KENTUCKY LEAGUE OF CITIES
WORKERS' COMPENSATION TRUST
Financial Statements

Years Ended June 30, 2012 and 2011
with Independent Auditors' Report Thereon

CONTENTS

DEAN || DORTON || ALLEN || FORD PLLC

Independent Auditors' Report

Board of Trustees
Kentucky League of Cities Workers' Compensation Trust
Lexington, Kentucky

We have audited the accompanying statement of net assets of Kentucky League of Cities Workers' Compensation Trust (the Trust) as of June 30, 2012, and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Trust management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Trust as of and for the year ended June 30, 2011, were audited by other auditors whose report, dated October 26, 2011, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit 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, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2012 financial statements referred to above present fairly, in all material respects, the financial position of the Trust as of June 30, 2012, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 8, 2012 on our consideration of the Trust's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that management's discussion and analysis on pages 3 - 5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United

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States of America, which consisted of inquires of management about methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

The supplementary information on page 23 is presented for purposes of additional analysis and is not a required part of the financial statements but is supplementary information required by the Department of Insurance of the Commonwealth of Kentucky. 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 not been subjected to the auditing procedures applied in the audit of the financial statements. Accordingly, it is inappropriate to and we do not express an opinion on the supplementary information referred to above.

Dean Dorton Allen Ford, PLLC

October 8, 2012
Lexington, Kentucky

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST

Management's Discussion and Analysis (*Unaudited*)

Our discussion and analysis of the Kentucky League of Cities (KLC) Workers' Compensation Trust (the Trust) provides an overview of the Trust's financial activity for the fiscal year ended June 30, 2012. It should be read in conjunction with the consolidated financial statements, which begin on page 6.

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 $1,546,305 for the current fiscal year as compared to a $4,036,313 increase during the prior fiscal year.

Table 1
Net Assets

	2012	2011
Cash and investments	$ 53,579,799	$ 50,242,308
Capital and other assets	10,576,009	10,204,233
Total assets	64,155,808	60,446,541
Unpaid losses and loss adjustment expenses	31,686,257	31,420,388
Other liabilities	6,140,326	4,243,233
Total liabilities	37,826,583	35,663,621
Total net assets	$ 26,329,225	$ 24,782,920

Statement of Revenues, Expenses and Changes in Net Assets

Table 2 shows the revenues and expenses of the Trust and is also presented on the accrual basis. Net earned premium revenue has decreased by $713,264 or 6.4% from the prior fiscal year. Although realized investment gains increased compared to prior years, unrealized losses increased by $2,928,205 which attributed primarily to the 41.55% decline in total investment related revenues. In accordance with Government Accounting Standards Board (GASB) 31, the Trust must report all changes where the fair market value of investment holdings decreased below their carrying value as an unrealized loss during the current reporting year.

During the current fiscal year, the Trust changed its case reserving philosophy. Previously, medical case reserves reflected the expected payments for the upcoming ten years. The new case reserving philosophy reflects the expected payments for the lifetime of the claim. Case reserves were increased significantly as a result of the change in case reserve philosophy. This increase was offset by favorable loss development for prior years resulting in a reduction in ultimate losses. Therefore, total loss and loss adjustment expenses for the current fiscal year were less than expected, resulting in an overall net decrease of 2.11%. General administrative expenses decreased by 2.05% compared to fiscal year 2011.

Table 2
Change in Net Assets

Year ended June 30,	2012	2011
Net premiums earned	$ **10,412,922**	$ 11,126,186
Investment and other revenue and gains	**2,852,290**	4,879,475
Total revenue	**13,265,212**	16,005,661
Losses and loss adjustment expenses	**7,642,559**	7,807,521
General administrative expenses	**4,076,348**	4,161,827
Total expenses	**11,718,907**	11,969,348
Change in net assets	$ **1,546,305**	$ 4,036,313

Description of Current and Expected Conditions

The Trust has changed claims systems and is currently changing underwriting systems. This change in platform should allow for efficiency gains and provide for more robust reporting capabilities.

The KLC Executive Board hired Jonathan Steiner as KLC Executive Director effective November 2010, Doug Goforth as Chief Insurance Services Officer effective January 2011 and Dawn Harlow as Chief Financial Officer effective April 2012.

Contacting the Organization's Financial Management

This financial report is designed to provide a general overview of 2012'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, 2012 and 2011

	2012	2011
Assets		
Investment securities, at fair value	$ 43,161,873	$ 46,265,490
Cash and cash equivalents	10,417,926	3,976,818
Accounts receivable, net of allowance for doubtful accounts of $20,000 in both 2012 and 2011	305,455	341,548
Reinsurance receivable	1,531,016	1,195,073
Accrued investment income	357,013	334,533
Prepaid expenses	75,854	82,870
Membership in NLC Mutual Insurance Company	241,255	241,255
Equipment, net of accumulated depreciation of $1,222,685 and $1,215,522 for 2012 and 2011, respectively	65,416	8,954
Surplus note receivable	8,000,000	8,000,000
Total assets	$ 64,155,808	$ 60,446,541
Liabilities and Net Assets		
Unpaid losses and loss adjustment expenses:		
Reported claims	$ 15,529,079	$ 10,162,334
Incurred but not reported claims	15,064,992	20,398,674
Unallocated loss adjustment expenses	1,092,186	859,380
Total unpaid losses and loss adjustment expenses	31,686,257	31,420,388
Accounts payable	602,805	191,710
Payable to related entity	4,442,594	3,443,077
Advance premiums	1,094,927	608,446
Total liabilities	37,826,583	35,663,621
Net assets	26,329,225	24,782,920
Total liabilities and net assets	$ 64,155,808	$ 60,446,541

See accompanying notes.

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST

Statements of Revenues, Expenses and Changes in Net Assets

Years ended June 30, 2012 and 2011

	2012	2011
Operating revenue:		
Net premiums earned	$ 10,412,922	$ 11,126,186
Operating expenses:		
Losses and loss adjustment expenses	7,642,559	7,807,521
Commission expense	764,439	686,214
Claims administration expense	994,321	1,132,052
Loss prevention expenses	166,800	183,026
Professional fees	155,163	95,279
Administrative fees, related entity	1,795,061	1,807,264
Other expenses	200,564	257,992
Total operating expenses	11,718,907	11,969,348
Operating loss	(1,305,985)	(843,162)
Nonoperating revenue:		
Interest and investment revenue and gains	2,852,290	4,879,475
Change in net assets	1,546,305	4,036,313
Net assets, beginning of year	24,782,920	20,746,607
Net assets, end of year	$ 26,329,225	$ 24,782,920

See accompanying notes.

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST

Statements of Cash Flows

Years ended June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Premiums collected	$ **10,793,829**	$ 10,313,125
Losses and loss adjustment expenses paid	**(7,376,690)**	(8,040,829)
Underwriting expenses paid	**(2,915,380)**	(3,942,167)
Other receipts (payments)	**69,547**	(383,818)
Net cash provided by (used in) operating activities	**571,306**	(2,053,689)
Cash flows from investing activities:		
Purchases of investments	**(25,219,725)**	(43,952,462)
Proceeds from sale of investments	**28,323,342**	42,929,040
Interest and dividends received	**2,829,810**	2,062,409
Net cash provided by investing activities	**5,933,427**	1,038,987
Cash flows from capital and related financing activities:		
Capital expenditures	**(63,625)**	-
Net cash used in financing activities	**(63,625)**	-
Net increase (decrease) in cash and cash equivalents	**6,441,108**	(1,014,702)
Cash and cash equivalents, beginning of year	**3,976,818**	4,991,520
Cash and cash equivalents, end of year	$ **10,417,926**	$ 3,976,818

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST

Statements of Cash Flows, continued

Years ended June 30, 2012 and 2011

	2012	2011
Reconciliation of operating loss to net cash provided by operating activities:		
Operating loss	$ **(1,305,985)**	$ (843,162)
Adjustments:		
Depreciation	**7,163**	7,164
Provision for doubtful accounts	**-**	1,880
Increase (decrease) in cash due to changes in:		
Accounts receivable	**(105,574)**	393,119
Reinsurance receivable	**(335,943)**	(64,407)
Prepaid expenses	**7,016**	335,719
Unpaid losses and loss adjustment expenses	**265,869**	(233,308)
Accounts payable	**411,095**	(259,656)
Payable to related entity	**1,141,184**	(182,978)
Advance premiums	**486,481**	(1,208,060)
Net cash provided by (used in) operating activities	$ **571,306**	$ (2,053,689)

See accompanying notes.

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST

Notes to the Financial Statements

1. Description of Organization

Effective July 1, 1978, the Kentucky Association of Counties (KACo) and the Kentucky League of Cities, Inc. (KLC) formed the KACo-KLC Self-Insurance (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. In 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 Statues. 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 385 and 404 members as of June 30, 2012 and 2011, 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 property/casualty 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 cost 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.

1. Description of Organization, continued

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 liabilities come due more quickly than assets mature, an issuer 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.

2. Summary of Significant Accounting Policies

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 Proprietary 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.

Use of 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 footnote 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.

2. Summary of Significant Accounting Policies, continued

Investment Securities

Investment securities consist of fixed maturity debt and equity securities that the Trust 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, reported within nonoperating revenue.

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

Cash and Cash Equivalents

Cash and cash equivalents consist principally of money market fund investments. For purpose 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.

Accounts Receivable

In accordance with accounting principles 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.

Equipment

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

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.

2. Summary of Significant Accounting Policies, continued

Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses are based on estimates of the ultimate cost of claims (including future claims adjustment expense) 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 cost depends 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 reflects 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 2012 and 2011. Discounting reduced the liability by $5,537,134 and $5,724,438 as of June 30, 2012 and 2011, respectively. The effect of discounting on the provision for losses and loss adjustment expenses was an increase of $187,304 in 2012 and a decrease of $47,275 in 2011.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. The Trust evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. The Trust holds funds and collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at June 30, 2012 and 2011 are recoverable.

2. Summary of Significant Accounting Policies, continued

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 Trust. No refunds were issued during 2012 or 2011.

Federal Income Taxes

The Internal Revenue Service has ruled that the income of the Fund 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.

Subsequent Events

Management has evaluated subsequent events for accounting and disclosure requirements through October 8, 2012, the date that the financial statements were available to be issued. There were no events occurring during the evaluation period that require recognition or disclosure in the financial statements.

3. 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, 2012 and 2011 are as follows:

	2012	2011
Deposits and investments classified as cash and cash equivalents:		
Cash and cash equivalents	$ 4,141,617	$ 1,771,885
Money market mutual funds and uninvested cash	6,276,309	2,204,933
	10,417,926	3,976,818
Investments classified as investment securities:		
Corporate bonds	574,025	1,011,475
Municipal bonds	15,789,281	29,908,004
U.S. government agency funds	19,574,044	2,685,957
Equity securities	1,248,005	-
Equity mutual funds	5,976,518	10,232,521
Bond mutual funds	-	2,427,533
	43,161,873	46,265,490
Total deposits and investments	$ 53,579,799	$ 50,242,308

As of June 30, 2012, the Trust had the following investment maturities in years:

	Less than 1	1-5	6-10	More than 10
Corporate bonds	$ -	$ -	$ 574,025	$ -
Municipal bonds	1,237,088	587,522	3,798,976	10,165,695
U.S. government agency obligations	2,004,246	9,358,648	3,037,234	5,173,916
Total maturities	$ 3,241,334	$ 9,946,170	$ 7,410,235	$ 15,339,611

3. Deposits and Investments, continued

Interest and investment revenue is comprised of the following for the years ended June 30, 2012 and 2011:

	2012	2011
Interest and dividend income	$ 2,081,788	$ 2,057,514
Realized gain on sales of securities	1,626,163	749,417
Unrealized (loss) gain on securities	(855,661)	2,072,544
	$ 2,852,290	$ 4,879,475

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 statue 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&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 which 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.

3. Deposits and Investments, continued

Credit Risk, continued

As of June 30, 2012, the Trust was invested in the following government agency bonds; Federal Home Loan Bank, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association. Of these bonds that were rated, all ranged in ratings from AA- to AA+. The Trust also invested in money market funds that were not rated. Additional investments include bonds and corporate bonds. Of these bonds that were rated, all ranged in ratings from A to AAA.

Concentration of Credit Risk

More than 5% of the Trust's investments are in securities issued by Kentucky State Property and Building Commission. These investments represent 5.4% of the Trust's total investments.

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.

4. Reinsurance Coverage

For the years ended June 30, 2012 and 2011, respectively, the Trust purchased specific reinsurance coverage from Safety National, an "A" (Excellent) rated insurer rated by A.M. Best and Company, and ACE, an "A+" (Superior) rated insurer by A.M. Best and Company, respectively, for the excess layer of insurance only to cover losses in excess of $1,000,000. The Trust must self-insure up to the $1,000,000 per occurrence limit. For 2012 and 2011, employer's liability loss limitations were $4,000,000 (retention of $1,000,000 plus $3,000,000 of reinsurance).

Although the purchase of reinsurance coverage does not discharge the Trust from it 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.

Reinsurance premiums ceded were $738,366 and $847,592 for the years ended June 30, 2012 and 2011, respectively. Additional recoveries accrued on paid claims during 2012 and 2011 were $935,311 and $633,170, 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 $4,939,622 and $3,480,258 in 2012 and 2011, respectively.

5. Letter of Credit

To satisfy requirements of the Department of Insurance 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, 2012, renewable annually. As of June 30, 2012 and 2011, no amounts were outstanding under the letter of credit.

6. Related Party Transactions

The following entities are KLCIS related entities:

Kentucky League of Cities (KLC)
Kentucky League of Cities Insurance Agency (KLCIA)
Kentucky League of Cities Premium Finance Company (KLCPFC)
Kentucky League of Cities Unemployment Compensation Reimbursement Trust (KLCUCRT)
Kentucky League of Cities Insurance Services Association (KLCIS)
Kentucky School Boards Insurance Trust Workers Compensation Fund (KSBITWCF)
Kentucky School Boards Insurance Trust Property and Liability Fund (KSBITPLF)

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 $1,795,061 and $1,807,264 for the years ended June 30, 2012 and 2011, respectively.

The Trust participates in a marketing agreement with Kentucky League of Cities Insurance Agency (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 $359,170 and $311,284 for the years ended June 30, 2012 and 2011, respectively.

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

The Trust reports amounts as being due from or due to related parties. Related party receivables and payables included within the Trust's statements of net assets consist of the following as of June 30:

	2012	2011
KLC accounts receivable	$ 227,711	$ 824,176
KLCUCRT accounts receivable	997,385	786,201
KSBITPLF accounts receivable	141,667	66,743
KLCPFC accounts receivable (payable)	330,875	(162,150)
KLCIS accounts payable	(5,868,928)	(4,873,746)
KLCIA accounts payable	(271,304)	(84,301)
Total due to related entities	$ (4,442,594)	$ (3,443,077)

7. 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, 2012 and 2011 is summarized as follows:

	2012	2011
Net unpaid losses and loss adjustment expenses, beginning of year	$ 31,420,388	$ 31,653,696
Incurred losses and loss adjustment expenses:		
Provision for insured events of the current year	8,396,000	9,280,000
Decrease in provision for insured events of prior years	(753,441)	(1,472,479)
Total incurred losses and loss adjustment expenses	7,642,559	7,807,521
Payments:		
Losses and loss adjustment expenses attributable to insured events of the current year	2,166,759	2,412,348
Losses and loss adjustment expenses attributable to insured events of prior years	5,209,931	5,628,481
Total payments	7,376,690	8,040,829
Net unpaid losses and loss adjustment expenses, end of year	$ 31,686,257	$ 31,420,388

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

During the current fiscal year, the Trust changed its case reserving philosophy. Previously, medical case reserves reflected the expected payments for the upcoming ten years. The new case reserving philosophy reflects the expected payments for the lifetime of the claim. Case reserves were increased significantly as a result of the change in case reserve philosophy. This increase was offset by favorable loss development for prior years resulting in a reduction in ultimate losses. Therefore, total loss and loss adjustment expenses for the current fiscal year were less than expected, resulting in an overall net decrease of 2.11%.

8. Surplus Note Agreement

In 2010, the 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 20% 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 that five percent. This note has no fixed maturity date. The entire $8 million dollars will be recovered either through repayment or alternate plan as deemed appropriate by the DOI.

DEAN || DORTON || ALLEN || FORD PLLC

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Board of Trustees
Kentucky League of Cities Workers' Compensation Trust
Lexington, Kentucky

We have audited the financial statements of Kentucky League of Cities Workers' Compensation Trust (the Trust) as of and for the year ended June 30, 2012, and have issued our report thereon dated October 8, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Trust is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Trust's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Trust's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Trust's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Trust's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters we reported to management of the Trust in a separate letter dated October 8, 2012.

This report is intended solely for the information and use of the Board of Trustees, the audit committee and management of the Trust, and the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

Dean Dorton Allen Ford, PLLC

October 8, 2012
Lexington, Kentucky

KENTUCKY LEAGUE OF CITIES WORKERS' COMPENSATION TRUST
Claims Development Information (*Unaudited*)
Years ended June 30, 2003 through 2012

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 reestimated 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 reestimation 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 reestimated 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 reestimated 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 data for successive policy years.

		Workers' Compensation Pool									
		Fiscal and Policy Year Ended									
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
(1)	Earned premium revenue and net investment income:										
	Earned	$ 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	$ 14,003,578
	Ceded	589,056	830,510	1,089,205	1,095,237	1,700,660	1,340,759	1,219,481	1,368,978	847,592	738,366
	Net earned	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	13,265,212
(2)	Unallocated expenses	4,070,818	4,014,435	3,886,286	3,155,633	3,641,177	3,744,228	3,685,385	3,435,931	4,161,830	4,076,352
(3)	Estimated incurred claims and expenses, end of policy year:										
	Incurred	11,908,515	12,500,000	10,400,000	11,810,000	12,060,000	12,000,000	10,980,000	9,300,000	9,280,000	8,396,000
	Ceded	514,764	-	-	-	-	-	-	-	-	-
	Net incurred	11,393,751	12,500,000	10,400,000	11,810,000	12,060,000	12,000,000	10,980,000	9,300,000	9,280,000	8,396,000
(4)	Net paid (cumulative) as of:										
	End of policy year	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	2,166,759
	One year later	4,860,134	5,934,955	5,241,080	5,615,096	5,710,452	3,713,329	4,582,157	4,267,533	4,305,129	
	Two years later	6,579,844	7,536,842	6,681,882	7,138,085	7,439,053	4,700,280	5,962,097	5,408,939		
	Three years later	7,164,848	8,694,677	7,469,538	7,638,292	8,400,115	5,134,088	6,829,093			
	Four years later	8,577,852	9,584,453	7,774,517	8,087,935	8,995,800	5,424,794				
	Five years later	9,121,981	10,407,571	7,970,650	8,386,011	9,258,624					
	Six years later	9,308,808	10,698,540	8,080,195	8,513,158						
	Seven years later	9,484,302	11,031,694	8,317,300							
	Eight years later	9,633,390	11,241,048								
	Nine years later	9,786,088									
(5)	Reestimated ceded claims and expenses	-	518,242	-	-	-	-	-	-	-	-
(6)	Reestimated net incurred claims and expenses:										
	End of policy year	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	8,396,000
	One year later	10,540,000	12,370,000	10,300,000	11,536,000	12,866,000	10,250,000	10,580,000	9,000,000	8,770,000	
	Two years later	12,160,000	12,250,000	10,440,000	11,306,000	12,099,000	9,370,000	10,300,000	8,360,000		
	Three years later	11,611,000	12,796,000	10,025,000	10,812,000	12,055,000	8,240,000	10,560,000			
	Four years later	11,894,807	13,043,000	9,661,000	10,796,000	11,772,000	7,270,000				
	Five years later	11,472,774	13,429,000	9,396,000	10,512,000	12,104,000					
	Six years later	11,436,097	13,273,000	9,682,000	10,467,000						
	Seven years later	11,195,357	13,015,000	9,771,000							
	Either years later	11,393,751	13,105,108								
	Nine years later	11,403,109									
(7)	Increase (decrease) in estimated net incurred claims and expenses from the end of the policy year	9,358	605,108	(629,000)	(1,343,000)	44,000	(4,730,000)	(420,000)	(940,000)	(510,000)	-

See independent auditors' report.