Strothman & Company P S C

Certified Public Accountants & Advisors

Financial Statements

Commonwealth Postsecondary Education Prepaid Trust Fund aka Kentucky's Affordable Prepaid Tuition

June 30, 2005

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Strothman & Company P S C
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Independent Auditors' Report

Board of Directors
Commonwealth Postsecondary Education Prepaid Trust Fund
aka Kentucky's Affordable Prepaid Tuition
Frankfort, Kentucky

We have audited the accompanying financial statements of Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition (the "Plan"), a fiduciary fund of Kentucky Higher Education Assistance Authority, (a component unit of the Commonwealth of Kentucky), as of and for the year ended June 30, 2005, as listed in the table of contents. These financial statements are the responsibility of the Plan's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net deficit, as of June 30, 2005, and the respective changes in fiduciary net deficit of the Plan for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 23, 2005 on our consideration of the Plan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 8 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Strothman & Company PSC

Louisville, Kentucky
September 23, 2005

I. Description of Business:

The Commonwealth Postsecondary Education Prepaid Tuition Trust Fund, also known as Kentucky's Affordable Prepaid Tuition or KAPT (the "Plan"), was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes ("KRS") 164A.700-709. During fiscal year 2004, it was governed and administered by the Kentucky Higher Education Assistance Authority (the "Authority"), a component unit of the Commonwealth of Kentucky (the "Commonwealth").

Effective July 1, 2004, governance of the Plan reverted to the Board of Directors of the Commonwealth Postsecondary Education Prepaid Tuition Trust Fund as defined in KRS 164A.701. Administration of the Plan remained with the Authority.

The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan's investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

The Plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition contracts based upon current tuition levels and receive benefits equal to tuition rates in place at the time that the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan, and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of the Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky. Participants may elect to spread payments to the Plan over three, five or seven years or until the anticipated year of the student's enrollment in a qualified postsecondary education institution.

Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college or university in the United States. If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books, and supplies.

Participants may withdraw from the Plan at any time for any reason. Terminating participants are refunded any contract payments made plus investment earnings (if applicable), less benefits received, administrative and cancellation fees. Non-qualified withdrawals are subject to a 10% penalty in accordance with Section 529 of the Internal Revenue Code ("IRC") except in cases where the withdrawal is: (i) made on account of the death or disability of the student, (ii) made on

Continued

account of a scholarship received by the student to the extent that that the withdrawal does not exceed the amount of the scholarship, or (iii) a non-taxable transfer to another account or to another IRC Section 529 program for a different student who is a family member of the original student.

II. Overview of Financial Statements:

The Management's Discussion and Analysis is intended to serve as an introduction to the Plan's financial statements. The basic financial statements include a statement of fiduciary net deficit and a statement of changes in fiduciary net deficit.

The statement of fiduciary net deficit presents information on Plan assets and liabilities with the difference between the two reported as the net deficit.

The statement of changes in fiduciary net deficit presents information that reflects how the Plan's net deficit changed during the year. All changes in net deficit are reported as soon as the underlying event occurs, regardless of the timing of the related cash flows. Accordingly, additions and deductions are reported in the statement for some items that will result in cash flows in future fiscal periods.

III. Financial Analysis:

The following information presents comparative financial data between the current fiscal year and prior fiscal year. The Plan held its first enrollment period to sell new contracts since fall 2002 in fiscal year 2005. Accordingly, the Plan experienced significant growth in Plan assets and liabilities.

A condensed summary of the Plan's net deficit is as follows:

	June 30	
Net Deficit Information	**2005**	**2004**
Cash, cash equivalents and investments	$106,402,910	$63,562,664
Contributions receivable	28,330,233	24,400,795
Capital assets	2,517	4,534
Other assets	647,071	411,575
Total Assets	135,382,731	88,379,568
Accounts payable, accrued expenses and note payable	28,804	945,367
Tuition benefits payable	141,948,827	99,323,706
Total Liabilities	141,977,631	100,269,073
Net Deficit	($6,594,900)	($11,889,505)

Continued

Statement of Fiduciary Net Deficit

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

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

The Plan retired its note payable to the Commonwealth's Unclaimed Property Fund in 2005, decreasing other liabilities by $900,000.

Continued

A condensed summary of Changes in Plan Net Deficit is as follows:

Changes in Fiduciary Net Deficit Information	June 30 2005	June 30 2004
Contract income	$32,075,577	$2,256,417
Fee revenue	196,975	102,719
Investment revenue	5,233,577	7,852,741
Other revenue	26,244	17,034
Total Additions	37,532,373	10,228,911
Administrative expenses, personnel and professional services	1,635,293	729,989
Refunds	1,032,066	354,616
Trustee expense	338,043	139,901
Tuition benefits expense	43,121,248	11,399,497
Total Deductions	46,126,650	12,624,003
Changes in Net Deficit Before Transfers	(8,594,277)	(2,395,092)
Transfer from the Authority	188,649	119,136
Transfer from Unclaimed Property Fund	13,700,051	
Change in Net Deficit	$ 5,294,423	$(2,275,956)

Changes in Fiduciary Net Deficit

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

Continued

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

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

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

IV. Conditions Affecting Financial Position

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

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

Continued

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

The Plan paid tuition benefits of $618,000 during fiscal year 2005. The Plan expects to pay $2.6 million in tuition benefits in fiscal year 2006. The Plan currently has cash, cash equivalents and investments of $106.4 million. Based on calculations provided by an actuary, projected cash flows, which consider payments received on new and existing tuition contracts, net investment yield, administrative costs and tuition benefit payments, are sufficient to meet the obligations of the Plan through 2024. If the court orders the payment of the $13.7 million to the General Fund, projected cash flows are sufficient to meet the obligations of the Plan through 2021.

The actual value of future tuition benefit obligations of the Plan is dependent on future tuition increases. The Plan routinely reviews its actuarial assumptions with regard to tuition increases and makes adjustments whenever considered necessary. The Plan believes that the current assumptions utilized in the determination of its tuition benefits payable adequately estimate future tuition increases.

House Bill 184, passed by the 2005 General Assembly, transferred governance of the Plan to the Authority's Board of Directors effective July 1, 2005. To demonstrate its support of Plan contract holders, the new KAPT Board of Directors passed a resolution at its August 25, 2005 meeting affirming its commitment to protect the interest of Plan contract holders. The Board chairman sent a letter to all Plan contract holders emphasizing the Board's full support of Plan contracts and commitment to its responsibility to protect all KAPT contracts that were entered in good faith by each account holder.

Statement of Fiduciary Net Deficit

Commonwealth Postsecondary Education Prepaid Trust Fund
aka Kentucky's Affordable Prepaid Tuition

June 30, 2005

ASSETS	
Current:	
Cash and cash equivalents	$ 9,763,400
Contributions receivable, net of allowance for withdrawals of $1,172,257	7,619,086
Fees receivable	188,826
Accrued interest income	458,245
Total Current Assets	18,029,557
Noncurrent:	
Contributions receivable, net of allowance for withdrawals of $3,689,445	20,711,147
Investments	96,639,510
Fixed assets, net	2,517
Total Noncurrent Assets	117,353,174
Total Assets	135,382,731
LIABILITIES	
Current:	
Accounts payable and accrued expenses	28,804
Noncurrent:	
Tuition benefits payable	141,948,827
Total Liabilities	141,977,631
NET DEFICIT	
Net Deficit	$ (6,594,900)

See Notes to Financial Statements

Statement of Changes in Fiduciary Net Deficit

Commonwealth Postsecondary Education Prepaid Trust Fund
aka Kentucky's Affordable Prepaid Tuition

Year Ended June 30, 2005

Additions:	
Contract income, net	$ 32,075,577
Fee revenue	196,975
Investment Revenue:	
Net unrealized gain on investments	399,932
Interest and investment income	4,833,645
Other Income	26,244
Total Additions	37,532,373
Deductions:	
Administrative expenses	128,077
Personnel and professional expenses	678,819
Other administrative expense	826,379
Refunds	990,777
Trustee fee expense	257,122
Tuition benefits expense - payable	42,625,121
Tuition benefits expense - paid	618,337
Other expenses	2,018
Total Deductions	46,126,650
Change in Net Deficit Before Transfers	(8,594,277)
Transfers:	
Transfer from Internal Service Fund	188,649
Transfer from Unclaimed Property Fund	13,700,051
Change in Net Deficit After Operating Transfers	5,294,423
Net Deficit at Beginning of Year	(11,889,323)
Net Deficit at End of Year	$ (6,594,900)

See Notes to Financial Statements

Note A--Description of Business

The Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition or KAPT (the "Plan"), was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes ("KRS") 164A.700-709.

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

The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan's investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

The Plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition units at current tuition levels and receive benefits equal to tuition rates in place at the time the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan, and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky. Participants may elect to spread payments to the Plan over three, five, or seven years or until the anticipated year of the student's enrollment in a qualified postsecondary education institution.

Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college or university in the United States. If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books, and supplies.

Continued

Note A--Description of Business--Continued

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

Note B--Summary of Significant Accounting Policies

Basis of Presentation--The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the Standards of the Governmental Accounting Standards Board ("GASB"). The Plan is a private-purpose trust fund, reporting assets held in a trustee capacity for others which are unavailable to finance government functions, that does not meet the definition of a pension trust or investment trust as defined by GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – For State and Local Governments. As a fiduciary fund, the Plan's financial statements are presented using the economic resources management focus and the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America.

Administration--Administrative costs are paid from application and administrative fees plus earnings on Plan investments.

Cash and Equivalents--Cash and cash equivalents include all cash, demand deposit accounts, money market accounts, and all investments with a purchased maturity of 90 days or less.

Investments--The Plan invests in certain debt and equity instruments, which are reported at fair value. Fair values are determined using quoted market values as of the last day of the reporting period where available. Securities for which quoted market prices are not available are valued using estimates based on similar securities.

Continued

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

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

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

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

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

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

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

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

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

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

Continued

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

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

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

Asset Restrictions--Assets of the Plan are restricted for payment of participant benefits and Plan administration.

Contributions--Contributions are recorded in the period in which a contract is entered into by a participant. Lump sum amounts received as payment in full are recorded at the amount received. Tuition contracts to be paid over time are recorded net of an allowance for withdrawals.

Use of Estimates--The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include amounts based on estimates and assumptions that affect the reported values of assets, liabilities, contributions, and deductions. Actual results and amounts may vary significantly from these estimates.

Risks and Uncertainties--Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term could materially affect the amounts reported in the statement of net deficit and the statement of changes in the net deficit.

Note C--Relationship with the Commonwealth's Unclaimed Property Fund

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

Continued

Note C--Relationship with the Commonwealth's Unclaimed Property Fund--Continued

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

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

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

Note D--Cash and Investments

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

Custodial Credit Risk and Interest Rate Risk--The Plan's investment policy does not contain a requirement for the collateralization of cash and investments nor does it require investments to be maintained in the Plan's name. As of June 30, 2005, the Plan's custodial credit risk for cash on deposit was as follows:

Insured (FDIC)	$ 100,000
Uninsured	
Collateralized by securities held by the pledging financial institutions	214,694
On deposit with Kentucky State Treasurer	84,626
Total	$ 399,320

Continued

Note D--Cash and Investments--Continued

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

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

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

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

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

Continued

Note D--Cash and Investments--Continued

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

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

Note E--Note Payable

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

Note F--Tuition Benefit Payable

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

Investment Rates--The investment yield assumption is based on estimates of the yields that will be available on the investment portfolio and cash and cash equivalents. Since inception, the gross investment yield assumption has been 7.76% per annum.

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

Continued

Note F--Tuition Benefit Payable--Continued

Tuition Increases--Tuition increases are based on the known increases for the next academic year and best estimates of future tuition increases for Kentucky's public two-year colleges and four-year universities. Upon inception of the Plan, in Fiscal Year 2002, the assumption for tuition increases was 6.5% for all future academic years. As of June 30, 2003, known tuition increases for the 2003-2004 academic year were 23.4% for the Value Plan and 14.4% for the Standard Plan and the Premium Plan. The assumption for tuition increases was adjusted to 7.5% for the next five academic years and 6.5% for all academic years thereafter. As of June 30, 2004, known tuition increases for the 2004-2005 academic year were 24.2% for the Value Plan and 16.9% for the Standard Plan and the Premium Plan. The tuition increase assumption was adjusted to 7.5% annually through the academic year ending June 30, 2011, and increased from 6.5% to 7.00% for each academic year thereafter. As of June 30, 2005, known tuition increases for the 2005-2006 academic year were 6.5% for the Value Plan and 12.5% for the Standard Plan and the Premium Plan. The tuition increase assumption is 7.5% through year ending June 30, 2012, 7.25% annually through year ending June 30, 2014, and 7.0% annually thereafter. For the period from inception to June 30, 2005, the annualized tuition increase for the highest-priced Kentucky public university, as applicable to the tuition benefits payout rate of the KAPT Standard Plan, which represents 90% of KAPT enrollments, has been 10.5%. For the Kentucky Community and Technical College System, as applicable to the tuition benefits payout rate of the Value Plan, the average annualized tuition increase from inception to June 30, 2005, has been 26.7%. For the University of Kentucky, as applicable to the tuition benefits payout rate of the KAPT Premium Plan, the average annualized tuition increase from inception to June 30, 2005, has been 12.6%.

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