

Kentucky League of Cities Insurance Services Association
Financial Statements and Supplemental Information
Years Ended June 30, 2011 and 2010

Kentucky League of Cities Insurance Services Association

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June 30, 2011 and 2010

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Independent Auditor's Report on Financial Statements

To the Board of Trustees of
Kentucky League of Cities Insurance Services Association

We have audited the accompanying statements of net assets of Kentucky League of Cities Insurance Services Association (KLCIS) 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 KLCIS' 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 KLCIS'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 Insurance Services Association 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 3 - 4 and the claims development information included on pages 18 - 19 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.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements. The supplementary information included on pages 16 - 17 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects, in relation to the basic financial statements taken as a whole.

Mountjoy Chilton Medley LLP

Lexington, Kentucky
October 26, 2011

Kentucky League of Cities Insurance Services Association

Management Discussion and Analysis (*Unaudited*)

Our discussion and analysis of the Kentucky League of Cities Insurance Services Association (KLCIS) provides an overview of KLCIS'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 KLCIS and is presented on the accrual basis. Total net assets increased \$908,753 for the current fiscal year, compared to the increase of \$1,159,750 during the prior fiscal year. The current year's increase was largely attributable to market value appreciation on investments held to maturity and continued efficiency in claims management, which is also consistent with the prior year's success and gain to surplus.

Table 1
Net Assets

	<u>June 30, 2011</u>	<u>June 30, 2010</u>
Cash and investments	\$ 31,936,445	\$ 28,994,211
Capital and other assets	<u>7,196,889</u>	<u>9,167,257</u>
Total assets	39,133,334	38,161,468
Unpaid losses and loss adjustment expenses	27,399,505	25,234,824
Other liabilities	<u>2,395,019</u>	<u>4,496,587</u>
Total liabilities	<u>29,794,524</u>	<u>29,731,411</u>
Total net assets	<u>\$ 9,338,810</u>	<u>\$ 8,430,057</u>

Kentucky League of Cities Insurance Services Association
Management Discussion and Analysis (Unaudited), continued

Statements of Revenues, Expenses and Changes in Net Assets

Table 2 shows the revenue and expenses of KLCIS and is also presented on the accrual basis. Net earned premium revenue has decreased \$370,418 or 1.9% from the prior fiscal year. General administrative expenses decreased by 8.9% compared to fiscal year 2010, mostly due to lower commission expense and no longer offering a discount on early payments for premium renewals. We were very successful in resolving numerous open claims on older policy years resulting in net overall reserve takedowns of approximately \$500,000 for liability, property and workers' compensation Trusts combined.

Table 2
Changes in Net Assets

	Year Ended	
	June 30, 2011	June 30, 2010
Net premiums earned	\$ 19,362,005	\$ 19,732,423
Investment and other revenue (expense) and gains (losses)	2,130,467	1,724,814
Total revenues	21,492,472	21,457,237
Losses and loss adjustment expenses	12,420,300	11,332,450
General administrative expenses	8,163,419	8,965,037
Total expenses	20,583,719	20,297,487
Total change in net assets	\$ 908,753	\$ 1,159,750

Description of Current Expected Conditions

Looking ahead, KLCIS hopes to benefit from an increase in market stability, where its investments have an opportunity to yield steadier, more long-lasting returns. For the upcoming 2012 fiscal year, KLCIS retained the services of Towers Watson, a reinsurance brokerage and consulting firm, to assist with outsourcing its reinsurance placement into a more globalized market (the Trust formerly utilized an employee to broker this internally). The end result was a partnership with two new "A" rated excess insurers at substantial estimated cost savings to the Trust. The estimated cost savings from placing the excess insurance should amount to approximately \$1,150,000, when Liability and Property savings are combined.

Contacting the Organization's Financial Management

This financial report is designed to provide a general overview of 2011's finances and to show the KLCIS' 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 Insurance Services Association
Statements of Net Assets
June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Assets		
Investment securities, at fair value	\$ 30,157,567	\$ 26,949,632
Cash and cash equivalents	1,778,878	2,044,579
Accounts receivable (net of allowance for doubtful accounts of \$30,000 and \$29,964 in 2011 and 2010, respectively)	203,465	261,104
Reinsurance receivable	847,012	1,061,996
Receivable from related entity	4,873,747	6,220,576
Accrued investment income	179,945	244,308
Membership in NLC Mutual Insurance Company	620,037	620,037
Property and equipment (net of accumulated depreciation of \$1,059,543 and \$1,024,214 for 2011 and 2010, respectively)	88,710	124,039
Prepaid expenses	<u>383,973</u>	<u>635,197</u>
Total Assets	<u>\$ 39,133,334</u>	<u>\$ 38,161,468</u>
Liabilities and Net Assets		
Unpaid losses and loss adjustment expenses:		
Reported claims	\$ 12,752,192	\$ 10,521,796
Incurred but not reported claims	13,717,661	13,838,625
Unallocated loss adjustment expenses	<u>929,652</u>	<u>874,403</u>
Total unpaid losses and loss adjustment expenses	27,399,505	25,234,824
Accounts payable	147,817	348,847
Advance premiums	<u>2,247,202</u>	<u>4,147,740</u>
Total Liabilities	29,794,524	29,731,411
Net Assets	<u>9,338,810</u>	<u>8,430,057</u>
Total Liabilities and Net Assets	<u>\$ 39,133,334</u>	<u>\$ 38,161,468</u>

See accompanying notes.

Kentucky League of Cities Insurance Services Association
Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Operating Revenue		
Net premiums earned	\$ 19,362,005	\$ 19,732,423
Operating Expenses		
Losses and loss adjustment expenses	12,420,300	11,332,450
Commission expense	2,633,801	2,918,788
Claims administration expense	1,007,014	1,064,104
Loss prevention expenses	251,072	164,659
Professional fees	383,958	458,388
KLC administrative fees	3,564,877	3,795,712
Other expenses	<u>322,697</u>	<u>563,386</u>
Total Operating Expenses	<u>20,583,719</u>	<u>20,297,487</u>
Operating Loss	(1,221,714)	(565,064)
Nonoperating Revenue		
Interest and investment revenue and gains	2,103,981	1,713,833
Other income	<u>26,486</u>	<u>10,981</u>
Total Nonoperating Revenue	<u>2,130,467</u>	<u>1,724,814</u>
Change in Net Assets	908,753	1,159,750
Net Assets at Beginning of Year	<u>8,430,057</u>	<u>7,270,307</u>
Net Assets at End of Year	<u>\$ 9,338,810</u>	<u>\$ 8,430,057</u>

See accompanying notes.

Kentucky League of Cities Insurance Services Association
Statements of Cash Flows
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash Flows From Operating Activities		
Premiums collected	\$ 17,519,106	\$ 11,122,700
Losses and loss adjustment expenses paid	(10,255,619)	(11,649,650)
Underwriting expenses paid	(5,880,635)	(9,736,950)
Other payments	<u>(635,448)</u>	<u>(389,278)</u>
Net Cash Provided/(Used) by Operating Activities	747,404	(10,653,178)
Cash Flows From Investing Activities		
Purchases of investments	(40,024,346)	(41,033,916)
Proceeds from maturity of investments	3,009,158	6,273,217
Proceeds from sale of investments	35,149,461	37,707,131
Interest and dividends received	<u>826,136</u>	<u>1,243,063</u>
Net Cash (Used)/Provided by Investing Activities	(1,039,591)	4,189,495
Cash Flows From Capital and Related Financing Activities		
Proceeds from sale of capital assets	-	17,000
Other	<u>26,486</u>	<u>10,981</u>
Net Cash Provided by Capital and Related Financing Activities	<u>26,486</u>	<u>27,981</u>
Net Decrease in Cash and Cash Equivalents	(265,701)	(6,435,702)
Cash and Cash Equivalents at Beginning of Year	<u>2,044,579</u>	<u>8,480,281</u>
Cash and Cash Equivalents at End of Year	<u>\$ 1,778,878</u>	<u>\$ 2,044,579</u>

See accompanying notes.

Kentucky League of Cities Insurance Services Association
Statements of Cash Flows (Continued)
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Reconciliation of Operating Loss to Net Cash Provided/(Used) by		
Operating Activities:		
Operating Loss	\$ (1,221,714)	\$ (565,064)
Adjustments to reconcile operating loss to net		
cash used in operating activities:		
Depreciation	35,329	64,293
Loss on disposal of equipment	-	2,357
Provision for doubtful accounts	36	(36)
Changes in:		
Accounts receivable	57,603	43,181
Reinsurance receivable	214,984	(85,615)
Receivable from related entity	1,346,829	(1,140,348)
Prepaid expenses	251,224	(149,554)
Unpaid losses and loss adjustment expenses	2,164,681	(288,778)
Accounts payable	(201,030)	119,254
Advance premiums	<u>(1,900,538)</u>	<u>(8,652,868)</u>
Net cash provided/(used) by operating activities	<u>\$ 747,404</u>	<u>\$ (10,653,178)</u>

See accompanying notes.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements
June 30, 2011 and 2010

Note A – Nature of Organization and Operations

Kentucky Municipal Risk Management Association was established in April 1987 under the authorization of the Kentucky Interlocal Cooperation Act of the Kentucky Revised Statutes for the purpose of creating and operating various self-insurance, insurance and investment trusts. It is an unincorporated, nonprofit association voluntarily established by the participating cities, urban-county governments and related public agencies and political subdivisions within the Commonwealth of Kentucky. During 2003, the Association changed its name to Kentucky League of Cities Insurance Services Association (KLCIS).

KLCIS 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. KLCIS' general objectives are to formulate, develop and administer, on behalf of the member political subdivisions, a program of insurance and to obtain lower costs for that coverage. KLCIS offers general, public official, law enforcement and auto liability coverage as well as auto physical damage coverage for participating municipalities (the liability pool). All coverages are written on an occurrence basis. In addition, KLCIS operates a property insurance program for participating municipalities (the property pool). Participation in the liability and property pools included 405 and 356 members, respectively as of June 30, 2011 and 414 and 363 members, respectively as of June 30, 2010.

Following is a description of the most significant risks facing property/casualty insurers and how KLCIS 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. KLCIS 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. KLCIS 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. KLCIS mitigates this risk by attempting to match the maturity schedule of its assets with the expected payouts of its liabilities. To the extent that liabilities come due more quickly than assets mature, an issuer would have to sell assets prior to maturity and recognize a gain or loss. KLCIS uses the segmented time distribution method to measure interest rate risk.

Geographic Risk:

Geographic risk is the risk that catastrophic losses will occur in one concentrated area where KLCIS does business. KLCIS writes all of its business in Kentucky. KLCIS mitigates this risk by adhering to specified underwriting practices and by obtaining catastrophic reinsurance coverage.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note B – Summary of Significant Accounting Policies

1. Basis of Accounting: KLCIS 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.

KLCIS 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, KLCIS has adopted GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*. Therefore, KLCIS 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 KLCIS intends to use as 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 interest and investment revenue, under 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, KLCIS considers all short-term investments with original maturities of three months or less to be cash equivalents.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note B – Summary of Significant Accounting Policies (Continued)

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.
6. Property and Equipment: Property and equipment consists of leasehold improvements, furniture and fixtures, computer equipment and related software. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets. For the years ended June 30, 2011 and 2010, depreciation expense amounted to \$35,329 and \$64,293, respectively.
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.
8. Unpaid Losses and Loss Adjustment Expenses: Unpaid losses and loss adjustment expenses are based on estimates of the ultimate cost of claims (including future claim adjustment expenses) that have been reported but not settled, and of claims that have been incurred but not yet reported. The length of time for which such costs must be estimated varies depending on the coverage involved. Estimated amounts of salvage, subrogation and reinsurance recoverable on unpaid claims are deducted from the liability for unpaid claims. Because actual claims costs depend on such complex factors as inflation, changes in doctrines of legal liability, and damage awards, the process used in computing claims liabilities does not necessarily result in an exact amount. Claims liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation in the calculation of estimated future claims costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made.

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 \$1,635,081 and \$1,450,985 as of June 30, 2011 and 2010, respectively. The effect of discounting on the provision for losses and loss adjustment expenses was a decrease of \$184,096 in 2011 and \$30,086 in 2010.

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

KLCIS has received initial capital contributions from members to provide start-up surplus. Capital contributions were primarily determined based on a percentage of current annual premiums. Capital contributions are refundable only at the discretion of the Board of Trustees.

In the event of adverse loss experience, KLCIS 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. There have been no assessments levied since the inception of KLCIS. No refunds were issued during 2011 or 2010.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note B – Summary of Significant Accounting Policies (Continued)

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

Note C – Deposits and Investments

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

	<u>2011</u>	<u>2010</u>
Cash and cash equivalents	\$ 145,094	\$ 306,565
Money market mutual funds	<u>1,633,784</u>	<u>1,738,014</u>
Deposits and investments classified as cash and cash equivalents	1,778,878	2,044,579
Certificates of deposit	-	296,658
Corporate bonds	6,779,121	5,782,303
Municipal bonds	7,248,969	5,058,294
U.S. government agency obligations	9,695,284	11,817,582
Equity mutual funds	2,832,671	1,377,111
Equity securities	3,472,742	2,617,684
Miscellaneous	<u>128,780</u>	<u>-</u>
Investments classified as investment securities	<u>30,157,567</u>	<u>26,949,632</u>
Total deposits and investments	<u>\$ 31,936,445</u>	<u>\$ 28,994,211</u>

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

	Investment Maturities (in Years)			
	<u>Less Than 1</u>	<u>1-5</u>	<u>6-10</u>	<u>More Than 10</u>
Corporate bonds	\$ 770,355	\$ 4,674,876	\$ 1,333,890	\$ -
Municipal bonds	757,841	6,063,351	427,777	-
U.S. government agency obligations	<u>1,512,900</u>	<u>6,317,820</u>	<u>1,864,564</u>	-
Total maturities	<u>\$ 3,041,096</u>	<u>\$ 17,056,047</u>	<u>\$ 3,626,231</u>	<u>\$ -</u>

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note C – Deposits and Investments (Continued)

Interest and investment revenue is comprised of the following for the years ended June 30, 2011 and 2010:

	2011	2010
Interest and dividend income	\$ 761,773	\$ 1,070,935
Realized gains (losses) on sales of securities	469,400	(204,518)
Unrealized gains on securities	872,808	847,416
	<u>\$ 2,103,981</u>	<u>\$ 1,713,833</u>

Credit Risk

Pursuant to state law, no more than 20% of admitted assets may be invested in medium and lower grade investments; no more than 10% of admitted assets may be invested in lower grade securities; investments with a rating of 5 or 6 from a nationally recognized statistical rating organization (NRSRO) cannot exceed 3% of admitted assets; investments with a rating of 6 from a NRSRO cannot exceed 1% of admitted assets. KLCIS' internal investment policy does not allow the purchase of medium or lower grade investments; however, investments already owned may be retained when the rating drops from high grade to medium or lower grades.

State law and KLCIS' policy both state that total medium and lower grade investments issued, assumed, guaranteed, accepted or insured by any one organization (or as to asset back securities, any interest in a single asset or pool of assets) may not exceed 1% of admitted assets. KLCIS' policy further states that total medium grade holdings tied to a single source shall be limited to 1% of total assets. State law and KLCIS' policy both require that no more than 3% of admitted assets shall be invested in any single asset or, for asset backed securities, any single pool of assets.

State law requires that no individual equity holding shall comprise greater than 10% of the equity portion of the portfolio at the time of purchase. It also states 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, state law requires 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.

As of June 30, 2011, KLCIS was invested in the following government agency bonds: Federal Farm Credit Bank, 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. KLCIS also invested in corporate bonds which ranged in ratings from A to AA. Additional investments included U.S. Treasury notes and bonds, bond mutual funds, and municipal bonds, all of which had A to AAA ratings.

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.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note D – Reinsurance Coverage

The Board of Trustees has authorized KLCIS' participation in NLC Mutual Insurance Company (NLC-MIC). NLC-MIC was organized for the purpose of providing reinsurance coverage to participating members of the National League of Cities. KLCIS was not required to make a capital contribution to NLC-MIC during 2011 and 2010. In order to reduce KLCIS' ultimate loss exposure arising from large losses in the liability pool, KLCIS purchases specific excess of loss reinsurance coverage for protection against losses in excess of \$750,000 per occurrence in 2011 and \$500,000 per occurrence in 2010.

For 2011 and 2010, KLCIS purchased reinsurance coverage for the liability pool from one reinsurance carrier rated "A+" (Superior) by A.M. Best and Company. KLCIS purchased a buffer layer of reinsurance, defined as \$250,000 in excess of \$750,000, as specific reinsurance coverage per occurrence from ACE USA (ACE). In addition to this coverage, KLCIS also purchased an excess reinsurance policy from ACE for specific coverage on claims \$9,000,000 in excess of \$1,000,000.

Reinsurance coverage for the property pool is purchased from various reinsurers, each of which has been assigned a rating of "A" (Excellent) by A.M. Best and Company. In addition to specific excess of loss reinsurance, the property pool also maintains aggregate reinsurance coverage. Policy limits vary based upon the type and amount of insured risk. Reinsurance premiums are based upon a percentage of direct property pool premium revenue or total insured value.

Although the purchase of reinsurance coverage does not discharge KLCIS 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 KLCIS for accounting purposes to treat insured risks, to the extent of reinsurance coverage, as though they were risks for which KLCIS is not liable. However, KLCIS remains contingently liable in the event its reinsurers are unable to meet their contractual obligations.

Reinsurance premiums ceded were \$4,072,575 and \$5,714,367 for the years ended June 30, 2011 and 2010, respectively. Additional recoveries accrued on paid claims during 2011 and 2010 were \$1,587,220 and \$3,084,505, 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 \$967,322 and \$2,259,821 in 2011 and 2010, respectively.

Note E – Related Party Transactions

KLCIS was organized by KLC, Inc. at the request of the state municipalities. KLC provides substantially all of KLCIS' 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 \$3,564,877 and \$3,795,712 for the years ended June 30, 2011 and 2010, respectively.

KLCIS participates in a marketing agreement with Kentucky League of Cities Insurance Services, Inc. (the Agency) which provides that KLCIS pay a commission for member accounts marketed or serviced by the Agency. Commission expense under the agreement was \$682,089 and \$821,956 for the years ended June 30, 2011 and 2010, respectively.

KLCIS' directors' and officers' insurance provides coverage for KLC board members. Also, certain trustees of KLCIS are directors for KLC. The Kentucky League of Cities serves as Administrator of KLCIS.

Kentucky League of Cities Insurance Services Association
Notes to Financial Statements (Continued)
June 30, 2011 and 2010

Note F – 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:

	<u>Liability Pool</u>		<u>Property Pool</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Net unpaid losses and loss adjustment expenses, beginning of year	\$ 24,500,966	\$ 24,438,332	\$ 733,858	\$ 1,085,270
Incurred losses and loss adjustment expenses:				
Provision for insured events of the current year	13,486,832	10,948,096	2,070,747	1,755,718
Increase (decrease) in provision for insured events of prior years	<u>(3,128,899)</u>	<u>(1,489,585)</u>	<u>(8,380)</u>	<u>118,221</u>
Total incurred losses and loss adjustment expenses	<u>10,357,933</u>	<u>9,458,511</u>	<u>2,062,367</u>	<u>1,873,939</u>
Payments:				
Losses and loss adjustment expenses attributable to insured events of the current year	2,397,494	2,073,659	842,088	1,096,057
Losses and loss adjustment expenses attributable to insured events of prior years	<u>6,167,235</u>	<u>7,322,218</u>	<u>848,802</u>	<u>1,129,294</u>
Total payments	<u>8,564,729</u>	<u>9,395,877</u>	<u>1,690,890</u>	<u>2,225,351</u>
Net unpaid losses and loss adjustment expenses, end of year	<u>\$ 26,294,170</u>	<u>\$ 24,500,966</u>	<u>\$ 1,105,335</u>	<u>\$ 733,858</u>

An increase (decrease) in the provision for insured events of prior years signifies that KLCIS expects higher (lower) than anticipated ultimate losses in the final disposition of claims.

Note G – Commitments and Contingencies

KLCIS is the guarantor for an irrevocable standing letter of credit with a bank for a related party. The letter of credit permitted borrowings of \$3.3 million as of June 30, 2011. As of June 30, 2011 and 2010, no amounts were outstanding under the letter of credit. The investments of KLCIS are used as collateral for the letter of credit.

KLCIS is party to certain legal actions arising through the normal course of business. Management believes that these actions are without merit or that the ultimate liability, if any, will not materially affect KLCIS's financial position or results of operations.

Supplementary Information

Kentucky League of Cities Insurance Services Association
Statements of Net Assets Information
June 30, 2011 and 2010

	2011			2010		
	Liability Pool	Property Pool	Total	Liability Pool	Property Pool	Total
Assets						
Investment securities, at fair value	\$ 30,157,567	\$ -	\$ 30,157,567	\$ 26,949,632	\$ -	\$ 26,949,632
Cash and cash equivalents	1,778,878	-	1,778,878	2,044,579	-	2,044,579
Accounts receivable	151,779	51,686	203,465	148,399	112,705	261,104
Reinsurance receivable	-	847,012	847,012	79,069	982,927	1,061,996
Receivable from related entity	138,878	4,734,869	4,873,747	1,435,502	4,785,074	6,220,576
Accrued investment income	179,945	-	179,945	244,308	-	244,308
Membership in NLC Mutual Insurance Company	620,037	-	620,037	620,037	-	620,037
Property and equipment	86,951	1,759	88,710	120,873	3,166	124,039
Prepaid expenses	158,582	225,391	383,973	239,900	395,297	635,197
Total Assets	<u>\$ 33,272,617</u>	<u>\$ 5,860,717</u>	<u>\$ 39,133,334</u>	<u>\$ 31,882,299</u>	<u>\$ 6,279,169</u>	<u>\$ 38,161,468</u>
Liabilities and Net Assets						
Unpaid losses and loss adjustment expenses:						
Reported claims	\$ 11,831,319	\$ 920,873	\$ 12,752,192	\$ 10,020,709	\$ 501,087	\$ 10,521,796
Incurred but not reported claims	13,564,306	153,355	13,717,661	13,629,466	209,159	13,838,625
Unallocated loss adjustment expenses	898,545	31,107	929,652	850,791	23,612	874,403
Accounts payable	103,341	44,476	147,817	231,263	117,584	348,847
Advance premiums	1,594,859	652,343	2,247,202	2,881,213	1,266,527	4,147,740
Total Liabilities	27,992,370	1,802,154	29,794,524	27,613,442	2,117,969	29,731,411
Net Assets	<u>5,280,247</u>	<u>4,058,563</u>	<u>9,338,810</u>	<u>4,268,857</u>	<u>4,161,200</u>	<u>8,430,057</u>
Total Liabilities and Net Assets	<u>\$ 33,272,617</u>	<u>\$ 5,860,717</u>	<u>\$ 39,133,334</u>	<u>\$ 31,882,299</u>	<u>\$ 6,279,169</u>	<u>\$ 38,161,468</u>

See accompanying independent auditor's report.

Kentucky League of Cities Insurance Services Association
Statements of Revenues, Expenses and Change in Net Assets Information
June 30, 2011 and 2010

	2011			2010		
	Liability Pool	Property Pool	Total	Liability Pool	Property Pool	Total
Operating Revenue						
Net premiums earned	\$ 15,246,070	\$ 4,115,935	\$ 19,362,005	\$ 14,734,674	\$ 4,997,749	\$ 19,732,423
Total Operating Revenue	15,246,070	4,115,935	19,362,005	14,734,674	4,997,749	19,732,423
Operating Expenses						
Losses and loss adjustment expenses	10,357,933	2,062,367	12,420,300	9,458,511	1,873,939	11,332,450
Commission expense	1,657,353	976,448	2,633,801	1,799,627	1,119,161	2,918,788
Claims administration expense	788,565	218,449	1,007,014	832,214	231,890	1,064,104
Loss prevention expenses	250,267	805	251,072	164,206	453	164,659
Professional fees	115,849	268,109	383,958	133,929	324,459	458,388
KLC administrative fees	2,646,653	918,224	3,564,877	2,818,031	977,681	3,795,712
Other expenses	247,915	74,782	322,697	389,397	173,989	563,386
Total Operating Expenses	16,064,535	4,519,184	20,583,719	15,595,915	4,701,572	20,297,487
Operating Income (Loss)	(818,465)	(403,249)	(1,221,714)	(861,241)	296,177	(565,064)
Nonoperating Revenue						
Interest and investment revenue and gains	1,808,267	295,714	2,103,981	1,438,143	275,690	1,713,833
Other income	21,588	4,898	26,486	8,771	2,210	10,981
Total Nonoperating Revenue	1,829,855	300,612	2,130,467	1,446,914	277,900	1,724,814
Increase (Decrease) in Net Assets	1,011,390	(102,637)	908,753	585,673	574,077	1,159,750
Net Assets at Beginning of Year	4,268,857	4,161,200	8,430,057	3,683,184	3,587,123	7,270,307
Net Assets at End of Year	<u>\$ 5,280,247</u>	<u>\$ 4,058,563</u>	<u>\$ 9,338,810</u>	<u>\$ 4,268,857</u>	<u>\$ 4,161,200</u>	<u>\$ 8,430,057</u>

See accompanying independent auditor's report.

KENTUCKY LEAGUE OF CITIES INSURANCE SERVICES ASSOCIATION
Claims Development Information (Unaudited)
Years ended June 30, 2002 through 2011

The following table illustrates how the Association's earned premium revenue (net of reinsurance) and investment income compare to related costs of loss (net of loss assumed by reinsurers) and other expenses assumed by the Association as of the end of each of the last ten years. The rows of the table are defined as follows: (1) This line shows the total of each fiscal year's gross premium revenue and investment revenue, premium revenue ceded to reinsurers, and net earned premium revenue and reported investment revenue. (2) This line shows each fiscal year's other operating costs of the Association including overhead and claims expense not allocable to individual claims. (3) This line shows the Association's gross incurred claims and allocated claims adjustment expenses, claims assumed by reinsurers, and net incurred claims and allocated adjustment expenses (both paid and accrued) as originally reported as of the end of the first year in which the event that triggered coverage under the contract occurred (called policy year). (4) This section shows the cumulative net amounts paid as of the end of successive years for each policy year. (5) This line shows the latest restimated amount of claims assumed by reinsurers as of the end of the current year for each accident year. (6) This section shows how each policy year's net incurred claims increased or decreased as of the end of successive years. (This annual restatement results from new information received on known claims, reevaluation of existing information on known claims, and emergence of new claims not previously known). (7) This line compares the latest restimated net incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of net claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and restimated amounts commonly is used to evaluate the accuracy of net incurred claims currently recognized in less mature policy years. The columns of the table show the data for successive policy years.

	Fiscal and Policy Year Ended									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
(1) Earned premium revenue and net investment income:										
Earned	\$ 7,883,074	\$ 11,358,250	\$ 16,973,665	\$ 19,765,935	\$ 20,200,768	\$ 22,961,726	\$ 21,786,096	\$ 18,807,426	\$ 20,240,370	\$ 19,402,472
Ceded	1,301,088	2,354,396	3,471,917	3,307,028	3,736,606	4,376,168	4,565,945	4,122,608	4,067,453	2,349,133
Net earned	6,581,986	9,003,854	13,501,748	16,458,907	16,464,162	18,585,560	17,220,151	14,684,818	16,172,917	17,053,337
(2) Unallocated expenses	2,400,309	3,001,085	3,218,807	4,416,630	4,988,671	5,866,615	6,426,405	6,251,928	6,217,737	5,706,602
(3) Estimated incurred claims and expenses, end of policy year:										
Incurred	7,602,885	8,468,065	8,470,150	8,514,460	8,746,208	10,534,883	11,669,774	11,768,385	10,948,096	13,486,832
Ceded	7,602,885	8,266,741	8,403,674	8,514,460	8,748,208	10,534,883	11,669,774	11,768,385	10,948,096	13,486,832
(4) Net paid (cumulative) as of:										
End of policy year	1,999,577	3,324,421	4,987,462	6,596,626	8,294,133	10,040,359	11,836,829	13,684,359	15,581,859	17,521,461
One year later	3,160,687	4,807,659	6,509,111	8,294,133	10,040,359	11,836,829	13,684,359	15,581,859	17,521,461	19,461,013
Two years later	4,807,659	6,509,111	8,294,133	10,040,359	11,836,829	13,684,359	15,581,859	17,521,461	19,461,013	21,400,565
Three years later	6,309,111	8,091,810	9,852,216	11,669,774	13,551,353	15,480,932	17,460,511	19,499,090	21,597,669	23,755,248
Four years later	7,752,216	9,552,216	11,400,972	13,303,391	15,253,000	17,253,000	19,303,391	21,400,972	23,553,000	25,703,391
Five years later	8,752,216	10,600,604	12,500,604	14,450,604	16,400,604	18,350,604	20,300,604	22,250,604	24,200,604	26,150,604
Six years later	9,552,216	11,400,604	13,250,604	15,100,604	16,950,604	18,800,604	20,650,604	22,500,604	24,350,604	26,200,604
Seven years later	10,100,604	11,950,604	13,800,604	15,650,604	17,500,604	19,350,604	21,200,604	23,050,604	24,900,604	26,750,604
Eight years later	10,552,216	12,400,604	14,250,604	16,100,604	17,950,604	19,800,604	21,650,604	23,500,604	25,350,604	27,200,604
Nine years later	10,852,216	12,700,604	14,550,604	16,400,604	18,250,604	20,100,604	21,950,604	23,800,604	25,650,604	27,500,604
(5) Restimated ceded claims and expenses	1,475,272	1,225,498	-	855,518	579,634	-	-	-	-	-
(6) Restimated net incurred claims and expenses:										
End of policy year	7,602,885	8,266,741	8,403,674	8,514,460	8,748,208	10,534,883	11,669,774	11,768,385	10,948,096	13,486,832
One year later	7,812,030	7,803,870	7,999,959	7,992,200	8,192,945	8,306,546	8,420,147	8,533,748	8,647,349	8,760,950
Two years later	7,269,131	7,764,965	7,721,014	8,265,582	9,704,319	9,453,663	12,129,275	11,603,798	10,904,727	10,205,656
Three years later	8,177,556	8,455,451	8,136,219	9,005,291	9,417,554	8,999,121	11,169,006	10,604,964	10,040,922	9,476,880
Four years later	8,811,139	8,568,377	8,428,837	8,989,550	9,361,716	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
Five years later	9,069,709	8,069,709	8,567,057	9,033,382	9,218,937	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
Six years later	8,954,191	7,254,685	8,327,301	8,973,507	9,218,937	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
Seven years later	9,034,064	7,234,646	8,246,638	8,973,507	9,218,937	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
Eight years later	9,037,357	7,137,767	8,246,638	8,973,507	9,218,937	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
Nine years later	9,079,981	7,137,767	8,246,638	8,973,507	9,218,937	8,464,356	11,169,006	10,604,964	10,040,922	9,476,880
(7) Increase (decrease) in estimated net incurred claims and expenses from the end of policy year	1,477,096	(1,128,874)	(157,036)	459,047	470,789	(2,070,487)	(620,768)	(1,163,421)	(43,369)	-

See accompanying independent auditor's report

KENTUCKY LEAGUE OF CITIES INSURANCE SERVICES ASSOCIATION
Claims Development Information (Unaudited)
Years ended June 30, 2002 through 2011

	Property 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	\$ 3,353,438	\$ 4,579,217	\$ 4,767,188	\$ 5,301,624	\$ 5,722,978	\$ 6,719,752	\$ 6,811,806	\$ 6,365,897	\$ 6,920,352	\$ 6,136,069
Ceded	865,604	1,168,963	1,823,338	1,784,738	1,873,329	2,407,379	1,546,039	1,292,868	1,646,914	1,724,440
Net earned	2,487,834	3,410,254	2,943,850	3,536,886	3,849,649	4,312,373	5,265,767	5,073,029	5,273,438	4,411,649
(2) Unallocated expenses	771,984	1,278,079	1,576,757	1,362,933	1,648,508	1,998,126	2,324,599	2,561,715	2,856,688	2,456,817
(3) Estimated incurred claims and expenses, end of policy year:										
Incurred	731,596	2,031,350	930,403	2,400,425	2,155,018	1,768,183	2,260,910	2,116,384	1,755,718	2,070,747
Ceded	-	858,546	-	801,118	352,000	505,000	507,046	735,645	2,186,714	315,968
Net incurred	731,596	1,172,804	930,403	1,599,307	1,803,018	1,263,183	1,753,864	1,380,739	(430,996)	1,754,779
(4) Net paid (cumulative) as of:										
End of policy year	552,950	484,097	311,952	1,123,046	1,095,824	878,190	1,116,949	589,117	1,096,057	842,088
One year later	768,755	1,583,802	918,602	1,564,130	1,708,538	1,154,813	1,492,362	2,031,162	1,690,691	-
Two years later	806,575	1,593,104	918,602	1,609,723	1,713,367	1,304,994	1,607,098	2,066,094	-	-
Three years later	806,575	1,648,368	935,017	1,608,723	1,713,586	1,304,994	1,686,563	-	-	-
Four years later	806,575	1,648,368	935,017	1,609,723	1,713,586	1,305,082	-	-	-	-
Five years later	806,575	1,648,368	921,691	1,609,724	1,713,674	-	-	-	-	-
Six years later	781,576	1,620,532	921,691	1,611,815	-	-	-	-	-	-
Seven years later	781,576	1,620,532	921,691	-	-	-	-	-	-	-
Eight years later	781,576	1,620,532	-	-	-	-	-	-	-	-
Nine years later	806,575	-	-	-	-	-	-	-	-	-
(5) Reestimated ceded claims and expenses	-	-	13,576	1,249,869	537,724	326,308	478,414	735,645	-	13,218
(6) Reestimated net incurred claims and expenses:										
End of policy year	731,596	1,172,804	930,403	1,599,307	1,803,018	1,263,183	1,753,864	1,380,739	1,755,718	2,070,747
One year later	768,755	1,594,969	938,960	1,635,969	1,718,482	1,264,838	1,513,503	2,243,833	1,745,691	-
Two years later	832,157	1,628,318	918,602	1,609,723	1,716,736	1,312,843	1,607,098	2,091,094	-	-
Three years later	806,575	1,648,368	935,017	1,609,723	1,713,586	1,304,994	1,686,563	-	-	-
Four years later	806,575	1,648,368	935,017	1,609,723	1,713,586	1,305,082	-	-	-	-
Five years later	806,575	1,648,368	921,741	1,609,724	1,713,674	-	-	-	-	-
Six years later	781,576	1,620,532	921,691	1,611,815	-	-	-	-	-	-
Seven years later	781,576	1,620,532	921,691	-	-	-	-	-	-	-
Eight years later	781,576	1,620,532	-	-	-	-	-	-	-	-
Nine years later	806,575	-	-	-	-	-	-	-	-	-
(7) Increase (decrease) in estimated net incurred claims and expenses from the end of policy year	74,979	447,728	(6,712)	12,508	(89,344)	41,899	(67,301)	710,355	(10,027)	-

See description of lines (1) through (7) on previous page.

See accompanying independent auditor's report