KENTUCKY EMPLOYEES HEALTH PLAN
FRANKFORT, KENTUCKY

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORTS

June 30, 2006

KENTUCKY EMPLOYEES HEALTH PLAN
FRANKFORT, KENTUCKY

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MOORE STEPHENS POTTER LLP
CERTIFIED PUBLIC ACCOUNTANTS ▪ BUSINESS ADVISORS

INDEPENDENT AUDITOR'S REPORT

To the Secretary of the Personnel Cabinet
Commonwealth of Kentucky
Frankfort, Kentucky

We have audited the accompanying statement of net assets of the Kentucky Employees Health Plan as of June 30, 2006, and the related statements of revenues, expenses, and changes in net assets and cash flows for the period from inception (January 1, 2006) to June 30, 2006. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from 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 audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Kentucky Employees Health Plan, and are not intended to present fairly the financial position of the Commonwealth of Kentucky, or the results of its operations and cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Kentucky Employees Health Plan, as of June 30, 2006 and the results of its operations and its cash flows for the initial period then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 28, 2006 on our consideration of the Kentucky Employees Health Plan's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The one year-year claims development information on page 23 is not a required part of the basic financial statements but supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Moore Stephens Potter, LLP

MOORE STEPHENS POTTER, LLP
November 28, 2006

KENTUCKY EMPLOYEES HEALTH PLAN
STATEMENT OF NET ASSETS
June 30, 2006

A S S E T S

Current assets:	
Cash and cash equivalents	$ 114,008,983
Premiums receivable	65,927,469
Pharmacy rebate receivable	11,454,203
Other receivable	1,181,386
Interfund receivable	8,190
Total current assets	192,580,231
Other assets:	
Investments	63,263,790
Total assets	255,844,021

L I A B I L I T I E S

Current liabilities:	
Accounts payable	431,133
Due to Personnel Cabinet	680,832
Interfund payable	8,190
Deferred revenue	87,760,530
Incurred but unpaid claims	73,687,555
Compensated absences	158,492
Total current liabilities	162,726,732
Long-term liabilities:	
Compensated absences	97,759
Total liabilities	162,824,491

N E T A S S E T S

Net assets:	
Unrestricted	$ 93,019,530

See accompanying notes.

KENTUCKY EMPLOYEES HEALTH PLAN
STATEMENT OF REVENUES, EXPENSES, AND
CHANGES IN NET ASSETS
Period from January 1, 2006 (Inception), to June 30, 2006

Operating revenues:	
Premium revenues	$ 578,263,236
Pharmacy rebates	11,454,203
Administrative fees	5,688,040
Other operating revenues	29,810
Total operating revenue	595,435,289
Operating expenses:	
Benefits	467,314,552
Claims adjustment expense	4,828,555
Claims processing fees	28,997,917
Personnel expenses	1,139,343
Professional services	941,201
Commodities and supplies	434,787
Utilities, rentals and other	82,795
Travel	8,289
Total operating expenses	503,747,439
Operating income	91,687,850
Nonoperating revenues:	
Investment income	3,205,094
Income before other financing sources (uses)	94,892,944
Other financing sources (uses):	
Net operating transfers out	(1,873,414)
Change in net assets	93,019,530
Net assets, beginning of year	0
Net assets, end of year	$ 93,019,530

See accompanying notes.

KENTUCKY EMPLOYEES HEALTH PLAN

STATEMENT OF CASH FLOWS

Period from January 1, 2006 (Inception), to June 30, 2006

Cash flows from operating activities:	
Premium collected	$ 599,152,797
Administrative fees collected	5,450,154
Other operating cash collected	29,810
Benefits paid	(398,455,552)
Claims processing fees paid	(28,856,523)
Payments to employees for services	(1,139,343)
Payments to suppliers of goods and services	(1,177,333)
Net cash provided by operating activities	175,004,010
Cash flows from noncapital financing activities:	
Operating transfers to other funds	(936,331)
Cash flows from investing activities:	
Investment income	3,157,843
Net investment activity	(63,216,539)
Net cash used in investing activities	(60,058,696)
Net increase in cash and cash equivalents	114,008,983
Cash and cash equivalents, beginning of year	0
Cash and cash equivalents, end of year	$ 114,008,983
Reconciliation of operating income to net cash provided by operating activities operating activities:	
Operating income	$ 91,687,850
Adjustments to reconcile operating income to net cash provided by operating activities:	
(Increase) decrease in:	
Premiums receivable	(65,927,469)
Pharmacy rebate receivable	(11,454,203)
Other receivable	(1,181,386)
Increase (decrease) in:	
Accounts payable	431,133
Deferred premiums	87,760,530
Incurred but unpaid claims	73,687,555
Net cash provided by operating activities	$ 175,004,010
Supplemental schedule of noncash investing activities:	
Change in fair value of investments	$ 47,251

See accompanying notes.

KENTUCKY EMPLOYEES HEALTH PLAN
STATEMENT OF FIDUCIARY NET ASSETS
June 30, 2006

	Flexible Spending Accounts
A S S E T S	
Cash and cash equivalents - restricted	$ 2,770,575
L I A B I L I T I E S	
Amounts held in custody for others	$ 2,770,575

See accompanying notes.

KENTUCKY EMPLOYEES HEALTH PLAN
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 1 - DESCRIPTION OF THE PLAN

The following brief description of the Kentucky Employees Health Plan (the Plan) is provided for general information purposes only. Participants should refer to the Plan document for more complete information.

Organization:

Pursuant to Kentucky Revised Statues 18A.225, 18A.226, 18A.227, the Commonwealth of Kentucky is required to administrate and facilitate an employee health insurance program as part of a flexible benefits plan. The Department for Employee Insurance (the Department) is responsible for overseeing the Kentucky Employees Health Plan (KEHP), as well as, the Flexible Spending Account Program for state employees. The Department is to:

1. Provide exemplary customer service to the KEHP members, which include employees in state government, boards of education, health departments, retirees, persons covered under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), survivors, and certain other local government employees. COBRA allows temporary continuance of insurance coverage under certain circumstances. Survivors are individuals who were covered eligible dependents of a participant in the Plan at the time of the participant's death.

2. Support state government employees with health insurance and/or flexible spending accounts.

3. Receive, analyze, and maintain health insurance data to assist the Commonwealth in making decisions relative to the state health insurance plan.

4. Support the ongoing efforts of the Employee Advisory Committee and the Kentucky Group Health Insurance Board, which includes the development of recommendations on the future direction of the Program.

Premiums and Participants:

The health benefits for governmental participants are funded by monthly premiums paid by individuals and state and local governmental units. A participant may extend coverage to dependents for an additional monthly premium based on the coverage requested. Premiums for Plan participants and their dependents are collected by the Department for Employee Insurance and held in a trust fund until needed for the payment of benefits.

NOTE 1 - DESCRIPTION OF THE PLAN (CONTINUED)

Premiums and Participants (Continued):

The Plan develops premium equivalent rates each year by utilizing historical trend information, current claims experience, and national trends. An outside actuarial consultant advises the Plan Administrator regarding premium rates. If premium rates are changed, they become effective the beginning of a calendar year.

Plan participants are not subject to supplemental assessment in the event of a premium deficiency. At the time of premium payment, the risk of loss due to incurred benefit costs is transferred from the participant to the Plan. If the assets of the Plan were to be exhausted, participants would not be responsible for the Plan's liabilities.

At June 30, 2006, the Plan provided health coverage to 122 state agencies with approximately 34,900 primary participants (not including dependents), 183 school districts with approximately 68,000 primary participants, 178 local government entities and health departments with approximately 8,400 primary participants, and 2 retiree divisions with approximately 38,000 primary participants. There were approximately 7,100 cross referenced spouses with an additional 12,500 cross referenced dependents. Total lives covered by the Plan including dependents are approximately 235,000.

All state agencies and local boards of education in the Commonwealth are required to offer to their active employees the coverage selections offered by the Plan. Local government entities may elect to participate in the Plan.

Benefits:

Three plans are offered to participants: Commonwealth Essential, Commonwealth Enhanced, and Commonwealth Premier.

Participants selecting the Commonwealth Essential Plan are responsible for a $750 single ($1,500 family) deductible for generally all services before the insurance will begin reimbursement of 75%. The same services when using non-network providers are reimbursed at 50% after the participant meets a $1,500 single ($3,000 family) deductible. The Plan reimburses allowed charges at 100% once the member has reached the $3,500 and $7,000 per member out-of-pocket maximum for network providers and non-network providers, respectively. The plan covers routine child and adult care at 100%.

NOTE 1 - DESCRIPTION OF THE PLAN (CONTINUED)

Benefits (Continued):

Participants selecting the Commonwealth Enhanced Plan are responsible for a $10 co-payment and a $250 single ($500 family) deductible for outpatient services, diagnostic testing and preventative care. The same services when using non-network providers are reimbursed at 60% after the member meets a $500 ($1,000 family) deductible. For other services, network provider and non-network provider benefits are generally reimbursed at 80% and 60%, respectively, after the appropriate deductibles are met. The Plan reimburses allowed charges at 100% once the member has reached the $1,250 and $2,500 per member out-of-pocket maximum for network providers and non-network providers, respectively.

Participants selecting the Commonwealth Premier Plan are responsible for a $10 co-payment and a $250 single ($500 family) deductible for outpatient services, diagnostic testing and preventative care. The same services when using non-network providers are reimbursed at 70% after the member meets a $500 ($1,000 family) deductible. For other services, network provider and non-network provider benefits are generally reimbursed at 90% and 70%, respectively, after the appropriate deductibles are met. The Plan reimburses allowed charges at 100% once the member has reached the $1,000 and $2,000 per member out-of-pocket maximum for network providers and non-network providers, respectively.

Prescription drugs are categorized into three categories: first tier, second tier, and third tier. The categories are the same under both retail and mail order prescriptions. Generally the retail is considered a 30 day supply and the mail order is considered a 90 day supply.

Under the Commonwealth Essential, all prescription drugs are subject to 25% coinsurance, with minimum and maximum limitations as follows:

(i) At retail, first tier drugs have a minimum of $10 and a maximum of $25, second tier drugs have a minimum of $20 and a maximum of $50, and third tier drugs have a minimum of $35 and a maximum of $100; and

(ii) Under mail order, first tier drugs have a minimum of $20 and a maximum of $50, second tier drugs have a minimum of $40 and a maximum of $100, and third tier drugs have a minimum of $70 and a maximum of $200.

Under the Commonwealth Enhanced retail plan first tier drugs are $5, second tier drugs are $15 and third tier drugs are $30 for in-network. After the 75th prescription under second and third tier drugs the co-payment will reduce to $10 for second tier and $20 for third tier. Prescriptions filled out-of-network are covered 60%. Under the Enhanced mail order plan first tier drugs are $10, second tier drugs are $30, and third tier drugs are $60.

NOTE 1 - DESCRIPTION OF THE PLAN (CONTINUED)

Benefits (Continued):

Under the Commonwealth Premier retail plan first tier drugs are $5, second tier drugs are $15, and third tier drugs are $30 for in-network. After the 75th prescription under second and third tier drugs the co-payment will reduce to $10 for second tier and $20 for third tier. Prescriptions filled out-of-network are covered 70%. Under the Premier mail order plan first tier drugs are $10, second tier drugs are $30 and third tier drugs are $60.

The Commonwealth of Kentucky has also established the Commonwealth of Kentucky Flexible Spending Account (FSA). The FSA allows you to use pre-tax Contributions to pay for qualified expenses. The FSA contains two components:

(i) The Health Care Flexible Spending Account (HCFSA). The HCFSA allows participants to elect a specified amount of pre-tax contributions to be used for reimbursement of eligible medical expenses. The HCFSA is intended to qualify as a Code Section 105 and 106 self-insured medical reimbursement plan.

(ii) The Dependent Care Flexible Spending Account (DCFSA). This DCFSA allows participants to elect a specified amount of pre-tax contributions to be used for reimbursement of eligible employment-related dependent care expenses. This DCFSA is intended to qualify as a Code Section 105 and 106 dependent care reimbursement plan.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of the Plan is presented to assist in understanding the Plan's financial statements. The financial statements and notes are representations of the Plan's management who is responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Reporting Entity:

The Plan’s financial statements are included in the Commonwealth’s Comprehensive Annual Financial Report as an enterprise fund within the Insurance and Administration Fund. The intent of an enterprise fund is to finance or recover, primarily through user charges, the costs of providing goods and services. An enterprise fund prepares operating statements using as its measurement focus the flow of economic resources. Such operating statements are designed to report events and transactions that increase or decrease an entity’s economic resources (i.e., all assets and liabilities). Enterprise fund transactions are accounted for using the accrual basis, under which revenues are recorded when earned, and expenses are recorded when the liabilities are incurred.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Basis of Accounting:

The Plan's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Governmental Accounting Standards Board (GASB) is responsible for establishing GAAP for state and local governments through its pronouncements (Statements and Interpretations). Governments are also required to follow the pronouncements of the Financial Accounting Standards Board (FASB) issued through November 30, 1989 (when applicable) that do not conflict with or contradict GASB pronouncements. The more significant accounting policies established in GAAP and adopted by the Plan are discussed below.

Basis of Presentation:

The Plan follows the provisions of the Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussions and Analysis – for State and Local Governments,* Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and Statement No. 38, *Certain Financial Statement Note Disclosures*, which establish the financial reporting standards for all state and local government entities.

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at 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 incurred but unpaid claims. In connection with the determination of incurred but unpaid claims, management uses the methodology discussed in Incurred but Unpaid Claims as discussed in Note 2 below to estimate the liability.

Management believes that the liability for incurred but unpaid claims is adequate. While management uses available information to estimate incurred but unpaid claims, 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 the State. The future changes will be charged or credited to expenses when they occur.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Description of Net Asset Classes:

Invested in capital, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year end, the portion of debt attributable to the unspent proceeds are not included in the calculation of invested capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

Restricted – This component of net assets consists of constraints placed on net assets used through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

Unrestricted – This component of net assets consists of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt".

Cash and Cash Equivalents:

The Plan considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Investments:

Investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the statement of net assets. Unrealized gains and losses are included in the change in net assets in the accompanying statement of revenues, expenses, and changes in net assets.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Incurred but Unpaid Claims:

The Plan establishes liabilities for incurred but unpaid claims based on its estimate of the ultimate cost of settling claims that have been reported but not yet settled, and claims that have been incurred but not yet reported. Although such estimates are the Plan's best estimates of the incurred claims to be paid, due to the complex nature of the factors involved in the calculation, the actual results may be more or less than the estimate. The claim liabilities are recomputed on a periodic basis using actuarial and statistical techniques which consider the effects of the general economic conditions, such as inflation, and other factors of past experience, such as changes in participant accounts. Adjustments to claim liabilities are recorded in the periods in which they are made. Claims must be filed no later than the last day of the calendar year immediately following the calendar year in which the loss is sustained unless an extenuating circumstance can be shown to exist.

Operating Revenues and Expenses:

Balances classified as operating revenues and expenses are those which comprise the Plan's principal ongoing operations. Since the Plan's operations are similar to those of any other insurance company, most revenues and expenses are considered operating. The Plan does not record deferred acquisition costs since administrative expenses are primarily maintenance expenses and not acquisition expenses.

Premiums:

Premiums are recognized in the period when the insurance coverage is provided. Premiums are due monthly from the employers and participants according to the rates adopted by the Council.

Fiduciary Funds:

Fiduciary funds are defined as funds used to report assets held in a trustee or agency capacity for others and which, therefore, cannot be used to support the government’s own programs. Fiduciary funds consist of unspent participant contributions to the Flexible Spending Account. Agency funds held in the Flexible Spending Accounts consist of pre-tax monies received from employees to be used on a reimbursement basis for expenses paid by employees for either health and/or dependent care expenditures.

NOTE 3 - CASH DEPOSITS

Cash includes amounts on deposit with the Commonwealth's cash and investment pool. See the Commonwealth's Comprehensive Annual Financial Report for the year ended June 30, 2006, for disclosure of the credit risk classifications of the cash and investment pool. The carrying amount of the Plan's cash and cash equivalents invested in the Commonwealth's cash and investment pool balance was $107,986,127.

The carrying amount of the Plan's deposits with local financial institutions was $6,022,856 and the bank balance was $26,298,581 at June 30, 2006. The difference between the bank balance and the carrying amount represents outstanding checks and deposits in transit. Of the bank balance, $100,000 was insured by federal depository insurance and the balance was uninsured and uncollateralized. Included in the Plan's deposits at June 30, 2006 are overnight sweep deposits of $25,700,000.

Flexible Spending Account:

Cash includes amounts on deposit with the Commonwealth's cash and investment pool. See the Commonwealth's Comprehensive Annual Financial Report for the year ended June 30, 2006, for disclosure of the credit risk classifications of the cash and investment pool. The carrying amount of the Flexible Spending Account's cash and cash equivalents invested in the Commonwealth's cash and investment pool balance was $3,183,095.

The carrying amount of the Flexible Spending Account's deposits with local financial institutions was $(412,520) and the bank balance was $0 at June 30, 2006. The difference between the bank balance and the carrying amount represents outstanding checks.

NOTE 4 - INVESTMENTS

All Plan investments are held directly in the Commonwealth's investment pool, which has statutory responsibility and authority to safeguard the funds. At June 30, 2006, the Plan's share of investments in the Commonwealth's investment pool totaled $63,263,790. Legally authorized investments generally include obligations of or guaranteed by the United States; obligations of any corporation of the United States Government; asset backed securities; U.S. dollar denominated corporate securities; collateralized certificates of deposit; bankers' acceptances; commercial paper and repurchase agreements. The Commonwealth is also eligible to invest in reverse repurchase agreements. See the Commonwealth's Comprehensive Annual Financial Report for the year ended June 30, 2006, for disclosure of the credit risk classifications of the cash and investment pool.

NOTE 5 - BENEFIT RESERVES

As discussed in Note 1, the Plan establishes liabilities for incurred but unpaid claims based on its estimate of the ultimate cost of settling claims that have been reported but not yet settled, and of claims that have been incurred but not yet reported.

Changes in the aggregate liabilities for claims and claims adjustment expenses during 2006 are as follows:

Balance, beginning of year	$	0
Claims incurred		472,143,107
Claims paid		(398,455,552)
Balance, end of year	$	73,687,555

The incurred but unpaid claims liability of $73,687,555 at June 30, 2006 includes a liability for claims adjustment expenses of $4,828,555.

NOTE 6 - REINSURANCE

As of June 30, 2006, the Plan has not transferred any risk of loss through reinsurance contracts.

NOTE 7 - COMPENSATED ABSENCES

The policy of the Commonwealth of Kentucky is to record the cost of annual and compensatory leave. Annual leave is accumulated at amounts ranging from 7.50 to 15.00 hours per month, determined by length of service, with a maximum accumulation ranging from 30 to 60 days. The calendar year is the period used for determining accumulated leave. At June 30, 2006, the estimated liability for accrued annual leave for the Plan is $177,533. Compensatory leave is granted to authorized employees. At June 30, 2006 the estimated liability for compensatory leave for the Plan is $78,718.

Changes in compensated absences for the six months ended June 30, 2006 are summarized as follows:

Beginning Balance	Additions	Reduction	Ending Balance	Amounts Due Within One Year
$ 0	$ 256,251	$ 0	$ 256,251	$ 158,492

NOTE 7 - COMPENSATED ABSENCES (CONTINUED)

It is the policy of the Plan to record the cost of sick leave when paid. Generally, sick leave (earned one day per month with unlimited accumulation) is paid when an employee is absent due to illness, injury, or related family death. Sick leave accumulated in excess of six months is added to an employees years of service at the time of retirement. There was no liability recorded for sick leave at June 30, 2006. The estimated accumulated amount of unused sick leave at that date for the Plan was $171,725.

NOTE 8 - PHARMACY REBATES

During the period January 1, 2006 through June 30, 2009 the Plan is guaranteed a rebate from the Plan's pharmacy third party administrator of $4.65 for each retail prescription filled and $17.50 for each prescription filled through the mail. The Plan recorded $11,454,203 in pharmacy rebates for the six months ended June 30, 2006.

NOTE 9 - ADMINISTRATION FEES

The Plan assesses a monthly fee to participating employers for each participant in the Plan. This fee is accumulated in a separate administrative account outside of the trust fund and is used to pay for general and administrative expenses associated with administering the Plan. The plan recorded $5,688,040 in administrative fees for the six months ended June 30, 2006.

NOTE 10 - RETIREMENT PLAN

All Plan employees who work more than one hundred hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement System (KERS), a cost-sharing multi-employer public employee retirement system. The total payroll for the Plan's employees totaled $945,094 for the six months ended June 30, 2006.

Employees who retire at or after age 65 with 48 months of credited service are entitled to a retirement benefit based on a range of 1.97% to 2.20% of the final-average salary multiplied by their years of service. Final-average salary is the employee's average of the three or five fiscal years during which the employee had the highest average monthly salary. Benefits fully vest on reaching five years of service. Vested employees may retire after twenty-seven years of service and receive full benefits or retire after age 55 and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

NOTE 10 - RETIREMENT PLAN (CONTINUED)

Covered employees are required by state statute to contribute 5% of their salary to the KERS. The Plan is required by the same statute to contribute 5.89% of the covered employees' salaries. The contribution requirement for the six months ended June 30, 2006, was $55,635 from the Plan and $47,393 from employees.

Ten year historical trend information showing the KERS progress in accumulating sufficient assets to pay benefits when due is presented in the Kentucky Employees' Retirement System's Annual Financial Report (which is a matter of public record). The most recent actuarial valuation was as of June 30, 2005. The Commonwealth of Kentucky's Comprehensive Annual Financial Report should be referred to for additional disclosures related to the Kentucky Employees' Retirement System.

In addition to the above defined benefit pension plan, the Plan's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship.

NOTE 11 - INTERGOVERNMENTAL PAYABLES

Intergovernmental payable of $680,832 at June 30, 2006, consist of $400,000 due to the Commonwealth of Kentucky Personnel Cabinet for administrative fees and $280,832 for operating transfers.

NOTE 12 - OPERATING TRANSFERS

The following table summaries operating transfers between the Plan and the Commonwealth of Kentucky Personnel Cabinet during the six months ended June 30, 2006 for personnel and general and administrative expenses:

Transfers from the Commonwealth of Kentucky Personnel Cabinet	$	3,984,364
Transfers to the Commonwealth of Kentucky Personnel Cabinet		(5,857,778)
Net operating transfers out	$	(1,873,414)

NOTE 13 - RISK MANAGEMENT

The Plan is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; and errors and omissions. The Plan utilizes the Commonwealth of Kentucky's Risk Management Fund to cover exposure to these potential losses. The Commonwealth of Kentucky's Comprehensive Annual Financial Report should be referred to for additional disclosures related to the Risk Management Fund.

NOTE 14 - COMMITMENTS

The Plan has entered into long term contracts with certain vendors for processing medical claims and processing pharmacy claims in support of the Plan's operations. The medical claims processing contract expires June 30, 2008. The total amount to be paid for processing medical claims is based on a monthly per participant cost with no limit. The contract provisions also include a terminal administration fee equal to three months cost per participant and a fee for claims runoff after twelve months.

The pharmacy claims processing contract also expires June 30, 2008. The total amount to be paid for processing pharmacy claims is based on a per claim cost with no limit.

The fees incurred by the Plan for services performed by the above third party administrators totaled approximately $28,998,000 for the six months ended June 30, 2006.

The Plan has also entered into a long term contract with a vendor to provide health insurance consultation and actuarial services including premium rate setting. This contract expires June 30, 2008. The total amount to be paid on the contract shall not exceed $2.8 million.

NOTE 15 - RECENT GASB PRONOUNCEMENT

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45, "*Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*." GASB Statement No. 45 requires employers that participate in single-employer or agent multiple-employer other postemployement benefit (OPEB) plans to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. This statement is first effective for periods beginning after December 15, 2006. Early implementation is encouraged. The Plan has not yet determined the impact, if any, that GASB No. 45 will have on its financial statements.

MOORE STEPHENS POTTER LLP
CERTIFIED PUBLIC ACCOUNTANTS ▪ BUSINESS ADVISORS

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Secretary of the Personnel Cabinet
Commonwealth of Kentucky
Frankfort, Kentucky

We have audited the accompanying financial statements of the Kentucky Employees Health Plan as of and for the six months ended June 30, 2006, and have issued our report thereon dated November 28, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Kentucky Employees Health Plan's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Kentucky Employees Health Plan's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as item 2006-1.

We noted certain other matters that we reported to management of the Kentucky Employees Health Plan in a separate letter dated November 28, 2006.

This report is intended solely for the information and use of Plan management, the Personnel Cabinet of the Commonwealth of Kentucky, the Finance and Administration Cabinet of the Commonwealth of Kentucky, and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

Moore Stephens Potter, LLP

MOORE STEPHENS POTTER, LLP
November 28, 2006

KENTUCKY EMPLOYEES HEALTH PLAN
SCHEDULE OF AUDIT FINDINGS
Six Months Ended June 30, 2006

Schedule of auditor's results

We have issued an unqualified opinion dated November 28, 2006, on the financial statements of the Kentucky Employees Health Plan as of and for the year ended June 30, 2006.

Internal Control over financial reporting:

Material weakness(es) identified?	_____ yes	__X__ no
Reportable condition(s) identified that are not considered to be material weaknesses?	_____ yes	__X__ none reported
Noncompliance material to financial statements noted?	__X__ yes	_____ no

KENTUCKY EMPLOYEES HEALTH PLAN
SCHEDULE OF AUDIT FINDINGS
Six Months Ended June 30, 2006

Finding relating to the financial statements

Finding 2006-1

Condition - According to KRS 66.480(1)(d) and KRS 41.240(4), the depository institution should pledge or provide sufficient collateral which, together with Federal Deposit Insurance Corporation insurance, equals or exceeds the amount of public funds on deposit at all times. The Plan's deposits of public funds in depository institutions were uninsured and unsecured.

Cause - The Plan has uninsured and unsecured deposits over FDIC limits.

Effect - At June 30, 2006, $26,198,581 of the Plan's deposits of public funds in depository institutions were uninsured and unsecured.

Auditor's Recommendation - We recommend that the Plan require the depository institution to pledge or provide collateral in an amount sufficient to secure deposits of public funds at all times.

Management's Response - The Department of Employee Insurance (DEI) management agrees with the recommendation to secure all public funds on deposit for operating the Plan. These funds are on deposit in two National City Treasury Management accounts which include the electronic transfers to an escrow account and those funds deposited by checks to a lockbox for premium payments from school boards, health departments, and some local governments. Plan funds are currently swept in to overnight investments for a higher rate of interest and returned the next business day. However, the investments do not meet the statutory requirements for state investment, so the Personnel Cabinet has asked the Office of Financial Management in the Finance and Administration Cabinet to make arrangements with National City Bank and Humana to invest the funds into money market instruments that will be in compliance.

In advance of this review, management has changed procedures, effective January 2, 2007, such that funds will be transferred as each check is issued rather than when each check is presented to the bank. This will eliminate the need to advance state funds to Humana and effectively will move investment funds to the state depository and solve the problem. We will continue to require an overnight sweep of the funds on deposit to the advantage of the Commonwealth.

KENTUCKY EMPLOYEES HEALTH PLAN

REQUIRED SUPPLEMENTAL INFORMATION

ONE-YEAR CLAIMS DEVELOPMENT INFORMATION

			2006
1	Earned premium revenue	$	578,263,236
2	Administrative fees		31,604,332
3	Incurred claims as originally estimated		472,143,107
4	Claims paid (cumulative) as of:		
	End of fiscal year		(398,455,552)
5	Re-estimation of incurred claims:		
	End of fiscal year		472,143,107
6	Increase (decrease) in estimated incurred claims from the original estimate using re-estimation as of end of the most recent fiscal year	$	0

The table above illustrates how the Plan's earned revenues compare to related costs of loss and other expenses assumed by the Plan as of the end of the year. The rows of the table are identified as follows:

1) This line shows the total fiscal year's earned premium revenues.
2) This line shows the fiscal year's administrative fees.
3) This line shows the incurred claims (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called policy year).
4) This line shows the cumulative amount paid as of the end of the successive year for each policy year.
5) This line shows how the policy year's incurred claims increased or decreased as of the end of the year. This annual re-estimation results from new information received on known claims, re-evaluation of existing information on known claims, as well as emergence of new claims not previously known.
6) This line compares the latest re-estimated incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature policy years.