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, 2006

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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, 2006, as listed in the table of contents. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion 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, 2006, 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 26, 2006 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.

Louisville, Kentucky
September 26, 2006

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 Statute (KRS) 164A.700-709. During fiscal year 2005, it was governed and administered by the Kentucky Higher Education Assistance Authority (the "Authority"), a component unit of the Commonwealth of Kentucky (the "Commonwealth").

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

The plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition 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 expense 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

I. Description of Business--Continued:

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 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:

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. In fiscal year 2005, the Plan held its first enrollment period since fall 2002 to sell new contracts. Accordingly, the Plan experienced significant growth in Plan assets and liabilities. The Authority's board chose not hold an enrollment period in fiscal year 2006.

Continued

III. Financial Analysis--Continued:

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

Net Deficit Information	**June 30**	
	2006	**2005**
Cash, cash equivalents and investments	$118,551,236	$106,402,910
Contributions receivable	24,499,757	28,330,233
Capital assets		2,517
Other assets	712,139	647,071
Total Assets	143,763,132	135,382,731
Accounts payable and accrued expenses	14,975	28,804
Tuition benefits payable	164,057,395	141,948,827
Total Liabilities	164,072,370	141,977,631
Net Deficit	$(20,309,238)	$ (6,594,900)

Statement of Fiduciary Net Deficit

The Plan's total assets increased $8.4 million, which resulted from an increase in cash, cash equivalents and investments of $12.1 million, other assets of $100,000 and decrease in contributions receivable and accrued income of $3.8 million. Cash, cash equivalents and investments increased because of contract receipts of $11.2 million (including $600,000 of contract income) and investment revenue of $7.3 million, net of disbursements for matriculation of accounts of $4.1 million, cancellation of accounts of $1.4 million and operating expenses and trustee fees net of transfers of $900,000. The contributions receivable decreased because no new contracts were sold in fiscal year 2006 and participants paid and/or cancelled contracts totaling $3.8 million, net of the allowance for cancellations.

The Plan liabilities increased $22.1 million, almost entirely from the increase in Tuition Benefits Payable. The $22.1 million increase in Tuition Benefits Payable resulted from 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 2006-2007 academic year. The University of Kentucky tuition increase, on which the majority of Plan tuition payouts are based, increased 12% for the 2006-2007 academic year. In fiscal year 2005, the tuition increase assumptions were based on 7.5% increases annually through June 30, 2012, 7.25% annually through June 30, 2014, and 7.0% annually thereafter. To reflect higher than anticipated tuition increases, assumptions in 2006 were raised to 11% for the 2007-2008 academic year, 10% for the 2008-2009 academic year, and 7% for each year thereafter.

Continued

III. **Financial Analysis**--Continued:

Statement of Fiduciary Net Deficit--Continued:

Projected investment expense was changed as follows. In fiscal year 2005, projected investment expense was calculated on a sliding scale of costs related to total assets, 49 basis points on the first $25 million, 28 basis points on the next $25 million, and 21 basis points on assets in excess of $50 million. In fiscal year 2006 projected investment expense was calculated based on 35 basis points on all invested assets. Projected administrative expenses remained unchanged at $6.2 million in 2005.

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

	June 30	
Changes in Fiduciary Net Deficit Information	**2006**	**2005**
Contract income	$5,197,618	$32,075,577
Fee revenue	17,262	196,975
Investment revenue	7,346,810	5,259,821
Total Additions	12,561,690	37,532,373
Administrative expenses, personnel and professional services	875,417	1,635,293
Refunds	1,421,005	1,032,066
Trustee expense	313,210	338,043
Tuition benefits expense	23,907,932	43,121,248
Total Deductions	26,517,564	46,126,650
Changes in Net Deficit Before Transfers	(13,955,874)	(8,594,277)
Transfer from the Authority	241,536	188,649
Transfer from Unclaimed Property		13,700,051
Change in Net Deficit	$(13,714,338)	$ 5,294,423

Continued

III. Financial Analysis--Continued:

Changes in Fiduciary Net Deficit

The Plan recognized an increase in net deficit of $14 million for fiscal year 2006, before operating transfers compared to a $8.6 million increase in net deficit for the prior year, which represents additional operating loss of $5.4 million over prior year.

The Plan held an enrollment period in fiscal year 2005 and received $32 million in contract income. 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, which increased contract revenue of $2.4 million in fiscal year 2005. The Plan also recognized $5.3 million of investment income in fiscal year 2005.

In fiscal year 2006, the Plan did not hold an enrollment period and contract income was comprised entirely of interest income on existing contracts and net reduction in allowance for contract cancellations, resulting in a $26.9 million decrease from prior year. Investment income increased $2.1 million due primarily to the overall increase in investments, from $96 million in 2005 to $112 million in 2006 (a 17% increase), and better investment performance in fiscal year 2006 over 2005.

Fee revenue decreased from prior year $180,000 due to the age of existing contracts. The Plan recognized other revenue of $13,000, which is consistent with prior year.

Administrative expenses decreased approximately $700,000, from $1.6 million to $900,000. Administrative expenses decreased 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 2006.

Due to the addition of the 1,860 contracts sold during the enrollment period in fiscal year 2005, recent volume of matriculated accounts ($4.1 million) and changes in actuarial assumptions as discussed above, the increase in tuition benefits expense was $19.2 million less than prior year. Trustee expense and refunds remained relatively consistent with prior year.

The Plan recorded a transfer from the Unclaimed Property Fund of $13.7 million in fiscal year 2005. In accordance with KRS 393.015, the board of directors voted to transfer the funds in December 2005 to eliminate the Plan's actuarial deficit as of June 30, 2004. There was no such transfer in fiscal year 2006. The Plan maintains one employee for operational functions. In fiscal year 2006, 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. Accordingly, the Plan recorded a transfer from the Authority in fiscal year 2006 of $241,000, an increase of $53,000 over prior year. The increase in transfers from the Authority resulted from overall increases in expenses at the Authority and increases in accounting and legal activities provided by the Authority to the Plan.

Continued

IV. Conditions Affecting Financial Position

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.

On April 14, 2006, the Franklin Circuit Court ruled that repeal of KRS 393.015 in the 2005 biennial budget was not valid as it pertained to existing account holders, but only as it pertained to new account holders after the repeal, and the budgetary mandate that KAPT pay to the state's General Fund $13.7 million dollars (drawn by the prior KAPT board from the state's Unclaimed Property Fund) was not valid. No appeal was taken from this ruling and the decision is final.

On April 24, 2006, a budget bill, HB 380 became law. Part XXXI of that bill amended certain statutes pertaining to KAPT, providing that: (a) all prepaid tuition contracts in existence on the effective date of the bill ("old contracts") shall be supported by the full faith and credit of the Commonwealth; (b) If an actuarial report indicates that there will be a deficit experienced in the next biennium for old contracts, then the Secretary of Finance will include the needed amount in the biennial budget request and the General Assembly shall appropriate the necessary funds; (c) new contracts entered into after the effective date of the bill for a tuition plan shall contain actuarially sound premiums sufficient to prevent their contribution to a program fund deficit; and (d) the Commonwealth shall have no obligation to support new contracts entered into after the effective date of the bill.

Statement of Fiduciary Net Deficit

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

For the Year Ended June 30, 2006

ASSETS		
Current:		
Cash and cash equivalents		$ 6,008,458
Contributions received		5,635,989
Fees receivable		199,549
Accrued interest income		512,590
Total Current Assets		12,356,586
Noncurrent:		
Investments		112,542,778
Contributions received		18,863,768
Total Noncurrent Assets		131,406,546
	Total Assets	143,763,132
LIABILITIES		
Current:		
Accounts Payable		14,947
Accrued Expenses		28
Total Current Liabilities		14,975
Noncurrent: Tuition benefits payable		164,057,395
Total Liabilities		164,072,370
NET DEFICIT		
Net Deficit		$(20,309,238)

See Notes to Financial Statements

Statement of Changes in Fiduciary Net Deficit

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

For the Year Ended June 30, 2006

Additions:	
Contract income, net	$ 5,197,618
Fee revenue	17,262
Investment Revenue:	
Interest and investment income	7,317,576
Net unrealized gain on investments	16,436
Other income	12,798
Total Additions	12,561,690
Deductions:	
Administrative expenses	88,168
Personnel and professional expenses	626,110
Other administrative expense	158,624
Refunds	1,421,005
Trustee fee expense	313,210
Tuition benefits expense - payable	19,800,953
Tuition benefits expense - paid	4,106,979
Other expenses	2,517
Total Deductions	26,517,566
Change in Net Deficit Before Transfers	(13,955,876)
Transfer from Internal Service Fund of the Authority	241,536
Change in Net Deficit After Operating Transfer	(13,714,340)
Net Deficit at Beginning of Year	(6,594,898)
Net Deficit at End of Year	$ (20,309,238)

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 investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

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

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

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, 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* ("GASB No. 34"). As a fiduciary fund of the Authority, the Plan's financial statements are presented using the economic resources measurement 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 Cash 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/Miscap U.S. stocks		10%
Non-U.S. stocks		5%
	Total Equities	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 in the securities of any one issuer;

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

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

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

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

vi. No more than 10% of the total amount of the fixed-income portion of the investment account shall be committed to the securities of any one issuer at the time of purchase, with the exception of securities issued or guaranteed by the full faith and credit of the United States of America or AAA-rated 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 and terminations.

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 would 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

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.

On April 14, 2006, the Franklin Circuit Court ruled that repeal of KRS 393.015 in the 2005 biennial budget was not valid as it pertained to existing account holders, but only as it pertained to new account holders after the repeal, and the budgetary mandate that KAPT pay $13.7 million (drawn by the prior KAPT board from the state's Unclaimed Property Fund) to the state's General Fund was not valid. No appeal was taken from this ruling and the decision is final.

On April 24, 2006, a budget bill (HB 380) became law. Part XXXI of that bill amended certain statutes pertaining to KAPT, providing that: (a) all prepaid tuition contracts in existence on the effective date of the bill ("old contracts") shall be supported by the full faith and credit of the Commonwealth; (b) If an actuarial report indicates that there will be a deficit experienced in the next biennium for old contracts, then the Secretary of Finance will include the needed amount in the biennial budget request and the General Assembly shall appropriate the necessary funds; (c) new contracts entered into after the effective date of the bill for a tuition plan shall contain actuarially sound premiums sufficient to prevent their contribution to a program fund deficit; and (d) the Commonwealth shall have no obligation to support new contracts entered into after the effective date of the bill.

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.

Continued

Note D--Cash and Investments--Continued

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. Furthermore, the Plan's investment policy does not limit maturities on investments. As of June 30, 2006, the Plan maintained custodial credit risk for cash on deposit as follows:

	Bank Balance
Insured (FDIC)	$ 100,000
Uninsured:	
Collateralized by securities held by the pledging financial institution	494,469
On deposit with Kentucky State Treasurer	157,285
Total	$ 751,754

As of June 30, 2006, all investments were registered in the Plan's name and maintained by an external trustee. The investment balances as of June 30, 2006 are summarized as follows:

	Fair Value	Weighted Average Maturity
Corporate bonds	$15,375,045	4.82
U.S. Treasury and government agency securities	25,838,956	11.85
Corporate stock	71,328,777	
Money market securities	5,256,704	
	$117,799,482	

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

Concentration of Credit Risk--The 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 money market securities.

Continued

Note D--Cash and Investments--Continued

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 interest-bearing securities with an investment grade rating, as long as the overall fixed income portfolio maintains a minimum rating of A by Moody's or Standard & Poors. Any investment in short-term commercial paper, maturing within 9 months, must have a minimum rating of A-1 by Standard & Poors or Prime 1 by Moody's.

As of June 30, 2006, the Plan maintained securities issued by U.S. Treasury and governmental agencies with a Standard & Poor rating of AAA. The following table summarizes the Standard & Poors rating for all corporate bonds held by the Plan as of June 30, 2006.

Rating	Fair Value
AAA	$2,228,541
AA	$448,524
AA-	2,561,313
A+	3,313,473
A	3,375,347
A-	1,471,728
BBB+	992,331
BBB	736,083
BBB-	195,795
B+	51,910
	$15,375,045

Note E--Tuition Benefit Payable

The following assumptions developed by management were used in the actuarial valuation as of June 30, 2006. 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 is assumed to be 35 basis points on all invested assets.

Continued

Note E--Tuition Benefit Payable--Continued

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

- 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 was adjusted to 7.5% through year ending June 30, 2012, 7.25% annually through year ending June 30, 2014, and 7.0% annually thereafter.

- As of June 30, 2006, the known tuition increases for the 2006-2007 academic year were 11.2% for the Value Plan and 12% for the Standard Plan and the Premium Plan. The tuition increase assumption was adjusted to 11% for the 2007-2008 academic year, 10% for 2008-2009 academic year, and 7% for each year thereafter.

For the period from inception to June 30, 2006, 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 11%. 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, 2006, has been 21.6%. 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, 2006 has been 12.6%.

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