

Kentucky Associated General Contractors Self Insurers' Fund

Financial Statements as of and for the
Years Ended December 31, 2012 and 2011, and
Independent Auditors' Report

KENTUCKY ASSOCIATED GENERAL CONTRACTORS SELF INSURERS' FUND

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees
Kentucky Associated General Contractors Self Insurers' Fund
Louisville, Kentucky

We have audited the accompanying financial statements of Kentucky Associated General Contractors Self Insurers' Fund (the "Fund"), which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of income and comprehensive income, changes in fund balance, 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 audit 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 auditor's 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 Fund'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 Fund's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky Associated General Contractors Self Insurers' Fund as of December 31, 2012 and 2011, 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.

Deloitte & Touche LLP

April 4, 2013

KENTUCKY ASSOCIATED GENERAL CONTRACTORS SELF INSURERS' FUND

BALANCE SHEETS AS OF DECEMBER 31, 2012 AND 2011

| | 2012 | 2011 |
|--|-----------------------|-----------------------|
| ASSETS | | |
| CASH AND CASH EQUIVALENTS | \$ 21,628,170 | \$ 28,550,175 |
| INVESTMENTS | 303,548,431 | 293,122,283 |
| RECEIVABLES: | | |
| Premiums | 8,696,469 | 9,041,783 |
| Aggregate excess insurance | 392,164 | 391,525 |
| Specific excess insurance | 33,800,322 | 20,562,269 |
| Accrued interest | 1,903,010 | 2,092,085 |
| Income taxes receivable | 830,249 | 113,993 |
| PREPAID REINSURANCE | <u>951,168</u> | <u>951,168</u> |
| TOTAL | <u>\$ 371,749,983</u> | <u>\$ 354,825,281</u> |
| LIABILITIES AND FUND BALANCE | | |
| LIABILITIES: | | |
| Estimated liability for claims: | | |
| Incurred and reported | \$ 143,907,258 | \$ 136,571,439 |
| Incurred but not reported and loss adjustment expense | <u>114,927,882</u> | <u>103,569,836</u> |
| Total estimated liability for claims | <u>258,835,140</u> | <u>240,141,275</u> |
| Payables and accrued expenses: | | |
| Premiums refundable | 1,294,669 | 1,309,196 |
| Service fee and other fees payable | 3,837,547 | 3,944,110 |
| Member deposits | 10,621,007 | 10,986,234 |
| Tax assessments collected on premiums | 919,558 | 928,834 |
| Deferred tax liability | 5,722,124 | 4,845,503 |
| Accrued member dividends | <u>44,770,741</u> | <u>49,378,352</u> |
| Total liabilities | <u>326,000,786</u> | <u>311,533,504</u> |
| FUND BALANCE: | | |
| Retained earnings | 29,749,911 | 28,999,634 |
| Accumulated other comprehensive income — net of income taxes | <u>15,999,286</u> | <u>14,292,143</u> |
| Total fund balance | <u>45,749,197</u> | <u>43,291,777</u> |
| TOTAL | <u>\$ 371,749,983</u> | <u>\$ 354,825,281</u> |

See notes to financial statements.

KENTUCKY ASSOCIATED GENERAL CONTRACTORS SELF INSURERS' FUND

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

| | 2012 | 2011 |
|--|---------------------|---------------------|
| REVENUES: | | |
| Premiums earned | \$ 58,481,676 | \$ 56,808,862 |
| Net investment income | 8,661,624 | 9,297,653 |
| Net realized investment gains (losses) | 1,006,478 | (461,218) |
| Other | <u>771,443</u> | <u>2,260,558</u> |
| Total revenues | <u>68,921,221</u> | <u>67,905,855</u> |
| EXPENSES: | | |
| Claims incurred | 42,719,977 | 41,074,755 |
| Service fee | 6,333,566 | 6,152,400 |
| Commissions | 5,848,168 | 5,680,886 |
| Excess insurance premiums | 840,000 | 840,000 |
| Loss control | 893,104 | 929,480 |
| Premium audits | 564,136 | 563,162 |
| Other operating expenses | <u>1,666,065</u> | <u>1,476,308</u> |
| Total expenses | <u>58,865,016</u> | <u>56,716,991</u> |
| INCOME BEFORE DIVIDENDS DECLARED TO MEMBERS AND INCOME TAX EXPENSE | 10,056,205 | 11,188,864 |
| DIVIDENDS DECLARED TO MEMBERS | <u>9,300,000</u> | <u>8,700,000</u> |
| INCOME BEFORE INCOME TAX EXPENSE | 756,205 | 2,488,864 |
| INCOME TAX EXPENSE | <u>5,928</u> | <u>722,709</u> |
| NET INCOME | <u>750,277</u> | <u>1,766,155</u> |
| OTHER COMPREHENSIVE INCOME — Before tax — unrealized gains (losses) on investments: | | |
| Unrealized holding gains arising during the year | 3,593,058 | 4,869,090 |
| Reclassification adjustment for losses (gains) included in net income | <u>(1,006,478)</u> | <u>461,218</u> |
| OTHER COMPREHENSIVE INCOME — Before tax | 2,586,580 | 5,330,308 |
| INCOME TAX EXPENSE RELATIVE TO OTHER COMPREHENSIVE INCOME | <u>(879,437)</u> | <u>(1,812,305)</u> |
| OTHER COMPREHENSIVE INCOME — Net of tax | <u>1,707,143</u> | <u>3,518,003</u> |
| COMPREHENSIVE INCOME | <u>\$ 2,457,420</u> | <u>\$ 5,284,158</u> |

See notes to financial statements.

**KENTUCKY ASSOCIATED GENERAL CONTRACTORS
SELF INSURERS' FUND**

**STATEMENTS OF CHANGES IN FUND BALANCE
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011**

| | Retained Earnings | Accumulated Other Comprehensive Income | Fund Balance |
|---|------------------------------|---|-------------------------|
| BALANCE — December 31, 2010 | \$ 27,233,479 | \$ 10,774,140 | \$ 38,007,619 |
| Net income | 1,766,155 | | 1,766,155 |
| Change in accumulated other comprehensive income — net of income taxes | <u> </u> | <u>3,518,003</u> | <u>3,518,003</u> |
| BALANCE — December 31, 2011 | 28,999,634 | 14,292,143 | 43,291,777 |
| Net income | 750,277 | | 750,277 |
| Change in accumulated other comprehensive income — net of income taxes | <u> </u> | <u>1,707,143</u> | <u>1,707,143</u> |
| BALANCE — December 31, 2012 | <u>\$ 29,749,911</u> | <u>\$ 15,999,286</u> | <u>\$ 45,749,197</u> |

See notes to financial statements.

**KENTUCKY ASSOCIATED GENERAL CONTRACTORS
SELF INSURERS' FUND**

**STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011**

| | 2012 | 2011 |
|---|-----------------------------|-----------------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 750,277 | \$ 1,766,155 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Dividends declared to members | 9,300,000 | 8,700,000 |
| (Gain) loss on sale of investments | (1,006,478) | 461,218 |
| Deferred tax benefit liability | (2,816) | (324,442) |
| Amortization of investment premiums and discounts — net | (1,782,305) | (314,764) |
| Changes in assets and liabilities: | | |
| Receivables | (137,033) | (2,437,486) |
| Prepaid insurance | | (825,000) |
| Income taxes receivable | (716,256) | 1,487,863 |
| Estimated liability for claims | 6,126,594 | 5,980,116 |
| Payables and accrued expenses | (121,089) | (71,182) |
| Member deposits | (365,227) | (314,158) |
| Tax assessments collected on premiums | (9,276) | (3,137) |
| | <u>12,036,391</u> | <u>14,105,183</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments | (112,298,432) | (72,395,199) |
| Proceeds from sales and maturities of investments | <u>107,247,647</u> | <u>78,478,554</u> |
| | <u>(5,050,785)</u> | <u>6,083,355</u> |
| CASH FLOWS FROM FINANCING ACTIVITY — | | |
| Payment of dividends to members | <u>(13,907,611)</u> | <u>(10,604,293)</u> |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (6,922,005) | 9,584,245 |
| CASH AND CASH EQUIVALENTS — Beginning of year | <u>28,550,175</u> | <u>18,965,930</u> |
| CASH AND CASH EQUIVALENTS — End of year | <u>\$ 21,628,170</u> | <u>\$ 28,550,175</u> |
| SUPPLEMENTAL CASH FLOW INFORMATION — | | |
| Cash paid for income taxes | <u>\$ 823,327</u> | <u>\$ -</u> |

See notes to financial statements.

KENTUCKY ASSOCIATED GENERAL CONTRACTORS SELF INSURERS' FUND

NOTES TO FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

1. OPERATIONS OF THE FUND

Kentucky Associated General Contractors Self Insurers' Fund's (the "Fund") purpose is to meet and fulfill employer member obligations and liabilities under the Kentucky Workers' Compensation Act, pursuant to KRS Section 342.350. The operations of the Fund are covered under a Trust Agreement. Insurance coverage is provided to members of construction industry associations in Kentucky. Claims administration and management services are provided by Ladegast & Heffner Claims Service under a contract that extends through December 31, 2017. The service fee is based on a percentage of premiums earned.

2. SIGNIFICANT ACCOUNTING POLICIES

Cash and Cash Equivalents — Cash equivalents include money market funds and certain investments in highly liquid debt instruments with maturities of 3 months or less, which are stated at cost, which approximates fair value. The Fund's bank balances are held at a single financial institution, and at times, balances may exceed federally insured amounts.

Investments — Investments are classified as available-for-sale securities and are reported at fair value. Unrealized holding gains and losses, net of income taxes, are reported as accumulated other comprehensive income, a separate component of fund balance, until realized. The specific identification method is used to determine cost to compute realized gains or losses. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price). Observable inputs or unobservable inputs, defined by the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements*, may be used in the calculation of fair value. ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three levels of the fair value hierarchy are described below:

Level 1 — Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 — Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly;

Level 3 — Prices or valuations that require inputs that are both significant to the fair value measure and unobservable.

In accordance with ASC Topic 820, assets measured at fair value on a recurring basis at December 31 are as follows:

| 2012 | Recurring Fair Value Measures | | | |
|--------------------------------------|-------------------------------|----------------------|-------------|-----------------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Investment securities — | | | | |
| Available-for-sale securities: | | | | |
| US Treasury notes and bonds | \$ 212,490,413 | \$ - | \$ - | \$ 212,490,413 |
| Domestic common stocks: | | | | |
| Technology common stocks | 6,022,543 | | | 6,022,543 |
| Basic material common stocks | 4,532,222 | | | 4,532,222 |
| Financial common stocks | 4,074,895 | | | 4,074,895 |
| Other common stocks and mutual bonds | 28,611,229 | | | 28,611,229 |
| Corporate obligations | | 31,193,580 | | 31,193,580 |
| Municipal obligations | | 16,060,480 | | 16,060,480 |
| Other | 563,069 | | | 563,069 |
| Total | <u>\$ 256,294,371</u> | <u>\$ 47,254,060</u> | <u>\$ -</u> | <u>\$ 303,548,431</u> |
| | | | | |
| 2011 | Recurring Fair Value Measures | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| Investment securities — | | | | |
| Available-for-sale securities: | | | | |
| US Treasury notes and bonds | \$ 212,741,694 | \$ - | \$ - | \$ 212,741,694 |
| Domestic common stocks: | | | | |
| Technology common stocks | 5,761,656 | | | 5,761,656 |
| Basic material common stocks | 4,460,981 | | | 4,460,981 |
| Financial common stocks | 4,118,379 | | | 4,118,379 |
| Other common stocks and mutual bonds | 26,562,443 | | | 26,562,443 |
| Corporate obligations | | 25,988,622 | | 25,988,622 |
| Municipal obligations | | 13,245,180 | | 13,245,180 |
| Other | 243,328 | | | 243,328 |
| Total | <u>\$ 253,888,481</u> | <u>\$ 39,233,802</u> | <u>\$ -</u> | <u>\$ 293,122,283</u> |

The Fund does not value any liabilities at fair value. The Fund does not measure any assets or liabilities at fair value on a nonrecurring basis. For all other classes of financial instruments, the carrying amount approximates fair value due to the short-term nature of the asset or liability.

Investments, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. It is reasonably possible that changes in the investment values could occur in the near term and that such changes could materially affect the amounts reported in the balance sheets.

Estimated Liability for Claims — Estimates of the liability for incurred (reported and not reported) claims are actuarially determined using development factor methods. These methods use past observed patterns of the time between when a claim is incurred and when a claim is paid to estimate incurred claims from available paid claims information. Liabilities are based on the estimated ultimate cost of settling the claims. The unpaid claims liabilities are necessarily based on estimates and, accordingly, the ultimate liability may be in excess of or less than the amounts provided. Adjustments to the estimated liability for claims are charged or credited to expense in the periods in which they become known. Any adjustments could be material to the financial statements. In accordance with ASC Topic 210, *Balance Sheet — Offsetting*, estimated amounts of excess insurance recoverable are shown as assets, and are not netted against the estimated liability for claims as of December 31, 2012. As of December 2011, and in prior years reported, the estimated amount of insurance recoverable for incurred but not reported claims

were reported net of the related liabilities. The Fund accounts for the estimated liability for claims on a discounted basis to more accurately reflect the long-term payout of the workers' compensation claims. The estimated liability for claims is discounted using an interest rate of 1.5%.

Member Dividends — Distributions to members in the form of dividends may be declared by the Board of Trustees, but under Kentucky Department of Insurance Regulations, dividends may not be paid until the end of the thirty-sixth month after the expiration of the self-insurance term. The Fund reflects dividends as a charge to income and a liability in the year declared.

Premiums Earned — The Fund enters into individual workers' compensation insurance policy contracts with each Member Company, thus forming a group self-insured fund. Premiums are due at the beginning of each month based on the previous month's exposure plus any current period known charges. Premiums are recognized as revenue during the period in which the Fund is obligated to provide coverage to said group of employers.

Member Deposits — Member deposits represent 25% of each member's estimated normal premium at the inception of membership in the Fund. Member deposits are subject to periodic updates based on each member's most recent audited premium. Once a member's coverage through the Fund has been terminated and all outstanding balances due to the Fund or the applicable trade association have been paid, the member's deposit will be refunded.

Use of Estimates — Financial statements prepared in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

Subsequent Events — There were no subsequent events requiring adjustment to the financial statements or disclosure through April 4, 2013, the date that the financial statements were available for issuance.

Recent Accounting Pronouncements — In June 2011, the FASB issued new guidance on comprehensive income statement presentation (*ASU 2011-05 — "Comprehensive Income (Topic 220)"*). Under the amendments to Topic 220, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, thus the adoption of such standard did not have a material impact on the Fund's reported results of operations and financial position.

In February 2013, the FASB issued ASU No. 2013-02, "*Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*," or "*ASU 2013-02*" which requires disclosure of significant amounts reclassified out of accumulated other comprehensive income by component and their corresponding effect on the respective line items of net income. This guidance is effective for reporting periods beginning after December 15, 2012 and is not expected to have a material impact on the Fund's consolidated financial statements or financial statement disclosures.

3. INVESTMENTS

Investments as of December 31, 2012 and 2011, consist of the following:

| | 2012 | | | |
|------------------------------------|------------------------------|---------------------------------------|--|------------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Treasury notes and bonds | \$ 199,257,685 | \$ 13,318,044 | \$ (85,316) | \$ 212,490,413 |
| Domestic common stocks: | | | | |
| Technology common stocks | 5,382,201 | 667,774 | (27,432) | 6,022,543 |
| Basic material common stocks | 3,526,484 | 1,211,358 | (205,620) | 4,532,222 |
| Financial common stocks | 3,216,452 | 858,443 | | 4,074,895 |
| Other common stocks & mutual bonds | 21,868,502 | 6,742,727 | | 28,611,229 |
| Corporate obligations | 29,493,933 | 1,738,533 | (38,886) | 31,193,580 |
| Municipal obligations | 16,000,000 | 95,520 | (35,040) | 16,060,480 |
| Other | 561,834 | 1,235 | | 563,069 |
| Total | <u>\$ 279,307,091</u> | <u>\$ 24,633,634</u> | <u>\$ (392,294)</u> | <u>\$ 303,548,431</u> |

| | 2011 | | | |
|------------------------------------|------------------------------|---------------------------------------|--|------------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Treasury notes and bonds | \$ 198,708,776 | \$ 14,083,214 | \$ (50,296) | \$ 212,741,694 |
| Domestic common stocks: | | | | |
| Technology common stocks | 6,132,147 | 413,702 | (784,193) | 5,761,656 |
| Basic material common stocks | 3,598,205 | 1,194,943 | (332,167) | 4,460,981 |
| Financial common stocks | 3,630,265 | 586,308 | (98,194) | 4,118,379 |
| Other common stocks & mutual bonds | 22,325,307 | 4,515,881 | (278,745) | 26,562,443 |
| Corporate obligations | 23,829,495 | 2,253,584 | (94,457) | 25,988,622 |
| Municipal obligations | 13,000,000 | 245,180 | | 13,245,180 |
| Other | 243,328 | | | 243,328 |
| Total | <u>\$ 271,467,523</u> | <u>\$ 23,292,812</u> | <u>\$ (1,638,052)</u> | <u>\$ 293,122,283</u> |

The components of net investment income as of December 31, 2012 and 2011, are presented below:

| | 2012 | 2011 |
|-------------------------------------|----------------------------|----------------------------|
| Investment income: | | |
| Interest on fixed income securities | \$ 7,825,176 | \$ 8,694,693 |
| Dividends on equity securities | 1,235,769 | 962,574 |
| Other investment income | 7,256 | 6,887 |
| Less investment expense | <u>(406,577)</u> | <u>(366,501)</u> |
| Net investment income | <u>\$ 8,661,624</u> | <u>\$ 9,297,653</u> |

The components of net realized investment gains and (losses) included in earnings as of December 31, 2012 and 2011, are as follows:

| | 2012 | 2011 |
|---|---------------------|---------------------|
| Net realized investment gains (losses): | | |
| Fixed income: | | |
| Gross realized gains | \$ 1,107,780 | \$ 283,090 |
| Gross realized losses | (165,035) | (46,250) |
| Equity securities: | | |
| Gross realized gains | 1,061,599 | 543,359 |
| Gross realized losses | <u>(997,866)</u> | <u>(1,241,417)</u> |
| Net realized investment gains (losses) | <u>\$ 1,006,478</u> | <u>\$ (461,218)</u> |

Debt instruments held as of December 31, 2012, will mature as follows:

| Maturing | Amortized Cost | Fair Value |
|--------------------------------|-----------------------|-----------------------|
| Within 1 year | \$ 31,903,286 | \$ 32,364,511 |
| After 1 year through 5 years | 102,347,692 | 110,136,387 |
| After 5 years through 10 years | 104,330,605 | 110,803,495 |
| After 10 years | <u>6,170,035</u> | <u>6,440,080</u> |
| Total | <u>\$ 244,751,618</u> | <u>\$ 259,744,473</u> |

In lieu of purchasing a bond, as required by the Kentucky Department of Insurance, the Fund has pledged approximately \$24,207,000 of investments, at fair value, as collateral for the payment of workers' compensation claims as of December 31, 2012. The amount pledged is to remain under the joint control of the Fund and the Department of Insurance, for the exclusive payment of any liability for workers' compensation claims incurred by the Fund.

The following tables provide the unrealized losses and fair values, by investment category and by length of time the individual securities have been in a continuous unrealized loss position, at December 31, 2012 and 2011:

| | 2012 | | | | | |
|---|---------------------|----------------------|--------------------|----------------------|---------------------|----------------------|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury notes and bonds | \$24,236,433 | \$ (28,967) | \$2,009,840 | \$ (56,349) | \$26,246,273 | \$ (85,316) |
| Domestic common stocks: | | | | | | |
| Technology common stocks | 1,838,659 | (27,432) | | | 1,838,659 | (27,432) |
| Basic material common stocks | | | 574,998 | (205,620) | 574,998 | (205,620) |
| Financial common stocks | | | | | | |
| Other common stocks and mutual bonds | 8,824,525 | (38,886) | | | 8,824,525 | (38,886) |
| Corporate obligations | <u>12,964,960</u> | <u>(35,040)</u> | | | <u>12,964,960</u> | <u>(35,040)</u> |
| Total | <u>\$47,864,577</u> | <u>\$(130,325)</u> | <u>\$2,584,838</u> | <u>\$(261,969)</u> | <u>\$50,449,415</u> | <u>\$(392,294)</u> |

| | 2011 | | | | | |
|--------------------------------------|---------------------|--------------------|--------------------|--------------------|---------------------|----------------------|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury notes and bonds | \$ 6,357,488 | \$ (50,296) | \$ - | \$ - | \$ 6,357,488 | \$ (50,296) |
| Domestic common stocks: | | | | | | |
| Technology common stocks | 2,785,312 | (338,070) | 816,435 | (446,123) | 3,601,747 | (784,193) |
| Basic material common stocks | 494,271 | (286,346) | 593,550 | (45,821) | 1,087,821 | (332,167) |
| Financial common stocks | | | 422,500 | (98,194) | 422,500 | (98,194) |
| Other common stocks and mutual bonds | 1,073,590 | (100,827) | 1,132,808 | (177,918) | 2,206,398 | (278,745) |
| Corporate obligations | | | 1,506,360 | (94,457) | 1,506,360 | (94,457) |
| Total | <u>\$10,710,661</u> | <u>\$(775,539)</u> | <u>\$4,471,653</u> | <u>\$(862,513)</u> | <u>\$15,182,314</u> | <u>\$(1,638,052)</u> |

At December 31, 2012, one equity security with a total unrealized loss of \$205,620 was in that position for 12 months or more; and one corporate obligation with a total unrealized loss of \$56,349 was in that position for 12 months or more. Based on consideration of various factors, such as credit quality of the bonds, no event of default of issuer, or government guarantee of principle, these assets presently do not meet the Fund's other-than-temporary asset impairment criteria and will not be impaired unless they meet the impairment criteria in the future.

Bond fair values are subject to fluctuation based on, among other things, changes in interest rates. In a rising rate environment, bond values may experience a drop in market price which is normally recovered as the bond approaches its maturity date. The Fund has the intent and ability to hold all bond investments until recovery. At December 31, 2012, the Fund did not have the intent to sell any bonds whose fair value was less than amortized cost, it was not more likely than not the Fund would be required to sell such securities, and the present values of the expected future cash flows are sufficient to recover the entire amortized cost of the securities.

4. EXCESS INSURANCE

The Fund uses excess insurance agreements to limit its exposure on payment of claims. Excess insurance permits recovery of a portion of claims incurred from excess insurers, although it does not discharge the Fund from the primary liability as direct insurer. The amount of excess insurance coverage varies during each of the excess insurance periods.

Aggregate excess insurance provides coverage if the total losses of the Fund exceed certain percentages of earned premium. The Fund discontinued the purchase of aggregate excess coverage effective May 1, 1994 and has subsequently received an annual purchase waiver by fulfilling the requirements as set-forth by the Kentucky Department of Insurance. At December 31, 2012 and 2011, aggregate excess insurance receivables with an undiscounted value of \$413,809 and \$413,048, respectively, were associated primarily with one excess insurer.

Specific excess insurance provides coverage for each loss in excess of certain amounts. At December 31, 2012 and 2011, specific excess insurance receivables with an undiscounted value of \$40,340,048 and \$24,561,677, respectively, were associated primarily with one excess insurer. The Fund does not hold any collateral under any excess insurance agreements. In the event that any of the excess insuring companies might be unable to meet their obligations under existing excess insurance agreements, the Fund would be liable for such amounts.

5. ESTIMATED LIABILITY FOR CLAIMS

Activity in the estimated liability for claims at December 31, 2012 and 2011, is summarized as follows:

| | 2012 | 2011 |
|--|----------------------|----------------------|
| Balance — January 1 | \$240,141,275 | \$234,161,159 |
| Less excess insurance receivables | <u>20,953,794</u> | <u>19,872,797</u> |
| Net balance — January 1 | <u>219,187,481</u> | <u>214,288,362</u> |
| Incurred related to: | | |
| Current year — undiscounted | 43,692,895 | 39,994,112 |
| Increase in prior years' estimates — undiscounted | <u>73,920</u> | <u>2,020,786</u> |
| Total incurred — undiscounted | 43,766,815 | 42,014,898 |
| Less effect of discounting reserves | <u>(1,046,821)</u> | <u>(940,117)</u> |
| Net incurred | <u>42,719,994</u> | <u>41,074,781</u> |
| Paid related to: | | |
| Current year | 8,505,506 | 9,167,050 |
| Prior years | <u>28,759,315</u> | <u>27,008,612</u> |
| Total paid | <u>37,264,821</u> | <u>36,175,662</u> |
| Net balance — December 31 | 224,642,654 | 219,187,481 |
| Plus excess insurance receivables | <u>34,192,486</u> | <u>20,953,794</u> |
| Balance — December 31 | <u>\$258,835,140</u> | <u>\$240,141,275</u> |

At December 31, 2012 and 2011, estimated liabilities for claims of \$255,175,659 and \$261,248,504, respectively, net of excess insurance receivables, are presented above at their discounted net present value of \$224,642,654 and \$219,187,481, respectively.

As a result of changes in estimates of insured events in prior years, the claims and claim adjustment expenses increased by \$73,920 in 2012, reflecting higher-than-anticipated losses for claims for workers' compensation in the current year.

Estimated liabilities for claims and the related insurance recoverable at December 31, 2012 and 2011, are as follows:

| | 2012 | 2011 |
|--|-----------------------|-----------------------|
| Estimated liability for claims — gross of excess insurance receivables | \$ 258,835,140 | \$ 240,141,275 |
| Less excess and specific insurance receivables | <u>(34,192,486)</u> | <u>(20,953,794)</u> |
| Estimated liability for claims — net of excess insurance receivables | <u>\$ 224,642,654</u> | <u>\$ 219,187,481</u> |

In accordance with ASC Topic 210, *Balance Sheet — Offsetting*, estimated amounts of excess insurance recoverable are shown as assets, and are not netted against the estimated liability for claims as of December 31, 2012. As of December 2011, and in prior years reported, the estimated amount of insurance recoverable for incurred but not reported claims were reported net of the related liabilities.

6. INCOME TAXES

The Fund's tax status is that of an insurance company subject to the provisions of Section 831 of the Internal Revenue Code of 1986, as amended. Under provisions of the Code, the Fund is permitted deductions for member dividends declared but not paid. The provision for federal income taxes is based upon an income tax return for the Fund as a stand-alone entity. The Fund has \$379,053 of alternative minimum tax credits to utilize against future taxes. These credits have no expiration. The Fund has no operating loss carry forwards and \$316,180 of capital loss carry forwards. These capital loss carry forwards will expire after 2016.

The tax effects of temporary differences, which give rise to the deferred taxes at December 31, 2012 and 2011, are as follows:

| | 2012 | 2011 |
|------------------------------------|-----------------------|-----------------------|
| Estimated liability for claims | \$ 2,033,377 | \$ 1,799,590 |
| Capital loss carryover | 107,501 | 433,970 |
| Other | 379,053 | 283,556 |
| Net unrealized gain on investments | <u>(8,242,056)</u> | <u>(7,362,619)</u> |
| Net deferred tax liability | <u>\$ (5,722,125)</u> | <u>\$ (4,845,503)</u> |

Income tax expense for the years ended December 31, 2012 and 2011, consist of the following:

| | 2012 | 2011 |
|----------------------|-----------------|-------------------|
| Current year expense | \$ 8,744 | \$ 1,047,151 |
| Deferred benefit | <u>(2,816)</u> | <u>(324,442)</u> |
| Income tax expense | <u>\$ 5,928</u> | <u>\$ 722,709</u> |

ASC Topic 740, *Income Taxes*, prescribes a recognition threshold and measurement attribute for the recognition, measurement, presentation, and disclosure of uncertain tax positions that the Fund has taken or expects to take on a tax return. ASC Topic 740 provides that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation process, based on the technical merits of the income tax position. Income tax positions must meet a more likely than not recognition threshold to be recognized. As of December 31, 2012 and 2011, the Fund's liability for uncertain tax positions was not material. The company believes it is no longer subject to income tax examinations for years prior to 2008.

7. RELATED PARTY TRANSACTIONS

Service fee expenses to Ladegast & Heffner Claims Service were \$6,333,566 and \$6,152,400, for the years ended December 31, 2012 and 2011, respectively. At December 31, 2012 and 2011, service fee liabilities of \$831,500 and \$890,460, respectively, were due to Ladegast & Heffner Claims Service.

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