

Report on Audits of Financial Statements

South Carolina State Accident Fund

for the years ended June 30, 2006 and 2005

State of South Carolina



Office of the State Auditor

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October 12, 2006

The Honorable Mark Sanford, Governor
and
Mr. Harry B. Gregory, Jr., Director
South Carolina State Accident Fund
Columbia, South Carolina

This report on the audit of the financial statements of the South Carolina State Accident Fund for the fiscal year ended June 30, 2006 was issued by Scott McElveen, L.L.P., Certified Public Accountants, under contract with the South Carolina Office of the State Auditor.

If you have any questions regarding this report, please let us know.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Richard H. Gilbert Jr.", written in a cursive style.

Richard H. Gilbert, Jr., CPA
Deputy State Auditor

RHGjr/trb

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Independent Auditors' Report

Mr. Richard H. Gilbert, Jr.
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

We have audited the accompanying statements of net assets of the South Carolina State Accident Fund (the "Fund") as of June 30, 2006 and 2005, and the related statements of revenues, expenses, and changes in net assets, 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 and the standards applicable to financial audits contained in *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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

As described in Note 1 to the financial statements, the financial statements of the Fund are intended to present the financial position and results of operations of only that portion of the financial reporting entity of the State of South Carolina that is attributable to the transactions of the Fund. They do not purport to and do not present the financial position of the State of South Carolina as of June 30, 2006 and 2005 nor changes in its financial position or cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America, and do not include any other agencies, divisions or component units of the State of South Carolina.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 22, 2006, on our consideration of the Fund'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. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis, as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Scott McElveen, L.L.P.

Columbia, South Carolina
September 22, 2006

Required Supplementary Information

STATE ACCIDENT FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

The South Carolina State Accident Fund (the "Fund") presents a management's discussion and analysis of its financial statements for fiscal year 2006. The discussion includes an overview of the financial activity for the year. This report is prepared in accordance with Governmental Accounting Standards Board Statement 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*. This discussion should be read in conjunction with the Fund's financial statements and accompanying notes.

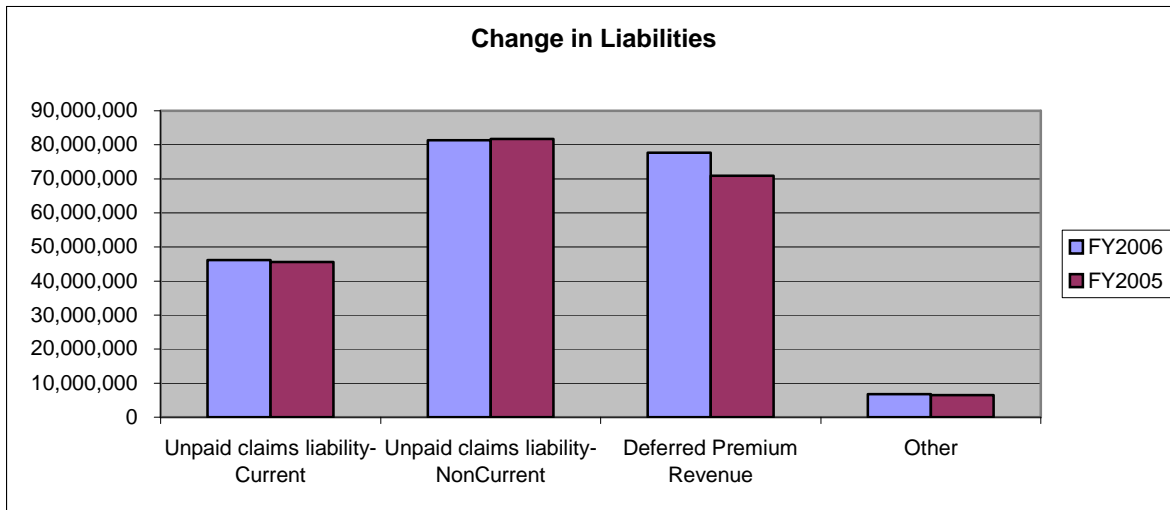
Overview of the Financial Statements and Financial Analysis

The Statement of Net Assets presents information reflecting the Fund's assets, liabilities, and net assets. This statement provides the reader with a snapshot view at a point in time. Net Assets represents the amount of total assets less liabilities. Assets and liabilities are shown as current and long term. Current assets and liabilities are those with immediate liquidity or which are collectible or due within twelve months of the statement date. The Statement of Net Assets indicates the funds available for the Fund's operation along with the liabilities that will come due during the next fiscal year. Net assets improved by approximately \$197 thousand over the prior fiscal year.

Unpaid claims liabilities are a large part of the Fund's liabilities and have been separated into current (to be paid within one year) and long-term (to be paid after one year). Current and long-term estimated unpaid claim liabilities had little change compared to the prior year. (See Change in Liabilities chart below) Another large part of the liabilities is deferred premium revenue, which represents the amount of premium billed, but not yet earned, for the future period. Deferred premium revenues increased by approximately \$6 million due to an increase in the number of policyholders and an increase in rates effective January 1, 2006.

June 30, 2006

	FY2006	FY2005
ASSETS		
Current assets	\$ 98,258,048	\$ 90,811,543
Capital assets, net of accumulated depreciation	70,319	146,630
Other noncurrent assets	817,592	901,293
Total assets	99,145,959	91,859,466
LIABILITIES		
Current liabilities	130,439,934	122,984,880
Noncurrent liabilities	81,463,865	81,829,102
Total liabilities	211,903,799	204,813,982
Net Assets		
Invested in capital assets	70,319	146,630
Unrestricted	(112,828,159)	(113,101,146)
Total net assets	\$ (112,757,840)	\$ (112,954,516)



The chart above shows the breakdown of liabilities and the change compared to the previous fiscal year.

Statements of Revenues, Expenses, and Changes in Net Assets

This statement represents operating revenues and expenses, as well as the non-operating revenues and expenses during the operating year. The purpose of this statement is to present the reader with information relating to monies received and expenses paid during the year. The Fund's revenue comes primarily from premium income for workers' compensation insurance coverage provided to state agencies and political subdivisions. The major expenses are from incurred claim liabilities, which include medical costs and lost wages paid to injured workers and the change in anticipated future payments. Though the Fund is a state agency, its normal operation is similar to that of other property and casualty insurance companies. The Fund receives no state appropriations.

The Fund is a proprietary fund entity; therefore, the statement of Revenues, Expenses, and Changes in Net Assets has been prepared on the accrual basis. Statements prepared using the accrual basis recognize revenues when earned and expenses when incurred.

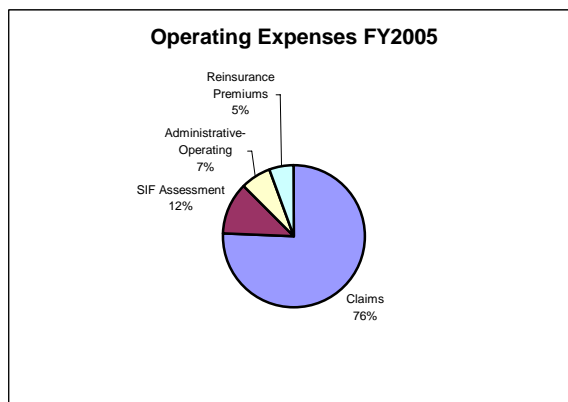
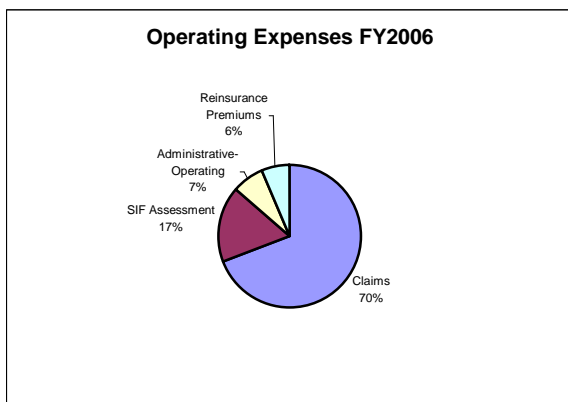
Operating revenues decreased by approximately \$5.9 million in fiscal year 2006 compared to fiscal year 2005. This decrease was due to the transfer of Department of Education – Transportation school bus drivers to the local school districts.

The operating expenses in this statement include administrative expenses, claims paid, and claims incurred during the year. Operating expenses decreased by approximately \$11.9 million compared to the prior fiscal year. This decrease was partly due to the change in reserves in accordance with the actuarial report. Fiscal year 2005 had a change in reserves of \$8.5 million (which increased the claims paid and incurred) while the fiscal year 2006 change in reserves was only \$273,000. The administrative cost ratio for fiscal year 2006 was 7.7% compared to 7.8% in fiscal year 2005. The administrative cost ratio means 7.7% of premium dollars were used to operate the Fund during the fiscal year. The Fund has one of the lowest administrative cost ratios in the workers' compensation industry.

**Condensed Statements of Revenues, Expenses, and Changes in Net Assets
for the year ended June 30, 2006**

	2006	2005
Operating revenues	\$ 72,706,067	\$ 78,689,929
Operating expenses	<u>73,519,791</u>	<u>85,454,675</u>
Operating loss	(813,724)	(6,764,746)
Nonoperating revenues and expenses	<u>1,010,400</u>	<u>893,192</u>
Increase (Decrease) in net assets	196,676	(5,871,554)
Nets assets - beginning of year	<u>(112,954,516)</u>	<u>(107,082,962)</u>
Net assets at end of year	<u><u>\$ (112,757,840)</u></u>	<u><u>\$ (112,954,516)</u></u>

The charts below indicates that during the past two fiscal years 70-76% of expenses have been paid directly to injured workers or to medical providers on behalf of the injured worker.



Capital Asset and Debt Activity

Capital assets additions were \$41,199 and related to the purchase of six new switches that are used to connect users to the network. The switches were not put into operation before June 30, 2006 therefore, no depreciation expense was included for fiscal year 2006. These purchases enabled the Fund to maintain and improve its operations. There were no other significant additions to capital assets and no capital asset retirements during the fiscal year. The Fund had no changes in credit rating or debt limitations that may affect future financing.

Economic Outlook

After some financially challenging years, the Fund concluded fiscal year 2006 with a net income of \$196,676. That net gain was a significant improvement over the fiscal year 2005 net loss of \$5.9 million. This performance is the result of focused efforts to improve operational efficiency, quality case management, and effective premium pricing. We continue to work with our actuaries and reinsurers to ensure that we operate in a responsible manner. As part of continuing efforts to address prior operating losses, a rate change was made effective January 1, 2006. During fiscal year 2006, the Fund's policy retention ratio was 99.36%. By continuing to improve services and controlling cost in a hardening workers' compensation market, we expect to attract additional policyholders and retain our high retention ratio.

The National Council on Compensation Insurance, a national rate making organization, estimates that medical and indemnity costs will continue to rise in South Carolina and nationwide. Even though the Fund's average claim costs remain below the industry average, we continue to seek and utilize cost containment tools to further reduce cost to our policyholders.

The Fund's current cost containment programs include:

- The managed care program implemented during fiscal year 2002 continues to have a moderating influence.
- Reinsurance coverage purchased to cover risk in excess of retention limits.
- A third party subrogation program implemented to increase recoveries.
- Several negotiated agreements to reduce charges below the Workers' Compensation Commission fee schedule:
 - A physical therapy network developed and implemented during fiscal year 2005.
 - A pricing discount agreement on diagnostic images was implemented.
 - Hospital fee reduction service.

While currently in the process of reviewing all existing programs and contracts, the Fund is also actively pursuing additional cost-saving opportunities:

- In the process of awarding a pharmacy discount program with charges below the Workers' Compensation Commission Fee Schedule.
- In the process of awarding a medical provider and hospital bill review program with charges below the Workers' Compensation Commission Fee Schedule.
- In the process of developing a new Request For Proposal (RFP) for medical case management.
- In the process of developing a new Request For Proposal (RFP) for claims management services.

During the 2003 legislative session, the General Assembly exercised its authority to redirect money held in trust funds. As required by Proviso 73.2, the Fund transferred \$11,585,710 in fiscal year 2004 to the State's General Fund, in addition to the \$1,791,269 transferred during fiscal year 2003. The short-term impact of this transfer was the reduction of our Cash and Cash Equivalents as of June 30, 2003 from \$14.8 million to \$6.1 million as of June 30, 2004. Although our cash flow increased to \$23 million for fiscal year 2005, the transfer of funds earmarked for future liabilities continue to contribute to the shortfall for future liabilities. Recognizing that the short and long term effects of such reductions can be significant to a provider of workers' compensation coverage, the General Assembly, as provided by Proviso 73.14, will transfer \$13,376,979 to the Fund in fiscal year 2007 to repay funds redirected in fiscal years 2003 and 2004. The repayment of these funds will help to improve the Fund's financial position. The Fund takes serious its obligation to provide workers' compensation coverage to state, county and local governments as cost-effectively as possible. Although the State Treasurer guarantees the obligating of the Fund, it is the Fund's goal to ensure it operates responsively by utilizing acceptable actuarial and accounting standards.

South Carolina State Accident Fund
Statements of Net Assets
June 30,

	<u>2006</u>	<u>2005</u>
Assets:		
Current assets:		
Cash and cash equivalents	\$ 26,037,228	\$ 23,200,358
Premiums receivable	71,084,440	66,861,463
Claims recoveries and reimbursement receivables	763,686	426,032
Recoverable under reinsurance annuity contract	120,364	120,364
Accrued interest receivable	237,326	148,983
Prepaid expenses	15,004	54,343
Total current assets	<u>98,258,048</u>	<u>90,811,543</u>
Noncurrent assets:		
Capital assets, net of accumulated depreciation	70,319	146,630
Recoverable under reinsurance annuity contract	81,642	89,986
Investment in reinsurance annuity contract, net of accumulated amortization of \$470,987 and \$546,345, respectively	<u>735,950</u>	<u>811,307</u>
Total noncurrent assets	<u>887,911</u>	<u>1,047,923</u>
Total assets	<u><u>\$ 99,145,959</u></u>	<u><u>\$ 91,859,466</u></u>
Liabilities and Net Assets		
Current liabilities:		
Cash overdraft	\$ —	\$ 14,481
Accounts payable	160,882	465,353
Accrued compensated absences and related benefits	254,183	257,994
Accrued payroll and related liabilities	296,146	306,479
Accrued refundable premiums	5,934,359	5,367,063
Deferred premium revenue	77,654,364	70,955,510
Unpaid claims liability and claims adjustment expenses payable within one year, net	<u>46,140,000</u>	<u>45,618,000</u>
Total current liabilities	<u>130,439,934</u>	<u>122,984,880</u>
Noncurrent liabilities:		
Accrued compensated absences and related benefits	94,865	81,102
Unpaid claims liability and claims adjustment expenses payable beyond one year – net	<u>81,369,000</u>	<u>81,748,000</u>
Total noncurrent liabilities	<u>81,463,865</u>	<u>81,829,102</u>
Total liabilities	<u>211,903,799</u>	<u>204,813,982</u>
Net assets		
Invested in capital assets	70,319	146,630
Unrestricted deficit	<u>(112,828,159)</u>	<u>(113,101,146)</u>
Total net assets	<u>(112,757,840)</u>	<u>(112,954,516)</u>
Total liabilities and net assets	<u><u>\$ 99,145,959</u></u>	<u><u>\$ 91,859,466</u></u>

The accompanying notes are an integral part of these financial statements.

South Carolina State Accident Fund
Statements of Revenues, Expenses and Changes in Net Assets
for the years ended June 30,

	<u>2006</u>	<u>2005</u>
Operating Revenues		
Premiums	<u>\$ 72,706,067</u>	<u>\$ 78,689,929</u>
Operating Expenses		
Claims	50,779,720	64,656,041
Second Injury Fund assessment	12,788,426	10,115,523
Administrative:		
Personal services and employee benefits	3,873,339	3,809,297
Contractual services	576,076	692,854
Rent and insurance	331,430	324,030
Supplies and materials	114,867	118,822
Depreciation	117,509	844,743
Amortization expense of reinsurance annuity contract premium	75,358	56,518
Reinsurance premiums	4,705,582	4,698,047
Other expenses	128,384	117,800
Actuarial fee	<u>29,100</u>	<u>21,000</u>
Total operating expenses	<u>73,519,791</u>	<u>85,454,675</u>
Operating loss	<u>(813,724)</u>	<u>(6,764,746)</u>
Nonoperating revenues:		
Interest/investment income	1,010,260	892,987
Other revenues	140	205
Total nonoperating revenues	<u>1,010,400</u>	<u>893,192</u>
Increase (decrease) in net assets	196,676	(5,871,554)
Net deficit, at beginning of year	<u>(112,954,516)</u>	<u>(107,082,962)</u>
Net deficit, at end of year	<u><u>\$ (112,757,840)</u></u>	<u><u>\$(112,954,516)</u></u>

The accompanying notes are an integral part of these financial statements.

South Carolina State Accident Fund
Statements of Cash Flows
for the years ended June 30,

	2006	2005
Cash flows from operating activities:		
Cash received for premiums from state agencies	\$ 57,594,972	\$ 66,480,695
Cash received for premiums from other entities	18,154,267	17,603,388
Cash received for reimbursements of claims expense from state agencies	14,983,620	15,063,272
Cash received for reimbursements of claims expense from other entities	1,835,910	1,614,043
Payments for claims	(67,785,561)	(64,900,015)
Payments for salaries and related benefits	(3,873,719)	(3,775,280)
Payments of second injury fund assessment to other state agency	(12,788,426)	(10,115,523)
Payments for other administrative expenses to other state agencies	(468,575)	(118,575)
Payments for other administrative expenses to other entities	(5,681,995)	(5,416,089)
Net cash provided by operating activities	<u>1,970,493</u>	<u>16,435,916</u>
Cash Flows from Non-Capital and Related Financing Activities:		
Other receipts	140	205
Repayment of cash overdraft, net	(14,481)	(126,218)
Net cash used in non-capital and related financing activities	<u>(14,341)</u>	<u>(126,013)</u>
Cash Flows from Capital and Related Financing Activities:		
Acquisition of capital assets	(41,199)	(32,487)
Net cash used in capital and related financing activities	<u>(41,199)</u>	<u>(32,487)</u>
Cash Flows from Investing Activities:		
Interest/investment income received	921,917	856,807
Net cash provided by investing activities	<u>921,917</u>	<u>856,807</u>
Net increase in cash and cash equivalents	2,836,870	17,134,223
Cash and cash equivalents, beginning of year	<u>23,200,358</u>	<u>6,066,135</u>
Cash and cash equivalents, end of year	<u><u>\$ 26,037,228</u></u>	<u><u>\$ 23,200,358</u></u>
Reconciliation of net operating revenues (expenses) to net cash provided by operating activities:		
Operating loss	\$ (813,724)	\$ (6,764,746)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation and amortization	192,867	901,261
Changes in assets and liabilities:		
Premiums receivable	(4,222,977)	5,397,760
Claims recoveries and reimbursement receivables	(337,654)	(109,423)
Prepaid expenses	39,339	528,423
Recoverable under reinsurance annuity contract	8,344	61,764
Accounts payable	(304,471)	(90,534)
Accrued compensated absences and related benefits	9,953	44,416
Accrued payroll and related liabilities	(10,333)	(10,399)
Accrued refundable premiums	567,295	1,315,777
Deferred premium revenue	6,698,854	(1,319,383)
Estimate of unpaid claims liability	143,000	16,481,000
Total adjustments	<u>2,784,217</u>	<u>23,200,662</u>
Net cash provided by operating activities	<u><u>\$ 1,970,493</u></u>	<u><u>\$ 16,435,916</u></u>

The accompanying notes are an integral part of these financial statements.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies

Reporting Entity – The Fund, a primary entity, is part of the primary government of the State of South Carolina and is included in the Comprehensive Annual Financial Report of the State of South Carolina. The Fund was established by Section 42-7-10 of the Code of Laws of South Carolina, as amended, to provide workers' compensation insurance coverage to State entities. Although the State of South Carolina (the "State") is the Fund's predominant participant, counties, municipalities, and other political subdivisions of the State may elect to participate. The State assumes the full risk for the covered claims. The Fund is responsible for investigating, adjusting and paying workers' compensation claims as awarded by the Workers' Compensation Commission for job related accidental injury, disease, or death to employees of participants.

The Fund is administered by a director, appointed by the Governor, with the advice and consent of the Senate, for a term of six years. The accompanying financial statements present the financial position, results of operations, and cash flows solely of the Fund and do not include any other departments, institutions, component units, etc. of the State.

The core of the financial reporting entity is the primary government which has a separately elected governing body. As required by generally accepted accounting principles, the financial reporting entity includes both the primary government and all of its component units. Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. In turn, component units may have component units.

An organization other than a primary government may serve as a nucleus for a reporting entity when it issues separate financial statements. That organization is identified herein as a primary entity.

A primary government or entity is financially accountable if it appoints a voting majority of the organization's governing body including situations in which the voting majority consists of the primary entity's officials serving as required by law (e.g., employees who serve in an ex-officio capacity on the component unit's board are considered appointments by the primary entity) and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary entity. The primary entity also may be financially accountable if an organization is fiscally dependent on it even if it does not appoint a voting majority of the board. An organization is fiscally dependent on the primary government or entity that holds one or more of the following powers:

- (1) Determines its budget without another government's having the Fund to approve and modify that budget.
- (2) Levies taxes or set rates or charges without approval by another government.
- (3) Issues bonded debt without approval by another government.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Reporting Entity (continued) – The organization is fiscally independent if it holds all three of those powers. Based on the criteria, the Fund has determined it is not a component of another entity and it has no component units.

The budget, personnel, procurement, and other laws of the State and the policies and procedures for State agencies are applicable to the activities of the Fund.

Fund Accounting – The State government uses funds to report its financial position and the results of its operations. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities.

A fund is a separate fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with related liabilities and residual equities or balances and changes therein which are segregated to carry on specific activities or attain certain objectives in accordance with applicable regulations, restrictions, or limitations.

The Fund is an internal service fund of the proprietary fund type of the State. Such funds account for the financing of goods and services.

Basis of Accounting – The accounting policies of the Fund conform to generally accepted accounting principles (“GAAP”) applicable to proprietary activities as prescribed by the Governmental Accounting Standards Board (“GASB”), the recognized standard-setting body for GAAP for all state governmental entities. Proprietary fund entities use the accrual basis of accounting. If measurable, revenues are recognized when earned and expenses when incurred. In accordance with GASB Statement 20, the Fund has elected to apply all applicable GASB pronouncements as well as all applicable FASB pronouncements issued on or before November 30, 1989 not in conflict with GASB standards.

Cash and Cash Equivalents – Amounts represent cash on deposit with the State’s Treasurer, cash in banks, and cash invested in various instruments by the State Treasurer as part of the State’s internal cash management pool and short-term investments not held by the State Treasurer’s Office and having a maturity at purchase of three months or less.

Because the internal cash management pool operates as a demand deposit account, amounts invested in the pool are classified as cash and cash equivalents. The pool includes some long-term investments such as obligations of the United States and certain agencies of the United States, obligations of the State and certain of its political subdivisions, certificates of deposit, collateralized repurchase agreements, and certain corporate bonds.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents (continued) – The State’s internal cash management pool consists of a general deposit account and several special deposit accounts. The State records each fund’s equity interest in the general deposit account; however, all earnings on that account are credited to the General Fund of the State. Investments held by the pool are carried at fair value. Interest earned on the agency’s special deposit account is posted to the agency’s account at the end of each month and is retained by the agency. The Fund records and reports its deposits in the general deposit account at cost. The Fund reports its deposits in the special deposit accounts at fair value. Interest earnings are allocated based on the percentage of the Fund’s accumulated daily income receivable to the total interest receivable of the pool. Reported investment income includes interest earnings, realized gains/losses and unrealized gains/losses on investments in the pool arising from changes in fair value. Realized gains and losses are allocated daily and are included in the accumulated income receivable. Unrealized gains and losses are allocated at year-end based on the percentage ownership in the pool.

Although the cash management pool includes some long-term investments, it operates as a demand deposit account, therefore, for credit and other risk information pertaining to the cash management pool, see the Comprehensive Annual Financial Report of the State of South Carolina.

Capital Assets – Capital assets are recorded at cost at the date of acquisition. The Fund follows capitalization guidelines established by the State. All land is capitalized, regardless of cost. The Fund capitalizes movable personal property with a unit value in excess of \$5,000 and a useful life in excess of two years and intangible assets including software costing in excess of \$100,000. Routine repairs and maintenance are charged to operating expenses in the year in which the expense was incurred.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 3 to 10 years.

Unpaid Claims Liability – The Fund establishes unpaid claims liabilities based on estimates of the ultimate cost of claims that have been reported but not settled, and of claims that have been incurred but not reported. The amount accrued includes estimated specific incremental claims adjustment expenses but not administrative expenses. Estimated amounts of salvage and subrogation and reinsurance recoverable, if any, on both settled and unsettled claims have been deducted from the liability for unpaid claims to the extent reasonably estimable. In addition, to the extent reasonably estimable, the liability for unpaid claims has been adjusted for amounts to be recovered or reimbursed from participants who retain the risk of loss for specific periods. This includes amounts recoverable from the State for state agency claims prior to July 1, 1986. See Note 8 for further explanation. Claims liabilities for claims of the South Carolina Department of Transportation (“DOT”) prior to January 1, 1994, are not included in the Fund’s claims liability. (See below and Note 4 for further information). Because actual claims costs depend on such complex factors as inflation, changes in doctrine of legal liability, and damage awards, the process used in computing claims liabilities does not necessarily result in an exact amount.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Unpaid Claims Liability (continued) – Claims liabilities are recomputed annually as of fiscal year end using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. While management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided.

The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in current earnings. A provision for inflation in the calculation of estimated future claims costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made.

DOT and the South Carolina Department of Public Safety (“DPS”) managed their own workers’ compensation claims prior to restructure. When they became policyholders, the Fund agreed to provide claim services for their claims with a date of injury prior to January 1, 1994 for DOT and August 1, 1993 for DPS. Because the Fund was not the insurer and had not collected premiums to cover these losses, the agencies reimbursed the Fund for the cost of these claims. In the 1998-1999 Appropriations Bill 700, Proviso 44.4 stated, “(SAF: Workers’ Compensation Claims) from the funds in the Workers’ Compensation Trust Fund, the Fund shall purchase an annuity for the purpose of funding the future obligation for workers’ compensation claims filed prior to restructuring by South Carolina Department of Highways and Public Transportation employees.” After June 30, 1998 the Fund was no longer reimbursed, as originally agreed upon. Instead it used the funds received from the annuity purchased under the proviso to pay these claims. This annuity is being amortized over the life of the contract in proportion to annuity proceeds received. See note 4 for further discussion.

Reinsurance – The Fund has obtained reinsurance coverage to reduce its exposure to losses on insured events. Losses in excess of \$1,000,000 from an insured event are covered up to limits based on the type of injury as set by the worker’s compensation statutes of the South Carolina Code of Laws, with the Fund retaining the risk for the first \$1,000,000 of loss. Reinsurance permits recovery of a portion of losses from reinsurers, although it does not discharge the primary liability of the Fund as direct insurer of the risks reinsured. The Fund does not report reinsured risks as liabilities unless it is probable that those risks will not be covered by reinsurers. The prior policy covered losses in excess of \$600,000. The reinsurance coverage also reduces its exposure to losses on insured events related to State owned aircrafts in excess of \$1,000,000 per occurrence up to the limit of \$9,000,000. In addition, the Fund purchased a reinsurance covering losses resulting from an Act of Terrorism up to \$2,000,000 per claimant for calendar year 2006 and 2005.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Recognition of Premium Revenue, Receivables and Deferred Revenue – Premiums are recognized as revenue on a pro rata basis over the policy term. Policies are billed and issued on both the fiscal year and calendar year basis. Premiums are based on an actuarial method and are currently adjusted so that over a reasonable period of time expected revenues, including investment income, and anticipated expenses will be approximately equal. In addition, premium revenue includes accrued premium adjustments for additional premiums owed by policyholders as determined based on actual payrolls for the policy period which are in excess of estimated premiums billed which were based on estimated payroll costs. Revenue is reduced for refunds payable. Estimated premiums receivables and refund payables are recorded as of year-end for future anticipated premium adjustments for the policy years which end within the Fund's fiscal year. A receivable is recorded at the time the annual estimated premium is billed even though some/all of the amount may not be currently due. Deferred revenue is recognized to the extent that the premiums billed and not yet received are for future periods. In addition, deferred revenue is recognized for unearned premiums received.

Budget Policy – The Fund is granted an annual appropriation for operating purposes by the General Assembly (to be funded by workers' compensation premiums and interest earned thereon). The appropriation as enacted becomes the legal operating budget for the Fund. The General Assembly enacts the budget through passage of specific line-item appropriations by program within budgetary unit, within budgetary fund category, State General Fund or other budgeted funds. Budgetary control is maintained at the line-item level of the entity. Agencies may process disbursement vouchers in the State's budgetary accounting system only if enough cash and appropriation authorization exist.

Transfers of funds may be approved by the State Budget and Control Board under its Fund or by the agency as set forth in the 2006 Appropriations Act proviso 72.14 as follows: Agencies are authorized to transfer appropriations within programs and within the agency with notification to the Division of Budget and Analyses and the State Comptroller General. No such transfer may exceed twenty percent of the program budget. Transfers from personal services accounts or from other operating accounts may be restricted to any level set by the Board.

Agencies may charge vendor, interagency, and interfund payments for fiscal year 2006 to 2007 appropriations in July. Any unexpended appropriations as of June 30 automatically lapse on July 31 unless authorization is received from the General Assembly to carry over the funds to the ensuing fiscal year. State law does not precisely define the budgetary basis of accounting. For each fiscal year, the level of legal control for each agency is reported in a publication by the State Comptroller General. The current Appropriations Act states that the General Assembly intends to appropriate all monies to operate State government for the current fiscal year. The State's annual budget is prepared primarily on the modified accrual basis of accounting with several exceptions, principally the cash basis for payroll expenses and certain non-State appropriations revenue.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Budget Policy (continued) – The Fund’s budget includes administrative expenses and specifically excludes claims expense and the Second Injury Fund assessment. Amounts to be expended for capital assets are also budgeted. Expenses prepared on the accrual basis do not vary significantly from the budgetary basis. In accordance with generally accepted accounting principles applicable to business-type activities, a comparison of actual revenues and expenses to the budgeted amounts has not been presented.

Statement of Cash Flows – For purposes of cash flows, the Fund considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The State’s internal cash management pool is included in this definition of cash equivalents.

Compensated Absences – Generally all permanent full-time State employees and certain part-time employees scheduled to work at least one-half of the Fund’s workweek are entitled to accrue and carry forward at calendar year-end maximums of 180 days sick leave and of 45 days annual vacation leave.

Upon termination of State employment, employees are entitled to be paid for accumulated unused annual vacation leave up to the maximum, but are not entitled to any payment for unused sick leave. The compensated absences liability includes accrued annual leave and compensatory holiday and overtime leave earned for which the employees are entitled to paid time off or payment at termination. The Fund calculates the compensated absences liability based on recorded balances of unused leave for which the employer expects to compensate employees through paid time off or cash payments at termination. That liability is determined by using fiscal year-end current salary costs and the cost of the salary-related benefit payments. The net change in the liability is recorded in the current year in the personal services and employee benefits expense category.

Operating and Nonoperating Revenues and Expenses – The Fund distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and delivering goods in connection with a proprietary fund’s principal ongoing operations. The Fund’s primary operating revenues are from premium revenues. Operating expenses include the cost of sales or services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Net Assets – Net assets are categorized as follows:

Invested in capital assets: This represents the Fund’s total investment in capital assets, net of outstanding debt obligations, if any, related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

Unrestricted net assets: Unrestricted net assets (deficit) represent the remainder of the Fund’s liabilities in excess of assets excluding those net assets reported in other categories.

South Carolina State Accident Fund

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Use of Estimates – The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Such estimates include the unpaid claims liability.

Note 2. Risk Management

Insurance Coverage – The Fund, an administrative agency, is exposed to various risks of loss and maintains State or commercial insurance coverage for each of those risks. Management believes such coverage is sufficient to preclude any significant uninsured losses for the covered risks. There were no significant reductions in insurance coverage from prior years except for the increase in the base before reinsurance is received as discussed in Note 1. The cost of settled claims and claim losses has not exceeded this coverage in any of the past three years. The Fund pays insurance premiums to itself and certain other State agencies to cover risks that may occur in normal operations. The insurers promise to pay to or on behalf of the insured for covered economic losses sustained during the policy period in accordance with insurance policy and benefit program limits.

State management believes it is more economical to manage certain risks internally and set aside assets for claim settlement. Several State funds accumulate assets and the State itself assumes substantially all risks for the following type of claims:

1. Claims of State employees for unemployment compensation benefits. This type of claim is handled through the South Carolina Employment Security Commission;
2. Claims of covered employees for workers' compensation benefits for job-related illnesses or injuries. This type of claim is handled by the Fund;
3. Claims of covered public employees for health and dental insurance benefits. This type of claim is handled by the Office of Insurance Services; and
4. Claims of covered public employees for long-term disability and group-life insurance benefits. This type of claim is handled through the Office of Insurance Services. Employees elect health coverage through either a health maintenance organization or through the State's self-insured plan. All of the other coverages listed above are through the applicable State self-insured plan except dependent and optional life premiums are remitted to commercial carriers.

The Fund and other entities pay premiums to the State's Insurance Reserve Fund ("IRF") which issues policies, accumulates assets to cover the risks of loss, and pays claims incurred for covered losses related to the following assets, activities, and/or events:

1. Theft of, damage to, or destruction of assets – building contents;
2. General tort claims; and
3. Data processing equipment.

South Carolina State Accident Fund

Notes to Financial Statements

Note 2. Risk Management (continued)

The IRF is a self-insurer and purchases reinsurance to obtain certain services and specialized coverage and to limit losses in the areas of property insurance. Also, the IRF purchases reinsurance for catastrophic property insurance. Reinsurance permits partial recovery of losses from reinsurers, but the IRF remains primarily liable. The IRF's rates are determined actuarially.

State agencies and other entities are the primary participants in the State's Health and Disability Insurance Fund and in the IRF.

The Fund obtains coverage of up to \$100,000 per occurrence through a commercial insurer for employee fidelity bond insurance for all employees for losses arising from theft or misappropriation. The Fund has not transferred the portion of the risk of loss related to insurance policy deductibles for its property contents, general torts, and fidelity bond coverage's to a State or commercial insurer. There were no expenses incurred for the years ended June 30, 2006 and 2005 for actual claim payments related to such retained risk of loss.

The Fund has not reported an estimated claims loss expense and the related liability at June 30, 2006 and 2005, based on the requirements of GASB Statements No. 10 and No. 30, which state that a liability for claims must be reported only if information prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred on or before June 30, 2006 and 2005, and the amount of loss is reasonably estimable. In management's opinion, claims losses in excess of insurance coverage, if any, are unlikely and, if incurred, would be insignificant to the Fund's financial position. Furthermore, there is no evidence of asset impairment or other information to indicate that a loss should be recorded. Therefore, no loss accrual has been recorded.

Note 3. Deposits and Investments

Cash and cash equivalents consist of deposits under the control of the State Treasurer, who by law, has sole authority for investing State funds and deposits under the control of the Fund. However, as authorized by the State Treasurer's office, certain funds used to pay claims are deposited with financial institutions.

Deposits – State law requires full collateralization of all State Treasurer's bank balances. The State Treasurer must correct any deficiencies in collateral within seven days. With respect to investments in the State's cash management pool, all of the State Treasurer's investments are insured or registered or are investments for which the securities are held by the State or its agents in the State's name. Information pertaining to the carrying amounts, market values, credit and other risks as required by GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, of the State Treasurer's investments is disclosed in the Comprehensive Annual Financial Report of the State. Copies of this report may be obtained from the South Carolina Office of the Comptroller General, 1200 Senate Street, 305 Wade Hampton Office Building, Columbia, South Carolina 29201 or by visiting the Comptroller General's website at <http://www.cg.state.sc.us/>.

South Carolina State Accident Fund

Notes to Financial Statements

Note 3. Deposits and Investments (continued)

Deposits (continued) – At June 30, 2006 and 2005, cash and cash equivalents on deposit in the State's cash management pool and bank was \$26,037,228 and \$23,200,358, respectively. At June 30, 2006 and 2005, the bank balance in financial institutions was \$2,010,694 and \$1,006,533, respectively. The entire bank balance was covered by insurance and collateralized with securities held by the Fund, or by its agent in the Fund's name.

Investments – Investments meet the State's investment guidelines and consists of overnight repurchase agreements which are fully collateralized by U.S. Treasury securities. Because of the relatively small amount of the investments in overnight repurchase agreements, management does not believe that there is any concentration of credit risk associated with its investments. Fair value of investments approximates cost because of the short maturity of these investments.

All of the Fund's investments are stated at fair value except those meeting certain specific requirements. Purchases and sales are accounted for on the trade date. Unrealized gains and losses on investments have been recorded on the accrual basis. Earnings are recorded on the accrual basis. The Fund had no investments at June 30, 2006 and 2005.

Note 4. Investment in Reinsurance Annuity Contract

Under the 1993 Restructuring Act, the DOT and the DPS were created and were charged with responsibilities of the former Department of Highways and Public Transportation effective July 1, 1993. Proviso 44.4 of the 1998-1999 Appropriation Act passed by the General Assembly required the Fund to purchase an annuity for the purpose of funding the future obligation for workers' compensation claims filed prior to restructuring by the Department of Highways and Public Transportation employees using funds from the Workers' Compensation Trust Fund. While the State believes the annuity will provide funding adequate to cover this liability, the Fund has ultimate responsibility to pay these claims should the annuity funding be inadequate. On March 11, 1999 the Fund purchased a type one annuity that will pay a fixed amount quarterly for a period of forty years. The annuity was effective as of January 1, 1999. The Fund received its first quarterly annuity payment on April 5, 1999. For the year ended June 30, 2006 and 2005, the Fund paid approximately \$112,000 and \$58,600, respectively, of the DOT claims covered by this annuity. They received reimbursement of \$120,364 under this contract for the years ended June 30, 2006 and 2005. The amount of approximately \$202,000 and \$210,000, shown on the statement of net assets, as current and noncurrent, as recoverable under reinsurance annuity contract, represents amounts due under the annuity that will be collected in the future for cumulative claims payments in excess of cumulative annuity receipts. The estimated future claims is \$1,208,000 which is not included in the unpaid claims liability and claims adjustment expenses payable on the statement of net assets. Under the terms of the annuity the Fund will receive 160 quarterly payments. For the first forty payments the Fund will receive \$30,091 per quarter, the next forty payments will be for \$15,022, the next forty payments will be for \$3,726, and the last forty will be for \$2,364. Total amount to be received under the annuity will be \$2,048,120.

South Carolina State Accident Fund

Notes to Financial Statements

Note 4. Investment in Reinsurance Annuity Contract (continued)

The total price of the annuity was \$1,282,294 and was paid in a single premium. The amount of the annuity to purchase was determined actuarially. The amount remaining to be received by the Fund at June 30, 2006 and 2005 was \$1,175,481 and \$1,265,754, respectively.

The liability for these claims is not reported by either the Fund or the DOT because the State feels that the proceeds from the annuity contract will provide adequate funding to pay these claims and the risk of loss is remote. The annuity is being amortized over the life of the annuity in proportion to annuity proceeds received. The amount of amortization charged for the year ended June 30, 2006 and 2005 was \$75,358 and \$56,518, respectively, and is included as amortization expense in the statement of revenues, expenses and changes in net assets.

Note 5. Premiums Receivable

Premiums receivable consist of amounts receivable from the following:

	<u>2006</u>	<u>2005</u>
County and Municipal Governments and Agencies	\$ 5,527,238	\$ 5,425,891
State Agencies	65,557,202	61,435,572
	<u>\$ 71,084,440</u>	<u>\$ 66,861,463</u>

Included in premium receivable and premium revenue is \$1,318,808 and \$1,344,298 receivable from state agencies and \$101,218 and \$201,610 from county and municipal governments and agencies for estimated additional premium adjustments not processed as of June 30, 2006 and 2005, respectively. The majority of premiums receivable represent billings for future periods which have not been earned as of fiscal year-end.

Note 6. Capital Assets

Capital assets activity for the year ended June 30, 2006 is summarized as follows:

	Beginning Balance July 1, 2005	Increases	Decreases	Ending Balance June 30, 2006
Equipment and furniture	\$ 702,207	\$ 41,199	\$ —	\$ 743,406
Software	8,152,000	—	—	8,152,000
Total capital assets at historical cost	<u>8,854,207</u>	<u>41,199</u>	<u>—</u>	<u>8,895,406</u>
Less accumulated depreciation for:				
Equipment and furniture	626,777	46,308	—	673,085
Software	8,080,800	71,202	—	8,152,002
Total accumulated depreciation	<u>8,707,577</u>	<u>117,510</u>	<u>—</u>	<u>8,825,087</u>
Capital assets, net of accumulated depreciation	<u>\$ 146,630</u>	<u>\$ (76,311)</u>	<u>\$ —</u>	<u>\$ 70,319</u>

South Carolina State Accident Fund

Notes to Financial Statements

Note 7. Accrued Refundable Premiums

Policyholders are billed annually for estimated premiums based on the policyholder's estimated payroll. After the policy period ends, policyholders submit the details of the actual salaries paid and the Fund adjusts the premium based on the actual payroll and a rating modifier based on claims experience. The amounts the Fund owed policyholders for estimated premiums in excess of actual adjusted premiums at June 30, 2006 and 2005 was \$413,107 and \$346,030, respectively for those county and municipal policyholders. An additional \$5,521,252 and \$5,021,033 was due to State agencies. Included in these amounts is \$86,776 and \$45,773 estimated due to county and municipal governments and agencies and \$5,177,296 and \$4,879,106 estimated due to State agencies for estimated premium adjustments not processed as of June 30, 2006 and 2005, respectively.

Note 8. Unpaid Claims Liability and Claims Adjustment Expenses

The amount accrued for unpaid claims liability and claims adjustment expenses is an actuarially determined amount, based on the Fund's historical claims expenses adjusted for current factors, for the estimated ultimate cost of settling claims for events which occurred on or before year-end but were unpaid at the end of the year. To the extent claims were incurred on behalf of state agencies prior to July 1, 1986, reimbursement will be due from the State when the claims are paid. Estimated amounts recoverable from subrogation have been deducted from the claims liability.

The estimated reimbursement due from the State for claims prior to July 1, 1986, which is included in unpaid claims liability and claims liability adjustment expense, is as follows:

Due within one year	\$ 115,000
Due after one year	510,000
Total	<u>\$ 625,000</u>

The amounts accrued for unpaid claims liability and claims adjustment expenses, net of amounts recoverable from the State, for the past two years are as follows:

	<u>2006</u>	<u>2005</u>
Unpaid claims liability and claim adjustment expenses payable at beginning of year	\$ 127,366,000	\$ 110,885,000
Current year claims and changes in estimates	50,779,720	64,656,041
Claims payments	<u>(50,636,720)</u>	<u>(48,175,041)</u>
Total unpaid claims liability and claim adjustment expenses payable at the end of year	<u>\$ 127,509,000</u>	<u>\$ 127,366,000</u>

This claims liability is further categorized as follows:

State Agencies	116,675,000	99,315,000
Counties and Municipalities	10,834,000	28,051,000
Total	<u>\$ 127,509,000</u>	<u>\$ 127,366,000</u>

South Carolina State Accident Fund

Notes to Financial Statements

Note 9. Second Injury Fund Assessment

The Fund is required to pay an annual assessment to the Second Injury Fund of the State. The assessment is usually billed in the first quarter of the fiscal year and is based on a specified percentage of total claims paid by the Second Injury Fund during the previous calendar year. The Second Injury Fund handles claims for workers who have permanent physical impairments and incur subsequent disability from injury by accidents arising out of and in the course of employment. The assessment for fiscal year 2006 and 2005 was \$12,788,426 and \$10,115,523, respectively. The Fund receives reimbursements of claims expense from the Second Injury Fund. The total amount recovered during fiscal year 2006 and 2005 was approximately \$15,872,600 and \$15,218,000, respectively which is reported as a reduction of claims expense.

Note 10. Pension Plan

The Retirement Division of the State Budget and Control Board maintains four independent defined benefit plans and issues its own publicly available Comprehensive Annual Financial Report ("CAFR") which includes financial statements and required supplementary information. A copy of the separately issued CAFR may be obtained by writing to the Retirement Division, 202 Arbor Lake Drive, Columbia, South Carolina 29223. Furthermore, the Division and the four pension plans are included in the CAFR of the State.

The majority of employees of the Fund are covered by a retirement plan through the South Carolina Retirement System ("SCRS"), a cost-sharing multiple-employer defined benefit pension plan administered by the Retirement Division, a public employee retirement system. Generally, all state employees are required to participate in and contribute to the SCRS as a condition of employment unless exempted by law as provided in Section 9-1-480 of the South Carolina Code of Laws. This plan provides retirement annuity benefits as well as disability, cost of living adjustment, death, and group-life insurance benefits to eligible employees and retirees.

Under the SCRS, employees are eligible for a full service retirement annuity upon reaching age 65 or completion of 28 years credited service regardless of age. The benefit formula for full benefits effective since July 1, 1989, for the SCRS is 1.82 percent of an employee's average final compensation multiplied by the number of years of credited service. Early retirement options with reduced benefits are available as early as age 55. Employees are vested for a deferred annuity after five years of service and qualify for a survivor's benefit upon completion of 15 years credited service (five years effective January 1, 2001). Disability annuity benefits are payable to employees totally and permanently disabled provided they have a minimum of five years credited service. This requirement does not apply if the disability is a result of a job related injury. A group-life insurance benefit equal to an employee's annual rate of compensation is payable upon the death of an active employee with a minimum of one year of credited service.

South Carolina State Accident Fund

Notes to Financial Statements

Note 10. Pension Plan (continued)

Effective January 1, 2001, Section 9-1-2210 of the South Carolina Code of Laws allows employees eligible for service retirement to participate in the Teacher and Employee Retention Incentive (“TERI”) Program. TERI participants may retire and begin accumulating retirement benefits on a deferred basis without terminating employment for up to five years. Upon termination of employment or at the end of the TERI period, whichever is earlier, participants will begin receiving monthly service retirement benefits which will include any cost of living adjustments granted during the TERI period. Because participants are considered retired during the TERI period, they do not make SCRS contributions, do not service credit, and are ineligible to receive group life insurance benefits or disability retirement benefits.

Since July 1, 1988, employees participating in the SCRS have been required to contribute 6.0% of all compensation. Effective July 1, 2004 the employer contribution rate became 10.80% which included a 3.25% surcharge to fund retiree health and dental insurance coverage. The Fund’s actual contributions to the SCRS for the most recent fiscal years ended June 30, 2006, 2005 and 2004 were approximately \$326,000, \$310,000 and \$231,000, respectively, and equaled the required contributions of 7.55% (excluding the surcharge) for each year. Also, the Fund paid employer group life insurance contributions of approximately \$4,400 and \$4,600 at the rate of .15% of compensation for the current fiscal year ending June 30, 2006 and 2005, respectively.

The amounts paid by the Fund for pension, group-life, and post-retirement benefits are included as personal services expenses.

Article X, Section 16, of the South Carolina Constitution requires that all State-operated retirement systems be funded on a sound actuarial basis. Title Nine of the South Carolina Code of Laws of 1976, as amended, prescribes requirements relating to membership, benefits, and employee/employer contributions for each pension plan. Employee and employer contribution rates to SCRS are actuarially determined. The surcharges to fund retiree health and dental insurance are not part of the actuarially established rates. Annual benefits, payable monthly for life, are based on length of service and on average final compensation (an annualized average of the employee’s highest 12 consecutive quarters of compensation).

The Systems do not make separate measurements of assets and pension liabilities obligations for individual employers. Under Title 9 of the South Carolina Code of Laws, the Fund’s liability under the plans is limited to the amount of contributions (stated as a percentage of covered payroll) established by the State Budget and Control Board. Therefore, the Fund’s liability under the pension plans is limited to the contribution requirements for the applicable year from amounts appropriated therefore in the South Carolina Appropriation Act and amounts from other applicable revenue sources. Accordingly, the Fund recognizes no contingent liability for unfunded costs associated with participation in plans. At retirement, employees participating in the SCRS may receive additional service credit (at a rate of 20 days equal to one month of service) for up to 90 days for accumulated unused sick leave.

South Carolina State Accident Fund

Notes to Financial Statements

Note 11. Postemployment and Other Employee Benefits

In accordance with the South Carolina Code of Laws and the annual Appropriation Act, the State provides certain health care, dental, and life insurance benefits to certain active and retired State employees and certain surviving dependents of retirees. All permanent full-time and certain permanent part-time employees of the Fund are eligible to receive these benefits. The State provides postemployment health and dental benefits to employees who retire from State service or who terminated with at least 20 years of State service who meet one or more of the eligibility requirements, such as age, length of service, and hire date.

Generally those who retire must have at least 10 years of retirement service credit to qualify for these State-funded benefits. Benefits are effective at date of retirement when the employee is eligible for retirement benefits.

These benefits are provided through annual appropriations by the General Assembly to the Fund for its active employees and to the State Budget and Control Board for all participating State retirees except the portions funded through the pension surcharge and provided from other applicable fund sources of the Fund for its active employees who are not funded by State General Fund appropriations. The State finances health and dental plan benefits on a pay-as-you-go basis.

The Fund recorded employer contributions expenses applicable to these insurance benefits for active employees in the amount of approximately \$289,000 and \$253,000 for the years ended June 30, 2006 and 2005, respectively. As discussed in Note 10, the Fund paid approximately \$106,000 and \$93,000 applicable to the 3.25% surcharge included with the employer contributions for retirement benefits for the fiscal years ended June 30, 2006 and 2005, respectively. These amounts were remitted to the SCRS for distribution to the Office of Insurance Services for retiree health and dental insurance benefits.

Information regarding the cost of insurance benefits applicable to Fund retirees is not available. By State law, the Fund has no liability for retirement benefits. Accordingly, the cost of providing these benefits for retirees is not included in the accompanying financial statements. In addition, the South Carolina General Assembly periodically directs the Retirement Systems to pay supplemental (cost of living) increases to retirees. Such increases are primarily funded from the System's earnings; however, a portion of the required amount is appropriated from the South Carolina General Fund annually.

Note 12. Deferred Compensation Plans

Several optional deferred compensation plans are available to State employees and employers of its political subdivisions. Certain employees of the Fund have elected to participate. The multiple-employer plans, created under Internal Revenue Code Sections 457, 401 (k), and 403 (b), are administered by third parties and are not included in the Comprehensive Annual Financial Report of the State. Compensation deferred under the plans is placed in trust for the contributing employees.

South Carolina State Accident Fund

Notes to Financial Statements

Note 12. Deferred Compensation Plans (continued)

The State has no liability for losses under the plans. Employees may withdraw the current value of their contributions when they terminate State employment. Employees may also withdraw contributions prior to termination if they meet requirements specified by the applicable plan.

Note 13. Operating Leases

The Fund leases its office space and computer from an external party. The lease for the rental of office space expires June 30, 2007. The lease contains a renewal option for up to five years at the same terms and conditions, except that the rental rate shall be negotiated. During fiscal year 2003, the Fund leased computers for 2 year periods with a renewal option for an additional two years with the lessor to provide new equipment. It also leases office equipment and vehicles under short-term and/or cancelable operating leases. In the normal course of business, operating leases are generally renewed or replaced by other leases. Operating leases are generally payable on a monthly basis. Minimum future rental obligations under the noncancelable lease with a remaining term in excess of one year are as follows:

<u>Fiscal Year Ending June 30,</u>	<u>Amount</u>
2007	303,172
2008	26,177
Totals	<u>\$ 329,349</u>

Operating lease expenses for the fiscal year ended June 30, 2006 and 2005, were approximately \$262,000 and \$262,000, respectively for office space and approximately \$41,000 and \$53,000, respectively for office equipment.

Note 14. Long-Term Liabilities

Accrued compensated absences activity for the year ended June 30, 2006 was as follows:

	<u>June 30, 2005</u>	<u>Additions</u>	<u>Reductions</u>	<u>June 30, 2006</u>	<u>Due within one year</u>
Accrued compensated absences and related benefits	<u>\$ 339,096</u>	<u>\$ 256,888</u>	<u>\$ (246,936)</u>	<u>\$ 349,048</u>	<u>\$ 254,183</u>

Note 15. Transactions with State Entities

The Fund has significant transactions with the State and various State agencies. Services received at no cost from State Agencies include maintenance of certain accounting records and payroll and disbursement processing from the Comptroller General's office; check preparation, banking, and investment functions from the State Treasurer; legal services from the Attorney General's office; and record storage for the Department of Archives and History.

South Carolina State Accident Fund

Notes to Financial Statements

Note 15. Transactions with State Entities (continued)

Other services received at no cost from the various divisions of the State Budget and Control Board include pension plan administration, insurance plans administration, audit services, personnel management, assistance in the preparation of the State Budget, property management and record keeping, review and approval of certain budget amendments, procurement services, and other centralized functions.

The Fund had financial transactions with various State Agencies during the year ended June 30, 2006 and 2005. Significant payments were made to divisions of the State Budget and Control Board for pension and insurance plan contributions, vehicle rental, insurance coverage, office supplies, printing, telephone, interagency mail, and data processing services. Payments were also made for unemployment coverage for employees to the Employment Security Commission. The amount of expenses applicable to these transactions is not readily determinable.

The Fund provided no services free of charge to other State Agencies during the years ended June 30, 2006 and 2005.

Total revenues from other State agencies based on the agency classification chart prepared by the Fund are as follows:

	2006	2005
General Government	\$ 2,089,452	\$ 1,547,467
Administration of Justice	17,408,698	14,316,376
Education	261,577	10,770,931
External	1,276,094	1,123,162
Higher Education	13,208,904	12,394,526
Health and Environment	11,129,683	11,997,236
Housing Authority	44,703	41,974
Resource and Economic Development	1,986,453	1,705,178
Social Services	1,559,859	3,593,658
Transportation	7,654,800	5,818,935
Unemployment Compensation	270,115	96,866
Other business types	165,504	39,430
	<u>\$ 57,055,842</u>	<u>\$ 63,445,739</u>

The Fund recorded \$66,890 and \$68,504 in the fiscal year as reimbursements of claims expense from the State for claims prior to 1986, for the years ended June 30, 2006 and 2005 respectively. The amount of \$6,168 and \$21,579 was billed subsequent to June 30, 2006 and 2005, respectively, and is included in the claims recoveries and reimbursement receivables account on the balance sheet.

The Fund recorded \$4,628 and \$19,457 in the fiscal years ended June 30, 2006 and 2005, respectively, as reimbursements of claims expense from the South Carolina Adjutant General's Office. The amount is also included in the claims recoveries and reimbursement receivables account on the balance sheet.

South Carolina State Accident Fund

Notes to Financial Statements

Note 16. Net Loss/Net Assets Deficit

The statement of revenues, expenses, and changes in net assets shows a net increase of \$196,676 and a net decrease of \$5,871,554 for the years ended June 30, 2006 and 2005, respectively. The Fund has a net asset deficit of \$112,757,840 and \$112,954,516.

The deficit includes lost interest earnings through 1995. Prior to 1990, all investment income earnings of the Fund were credited to the General Fund of the State. For fiscal years 1991 and 1992, the Fund received one-third and two-thirds of the investment income. Section 42-7-75 of the South Carolina Code of Laws require the State Treasurer to deposit in the Fund's trust account monthly sufficient funds to pay expenses and claims required by law to be paid with the amount limited to the amount of investment income which the Fund would have earned since its inception if all investment earnings had been credited to the Fund. Estimates prepared by management in 1995 estimated that limit to be approximately \$12,300,000 assuming an interest rate of 4% to approximately \$20,600,000 using an interest rate of 6%.

To reduce the deficit, the Fund purchased excess of loss reinsurance for accidents that occur on and after July 1, 2000. Claim costs in excess of \$600,000 were reinsured with the amount increasing to \$1,000,000 as of January 1, 2006. The Fund implemented a medical management cost containment program in 2001 that is expected to reduce claim costs significantly. Increases in medical costs have stabilized for those agencies utilizing this program.

Management is hopeful that these actions along with the rate modification that took effect in the 2006 fiscal year will result in positive movement toward elimination of the Fund financial deficit.

Note 17. Concentrations of Credit Risk and Other Concentrations

The Fund has reinsurance contracts with providers which share or limit the Fund's exposure to losses. However, should the reinsurance providers be unable to meet their obligations settlement of these amounts will ultimately be the responsibility of the Fund. The Fund provides services to South Carolina governmental entities. The limited make-up of the membership group, as well as the limited geographic region in which the Fund operates, increases the Fund's exposure to business concentrations.

**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***

Mr. Richard H. Gilbert, Jr.
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

We have audited the basic financial statements of South Carolina State Accident Fund (the "Fund") as of and for the year ended June 30, 2006, and have issued our report thereon dated September 22, 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 Fund'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 controls over financial reporting would not necessarily disclose all matters in 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 Fund'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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information of the Governor of the State of South Carolina, State Auditor, and Fund management, and is not intended to be and should not be used by anyone other than these specified parties.

Scott McElveen, L.L.P.

Columbia, South Carolina
September 22, 2006