THE KENTUCKY ASSOCIATION OF COUNTIES - WORKERS COMPENSATION FUND

FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

Years Ended June 30, 2012 and 2011

CONTENTS

DMLO
DEMING MALONE
LIVESAY & OSTROFF
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

To the Board of Trustees
The Kentucky Association of Counties - Workers Compensation Fund
Frankfort, Kentucky

We have audited the accompanying balance sheets of The Kentucky Association of Counties-Workers Compensation Fund as of June 30, 2012 and 2011, 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 The Kentucky Association of Counties - Workers Compensation Fund as of June 30, 2012 and 2011 and 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 31, 2012

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THE KENTUCKY ASSOCIATION OF COUNTIES -
WORKERS COMPENSATION FUND

BALANCE SHEETS
June 30, 2012 and 2011

ASSETS	2012	2011
Cash and cash equivalents	$ 11,940,686	$ 5,050,907
Investments	49,742,123	56,606,445
Investment - County Reinsurance, Limited	242,211	242,211
Member premiums receivable, less allowance for doubtful accounts of $50,000 in 2012 and 2011	21,232,002	21,520,215
Accrued interest receivable	196,926	205,651
Other	220,732	255,559
Total assets	$ 83,574,680	$ 83,880,988
LIABILITIES AND MEMBERS' EQUITY		
Estimated liability for future claims, net of estimated recoveries:		
Reported claims	$	$
Claims incurred but not reported		
	50,761,000	44,364,000
Unallocated loss adjustment expenses	78,000	77,000
Dividend payable	2,000,000	
Return premiums due to members	1,125,746	736,988
Deferred member premiums	20,195,906	20,054,035
Deferred special fund tax	1,313,341	1,304,172
Accounts payable	151,007	204,927
Total liabilities	75,625,000	66,741,122
MEMBERS' EQUITY	7,949,680	17,139,866
Total liabilities and members' equity	$ 83,574,680	$ 83,880,988

See Notes to Financial Statements.

THE KENTUCKY ASSOCIATION OF COUNTIES - WORKERS COMPENSATION FUND

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN MEMBERS' EQUITY

Years Ended June 30, 2012 and 2011

	2012	2011
REVENUES		
Member premiums	$ 19,589,531	$ 20,277,039
Special fund tax	1,279,454	1,304,136
Investment income	1,670,153	1,748,409
Realized and unrealized (loss) gain on investments	(296,976)	1,616,174
Total revenues	22,242,162	24,945,758
EXPENSES		
Claims expense, net of recoveries		
Special fund tax		
Reinsurance premiums		
Administration and marketing		
Professional fees		
Management expense		
Total expenses	29,432,348	25,658,068
Excess of expenses over revenues before distributions to members	(7,190,186)	(712,310)
NET DISTRIBUTIONS TO MEMBERS	(2,000,000)	
Decrease in members' equity	(9,190,186)	(712,310)
Members' equity, beginning of year	17,139,866	17,852,176
Members' equity, end of year	$ 7,949,680	$ 17,139,866

See Notes to Financial Statements.

THE KENTUCKY ASSOCIATION OF COUNTIES - WORKERS COMPENSATION FUND

STATEMENTS OF CASH FLOWS
Years Ended June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from member premiums	$ 21,696,996	$ 21,331,716
Reinsurance and other recoveries collected	562,105	426,990
Cash paid to suppliers	(6,967,681)	(6,697,381)
Claims paid	(16,647,865)	(15,518,870)
Investment income received	1,678,878	1,848,460
Net cash provided by operating activities	322,433	1,390,915
Cash flows from investing activities:		
Purchase of investments	(27,253,293)	(23,853,481)
Proceeds from sale and maturities of investments	33,820,639	23,296,068
Net cash provided by (used in) investing activities	6,567,346	(557,413)
Net increase in cash and cash equivalents	6,889,779	833,502
Cash and cash equivalents at beginning of year	5,050,907	4,217,405
Cash and cash equivalents at end of year	$ 11,940,686	$ 5,050,907

SUPPLEMENTAL DISCLOSURE OF NONCASH FINANCING ACTIVITIES

In October 2011, the Board of Trustees of the Fund declared a $2,000,000 dividend for the policy year ended June 30, 2007 payable to its eligible members, pursuant to the Fund's By-Laws and all other applicable provisions, in July 2012.

See Notes to Financial Statements.

	2012	2011
RECONCILIATION OF EXCESS OF EXPENSES OVER REVENUES TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Excess of expenses over revenues	$ (7,190,186)	$ (712,310)
Adjustments to reconcile excess of expenses over revenues to net cash provided by operating activities:		
Realized and unrealized loss (gain) on investments	296,976	(1,616,174)
Changes in assets and liabilities:		
Decrease (increase) in:		
Member premiums receivable	288,213	(684,696)
Accrued interest receivable	8,725	100,051
Other	34,827	(63,165)
Increase (decrease) in:		
Estimated liability for future claims	6,397,000	3,924,000
Unallocated loss adjustment expense	1,000	2,000
Return premiums due to members	388,758	(264,370)
Deferred revenue	151,040	699,607
Accounts payable	(53,920)	5,972
Total adjustments	7,512,619	2,103,225
Net cash provided by operating activities	$ 322,433	$ 1,390,915

THE KENTUCKY ASSOCIATION OF COUNTIES -
WORKERS COMPENSATION FUND

NOTES TO FINANCIAL STATEMENTS

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

Nature of business:

The Kentucky Association of Counties - Workers Compensation Fund (Fund) was formed pursuant to Kentucky Revised Statutes 342.350(4) to develop, implement and administer a program of workers' compensation group self-insurance for the counties and political subdivisions of the Commonwealth of Kentucky who are members of The Kentucky Association of Counties (KACo). The Fund operates solely for the mutual and exclusive benefit of its members as a non-profit entity. The Fund's participants consisted of 113 counties and 519 political subdivisions for 2012.

Summary of significant accounting policies:

This summary of significant accounting policies of the Fund is presented to assist in understanding the Fund's financial statements. The financial statements 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.

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.

Investments:

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

NOTES TO FINANCIAL STATEMENTS

The Fund has significant investments in mutual funds, common stocks, government securities, and corporate bonds held by Central Bank and 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.

Revenue and expense recognition:

Revenue derived from members' premiums is recognized over the period to which the premiums relate. Deferred revenue represents members' premiums billed but not yet earned. The Fund has the right to assess additional premiums at any time to cover the excess of claims incurred over previous premium assessments.

Fund expenses for reinsurance premiums, management and marketing fees and royalties are expensed ratably over the period of coverage.

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.

The most significant estimate included in the financial statements is the estimated liability for future claims (see Note 5).

Reinsurance:

The Fund uses reinsurance agreements to reduce its exposure to specific losses in excess of $850,000 per occurrence. Reinsurance permits recovery of a portion of losses from reinsurers, although it does not discharge the primary liability of the Fund as direct insurer of the risks reinsured. The Fund does not report reinsured risks as liabilities unless it is probable that those risks will not be covered by the reinsurer.

NOTES TO FINANCIAL STATEMENTS

Allowance for uncollectible accounts:

As of June 30, 2012 and 2011, substantially all of the member premiums receivable consist of advance billings on the next year's premiums, which is also included in deferred revenue, and additional year-end payroll audit receivables. All member premiums receivable are reviewed by management and evaluated for collectability.

Management considers all amounts fully collectible and maintains an allowance for doubtful accounts of $50,000 for any potential bad debts or subsequent premium adjustments.

Income taxes:

The Fund is exempt from income taxes as provided 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.

As of June 30, 2012 and 2011, 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 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.

NOTES TO FINANCIAL STATEMENTS

Geographic risk is the risk that catastrophic losses will occur in one concentrated area where the Fund does business. The Fund mitigates this risk by adhering to specified underwriting practices and by obtaining adequate reinsurance coverage.

Subsequent events:

Subsequent events have been evaluated through October 31, 2012, 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 a trust fund at Central Bank & Trust Company and FSC Securities Corporation at June 30, 2012 consisted of the following:

	2012		
	Face Value	Cost	Fair Market Value
Mortgage-backed securities:			
Federal Farm Credit Banks	$12,850,000	$12,842,000	$12,911,429
Federal Home Loan Banks	6,000,000	6,025,989	6,159,100
Federal National Mortgage Association	4,200,000	4,192,000	4,206,746
	23,050,000	23,059,989	23,277,275
Corporate bonds	5,700,000	5,777,863	6,075,920
Common stocks		7,664,441	8,154,869
Mutual funds		11,425,079	11,565,277
Municipal bonds		363,686	393,062
Other investments		257,322	275,720
Total investments		$48,548,380	$49,742,123

NOTES TO FINANCIAL STATEMENTS

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

	2011		
	Face Value	Cost	Fair Market Value
Mortgage-backed securities:			
Federal National Mortgage Association	$13,550,000	$13,547,075	$13,536,214
Federal Home Loan Banks	10,014,286	10,042,225	10,150,173
Federal Farm Credit Banks	5,500,000	5,500,000	5,568,850
	29,064,286	29,089,300	29,255,237
Corporate bonds	6,200,000	6,294,498	6,617,560
Common stocks		7,756,148	8,459,067
Mutual funds		11,425,079	11,632,625
Municipal bonds		363,686	388,695
Other investments		257,322	253,261
Total investments		$55,186,033	$56,606,445

Maturity dates of investments at fair market value are as follows at June 30, 2012:

Due within one year	$ 517,070
Due after one year through five years	10,607,818
Due after five years through ten years	17,921,369
Due after ten years	700,000
Mutual funds	11,565,277
Common stocks	8,154,869
Other investments	275,720
	$49,742,123

The Fund is an equity member of County Reinsurance, Limited (CRL), which is the Fund's reinsurance provider. The Fund's equity in CRL is based on capital contributions to CRL plus an allocation of CRL's earnings. Upon the termination of the Fund's membership in CRL, the Fund can request a repayment of its original capital contributions plus a portion of CRL's earnings during its membership, which is granted at the discretion of CRL's Board of Directors. The investment in CRL is recorded at cost equal to the Fund's capital contributions to date of $242,211. The Fund's 3.59% share of CRL's total members' equity is approximately $939,000 as of December 31, 2011.

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, 2012.

Corporate bonds, municipal bonds, exchange traded funds and mortgage-backed securities - valued at the quoted market prices for similar assets.

Common stock and mutual funds – valued at the unadjusted quoted market price as of the financial statement date.

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, 2012 and 2011:

	June 30, 2012		
	Level 1	Level 2	Total
Mortgage-backed securities		$23,277,275	$23,277,275
Mutual funds:			
Bond fund	$11,307,565		11,307,565
Small cap fund	257,712		257,712
Corporate bonds		6,075,920	6,075,920
Common stocks:			
Basic materials	1,634,524		1,634,523
Consumer goods	811,036		811,036
Financial	1,168,723		1,168,723
Healthcare	534,544		534,544
Industrial goods	703,682		703,682
Services	1,037,812		1,037,812
Technology	1,911,621		1,911,621
Utilities	352,927		352,927
Municipal bonds		393,062	393,062
Exchange traded fund		275,720	275,720
Total assets at fair value	$19,720,146	$30,021,977	$49,742,123

	June 30, 2011		
	Level 1	Level 2	Total
Mortgage-backed securities		$29,255,237	$29,255,237
Mutual funds:			
Bond fund	$11,355,762		11,355,762
Small cap fund	276,863		276,863
Corporate bonds		6,617,560	6,617,560
Common stocks:			
Basic materials	1,437,432		1,437,432
Consumer goods	800,501		800,501
Financial	1,124,150		1,124,150
Healthcare	660,047		660,047
Industrial goods	1,024,590		1,024,590
Services	1,002,753		1,002,753
Technology	2,100,194		2,100,194
Utilities	309,400		309,400
Municipal bonds		388,695	388,695
Exchange traded fund		253,261	253,261
Total assets at fair value	$20,091,692	$36,514,753	$56,606,445

Note 4. Other Assets

Other assets consist of the following:

	2012	2011
Prepaid building maintenance	$ 1,500	$ 4,500
Prepaid administrative fees	219,232	251,059
	$220,732	$255,559

NOTES TO FINANCIAL STATEMENTS

Note 5. Estimated Unpaid Claims Liabilities

Under Kentucky Law, the Fund is required to pay all valid claims against its members.

The estimated liability for future claims, net of estimated recoveries for reinsurance, deductibles and subrogation was determined by Fund management as a result of consultation with the Fund's actuaries, Oliver Wyman Actuarial Consulting, Inc. and By The Numbers Actuarial Consulting, Inc. for the years ended June 30, 2012 and 2011.

The actuaries provide 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 revenues, expenses and changes in members' equity reflect adjustments in the year they occur.

For the years ended June 30, 2012 and 2011, the liability selected by management was the mid-range or "best estimate" as determined by the actuaries and was discounted at 4.0% and 5.0%, respectively, based upon an estimate of the Fund's yield on its investments and expected claims payment patterns as developed by the actuaries. The loss payment pattern used could vary significantly from actual which would have a direct effect on the liability for estimated claims. The liability, without consideration for the time value of money, for 2012 and 2011 was approximately $60,900,000 and $55,600,000, respectively.

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, 2012 and 2011:

	2012	2011
Unpaid claims and claim adjustment expenses at beginning of year	$	$
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		
Payments:		
Claim and claim adjustment expenses paid attributable to insured events of current and prior years, net of recoveries collected		
Unpaid claims and claim adjustment expenses at end of year	$ 50,761,000	$ 44,364,000

Note 6. Unallocated Loss Adjustment Expenses

An estimated liability for future expenses of handling prior year claims has been determined by management and the Fund's actuaries, as of June 30, 2012 and 2011, and recorded as unallocated loss adjustment expenses.

Note 7. Related Party Transactions

The Fund is under a Program Administration Agreement with KACo in which the Fund reimburses KACo for certain management and administrative expenses. Total fees for the years ended June 30, 2012 and 2011 were $1,170,985 and $1,071,246, respectively. As of June 30, 2012 and 2011, the Fund had prepaid administrative fees of $219,232 and $251,059, respectively.

The Fund is under a Program Administration Agreement with KACo in which the Fund pays KACo for certain management services. The fee is based on 3% of earned premiums collected. For the years ended June 30, 2012 and 2011, the agreement included a base management fee of $347,120 and $348,450, respectively, in addition to the 3% of earned premiums collected. Total fees for the years ended June 30, 2012 and 2010 were $951,634 and $953,437, respectively. As of June 30, 2012 and 2011, the Fund had a payable to KACo of $2,805 and $24,787, respectively.

The Fund has a licensing agreement with KACo that requires the Fund to pay a royalty to KACo in return for the use of KACo's name and logo. For each of the years ended June 30, 2012 and 2011 the royalty was a fixed amount of $1,000.

KACo established the Kentucky Association of Counties Program Guaranty Fund. The purpose of the Guaranty Fund is to make available, on an as needed basis, financial support to the various programs sponsored by and operating under service agreements with KACo, which includes the Fund. The Guaranty Fund receives contributions from KACo and certain of its programs. The Fund made no contributions to the Guaranty Fund for each of the years ended June 30, 2012 and 2011.

KACo established the KACo Finance Corporation. The purpose of the Finance Corporation is to create a statewide bond pool system to allow counties and eligible subdivisions to issue bonds carrying an AA rating. As of June 30, 2012 and 2011, the Fund has purchased a $700,000 bond in the KACo Finance Corporation, which is held in trust with Central Bank & Trust Company.

Note 8. Compensating Cash and Investment Balances

Commonwealth of Kentucky, Department of Insurance, requires the Fund to maintain compensating cash and investment balances of at least ten (10) percent of outstanding future claims reserves as of the beginning of the policy year. The compensating balance for the years ended June 30, 2012 and 2011 of $5,100,000 and $4,400,000, respectively, was held by Central Bank and Trust Company.

Note 9. Concentration of Credit Risk

The Fund maintains its cash accounts at a bank in Kentucky. Accounts at the bank are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $250,000. At June 30, 2012, the uninsured cash balances totaled approximately $11,400,000.