

# KESA

Workers' Comp  
From Head To Toe

A close-up photograph of a woman's face, focusing on her eyes and forehead. She has dark hair pulled back and is looking upwards and to the left. The background is a solid light green color.

KESA paid  
393 eye injury  
claims in 2008.  
Personal protective  
equipment should  
never be  
overlooked.

“Workers’ comp from head to toe” means more than total coverage for workers. It means total coverage for Kentucky. For over 29 years, that’s been our first priority.

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## *A message from our Executive Director*



KESA is in the business of evaluating risk. Every day we study, analyze, and prepare for workplace injuries because every day, despite our best prevention efforts and those of our member companies, workplace injuries occur. And when a workplace injury occurs, it has a long-reaching ripple effect on all involved: the employee who must undergo medical treatment, the family who is dependent on the worker's income, and the employer whose productivity is compromised. KESA steps in to care for the employee from head to toe, to make the employee whole, and to provide medical and indemnity payments so he or she can recover as quickly as possible and get back on the job.

To help injured employees, KESA's first responsibility is to maintain financial strength and stability regardless of the overall economic climate. Our 2008 audited financial statements are presented in the following pages for your review. We closed 2008 with our earned premiums reaching \$50,399,584, down 13% from \$58,163,680 at the close of 2007. Our cash and invested assets grew to \$145,338,716, up 3.7% from \$140,112,259 a year ago, and our members' equity totaled \$19,590,526, which was just under last year's \$20,124,137. Our insured payrolls topped \$4 billion and our member count grew to 5,643 from 5,404 last year.

As we enter our thirtieth year of providing workers' comp coverage for employers and employees in the Commonwealth of Kentucky, KESA will continue to build upon its legacy of integrity, responsibility, and financial strength. And when workplace injuries occur, KESA will be there to help the injured employee recover fully and get back to work. KESA, Workers' Comp From Head To Toe.

A handwritten signature in blue ink that reads "Gregory L. Buie". The signature is written in a cursive, flowing style.

Gregory L. Buie  
Executive Director



Hand injuries are  
KESA's 4th most  
frequent claim.  
In 2008, KESA  
paid 564 hand  
injury claims.

Carpal tunnel syndrome  
is the #1 cause of missed  
days for workers 45 to 64.  
The National Institutes  
of Health estimates that  
carpal tunnel causes 3 of  
every 10,000 employees  
to lose time at work.

## *About KESA*

### **KESA is a not-for-profit fund**

Unlike conventional insurance companies with ambitious profit goals, KESA is a not-for-profit fund. If we collect more premiums than needed for administrative and claims costs, we return the unused premiums back to our members by lowering premiums, increasing members' equity, or paying dividends.

Some companies have shied away from workers' comp funds because of a fund's right to assess additional premiums. KESA works diligently every day to negate any possibility of an assessment. First and foremost, KESA reserves properly for all claims activity, meaning we set aside an appropriate amount of funds to cover claims to their ultimate cost. Also, KESA properly evaluates and prices each account and we educate member companies in safety and loss prevention. KESA also uses a portion of members' premiums to purchase excess insurance, which is insurance provided by another carrier that assumes a part of the financial liability of catastrophic claims. KESA also strategically invests the members' premium dollars, which generates investment income that is used to offset expenses.

### **KESA covers Kentucky**

KESA's only objective is to write workers' comp coverage in the Commonwealth of Kentucky. That means, like you, we live here and work here. We've traveled the state many times over to handle claims, offer safety and loss prevention seminars, and meet with our members and agents. KESA is in its 29th year of writing coverage in Kentucky, which means we know the key people in workers' comp—the doctors and other medical providers, lawyers, and administrative law judges. That means KESA knows the right person to call to get you the help you need fast. KESA knows Kentucky.

### **KESA is financially stable**

While other workers' comp providers have come and gone, KESA has stood strong for over 29 years. Our longevity stems from our commitment to be a fiscally responsible fund. KESA is regulated by the Kentucky Office of Insurance, which performs periodic comprehensive audits. Plus, each year we have to reapply to the Office of Insurance to maintain our status as a group self-insurance fund. We are required to submit actuarial reporting as well as annual financial reports to assess our strength and integrity as a self-insured fund. In addition to state regulation, a member elected Board of Trustees oversees KESA and closely monitors the fund's activities.

DEAN DORTON FORD  
P.C.

Independent Auditors' Report

Board of Trustees  
KESA, The Kentucky Workers'  
Compensation Fund  
Louisville, Kentucky

We have audited the accompanying balance sheets of KESA, The Kentucky Workers' Compensation Fund (the Fund) as of December 31, 2008 and 2007, and the related statements of income, comprehensive income and change in members' equity and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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 the Fund as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

April 17, 2009  
Louisville, Kentucky



Last year,  
KESA paid over  
\$2.4 million  
in claims for  
shoulder injuries—  
the second  
highest category.



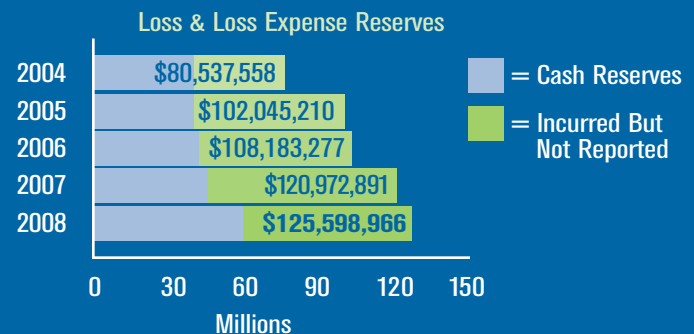
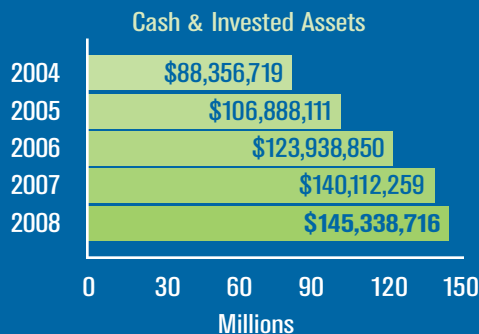
Knee injuries  
are costly. KESA  
paid over  
\$2.3 million in  
knee injury claims  
in 2008.


# Balance Sheet

December 31, 2008 and 2007

	2008	2007
<b>ASSETS</b>		
Investments	\$124,637,229	\$132,155,691
Cash and Cash Equivalents	20,701,487	7,956,568
Prepaid excess insurance premiums	429,102	665,389
Prepaid income taxes	—	108,806
Accrued interest and dividends	1,086,218	1,029,087
Premiums receivable, net	14,228,203	15,671,216
Excess insurance receivables and recoverables	5,254,778	6,350,303
Deferred federal income taxes	2,089,972	661,084
Furniture and equipment, net	1,794,369	2,535,177
Other assets	185,243	147,768
<b>Total assets</b>	<b>\$170,406,601</b>	<b>\$167,281,089</b>
<b>LIABILITIES AND MEMBERS' EQUITY</b>		
Unpaid losses and loss adjustment expenses:		
Reported losses	\$48,252,262	\$47,165,451
Incurred but not reported losses	77,346,704	73,807,440
<b>Total unpaid losses and loss adjustment expenses</b>	<b>125,598,966</b>	<b>120,972,891</b>
Unearned premiums	19,538,475	20,512,573
Advance premiums	2,114,722	2,450,174
Commissions payable	487,131	493,191
Accounts payable and accrued expenses	1,455,122	1,148,256
Federal income taxes payable	234,312	—
Special Fund tax payable	1,387,347	1,579,867
<b>Total liabilities</b>	<b>150,816,075</b>	<b>147,156,952</b>
<b>Members' equity</b>	<b>19,590,526</b>	<b>20,124,137</b>
<b>Total liabilities and members' equity</b>	<b>\$170,406,601</b>	<b>\$167,281,089</b>

See accompanying notes.





Workers aged  
20 – 34 are most  
likely to miss work  
because of back  
injury. The top  
reason is a  
sprain to the  
lumbar region.\*

\*Source: NCCI

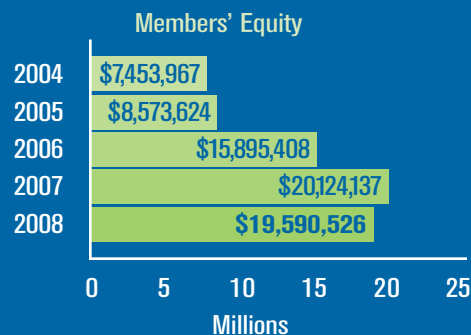
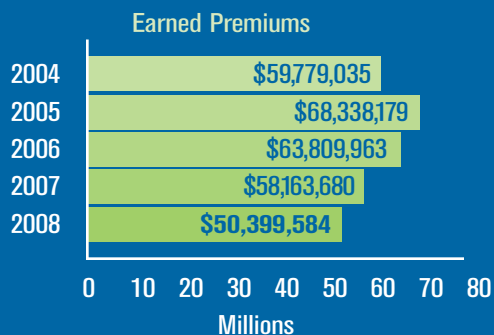
2008 National Council on Compensation Insurance, Inc.

# Statement of Income, Comprehensive Income and Change in Members' Equity

Years ended in December 31, 2008 and 2007

	2008	2007
<b>REVENUES:</b>		
Premiums earned	\$50,399,584	\$58,163,680
Net investment income	5,136,532	5,242,947
Net realized (losses) gains on investments	(1,618,235)	381,806
<b>Total revenues</b>	<b>\$53,917,881</b>	<b>63,788,433</b>
<b>EXPENSES:</b>		
Losses and loss adjustment expenses, net	37,481,331	43,336,220
Excess insurance premiums	4,437,029	4,748,411
Commissions	6,047,950	6,979,642
Underwriting expenses	4,788,170	4,497,067
<b>Total Expenses</b>	<b>\$52,754,480</b>	<b>59,561,340</b>
Income before impairment and income taxes	1,163,401	4,227,093
Impairment of investments	1,595,476	—
Provision for income taxes:		
Current	593,165	629,987
Deferred	(1,110,220)	476,506
<b>Total income tax (benefit) provision</b>	<b>(517,055)</b>	<b>1,106,493</b>
<b>Net Income</b>	<b>\$84,980</b>	<b>3,120,600</b>
Other comprehensive income, net of tax:		
Unrealized (losses) gains on securities available-for-sale, net of reclassification adjustment	(618,591)	1,108,129
<b>Total comprehensive (loss) income</b>	<b>(533,611)</b>	<b>4,228,729</b>
Members' equity, beginning of year	20,124,137	15,895,408
<b>Members' equity, end of year</b>	<b>\$19,590,526</b>	<b>\$20,124,137</b>

See accompanying notes.



# Statement of Cash Flows

Years ended in December 31, 2008 and 2007

	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$84,980	\$3,120,600
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	820,065	723,684
Net realized losses (gains) on investments	1,618,235	(381,806)
Impairment of investments	1,595,476	—
Amortization of premiums and discounts, net	413,019	(28,123)
Loss on disposal of furniture and equipment	2,038	—
Bad debt expense	251,998	294,552
Deferred federal income taxes	(1,110,220)	476,506
Increase (decrease) in cash due to changes in:		
Prepaid excess insurance premiums	236,287	(459,468)
Prepaid income taxes	108,806	(108,806)
Accrued interest and dividends	(57,131)	(28,098)
Premiums receivable, net	1,191,015	2,025,907
Excess insurance receivables and recoverables	1,095,525	(82,273)
Other assets	(37,475)	(6,820)
Unpaid losses and loss adjustment expenses	4,626,075	12,789,614
Unearned premiums	(974,098)	(1,986,798)
Advance premiums	(335,452)	(29,043)
Commissions payable	(6,060)	43,940
Accounts payable and accrued expenses	306,866	64,753
Federal income taxes payable	234,312	(1,284,012)
Special Fund tax payable	(192,520)	(413,191)
<b>Net cash provided by operating activities</b>	<b>\$9,871,741</b>	<b>\$14,731,118</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of investments	(52,232,359)	(49,656,021)
Proceeds from sales of investments	22,243,339	17,006,782
Purchase from maturities of investments	32,943,493	17,350,490
Purchase of furniture and equipment	(81,295)	(646,620)
Net cash provided by (used in) investing activities	2,873,178	(15,945,369)
Net increase (decrease) in cash and cash equivalents	12,744,919	(1,214,251)
Cash and cash equivalents, beginning of year	7,956,568	9,170,819
<b>Cash and cash equivalents, end of year</b>	<b>\$20,701,487</b>	<b>\$7,956,568</b>
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid during the year for income taxes	\$250,000	\$250,000
Noncash investing activities:		
Unrealized (losses) gains on securities, net of reclassification adjustment	\$(937,259)	\$1,678,983
Deferred tax benefit (provision) related to change in unrealized gains and losses on securities	318,668	(570,854)

See accompanying notes.

# Notes to Financial Statements

## 1. Description of the Fund

KESA, The Kentucky Workers' Compensation Fund (the Fund) was organized January 1, 1980 as a self-insurance fund administered by Trustees, who are primarily members of the Kentucky Employers Safety Association, Inc. The purpose of the Fund is to provide insurance to members for workers' compensation risks. The Fund is not intended to be a profit-making entity.

The Fund's bylaws and certain statutes of the Commonwealth of Kentucky state that premiums are to be collected in an amount necessary to provide the Fund sufficient monies to pay claims based upon statutory requirements. The Trustees are restricted from utilizing any of the premiums collected for any purpose unrelated to workers' compensation for a period of at least 36 months after the expiration of the self-insurance term.

It is the Trustees' intent to apply excess premiums arising from a self-insurance term as an offset against premium deficiencies which may arise from other self-insurance terms. Any excess premiums remaining after the above application may be refunded at the discretion of the Trustees at the end of the 36month period. If the assets of the Fund are not sufficient to permit the Fund to discharge its liabilities and to maintain required reserves, the Fund may assess its members for the amount necessary to eliminate the deficiency.

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

### Legal and Regulatory Risk

Legal and regulatory risk is the risk that changes in state laws or in the regulatory environment in which an insurer operates will occur and create additional losses or expenses not anticipated by the insurer in pricing its products. KESA is exposed to this risk because substantially all of its business is written 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 excess insurers, that owe the insurer money will not pay. KESA minimizes this risk by adhering to a conservative investment strategy, by utilizing financially sound excess insurers, 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. KESA 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 insurer would have to sell assets prior to maturity and recognize a gain or loss.

## 2. Summary of Significant Accounting Policies

### Basis of Presentation

The Fund 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.

# Notes to Financial Statements, *continued*

## 2. Summary of Significant Accounting Policies, *continued*

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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.

### Investments

Investment securities are classified upon acquisition as held-to-maturity, trading or available-for-sale. Currently, all of the Fund's investments are held as available-for-sale securities. Available-for-sale securities are those securities that would be available to be sold in the future in response to liquidity needs, changes in market interest rates and asset-liability management strategies. Available-for-sale securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of members' equity, net of deferred tax. Equity securities are carried at quoted market values. Fair values of fixed maturities and equity securities are determined on the basis of dealer or market quotations or comparable securities on which quotations are available. The Fund regularly evaluates all of its investments based on current economic conditions, credit loss experience and other specific developments. If there is a decline in a security's net realizable value that is determined to be other than temporary, it is treated as a realized loss and the cost basis of the security is reduced to its estimated fair value.

Amortization of premiums and accretion of discounts are recorded using a method that approximates a level yield. The specific-identification method is used to determine the cost of securities. The Fund considers anticipated investment income in determining if a premium deficiency exists.

### Derivative Instruments

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), requires that every derivative instrument be recorded on the balance sheet as an asset or liability measured at its fair value and that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. The Fund invests in derivative instruments as part of the overall investment strategy to diversify its portfolio. A limited number of the Fund's investments are defined as derivatives under SFAS 133. These investments are considered embedded derivative instruments and have not been designated as hedges; accordingly, the changes in market values are recorded in earnings. The mark-to-market impact of these derivatives on earnings was a loss of \$901,066 and a gain of \$241,173 as of December 31, 2008 and 2007, respectively.

# Notes to Financial Statements, *continued*

## 2. Summary of Significant Accounting Policies, *continued*

### Cash and Cash Equivalents

Cash and cash equivalents in the financial statements include cash on hand, cash in bank, money market accounts and U.S. Treasury notes with a maturity of three months or less.

### Allowance for Doubtful Accounts

The Fund estimates its allowance for doubtful accounts as 0.5% of written premiums each year adjusted subsequently based on a qualitative analysis of individual account billing and payment history. Premiums receivable are shown on the balance sheet net of an allowance for doubtful accounts of approximately \$1,382,000 and \$1,138,000 at December 31, 2008 and 2007, respectively. Amounts are charged to operations at the point they are determined to be uncollectible.

### Furniture and Equipment

Furniture and equipment are stated at cost less accumulated depreciation. Depreciation is provided for in amounts sufficient to allocate the cost of depreciable assets to operations over estimated service lives ranging from five to seven years, utilizing the straight-line method. Accumulated depreciation was \$2,857,268 and \$2,051,092 as of December 31, 2008 and 2007, respectively. Depreciation expense was \$820,065 and \$723,684 during 2008 and 2007, respectively.

### Premium Revenue, Advance Premiums and Unearned Premiums

Premium revenue is based on the total covered payroll of participating employers and is recognized as earned on a pro rata basis over the policy coverage period. The unearned portion of such premiums is recorded as unearned premiums on the accompanying balance sheet. Advance premiums represent the portion of premiums received prior to the policy's effective date.

Earned premiums are recorded as revenue net of the Kentucky Special Fund tax assessments which are invoiced and collected along with insurance premiums. These assessments are remitted quarterly to the Kentucky Workers' Compensation Funding Commission.

### Unpaid Losses and Loss Adjustment Expenses

The provision for losses and loss adjustment expenses includes unpaid claims and expenses associated with settling claims, including legal fees. The liability for unpaid losses and loss adjustment expenses is based on claims adjusters' evaluations of individual claims and management's evaluation and an actuarial review of experience with respect to the probable number and nature of claims arising from losses that have been incurred but have not yet been reported. The liability represents the estimated ultimate cost of settling the claims, including the effects of inflation and other societal and economic factors. Any adjustments resulting from the settlement of losses will be reflected in earnings at the time the adjustments are determined.

### Excess Insurance

In the normal course of business, the Fund seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or excess insurers. Excess insurance premiums, losses and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the excess insurance contracts.

# Notes to Financial Statements, *continued*

## 2. Summary of Significant Accounting Policies, *continued*

### Advertising

Advertising costs are expensed as incurred. Total advertising expenses included in underwriting expenses are \$388,306 and \$266,817 for 2008 and 2007, respectively.

### Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred income taxes are provided for cumulative temporary differences between the balances of assets and liabilities determined under GAAP and balances determined for tax reporting purposes. The Fund is exempt from state income taxes.

In accordance with Financial Accounting Standards Board (FASB) Staff Position No. FIN 48-3, the Fund has elected to defer the effective date of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, until its fiscal year ending December 31, 2009. The Fund has continued to account for any uncertain tax positions in accordance with literature that was authoritative immediately prior to the effective date of FIN 48, such as FASB Statement No. 109, *Accounting for Income Taxes*, and FASB Statement No. 5, *Accounting for Contingencies*.

### Comprehensive Income

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

### Reclassifications

Certain 2007 amounts have been reclassified to conform to the 2008 presentation with no effect on net income or members' equity.

## Notes to Financial Statements, *continued*

### 3. Investments

The December 31, 2008 amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agency securities	\$ 31,637,864	\$ 2,511,033	\$ —	\$ 34,148,897
Corporate securities	4,790,208	257,354	(4,743)	5,042,819
Municipal securities	21,481,601	494,308	(209)	21,975,700
Convertible bonds	9,525,594	104,482	(1,400,834)	8,229,242
Mortgage-backed securities	44,761,069	1,226,455	(565,127)	45,422,397
Total fixed maturities	112,196,336	4,593,632	(1,970,913)	114,819,055
Mutual funds	83,683	10	(26,805)	56,888
Equity securities	11,683,388	545,413	(2,467,515)	9,761,286
Total	\$ 123,963,407	\$ 5,139,055	\$ (4,465,233)	\$ 124,637,229

The December 31, 2007 amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agency securities	\$ 42,041,858	\$ 1,235,436	\$ (12,043)	\$ 43,265,251
Corporate securities	1,133,097	585	(3,585)	1,130,097
Municipal securities	20,984,680	101,156	(255,932)	20,829,904
Convertible bonds	11,053,251	628,412	(402,354)	11,279,309
Mortgage-backed securities	41,704,314	361,127	(429,073)	41,636,368
Total fixed maturities	116,917,200	2,326,716	(1,102,987)	118,140,929
Mutual funds	60,801	6,973	(142)	67,632
Equity securities	12,420,923	2,476,959	(950,752)	13,947,130
Total	\$ 129,398,924	\$ 4,810,648	\$ (2,053,881)	\$ 132,155,691

Proceeds from sales and maturities of investments during 2008 and 2007 were \$55,186,832 and \$34,357,272, respectively. Gross realized gains from fixed income securities were \$158,074 and \$586,843 for 2008 and 2007, respectively, and gross realized losses from fixed income securities were \$1,894,454 and \$148,706 for 2008 and 2007, respectively. Gross realized gains from equity securities were \$1,209,765 and \$584,238 for 2008 and 2007, respectively, and gross realized losses from equity securities were \$2,687,096 and \$640,569 for 2008 and 2007, respectively.

The amortized cost and fair value of investments at December 31, 2008, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations

## Notes to Financial Statements, *continued*

### 3. Investments, *continued*

with or without call or repayment penalties. The average rate of assumed investment yield in effect for 2008 and 2007 was 4.53% and 4.57%, respectively.

	Amortized Cost	Fair Value
Due in one year or less	\$ 12,605,515	\$ 12,661,712
Due after one year through five years	27,027,490	28,320,151
Due after five years through ten years	20,472,489	21,741,427
Due after ten years	52,090,842	52,095,765
	<u>\$ 112,196,336</u>	<u>\$ 114,819,055</u>

The following table provides 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, 2008 and 2007:

	December 31, 2008					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate securities (1)	\$ 505,800	\$ (4,743)	\$ —	\$ —	\$ 505,800	\$ (4,743)
Municipal securities (1)	99,791	(209)	—	—	99,791	(209)
Convertible bonds (23)	5,050,434	(1,009,421)	1,235,720	(391,413)	6,286,154	(1,400,834)
Mortgage-backed securities (14)	5,056,162	(545,293)	2,072,018	(19,834)	7,128,180	(565,127)
Mutual funds (13)	42,476	(20,229)	10,451	(6,576)	52,927	(26,805)
Equity securities (76)	4,926,325	(1,996,263)	1,328,947	(471,252)	6,255,272	(2,467,515)
<b>Total</b>	<b>\$ 15,680,988</b>	<b>\$ (3,576,158)</b>	<b>\$ 4,647,136</b>	<b>\$ (889,075)</b>	<b>\$ 20,328,124</b>	<b>\$ (4,465,233)</b>

	December 31, 2007					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government and agency securities (3)	\$ —	\$ —	\$ 4,244,380	\$ (12,043)	\$ 4,244,380	\$ (12,043)
Corporate securities (3)	—	—	1,030,310	(3,585)	1,030,310	(3,585)
Municipal securities (9)	—	—	10,584,713	(255,932)	10,584,713	(255,932)
Convertible bonds (12)	3,082,370	(143,420)	2,066,116	(258,934)	5,148,486	(402,354)
Mortgage-backed securities (26)	2,237,143	(48,855)	16,947,525	(380,218)	19,184,668	(429,073)
Mutual funds (3)	7,976	(87)	4,019	(55)	11,995	(142)
Equity securities (44)	3,048,548	(649,501)	1,576,060	(301,251)	4,624,608	(950,752)
<b>Total</b>	<b>\$ 8,376,037</b>	<b>\$ (841,863)</b>	<b>\$ 36,453,123</b>	<b>\$ (1,212,018)</b>	<b>\$ 44,829,160</b>	<b>\$ (2,053,881)</b>

# Notes to Financial Statements, *continued*

## 3. Investments, *continued*

Management evaluates securities for other-than-temporary impairments at least on a yearly basis and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Fund to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

These unrealized losses relate principally to current interest rates for similar types of securities. Bond market 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. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies, or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. During 2008, the Fund recorded other-than-temporary impairments of \$1,595,476 on securities. During 2007, the Fund had no other-than-temporary impairments.

As required by the Kentucky Department of Insurance, the Fund has pledged surety in the amount of \$13,923,402 as collateral for the payment of workers' compensation claims. The amount pledged is to remain under the joint control of the Fund and the Kentucky Office of Insurance, for the exclusive payment of any liability for workers' compensation claims due through December 31, 2008. As of December 31, 2007, the amount pledged was \$11,689,748.

# Notes to Financial Statements, *continued*

## 4. Fair Value Measurements

In 2008, the Fund adopted FASB Statement No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value as the price 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 statement establishes a framework for measuring fair value and expands disclosures regarding fair value measurements in accordance with GAAP. SFAS 157 applies to fair value measurements already required or permitted by existing standards.

One key component of the implementation of SFAS 157 includes the development of a three-tiered fair value hierarchy. Assets and liabilities reported at fair value are placed in one of the three tiers based upon the “inputs” used to determine fair value at the measurement date. These inputs are summarized in the three broad levels listed below:

- Level 1 quoted prices in active markets for identical assets,
- Level 2 other significant inputs (including quoted prices of similar securities, interest rates, prepayment spreads, credit risk, etc.), and
- Level 3 significant unobservable inputs.

The fair value of assets and liabilities, if applicable, at December 31, 2008 are as follows:

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>ASSETS</b>				
U.S. government and agency securities	\$ 34,148,897	\$ 14,712,523	\$ 19,436,374	\$ —
Corporate securities	5,042,819	—	5,042,819	—
Municipal securities	21,975,700	—	21,975,700	—
Convertible bonds	8,229,242	—	8,229,242	—
Mortgage-backed securities	45,422,397	—	45,422,397	—
Mutual funds	56,888	56,888	—	—
Equity securities	9,761,286	8,217,693	1,543,593	—
<b>Total Assets</b>	<b>\$ 124,637,229</b>	<b>\$ 22,987,104</b>	<b>\$ 101,650,125</b>	<b>\$ —</b>

# Notes to Financial Statements, *continued*

## 5. Unpaid Losses and Loss Adjustment Expenses

Activity in the liability for unpaid losses and loss adjustment expenses, before discounting, is summarized as follows:

	2008	2007
Balance at January 1	\$ 144,493,454	\$ 128,467,034
Less excess insurance recoverable	(6,137,322)	(6,028,654)
Net balance at January 1	138,356,132	122,438,380
Incurred related to:		
Current year	47,485,993	48,573,265
Prior years	(9,114,080)	(215,615)
Total incurred	38,371,913	48,357,650
Paid related to:		
Current year	12,383,677	11,714,960
Prior years	19,865,337	20,724,938
Total paid	32,249,014	32,439,898
Net balance at December 31	144,479,031	138,356,132
Plus excess insurance recoverable	4,980,421	6,137,322
Balance at December 31	\$ 149,459,452	\$ 144,493,454

The aggregate liability has been discounted using discount factors over the anticipated payment periods to reflect the time value of money. At December 31, 2008 and 2007, the Fund discounted its aggregate liability using an interest rate of 4.06% and 3.97%, respectively. At December 31, 2008 and 2007, reserves for estimated claims and claims adjustment expenses have been discounted by approximately \$23,860,000 and \$23,520,000, respectively. Of the discount, approximately \$4,903,000 and \$5,352,000 relate to current year incurred losses for 2008 and 2007, respectively.

## 6. Federal Income Taxes

The Fund files its federal income tax return as “an insurance company other than a life insurance company” under Section 831 of the Internal Revenue Code. In lieu of state income taxes, state regulations require that group self-insurers pay premium-based taxes in support of the Commonwealth of Kentucky Special Fund.

As described in Note 2, deferred income taxes are provided for temporary differences resulting from the recognition of income and expenses in different periods for financial statement and income tax purposes under FAS 109. FAS 109 requires an asset and liability approach to financial accounting and reporting for income taxes. The difference between the financial statement and tax bases of assets and liabilities is determined annually. Valuation allowances are

# Notes to Financial Statements, *continued*

## 6. Federal Income Taxes, *continued*

established, if necessary, to reduce the deferred tax asset to the amount that will more likely than not be realized. The difference between federal income taxes computed at 34%, the statutory rate, and federal income tax expense is due primarily to the Fund's investments in tax exempt securities and realized capital losses.

Significant components of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are presented below:

	2008	2007
<b>Deferred tax assets:</b>		
Advance and unearned premiums	\$ 1,472,417	\$ 1,561,467
Allowance for doubtful accounts	469,953	387,064
Capital loss carryforward	1,150,935	58,273
Total deferred tax assets	3,093,305	2,006,804
<b>Deferred tax liabilities:</b>		
Net unrealized gains on available-for-sale securities	536,587	855,302
Other	466,746	490,418
Total deferred tax liabilities	1,003,333	1,345,720
Net deferred tax assets	\$ 2,089,972	\$ 661,084

At December 31, 2008 the Fund had capital loss carry-forwards of approximately \$3,214,000 that will expire at various times through 2013. The Fund paid federal income taxes of \$250,000 in both 2008 and 2007. The Fund's pretax income for income tax purposes was more than that reported in the financial statements by approximately \$1,884,000 for the year ended December 31, 2008, and less than that reported in the financial statements by approximately \$2,332,000 for the year ended December 31, 2007.

## 7. Excess Insurance Coverage

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

For the years ended December 31, 2008 and 2007, the Fund carried specific excess insurance, which provided statutory limits in excess of \$1,000,000 per occurrence. Aggregate excess insurance provides coverage if the total losses of the Fund exceed an established loss fund. The Fund has not purchased aggregate insurance since 2002 but has obtained a waiver of the requirement to purchase aggregate insurance coverage from the Kentucky Department of Insurance.

Although the purchase of excess insurance coverage does not discharge the Fund from its primary liability to its members, the excess insurance company that assumes the coverage assumes the related liability, and it is the practice of organizations

# Notes to Financial Statements, *continued*

## 7. Excess Insurance Coverage, *continued*

such as the Fund for accounting purposes to treat insured risks, to the extent of excess insurance coverage, as though they were risks for which the Fund is not liable. However, the Fund remains contingently liable in the event its excess insurer is unable to meet their contractual obligation.

Excess insurance premiums were \$4,437,029 and \$4,748,411 for the years ended December 31, 2008 and 2007, respectively. Excess insurance recoveries on paid claims during 2008 and 2007 were \$274,356 and \$212,981, respectively. The estimated recoverables on claims were \$4,980,421 and \$6,137,322 in 2008 and 2007, respectively. See Note 5 for further information.

## 8. Comprehensive (Loss) Income

The amount of other comprehensive (loss) income and the related income tax components are as follows as of December 31:

	2008	2007
Unrealized holding (losses) gains arising during the year	\$ (4,150,970)	\$ 2,060,789
Reclassification adjustment for losses (gains) realized on investments	3,213,711	(381,806)
Other comprehensive (loss) income	(937,259)	1,678,983
Related income tax benefit (expense)	318,668	(570,854)
Other comprehensive (loss) income, net of tax	\$ (618,591)	\$ 1,108,129

## 9. Retirement Plan

The Fund has a 401(k) savings plan which allows eligible employees to contribute up to the maximum amount allowed by the Internal Revenue Service. The Fund will match one hundred percent of each participant's elective contribution up to four percent of their compensation. The Fund's matching contribution was \$97,366 and \$95,173 in 2008 and 2007, respectively.

## 10. Commitments

The Fund leases various equipment and office space under operating leases expiring at various dates through December 2010. Total rental expense in 2008 and 2007 was \$327,854 and \$315,842, respectively. The Fund has the option to renew the office space lease for an additional five year term.

The following schedule details future minimum lease payments as of December 31, 2008 for operating leases with initial or remaining lease terms in excess of one year.

	Rental Cost
2009	\$ 269,980
2010	145,619
	\$ 415,599

# Notes to Financial Statements, *continued*

## 11. Contingencies

The Fund is involved in various lawsuits on behalf of members involving compensatory insurance claims. Estimates of these potential liabilities have been taken into consideration in determining the reserve for reported claims, and any payments resulting from these claims will be charged to such reserve (see Note 5).

## 12. Concentration of Credit Risk

At various times during the year, the Fund's cash in bank balance exceeded the federally insured limits. Effective October 3, 2008, FDIC deposit insurance temporarily increased from \$100,000 to \$250,000 for each individual account through December 31, 2009. As of December 31, 2008 and 2007, the Fund's uninsured cash balance totaled \$4,767,772 and \$1,330,370, respectively.

The Fund evaluates the financial condition of its excess insurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the excess insurers to minimize its exposure to significant losses from excess insurer insolvency. At December 31, 2008 and 2007, excess insurance receivables with a carrying value of \$5,254,778 and \$6,350,303, respectively, were associated with multiple excess insurers with a rating of A or better by A.M. Best Company. The Fund maintains no collateral or other security for financial instruments subject to credit risk.

## 13. Fair Value of Financial Instruments

The following methods and assumptions were used by the Fund in estimating its fair value disclosures for financial instruments:

*Investment in Securities:* For investments in securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

*Cash and Cash Equivalents and Other Items For Which Fair Value Disclosure is Required:* The carrying amount reported in the balance sheet for such items is either fair value or approximates fair value, due to their short-term nature.

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