# Kentucky League of Cities Workers' Compensation Trust

## Financial Statements

## Years Ended June 30, 2011 and 2010

**Kentucky League of Cities Workers' Compensation Trust**

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June 30, 2011 and 2010

Mountjoy
Chilton
Medley

**Independent Auditor's Report on Financial Statements**

To the Board of Trustees
**Kentucky League of Cities Workers' Compensation Trust**

We have audited the accompanying statements of net assets of Kentucky League of Cities Workers' Compensation Trust (the "Trust") as of June 30, 2011 and 2010 and the related statements of revenues, expenses and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. 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 of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Trust's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky League of Cities Workers' Compensation Trust as of June 30, 2011 and 2010 and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis on pages 2 - 4 and the claims development information included on page 17 are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. These sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
October 26, 2011

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**Kentucky League of Cities Workers' Compensation Trust**

**Management Discussion and Analysis (*Unaudited*)**

Our discussion and analysis of the Kentucky League of Cities Workers' Compensation Trust (the Trust) provides an overview of the Trust's financial activity for the fiscal year ended June 30, 2011. It should be read in conjunction with the financial statements, which begin on page 5.

## Using This Annual Report

This report consists of a series of financial statements, notes to the financial statements, and supplemental information.

## Statements of Net Assets

Table 1 shows all the assets and liabilities of the Trust and is presented on the accrual basis. Total net assets increased $4,036,313 for the current fiscal year as compared to a $6,386,175 increase during the prior fiscal year. Most of the favorable result was due to a change in the investment markets, where net investment income continued on a positive trend for most of 2011, as the market continued to regain value previously lost. Of the current year's investment income, most of the return comes from unrealized gains (or market appreciation) on the investment holdings held by the trust. Additional factors that contributed to the current year's overall success were continued downward trends in loss costs for Workers' Compensation in the state of Kentucky and continued efficient claims handling to settle older claims for less than reserved amounts.

Table 1
Net Assets

| | June 30, 2011 | June 30, 2010 |
|---|---|---|
| Cash and investments | $ 50,242,308 | $ 47,411,627 |
| Capital and other assets | 10,204,233 | 10,882,603 |
| Total assets | 60,446,541 | 58,294,230 |
| Unpaid losses and loss adjustment expenses | 31,420,388 | 31,653,696 |
| Other liabilities | 4,243,233 | 5,893,927 |
| Total liabilities | 35,663,621 | 37,547,623 |
| Total net assets | $ 24,782,920 | $ 20,746,607 |

## Statements of Revenues, Expenses and Changes in Net Assets

Table 2 shows the revenue and expenses of the Trust and is also presented on the accrual basis. Net earned premium revenue has decreased $870,339 or 7.3% from the prior fiscal year. General administrative expenses decreased 7.9% as compared to the 7.3% decrease in net earned premiums. Although unrealized investment income declined compared to the previous fiscal year, overall the Trust's investments showed considerable recovery, compared to recent historical unrealized market losses. In essence, the holdings of the Trust recaptured most of their true value, which is recognizable as income during the current year to be in conformance with Governmental Accounting Standards Board (GASB) 31.

The Trust management records loss estimates to the actuarial determined best estimate.

Table 2
Net Assets

| | Year Ended June 30, 2011 | Year Ended June 30, 2010 |
|---|---|---|
| Net premiums earned | $ 11,126,186 | $ 11,996,525 |
| Investment and other revenue (expense) and gains (losses) | 4,879,475 | 5,282,172 |
| Total revenues | 16,005,661 | 17,278,697 |
| Losses and loss adjustment expenses | 7,807,521 | 6,375,758 |
| General administrative expenses | 4,161,827 | 4,516,764 |
| Total expenses | 11,969,348 | 10,892,522 |
| Total change in net assets | $ 4,036,313 | $ 6,386,175 |

## Description of Current Expected Conditions

Looking ahead, the Trust hopes to continue to benefit from its medical bill utilization review program as much as it did in the current year. For 2011, the Trust saved over $200,000 in medical costs (written prescriptions) by reviewing the medical bills to ensure the use of generic brand prescription drugs, whenever possible. Of the total prescriptions written for the year, 76% were generic, as opposed to the formulary brand equivalent. Additionally, the Trust hopes that favorable loss trends will continue to prevail on prior policy years. The Trust has benefitted from three consecutive years of reserve takedowns on older policy years, meaning that on average, claims have been settling for less than initially estimated.

## Contacting the Trust's Financial Management

This financial report is designed to provide a general overview of Kentucky League of Cities Workers' Compensation Trust's finances and to show the Trust's accountability to its members. If you have any questions about this report or need additional information, contact the Kentucky League of Cities office at 100 East Vine Street, Suite 800, Lexington, KY 40507.

**Kentucky League of Cities Workers' Compensation Trust**
**Statements of Net Assets**
**June 30, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| **Assets** | | |
| Investment securities, at fair value | $ 46,265,490 | $ 42,420,107 |
| Cash and cash equivalents | 3,976,818 | 4,991,520 |
| Accounts receivable (net of allowance for doubtful accounts of $20,000 and $18,120 for 2011 and 2010, respectively) | 341,548 | 736,547 |
| Reinsurance receivable | 1,195,073 | 1,130,666 |
| Accrued investment income | 334,533 | 339,428 |
| Membership in NLC Mutual Insurance Company | 241,255 | 241,255 |
| Equipment (net of accumulated depreciation of $1,215,522 and $1,208,358 for 2011 and 2010, respectively) | 8,954 | 16,118 |
| Surplus note receivable | 8,000,000 | 8,000,000 |
| Other assets | 82,870 | 418,589 |
| Total Assets | $ 60,446,541 | $ 58,294,230 |
| **Liabilities and Net Assets** | | |
| Unpaid Losses and Loss Adjustment Expenses: | | |
| Reported claims | $ 10,162,334 | $ 10,042,354 |
| Incurred but not reported claims | 20,398,674 | 20,760,723 |
| Unallocated loss adjustment expenses | 859,380 | 850,619 |
| Total Unpaid Losses and Loss Adjustment Expenses | 31,420,388 | 31,653,696 |
| Accounts payable | 191,710 | 451,366 |
| Payable to related entity | 3,443,077 | 3,626,055 |
| Advance premiums | 608,446 | 1,816,506 |
| Total Liabilities | 35,663,621 | 37,547,623 |
| Net Assets | 24,782,920 | 20,746,607 |
| Total Liabilities and Net Assets | $ 60,446,541 | $ 58,294,230 |

See accompanying notes.

**Kentucky League of Cities Workers' Compensation Trust**
**Statements of Revenues, Expenses and Changes in Net Assets**
**Years Ended June 30, 2011 and 2010**

| | **2011** | **2010** |
|---|---|---|
| Operating Revenue | | |
| Net premiums earned | $ 11,126,186 | $ 11,996,525 |
| Operating Expenses | | |
| Losses and loss adjustment expenses | 7,807,521 | 6,375,758 |
| Commission expense | 686,214 | 698,720 |
| Claims administration expense | 1,132,052 | 1,200,873 |
| Loss prevention expense | 183,026 | 104,015 |
| Professional fees | 95,279 | 242,824 |
| KLC administrative fees | 1,807,264 | 1,924,289 |
| Other expenses | 257,992 | 346,043 |
| Total Operating Expenses | 11,969,348 | 10,892,522 |
| Operating (Loss) Income | (843,162) | 1,104,003 |
| Nonoperating Income | | |
| Interest and investment revenue and gains | 4,879,475 | 5,282,172 |
| Change in Net Assets | 4,036,313 | 6,386,175 |
| Net Assets at Beginning of Year | 20,746,607 | 14,360,432 |
| Net Assets at End of Year | $ 24,782,920 | $ 20,746,607 |

See accompanying notes.

**Kentucky League of Cities Workers' Compensation Trust**
**Statements of Cash Flows**
**Years Ended June 30, 2011 and 2010**

| | **2011** | **2010** |
|---|---|---|
| Cash Flows From Operating Activities | | |
| Premiums collected | $ 10,313,125 | $ 6,976,414 |
| Losses and loss adjustment expenses paid | (8,040,829) | (7,751,619) |
| Underwriting expenses paid | (3,942,167) | (467,830) |
| Miscellaneous payments | (383,818) | (539,477) |
| Net Cash Used by Operating Activities | (2,053,689) | (1,782,512) |
| Cash Flows From Investing Activities | | |
| Purchases of investments | (43,952,462) | (85,915,983) |
| Proceeds from the sale of investments | 42,929,040 | 88,396,768 |
| Issuance of surplus note | - | (8,000,000) |
| Interest and dividends received | 2,062,409 | 1,910,424 |
| Net Cash Provided/(Used) by Investing Activities | 1,038,987 | (3,608,791) |
| Net Decrease in Cash and Cash Equivalents | (1,014,702) | (5,391,303) |
| Cash and Cash Equivalents at Beginning of Year | 4,991,520 | 10,382,823 |
| Cash and Cash Equivalents at End of Year | $ 3,976,818 | $ 4,991,520 |

See accompanying notes.

**Kentucky League of Cities Workers' Compensation Trust**
**Statements of Cash Flows (Continued)**
**Years Ended June 30, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| Reconciliation of operating (loss) income to net cash used in operating activities: | | |
| Operating (loss) income | $ (843,162) | $ 1,104,003 |
| Adjustments to reconcile operating income to net cash used in operating activities: | | |
| Depreciation | 7,164 | 7,164 |
| Provision for doubtful accounts | 1,880 | (1,880) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 393,119 | (89,900) |
| Reinsurance receivable | (64,407) | (194,109) |
| Receivable from related entity | - | 670,696 |
| Other assets | 335,719 | (314,059) |
| Unpaid losses and loss adjustment expenses | (233,308) | (1,375,861) |
| Accounts payable | (259,656) | (286,291) |
| Payable to related entity | (182,978) | 3,626,055 |
| Advance premiums | (1,208,060) | (4,928,330) |
| Net Cash Used in Operating Activities | $ (2,053,689) | $ (1,782,512) |

See accompanying notes.

**Note A – Nature of Organization and Operations**

Effective July 1, 1978, the Kentucky Association of Counties (KACo) and the Kentucky League of Cities, Inc. (KLC) (formerly Kentucky League of Cities) formed the KACo-KLC Self-Insurance Fund (KACo-KLC Fund). The KACo-KLC Fund was formed as a joint city/county group workers' compensation self-insurance fund.

Effective June 30, 1993, the KACo-KLC Fund ceased writing new business. On July 1, 1993, both KACo and KLC formed new, separate group workers' compensation self-insurance funds for their respective members. Kentucky League of Cities Workers' Compensation Trust (the Trust) was established under the authorization of the Kentucky Interlocal Cooperation Act of the Kentucky Revised Statutes. It is an unincorporated, nonprofit trust voluntarily established by the participating cities, urban-county governments and related public agencies and political subdivisions within the Commonwealth of Kentucky.

The Trust has received a Certificate of Filing from the Department of Insurance of the Commonwealth of Kentucky but is exempt from most statutory requirements that commercial insurers must follow. The Trust's general objectives are to formulate, develop and administer, on behalf of the member political subdivisions, a workers' compensation insurance program and to obtain lower costs for that coverage. All coverages are written on an occurrence basis. Participation in the Trust included 404 and 415 members as of June 30, 2011 and 2010, respectively.

On July 1, 1995 the assets, liabilities, and responsibility for effective claims administration stemming from existing open claims obligations of the KACo-KLC Fund were divided proportionally between the KACo Fund and the Trust. The Trust's portion of the KACo-KLC Fund is known as the Prior Workers' Compensation Fund, which is now a component of the Trust.

Following is a description of the most significant risks facing workers' compensation insurers and how the Trust mitigates those risks:

*Legal/Regulatory Risk:*

Legal/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 Trust 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.

*Credit Risk*:

Credit risk is the risk that issuers of securities owned by an insurer will default or that other parties, including reinsurers that owe the insurer money will not pay. The Trust minimizes this risk by adhering to a conservative investment strategy, by utilizing financially sound reinsurers, by maintaining credit and collection policies, and by providing an allowance for any amounts deemed uncollectible.

*Interest Rate Risk:*

Interest rate risk is the risk that interest rates will change and cause a decrease in the value of an insurer's investments. The Trust mitigates this risk by attempting to match the maturity schedule of its assets with the expected payouts of its liabilities. To the extent that such liabilities come due more quickly than assets mature, an insurer would have to sell assets prior to maturity and recognize a gain or loss. The Trust uses the segmented time distribution method to measure interest rate risk.

**Note B – Summary of Significant Accounting Policies**

1. Basis of Accounting: The Trust uses the accrual basis of accounting. Under this method, revenues are recognized in the accounting period in which they are earned and expenses are recognized in the period incurred.

   The Trust presents its financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to government units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. As a proprietary activity, the Trust has adopted GASB Statement No. 20, *Accounting and Financial Reporting for Propriety Funds and other Governmental Entities that Use Proprietary Fund Accounting*. Therefore, the Trust follows GASB pronouncements, Financial Accounting Standards Board (FASB) and predecessor boards' pronouncements issued on or before November 30, 1989, except those that conflict with or contradict GASB pronouncements.

2. Accounting 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 amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

   Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of unpaid losses and loss adjustment expenses, management uses the methodology described later in this note in *Unpaid Losses and Loss Adjustment Expenses*.

   Management believes that the liability for unpaid losses and loss adjustment expenses is adequate. While management uses available information to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expenses when they occur.

3. Investment Securities: Investment securities consist of fixed maturity debt and equity securities that the Trust intends to use as a part of its asset/liability management policy and securities that may be sold in response to unexpected liquidity needs.

   Investment securities are stated at fair value based, generally, on quoted market prices. Changes in the fair value of investment securities are reported as revenue. The specific identification method is used to determine the cost of securities sold. Realized and unrealized gains and losses are included in non-operating revenue.

   The investment in the NLC Mutual Insurance Company is carried at cost as required by the Kentucky Department of Insurance.

4. Cash and Cash Equivalents: Cash and cash equivalents consist principally of money market fund investments. For purposes of the statement of cash flows, the Trust considers all short-term investments with original maturities of three months or less to be cash equivalents.

5. Accounts Receivable: In accordance with accounting practices generally accepted in the insurance industry, the Trust records audit premiums as of the fiscal year-end in which they were earned. The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible uncollectible accounts based on prior experience. Amounts are charged against the allowance when management determines that collectability is doubtful.

**Note B – Summary of Significant Accounting Policies (Continued)**

6. Equipment: Equipment consists of computer equipment and related software. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets.

7. Premium Revenue: Premiums for contracts are recognized as earned on a pro rata basis over the contract period. Advance premiums relate to premiums paid by members for insurance coverage for the subsequent insurance period. Policy coverage is matched with revenue so as to result in recognition of profits over the life of the policies through establishment of reserves for incurred claims. All policy years coincide with the Trust's fiscal year.

8. Unpaid Losses and Loss Adjustment Expenses: The provision for losses and loss adjustment expenses includes paid and unpaid claims and expenses associated with settling claims, including legal fees. The liability for unpaid losses and loss adjustment expenses is based on claims adjusters' evaluations of individual claims and management's evaluation and an actuarial review of experience with respect to the probable number and nature of claims arising from losses that have been incurred but have not yet been reported.

   The liability represents the estimated ultimate cost of settling the claims, including the effects of inflation and other societal and economic factors. Any adjustments resulting from the settlement of losses will be reflected in earnings at the time the adjustments are determined. To reflect its present value, the liability for unpaid losses and loss adjustment expenses has been discounted at 3% for both 2011 and 2010. Discounting reduced the liability by $5,724,438 and $5,677,163 as of June 30, 2011 and 2010, respectively. The effect of discounting on the provision for losses and loss adjustment expenses was a (decrease)/increase of ($47,275) and $4,871 in 2011 and 2010, respectively.

9. Net Assets: The Board of Trustees may, at its discretion, refund to members the savings, if any, resulting from operations of the Trust in the form of dividends or reduced premiums. The amount of any future dividends or reductions in premiums is dependent on the Trust's ultimate liability for claims incurred and, accordingly, the amount may differ from the net assets.

   In the event of adverse loss experience, the Trust can assess additional amounts to the members. An assessment would be computed and established by the Board of Trustees with each member's share being in proportion to their annual premiums, relative to premiums of all members. Capital contributions are refundable only at the discretion of the Board of Trustees. There have been no assessments levied since the inception of the KLCWCT. No refunds were issued during 2011 or 2010.

10. Federal Income Taxes: The Internal Revenue Service has ruled that the income of the Trust is excludable from gross income and, therefore, exempt from taxation pursuant to the Internal Revenue Code Section 115, which pertains to instrumentalities of state and local governments.

**Note C – Deposits and Investments**

The composition of the Trust's investment portfolio must meet certain criteria as set forth in the Kentucky Administrative Regulations. Investments held by the Trust as of June 30, 2011 and 2010 are as follows:

| | 2011 | 2010 |
|---|---|---|
| Cash and cash equivalents | $ 1,771,885 | $ 4,142,762 |
| Money market mutual funds and uninvested cash | 2,204,933 | 848,758 |
| Deposits and investments classified as cash and cash equivalents | 3,976,818 | 4,991,520 |
| Corporate bonds | 1,011,475 | 920,719 |
| Municipal securities | 29,908,004 | 27,286,981 |
| U.S. government agency obligations | 2,685,957 | 2,953,366 |
| Equity securities | - | 1,047,848 |
| Equity mutual funds | 10,232,521 | 7,480,191 |
| Bond mutual funds | 2,427,533 | 2,731,002 |
| Investments classified as investment securities | 46,265,490 | 42,420,107 |
| Total deposits and investments | $ 50,242,308 | $ 47,411,627 |

As of June 30, 2011, the Trust had the following investment maturities:

| | Investment Maturities (In Years) | | | |
|---|---|---|---|---|
| | Less than 1 | 1-5 | 6-10 | More than 10 |
| Corporate bonds | $ - | $ 188,640 | $ 822,835 | $ - |
| Municipal securities | 2,163,185 | 11,135,467 | 4,716,323 | 11,893,029 |
| U.S. government agency obligations | - | 1,223,430 | 586,644 | 875,883 |
| Total maturities | $ 2,163,185 | $ 12,547,537 | $ 6,125,802 | $ 12,768,912 |

**Note C – Deposits and Investments (Continued)**

Investment and interest revenue and gains for assets limited to use, cash equivalents, and other investments are comprised of the following for the years ended June 30, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Interest and dividend income | $ 2,057,514 | $ 1,923,761 |
| Realized gain on sales of securities | 749,417 | 912,813 |
| Unrealized gain on securities | 2,072,544 | 2,445,598 |
| | $ 4,879,475 | $ 5,282,172 |

Credit Risk

State law and the Trust investment guidelines assert that corporate bonds are allowable if issued, assumed, or guaranteed by a solvent institution created and existing under the laws of the United States of America. They also state that corporate bond investments shall not exceed 15% of the total market value of the portfolio at the time of purchase and that the bond has a minimum rating of A.

State law and the Trust investment guidelines assert that no individual equity holding shall comprise greater than 10% of the equity portion of the portfolio at the time of purchase. Both also state that an investment in an individual holding shall not represent at the time of purchase more than 5% of the market value of the holding. Furthermore, both state that investments in equities shall not exceed 20% of the total market value of the portfolio of the self-insurance group at the time of purchase. In addition, mutual funds that are registered investment advisors licensed by the Securities Exchange Commission and Commonwealth of Kentucky to perform investment services are allowable and shall not exceed 20% of the total market value of the portfolio at the time of purchase.

With respect to cash and statute defined bonds, both sets of guidelines state that, of the total investments held, no less than 75% of the total market value shall be held in cash, cash equivalents, and fixed income. Also, not less than 15% of the total investments shall be held in cash, cash equivalents or U.S. Treasuries and federal agency securities with a 1 year or less maturity. The Trust may also invest surplus funds or reserves not needed for current obligations in the following: U.S. government bonds, Treasury notes and T-bills or other direct obligations guaranteed by the full faith and credit of the United States of America, tax exempt obligations issued by Kentucky or its agencies with a minimum Standard and Poor's (S&P) rating of A.

Furthermore, the Trust may also invest in obligations issued by a country, district, municipality or other legal authority within Kentucky with a minimum S&P rating of AA. Investments may also be made in investment share accounts in a savings and loan institution in Kentucky who is insured by the Federal Deposit Insurance Corporation. Finally, the Trust may also invest in certificates of deposit if issued by a duly chartered commercial bank in Kentucky.

As of June 30, 2011, the Trust was invested in the following government agency bonds: Federal Home Loan Bank, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association and Government National Mortgage Association. All of these bonds had AAA ratings. The Trust also invested in money market funds with a rating of AAA. Additional investments include U.S. Treasury notes and bonds and corporate bonds which ranged in ratings from A to AAA.

## Note C – Deposits and Investments (Continued)

Custodial Credit Risk - Deposits

The Trust maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Trust has not experienced any losses in such accounts. Management believes it is not exposed to any significant credit risk related to cash. Cash equivalents include investments in a money market fund that are not federally insured.

## Note D – Reinsurance Coverage

Beginning in 2008, the Trust purchased reinsurance coverage from ACE USA, an "A" rated insurer by A.M. Best and Company, for claims paid in excess of $750,000 but less than $2,000,000. As part of this agreement, the Trust also purchased a $250,000 corridor of aggregate reinsurance on claims in excess of $750,000. Under this contract, the aggregate corridor threshold must be met before any specific reinsurance would take effect. For claims in excess of $2,000,000, the Trust purchased reinsurance coverage from ACE USA. For 2010, employer's liability loss limitations are $4,000,000 (retention of $750,000 plus $3,250,000 of reinsurance).

Although the purchase of reinsurance coverage does not discharge the Trust from its primary liability to its members, the reinsurance company that assumes the coverage assumes the related liability, and it is the practice of organizations such as the Trust for accounting purposes to treat insured risks, to the extent of reinsurance coverage, as though they were risks for which the Trust is not liable. However, the Trust remains contingently liable in the event its reinsurers are unable to meet their contractual obligations.

For the current year ended June 30, 2011, the Trust purchased specific reinsurance coverage from ACE, an"A+" (Superior) rated insurer by A.M. Best and Company, for the excess layer of insurance only to cover losses in excess of $1,000,000. In effect, this eliminated any buffer layer of reinsurance that the Trust must now self-insure up to the $1,000,000 per occurrence limit. For 2011, employer's liability loss limitations are $4,000,000 (retention of $1,000,000 plus $3,000,000 of reinsurance).

Reinsurance premiums ceded were $847,592 and $1,368,978 for the years ended June 30, 2011 and 2010, respectively. Additional recoveries accrued on paid claims during 2011 and 2010 were $633,170 and $1,208,564, respectively. The liability for unpaid losses and loss adjustment expenses has been reduced to reflect reinsurance recoverables on policy case reserves and estimated recoverables on claims incurred but not reported by $3,480,258 and $3,216,312 in 2011 and 2010, respectively.

## Note E – Related Party Transactions

The Trust was organized by KLC at the request of the state municipalities. KLC provides substantially all of the Trust's operational, management and administrative services in exchange for an administrative fee based on allocated costs plus a percentage of earned premiums. Total administrative fees under the agreement amounted to $1,807,264 and $1,924,289 for the years ended June 30, 2011 and 2010, respectively.

**Note E – Related Party Transactions (Continued)**

The Trust participates in a marketing agreement with Kentucky League of Cities Insurance Services, Inc. (the Agency) which provides that the Trust pay a commission for member accounts marketed or serviced by the Agency. Commission expense under the agreement was $311,284 and $256,144 for the years ended June 30, 2011 and 2010, respectively.

The Trust's directors' and officers' insurance provides coverage for KLC board members. Also, certain trustees of the Trust are directors for KLC.

**Note F – Letter of Credit**

To satisfy requirements of the Department of Workers' Claims of the Commonwealth of Kentucky, the Trust maintains a letter of credit with a bank with permitted borrowings of $3.3 million as of June 30, 2011, renewable annually. As of June 30, 2011 and 2010 no amounts were outstanding under the letter of credit.

**Note G – Liability for Unpaid Losses and Loss Adjustment Expenses**

Activity in the liability for unpaid losses and loss adjustment expenses for the years ended June 30, 2011 and 2010 is summarized as follows:

| | 2011 | 2010 |
|---|---|---|
| Net unpaid losses and loss adjustment expenses, beginning of year | $ 31,653,696 | $ 33,029,557 |
| Incurred losses and loss adjustment expenses: | | |
| Provision for insured events of the current year | 9,280,000 | 9,300,000 |
| Decrease in provision for insured events of prior years | (1,472,479) | (2,924,242) |
| Total incurred losses and loss adjustment expenses | 7,807,521 | 6,375,758 |
| Paid losses and loss adjustment expenses: | | |
| Attributable to insured events of the current year | 2,412,348 | 2,173,724 |
| Attributable to insured events of prior years | 5,628,481 | 5,577,895 |
| Total payments | 8,040,829 | 7,751,619 |
| Net unpaid losses and loss adjustment expenses, end of year | $ 31,420,388 | $ 31,653,696 |

A decrease in the provision for insured events of prior years signifies that the Trust expects lower than anticipated ultimate losses in the final disposition of claims.

**Note H – Surplus Note Receivable**

In 2010, the Kentucky Department of Insurance (DOI) approved the opportunity for the Trust to administer the KSBIT program, provided that the Trust issue an $8 million dollar surplus note receivable in exchange for an investment in KSBIT. Interest is due quarterly until the note is paid in full. Interest is calculated at a rate per annum which shall be equal to the sum of the year to date yield on the S&P Index weighted at twenty percent plus the year to date yield on the Bar Cap Index weighted at eighty percent. Provided, however, in no event shall the annual interest rate be less than one percent or greater than five percent. This note has no fixed maturity date. As KSBIT gains increased financial stability the entire $8 million dollars will be recovered either through repayment or alternate plan as deemed appropriate by the DOI.

**Supplementary Information**

# KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST
## Claims Development Information (*Unaudited*)
## Years ended June 30, 2002 through 2011

The following table illustrates how the Trust's contributions and investment income compare to related costs of claims incurred and other expenses of the Trust for each of the last ten years. The lines of the table are defined as follows: (1) Shows the total of each year's contributions earned and investment income. (2) Shows each year's expenses other than claims. (3) Shows incurred claims (both paid and accrued), as originally reported at the end of the first policy year. (4) shows the cumulative amounts paid, net of reinsurance received, as of the end of successive years for each policy year. (5) Shows how each policy year's incurred claims, net of reinsurance, increased or decreased as of the end of successive years. This annual reestimation results from new information received on known claims, reevaluation of existing information of known claims, as well as emergence of new claims not previously known. (6) Compares the latest reestimated incurred claims amount to the amount originally established (line 3), net of reinsurance, and shows whether this latest estimate of claims incurred is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and reestimated amounts is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature policy years. The columns of the table show data for successive policy years.

| | Workers' Compensation Pool Fiscal and Policy Year Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| (1) Earned premium revenue and net investment income: | | | | | | | | | | |
| Earned | $ 8,901,655 | $ 12,838,577 | $ 14,391,623 | $ 16,880,970 | $ 16,141,308 | $ 19,578,024 | $ 17,552,153 | $ 15,325,296 | $ 18,454,798 | $ 16,853,253 |
| Ceded | 408,328 | 589,056 | 830,510 | 1,089,205 | 1,095,237 | 1,700,660 | 1,340,759 | 1,219,481 | 1,368,978 | 847,592 |
| Net earned | 8,493,327 | 12,249,521 | 13,561,113 | 15,791,765 | 15,046,071 | 17,877,364 | 16,211,394 | 14,105,815 | 17,085,820 | 16,005,661 |
| (2) Unallocated expenses | 3,474,592 | 4,070,818 | 4,014,438 | 3,886,286 | 3,155,633 | 3,641,177 | 3,744,228 | 3,685,386 | 3,435,931 | 3,062,462 |
| (3) Estimated incurred claims and expenses, end of policy year: | | | | | | | | | | |
| Incurred | 6,381,123 | 10,504,764 | 12,500,000 | 10,400,000 | 11,810,000 | 12,060,000 | 12,000,000 | 10,980,000 | 9,300,000 | 9,280,000 |
| Ceded | - | 514,764 | - | - | - | - | - | - | - | - |
| Net incurred | 6,381,123 | 9,990,000 | 12,500,000 | 10,400,000 | 11,810,000 | 12,060,000 | 12,000,000 | 10,980,000 | 9,300,000 | 9,280,000 |
| (4) Net paid (cumulative) as of: | | | | | | | | | | |
| End of policy year | 1,593,001 | 2,458,689 | 2,947,856 | 2,615,508 | 3,050,893 | 2,918,294 | 2,242,501 | 2,625,675 | 2,173,724 | 2,412,348 |
| One year later | 3,124,428 | 4,860,134 | 5,934,955 | 5,241,080 | 5,615,096 | 5,710,452 | 3,713,329 | 4,582,157 | 4,267,533 | |
| Two years later | 4,317,615 | 6,579,844 | 7,536,842 | 6,681,882 | 7,138,085 | 7,439,053 | 4,700,280 | 5,962,097 | | |
| Three years later | 5,343,867 | 7,164,648 | 8,694,677 | 7,469,538 | 7,638,292 | 8,400,115 | 5,134,088 | | | |
| Four years later | 5,882,374 | 8,577,852 | 9,584,453 | 7,774,517 | 8,087,935 | 8,995,800 | | | | |
| Five years later | 6,491,166 | 9,121,981 | 10,407,571 | 7,970,650 | 8,386,011 | | | | | |
| Six years later | 6,774,963 | 9,308,808 | 10,698,540 | 8,080,195 | | | | | | |
| Seven years later | 7,194,768 | 9,484,302 | 11,031,694 | | | | | | | |
| Eight years later | 7,332,847 | 9,633,390 | | | | | | | | |
| Nine years later | 7,393,965 | | | | | | | | | |
| (5) Reestimated ceded claims and expenses | 25,704 | - | 518,242 | - | - | - | - | - | - | - |
| (6) Reestimated net incurred claims and expenses: | | | | | | | | | | |
| End of policy year | 6,381,123 | 9,990,000 | 12,500,000 | 10,400,000 | 11,810,000 | 12,060,000 | 12,000,000 | 10,980,000 | 9,300,000 | 9,280,000 |
| One year later | 6,310,000 | 10,540,000 | 12,370,000 | 10,300,000 | 11,536,000 | 12,866,000 | 10,250,000 | 10,580,000 | 9,000,000 | |
| Two years later | 7,990,000 | 12,160,000 | 12,250,000 | 10,441,000 | 11,306,000 | 12,099,000 | 9,370,000 | 10,300,000 | | |
| Three years later | 8,673,000 | 11,611,000 | 12,796,000 | 10,025,000 | 10,812,000 | 12,055,000 | 8,240,000 | | | |
| Four years later | 8,908,453 | 11,894,807 | 13,043,000 | 9,661,000 | 10,796,000 | 11,772,000 | | | | |
| Five years later | 8,781,276 | 11,472,774 | 13,429,000 | 9,396,000 | 10,512,000 | | | | | |
| Six years later | 8,469,668 | 11,436,097 | 13,273,000 | 9,682,000 | | | | | | |
| Seven years later | 8,178,248 | 11,195,357 | 13,015,000 | | | | | | | |
| Eight years later | 8,301,572 | 11,393,751 | | | | | | | | |
| Nine years later | 8,220,180 | | | | | | | | | |
| (7) Increase (decrease) in estimated net incurred claims and expenses from the end of policy year | 1,839,057 | 1,403,751 | 515,000 | (718,000) | (1,298,000) | (288,000) | (3,760,000) | (680,000) | (300,000) | - |

See accompanying independent auditor's report