Proprietary Fund net assets is primarily due to Authority and Corporation lending activities. Total proprietary fund assets grew from approximately \$933 million at June 30, 2002, to \$1.170 billion at June 30, 2003. Net loans outstanding totaled \$807 million at June 30, 2003, a \$91 million increase over June 30, 2002. This increase included \$251 million in loan acquisitions (both originations and purchases) offset by borrower payments, consolidation loan payments, and principal forgiveness on loans. Other assets increased by \$234 million as a result of increased cash, cash equivalents and investments due to the issuance of revenue bonds and capital improvements. During fiscal year 2003, the Corporation completed two debt issuances, totaling \$271 million. These debt issuances were offset by \$37 million in bond maturities. This increase was the largest component of the Authority's increase in total proprietary fund liabilities. Other proprietary fund liabilities decreased, resulting from a change in the provision for arbitrage liability and the change in defaulted loan collection approach. In fiscal year 2002, the Authority maintained defaulted loan collection contracts with two outside providers, and paid commissions on a daily basis. On July 1, 2002, the Authority cancelled the collection contracts with outside providers and began collecting all defaulted loans in-house.

Statement of Revenues, Expenditures, and changes in Net Assets

Governmental fund revenues for fiscal year 2003 increased \$9.6 million, 10% over the same period a year ago, primarily due to the increased funding for the Kentucky Educational Excellence Scholarship (KEES) Program. In 1998, the Kentucky State Legislature created the KEES program and tied state lottery revenue to KEES and need-based scholarship and grant funding. In fiscal year 2002, the Authority received 57% of lottery revenue. In fiscal year 2003, the Authority received 64% of lottery revenue. Governmental expenditures also increased 24%, which is comprised of a 25% increase in direct benefits to students and offset by a slight decrease in administrative costs. Direct benefits increased primarily due to the increase in KEES awards. The Kentucky Tuition Grant (KTG) and College Access Program (CAP) programs also noted increases in direct benefits (KTG increased 11.6% and CAP increased 5.3%). The increases in CAP and KTG, as more fully described in the footnotes to the financial statements, resulted from the Corporation contributing \$1 million to each the KTG and CAP programs in fiscal year 2003.

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis

Financial Analysis – Governmental Fund and Proprietary Funds, continued

The Authority's proprietary fund experienced a 43% decrease in changes in net assets before operating and other transfers, resulting from a 13% decrease in revenue and a 3% decrease in expenditures. The decrease in revenue was primarily caused by a decrease in interest income and a decrease in defaulted loan commissions offset by an increase in service fees. Interest and investment income, which includes interest on loans and investments, decreased by 29% due to the declining interest rates in FY 2003 and yield reductions related to the interest forgiveness program. The average yield from interest on loans was 4.26% for fiscal year 2003 versus 6.32% in FY 2002. Likewise, investment yields declined from 2.54% in FY 2002 to 1.33% in FY 2003. Service fees increased due to growth in the portfolio of loans for a large client for whom the Corporation performs third-party servicing activities. Additional revenue decreases totaling approximately \$2 million were due to the change in the defaulted loan collection process. As previously discussed, prior to fiscal year 2003, the Authority maintained defaulted loan collection contracts with two organizations, GRC and DCS, and collected some defaulted loans in-house. On July 1, 2002, the Authority cancelled the collection contracts with GRC and DCS and started collecting all defaulted loans in-house. Additionally, during the period July 1, 2002 through September 30, 2002, the Authority conducted an "amnesty program" where the Authority waived all collection costs on loans paid-in-full (which ultimately resulted in reduced revenue).

The decrease in proprietary expenses was caused primarily by the decrease in interest on debt and a decrease in the provision for arbitrage liabilities. Interest on debt decreased by 23% due to declining interest rates on the variable rate bonds outstanding. Average rates declined from 2.79% in fiscal year 2002 to 1.87% in fiscal year 2003. The provision for arbitrage liabilities decreased approximately \$11.5 million due to borrower benefits given to certain borrowers in the portfolio. These benefits resulted in principal and interest forgiveness of approximately \$7.9 million, which had the effect of reducing the excess yield on certain of the Corporation's outstanding bond obligations by \$7.9 million thus reducing the provision for arbitrage liabilities. The decreases in these proprietary expenses were offset by increases in other operating expenses. Operating expenses for lender and related activities net of interest on debt, provision for arbitrage liabilities, and borrower benefits increased 50% due to costs related to the growing loan portfolio as the Corporation added loan servicing volume, a change in an accounting estimate and a significant increase in the provision for student loan losses. Defaulted loan collection expense increased by \$1 million, again mainly due to bringing 100% of the collection activity in-house. Guarantee operations expense decreased (due to operational improvements resulting from job duty realignments), and lender assistance operations expense increased because of additional costs allocated from accounting and information technology to upgrade the loan origination process. During the year ended June 30, 2003 the Corporation revised its estimate of the economic life of the loan over which the loan origination cost are amortized from eleven to eight years. A charge of \$1.4 million was taken to reflect this change in estimate. The provision for student loan losses increased by approximately \$880,000 due to additional servicing errors made by the Corporation's loan servicing operation on private loans owned by a third party. Due to these servicing errors, the Corporation was required to purchase these uninsured private loans.

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Financial Analysis – Fiduciary Funds

Statement of Net Assets

The FSLRF assets decreased approximately 50%, while liabilities decreased approximately 40%. The decrease in assets is attributed to the \$15.3 million of federal recall funds sent to the United States Treasury on September 1, 2002, and the decrease in federal reinsurance receivable as of June 30. On September 1, 2002, the Authority sent the United States Treasury \$14.2 million as required by Section 422(h) of the Higher Education Act, and \$1.2 million as required by Section 422 (i) of the Higher Education Act. The remaining decrease in assets resulted from the decrease in federal reinsurance, due to the timing of payments from the federal government. The decrease in liabilities resulted from the timing of payments to U.S.D.E. for defaulted loan collections.

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, 2002, the Authority maintained \$4.8 million on behalf of schools and lenders. At June 30, 2003, the Authority maintained approximately \$261,000 on behalf of schools and lenders. The Authority disbursed all Agency funds as of July 3, 2003.

The Trust is an Internal Revenue Code Section 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 \$11.1 million, due to new subscriptions received (\$11.1 million) and investment income of \$1.7 million, net of redemptions of \$1.7 million. Trust liabilities remained relatively constant during the fiscal year.

Changes in Fiduciary Net Assets

The FSLRF had a reduction in fiduciary net assets of approximately \$1.8 million for the year ended June 30, 2003 from operations, which is consistent with the year ended June 30, 2002. Loan claims expense increased approximately 33%, due primarily to the increase in defaulted loan claim volume from the Corporation and other third party lenders for which the Corporation provides servicing activities. The increase in loan claims expense also resulted from the increase in the Authority's guarantee portfolio. Federal reinsurance increased approximately 36% and has a direct correlation to loan claims expense (since the Authority files for federal reinsurance on all claims paid). The increase in loan claims expense (33%) did not match the increase in Federal reinsurance (36%) because of claim mix (with varying reinsurance rates from 95%-100%) and because the Authority increased its estimate of loan loss provision in fiscal year 2002 (and did not need a similar increase in fiscal year 2003).

Kentucky Higher Education Assistance Authority Management's Discussion and Analysis (Unaudited)

Financial Analysis – Fiduciary Funds, continued

Operating transfers changed significantly from prior year. In fiscal year 2002, the AOF transferred \$1.5 million to the FSLRF, which represents a settlement with the U.S.D.E. related to the adoption of the new financial model in fiscal year 1999. In fiscal year 2003, the FSLRF transferred \$1.47 million to the AOF, which represents investment income on federal recall money which is restricted for default aversion activities.

Trust activity in fiscal year 2003 was much improved over fiscal year 2002. In fiscal year 2002, the Trust recognized investment losses of \$1.8 million and interest income of only \$600,000, for a net loss of \$1.2 million. In fiscal year 2003, the Trust recognized investment gains of \$950,000 and interest income of \$700,000, totaling income of \$1.7 million. The improvement in investment activity resulted from improving market conditions in the fourth quarter of fiscal year 2003. The Trust did experience a reduction in subscriptions from prior year, due to increased competition of alternative plans in the market place and reduced marketing activities. Redemptions remained relatively constant during the fiscal year.

Kentucky Higher Education Assistance Authority
Government-Wide Statement of Net Assets
June 30, 2003

ASSETS	Governmental Activities	Business-Type Activities	Total
Current:			
Cash and cash equivalents	\$ 2,328,204	\$ 91,530,938	\$ 93,859,142
Receivable from Federal Student Loan Reserve Fund		446,147	446,147
Receivables	509,976	3,332,366	3,842,342
Special allowance receivable		1,156,105	1,156,105
Accrued interest income		17,289,865	17,289,865
Default aversion fees receivable		308,676	308,676
Investments		6,778,900	6,778,900
Teacher and Osteopathic Medicine scholarship loans (current portion)	278,000		278,000
Total current assets	<u>3,116,180</u>	<u>120,842,997</u>	<u>123,959,177</u>
Noncurrent:			
Restricted cash and cash equivalents		205,021,439	205,021,439
Investments		8,791,879	8,791,879
Teacher and Osteopathic Medicine scholarship loans	4,226,604		4,226,604
Teacher and Osteopathic Medicine scholarship advances	6,763,558		6,763,558
Property, plant and equipment, at cost, less accumulated depreciation		14,705,092	14,705,092
Loans, net		806,743,657	806,743,657
Deferred loan purchase premiums and originations costs, net		9,213,816	9,213,816
Deferred debt issuance costs		5,066,087	5,066,087
Total noncurrent assets	<u>10,990,162</u>	<u>1,049,541,970</u>	<u>1,060,532,132</u>
Total assets	<u>14,106,342</u>	<u>1,170,384,967</u>	<u>1,184,491,309</u>
LIABILITIES			
Current:			
Accounts payable and accrued expenses	175,784	9,078,574	9,254,358
Interest payable		1,374,460	1,374,460
Bond payable (current portion)		19,190,000	19,190,000
Total current liabilities	<u>175,784</u>	<u>29,643,034</u>	<u>29,818,818</u>
Noncurrent:			
Allowance for arbitrage liabilities		21,165,782	21,165,782
Bond payable		1,012,100,000	1,012,100,000
Total noncurrent liabilities	<u>-</u>	<u>1,033,265,782</u>	<u>1,033,265,782</u>
Total liabilities	<u>175,784</u>	<u>1,062,908,816</u>	<u>1,063,084,600</u>
NET ASSETS			
Invested in capital assets, net of expended debt proceeds		7,190,717	7,190,717
Unrestricted		11,355,470	11,355,470
Restricted for program benefits	13,930,558		13,930,558
Restricted for student aid and related activities		18,941,884	18,941,884
Restricted, other		69,988,080	69,988,080
Total net assets	<u>\$ 13,930,558</u>	<u>\$ 107,476,151</u>	<u>\$ 121,406,709</u>

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

Kentucky Higher Education Assistance Authority

Government-Wide Statement of Activities

For the year ended June 30, 2003

	Direct Expenses	Indirect Expenses	Program Revenue		Net (Expenses) Revenues and Changes in Net Assets		
			Charges for Services	Operating Grants and Contributions	Governmental Activities	Business-Type Activities	Total
Functions/Programs							
Primary government							
Governmental activities:							
Kentucky Tuition Grants	\$ 15,395,986	\$ 439,347		\$ 12,501,518	\$ (3,333,815)		\$ (3,333,815)
College Access Program Grants	36,346,107	461,087		29,978,676	(6,828,518)		(6,828,518)
Early Childhood Development	678,573	85,887		577,492	(186,968)		(186,968)
National Guard Tuition Awards	2,198,005	53,584		2,319,070	67,481		67,481
Kentucky Education Excellence Scholarships	58,190,982	628,686		58,571,749	(247,919)		(247,919)
Teacher Scholarships	3,403,038	352,733		976,600	(2,779,171)		(2,779,171)
Osteopathic Medicine Scholarships		104,470		1,612,190	1,507,720		1,507,720
Work Study	901,543	96,131			(997,674)		(997,674)
Outreach and other activities		749,493		93	(749,400)		(749,400)
Total governmental activities	117,114,234	2,971,418		106,537,388	(13,548,264)		(13,548,264)
Business-Type Activities							
Loan guarantee operations	5,513,436		7,552,231			2,038,795	2,038,795
Default collections	6,022,219		7,783,541			1,761,322	1,761,322
Lender assistance	2,722,152		715,726	1,473,023		(533,403)	(533,403)
Lending and related activities	40,796,039		49,615,260			8,819,221	8,819,221
Outreach and other activities	109,852		109,852				
Total business type activities	55,163,698		65,776,610	1,473,023		12,085,935	12,085,935
Total primary government	\$ 172,277,932	\$ 2,971,418	\$ 65,776,610	\$ 108,010,411	(13,548,264)	12,085,935	(1,462,329)
Transfers:							
Interfund transfer					2,520,477	(2,520,477)	
Federal Student Loan Reserve Fund transfer					3,000,000	(3,000,000)	
Transfer to Governmental Fund							
Total transfers					5,520,477	(5,520,477)	
Change in net assets					(8,027,787)	6,565,458	(1,462,329)
Net assets, beginning of year					21,958,345	100,910,693	122,869,038
Net assets, end of year					\$ 13,930,558	\$ 107,476,151	\$ 121,406,709

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

Kentucky Higher Education Assistance Authority

Statement of Net Assets – Proprietary Funds

June 30, 2003

	Authority			Corporation				Combined	
	Internal Service Fund	Agency Operating Fund	Authority Total	1983 General Bond Resolution	1997 General Bond Resolution	Line of Credit	Operating Fund	Corporation Total	Total
ASSETS									
Current:									
Cash and cash equivalents	\$ 3,871,088	\$ 6,384,336	\$ 10,255,424	\$ 62,525,961	\$ 12,271,170	\$ 205,736	\$ 6,272,647	\$ 81,275,514	\$ 91,530,938
Internal receivable (payable)	(1,505,467)	2,534,437	1,028,970	235,147	(1,413,456)	(159,197)	308,536	(1,028,970)	
Receivable from Federal Student Loan									
Receivables Fund		446,147	446,147						446,147
Receivables	8,501	1,166,454	1,174,955	617	484,230		1,672,564	2,157,411	3,332,366
Special allowance receivable				1,147,593	8,512			1,156,105	1,156,105
Accrued interest income		58,033	58,033	2,787,812	14,439,091	189	4,740	17,231,832	17,289,865
Default aversion fees receivable		308,676	308,676						308,676
Investments		393,724	393,724				6,385,176	6,385,176	6,778,900
Total current assets	2,374,122	11,291,807	13,665,929	66,697,130	25,789,547	46,728	14,643,663	107,177,068	120,842,997
Noncurrent:									
Restricted cash and cash equivalents	583,802		583,802	22,213,690	182,223,947			204,437,637	205,021,439
Investments		8,791,879	8,791,879						8,791,879
Internal receivable (payable) for capital projects	(583,802)	583,802							
Property, plant and equipment, at cost, less accumulated depreciation		12,460,385	12,460,385				2,244,707	2,244,707	14,705,092
Loans, net				143,855,602	662,888,055			806,743,657	806,743,657
Deferred loan purchase premiums and originations costs, net				519,704	8,694,112			9,213,816	9,213,816
Deferred debt issuance costs		141,823	141,823	838,471	4,085,793			4,924,264	5,066,087
Total noncurrent assets		21,977,889	21,977,889	167,427,467	857,891,907		2,244,707	1,027,564,081	1,049,541,970
Total assets	2,374,122	33,269,696	35,643,818	234,124,597	883,681,454	46,728	16,888,370	1,134,741,149	1,170,384,967
LIABILITIES									
Current:									
Accounts payable and accrued expenses	2,374,122	1,069,449	3,443,571	285,800	2,041,270	19,740	3,288,193	5,635,003	9,078,574
Interest payable		72,353	72,353	367,072	908,047	26,988		1,302,107	1,374,460
Bond payable (current portion)		310,000	310,000	18,880,000				18,880,000	19,190,000
Total current liabilities	2,374,122	1,451,802	3,825,924	19,532,872	2,949,317	46,728	3,288,193	25,817,110	29,643,034
Noncurrent:									
Allowance for arbitrage liabilities				18,907,467	2,258,315			21,165,782	21,165,782
Bond payable		7,930,000	7,930,000	148,520,000	855,650,000			1,004,170,000	1,012,100,000
Total noncurrent liabilities		7,930,000	7,930,000	167,427,467	857,908,315			1,025,335,782	1,033,265,782
Total liabilities	2,374,122	9,381,802	11,755,924	186,960,339	860,857,632	46,728	3,288,193	1,051,152,892	1,062,908,816
NET ASSETS									
Invested in capital assets, net of expended debt proceeds		4,946,010	4,946,010				2,244,707	2,244,707	7,190,717
Unrestricted							11,355,470	11,355,470	11,355,470
Restricted for student aid and related activities		18,941,884	18,941,884						18,941,884
Restricted, other				47,164,258	22,823,822			69,988,080	69,988,080
Total net assets	\$ -	\$ 23,887,894	\$ 23,887,894	\$ 47,164,258	\$ 22,823,822		\$ 13,600,177	\$ 83,588,257	\$ 107,476,151

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

Kentucky Higher Education Assistance Authority

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

For the year ended June 30, 2003

	Authority			Corporation					Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	1983 General Bond Resolution	1997 General Bond Resolution	Line of Credit	Operating Fund	Corporation Total	Total
Operating Revenues:									
Service fees		\$ 715,726	\$ 715,726				\$ 4,759,461	\$ 4,759,461	\$ 5,475,187
Debt recovery commission		7,783,541	7,783,541				2,307,152	2,307,152	10,090,693
Federal fees earned		6,580,179	6,580,179						6,580,179
Default aversion fee income		863,793	863,793						863,793
Interest income:									
Loans				\$ 6,165,094	\$ 27,268,432			33,433,526	33,433,526
Special Allowance				4,955,421	206,666			5,162,087	5,162,087
Investments		830,851	830,851	945,977	1,969,076	66,737	140,393	3,122,183	3,953,034
Other income	109,852	108,259	218,111						218,111
Total operating revenues	109,852	16,882,349	16,992,201	12,066,492	29,444,174	66,737	7,207,006	48,784,409	65,776,610
Operating expenses:									
Personnel and professional services	72,843	8,135,931	8,208,774	1,611,697	2,654,288	1,140	3,771,639	8,038,764	16,247,538
Other administrative expenses	29,065	2,492,567	2,521,632	603,462	1,193,973		1,786,815	3,584,250	6,105,882
Default commission expense		2,476,678	2,476,678						2,476,678
Interest expense	2,740	366,563	369,303	5,576,810	11,725,982	125,417		17,428,209	17,797,512
Amortization of bond issuance costs				193,528	136,767			330,295	330,295
Variable bond credit facility and remarketing fees				225,258	1,988,369	86,422		2,300,049	2,300,049
Provision for arbitrage liabilities				(7,863,189)	1,221,317			(6,641,872)	(6,641,872)
Amortization of loan purchase premiums and origination costs				350,233	2,758,208			3,108,441	3,108,441
Depreciation and amortization	5,204	705,649	710,853	157,178	311,500		446,970	915,648	1,626,501
Federal consolidation fees				542,621	1,196,960			1,739,581	1,739,581
Technical services				210,167	416,517		911,649	1,538,333	1,538,333
Provision for Student Loan Loss				(57,539)	206,172		1,180,998	1,329,631	1,329,631
Principal forgiveness				5,514,745				5,514,745	5,514,745
Other expenses		80,419	80,419	347,335	925,256	27,597	309,777	1,609,965	1,690,384
Total operating expenses	109,852	14,257,807	14,367,659	7,412,306	24,735,309	240,576	8,407,848	40,796,039	55,163,698
Income (loss) before transfers		2,624,542	2,624,542	4,654,186	4,708,865	(173,839)	(1,200,842)	7,988,370	10,612,912
Transfers in (out):									
Interfund transfer		(2,520,477)	(2,520,477)	(750,000)		29,362	720,638	-	(2,520,477)
Federal Student Loan Reserve Fund transfer		1,473,023	1,473,023						1,473,023
Transfer to Governmental Fund				(3,000,000)				(3,000,000)	(3,000,000)
Increase (decrease) in net assets		1,577,088	1,577,088	904,186	4,708,865	(144,477)	(480,204)	4,988,370	6,565,458
Net assets, beginning of year		22,310,806	22,310,806	46,260,072	18,114,957	144,477	14,080,381	78,599,887	100,910,693
Net assets, end of year		\$ 23,887,894	\$ 23,887,894	\$ 47,164,258	\$ 22,823,822		\$ 13,600,177	\$ 83,588,257	\$ 107,476,151

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

Kentucky Higher Education Assistance Authority

Statement of Cash Flows – Proprietary Funds

For the year ended June 30, 2003

	Authority			Corporation				Combined	
	Internal	Agency	Authority	1983 General	1997 General	Line	Operating	Corporation	Total
	Service	Operating	Total	Bond	Bond	of	Fund	Total	
Fund	Fund		Resolution	Resolution	Credit				
Cash flows from operating activities:									
Principal received on loans				\$ 38,951,254	\$ 119,625,989			\$ 158,577,243	\$ 158,577,243
Interest on loans				6,630,437	19,054,174			25,684,611	25,684,611
Special allowance				4,789,771	198,425			4,988,196	4,988,196
Client loan receipts							\$ 644,205,336	644,205,336	644,205,336
Servicing fees							3,512,241	3,512,241	3,512,241
Debt recovery commission/cost reimbursement		\$ (2,327,778)	\$ (2,327,778)				2,327,778	2,327,778	
Loans purchased, including premiums				80	(57,325,167)		(1,021,130)	(58,346,217)	(58,346,217)
Loans originated, including costs				(19,667,499)	(173,117,454)			(192,784,953)	(192,784,953)
Credit facility fees				(224,127)	(1,899,563)	(87,572)		(2,211,262)	(2,211,262)
Loan receipts remitted to clients							(644,001,717)	(644,001,717)	(644,001,717)
Service fees	\$ 109,852	605,702	715,554						715,554
Debt recovery commission		7,783,541	7,783,541						7,783,541
Federal fees		6,580,179	6,580,179						6,580,179
Default aversion fees		142,557	142,557						142,557
Other, net	977,238	(11,842,949)	(10,865,711)	(4,380,051)	(6,265,996)	107,074	(2,878,221)	(13,417,194)	(24,282,905)
Administrative expenses paid		(148,900)	(148,900)						(148,900)
Personnel and professional expenses paid									
Net cash provided by (used in) operating activities	1,087,090	792,352	1,879,442	26,099,865	(99,729,592)	19,502	2,144,287	(71,465,938)	(69,586,496)
Cash paid from noncapital financing activities:									
Proceeds from debt issued				40,600,000	230,650,000	11,495,000		282,745,000	282,745,000
Debt issuance costs				(188,918)	(958,854)			(1,147,772)	(1,147,772)
Debt principal payments				(36,970,000)		(11,495,000)		(48,465,000)	(48,465,000)
Interest on debt				(5,697,697)	(11,631,494)	(98,429)		(17,427,620)	(17,427,620)
Interfund transfers, net				(750,000)		29,362	720,638		
Transfer to governmental fund				(3,000,000)				(3,000,000)	(3,000,000)
Decrease in federal student loan reserve receivable		1,017,366	1,017,366						1,017,366
Cash requirements		(2,520,477)	(2,520,477)						(2,520,477)
Federal student loan reserve fund transfer		1,473,023	1,473,023						1,473,023
Transfer from KHESLC									
Net cash provided by (used in) noncapital financing activities		(30,088)	(30,088)	(6,006,615)	218,059,652	(69,067)	720,638	212,704,608	212,674,520
Cash flows from capital and related financing activities:									
Interfund transfers, net	(1,395,770)	1,395,770							
Capital expenditures		(3,108,306)	(3,108,306)				(1,736,682)	(1,736,682)	(4,844,988)
Bond principle payments		(300,000)	(300,000)						(300,000)
Interest paid on bonds		(366,563)	(366,563)						(366,563)
Net cash used in capital and related financing activities	(1,395,770)	(2,379,099)	(3,774,869)				(1,736,682)	(1,736,682)	(5,511,551)

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

Kentucky Higher Education Assistance Authority

Statement of Cash Flows – Proprietary Funds, Continued

For the year ended June 30, 2003

	Authority			Corporation				Combined	
	Internal Service Fund	Agency Operating Fund	Authority Total	1983 General Bond Resolution	1997 General Bond Resolution	Line of Credit	Operating Fund	Corporation Total	Total
	Cash flows from investing activities:								
Purchases of investments		\$ (16,372,849)	\$ (16,372,849)	\$ (24,451,765)			\$ (16,511,789)	\$ (40,963,554)	\$ (57,336,403)
Proceeds from sales/maturities of investments		19,890,294	19,890,294	60,756,675			17,300,000	78,056,675	97,946,969
Investment income		1,263,016	1,263,016	1,009,905	\$ 1,908,699	\$ 66,828	142,082	3,127,514	4,390,530
Net cash provided by investing activities		4,780,461	4,780,461	37,314,815	1,908,699	66,828	930,293	40,220,635	45,001,096
Net increases (decrease) in cash and cash equivalents	(308,680)	3,163,626	2,854,946	57,408,065	120,238,759	17,263	2,058,536	179,722,623	182,577,569
Cash and cash equivalents at beginning of year	4,763,570	3,220,710	7,984,280	27,331,586	74,256,358	188,473	4,214,111	105,990,528	113,974,808
Cash and cash equivalents at end of year	\$ 4,454,890	\$ 6,384,336	\$ 10,839,226	\$ 84,739,651	\$ 194,495,117	\$ 205,736	\$ 6,272,647	\$ 285,713,151	\$ 296,552,377
Reconciliation of income (loss) before transfers to net cash provided by (used in) operating activities:									
Income (loss) before transfers		\$ 2,624,542	\$ 2,624,542	\$ 4,654,186	\$ 4,708,865	\$ (173,839)	\$ (1,200,842)	\$ 7,988,370	\$ 10,612,912
Adjustments to reconcile income (loss) before transfers to net cash provided by (used in) operating activities:									
Investment income		(830,851)	(830,851)	(914,959)	(1,969,076)	(66,737)	(138,449)	(3,089,221)	(3,920,072)
Depreciation and amortization	\$ 5,204	705,649	710,853	157,178	311,500		446,970	915,648	1,626,501
Loss on equipment disposal		25,706	25,706				86,504	86,504	112,210
Interest on debt		366,563	366,563	5,576,810	11,725,982	125,417		17,428,209	17,794,772
Amortization of bond issuance costs				193,528	136,767			330,295	330,295
Amortization of loan purchase									
Premiums and origination costs				350,233	2,758,208			3,108,441	3,108,441
Provision for loan losses				(57,539)	206,172		1,180,998	1,329,631	1,329,631
Borrower interest converted to principal				(489,754)	(8,979,793)		(4,480)	(9,474,027)	(9,474,027)
Principal forgiveness				5,514,745				5,514,745	5,514,745
Other				(225,504)	(381,978)	(91)	311,600	(295,973)	(295,973)
Items not accounted for as revenues or expenses									
Principal received on loans				38,951,254	119,625,988			158,577,242	158,577,242
Loan purchased, including premiums				80	(57,325,167)		(1,021,130)	(58,346,217)	(58,346,217)
Loans originated				(19,667,499)	(173,117,454)			(192,784,953)	(192,784,953)
(Increases) decreases in assets:									
Receivables	(8,501)	(111,032)	(119,533)	16,990	(413,791)		(861,874)	(1,258,675)	(1,378,208)
Default aversion fee receivable		(15,587)	(15,587)						(15,587)
Accrued interest				1,000,057	705,158	91	(255)	1,705,051	1,705,051
Special allowance receivable				(165,650)	(173,891)			(173,891)	(173,891)
Interfund payable/receivable	1,100,363	(1,910,668)	(810,305)	(922,336)	(189,554)	135,810	1,942,901	966,821	156,516
Other current assets		(556,361)	(556,361)						(556,361)
Increases (decreases) in liabilities:									
Accounts payable and accrued expenses	(9,976)	499,449	489,473	(7,952)	1,432,908	(1,149)	1,402,344	2,826,151	3,315,624
Allowance for arbitrage				(7,864,003)	1,043,914			(6,820,089)	(6,820,089)
Interest payable		(5,058)	(5,058)						(5,058)
Net cash provided by operating activities	\$ 1,087,090	\$ 792,352	\$ 1,879,442	\$ 26,099,865	\$ (99,729,592)	\$ 19,502	\$ 2,144,287	\$ (71,465,938)	\$ (69,586,496)

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

Kentucky Higher Education Assistance Authority
Statement of Net Assets – Governmental Fund

June 30, 2003

	Governmental Fund
ASSETS	Student Aid
Current:	
Cash and cash equivalents	\$ 2,328,204
Receivables	509,976
Teacher and Osteopathic Medicine Scholarship loans (current portion)	<u>278,000</u>
Total current assets	<u>3,116,180</u>
Noncurrent:	
Teacher and Osteopathic Medicine Scholarship loans, net of allowance of \$1,850,000	4,226,604
Teacher and Osteopathic Medicine Scholarship advances	<u>6,763,558</u>
Total noncurrent assets	<u>10,990,162</u>
Total assets	<u>14,106,342</u>
LIABILITIES	
Current:	
Accounts payable	<u>175,784</u>
Total liabilities	<u>175,784</u>
NET ASSETS	
Restricted for program benefits	<u>\$ 13,930,558</u>

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

Kentucky Higher Education Assistance Authority
Statement of Revenues, Expenditures and Changes in Fund Balance/
Net Assets – Government Fund
for the year ended June 30, 2003

	Governmental Funds Student Aid
Revenues:	
Interest and investment income	\$ 205,090
Tobacco Settlement revenue	570,488
State General Fund revenue	45,860,000
Student Aid & Advancement Fund revenue	58,546,800
Federal funds revenue	817,800
Other income	537,210
Total revenues	<u>106,537,388</u>
Expenditures:	
Kentucky Tuition Grants	15,835,333
College Access Program Grants	36,807,194
Early Childhood Development Scholarships	764,460
National Guard Tuition Awards	2,251,589
Kentucky Education Excellence Scholarships	58,819,668
Teacher Scholarships	3,755,771
Osteopathic Medicine Scholarships	104,470
Work Study	997,674
Outreach and other activities	749,493
Total expenditures	<u>120,085,652</u>
Excess of expenditures over revenues	(13,548,264)
Other financing sources and uses, including transfers:	
Interfund transfers	2,520,477
Transfer from Corporation	3,000,000
Net change in net assets	(8,027,787)
Net assets, beginning of year	<u>21,958,345</u>
Net assets, end of year	<u><u>\$ 13,930,558</u></u>

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

Kentucky Higher Education Assistance Authority
Statement of Fiduciary Net Assets

June 30, 2003

ASSETS	Federal Student Loan Reserve Fund	Agency Fund	Kentucky Educational Savings Plan Trust
Current:			
Cash and cash equivalents	\$ 11,212,099	\$ 260,705	\$ 3,583
Investments	100,000		36,435,483
Receivables	4,239,840		204,602
Accrued interest income	101,781		
Other current assets	50,231		
Total current assets	15,703,951	260,705	36,643,668
Noncurrent:			
Investments	5,048,336		
Restricted investments, cash and cash equivalents	2,372,058		
Property, plant and equipment, at cost, less accumulated depreciation	155,838		
Total noncurrent assets	7,576,232		
Total assets	23,280,183	260,705	36,643,668
LIABILITIES			
Current:			
Accounts payable	1,940,238	260,705	81,589
Accrued expenses	1,800,000		19,223
Federal payable	446,147		
Default aversion fees payable	308,676		
Total current liabilities	4,495,061	260,705	100,812
NET ASSETS			
Invested in capital assets, net of debt	155,838		
Restricted for U.S.D.E. recall	2,372,058		
Restricted for other purposes	16,257,226		36,542,856
Total net assets	\$ 18,785,122		\$ 36,542,856

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

Kentucky Higher Education Assistance Authority
Statement of Changes in Fiduciary Net Assets
for the year ended June 30, 2003

	Federal Student Loan Reserve Fund	Kentucky Educational Savings Plan Trust
Additions:		
Federal reinsurance	\$ 52,823,599	
Subscriptions		\$ 11,167,545
Interest and investment income	966,714	1,663,809
Other income	179,751	1,038
	<hr/>	<hr/>
Total additions	53,970,064	12,832,392
Deductions:		
Program benefits:		
Loan claims	54,386,453	
Redemptions		1,732,163
Default aversion fee expense	863,793	
Other expenses	498,172	
	<hr/>	<hr/>
Total deductions	55,748,418	1,732,163
Change in net assets before operating transfers	(1,778,354)	11,100,229
Operating transfers to Agency Operating Fund	(1,473,023)	
Transfer to USDE for recall	(15,361,215)	
	<hr/>	<hr/>
Change in net assets after operating transfer	(18,612,592)	11,100,229
Net assets at beginning of year	37,397,714	25,442,627
	<hr/>	<hr/>
Net assets at end of year	<u>\$ 18,785,122</u>	<u>\$ 36,542,856</u>

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

Kentucky Higher Education Assistance Authority

Notes to Financial Statements

1. Description of Business:

The Kentucky Higher Education Assistance Authority (the Authority) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. The Authority guarantees eligible student loans, and through the Kentucky Higher Education Student Loan Corporation (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 Kentucky Educational Savings Plan Trust (the Trust), offers savings and investment opportunities for Kentuckians to save for higher education. Throughout the accompanying financial statements, the "Authority" refers to the combined group and its operations.

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 guarantee 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 U.S. Department of Education (the U.S.D.E.) 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, 1993 to September 30, 1998 was reduced to a maximum of 98% and federal reinsurance on guaranteed loans made on or after October 1, 1998, was reduced to a maximum of 95% (see Note 5).

Kentucky Higher Education Assistance Authority

Notes to Financial Statements

1. Description of Business, continued:

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 FLSRF and the Authority's AOF commenced activities with a zero fund equity. The funds in the newly established FSLRF were used to pay for the reimbursements to the lenders for defaulted student loan claims and pay the AOF for default aversion fees. Funds used to pay loan claims and AOF default aversion fees are replenished from reimbursements from the federal government. Other sources of revenues to the FSLRF include the Federal retention 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 fee (.10% of original principal balance outstanding as of September 30), and loan processing and insurance fees (.65% of loans guaranteed and disbursed during the federal fiscal year). Expenditures from the AOF include personnel, professional and other administrative expenses directly related to loan program operations, and commission expense paid to external collection agencies. Both the FSLRF and AOF are subject to federal oversight.

The Corporation is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky. The Corporation is authorized to finance loans for students attending eligible post-secondary institutions, service and collect education loans, and issue revenue bonds and notes not to exceed \$1,950 million 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).

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

1. Description of Business, continued:

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.

As of June 30, 2003 the Corporation held approximately \$807 million outstanding principal amount of FFELP Loans which are pledged pursuant to the 1983 GBR, the 1997 GBR or the Line of Credit Trust Agreement and serviced approximately \$3.3 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 (except in cases of servicing due diligence violations). 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 \$172 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 financing.

In addition to operations related to the FFELP program, the Authority administers the Kentucky Education Savings Plan Trust (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 the Board of Directors. The Authority has contracted with TIAA-CREF Tuition Financing, Inc. (TFI) 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.

All participants of the Trust establish an account in the name of a beneficiary. Contributions can be made among the Managed Allocation Option, 100% Equity Option, or the Guaranteed Option. Contributions in the Managed Allocation Option are allocated among eleven age bands, based on the age of the beneficiary. Each age band invests in varying percentages in 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 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. Beginning on May 15, 2003, the Guaranteed Option invests in a funding agreement issued by TIAA-CREF Life Insurance Company, a subsidiary of TIAA, which offers a guaranteed principal and a minimum rate of return of 3% per annum.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

1. Description of Business, continued:

The Authority administers the Kentucky Educational Excellence Scholarship Program, 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 U.S.D.E., an allocation of revenues from the Kentucky Lottery Corporation, Coal Severance Tax, Tobacco Settlement funds, and transfers from the AOF.

2. Summary of Significant Accounting Policies:

a. Basis of Presentation:

In June 1999, the Governmental Accounting Standard Board (GASB) adopted GASB statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis – for State and Local Governments" as amended by GASB No. 37 and modified by GASB No. 38, "Certain Financial Statement Disclosures," (collectively GASB 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 U.S. Department of Education. 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

b. Basis of Presentation, continued:

The Authority's combined fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to state government entities, which 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 program for the Commonwealth of Kentucky and U.S. Department of Education. 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 GASB pronouncements as well as Financial Accounting Standards Board pronouncements and Accounting Principles Board Opinions, issued on or before November 30, 1989 for its proprietary funds, unless those pronouncements conflict with or contradict GASB pronouncements.

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. Assets of the Trust are held by the Authority on behalf of program participants.

The Authority uses the accrual basis of accounting.

c. Investments:

Investments, which consist primarily of securities of the federal government or its agencies, commercial paper and collateralized mortgage obligations and mutual funds, 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

d. 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.

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.

e. Property, Plant and Equipment:

Property, plant and equipment, including construction in progress is stated at cost, less accumulated depreciation. Property, plant 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.

f. 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 balance sheet.

g. Allowance for Uncollectible Loans:

The Authority provides for losses on delinquent student loans based on an evaluation of the loan portfolio, current economic conditions and such other factors which, in the Authority's judgment, require consideration in estimating future delinquent loan losses.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

g. Allowance for Uncollectible Loans, continued:

As discussed in Note 1, loans held by the Corporation are guaranteed by the Authority. The Authority 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 Corporation's allowance for loan losses on FFELP loans was \$780,685 for loan principal and \$116,493 for accrued interest as of June 30, 2003. Additionally, the Corporation, is required to purchase loans owned by third party customers with certain loan servicing violations. As of June 30, 2003, the allowance for third party servicing loan losses was \$1,062,219 for principal and \$43,931 for accrued interest.

h. Interest Income on Loans:

The Authority earns interest income on loans from three sources: (1) the U.S.D.E. for subsidized interest earned while certain students are in school; (2) special allowance subsidies (discussed in Footnote 7); 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.

i. Commission on Debt Recovery:

The Authority's 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 balance sheet as they are not owned by the Authority.

j. Servicing Fees:

The Authority'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 balance sheet as they are not owned by the Authority.

k. Deferred Loan Purchase Premiums 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.

l. 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

m. Income Taxes:

The Authority is a state government agency established by the Kentucky General Assembly and is, therefore, not subject to federal or state income taxes. The Corporation is an independent *de jure* municipal corporation and political subdivision of the Commonwealth of Kentucky and is therefore not subject to federal or state income taxes.

n. Statement of Cash Flows:

In the statements of cash flows, the Authority considers highly liquid investments which mature within one month of purchase.

o. Use of Estimates:

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

p. Interfund Eliminations:

Interfund receivables and payables are eliminated in the governmental and business-type activities column 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.

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

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

r. 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.

s. 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.

t. 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

3. Cash and Investments:

Cash and investments as of June 30, 2003 are summarized as follows:

	At Fair Market Value			Total
	Investments	Cash Equivalents	Cash	
Governmental Fund:				
Cash deposited with Kentucky State Treasurer			\$2,328,204	\$2,328,204
Proprietary Funds:				
U.S. Treasury and government agency securities	\$ 10,819,891	\$ 435,095		11,254,986
Collateralized mortgage obligations	2,457,455			2,457,455
Corporate bonds	2,293,433			2,293,433
Money market securities		195,199,546		195,199,546
Government mutual funds		89,329,970		89,329,970
	15,570,779	284,964,611		300,535,390
Cash in bank			7,132,876	7,132,876
Cash deposited with Kentucky State Treasurer			4,454,890	4,454,890
	15,570,779	284,964,611	11,587,766	312,123,156
Fiduciary Funds:				
FSLRF Trust and Agency Fund:				
U.S. Treasury and government agency securities	4,162,382			4,162,382
Collateralized mortgage obligations	3,358,012			3,358,012
TIAA Institutional Mutual Funds	36,435,483			36,435,483
Government mutual funds		9,062,796		9,062,796
	43,955,877	9,062,796	-	53,018,673
Cash in bank			2,413,591	2,413,591
	43,955,877	9,062,796	2,413,591	55,432,264
Totals	\$59,526,656	\$294,027,407	\$16,329,561	\$369,883,624

Kentucky Higher Education Assistance Authority
Notes to Financial Statements, Continued

3. Cash and Investments, continued:

Deposits, identified as cash in the above summary, as of June 30, 2003 are as follows:

	<u>Financial Statement Amount</u>	<u>Bank Balance</u>
Insured (FDIC)	\$ 803,583	\$ 803,583
Uninsured:		
Covered by trustee agreement	8,742,884	9,678,076
On deposit with Kentucky State Treasurer	<u>6,783,094</u>	<u>6,783,089</u>
Total	<u><u>\$16,329,561</u></u>	<u><u>\$17,264,748</u></u>

Investments, including cash equivalents, categorized as of June 30, 2003 are summarized as follows:

	<u>Category 1</u>	<u>Uncategorized</u>	<u>Total</u>
U.S. Treasury and government agency obligations	\$15,417,368		\$15,417,368
Collateralized mortgage obligations	5,815,467		5,815,467
Corporate bonds	2,293,433		2,293,433
Money market securities		\$195,199,546	195,199,546
Government mutual funds		<u>134,828,249</u>	<u>134,828,249</u>
Total	<u><u>\$23,526,268</u></u>	<u><u>\$330,027,795</u></u>	<u><u>\$353,554,063</u></u>

The Authority is limited, by federal regulations, to invest in low risk securities, which are outlined in the Authority's Investment Policy and approved by the Board of Directors. The Authority's investments at year-end are categorized to give an indication of the level of credit risk assumed by the Authority. Category 1 Investments includes investments that are insured, registered, or held by the Authority or its agent in the Authority name.

Pursuant to GASB 34, restricted assets are to be classified according to their anticipated release from restriction, accordingly, \$205,021,439 cash and cash equivalents are classified as noncurrent assets in the Government-wide Statement of Net Assets.

Pursuant to the reauthorization, the Authority maintains cash, cash equivalents, and investments as a reserve of FFELP loan guarantee claim obligations.

The FSLRF and AOF Fund cash and investments are held by a corporate trustee as part of the Loan Guarantee Fund authorized by Chapter 164.754 of the Kentucky Revised Statutes.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

3. Cash and Investments, continued:

The Higher Education Act of 1965, as amended, states that the Authority must maintain a .25% minimum reserve level requirement. Assets of the Federal Fund must be at least .25% of the Agency's guaranteed loan portfolio's original principal balance outstanding. The Agency was in compliance with its minimum reserve level requirement as of June 30, 2003 as follows:

Outstanding loans (original principal balance)	\$3,522,896,497
Minimum reserve requirement	8,807,241
Federal Fund cash and investments	18,732,497

The 1997 Budget Reconciliation Act required payment of a portion of Federal Fund reserves to the U.S. Treasury, approximately \$14.2 million, on September 1, 2002. Prior to sending the payment to the U.S. Treasury, the Authority placed the funds in a designated investment account. The interest from the amount reserved was accumulated in a separate account. The interest earnings on the reserved funds may be utilized for new default aversion activities as defined in Federal Regulations. The 1998 amendments also required an additional \$3.5 million to be sent to the U.S. Treasury in three equal installments of \$1,186,000. On September 1, 2002, the Authority paid the first installment to the U.S. Treasury, the second and third installments are due in fiscal year 2005 and 2006, respectively. Because these cash and investment reserves are completely restricted, and not available for Authority's use in the FFELP program, it has been classified accordingly in the accompanying statement of net assets.

Kentucky Higher Education Assistance Authority
Notes to Financial Statements, Continued

4. Property, Plant and Equipment:

A summary of Property, Plant and Equipment follows:

	<u>June 30,</u> <u>2002</u>	<u>Additions</u>	<u>Deletions</u>	<u>June 30,</u> <u>2003</u>
Proprietary fund:				
Furniture and equipment	\$ 9,095,478	\$ 2,445,790	\$ (868,264)	\$ 10,673,004
Building		8,779,183		8,779,183
Construction in progress	8,779,183	2,399,199	(8,779,183)	2,399,199
System development				
Information services	55,955			55,955
Student Loan Servicing System	541,131			541,131
Debt Recovery System	139,350			139,350
Tuition Line Servicing System	16,922		(16,922)	
Accumulated depreciation	<u>(6,881,552)</u>	<u>(1,774,154)</u>	<u>772,976</u>	<u>(7,882,730)</u>
	<u>\$11,746,467</u>	<u>\$ 11,850,018</u>	<u>\$ (8,891,393)</u>	<u>\$14,705,092</u>
Fiduciary fund:				
Furniture and equipment	\$ 685,593		\$ 30,225	\$ 655,368
Accumulated depreciation	<u>(465,503)</u>	<u>(60,920)</u>	<u>(26,893)</u>	<u>(499,530)</u>
	<u>\$ 220,090</u>	<u>\$ (60,920)</u>	<u>\$ 3,332</u>	<u>\$ 155,838</u>

Depreciation expense totaled \$1,774,154 for the year ended June 30, 2003, of which \$1,626,501 was allocated to business-type activities and \$147,653 was allocated to governmental activities. Depreciation expense was allocated to the business-type activities functions as follows:

Loan guarantee operations	\$ 351,546
Default collections	200,203
Lending and related activities	915,648
Lender assistance	153,900
Other	<u>5,204</u>
	<u>\$1,626,501</u>

5. 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, 2003, the outstanding balance of aggregate insured student loans was approximately \$2,602,905,000.

Kentucky Higher Education Assistance Authority Notes to Financial Statements, Continued

5. Federal Family Education Loan Programs, continued:

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 federal fiscal year).

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

Annual Default Claims Rate	Reimbursement Rate		
	Through September 30, 1993	October 1, 1993 through September 30, 1998	October 1, 1998 and After
0% to 5%	100%	98%	95%
More than 5% up to 9%	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%	95% of claims to 5%, plus 85% of claims over 5% up to 9%
Over 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'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 \$2,800,000 at June 30, 2003 for losses on federal reinsurance.

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 will decrease to 23% as required by the 1998 Amendments.

Account Maintenance Fees (AMF): The 1988 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 basis 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

5. Federal Family Education Loan Programs, continued:

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 in fiscal year 2004, LPIF will be reduced to .40% of net guarantees, less cancellations.

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.

6. Loans:

The Corporation originates, purchases and holds various types of student loans as described in Note 1. 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 3.46% to 12% for the fiscal year ended June 30, 2003 depending upon the type and date of origination of the individual loan.

Kentucky Higher Education Assistance Authority
Notes to Financial Statements, Continued

6. Loans, continued:

Loans consist of the following at June 30, 2003:

Stafford – Subsidized	\$361,245,902
Stafford – Unsubsidized	239,988,375
PLUS/SLS	20,194,524
Consolidation	186,080,977
Other	<u>1,076,784</u>
Total gross loans	808,586,562
Allowance for loan loss	<u>(1,842,905)</u>
Net loans	806,743,657
Net deferred premium and loan origination costs	<u>9,213,816</u>
Net Loans and deferred premium and loan costs	<u><u>\$815,957,473</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, 2003, \$2,674,055 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 U.S.D.E.. The amount of the origination fees is based on a percentage of the gross loan amount.

The Corporation is also required to pay to U.S.D.E. certain Lender and Rebate Fees. The amount of the 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 Consolidation loans.

Loan origination costs are capitalized when the loan is made and are amortized; using the projected balances outstanding method, which approximates the effective interest method, over the estimated economic life of the loan. Purchase premiums are capitalized and amortized in the same manner. The capitalized loan origination costs, net of accumulated amortization, at June 30, 2003, were approximately \$9,213,816.

During the year ended June 30, 2003 the Corporation revised its estimate of the economic life of the loan over which loan origination costs are amortized from eleven to eight years. A charge of \$1,412,568 was taken to reflect this change in estimate.

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

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

7. Special Allowance:

The U.S.D.E. 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, 2003, 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 tax-exempt bonds issued prior to October 1, 1993 receive a floor rate of 9.50% on all student loans funded by those issues.

8. Principal and Interest Forgiveness:

During fiscal year 2003, the Corporation initiated an incentive program to encourage higher education and certain high-need occupations in the Commonwealth of Kentucky. In connection with the program, the Corporation forgave \$5,514,745 in FFELP loan principal and \$2,344,279 in accrued interest during the year ended June 30, 2003. For accounting purposes, the forgiven interest is treated as a reduction to student loan revenue in the period of the award and forgiven student loan principal is recorded as an operating expense in the period of the award.

9. Lease/Bond Payable:

On June 22, 2000, the Commonwealth of Kentucky State Property and Building Commission (the Commission) issued \$8,825,000 in bonds payable on behalf of the Authority. The proceeds of the bonds are to be used to house the Authority's operations located in Frankfort, Kentucky. The bonds bear interest at a fixed rate which vary from 4.85% to 5.75% and have a final maturity date of May 1, 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 deposited in certain funds and accounts created by the resolution and from rental income 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 therefrom. The scheduled payment of principal and interest on the bonds are guaranteed under an insurance policy issued by MBIA Insurance Corporation.

Kentucky Higher Education Assistance Authority
Notes to Financial Statements, Continued

9. Lease/Bond Payable, continued:

In connection with the issuance of the bonds, the Authority entered into a financing/lease agreement with 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, 2004.

The Authority has followed consolidation accounting principles as it relates to the issuance of the bonds and entering into 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 \$11,762,000 with approximately \$2.6 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 bond issue for the year ended June 30, 2003 is as follows:

	<u>June 30, 2002</u>	<u>Additions</u>	<u>Payments</u>	<u>June 30, 2003</u>
Bond payable	\$8,540,000	\$ -	\$300,000	\$8,240,000

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

Year Ending June 30,	Principal	Interest
2004	\$ 310,000	\$ 450,000
2005	330,000	434,000
2006	345,000	417,000
2007	360,000	400,000
2008	380,000	381,000
Five Years Ending June 30,		
2009-2013	2,220,000	1,584,000
2014-2018	2,895,000	911,000
2019-2023	<u>1,400,000</u>	<u>122,000</u>
	<u>\$8,240,000</u>	<u>\$4,699,000</u>

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

10. Revenue Bonds

The balance of revenue bonds held by the Corporation at June 30, 2003 and the related activity for the year ended June 30, 2003 is as follows (in thousands):

Series	Scheduled Maturity	Interest Rate	Beginning Balance @ July 1, 2002	Bond Maturities	New Issues	Ending Balance @ June 30, 2003
1983 General Bond Resolution						
1991 B	Semi-annually in various Amounts through June 1, 2004	6.80%	\$ 1,600	\$ (1,600)		-
1991 D	Semi-annually in various Amounts through December 1, 2011	6.75% to 7.10%	7,120	(7,120)		-
1991 E	December 1, 2011	Weekly	46,000			46,000
1993 B	Semi-annually in various Amounts through December 1, 2005	4.90% to 5.30%	75,800	(20,000)		55,800
1995 B	June 1, 2003	5.15%	750	(750)		-
1995 C	June 1, 2003	5.45%	3,000	(3,000)		-
1996 A	June 1, 2026	Weekly**	25,000			25,000
1996 B	June 1, 2003	5.15%	2,500	(2,500)		-
1997 B	June 1, 2003	5.15%	1,000	(1,000)		-
1997 D	June 1, 2003	5.40%	1,000	(1,000)		-
2003 A	December 1, 2032	Every 35 Days	-		20,600	20,600
2003 B	June 1, 2005	1.65%	-		20,000	20,000
1997 General Bond Resolution						
1997 A-1	May 1, 2027	Every 35 days**	45,250			45,250
1997 A-2	May 1, 2027	Every 35 days**	45,200			45,200
1997 B	May 1, 2027	Every 35 days**	44,550			44,550
1998 A-1	May 1, 2028	Every 28 days**	36,400			36,400
1998 A-2	May 1, 2028	Every 28 days**	36,400			36,400
1998 B	May 1, 2028	Every 35 days**	42,200			42,200
1999 A	May 1, 2029	Every 28 days**	51,350			51,350
1999 B	May 1, 2029	Every 35 days**	23,650			23,650
2000 A-1	May 1, 2030	Every 28 days**	42,100			42,100
2000 A-2	May 1, 2030	Every 28 days**	42,100			42,100
2000 A-3	May 1, 2030	Every 35 days**	42,050			42,050
2000 B	May 1, 2030	Every 35 days**	23,750			23,750
2001 A-1	May 1, 2031	Every 35 days**	59,850			59,850
2001 A-2	May 1, 2031	Every 35 days**	59,850			59,850
2001 B	May 1, 2031	Every 35 days**	30,300			30,300
2002 A-1	May 1, 2032	Every 28 days**	-		55,450	55,450
2002 A-2	May 1, 2032	Every 35 days**	-		55,450	55,450
2002 A-3	May 1, 2032	Every 35 days**	-		39,100	39,100
2003 A-1	May 1, 2033	Every 35 days**	-		63,700	63,700
2003 A-2	May 1, 2033	Every 35 days**	-		16,950	16,950
			\$ 788,770	\$ (36,970)	\$ 271,250	\$1,023,050

** Variable interest rate changes based on specified indices.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

10. Revenue Bonds, continued:

All Revenue Bonds except for the Senior Series 1997-A-1 and 1997-A-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 are tax-exempt issues.

Debt service requirements to maturity or redemption date on the Corporation's Revenue Bonds, assuming interest rates on variable rate debt remains at June 30, 2003 levels, are as follows:

	<u>Principal Repayment Amount (Thousands)</u>		
	83 GBR	97 GBR	Total
Year Ending June 30, 2004	\$ 18,880		\$ 18,880
Year Ending June 30, 2005	56,920		56,920
Year Ending June 30, 2006			
Year Ending June 30, 2007			
Year Ending June 30, 2008			
5 Years Ending June 30, 2013	46,000		46,000
5 Years Ending June 30, 2018			
5 Years Ending June 30, 2023			
5 Years Ending June 30, 2028	25,000	\$135,000	160,000
5 Years Ending June 30, 2033	<u>20,600</u>	<u>720,650</u>	<u>741,250</u>
	<u>\$167,400</u>	<u>\$855,650</u>	<u>\$1,023,050</u>
	<u>Interest Payments Amount (Thousands)</u>		
	83 GBR	97 GBR	Total
Year Ending June 30, 2004	\$4,193	\$ 14,494	\$ 18,687
Year Ending June 30, 2005	3,133	14,494	17,627
Year Ending June 30, 2006	1,264	14,494	15,758
Year Ending June 30, 2007	1,264	14,494	15,758
Year Ending June 30, 2008	1,264	14,494	15,758
5 Years Ending June 30, 2013	5,368	72,470	77,838
5 Years Ending June 30, 2018	3,146	72,470	75,616
5 Years Ending June 30, 2023	3,146	72,470	75,616
5 Years Ending June 30, 2028	2,427	69,478	71,905
5 Years Ending June 30, 2033	<u>1,088</u>	<u>28,721</u>	<u>29,809</u>
	<u>\$26,293</u>	<u>\$ 388,079</u>	<u>\$ 414,372</u>

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

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

11. Line of Credit:

The Corporation is a party to a line of credit agreement providing for advances to the Corporation not to exceed an aggregate outstanding principal balance of \$100 million. The borrowing period ends December 31, 2004, and can be extended at the discretion of both parties through December 31, 2005. During the year ended June 30, 2003, the Corporation drew down \$11,495,000 and made principal payments of \$11,495,000 on this line of credit. At June 30, 2003, there were no advances outstanding.

12. Allowance for Arbitrage Liabilities:

Certain 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, 2003, the Corporation is reporting a liability for yield adjustment payments and forgiveness of \$20,733,428 and for arbitrage rebate of \$432,355. 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.

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 1997-B, 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% above the bond yield (arbitrage yield), with the federal special allowance excluded from income. 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.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

12. Allowance for Arbitrage Liabilities, continued:

As discussed in Note 8, the Corporation instituted an incentive program to encourage higher education and certain high-need occupations in the Commonwealth of Kentucky. The Corporation determined that benefits awarded under this program qualify as reductions to excess yield on bonds subject to arbitrage restrictions. Accordingly, a reduction in arbitrage liability of \$7.9 million was recorded during the year ended June 30, 2003 for awards under the incentive program.

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.

13. Credit and Liquidity Facilities and Bond Remarketing:

The 1991 Series E and 1996 A Bonds are collateralized with Standby Bond Purchase Agreements, pursuant to which Landesbank Hessen-Thüringen 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 June 10, 2004, unless it is renewed, 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

Notes to Financial Statements, Continued

14. Retirement Plans:

The Commonwealth of Kentucky provides retirement benefits to all of the Authority 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 2003, and the employees contribute 5% of the 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 a retirement plan was approximately \$13,290,154 (which approximates total payroll) for the year June 30, 2003. KERS participants have a fully invested interest after the completion of 60 months service, 12 months of which are current service. The KERS contribution requirements for the year ended June 30, 2003 was approximately \$1,293,522, which consisted of \$629,009 in Authority contributions and \$664,513 from employees.

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 \$639,193 at June 30, 2003.

15. Restricted Net Assets:

- a. **Federal Student Loan Reserve Fund:** Net assets are restricted for certain FFELP activities, primarily the payments of claims.
- b. **Agency Operating Fund:** Net assets are restricted for certain FFELP activities and other student aid activities.
- c. **Education Finance Funds:** Net assets are restricted as required by the 1983 and 1997 General Bond Resolutions, the separate Series Resolutions, and Line of Credit Agreements.
- d. **Student Aid Funds:** The Student Aid net assets are restricted for the Student Aid Programs.

Kentucky Higher Education Assistance Authority

Notes to Financial Statements, Continued

16. Commitments and Contingencies

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, 2003, had plans to purchase approximately \$68 million of loans. These contracts cannot be terminated by either party.

The Corporation is a party to student loan servicing contracts with several third-party lenders. Under the terms of the contracts, should the Corporation fail to meet minimum servicing due diligence criteria, the Corporation must purchase the affected loans at par value plus accrued interest. At June 30, 2003, the Corporation serviced loans with a par value of approximately \$3,249,033,000 that were subject to servicing due diligence requirements. The Corporation has recorded a contingent loss of \$246,104 to cover related losses in the servicing portfolio as of June 30, 2003.

In February 1997, the U.S.D.E., Office of Inspector General, issued a final audit report which included a finding that the Authority had retained excess collection costs on post-default payments related to consolidation loans for the period June 1993 through September 1996. According to the U.S.D.E., the Authority should have retained 18.5% of the collections, versus the 27% allowable for other default collections.

The finding was disputed and, in September 1997, the Authority was notified that the Secretary of Education would forego enforcing audit exceptions on guarantors who retained 27% versus 18.5% on those collections prior to December 1995. However, the U.S.D.E. would continue to require agencies to return excess collection costs on consolidation pay-offs after that date.

Under the revised audit finding, the Authority's liability would be approximately \$500,000 for excess collection costs retained on consolidation pay-offs from December 1995 through September 1996. The Authority received a letter from the U.S.D.E. dated February 22, 2001, demanding payment of the \$500,000 based on the Inspector General Audit. On August 20, 2001, The Authority timely filed with the U.S.D.E. an appeal of that decision. The matter is pending an administrative hearing before the U.S.D.E. It is the Authority's position that the interpretation by U.S.D.E. under which the Inspector General issued its findings is erroneous and without statutory support.

Kentucky Higher Education Assistance Authority
Notes to Financial Statements, Continued

16. Commitments and Contingencies, continued:

The FSLRF, a fiduciary fund maintained on behalf of the U.S.D.E., 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 fiscal year ended June 30, 2003. As a result, the federal government's reinsurance rate for defaults for the fiscal year ended June 30, 2002, 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, 2003 is calculated as follows:

Amount of guaranteed student loans outstanding at lenders	\$ 2,602,904,617
Less minimum federal government share - 75%	<u>1,952,178,463</u>
	<u><u>\$ 650,726,154</u></u>

17. Subsequent Event:

The 2003 Kentucky General Assembly transferred responsibility for the Kentucky Affordable Prepaid Tuition program from the Office of the State Treasurer to the Authority. This transfer was mandated by Executive Order 2003-052, which transferred all funds, records, contracts, equipment and personnel from the Office of the State Treasurer to the Authority, effective July 1, 2003.