# COMMONWEALTH INSURANCE COMPANY, INC.

## FINANCIAL STATEMENTS

### Years Ended June 30, 2017 and 2016

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DMLO
DEMING MALONE
LIVESAY & OSTROFF
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, 2017 and 2016, 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.



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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, 2017 and 2016 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 13, 2017

## COMMONWEALTH INSURANCE COMPANY, INC.

### BALANCE SHEETS
June 30, 2017 and 2016

| Assets | 2017 | 2016 |
|---|---|---|
| Cash and cash equivalents | $ 496,139 | $ 1,124,783 |
| Investments | 7,073,367 | 5,702,873 |
| Prepaid income taxes | | 12,797 |
| Other assets | 44,117 | 39,389 |
| **Total assets** | $ 7,613,623 | $ 6,879,842 |
| **Liabilities and Stockholder's Equity** | | |
| Estimated liability for future claims, net of estimated recoveries: | | |
| Reported claims | $ 138,000 | $ 158,000 |
| Claims incurred but not reported | 452,000 | 437,000 |
| | 590,000 | 595,000 |
| Accounts payable | 4,970 | |
| Income taxes payable | 18,618 | |
| Deferred income tax | 74,000 | 72,000 |
| | 97,588 | 72,000 |
| **Total liabilities** | 687,588 | 667,000 |
| **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 | 5,266,958 | 4,556,204 |
| Accumulated other comprehensive income | 159,077 | 156,638 |
| | 6,926,035 | 6,212,842 |
| **Total liabilities and stockholder's equity** | $ 7,613,623 | $ 6,879,842 |

See Notes to Financial Statements.

## COMMONWEALTH INSURANCE COMPANY, INC.

## STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
Years Ended June 30, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| **Revenues** | | |
| Premium revenue | $ 950,000 | $ 950,000 |
| Investment income | 153,099 | 143,407 |
| Realized gains (losses) on investments | 102,481 | (9,068) |
| **Total revenues** | 1,205,580 | 1,084,339 |
| **Expenses** | | |
| Claims expense and change in estimated liability for future claims | (5,000) | 35,304 |
| Office and administrative fees | 149,263 | 130,446 |
| Professional fees | 41,633 | 34,575 |
| Management fee | 249,300 | 248,755 |
| Provision for income taxes | 59,630 | 37,024 |
| **Total expenses** | 494,826 | 486,104 |
| **Net income** | 710,754 | 598,235 |
| **Other Comprehensive Income** | | |
| Unrealized gain on investments, net of tax | 104,920 | 114,696 |
| Reclassification adjustment for realized (gains) losses | (102,481) | 9,068 |
| | 2,439 | 123,764 |
| **Total comprehensive income** | $ 713,193 | $ 721,999 |

See Notes to Financial Statements.

# COMMONWEALTH INSURANCE COMPANY, INC.

## STATEMENTS OF STOCKHOLDER'S EQUITY
Years Ended June 30, 2017 and 2016

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|---|---|---|---|---|
| **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** | 1,500,000 | 4,556,204 | 156,638 | 6,212,842 |
| Net income | | 710,754 | | 710,754 |
| Other comprehensive income, net | | | 2,439 | 2,439 |
| **Balances, June 30, 2017** | $ 1,500,000 | $ 5,266,958 | $ 159,077 | $ 6,926,035 |

See Notes to Financial Statements.

## COMMONWEALTH INSURANCE COMPANY, INC.

### STATEMENTS OF CASH FLOWS
Years Ended June 30, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Cash received from premiums | $ 950,000 | $ 950,000 |
| Cash paid for operating expenses | (435,654) | (413,120) |
| Claims paid | | (15,304) |
| Investment income received | 148,799 | 146,460 |
| Income taxes paid | (28,215) | (5,000) |
| **Net cash provided by operating activities** | 634,930 | 663,036 |
| **Cash Flows from Investing Activities** | | |
| Purchase of investments | (3,688,654) | (2,805,598) |
| Proceeds from sale of investments | 2,425,080 | 2,583,169 |
| **Net cash used in investing activities** | (1,263,574) | (222,429) |
| **Net (decrease) increase in cash and cash equivalents** | (628,644) | 440,607 |
| Cash and cash equivalents at beginning of year | 1,124,783 | 684,176 |
| Cash and cash equivalents at end of year | $ 496,139 | $ 1,124,783 |
| **Reconciliation of Net Income to Net Cash Provided by Operating Activities** | | |
| **Net income** | $ 710,754 | $ 598,235 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Realized (gains) losses on investments | (102,481) | 9,068 |
| Changes in assets and liabilities: | | |
| Decrease (increase) in: | | |
| Prepaid income taxes | 12,797 | |
| Other assets | (4,728) | 35,733 |
| Increase (decrease) in: | | |
| Estimated liability for future claims | (5,000) | 20,000 |
| Accounts payable | 4,970 | |
| Income taxes payable | 18,618 | |
| Total adjustments | (75,824) | 64,801 |
| **Net cash provided by operating activities** | $ 634,930 | $ 663,036 |

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., (Company) a wholly owned subsidiary of Kentucky Association of Counties Leasing Trust (COLT), provides employee dishonesty fidelity bond and business 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 and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**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.

**Investments:**

The Company records all investments at fair value. See Note 3 for discussion of fair value measurements.

The Company has 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. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the balance sheet.

**Revenue and recognition:**

Premium revenue is recognized over the period to which the insurance coverage relates.

**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.

**Subsequent events:**

Subsequent events have been evaluated through October 13, 2017 which is the date the financial statements were available to be issued.

## Note 2. Investments

Investments consists of marketable securities recorded at fair value and classified as "available-for-sale". The cost and fair value at June 30, 2017 and 2016 were as follows:

| | 2017 | | | |
|---|---|---|---|---|
| | Cost | Gross Unrealized Losses | Gross Unrealized Gains | Fair Value |
| U.S. Governmental securities | $3,178,779 | $(19,890) | $ 12,518 | $3,171,407 |
| Corporate bonds | 1,989,716 | (14,910) | 9,990 | 1,984,796 |
| Common stocks | 1,672,331 | (28,388) | 273,221 | 1,917,164 |
| Total investments | $6,840,826 | $(63,188) | $295,729 | $7,073,367 |

| | 2016 | | | |
|---|---|---|---|---|
| | Cost | Gross Unrealized Losses | Gross Unrealized Gains | Fair Value |
| U.S. Governmental securities | $2,334,784 | | $ 51,903 | $2,386,687 |
| Corporate bonds | 1,742,471 | $ (9,398) | 40,300 | 1,773,373 |
| Common stocks | 1,396,980 | (40,148) | 185,981 | 1,542,813 |
| Total investments | $5,474,235 | $(49,546) | $278,184 | $5,702,873 |

The aggregate annual maturities of the fair value of investments at June 30, 2017, based upon stated maturity dates are as follows:

| | |
|---|---|
| Due within one year | $ 836,589 |
| Due after one year through five years | 1,698,356 |
| Due after five years through ten years | 1,051,645 |
| Due after ten years | 1,569,613 |
| Common stocks | 1,917,164 |
| | $7,073,367 |

Realized gains or losses are computed based on specific identification of the cost of the securities sold. Proceeds from sales of securities were $2,425,080 and $2,583,169 for the years ended June 30, 2017 and 2016, respectively.

Investments with declines in fair value are evaluated for other-than-temporary impairment. The evaluation includes (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Other-than-temporary impairment of investments is reported in revenues. For the years ended June 30, 2017 and 2016, the Company did not record any other-than-temporary impairments.

The following table summarizes securities with unrealized losses at June 30, 2017 and 2016, aggregated by major security type and length of time in a continuous unrealized loss position:

| | 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value |
| U.S. Governmental securities | $(19,890) | $2,198,736 | | | $(19,890) | $2,198,736 |
| Corporate bonds | (3,873) | 279,332 | $(11,037) | $225,667 | (14,910) | 504,999 |
| Common stocks | (15,441) | 240,514 | (12,947) | 164,215 | (28,388) | 404,729 |
| Total investments | $(39,204) | $2,718,582 | $(23,984) | $389,882 | $(63,188) | $3,108,464 |

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

**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.

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, 2017 and 2016.

Common stocks – valued at the closing price reported on the active market on which the individual securities are traded.

Corporate bonds and U.S. Governmental securities – valued using pricing models maximizing the use of observable inputs for similar securities.

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 Company's assets at fair value as of June 30, 2017 and 2016:

| | 2017 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Total |
| U.S. Governmental securities | | $3,171,407 | $3,171,407 |
| Corporate bonds | | 1,984,796 | 1,984,796 |
| Common stocks: | | | |
| Technology | $ 394,827 | | 394,827 |
| Financial | 168,534 | | 168,534 |
| Basic materials | 207,720 | | 207,720 |
| Services | 282,633 | | 282,633 |
| Industrial goods | 287,790 | | 287,790 |
| Healthcare | 210,401 | | 210,401 |
| Consumer goods | 365,259 | | 365,259 |
| Total assets at fair value | $1,917,164 | $5,156,203 | $7,073,367 |

| | 2016 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Total |
| U.S. Governmental 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 | 328,846 | | 328,846 |
| Total assets at fair value | $1,542,813 | $4,160,060 | $5,702,873 |

## Note 4. Estimated Liability for Future Claims

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, 2017 and 2016.

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, 2017 and 2016, the actuary provided a possible range of discounted estimated liabilities. The discounted liability selected by management was discounted at 2.0% and 1.5%, 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:

| | Low | High | Selected |
|---|---|---|---|
| June 30, 2017 | $370,000 | $680,000 | $590,000 |
| June 30, 2016 | $330,000 | $700,000 | $595,000 |

The Company 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, 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| Unpaid claims and claim adjustment expenses at beginning of year | $595,000 | $575,000 |
| 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 | (5,000) | 35,304 |
| Payments: | | |
| Claims and claims adjustment expenses paid attributable to insured events of current and prior years net of recoveries collected | | (15,304) |
| Unpaid claims and claim adjustment expenses at end of year | $590,000 | $595,000 |

## Note 5. Related Party Transactions

For the years ended June 30, 2017 and 2016, 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 Kentucky Association of Counties (KACo) in which the Company reimburses KACo for certain administrative expenses. Total fees for the years ended June 30, 2017 and 2016 under this agreement were $90,165 and $77,509, respectively. As of June 30, 2017 and 2016, the Company had prepaid administrative fees of $22,287 and $21,393, 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, 2017 and 2016 include a base fee of $220,800 and $220,255, respectively, plus 3% of earned premiums collected. Total management fees for the years ended June 30, 2017 and 2016 were $249,300 and $248,755, respectively.

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, 2017 and 2016.

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, 2017 and 2016 was $1,000.

## 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, 2017 and 2016 were $59,630 and $37,024, respectively.

As of June 30, 2017 and 2016, 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.

Deferred tax assets and liabilities are recognized for future tax consequences resulting from differences between the financial statement amounts and income tax bases. Deferred tax assets and liabilities are computed using enacted tax rates applicable to periods in which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced, if applicable, by a valuation allowance when it is more likely than not that some portion of the deferred tax assets will not be realized. The Company's deferred tax liability of $74,000 and $72,000 as of June 30, 2017 and 2016, respectively, results from unrealized gains on investments and is included in other comprehensive income.

## 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, 2017, the Company's uninsured cash balance was approximately $158,000.