COMMONWEALTH INSURANCE COMPANY, INC.

FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Years Ended June 30, 2011 and 2010

CONTENTS

DMLO
DEMING MALONE
LIVESAY & OSTROFF
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

To the Stockholder
Commonwealth Insurance Company, Inc.
Frankfort, Kentucky

We have audited the accompanying balance sheets of Commonwealth Insurance Company, Inc. as of June 30, 2011 and 2010, and the related statements of income and retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Insurance Company, Inc. as of June 30, 2011 and 2010 and changes in stockholder's equity and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deming, Malone, Livesay & Ostroff

Louisville, Kentucky
October 26, 2011

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COMMONWEALTH INSURANCE COMPANY, INC.

BALANCE SHEETS
June 30, 2011 and 2010

ASSETS	2011	2010
Cash and cash equivalents	$ 2,901,548	$ 2,977,479
Investments, at fair market value	745,418	
Other	17,460	31,034
Total assets	$ 3,664,426	$ 3,008,513

LIABILITIES AND STOCKHOLDER'S EQUITY

Estimated liability for future claims, net of estimated recoveries:		
Claims incurred but not reported	$ 550,000	$ 510,000

STOCKHOLDER'S EQUITY

Common stock, no par value; authorized 1,000 shares; issued and outstanding, 600 shares	1,500,000	1,500,000
Retained earnings	1,614,426	998,513
	3,114,426	2,498,513
Total liabilities and stockholder's equity	$ 3,664,426	$ 3,008,513

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF INCOME AND RETAINED EARNINGS

Years Ended June 30, 2011 and 2010

	2011	2010
REVENUES		
Premium revenue	$ 965,535	$ 924,192
Investment income	53,214	43,424
Unrealized loss on investments	(5,129)	
Total revenues	1,013,620	967,616
EXPENSES		
Claims expense, net of recoveries	40,000	230,310
Management and marketing	134,229	167,127
Professional fees	14,083	13,027
Management fee	196,216	161,126
Provision for income taxes	13,179	11,514
Total expenses	397,707	583,104
Net income	615,913	384,512
Retained earnings, beginning of year	998,513	614,001
Retained earnings, end of year	$ 1,614,426	$ 998,513

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Cash received from premiums	$ 965,535	$ 924,192
Cash paid to suppliers	(337,527)	(530,391)
Investment income received	51,608	43,424
Income taxes paid	(5,000)	(5,000)
Net cash provided by operating activities	674,616	432,225
Cash flows from investing activities:		
Purchase of investments	(750,547)	
Net (decrease) increase in cash and cash equivalents	(75,931)	432,225
Cash and cash equivalents at beginning of year	2,977,479	2,545,254
Cash and cash equivalents at end of year	$ 2,901,548	$ 2,977,479

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

	2011	2010
Net income	$ 615,913	$ 384,512
Adjustments to reconcile net income to net cash provided by operating activities:		
Unrealized losses on investments	5,129	
Changes in assets and liabilities:		
Decrease (increase) in:		
Other	13,574	7,410
Increase (decrease) in:		
Estimated liability for future claims	40,000	50,000
Accounts payable		(9,697)
Total adjustments	58,703	47,713
Net cash provided by operating activities	$ 674,616	$ 432,225

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS

Note 1. Nature of Business and Summary of Significant Accounting Policies

Nature of business:

Commonwealth Insurance Company, Inc., a wholly owned subsidiary of Kentucky Association of Counties Leasing Trust (COLT), formed in 2005 provides employee dishonesty fidelity bond coverage to the members of the Kentucky Association of Counties - All Lines Fund (KALF), a related party (see Note 5). The Company has also been authorized by the Kentucky Department of Insurance to begin writing property coverage and as of July 1, 2008, began providing a layer of business income/extra expense coverage for members of KALF.

Summary of significant accounting policies:

This summary of significant accounting policies of Commonwealth Insurance Company, Inc. is presented to assist in understanding the Company's financial statements. The financial statements are representations of the Company's management who is responsible for the integrity and objectivity of the financial statements. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Estimates:

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

A significant estimate in these financial statements is the estimated liability for claims incurred but not reported (see Note 4).

NOTES TO FINANCIAL STATEMENTS

Legal, regulatory and geographic risk:

Legal and regulatory risk is the risk that changes in the legal or regulatory environment in which an insurer operates will occur and create additional losses or expenses not anticipated by the insurer in pricing its products. That is, regulatory initiatives designed to reduce insurer profits or new legal theories may create costs for the insurer beyond those currently recorded in the financial statements. The Company is exposed to this risk by writing all of its business in Kentucky, thus increasing its exposure to a single jurisdiction. This risk is reduced by underwriting and loss adjusting practices that identify and minimize the adverse impact of this risk.

Geographic risk is the risk that catastrophic losses will occur in one concentrated area where the Company does business. The Company mitigates this risk by adhering to specified underwriting practices.

Reinsurance:

In prior years, the Company used reinsurance agreements to reduce its exposure to large losses on insured events. Reinsurance permits recovery of a portion of losses from its reinsurer, although it does not discharge the primary liability of the Company as direct insurer of the risks reinsured. Beginning for the year ended June 30, 2010, the Company discontinued its reinsurance coverage and now covers the entire loss on insured events up to the maximum of $150,000 per event.

Investments:

The Company records all investments at fair market value. Fair value is established based upon readily determinable market quotations for equity and debt securities.

The Company has significant investments in government securities held by Central Bank & Trust Company. Investment securities are exposed to various risks, such as interest rate, market, and credit risks. Because of the level of risk associated with certain investment securities, it is at least reasonably possible that changes in values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the balance sheet.

NOTES TO FINANCIAL STATEMENTS

Cash and cash equivalents:

For purposes of the statement of cash flows, the Company considers only cash and investments with an original maturity of three months or less to be cash and cash equivalents.

Revenue and expense recognition:

Premium revenue is recognized over the period to which the insurance coverage relates. Deferred revenue represents premiums billed but not yet earned.

Expenses for management and marketing fees and royalties are expensed ratably over the period of coverage.

Subsequent events:

Subsequent events have been evaluated through October 26, 2011, which is the date the financial statements were available to be issued.

Note 2. Investments

Investments are carried at fair market value as determined based on quoted prices in active markets. Investments held in trust funds by Central Bank & Trust Company Corporation at June 30, 2011 consisted of the following:

	Face Value	Cost	Fair Market Value
Mortgage-Backed Securities:			
FNMA	$250,000	$250,391	$248,115
Federal Farm Credit Banks	500,000	500,156	497,303
Total investments	$750,000	$750,547	$745,418

The aggregate annual maturities of the fair market value of investments at June 30, 2011, based upon stated maturity dates are as follows:

Due within one to five years	$745,418

Note 3. Fair Value Measurements

Accounting principles generally accepted in the United States of America establish a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three levels of the fair value hierarchy are described as follows:

Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 – Inputs to the valuation methodology include: quoted prices for similar assets or liabilities in active or inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in methodologies used at June 30, 2011.

U.S. government securities – valued at the quoted market prices for similar assets.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes their valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following table sets forth, by level, within the fair value hierarchy, the Fund's assets at fair value as of June 30, 2011:

	Level 1
U.S. government securities:	
Federal Farm Credit Bank	$497,303
FNMA	248,115
Total assets at fair value	$745,418

Note 4. Estimated Unpaid Claims Liabilities

Under Kentucky Law, the Company is required to pay all valid claims against its policyholder. The estimated liability for future claims, net of estimated recoveries for reinsurance, deductibles and subrogation was determined by Company management as a result of consultation with the Company's actuary, By The Numbers Actuarial Consulting, Inc., for the years ended June 30, 2011 and 2010.

The actuary provides a range of the estimated liability for unpaid claims. Management selects an amount in that range which they believe represents a reasonable estimate of the ultimate liability. This estimate is based upon various factors such as loss control efforts, claim trends and historical claims information.

To the extent that claims information varies from management's estimates, the statement of income reflect adjustments in the year they occur.

For the years ended June 30, 2011 and 2010, the actuary provided a possible range of discounted estimated liabilities. The discounted liability selected by management was discounted at 4.75%, based upon an estimate of the Company's yield on its investments and expected claims payment patterns as developed by the actuary. The loss payment pattern used could vary significantly from actual which would have a direct effect on the liability for estimated claims. The range of discounted liabilities and the amounts selected by management are as follows:

	Low	High	Selected
June 30, 2011	$230,000	$660,000	$550,000
June 30, 2010	$190,000	$620,000	$510,000

The Fund establishes a liability for both reported and unreported insured events, which includes estimates of both future payments of losses and related claim adjustment expenses. The following represents changes in those aggregate liabilities, net of recoveries, for the years ended June 30, 2011 and 2010:

	2011	2010
Unpaid claims and claim adjustment expenses at beginning of year	$510,000	$460,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of current year and increases in provision for insured events of prior years net of recoveries	40,000	230,310
Payments:		
Claim and claim adjustment expenses paid attributable to insured events of current and prior years net of recoveries collected		(180,310)
Unpaid claims and claim adjustment expenses at end of year	$550,000	$510,000

Note 5. Related Party Transactions

For the years ended June 30, 2011 and 2010, 100% of the Company's premium revenue was derived from Kentucky Association of Counties - All Lines Fund, which provides coverage to its members.

The Company is under a Program Administration Agreement with KACo in which the Company reimburses KACo for certain administrative expenses. Total fees for the years ended June 30, 2011 and 2010 under this agreement were $51,731 and $82,493 respectively. As of June 30, 2011 and 2010, the Company had prepaid administrative fees of $12,591 and $19,126, respectively.

The Company is under a Management Fee Agreement with KACo in which the Company pays a fee to KACo for certain management services. The management fees for the years ended June 30, 2011 and 2010 include a base fee of $167,250 and $133,400, respectively, plus 3% of earned premiums collected. Total management fees for the years ended June 30, 2011 and 2010 were $196,216 and $161,126, respectively.

The Company also has a licensing agreement with KACo that requires the Company to pay a royalty to KACo in return for the use of KACo's name and logo. The royalty for each of the years ended June 30, 2011 and 2010 was $1,000.

The Company has an agreement with KACo Insurance Agency, Inc. (KIA), whereby KIA acts as the exclusive agent for the Company. The Company paid commissions to KIA of $12,851 and $12,778, for the years ended June 30, 2011 and 2010, respectively.

Note 6. Income Taxes

For federal income tax purposes, the Company is classified as an insurance company, other than a life insurance company, as described under Internal Revenue Code Section 831. The Company also qualifies under Code Section 834 for an alternative income tax calculation available to certain electing small insurance companies which have net premium income not exceeding $1,200,000. Under this election, the Company is taxed only on its net investment income. The Company is exempt from Kentucky corporate income taxes but is subject to a tax on its earned premiums collected as a captive insurer. Total federal and Kentucky tax expense for the years ended June 30, 2011 and 2010 were $13,179 and $11,514, respectively.

The Company follows the guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions in a company's financial statements. Income tax positions must meet a more-likely-than-not recognition threshold to be recognized. The following of this guidance did not have an effect on the Company's financial position and results of operations.

As of June 30, 2011 and 2010, the Company did not have any accrued interest or penalties related to income tax liabilities, and no interest or penalties have been charged to operations for the years then ended. Tax years still open under federal and state statute of limitations remain subject to review and change.

Note 7. Concentration of Credit Risk

The Company's cash accounts are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $250,000. At June 30, 2011, the Company's uninsured cash balance was approximately $2,346,000.