

**KENTUCKY ASSOCIATION OF COUNTIES -  
WORKERS COMPENSATION FUND**

**FINANCIAL STATEMENTS  
AND SUPPLEMENTARY INFORMATION**

**Years Ended June 30, 2013 and 2012**

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## INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying financial statements of Kentucky Association of Counties-Workers Compensation Fund, which comprise the balance sheets as of June 30, 2013 and 2012, and the related statements of revenues, expenses and changes in members' equity, 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.

### **Auditors' 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 auditors' 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 presentation of the financial statements.

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 Kentucky Association of Counties - Workers Compensation Fund 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, Lunsay & Petroff*

Louisville, Kentucky  
October 30, 2013

**KENTUCKY ASSOCIATION OF COUNTIES -  
WORKERS COMPENSATION FUND**

**BALANCE SHEETS**  
June 30, 2013 and 2012

<b>ASSETS</b>	<u>2013</u>	<u>2012</u>
Cash and cash equivalents	\$ 7,732,402	\$ 11,940,686
Investments	52,437,280	49,742,123
Investment - County Reinsurance, Limited	242,211	242,211
Member premiums receivable, less allowance for doubtful accounts of \$50,000 in 2013 and 2012	26,282,244	21,232,002
Accrued interest receivable	184,184	196,926
Other	<u>235,052</u>	<u>220,732</u>
Total assets	<u><u>\$ 87,113,373</u></u>	<u><u>\$ 83,574,680</u></u>
<b>LIABILITIES AND MEMBERS' EQUITY</b>		
Estimated liability for future claims, net of estimated recoveries:		
Reported claims	\$	\$
Claims incurred but not reported	<u>49,717,000</u>	<u>50,761,000</u>
Unallocated loss adjustment expenses	338,000	78,000
Dividend payable		2,000,000
Return premiums due to members	1,258,026	1,125,746
Deferred member premiums	25,225,104	20,195,906
Deferred special fund tax	1,640,684	1,313,341
Accounts payable	<u>235,314</u>	<u>151,007</u>
Total liabilities	78,414,128	75,625,000
<b>MEMBERS' EQUITY</b>	<u>8,699,245</u>	<u>7,949,680</u>
Total liabilities and members' equity	<u><u>\$ 87,113,373</u></u>	<u><u>\$ 83,574,680</u></u>

See Notes to Financial Statements.

**KENTUCKY ASSOCIATION OF COUNTIES -  
WORKERS COMPENSATION FUND**

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

Years Ended June 30, 2013 and 2012

	2013	2012
<b>REVENUES</b>		
Member premiums	\$ 19,638,804	\$ 19,589,531
Special fund tax	1,279,938	1,279,454
Investment income	1,479,770	1,670,153
Realized and unrealized loss on investments	(98,960)	(296,976)
Total revenues	22,299,552	22,242,162
<b>EXPENSES</b>		
Claims expense, net of recoveries		
Special fund tax		
Reinsurance premiums		
Administration and marketing		
Professional fees		
Management expense		
Total expenses	21,549,987	29,432,348
<b>Excess of revenues (expenses) before distributions to members</b>	749,565	(7,190,186)
<b>NET DISTRIBUTIONS TO MEMBERS</b>		(2,000,000)
<b>Increase (decrease) in members' equity</b>	749,565	(9,190,186)
Members' equity, beginning of year	7,949,680	17,139,866
Members' equity, end of year	\$ 8,699,245	\$ 7,949,680

See Notes to Financial Statements.

**KENTUCKY ASSOCIATION OF COUNTIES -  
WORKERS COMPENSATION FUND**

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

	<u>2013</u>	<u>2012</u>
<b>Cash flows from operating activities:</b>		
Cash received from member premiums	\$ 21,357,321	\$ 21,696,996
Reinsurance and other recoveries collected	75,401	562,105
Cash paid to suppliers	(6,923,232)	(6,967,681)
Claims paid	(15,416,169)	(16,647,865)
Investment income received	<u>1,492,512</u>	<u>1,678,878</u>
Net cash provided by operating activities	<u>585,833</u>	<u>322,433</u>
<b>Cash flows from investing activities:</b>		
Purchase of investments	(40,196,457)	(27,253,293)
Proceeds from sale and maturities of investments	<u>37,402,340</u>	<u>33,820,639</u>
Net cash (used in) provided by investing activities	<u>(2,794,117)</u>	<u>6,567,346</u>
<b>Cash flows from financing activities:</b>		
Distributions paid to members	<u>(2,000,000)</u>	<u>                    </u>
<b>Net (decrease) increase in cash and cash equivalents</b>	(4,208,284)	6,889,779
Cash and cash equivalents at beginning of year	<u>11,940,686</u>	<u>5,050,907</u>
Cash and cash equivalents at end of year	<u>\$ 7,732,402</u>	<u>\$ 11,940,686</u>

See Notes to Financial Statements.

	<u>2013</u>	<u>2012</u>
<b>RECONCILIATION OF EXCESS OF REVENUES (EXPENSES) TO NET CASH PROVIDED BY OPERATING ACTIVITIES</b>		
Excess of revenues (expenses)	\$ <u>749,565</u>	\$ <u>(7,190,186)</u>
Adjustments to reconcile excess of revenues (expenses) to net cash provided by operating activities:		
Realized and unrealized loss on investments	98,960	296,976
Changes in assets and liabilities:		
Decrease (increase) in:		
Member premiums receivable	(5,050,242)	288,213
Accrued interest receivable	12,742	8,725
Other	(14,320)	34,827
Increase (decrease) in:		
Estimated liability for future claims	(1,044,000)	6,397,000
Unallocated loss adjustment expense	260,000	1,000
Return premiums due to members	132,280	388,758
Deferred revenue	5,356,541	151,040
Accounts payable	<u>84,307</u>	<u>(53,920)</u>
Total adjustments	<u>(163,732)</u>	<u>7,512,619</u>
<b>Net cash provided by operating activities</b>	<u>\$ 585,833</u>	<u>\$ 322,433</u>



**KENTUCKY ASSOCIATION OF COUNTIES -  
WORKERS COMPENSATION FUND**

**NOTES TO FINANCIAL STATEMENTS**

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

**Nature of business:**

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 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 524 political subdivisions for 2013.

**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. 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 on the balance sheet.

### **Allowance for uncollectible accounts:**

As of June 30, 2013 and 2012, substantially all of the member premiums receivable consisted of advance billings on the next year's premiums, which are also included in deferred revenue and additional year-end payroll audit receivables. All member premiums receivable are reviewed by management and evaluated for collectibility.

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.

### **Reinsurance:**

The Fund uses reinsurance agreements to reduce its exposure to large losses. 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.

### **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.

## NOTES TO FINANCIAL STATEMENTS

### **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, 2013 and 2012, 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.

### **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).

### **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.

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.

## NOTES TO FINANCIAL STATEMENTS

### Subsequent events:

Subsequent events have been evaluated through October 30, 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 at Central Bank & Trust Company at June 30, 2013 consisted of the following:

	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
Mortgage-backed securities:			
Federal National Mortgage Association	\$20,750,000	\$20,765,067	\$20,064,307
Federal Farm Credit Banks	8,200,000	8,200,000	7,881,502
Federal Home Loan Banks	6,500,000	6,527,939	6,398,516
Federal Home Loan Mortgage	<u>2,000,000</u>	<u>2,000,000</u>	<u>1,913,600</u>
	<u>37,450,000</u>	<u>37,493,006</u>	<u>36,257,925</u>
Corporate bonds	<u>5,177,000</u>	<u>5,259,411</u>	<u>5,445,785</u>
Common stocks		<u>7,851,921</u>	<u>9,795,059</u>
Mutual funds		<u>150,000</u>	<u>288,075</u>
Municipal bonds		<u>363,686</u>	<u>360,850</u>
Other investments		<u>257,322</u>	<u>289,586</u>
Total investments		<u>\$51,375,346</u>	<u>\$52,437,280</u>

## NOTES TO FINANCIAL STATEMENTS

Investments held in trust funds at Central Bank & Trust Company and FSC Securities Corporation at June 30, 2012 consisted of the following:

	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
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	<u>4,200,000</u>	<u>4,192,000</u>	<u>4,206,746</u>
	<u>23,050,000</u>	<u>23,059,989</u>	<u>23,277,275</u>
Corporate bonds	<u>5,700,000</u>	<u>5,777,863</u>	<u>6,075,920</u>
Common stocks		<u>7,664,441</u>	<u>8,154,869</u>
Mutual funds		<u>11,425,079</u>	<u>11,565,277</u>
Municipal bonds		<u>363,686</u>	<u>393,062</u>
Other investments		<u>257,322</u>	<u>275,720</u>
Total investments		<u>\$48,548,380</u>	<u>\$49,742,123</u>

Maturity dates of investments at fair market value are as follows at June 30, 2013:

Due within one year	\$ 657,705
Due after one year through five years	14,149,790
Due after five years through ten years	26,217,065
Due after ten years	1,040,000
Mutual funds	288,075
Common stocks	9,795,059
Other investments	<u>289,586</u>
	<u>\$52,437,280</u>

## NOTES TO FINANCIAL STATEMENTS

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 its portion of CRL's earnings during its membership, which is paid out over five years or sooner, 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. Under the cost method of recording the investment in CRL, the Fund's financial statements do not include \$983,789 of the Fund's 3.53% share of CRL's member's equity of \$1,226,000.

### 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, 2013.

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

## NOTES TO FINANCIAL STATEMENTS

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

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 its 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 and 2012:

	June 30, 2013		
	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
Mortgage-backed securities		\$36,257,925	\$36,257,925
Corporate bonds		5,445,785	5,445,785
Common stocks:			
Basic materials	\$ 1,395,400		1,395,400
Consumer goods	684,127		684,127
Financial	1,649,075		1,649,075
Healthcare	1,028,842		1,028,842
Industrial goods	1,070,208		1,070,208
Services	1,602,910		1,602,910
Technology	2,001,233		2,001,233
Utilities	363,264		363,264
Mutual funds:			
Small cap fund	288,075		288,075
Municipal bonds		360,850	360,850
Exchange traded fund		289,586	289,586
Total assets at fair value	<u>\$10,083,134</u>	<u>\$42,354,146</u>	<u>\$52,437,280</u>

## NOTES TO FINANCIAL STATEMENTS

	June 30, 2012		
	Level 1	Level 2	Total
Mortgage-backed securities		\$23,277,275	\$23,277,275
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
Mutual funds:			
Bond fund	11,307,565		11,307,565
Small cap fund	257,712		257,712
Municipal bonds		393,062	393,062
Exchange traded fund		275,720	275,720
Total assets at fair value	<u>\$19,720,146</u>	<u>\$30,021,977</u>	<u>\$49,742,123</u>

### Note 4. Other Assets

Other assets consist of the following:

	2013	2012
Prepaid building maintenance		\$ 1,500
Prepaid administrative fees	\$210,034	219,232
Prepaid management fees	25,018	
	<u>\$235,052</u>	<u>\$220,732</u>



## 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. for the year ended June 30, 2013 and both Oliver Wyman Actuarial Consulting, Inc. and By The Numbers Actuarial Consulting, Inc. for the year ended June 30, 2012.

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 year ended June 30, 2013, the liability selected by management was the mid-range or "best estimate" as determined by Oliver Wyman Actuarial Consulting, Inc., discounted at 4% based upon an estimate of the Fund's yield on its investments and expected claims patterns as developed by the actuary. For the year ended June 30, 2012, the liability selected by management was the average of the mid-range or "best estimate" as determined by the actuaries and was discounted at 4.0%, 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 2013 and 2012 was approximately \$            and \$            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, 2013 and 2012:

**NOTES TO FINANCIAL STATEMENTS**

	<u>2013</u>	<u>2012</u>
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	<u>\$ 49,717,000</u>	<u>\$ 50,761,000</u>

**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, 2013 and 2012, and recorded as unallocated loss adjustment expenses.

**Note 7. 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, 2013 and 2012 of approximately \$5,100,000 was held by Central Bank and Trust Company.

**Note 8. 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, 2013, the uninsured cash balances totaled approximately \$7,400,000.

## NOTES TO FINANCIAL STATEMENTS

### Note 9. 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, 2013 and 2012 were \$1,146,266 and \$1,170,985, respectively. As of June 30, 2013 and 2012, the Fund had prepaid administrative fees of \$210,034 and \$219,232, 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, 2013 and 2012, the agreement included a base management fee of \$350,000 and \$347,120, respectively, in addition to the 3% of earned premiums collected. Total fees for the years ended June 30, 2013 and 2012 were \$929,589 and \$951,634, respectively. As of June 30, 2013, the Fund had prepaid administrative fees of \$25,018. As of June 30, 2012, the Fund had a payable to KACo of \$2,805.

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, 2013 and 2012, 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, 2013 and 2012.

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, 2013 and 2012, the Fund has purchased \$1,040,000 and \$700,000, respectively, of bonds in the KACo Finance Corporation, which is held in trust with Central Bank & Trust Company.