

COMMONWEALTH INSURANCE COMPANY, INC.

FINANCIAL STATEMENTS

Years Ended June 30, 2016 and 2015

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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, 2016 and 2015, and the related statements of income and comprehensive income, stockholder's 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 financial statement presentation.

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, 2016 and 2015 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, Linsay & Ostroff

Louisville, Kentucky
September 22, 2016

COMMONWEALTH INSURANCE COMPANY, INC.

BALANCE SHEETS

June 30, 2016 and 2015

Assets	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 1,124,783	\$ 684,176
Investments, at fair market value	5,702,873	5,293,748
Other	<u>52,186</u>	<u>87,919</u>
 Total assets	 <u><u>\$ 6,879,842</u></u>	 <u><u>\$ 6,065,843</u></u>
 Liabilities and Stockholder's Equity		
Estimated liability for future claims, net of estimated recoveries:		
Reported claims	\$ 158,000	\$ 143,000
Claims incurred but not reported	<u>437,000</u>	<u>432,000</u>
	595,000	575,000
 Deferred income taxes	 <u>72,000</u>	 <u> </u>
 Total liabilities	 <u><u>667,000</u></u>	 <u><u>575,000</u></u>
 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	4,556,204	3,957,969
Accumulated other comprehensive income	<u>156,638</u>	<u>32,874</u>
	<u>6,212,842</u>	<u>5,490,843</u>
 Total liabilities and stockholder's equity	 <u><u>\$ 6,879,842</u></u>	 <u><u>\$ 6,065,843</u></u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Years Ended June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Revenues		
Premium revenue	\$ 950,000	\$ 950,000
Investment income	143,407	132,882
Realized (losses) gains on investments	<u>(9,068)</u>	<u>38,945</u>
Total revenues	<u>1,084,339</u>	<u>1,121,827</u>
Expenses		
Claims expense and change in estimated liability for future claims	35,304	400,294
Management and marketing	130,446	128,178
Professional fees	34,575	31,609
Management fee	248,755	248,200
Provision for income taxes	<u>37,024</u>	<u>55,537</u>
Total expenses	<u>486,104</u>	<u>863,818</u>
Net income	<u>598,235</u>	<u>258,009</u>
Other Comprehensive Income		
Unrealized gain on investments, net of tax	114,696	57,477
Reclassification adjustment	<u>9,068</u>	<u>(38,945)</u>
	<u>123,764</u>	<u>18,532</u>
Total comprehensive income	<u><u>\$ 721,999</u></u>	<u><u>\$ 276,541</u></u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF STOCKHOLDER'S EQUITY

Years Ended June 30, 2016 and 2015

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balances, June 30, 2014	\$ 1,500,000	\$ 3,699,960	\$ 14,342	\$ 5,214,302
Net income		258,009		258,009
Other comprehensive income, net			18,532	18,532
Balances, June 30, 2015	1,500,000	3,957,969	32,874	5,490,843
Net income		598,235		598,235
Other comprehensive income, net			123,764	123,764
Balances, June 30, 2016	<u>\$ 1,500,000</u>	<u>\$ 4,556,204</u>	<u>\$ 156,638</u>	<u>\$ 6,212,842</u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities		
Cash received from premiums	\$ 950,000	\$ 950,000
Cash paid to suppliers	(413,120)	(391,159)
Claims paid	(15,304)	(260,294)
Investment income received	146,460	128,073
Income taxes paid	<u>(5,000)</u>	<u>(108,686)</u>
Net cash provided by operating activities	<u>663,036</u>	<u>317,934</u>
Cash Flows from Investing Activities		
Purchase of investments	(2,805,598)	(3,248,266)
Proceeds from sale of investments	<u>2,583,169</u>	<u>2,056,114</u>
Net cash used in investing activities	<u>(222,429)</u>	<u>(1,192,152)</u>
Net increase (decrease) in cash and cash equivalents	440,607	(874,218)
Cash and cash equivalents at beginning of year	<u>684,176</u>	<u>1,558,394</u>
Cash and cash equivalents at end of year	<u>\$ 1,124,783</u>	<u>\$ 684,176</u>
Reconciliation of Net Income to Net Cash Provided by Operating Activities		
Net income	<u>\$ 598,235</u>	<u>\$ 258,009</u>
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized losses (gains) on investments	9,068	(38,945)
Changes in assets and liabilities:		
Decrease (increase) in:		
Other	35,733	(32,388)
Increase (decrease) in:		
Estimated liability for future claims	20,000	140,000
Accounts payable and accrued expenses	<u> </u>	<u>(8,742)</u>
Total adjustments	<u>64,801</u>	<u>59,925</u>
Net cash provided by operating activities	<u>\$ 663,036</u>	<u>\$ 317,934</u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

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 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. 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).

NOTES TO FINANCIAL STATEMENTS

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.

Investments:

The Company records all investments at fair 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. The Company considers all investments to be classified as available-for-sale. Basis is determined on historical purchase price.

Cash and cash equivalents:

For purposes of the statements 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.

NOTES TO FINANCIAL STATEMENTS

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 22, 2016, 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 by Central Bank & Trust Company at June 30, 2016 consisted of the following:

			2016		
	<u>Face Value</u>	<u>Cost</u>	Gross Unrealized <u>Losses</u>	Gross Unrealized <u>Gains</u>	<u>Fair Value</u>
U.S. Governmental agency and Mortgage-Backed Securities:					
FNMA	\$ 501,866	\$ 504,914		\$ 9,556	\$ 514,470
FGPC	86,481	89,547		2,554	92,101
U.S Treasury note	1,315,000	1,318,189		15,042	1,333,231
FNMS	<u>421,446</u>	<u>422,134</u>		<u>24,751</u>	<u>446,885</u>
	<u>\$2,324,793</u>	<u>2,334,784</u>		<u>51,903</u>	<u>2,386,687</u>
Corporate bonds		<u>1,742,471</u>	<u>\$ (9,398)</u>	<u>40,300</u>	<u>1,773,373</u>
Common stocks		<u>1,396,980</u>	<u>(40,148)</u>	<u>185,981</u>	<u>1,542,813</u>
Total investments		<u>\$5,474,235</u>	<u>\$(49,546)</u>	<u>\$278,184</u>	<u>\$5,702,873</u>

NOTES TO FINANCIAL STATEMENTS

Investments held in trust funds by Central Bank & Trust Company at June 30, 2015 consisted of the following:

	2015				
	<u>Face Value</u>	<u>Cost</u>	Gross Unrealized <u>Losses</u>	Gross Unrealized <u>Gains</u>	Fair <u>Value</u>
U.S. Governmental agency and Mortgage-Backed Securities:					
FNMA	\$ 445,000	\$ 447,719	\$ (3,981)		\$ 443,738
FHLB	400,000	407,081	(2,868)		404,213
FHLMC	150,000	149,970	(5,174)		144,796
FFCB	350,000	350,000	(4,406)	\$ 87	345,681
FGPC	213,790	223,765		1,485	225,250
U.S Treasury note	350,000	351,390	(786)	129	350,733
FNMS	<u>544,110</u>	<u>545,492</u>	<u> </u>	<u>11,649</u>	<u>557,141</u>
	<u>\$2,452,900</u>	<u>2,475,417</u>	<u>(17,215)</u>	<u>13,350</u>	<u>2,471,552</u>
Corporate bonds		<u>1,188,342</u>	<u>(8,856)</u>	<u>9,798</u>	<u>1,189,284</u>
Common stocks		<u>1,343,011</u>	<u>(43,322)</u>	<u>83,957</u>	<u>1,383,646</u>
Municipal bonds		<u>254,104</u>	<u>(4,838)</u>	<u> </u>	<u>249,266</u>
Total investments		<u>\$5,260,874</u>	<u>\$(74,231)</u>	<u>\$107,105</u>	<u>\$5,293,748</u>

The aggregate annual maturities of the fair value of investments at June 30, 2016, based upon stated maturity dates are as follows:

Due within one year	\$ 410,833
Due after one year through five years	1,458,526
Due after five years through ten years	1,106,140
Due after ten years	1,184,561
Common stocks	<u>1,542,813</u>
	<u>\$5,702,873</u>

NOTES TO FINANCIAL STATEMENTS

The following table summarizes securities with unrealized losses at June 30, 2016 and 2015, aggregated by major security type and length of time in a continuous unrealized loss position:

	2016					
	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>
Corporate bonds	\$ (1,056)	\$ 81,723	\$ (8,342)	\$197,855	\$ (9,398)	\$279,578
Common stocks	<u>(12,500)</u>	<u>152,521</u>	<u>(27,648)</u>	<u>217,605</u>	<u>(40,148)</u>	<u>370,126</u>
Total investments	<u><u>\$(13,556)</u></u>	<u><u>\$234,244</u></u>	<u><u>\$(35,990)</u></u>	<u><u>\$415,460</u></u>	<u><u>\$(49,546)</u></u>	<u><u>\$649,704</u></u>

	2015					
	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>
U.S. Governmental agency and Mortgage-Backed Securities:						
FNMA	\$ (3,268)	\$ 394,451	\$ (713)	\$ 49,287	\$ (3,981)	\$ 443,738
FHLB	(331)	306,750	(2,537)	97,463	(2,868)	404,213
FHLMC			(5,174)	144,796	(5,174)	144,796
FFCB			(4,406)	195,594	(4,406)	195,594
US Treasury note	<u>(786)</u>	<u>300,702</u>			<u>(786)</u>	<u>300,702</u>
Corporate bonds	<u>(2,764)</u>	<u>190,085</u>	<u>(6,092)</u>	<u>311,329</u>	<u>(8,856)</u>	<u>501,414</u>
Common stocks	<u>(36,132)</u>	<u>475,095</u>	<u>(7,190)</u>	<u>140,785</u>	<u>(43,322)</u>	<u>615,880</u>
Municipal bonds			<u>(4,838)</u>	<u>249,266</u>	<u>(4,838)</u>	<u>249,266</u>
Total investments	<u><u>\$(43,281)</u></u>	<u><u>\$1,667,083</u></u>	<u><u>\$(30,950)</u></u>	<u><u>\$1,188,520</u></u>	<u><u>\$(74,231)</u></u>	<u><u>\$2,855,603</u></u>

NOTES TO FINANCIAL STATEMENTS

Investments in an unrealized loss position at June 30, 2016 and 2015 were temporarily impaired due to the current interest rate and market environment and not increased credit risk. In estimating other-than-temporary impairment losses, the Company considers, among other things, the length of time and the extent to which the fair value has been less than cost, and the financial condition and near-term prospects of the issuer. The Company does not intend to sell these securities, and it is more likely than not that the Company will not be required to sell before a period of time sufficient to allow for any anticipated recovery in cost.

Note 3. Fair Value Measurements

The framework for measuring fair value 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 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. If the asset or liability has a specified (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 maximize the use of observable inputs and minimize the use of unobservable inputs.

NOTES TO FINANCIAL STATEMENTS

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, 2016 and 2015.

Common stocks – valued at the unadjusted quoted market price as of the financial statement date.

Corporate bonds, municipal bonds, U.S. governmental agency 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, 2016:

	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
U.S. Governmental and			
Mortgage-backed securities		\$2,386,687	\$2,386,687
Corporate bonds		1,773,373	1,773,373
Common stocks			
Technology	\$ 322,762		322,762
Financial	87,098		87,098
Basic materials	92,911		92,911
Services	225,975		225,975
Industrial goods	325,829		325,829
Healthcare	159,392		159,392
Consumer goods	<u>328,846</u>		<u>328,846</u>
Total assets at fair value	<u>\$1,542,813</u>	<u>\$4,160,060</u>	<u>\$5,702,873</u>

NOTES TO FINANCIAL STATEMENTS

The following table sets forth, by level, within the fair value hierarchy, the Fund's assets at fair value as of June 30, 2015:

	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
U.S. Governmental and Mortgage-backed securities		\$2,471,552	\$2,471,552
Corporate bonds		1,189,284	1,189,284
Municipal bonds		249,266	249,266
Common stocks			
Technology	\$ 415,573		415,573
Financial	57,262		57,262
Basic materials	198,361		198,361
Services	58,252		58,252
Industrial goods	196,073		196,073
Healthcare	114,836		114,836
Consumer goods	<u>343,289</u>	<u> </u>	<u>343,289</u>
Total assets at fair value	<u>\$1,383,646</u>	<u>\$3,910,102</u>	<u>\$5,293,748</u>

Note 4. Estimated Unpaid Claims Liabilities

Under Kentucky Law, the Company is required to pay all valid claims against its policyholder. The Company covers losses for employee dishonesty coverage up to a maximum of \$140,000 per event after deductibles. The Company covers losses for business income coverage up to a maximum of \$125,000 per event after deductibles. The estimated liability for future claims, net of estimated recoveries for 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, 2016 and 2015.

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.

NOTES TO FINANCIAL STATEMENTS

For the years ended June 30, 2016 and 2015, the actuary provided a possible range of discounted estimated liabilities. The discounted liability selected by management was discounted at 1.5% and 2.0%, respectively, 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:

	<u>Low</u>	<u>High</u>	<u>Selected</u>
June 30, 2016	\$330,000	\$700,000	\$595,000
June 30, 2015	\$320,000	\$670,000	\$575,000

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, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Unpaid claims and claim adjustment expenses at beginning of year	\$575,000	\$ 435,000
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	35,304	400,294
Payments:		
Claims and claims adjustment expenses paid attributable to insured events of current and prior years net of recoveries collected.	<u>(15,304)</u>	<u>(260,294)</u>
Unpaid claims and claim adjustment expenses at end of year	<u>\$595,000</u>	<u>\$ 575,000</u>

NOTES TO FINANCIAL STATEMENTS

Note 5. Related Party Transactions

For the years ended June 30, 2016 and 2015, 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, 2016 and 2015 under this agreement were \$77,509 and \$74,416, respectively. As of June 30, 2016 and 2015, the Company had prepaid administrative fees of \$21,393 and \$21,598, 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, 2016 and 2015 include a base fee of \$220,255 and \$219,700, respectively, plus 3% of earned premiums collected. Total management fees for the years ended June 30, 2016 and 2015 were \$248,755 and \$248,200, 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, 2016 and 2015 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 \$23,750 for each of the years ended June 30, 2016 and 2015.

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. The Company's deferred tax liability of \$72,000 as of June 30, 2016, results from unrealized gains on investments and is included in other comprehensive income. There were no deferred taxes for the year ended June 30, 2015. Total federal and Kentucky tax expense for the years ended June 30, 2016 and 2015 were \$37,024 and \$55,537, respectively.

NOTES TO FINANCIAL STATEMENTS

As of June 30, 2016 and 2015, 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.

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, 2016, the Company's uninsured cash balance was approximately \$254,000.