It's Personal.

2004 Annual Report

We Keep Kentucky Working

Gregory L. Buie
Executive Director

KESA

We Keep Kentucky Working

The KESA Belief Statements

We believe in making decisions based on integrity not profitability.

We believe an injured employee deserves respect and we show respect through prompt and courteous service.

We believe it is our responsibility, along with our members and agents, to keep the work-force of Kentucky at work.

We believe that there is not now, nor will there be in the future, a better, more valuable, or more conscientious workers' compensation provider than KESA.

TO OUR PARTNERS

IT'S PERSONAL

At its very core, workers' compensation is a profoundly personal business. Although I may not be stationed deep in the trenches every day, I am close enough to the action to be constantly reminded that the essence of our business is human frailty and, many times, personal tragedy. For every workplace injury, there is a story of loss. Sometimes minimum loss; sometimes devastating, irreparable financial and emotional loss. KESA's job is to mitigate the loss, to make the person whole, to assist families jeopardized by lost wages, and, on a much larger scope, to keep the workforce of Kentucky fully in tact. To do that, we balance our understanding and compassion for human injury with a demanding, tenacious approach toward pricing, reserving, and investing our members' premiums so that each dollar is optimized. Every step of the way, the process is personal. From our in-house claims professionals talking one-on-one with injured employees each day, to our loss control staff working diligently with employers to identify and improve safety conditions in the workplace, to Nancy, our receptionist, who personally answers every phone call that rings in to KESA, we believe the personal touch is KESA's hallmark. Perhaps that's why, for 25 years, Kentucky's employers have chosen KESA as their clear choice for workers' compensation coverage.

FINANCIAL INTEGRITY

Like many of you, we spent most of 2004 reeling from the shockwave brought on by one of our competitors' gross financial mismanagement. In a well-respected effort to negate the possibility of any other group self-insurance fund faltering, the Kentucky Office of Insurance completed a comprehensive audit of our 2003 fund year and found, as we expected, that KESA was completely clean. The KOI's examination found no adjustments were necessary to our audited financial statements and that the fund balance as we reported to the state at the end of 2003 was the exact same fund balance as determined by the auditors during their exam.

The simple truth is KESA acts responsibly. We know fiscal responsibility to our members is our prevailing commitment and reason for existence. Financially and philosophically, KESA makes decisions based on intelligence, experience, and integrity.

Our 2004 audited financial statements are presented on the following pages for your review. They were prepared with the same meticulous attention to detail and scrupulous auditing practices as our previous financial statements. You'll see that we closed 2004 with our earned premiums reaching $59,779,035, up over 27% from $46,916,545 at the close of 2003. Our cash and invested assets grew to $88,356,719, up 31% from $67,384,927 a year ago, and our members' equity increased to $7,453,967 from last year's $6,669,186. Our insured payrolls topped $3,977,206,976 and our member count grew to 5,109 from 4,235 last year.

Without question, KESA's financial performance is exemplary. We adhere to our long-standing philosophy that steady, measured financial growth builds a strong, healthy fund. And our commitment to our members is to be here, surviving and thriving, for 25 more years and beyond. On that, you have my word.

Because for me, it is personal.

Gregory L. Buie

Gregory L. Buie
Executive Director

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, either in the form of a dividend or through lowered premiums.

Some companies have shied away from workers' comp funds because of a fund's right to assess additional premiums. KESA minimizes the possibility of an assessment by properly evaluating and pricing each account and by educating each member company in safety and loss control. KESA also uses a portion of members' premiums to purchase what is known as excess insurance – 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 claims liability.

KESA Covers Kentucky

KESA's only objective is to write workers' comp coverage in the state 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. And, with 25 years' experience writing coverage in Kentucky, we've also gotten to know the key people in workers' comp – the doctors and other medical providers, lawyers, administrative law judges, and the contacts at the Kentucky Office of Insurance. 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 25 years. Our longevity stems from our commitment to be a fiscally responsible fund. KESA is regulated by the Kentucky Office of Insurance, which requires us to submit actuarial reporting as well as financial reporting annually 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.

KESA's formula is simple. We keep our administrative expenses in check and make optimum use of each premium dollar through strategic investments. From our efficient claims handling to our tight accounting controls to the way we invest our members' premiums, KESA is a watchful guardian of our members' money. KESA delivers the strong financial performance our members can trust.

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, 2004 and 2003, and the related statements of income, comprehensive income and changes 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, 2004 and 2003, 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.

March 31, 2005
Lexington, Kentucky

KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

Balance Sheet

December 31, 2004 and 2003

	2004	2003
Assets		
Investments	**$ 83,457,754**	$ 54,906,866
Cash and cash equivalents	**4,898,965**	12,478,061
Accrued interest and dividends	**714,551**	508,064
Premiums receivable, net	**20,205,309**	15,409,887
Reinsurance receivables and recoverables	**8,357,234**	12,342,814
Deferred federal income taxes	**1,549,267**	1,686,945
Furniture and equipment, net	**1,113,293**	339,232
Other assets	**273,412**	157,239
Total assets	**$ 120,569,785**	$ 97,829,108
Liabilities and Members' Equity		
Unpaid losses and loss adjustment expenses:		
Reported losses	**$ 38,189,544**	$ 33,859,728
Incurred but not reported losses	**39,545,919**	28,016,830
Unallocated loss adjustment expenses	**2,359,800**	2,661,000
Total unpaid losses and loss adjustment expenses	**80,095,263**	64,537,558
Unearned premiums	**25,066,058**	19,083,134
Advance premiums	**1,995,760**	1,793,109
Reinsurance payable	**1,015,998**	1,098,651
Commissions payable	**169,424**	175,998
Accounts payable and accrued expenses	**941,778**	735,444
Federal income taxes payable	**262,196**	1,110,604
Special Fund tax payable	**3,569,341**	2,625,424
Total liabilities	**113,115,818**	91,159,922
Members' equity	**7,453,967**	6,669,186
Total liabilities and members' equity	**$ 120,569,785**	$ 97,829,108

KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

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

Years ended December 31, 2004 and 2003

	2004	2003
Revenues:		
Premiums earned	**$ 59,779,035**	$ 46,916,545
Net investment income	**2,461,108**	1,758,096
Net realized gains on investments		

58,460

2,460,916

Total revenues	**62,298,603**	
	51,135,557	

Expenses:

Losses and loss adjustment expenses, net

46,563,223

38,776,671

Excess insurance premiums

2,982,009

2,021,055

Commissions	**7,173,701**	5,639,672
Underwriting expenses	**3,557,683**	2,956,977

Total expenses

60,276,616

49,394,375

Income before income taxes	**2,021,987**	
	1,741,182	
Provision (benefit) for income taxes:		
Current	**262,673**	1,110,604
Deferred	**422,209**	(539,107)

Total income tax expense

684,882

571,497

Net income		**1,337,105**		1,169,685

Other comprehensive income, net of tax:
Unrealized losses on securities available for sale, net of reclassification adjustment
(552,324) (518,917)

Total comprehensive income
784,781

650,768

Members’ equity, beginning of year		**6,669,186**		6,018,418
Members’ equity, end of year	**$**	**7,453,967**	$	6,669,186

KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

Statement of Cash Flows

Years ended December 31, 2004 and 2003

	2004	2003
Cash flows from operating activities:		
Net income	**$ 1,337,105**	$ 1,169,685
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	**130,155**	166,764
Realized gains on sale of investment securities	**(58,460)**	(2,460,916)
Amortization of premiums and discounts, net	**157,958**	43,875
Bad debt expense	**246,679**	266,317
Increase (decrease) in cash due to changes in:		
Accrued interest and dividends	**(206,487)**	1,597
Premiums receivables, net	**(5,042,101)**	(3,173,535)
Reinsurance receivables and recoverables	**3,985,580**	(9,608,899)
Deferred federal income taxes	**422,209**	(528,944)
Other assets	**(116,173)**	(63,494)
Unpaid losses and loss adjustment expenses	**15,557,705**	21,023,040
Unearned premiums	**5,982,924**	5,669,056
Advance premiums	**202,651**	452,402
Reinsurance payable	**(82,653)**	116,396
Commissions payable	**(6,574)**	(94,039)
Accounts payable and accrued expenses	**206,334**	(101,248)
Federal income taxes payable	**(848,408)**	976,668

Special Fund tax payable **943,917** 686,281

Net cash provided by operating activities
22,812,361
14,541,006

Cash flows from investing activities:
Purchases of investments **(90,630,860)** (35,049,414)
Proceeds from sales and maturities of investments **61,143,619**
23,704,370
Purchase of furniture and equipment **(904,216)**
(123,767)

Net cash used in investing activities **(30,391,457)**
(11,468,811)

Net (decrease) increase in cash and cash equivalents

(7,579,096)

3,072,195

Cash and cash equivalents, beginning of year **12,478,061**
9,405,866

Cash and cash equivalents, end of year **$ 4,898,965** $ 12,478,061

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 36 month 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 reinsurers, that owe the insurer money will not pay. KESA minimizes this risk by adhering to a conservative investment strategy, by utilizing a financially sound reinsurer, by maintaining credit and collection policies, and by providing an allowance for any amounts deemed uncollectible.

1. Description of the Fund, 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. 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.

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.

During 2004 and 2003, the Fund reduced redundancies in its estimated incurred but not reported losses by approximately $5 million and $2.5 million, respectively. After discounting, the effect of this change was to decrease losses and loss adjustment expenses and increase net income for 2004 and 2003 by approximately $4.2 and $2.1 and (net of taxes) $2.8 and $1.4 million, respectively.

2. Summary of Significant Accounting Policies, continued

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 gain of $289,336 during 2004.

Cash and Cash Equivalents

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

2. Summary of Significant Accounting Policies, continued

<u>Allowance for Doubtful Accounts</u>

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 $270,000 and $317,000 at December 31, 2004 and 2003, respectively.

<u>Furniture and Equipment</u>

Furniture and equipment are stated at cost less accumulated depreciation. Depreciation is computed using an accelerated method over the estimated useful lives of the assets. Accumulated depreciation was $1,058,186 and $928,031 as of December 31, 2004 and 2003, respectively.

<u>Premium Revenue, Advance Premiums and Unearned Premiums</u>

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

2. Summary of Significant Accounting Policies, continued

Reinsurance

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 reinsurers. 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 reinsurance insurance contracts.

Advertising

Advertising costs are expensed as incurred. Total advertising expenses included in underwriting expenses are $151,840 and $119,000 for 2004 and 2003, 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.

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 availableforsale 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 2003 amounts have been reclassified to conform to the 2004 presentation with no effect on net income or members' equity.

3. Investments

The December 31, 2004 amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	Gross Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Fair Value
U.S. government and agency securities	**$ 33,538,305**	**$ 502,529**	**$ (318,510)**	**$ 33,722,324**
Corporate securities	**8,583,655**	**364,870**	**(29,137)**	**8,919,388**
Municipal securities	**13,300,373**	**156,930**	**(56,320)**	**13,400,983**
Convertible bonds	**6,133,920**	**371,625**	**(32,708)**	**6,472,837**
U.S. Treasury notes and bonds	**2,477,172**	**4,410**	**(8,450)**	**2,473,132**
U.S. Treasury bills	**1,999,841**	**-**	**-**	**1,999,841**
Total fixed maturities	**66,033,266**	**1,400,364**	**(445,125)**	**66,988,505**
Convertible preferred stock	**1,631,354**	**9,850**	**(56,457)**	**1,584,747**
Bond mutual funds	**6,664,552**	**-**	**(173,143)**	**6,491,409**
Equity securities	**8,121,291**	**359,328**	**(87,526)**	

				8,393,093
Total	**$ 82,450,463**	**$ 1,769,542**	**$ (762,251)**	**$ 83,457,754**

The December 31, 2003 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	$ 28,939,287	$ 1,264,524	$ (122,938)	$ 30,080,873
Corporate securities	5,334,110	413,471	-	5,747,581
U.S. Treasury bills	19,078,412	-	-	19,078,412
Total	$ 53,351,809	$ 1,677,995	$ (122,938)	$ 54,906,866

The net unrealized gains generate a deferred income tax liability of $244,189 and $528,720 at December 31, 2004 and 2003, respectively.

3. Investments, continued

Proceeds from sales and maturities of investments during 2004 and 2003 were $61,143,619 and $23,704,370, respectively; gross gains of $1,011,100 and $2,839,074 and gross losses of $952,640 and $378,158, respectively, were realized on those sales.

The amortized cost and fair value of investments at December 31, 2004, 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 with or without call or repayment penalties.

	Amortized Cost	Fair Value
Due in one year or less	$ 3,453,083	$ 3,457,493
Due after one year through five years	21,880,823	22,142,066
Due after five years through ten years	8,395,110	8,552,303
Due after ten years	32,304,250	32,836,643
	$ 66,033,266	$ 66,988,505

As required by the Kentucky Department of Insurance, the Fund has pledged surety in the amount of $6,664,552 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 Department of Insurance, for the exclusive payment of any liability for workers' compensation claims due through December 31, 2004.

4. Unpaid Losses and Loss Adjustment Expenses

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

	2004	2003
Balance at January 1	**$ 77,650,918**	$ 55,757,827
Less: reinsurance recoverable	**(8,965,964)**	(2,640,029)
Net balance at January 1	**68,684,954**	53,117,798
Incurred related to:		
Current year	**48,998,431**	37,748,390
Prior years	**2,392,506**	1,314,175
Total incurred	**51,390,937**	39,062,565
Paid related to:		
Current year	**11,872,756**	10,353,133
Prior years	**17,097,449**	13,142,276
Total paid	**28,970,205**	23,495,409
Net balance at December 31	**91,105,686**	68,684,954
Plus reinsurance recoverable	**7,968,661**	8,965,964
Balance at December 31	**$ 99,074,347**	$ 77,650,918

The aggregate liability has been discounted using discount factors over the anticipated payment periods to reflect the time value of money. At December 31, 2004 and 2003, the Fund discounted its aggregate liability using a 3.5% interest rate applied over the Fund's historical payment patterns of approximately 25 and 24 years, respectively. At December 31, 2004 and 2003, reserves for estimated claims and claims adjustment expenses have been discounted by approximately $18,979,000 and $13,113,000, respectively. Of the discount, approximately $5,632,000 and $8,267,000 relate to current year incurred losses for 2004 and 2003, respectively.

5. 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 the group selfinsurers pay premiumbased taxes in support of the Commonwealth of Kentucky Special Fund.

5. Federal Income Taxes, continued

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.

Significant components of the deferred tax assets and deferred tax liabilities at December 31, 2004 and 2003 are presented below:

	2004	2003
Deferred tax assets:		
Advance and unearned premiums	**$ 1,840,204**	$ 1,419,585
Allowance for doubtful accounts	**60,843**	91,336
Capital loss carryforward	**259,162**	279,259
Loss reserves	**-**	404,275
Other	**-**	21,210
Total deferred tax assets	**2,160,209**	2,215,665
Deferred tax liabilities:		
Net unrealized gains on securities availableforsale	**244,189**	
	528,720	
Loss reserves	**331,957**	-
Other	**34,796**	-
Total deferred tax liability	**610,942**	528,720
Net deferred tax assets	**$ 1,549,267**	$ 1,686,945

At December 31, 2004, the Fund had capital loss carryforwards of approximately $762,000 that will expire in 2008. The Fund paid income taxes of $1,111,081 and $133,936 in 2004 and 2003, respectively.

6. Reinsurance 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. Aggregate excess insurance provides coverage if the total losses of the Fund exceed an established loss fund.

For the years ended December 31, 2004 and 2003, the Fund carried specific excess insurance, which provided statutory (unlimited) limits in excess of $1,000,000 and $750,000 per occurrence, respectively. For 2003, which has been renewed for 2005, the fund obtained a waiver of the requirement to purchase aggregate insurance coverage from the Kentucky Department of Insurance.

6. Reinsurance Coverage, continued

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

Excess insurance premiums were $2,982,009 and $2,021,055 for the years ended December 31, 2004 and 2003, respectively. Reinsurance recoveries on paid claims during 2004 and 2003 were $3,755,575 and $151,840, respectively. The estimated recoverables on claims incurred but not reported was $7,968,661 and $8,965,964 in 2004 and 2003, respectively. See Note 4 for further information.

7. Comprehensive Income

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

	2004	2003
Unrealized holding (losses) gains arising during the year	**$ (778,395)**	$ 1,674,679
Reclassification adjustment for gains realized in income	**(58,460)**	(2,460,916)
Other comprehensive loss	**(836,855)**	(786,237)
Related income tax benefit	**284,531**	267,320
Other comprehensive loss, net of tax	**$ (552,324)**	$ (518,917)

8. Retirement Plan

The Fund has a 401(k) savings plan which allows eligible employees to contribute up to fifteen percent of their compensation. 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 $73,806 and $64,748 in 2004 and 2003, respectively.

9. Commitments

The Fund leases office space under a noncancellable operating lease which expires April 30, 2005. Rental expense under this lease was $154,311 and $155,425 for 2004 and 2003, respectively. The Fund is currently in negotiations to renew the lease. The expected future minimum rental commitments for the lease for 2005 is $38,816.

In October 2004, the Fund entered into a license agreement with a software company to update and improve its operating systems. Under terms of the license agreement, the Fund is to pay certain amounts as conversion milestones are reached. The total license fee to be paid under the agreement is approximately $2,073,000. As of December 31, 2004, the Fund has paid approximately $826,000.

10. 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 4).

KESA Management Team

Gregory L. Buie
Executive Director

Stephen A. Andrews
Sales Manager

Page Barrow, AU
Underwriting Manager

Kitty Baumgart
Controller

Linda K. Davis
Human Resources/Office Manager

Vi Durr
Client Relations Manager

Melinda Ellingsworth
Communications Manager

Kevin J. Fallahay
Claims Manager

Mike Kleier
Member Relations Manager

Rubyanne O'Bryan
Systems Administrator

Steve Udelhoven
Loss Control Manager

Advisors and Consultants

Actuary
Godbold, Malpere & Co.
Roswell, GA

Auditor
Dean, Dorton & Ford, PSC
Lexington, KY

Corporate Counsel
Frost Brown Todd LLC
Louisville, KY

Investment Advisor
Ernst & Young, LLP
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KESA

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