COMMONWEALTH INSURANCE COMPANY, INC.

FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Years Ended June 30, 2013 and 2012

CONTENTS

DMLO
DEMING MALONE
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CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying financial statements of Commonwealth Insurance Company, Inc. (a Kentucky corporation), which comprise the balance sheets as of June 30, 2013 and 2012, and the related statements of income and retained earnings, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall financial statement presentation.

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We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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, 2013 and 2012 and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deming, Malone, Livesay & Ostroff

Louisville, Kentucky
September 3, 2013

COMMONWEALTH INSURANCE COMPANY, INC.

BALANCE SHEETS
June 30, 2013 and 2012

	2013	2012
ASSETS		
Cash and cash equivalents	$ 1,938,002	$ 4,305,097
Investments, at fair market value	2,947,088	
Other	68,205	33,990
Total assets	$ 4,953,295	$ 4,339,087
LIABILITIES AND STOCKHOLDER'S EQUITY		
Estimated liability for future claims, net of estimated recoveries:		
Claims incurred but not reported	$ 290,000	$ 316,000
Reported claims		179,000
	290,000	495,000
Accounts payable	5,000	4,606
Total liabilities	295,000	499,606
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	3,158,295	2,339,481
	4,658,295	3,839,481
Total liabilities and stockholder's equity	$ 4,953,295	$ 4,339,087

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF INCOME AND RETAINED EARNINGS

Years Ended June 30, 2013 and 2012

	2013	2012
REVENUES		
Premium revenue	$1,119,010	$1,072,295
Investment income	38,921	33,429
Realized and unrealized (loss) gain on investments	(26,297)	4,582
Total revenues	1,131,634	1,110,306
EXPENSES		
Claims expense and change in estimated liability for future claims	(80,000)	(55,000)
Management and marketing	112,419	151,809
Professional fees	16,327	20,241
Management fee	253,570	258,289
Provision for income taxes	10,504	9,912
Total expenses	312,820	385,251
Net income	818,814	725,055
Retained earnings, beginning of year	2,339,481	1,614,426
Retained earnings, end of year	$3,158,295	$2,339,481

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF CASH FLOWS
Years Ended June 30, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Cash received from premiums	$1,119,010	$ 1,072,294
Cash paid to suppliers	(414,511)	(435,614)
Claims paid	(125,000)	
Investment income received	32,791	35,029
Income taxes paid	(6,000)	(18,160)
Net cash provided by operating activities	606,290	653,549
Cash flows from investing activities:		
Purchase of investments	(3,185,353)	
Proceeds from sale of investments	211,968	750,000
Net cash (used in) provided by investing activities	(2,973,385)	750,000
Net (decrease) increase in cash and cash equivalents	(2,367,095)	1,403,549
Cash and cash equivalents at beginning of year	4,305,097	2,901,548
Cash and cash equivalents at end of year	$1,938,002	$ 4,305,097

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

	2013	2012
Net income	$ 818,814	$ 725,055
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized and unrealized losses (gains) on investments	26,297	(4,582)
Changes in assets and liabilities:		
Decrease (increase) in:		
Other	(34,215)	(16,530)
Increase (decrease) in:		
Estimated liability for future claims	(205,000)	(55,000)
Accounts payable	394	4,606
Total adjustments	(212,524)	(71,506)
Net cash provided by operating activities	$ 606,290	$ 653,549

See 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), provides employee dishonesty fidelity bond, property and income/extra expense coverage to the members of the Kentucky Association of Counties - All Lines Fund (KALF), a related party (see Note 5).

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 generally accepted accounting principles 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. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual events and results could differ from those assumptions and estimates.

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

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 $125,000 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 had 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 September 3, 2013, 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 at June 30, 2013 consisted of the following:

	Face Value	Cost	Fair Market Value
Mortgage-Backed Securities:			
FNMA	$ 200,000	$ 200,000	$ 196,245
FHLB	300,000	302,439	292,104
FHLMC	150,000	149,970	143,423
Federal Farm Credit Banks	350,000	350,000	340,100
	$1,000,000	1,002,409	971,871
Mutual funds		424,207	414,094
Corporate bonds		462,931	453,295
Common stocks		768,057	804,340
Municipal bonds		254,104	242,877
Other investments		65,090	60,611
Total investments		$2,976,798	$2,947,088

The aggregate annual maturities of the fair market value of investments at June 30, 2013, based upon stated maturity dates are as follows:

Due within one year	$ 40,346
Due after one year through five years	517,270
Due after five years through ten years	1,110,427
Mutual funds	414,094
Common stocks	804,340
Other investments	60,611
	$2,947,088

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, 2013.

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

Corporate bonds, municipal bonds, exchange traded fund and mortgage-backed 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, 2013:

	Level 1	Level 2	Total
Mortgage-backed securities		$ 971,871	$ 971,871
Mutual funds			
International fund	$ 183,935		183,935
Mid cap fund	132,789		132,789
Small cap fund	97,370		97,370
Corporate bonds		453,295	453,295
Common stocks			
Technology	153,048		153,048
Financial	149,584		149,584
Basic materials	130,502		130,502
Services	117,728		117,728
Industrial goods	106,513		106,513
Healthcare	88,556		88,556
Consumer goods	58,409		58,409
Municipal bonds		242,877	242,877
Exchange traded fund		60,611	60,611
Total assets at fair value	$1,218,434	$1,728,654	$2,947,088

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, 2013 and 2012.

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 reflects adjustments in the year they occur.

For the years ended June 30, 2013 and 2012, the actuary provided a possible range of discounted estimated liabilities. The discounted liability selected by management was discounted at 1.6%, 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, 2013	$150,000	$345,000	$290,000
June 30, 2012	$250,000	$590,000	$495,000

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, 2013 and 2012:

	2013	2012
Unpaid claims and claim adjustment expenses at beginning of year	$ 495,000	$550,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of current year and changes in provision for insured events of prior years net of recoveries	(80,000)	(55,000)
Payments:		
Claims and claims adjustment expenses paid attributable to insured events of current and prior years net of recoveries collected.	(125,000)	
Unpaid claims and claim adjustment expenses at end of year	$ 290,000	$495,000

Note 5. Related Party Transactions

For the years ended June 30, 2013 and 2012, 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, 2013 and 2012 under this agreement were $74,936 and $109,369, respectively. As of June 30, 2013 and 2012, the Company had prepaid administrative fees of $55,964 and $22,924, 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, 2013 and 2012 include a base fee of $220,00 and $226,120, respectively, plus 3% of earned premiums collected. Total management fees for the years ended June 30, 2013 and 2012 were $253,570 and $258,289, 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, 2013 and 2012 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 $12,810 and $12,501, for the years ended June 30, 2013 and 2012, 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, 2013 and 2012 were $10,504 and $9,912, respectively.

As of June 30, 2013 and 2012, 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, 2013, the Company's uninsured cash balance was approximately $1,213,000.