

**KENTUCKY ASSOCIATION OF COUNTIES
UNEMPLOYMENT COMPENSATION
SELF-INSURANCE FUND**

FINANCIAL STATEMENTS

Years Ended June 30, 2011 and 2010

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees
Kentucky Association of Counties Unemployment
Compensation Self-Insurance Fund
Frankfort, Kentucky

We have audited the accompanying balance sheets of Kentucky Association of Counties Unemployment Compensation Self-Insurance Fund as of June 30, 2011 and 2010, and the related statements of revenues, expenses and changes in members' equity and cash flows for the years then ended. These financial statements are the responsibility of the Fund'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 Kentucky Association of Counties Unemployment Compensation Self-Insurance Fund as of June 30, 2011 and 2010, and the changes in members' 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 24, 2011

**KENTUCKY ASSOCIATION OF COUNTIES
UNEMPLOYMENT COMPENSATION SELF-INSURANCE FUND**

BALANCE SHEETS
June 30, 2011 and 2010

ASSETS	<u>2011</u>	<u>2010</u>
Cash and cash equivalents	\$ 2,497,148	\$ 2,278,068
Investments, at fair market value	5,413,357	7,361,829
Premiums receivable, less allowance for doubtful accounts of \$15,000	1,453,583	1,246,137
Accrued interest receivable	12,729	36,038
Prepaid expenses	<u>88,736</u>	<u>29,408</u>
Total assets	<u>\$ 9,465,553</u>	<u>\$ 10,951,480</u>
LIABILITIES AND MEMBERS' EQUITY		
Accounts payable	\$ 2,174	
Unemployment compensation claims payable	1,127,703	\$ 1,032,898
Deferred revenue	<u>1,281,576</u>	<u>1,111,673</u>
Total liabilities	2,411,453	2,144,571
Members' equity	<u>7,054,100</u>	<u>8,806,909</u>
Total liabilities and members' equity	<u>\$ 9,465,553</u>	<u>\$ 10,951,480</u>

See Notes to Financial Statements.

**KENTUCKY ASSOCIATION OF COUNTIES
UNEMPLOYMENT COMPENSATION SELF-INSURANCE FUND**

**STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN MEMBERS' EQUITY**

Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
REVENUES:		
Member premiums, net	\$ 2,397,919	\$ 2,419,277
Investment income	224,181	231,895
Realized gain (loss) on sale of investments	1,600	(2,618)
Unrealized (loss) gain on investments	<u>(40,353)</u>	<u>208,522</u>
Total revenues	<u>2,583,347</u>	<u>2,857,076</u>
EXPENSES:		
Unemployment compensation benefits	3,671,272	2,929,292
General and administrative expenses	415,534	440,375
KACO management fee	248,350	261,100
KACO royalty	<u>1,000</u>	<u>1,000</u>
Total expenses	<u>4,336,156</u>	<u>3,631,767</u>
Excess of expenses over revenues	(1,752,809)	(774,691)
Members' equity, beginning of year	<u>8,806,909</u>	<u>9,581,600</u>
Members' equity, end of year	<u><u>\$ 7,054,100</u></u>	<u><u>\$ 8,806,909</u></u>

See Notes to Financial Statements.

**KENTUCKY ASSOCIATION OF COUNTIES
UNEMPLOYMENT COMPENSATION SELF-INSURANCE FUND**

STATEMENTS OF CASH FLOWS
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Cash received from member premiums	\$ 2,360,376	\$ 2,262,275
Investment income received	247,490	234,519
Unemployment compensation benefits paid	(3,576,467)	(2,346,439)
Cash paid to suppliers and others	<u>(722,038)</u>	<u>(665,978)</u>
Net cash used in operating activities	<u>(1,690,639)</u>	<u>(515,623)</u>
Cash flows from investing activities:		
Purchase of investments	(2,090,281)	(4,392,199)
Proceeds from sale and maturities of investments	<u>4,000,000</u>	<u>4,015,000</u>
Net cash provided by (used in) investing activities	<u>1,909,719</u>	<u>(377,199)</u>
Net increase (decrease) in cash and cash equivalents	219,080	(892,822)
Cash and cash equivalents at beginning of year	<u>2,278,068</u>	<u>3,170,890</u>
Cash and cash equivalents at end of year	<u>\$ 2,497,148</u>	<u>\$ 2,278,068</u>

See Notes to Financial Statements.

	<u>2011</u>	<u>2010</u>
RECONCILIATION OF EXCESS OF EXPENSES OVER REVENUES TO NET CASH USED IN OPERATING ACTIVITIES		
Excess of expenses over revenues	<u>\$(1,752,809)</u>	<u>\$ (774,691)</u>
Adjustments to reconcile excess of expenses over revenues to net cash used in operating activities:		
Realized (gain) loss on sale of investments	(1,600)	2,618
Unrealized loss (gain) on investments	40,353	(208,522)
Changes in assets and liabilities:		
Decrease (increase) in:		
Premiums receivable	(207,446)	30,980
Accrued interest receivable	23,309	2,624
Prepaid expenses	(59,328)	36,497
Increase (decrease) in:		
Accounts payable	2,174	
Unemployment compensation claims payable	94,805	582,853
Deferred revenue	<u>169,903</u>	<u>(187,982)</u>
Total adjustments	<u>62,170</u>	<u>259,068</u>
Net cash used in operating activities	<u><u>\$(1,690,639)</u></u>	<u><u>\$ (515,623)</u></u>

**KENTUCKY ASSOCIATION OF COUNTIES
UNEMPLOYMENT COMPENSATION SELF-INSURANCE FUND**

NOTES TO FINANCIAL STATEMENTS

Note 1. Description of Fund and Summary of Significant Accounting Policies

The Kentucky Association of Counties Unemployment Compensation Self-Insurance Fund (Fund) was formed by the Kentucky Association of Counties (KACO) to receive contributions from eligible members to be used to reimburse the Commonwealth of Kentucky for unemployment compensation benefits paid to eligible members' employees. Governmental entities located in Kentucky who are members of KACO are eligible to make annual contributions to the Fund as determined by the Trustees in lieu of making contributions to the Kentucky Unemployment Compensation Fund. Each member is jointly and severally liable for reimbursing the Commonwealth in an amount equal to the quarterly benefits paid that are attributable to services performed in the employ of any or all members of the Fund.

Summary of significant accounting policies:

This summary of significant accounting policies of the Kentucky Association of Counties Unemployment Compensation Self-Insurance Fund is presented to assist in the understanding of the Fund's financial statements. The financial statements and notes are representations of the Fund'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.

Method of accounting:

The financial statements of the Fund have been prepared on the accrual basis of accounting.

Investments and credit risk:

Quoted market prices are used to value investments and are accounted for under Governmental Accounting Standards Board Statement (GASBS) No. 31 "Accounting and Financial Reporting for Certain Investments and for External Investment Pools".

NOTES TO FINANCIAL STATEMENTS

The Fund has significant investments in mutual funds and mortgage-backed securities held by Central Bank & Trust Company and FSC Securities Corporation. 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.

Premiums receivable:

Premiums receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a provision for bad debt expense and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to premiums receivable. Amounts are past due when not paid by the discount date.

Revenue recognition:

Member premiums revenue is recognized over the period to which the premiums relate. Premiums billed but not yet earned as of June 30, 2011 and 2010 are recorded as deferred revenue on the balance sheet.

Unemployment compensation claims payable:

The liability payable to the Commonwealth of Kentucky represents the actual benefits paid by the Commonwealth for the quarter ended June 30, 2011 and 2010.

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 reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTES TO FINANCIAL STATEMENTS

Cash and cash equivalents:

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

Income taxes:

The Fund is exempt from income taxes under Section 115 of the Internal Revenue Code. However, income from certain activities not directly related to the Fund's tax-exempt purpose may be subject to taxation as unrelated business income.

The Fund follows guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions in a fund'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 Fund's financial position and results of operations.

As of June 30, 2011 and 2010, the Fund 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.

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 Fund is exposed to this risk, plus a geographic risk, by writing all of its business in Kentucky, thus increasing its exposure to a single jurisdiction.

Subsequent events:

Management has evaluated subsequent events through October 24, 2011, the date which the financial statements were available to be issued.

NOTES TO FINANCIAL STATEMENTS

Note 2. Investments

Investments held in trust by Central Bank & Trust Company and FSC Securities Corporation at June 30, 2011 and 2010 consisted of the following:

	June 30, 2011		
	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
Eaton Vance Mutual Fund		<u>\$2,368,904</u>	<u>\$2,302,707</u>
Mortgage-backed securities:			
Federal Home Loan Bank	\$1,000,000	1,000,000	1,001,030
Federal National Mortgage	<u>2,100,000</u>	<u>2,100,000</u>	<u>2,109,620</u>
	<u>3,100,000</u>	<u>3,100,000</u>	<u>3,110,650</u>
 Total investments	 <u>\$3,100,000</u>	 <u>\$5,468,904</u>	 <u>\$5,413,357</u>
	June 30, 2010		
	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
Eaton Vance Mutual Fund		<u>\$2,278,623</u>	<u>\$2,185,673</u>
Mortgage-backed securities:			
Federal Home Loan Mortgage Corp.	\$1,000,000	1,000,000	1,015,090
Federal Home Loan Bank	2,200,000	2,196,150	2,232,659
Federal National Mortgage	<u>1,900,000</u>	<u>1,902,250</u>	<u>1,928,407</u>
	<u>5,100,000</u>	<u>5,098,400</u>	<u>5,176,156</u>
 Total investments	 <u>\$5,100,000</u>	 <u>\$7,377,023</u>	 <u>\$7,361,829</u>

NOTES TO FINANCIAL STATEMENTS

The aggregate fair market value of annual maturities of investments at June 30, 2011 and 2010, based upon stated maturity dates are as follows:

	<u>2011</u>	<u>2010</u>
Due within one to five years	\$2,109,620	\$ 1,827,338
Due after five to ten years	1,001,030	3,348,818
Eaton Vance Mutual Fund	<u>2,302,707</u>	<u>2,185,673</u>
	<u>\$5,413,357</u>	<u>\$7,361,829</u>

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 Fund 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.

Mutual funds – valued at the net asset value of shares held by the Fund at year end.

Mortgage-backed securities – valued using quoted market prices for similar assets.

NOTES TO FINANCIAL STATEMENTS

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 Fund 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 and 2010:

	<u>2011</u>	<u>2010</u>
	<u>Level 1</u>	<u>Level 1</u>
Mutual funds	\$2,302,707	\$2,185,673
Mortgage-backed securities	<u>3,110,650</u>	<u>5,176,156</u>
Total assets at fair value	<u>\$5,413,357</u>	<u>\$7,361,829</u>

Note 4. **Members' Equity**

Members' equity consists of separate accounts maintained for each member. Each member's equity balance is increased by its contributions and allocated share of investment and other revenues, and decreased by unemployment compensation benefits paid on its behalf, dividends distributed and the allocated share of other expenses. At June 30, 2011 and 2010, members' equity consists of:

	<u>2011</u>	<u>2010</u>
Members with equity	\$ 9,147,901	\$10,138,198
Members with a deficit	<u>(2,093,801)</u>	<u>(1,331,289)</u>
Total members' equity	<u>\$ 7,054,100</u>	<u>\$ 8,806,909</u>

NOTES TO FINANCIAL STATEMENTS

Note 5. Related Party Transactions

The Fund has a Program Administration Agreement whereby the Fund paid a set fee of \$106,300 and \$100,050 per quarter for 2011 and 2010, respectively, to KACO to provide management and administrative services for the Fund. The total fee is adjusted annually based upon the actual allocation of expenses covered by the agreement. For the years ended June 30, 2011 and 2010, actual expenses allocated to the Fund were \$84,962 and \$25,634 less than the program administration fee, respectively. This amount will be utilized to reduce the Fund's future payment to KACO and is included in prepaid expenses on the June 30, 2011 and 2010 balance sheets. An additional management fee of \$248,350 and \$261,100 was paid to KACO for the years ended June 30, 2011 and 2010, respectively.

The Fund has a licensing agreement with KACO that requires the Fund to pay an annual royalty to KACO in return for the use of KACO's name and logo. The Fund paid royalties of \$1,000 for each of the years ended June 30, 2011 and 2010.

Note 6. Concentration of Credit Risk

The Fund maintains its cash accounts at various banks in Kentucky. Accounts at each bank are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At June 30, 2011, the uninsured cash balances totaled approximately \$1,500,000.