

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL

Mr. Thomas L. Wagner, Jr., CPA
State Auditor
State of South Carolina
Columbia, South Carolina

Dear Mr. Wagner:

We have audited the combined financial statements of the South Carolina State Budget and Control Board, Office of Insurance Services (the "Office") as of and for the years ended June 30, 2001 and 2000, and have issued our report thereon dated September 21, 2001. These financial statements are the responsibility of the Office's management. Our responsibility is to express an opinion on these combined financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

The management of the Office is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of combined financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the combined financial statements of the Office for the years ended June 30, 2001 and 2000, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control. Accordingly, we do not express such an opinion or provide such assurance. With respect to the internal control, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control would not necessarily disclose all matters in the internal control components that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the combined 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. However, we noted the following matter involving internal control and its operation that we consider to be a material weakness as defined above.

During 2000/2001, the Health, Life and Disability Insurance Reserve Fund reported a net income of \$9,594,574. This income, along with losses in recent years, has resulted in a retained deficit of \$72,303,889 for the Fund at June 30, 2001. Additionally, Section 1-11-710(A)(4) of the South Carolina Code of Laws, 1976, as amended, stipulates that “a reserve equal to not less than an average of one and one-half months’ claims must be maintained in the accounts and all funds in excess of the reserve must be used to reduce premium rates or expand benefits as funding permits.” Under Proviso 63B.9 the reserve requirement was changed. The Proviso reads “Notwithstanding any other provision of law, the State Health Plan is only required to seek a twenty-two day reserve fund by the end of calendar year 2001.” As of June 30, 2001, the HLDIRF does not have a twenty-two day reserve fund. Management of the HLDIRF has reviewed the above situations and offers their analysis below. Although certain changes in the funding and coverages have taken place, there is no guarantee that the HLDIRF will return to a surplus position or that cash will be adequate to cover claims and administrative costs. Additional funding sources, such as further rate increases, State appropriations, etc. may be necessary to provide for the costs of the continued existence of the Plan.

Management’s analysis:

The State Health Plan continues to experience unprecedented claims expenditure growth. This is a result of continued dramatic increases in service volume and prescription drug costs. As was anticipated during calendar year 2000, State Health Plan expenditures exceeded income. Effective January 2001, a combination of increased funding and benefit payment reductions were enacted in an effort to improve the Plan's financial condition and restore Plan reserves. However, those measures were not sufficient to garner financial stability of the Plan. Further measures have been deemed necessary and additional funding increases and cost sharing initiatives have been enacted with an effective date of January 2002. These measures include a \$12 per month employee increase and an approximate average 9.5% increase in employer funding. In

addition to increased funding, several cost sharing initiatives are slated for implementation. They include a \$100 deductible for Emergency Room services (waived if admitted), a \$50 deductible for Outpatient services (waived for oncology, physical therapy and Emergency Room), a \$2 copayment increase for prescription drugs, a "pay the difference" generic substitution policy and a \$100/person increase in the out-of-pocket prescription drug maximum.

Additionally, beginning in 2002, the State Health Plan will be operating under a new Administrative Services Only contract with BCBSSC. This contract will allow for further cost savings initiatives for the Plan. Most notably, a nationwide network of hospitals and physicians, for which discounts will be made available to the Plan for members receiving services outside of South Carolina.

Management is and will be continually monitoring the financial condition of the State Health Plan, as well as keeping the Board and other interested parties updated as to the Plan's financial status.

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This report is intended solely for the information of the State Auditor, management and others within the Organization and is not intended to be and should not be used by anyone other than these specified parties.

We would be pleased to discuss the above matters or to respond to any questions, at your convenience.

September 21, 2001