ANNUAL REPORT 2007

earning your trust

KESA

WE KEEP KENTUCKY WORKING

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KESA We Keep Kentucky Working

A MESSAGE FROM OUR EXECUTIVE DIRECTOR

Gregory L. Buie

Earning your trust.

Trust is that elusive quality that we all look for in our relationships. Whether it's your best friend from high school or the brother or sister who has been a lifelong confidant, the people we trust mean the most to us. It may sound a little corny or cliché, but KESA works to earn your trust every day. And while we may not be on par with your family or your high school chums, we are a partner you can believe in.

We start with knowledge.

Most companies like to talk about their good service, and certainly service is paramount at KESA. But what does that really mean? To some companies it means having a service checklist like returning phone calls the same business day and promising to research a question if they don't know the answer. OK, that's good. But what is better is service excellence through knowledge. And that's what KESA delivers every day. Our employees will return your call the same business day and they are equipped with years of experience and industry knowledge to answer any question you can pose. Chances are you'll get a dose of workers' comp history, key legislative rulings, six additional resources to consult, and some safety tips too. KESA employs knowledge. And we're happy to share it.

We step it up with vision.

KESA invests in technology because we believe it provides great benefits to our members, agents, and the injured employees we serve. The vision behind our technology plan is to put the purest, most up-to-date information at the fingertips of our skilled employees as well as our members and agents. In 2007 we began implementation of an imaging system that streamlines our workflows and increases productivity. Because the imaging system seamlessly interfaces with our data management system, we can fully utilize our core system's functionality with the ease and efficiency of being paperless. Now we can do more in less time.

We seal it with strong financial results.

Our dedication to earning your trust is best shown by the capable way we manage our members' funds year after year. Financial responsibility is KESA's hallmark and our audited financial statements for the year ended 2007 are testimony to our commitment to financial excellence.

We closed 2007 with our earned premiums reaching $58,163,680. Our cash and invested assets grew to $140,112,259, up 13% from $123,938,850 a year ago, our insured payrolls topped $3.9 billion, and our member count hit 5,404. Our members' equity grew to $20,124,137 from last year's $15,895,408, a very significant 26.6% increase.

Clearly, KESA delivers the kind of stellar financial results that reflects our commitment to building a strong, healthy, member-focused workers' comp fund. Combine that with our 28 years of excellent service to the employers of Kentucky and our adherence to time-honored business principles, and you have a company you can believe in. A company you can trust.

Thank you for partnering with KESA. Together, we keep Kentucky working.

Gregory L. Buie
Executive Director

KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

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 28 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 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 in-house claims handling to our tight accounting controls to the way we invest our members' funds, KESA is a watchful guardian of our members' money. KESA delivers the strong financial performance our members can trust.

cpas consultants business advisors

DEAN || DORTON || FORD PSC

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, 2007 and 2006, 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, 2007 and 2006, 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.

As discussed in Note 2, during 2006, the Fund changed its estimated discount rates. The effect of this change in estimate was to decrease the total discount and net income by approximately $2.3 million (net of taxes, $1.5 million) for 2006.

Dean, Dorton & Ford, PSC

April 21, 2008
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KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

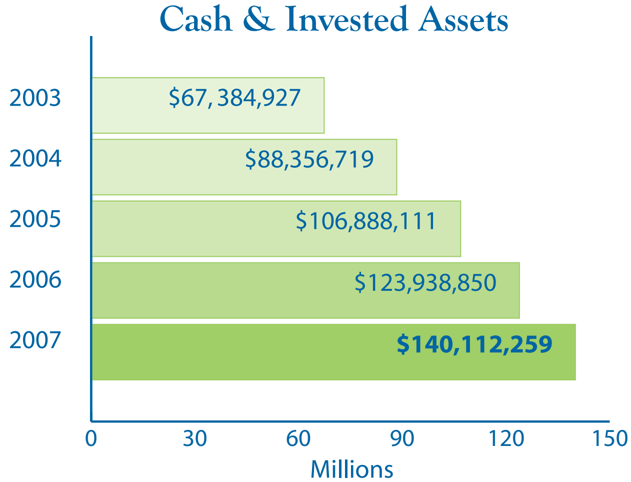
Balance Sheet

December 31, 2007 and 2006

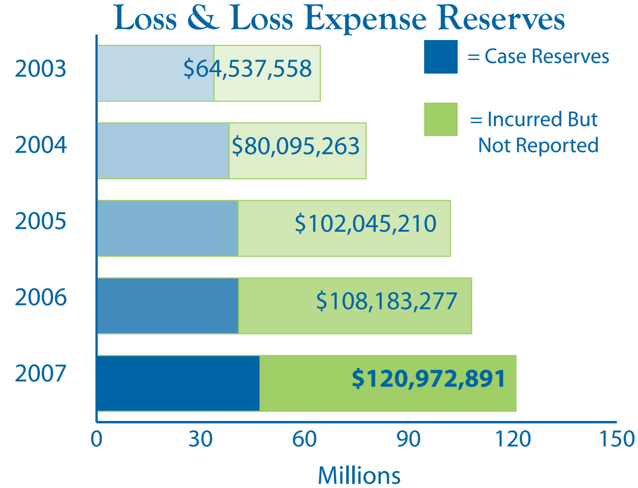
	2007	2006
Assets		
Investments	$ 132,155,691	$ 114,768,031
Cash and cash equivalents	7,956,568	9,170,819
Prepaid excess insurance premiums	665,389	205,921
Prepaid income taxes	108,806	—
Accrued interest and dividends	1,029,087	1,000,989
Premiums receivable, net	15,671,216	17,991,675
Excess insurance receivables and recoverables	6,350,303	6,268,030
Deferred federal income taxes	661,084	1,708,443
Furniture and equipment, net	2,535,177	2,612,241
Other assets	147,768	140,948
Total assets	**$ 167,281,089**	**$ 153,867,097**
Liabilities and Surplus		
Unpaid losses and loss adjustment expenses:		
Reported losses	$ 47,165,451	$ 40,983,539
Incurred but not reported losses	73,807,440	67,199,738
Total unpaid losses and loss adjustment expenses	120,972,891	108,183,277
Unearned premiums	20,512,573	22,499,371
Advance premiums	2,450,174	2,479,217
Commissions payable	493,191	449,251
Accounts payable and accrued expenses	1,148,256	1,083,503
Federal income taxes payable	—	1,284,012
Special Fund tax payable	1,579,867	1,993,058
Total liabilities	147,156,952	137,971,689
Members' equity	20,124,137	15,895,408
Total liabilities and members' equity	**$ 167,281,089**	**$ 153,867,097**

See accompanying notes.

Cash & Invested Assets



Loss & Loss Expense Reserves



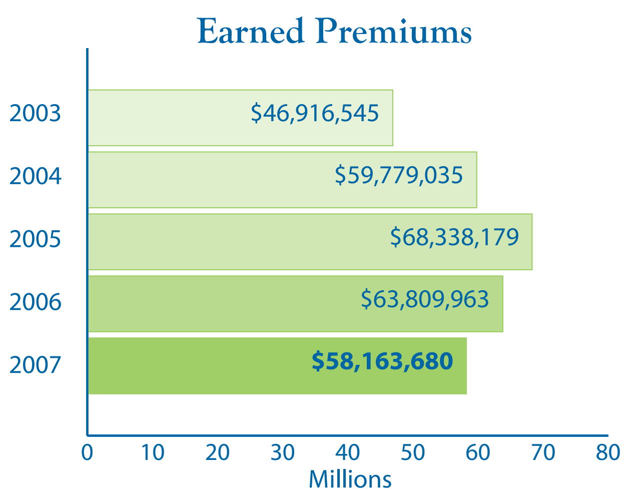
KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

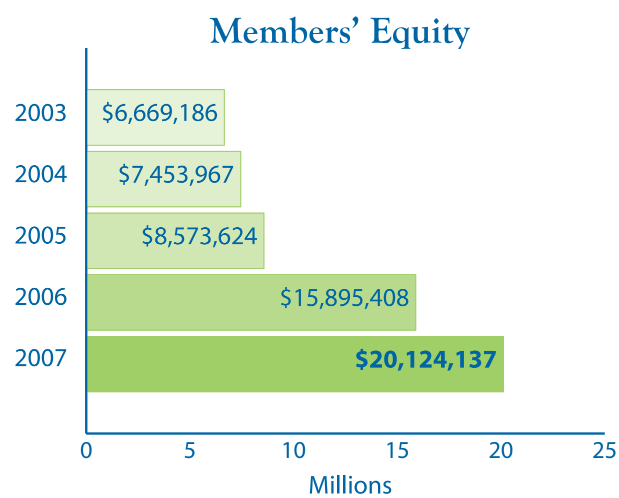
Statement of Income, Comprehensive Income and Change in Members' Equity

Years ended December 31, 2007 and 2006

	2007	2006
Revenues:		
Premiums earned	$ 58,163,680	$ 63,809,963
Net investment income	5,242,947	4,327,772
Net realized gains on investments	381,806	816,708
Total revenues	**63,788,433**	68,954,443
Expenses:		
Losses and loss adjustment expenses, net	43,336,220	42,620,499
Excess insurance premiums	4,748,411	5,101,405
Commissions	6,979,642	7,401,127
Underwriting expenses	4,497,067	4,576,202
Total expenses	**59,561,340**	59,699,233
Income before income taxes	4,227,093	9,255,210
Provision for income taxes:		
Current	629,988	2,344,037
Deferred	476,505	510,590
Total income tax provision	1,106,493	2,854,627
Net income	**3,120,600**	6,400,583
Other comprehensive income, net of tax:		
Unrealized gains on securities available-for-sale, net of reclassification adjustment	1,108,129	921,201
Total comprehensive income	4,228,729	7,321,784
Members' equity, beginning of year	15,895,408	8,573,624
Members' equity, end of year	**$ 20,124,137**	$ 15,895,408

See accompanying notes.





KESA, THE KENTUCKY WORKERS' COMPENSATION FUND

Statement of Cash Flows

Years ended December 31, 2007 and 2006

	2007	2006
Cash flows from operating activities:		
Net income	$ 3,120,600	$ 6,400,583
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	723,684	685,994
Net realized gains on investments	(381,806)	(816,708)
Amortization of premiums and discounts, net	(28,122)	293,637
Bad debt expense	294,552	288,171
Increase (decrease) in cash due to changes in:		
Prepaid excess insurance premiums	(459,468)	(205,921)
Prepaid income taxes	(108,806)	—
Accrued interest and dividends	(28,098)	(177,829)
Premiums receivable, net	2,025,907	(2,204,485)
Excess insurance receivables and recoverables	(82,273)	3,320,570
Deferred federal income taxes	476,505	511,281
Other assets	(6,820)	(36,407)
Unpaid losses and loss adjustment expenses	12,789,614	6,138,067
Unearned premiums	(1,986,798)	19,422
Advance premiums	(29,043)	150,196
Excess insurance payable	—	(796,024)
Commissions payable	43,940	151,329
Accounts payable and accrued expenses	64,753	(112,596)
Federal income taxes payable	(1,284,012)	2,121,480
Special Fund tax payable	(413,191)	(392,284)
Net cash provided by operating activities	**14,731,118**	15,338,476
Cash flows from investing activities:		
Purchases of investments	(49,656,021)	(47,991,338)
Proceeds from sales and maturities of investments	34,357,272	23,773,676
Purchase of furniture and equipment	(646,620)	(206,567)
Net cash used in investing activities	(15,945,369)	(24,424,229)
Net decrease in cash and cash equivalents	(1,214,251)	(9,085,753)
Cash and cash equivalents, beginning of year	9,170,819	18,256,572
Cash and cash equivalents, end of year	$ **7,956,568**	$ 9,170,819

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 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 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.

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

2. Summary of Significant Accounting Policies, continued

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 2006, the Fund changed its estimated discount rates. The effect of this change was to decrease the total discount by approximately $2.3 million (net of taxes, $1.5 million) for 2006.

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 $241,173 and $896,084 as of December 31, 2007 and 2006, respectively.

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.

Notes to Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

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 $1,138,000 and $878,000 at December 31, 2007 and 2006, respectively.

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 $2,051,092 and $1,391,803 as of December 31, 2007 and 2006, respectively. Depreciation expense was $723,684 and $685,994 during 2007 and 2006, 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.

Advertising

Advertising costs are expensed as incurred. Total advertising expenses included in underwriting expenses are $266,817 and $287,168 for 2007 and 2006, respectively.

2. Summary of Significant Accounting Policies, continued

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 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 2006 amounts have been reclassified to conform to the 2007 presentation with no effect on net income or members' equity.

Notes to Financial Statements, continued

3. Investments

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**

The December 31, 2006 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	$ 29,614,192	$ 274,084	$ (223,607)	$ 29,664,669
Corporate securities	1,566,514	—	(23,899)	1,542,615
Municipal securities	20,063,966	12,644	(440,546)	19,636,064
Convertible bonds	9,207,046	1,112,871	(94,680)	10,225,237
Mortgage-backed securities	41,012,694	135,091	(705,469)	40,442,316
Total fixed maturities	101,464,412	1,534,690	(1,488,201)	101,510,901
Mutual funds	40,000	1,340	(230)	41,110
Equity securities	11,531,931	1,969,375	(285,286)	13,216,020
Total	**$ 113,036,343**	**$ 3,505,405**	**$ (1,773,717)**	**$ 114,768,031**

Proceeds from sales and maturities of investments during 2007 and 2006 were $34,357,272 and $23,773,676, respectively. Gross realized gains from fixed income securities were $586,843 and $1,234,664 for 2007 and 2006, respectively, and gross realized losses from fixed income securities were $148,706 and $391,237 for 2007 and 2006, respectively. Gross realized gains from equity securities were $584,238 and $280,932 for 2007 and 2006, respectively, and gross realized losses from equity securities were $640,569 and $307,651 for 2007 and 2006, respectively.

Notes to Financial Statements, continued

3. Investments, continued

The amortized cost and fair value of investments at December 31, 2007, 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. The average rate of assumed investment yield in effect for 2007 and 2006 was 4.57% and 4.16%, respectively.

	Amortized Cost	Fair Value
Due in one year or less	$ 22,119,013	$ 22,399,465
Due after one year through five years	23,902,532	24,300,006
Due after five years through ten years	16,776,991	17,320,791
Due after ten years	54,118,664	54,120,667
	$ 116,917,200	$ 118,140,929

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, 2007 and 2006:

	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)
Total	**$ 8,376,037**	**$ (841,863)**	**$ 36,453,123**	**$ (1,212,018)**	**$ 44,829,160**	**$(2,053,881)**

	December 31, 2006					
	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	$ 6,342,527	$ (17,869)	$ 9,554,118	$ (205,738)	$ 15,896,645	$ (223,607)
Corporate securities	—	—	1,542,615	(23,899)	1,542,615	(23,899)
Municipal securities	5,300,647	(72,643)	12,701,257	(367,903)	18,001,904	(440,546)
Convertible bonds	1,366,723	(51,754)	585,968	(42,926)	1,952,691	(94,680)
Mortgage-backed securities	8,851,548	(69,169)	15,103,194	(636,300)	23,954,742	(705,469)
Mutual Funds	15,760	(230)	—	—	15,760	(230)
Equity securities	1,003,812	(64,063)	1,519,519	(221,223)	2,523,331	(285,286)
Total	**$ 22,881,017**	**$ (275,728)**	**$ 41,006,671**	**$ (1,497,989)**	**$ 63,887,688**	**$ (1,773,717)**

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. As management has the ability to hold the securities for the foreseeable future, no declines are deemed to be other-than-temporary. All were trading between more than 50% to less than 100% of amortized/accreted cost.

As required by the Kentucky Office of Insurance, the Fund has pledged surety in the amount of $11,689,748 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, 2007. As of December 31, 2006, the amount pledged was $10,289,035.

4. Unpaid Losses and Loss Adjustment Expenses

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

	2007	2006
Balance at January 1	$ 128,467,034	$ 122,397,591
Less excess insurance recoverable	(6,028,654)	(8,770,498)
Net balance at January 1	122,438,380	113,627,093
Incurred related to:		
Current year	48,573,265	47,716,315
Prior years	(215,615)	(6,649,667)
Total incurred	48,357,650	41,066,648
Paid related to:		
Current year	11,714,960	10,703,306
Prior years	20,724,938	21,552,055
Total paid	32,439,898	32,255,361
Net balance at December 31	138,356,132	122,438,380
Plus excess insurance recoverable	6,137,322	6,028,654
Balance at December 31	**$ 144,493,454**	**$ 128,467,034**

The aggregate liability has been discounted using discount factors over the anticipated payment periods to reflect the time value of money. At December 31, 2007 and 2006, the Fund discounted its aggregate liability using an interest rate of 3.97% and 3.89%, respectively. At December 31, 2007 and 2006, reserves for estimated claims and claims adjustment expenses have been discounted by approximately $23,520,000 and $20,284,000, respectively. Of the discount, approximately $5,352,000 and $4,464,000 relate to current year incurred losses for 2007 and 2006, 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 group self-insurers pay premium-based taxes in support of the Commonwealth of Kentucky Special Fund.

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, 2007 and 2006 are presented below:

	2007	2006
Deferred tax assets:		
Advance and unearned premiums	$ 1,561,467	$ 1,698,544
Allowance for doubtful accounts	387,064	298,620
Capital loss carryforward	58,273	188,087
Total deferred tax assets	2,006,804	2,185,251
Deferred tax liabilities:		
Net unrealized gains on available-for-sale securities	855,302	284,448
Other	490,418	192,360
Total deferred tax liabilities	1,345,720	476,808
Net deferred tax assets	$ 661,084	$ 1,708,443

At December 31, 2007, the Fund had capital loss carryforwards of approximately $171,000 that will expire at various times through 2010. The Fund paid federal income taxes of $250,000 in both 2007 and 2006. The Fund's pre-tax income for income tax purposes was less than that reported in the financial statements by approximately $2,332,000 and $2,426,000 for the years ended December 31, 2007 and 2006, respectively.

6. 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, 2007 and 2006, 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 Office 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 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 $4,748,411 and $5,101,405 for the years ended December 31, 2007 and 2006, respectively. Excess insurance recoveries on paid claims during 2007 and 2006 were $212,981 and $239,376, respectively. The estimated recoverables on claims were $6,137,322 and $6,028,654 in 2007 and 2006, respectively. See Note 4 for further information.

Notes to Financial Statements, continued

7. Comprehensive Income

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

	2007	2006
Unrealized holding gains arising during the year	$ 2,060,789	$ 2,212,467
Reclassification adjustment for gains realized on investments	(381,806)	(816,708)
Other comprehensive income	1,678,983	1,395,759
Related income tax expense	(570,854)	(474,558)
Other comprehensive income, net of tax	$ 1,108,129	$ 921,201

8. 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 $95,173 and $90,925 in 2007 and 2006, respectively.

9. Commitments

The Fund leases various equipment and office space under operating leases expiring at various dates through December 2010. Total rental expense in 2007 and 2006 was $315,842 and $312,091, 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, 2007 for operating leases with initial or remaining lease terms in excess of one year.

	Rental Cost
2008	$ 437,263
2009	429,767
2010	359,012
2011	125,612
	$ 1,351,654

Notes to Financial Statements, continued

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).

11. Concentration of Credit Risk

At various times during the year, the Fund's cash in bank balance exceeded the federally insured limits. As of December 31, 2007 and 2006, the Fund's uninsured cash balance totaled $1,330,370 and $1,060,485, 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, 2007 and 2006, excess insurance receivables with a carrying value of $6,350,303 and $6,268,030, 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.

12. 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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