KENTUCKY ASSOCIATION OF COUNTIES - WORKERS COMPENSATION FUND

FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

Years Ended June 30, 2015 and 2014

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DMLO
DEMING MALONE
LIVESAY & OSTROFF
CERTIFIED PUBLIC ACCOUNTANTS

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, 2015 and 2014, 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.

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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 Kentucky Association of Counties - Workers Compensation Fund as of June 30, 2015 and 2014 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
October 29, 2015

KENTUCKY ASSOCIATION OF COUNTIES -
WORKERS COMPENSATION FUND

BALANCE SHEETS
June 30, 2015 and 2014

Assets	2015	2014
Cash and cash equivalents	$ 8,488,871	$ 13,116,494
Investments	69,326,895	56,818,232
Investment - County Reinsurance, Limited	242,211	242,211
Member premiums receivable, less allowance for doubtful accounts of $50,000 in 2015 and 2014	25,555,889	26,414,064
Accrued interest receivable	235,097	200,367
Other	251,209	246,310
Total assets	$ 104,100,172	$ 97,037,678
Liabilities and Members' Equity		
Estimated liability for future claims, net of estimated recoveries:		
Reported claims		
Claims incurred but not reported		
	57,121,000	50,766,000
Unallocated loss adjustment expenses	407,000	381,000
Return premiums due to members	1,006,642	1,041,791
Deferred revenue	24,766,036	25,679,744
Deferred special fund tax	1,529,199	1,670,421
Accounts payable	263,015	291,898
Total liabilities	85,092,892	79,830,854
Members' Equity	19,007,280	17,206,824
Total liabilities and members' equity	$ 104,100,172	$ 97,037,678

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, 2015 and 2014

	2015	2014
Revenues		
Member premiums	$ 25,696,773	$ 25,041,900
Special fund tax	1,666,761	1,633,394
Investment income	1,961,835	1,504,261
Realized and unrealized gain on investments	754,547	2,837,378
Total revenues	30,079,916	31,016,933
Expenses		
Claims expense, net of recoveries		
Special fund tax		
Reinsurance premiums		
Administration and marketing		
Professional fees		
Management expense		
Total expenses	28,279,460	22,509,354
Excess of revenues over expenses	1,800,456	8,507,579
Members' equity, beginning of year	17,206,824	8,699,245
Members' equity, end of year	$ 19,007,280	$ 17,206,824

See Notes to Financial Statements.

KENTUCKY ASSOCIATION OF COUNTIES - WORKERS COMPENSATION FUND

STATEMENTS OF CASH FLOWS
Years Ended June 30, 2015 and 2014

	2015	2014
Cash Flows from Operating Activities		
Cash received from member premiums	$ 27,131,630	$ 26,811,616
Reinsurance and other recoveries collected	199,360	143,554
Cash paid to suppliers	(7,768,830)	(7,539,992)
Claims paid	(14,362,772)	(13,975,590)
Investment income received	1,927,105	1,488,078
Net cash provided by operating activities	7,126,493	6,927,666
Cash Flows from Investing Activities		
Purchase of investments	(40,837,173)	(37,344,332)
Proceeds from sale and maturities of investments	29,083,057	35,800,758
Net cash used in investing activities	(11,754,116)	(1,543,574)
Net (decrease) increase in cash and cash equivalents	(4,627,623)	5,384,092
Cash and cash equivalents at beginning of year	13,116,494	7,732,402
Cash and cash equivalents at end of year	$ 8,488,871	$ 13,116,494

See Notes to Financial Statements.

	2015	2014
Reconciliation of Excess of Revenues over Expenses to Net Cash Provided by Operating Activities		
Excess of revenues over expenses	$ 1,800,456	$ 8,507,579
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Realized and unrealized gain on investments	(754,547)	(2,837,378)
Changes in assets and liabilities:		
Decrease (increase) in:		
Member premiums receivable	858,175	(131,820)
Accrued interest receivable	(34,730)	(16,183)
Other	(4,899)	(11,258)
Increase (decrease) in:		
Estimated liability for future claims	6,355,000	1,049,000
Unallocated loss adjustment expenses	26,000	43,000
Return premiums due to members	(35,149)	(216,235)
Deferred revenue	(1,054,930)	484,377
Accounts payable	(28,883)	56,584
Total adjustments	5,326,037	(1,579,913)
Net cash provided by operating activities	$ 7,126,493	$ 6,927,666

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 533 political subdivisions for 2015.

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 value. Fair value is established based upon readily determinable market quotations for equity and debt securities.

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, 2015 and 2014, 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.

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, 2015 and 2014, 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.

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.

Newly issued standard not yet effective:

The Financial Accounting Standards Board has issued accounting standard No. 2014-09, *Revenue from Contracts with Customers*, concerning the accounting for revenue recognition. The standard is effective for years beginning after December 15, 2018. The Fund is evaluating the impact that adoption of the standard will have on future financial position and results of operations.

Subsequent events:

Subsequent events have been evaluated through October 29, 2015, which is the date the financial statements were available to be issued.

Note 2. Investments

Investments are carried at fair value as determined based on quoted prices in active markets. Investments held in trust funds at Central Bank & Trust Company at June 30, 2015 consisted of the following:

	Face Value	Cost	Fair Value
Mortgage-backed securities:			
Federal National Mortgage Association	$14,843,140	$14,995,226	$14,732,805
Federal Farm Credit Bank	2,750,000	2,750,000	2,683,775
Federal Home Loan Bank	6,276,507	6,401,256	6,271,325
Federal Home Loan Mortgage	1,575,000	1,601,100	1,575,102
Fannie Mae Mortgage Backed Securities Pools	2,242,007	2,305,676	2,333,045
Government National Mortgage Association	292,391	299,954	296,177
Federal Home Loan Mortgage Gold Pool	3,098,710	3,238,050	3,236,719
	31,077,755	31,591,262	31,128,948
U.S. Treasury notes	2,700,000	2,728,957	2,709,600
Corporate bonds	14,635,000	14,834,971	14,783,424
Common stocks		10,943,108	13,545,646
Mutual funds		7,097,360	7,159,277
Total investments		$67,195,658	$69,326,895

Investments held in trust funds at Central Bank & Trust Company at June 30, 2014 consisted of the following:

	Face Value	Cost	Fair Value
Mortgage-backed securities:			
Federal National Mortgage Association	$10,140,632	$10,142,854	$ 9,822,078
Federal Farm Credit Bank	4,350,000	4,350,000	4,241,039
Federal Home Loan Bank	6,000,000	6,027,939	5,939,101
Federal Home Loan Mortgage	3,000,875	3,032,480	3,024,747
Fannie Mae Mortgage Backed Securities Pools	1,350,701	1,379,596	1,399,703
Federal Home Loan Mortgage Gold Pool	626,075	657,273	662,212
	25,468,283	25,590,142	25,088,880
Corporate bonds	12,920,000	13,091,684	13,199,719
Common stocks		8,449,715	10,838,441
Mutual funds		5,686,412	5,801,720
Municipal bonds		253,450	262,150
Other investments		1,457,538	1,627,322
Total investments		$54,528,941	$56,818,232

Maturity dates of investments at fair market value are as follows at June 30, 2015:

Due within one year	$ 4,450,278
Due after one year through five years	20,167,536
Due after five years through ten years	15,093,289
Due after ten years	8,910,869
Mutual funds	7,159,277
Common stocks	13,545,646
	$69,326,895

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 $1,322,000 of the Fund's 3.52% share of CRL's member's equity of $1,564,000.

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 hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). 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. If the asset or liability has a specific (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.

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. All assets have been valued using a market approach. 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, 2015 and 2014.

Corporate bonds, U.S. Treasury notes 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.

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, 2015 and 2014:

	June 30, 2015		
	Level 1	Level 2	Total
Mortgage-backed securities		$31,128,948	$31,128,948
U.S. Treasury notes		2,709,600	2,709,600
Corporate bonds		14,783,424	14,783,424
Common stocks:			
Basic materials	$ 1,312,634		1,312,634
Consumer goods	1,537,320		1,537,320
Financial	1,959,828		1,959,828
Healthcare	2,320,266		2,320,266
Industrial goods	1,638,826		1,638,826
Services	2,128,482		2,128,482
Technology	2,528,787		2,528,787
Utilities	119,503		119,503
Mutual funds:			
International	2,284,319		2,284,319
Mid cap fund	1,797,112		1,797,112
Small cap fund	1,727,182		1,727,182
Large cap fund	965,402		965,402
Alternative fund	385,262		385,262
Total assets at fair value	$20,704,923	$48,621,972	$69,326,895

	June 30, 2014		
	Level 1	Level 2	Total
Mortgage-backed securities		$25,088,880	$25,088,880
Corporate bonds		13,199,719	13,199,719
Common stocks:			
Basic materials	$ 1,691,801		1,691,801
Consumer goods	1,405,742		1,405,742
Financial	1,632,777		1,632,777
Healthcare	1,626,920		1,626,920
Industrial goods	1,274,419		1,274,419
Services	865,053		865,053
Technology	2,268,145		2,268,145
Utilities	73,584		73,584
Mutual funds:			
International	2,254,307		2,254,307
Mid cap fund	2,239,224		2,239,224
Small cap fund	1,308,189		1,308,189
Municipal bonds		262,150	262,150
Exchange traded fund		1,627,322	1,627,322
Total assets at fair value	$16,640,161	$40,178,071	$56,818,232

Note 4. Other Assets

Other assets consist of the following:

	2015	2014
Prepaid administrative fees	$226,175	$230,726
Prepaid management fees	25,034	15,584
	$251,209	$246,310

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 actuary, Oliver Wyman Actuarial Consulting, Inc. for the years ended June 30, 2015 and 2014.

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 the estimate, the statement of revenues, expenses and changes in members' equity reflect adjustments in the year they occur.

For the years ended June 30, 2015 and 2014, the liability was discounted at 2% and 4%, respectively based upon an estimate of the Fund's yield on its investments and expected claims 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 liability, without consideration for the time value of money, for 2015 and 2014 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, 2015 and 2014:

	2015	2014
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	$ 57,121,000	$ 50,766,000

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 actuary, as of June 30, 2015 and 2014, 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, 2015 and 2014 of approximately $5,800,000 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 insured by the Federal Deposit Insurance Corporation (FDIC) up to $250,000. At June 30, 2015, the uninsured cash balances totaled approximately $8,200,000.

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, 2015 and 2014 were $1,184,825 and $1,150,673, respectively. As of June 30, 2015 and 2014, the Fund had prepaid administrative fees of $226,175 and $230,726, 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, 2015 and 2014, the agreement included a base management fee of $310,180 and $293,400, respectively, in addition to the 3% of earned premiums collected. Total fees for the years ended June 30, 2015 and 2014 were $1,073,346 and $1,041,901, respectively. As of June 30, 2015 and 2014, the Fund had prepaid administrative fees of $25,034 and $15,584, 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, 2015 and 2014, 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 did not make any contributions to the Guaranty Fund for each of the years ended June 30, 2015 and 2014.

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, 2015 and 2014, the Fund has purchased $1,040,000 of bonds in the KACo Finance Corporation, which is held in trust with Central Bank & Trust Company.

The Fund had a receivable due from KACo-All Lines Fund at June 30, 2014 of $59,919.