

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

AUDITED FINANCIAL STATEMENTS
AND OTHER FINANCIAL INFORMATION

YEAR ENDED JUNE 30, 2002

WITH
REPORT OF INDEPENDENT AUDITORS

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REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying basic financial statements of the South Carolina State Budget and Control Board, Employee Insurance Programs (the "Fund") as of and for the year ended June 30, 2002, as listed in the table of contents. These financial statements are the responsibility of the management of the South Carolina State Budget and Control Board, Employee Insurance Programs. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in *Note 1*, the accompanying financial statements of the South Carolina State Budget and Control Board, Employee Insurance Programs are intended to present the financial position and results of operations of its governmental and proprietary fund types and cash flows of its proprietary fund type of only that portion of the funds of the State of South Carolina that is attributable to the transactions of the funds of the South Carolina State Budget and Control Board, Employee Insurance Programs.

As discussed in *Note 19*, prior to the current fiscal year, the Fund incurred operating losses for four of the previous five years which has resulted in a significant retained deficit. See *Note 19* for additional information.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the funds of the South Carolina State Budget and Control Board, Employee Insurance Programs, as of June 30, 2002, and the results of operations of its governmental and proprietary fund types and cash flows of its proprietary fund type for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in *Note 18* that were applied to restate the 2001 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 25, 2002, 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 grants. That 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 Management's Discussion and Analysis and the Statement of Expenditures-Budget and Actual-All Budgeted Funds are not a part of the basic financial statements, but is supplementary information required by the *Governmental Accounting Standards Board* (GASB). Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

September 25, 2002

Management's Discussion & Analysis

This section of the South Carolina State Budget and Control Board, Employee Insurance Program (EIP) Audited Financial Statements and Other Financial Information presents management's discussion and analysis of EIP's financial performance during the fiscal year ended June 30, 2002. This discussion should be read in conjunction with the financial statements and the notes, which follow this section.

This is the first year of implementation of Governmental Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments. The financial statement presentation required by GASB Statement 34 provides a comprehensive perspective of EIP's assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows.

Financial Highlights:

- Business-Type Activities reported a change in net assets of \$3,129,299 for the year ended June 30, 2002 and negative net assets of \$69,614,594 at year end.
- Governmental Activities (Senior Drug Program) reported a change in net assets of \$2,956,526 for the year ended June 30, 2002 and positive net assets of \$5,662,478 at year-end.
- Combined Business-Type Activities and Governmental Activities reported a change in net assets of \$6,085,825 for the year ended June 30, 2002 and negative net assets of \$63,952,116 at year end.

Overview of Financial Statements:

The Employee Insurance Program is an internal service fund proprietary type engaged primarily in Business-Type Activities. EIP also administers the SilverCard program, a Governmental Activity. Following is a condensed Statement of Net Assets and a condensed Statement of Revenue, Expenses, and Changes in Net Assets and a condensed Statement of Cash Flows.

The Statement of Net Assets presents the financial position of EIP at the end of the fiscal year and requires classification of assets and liabilities into current and noncurrent categories. The difference between total assets and total liabilities is reflected in the net assets section, which displays net assets in three categories: invested in capital assets (net of related debt), restricted, and unrestricted. Net assets are one indicator of the current financial condition of EIP, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year.

The Statement of Revenues, Expenses, and Changes in Net Assets present revenues and expenses as operating and are detailed by classification.

The Statement of Cash Flows will aid readers in identifying the sources and uses of cash by the categories of operating, capital and related financing, non-capital financing, and investing activities.

Financial Analysis of EIP:

This schedule is a condensed version of EIP's assets, liabilities, and net assets and is prepared from the Statement of Net Assets.

**Net Assets
as of June 30, 2002
(In millions)**

	Governmental Activities
Current assets	\$ 73.6
Non-current assets	21.3
Total assets	<u>94.9</u>
Current liabilities	158.7
Non-current liabilities	0.2
Total liabilities	<u>158.9</u>
Net assets	
Restricted:	
Senior Drug Program	5.6
Investment in capital assets	-
Unrestricted	<u>(69.6)</u>
Total net assets	<u><u>\$ (64.0)</u></u>

The EIP's net assets have been restated as of July 1, 2001 due to a change in the capitalization level of assets. The details are reflected in *Note 18*, Restatement, of the accompanying notes to the financial statements.

The following schedule is a summary of the EIP's operating results for the fiscal year.

**Statement of Revenue, Expenses,
and Changes in Net Assets
(Proprietary Fund)
(In millions)**

Operating revenue	
Insurance Premiums	
Active employee	\$ 831.6
Retirees	211.8
Other premium revenue	9.3
Total operating revenue	<u>1,052.7</u>
Operating expenses	
Premiums	99.1
Claims	920.8
Administrative	33.3
Total operating expenses	<u>1,053.2</u>
Operating income (loss)	(0.5)
Adjustments	3.6
Net income (loss)	<u>3.1</u>
Net assets, beginning of year	<u>(72.7)</u>
Net assets, end of year	<u><u>\$ (69.6)</u></u>

**Statement of Revenues, Expenditures,
And Changes in Fund Balances
(Governmental Fund)
(In millions)**

Revenue:	
Tobacco settlement	\$ 17.3
Investment earnings	6.7
Other	0.2
Total revenue	<u>24.2</u>
Expenditures:	
Administrative fees	0.3
Claims expenses	21.0
Total expenditures	<u>21.3</u>
Excess of revenue over expenditures	2.9
Other financing sources	0.1
Excess of revenue and other financing sources over expenditures and other financing uses	<u>3.0</u>
Fund balance, beginning of year	<u>2.7</u>
Fund balance, end of year	<u>\$ 5.7</u>

A condensed version of Statement of Cash Flows is presented as follows:

**Condensed Statement of Cash Flows
(Proprietary Fund)
(In millions)**

Cash Flows from Operating Activities	\$ 15.5
Cash Flows from Capital and Related Financing Activities	
Cash Flows from Noncapital Financing Activities	(0.7)
Cash Flows from Investing Activities	<u>1.9</u>
Net increase in cash and cash equivalents	<u>16.7</u>
Cash and cash equivalents, beginning of year	<u>27.7</u>
Cash and cash equivalents, end of year	<u><u>\$ 44.4</u></u>

Comparative information of the condensed financial information derived from the financial statements is required under GASB 34; however, a reprieve of this comparative information has been granted during the implementation year. Comparative information will be presented when multiple years of data has been captured.

Overview of EIP:

The Employee Insurance Program manages group health, dental, life, accidental death and dismemberment and disability programs as authorized in § 1-11-710 and § 1-11-720 of the South Carolina Code of Laws. Also managed by EIP is the long-term care program as authorized in § 1-11-740 of the South Carolina Code of Laws.

Following is a table of benefits offered by EIP. The benefits are differentiated according to self-insured versus fully insured products.

Self-Insured Programs

State Health Plan (medical, prescription drug, and behavioral health)
MUSC Options (HMO)
Upstate Partners (HMO)
State Dental Plan
Basic Long Term Disability

Fully-Insured Programs

Companion Healthcare (HMO)
Dental Plus
State Life
Optional Life
Dependent Life
Long Term Care
Supplemental Long Term Disability

Benefits are offered to eligible employees and retirees of State agencies, school districts, local governments, and other enterprises. The State Health Plan is the significant driver of EIP's financial activity, accounting for over 90% of all revenue. Premium revenue is shared between the employer and the enrollee. For 2002, this split was 81% employer and 19% enrollee. A discussion of the Senior Drug Program is included at the end of the Management's Discussion and Analysis.

Following is a look at total enrollment in the State's insurance programs and the enrollment in the State Health Plan.

	<u>Program</u>	<u>State Health Plan</u>
Total Insured Persons:	414,075	379,507
Subscribers:	233,362	212,712
Spouses:	64,375	60,568
Children:	116,338	106,227
Total Subscribers:	233,362	212,712
Employees:	175,736	156,060
Retirees:	53,120	52,282
Survivors	2,701	2,679
COBRA	1,805	1,691
Active Employees:	175,736	156,060
State Agencies:	65,339	56,645
School Districts:	77,707	71,670
Local Governments:	26,512	23,452
Enterprises:	6,178	4,293

A short historical review of the State Health Plan's financial experience on a Plan Year basis (January through December) indicates five consecutive years of net losses, preceded by seven consecutive years of net gains. Even without rate increases in each of Plan Years 1994, 1995, and 1996, Plan income exceeded expenses. For Plan Years 1997 and 1998, contributions remained constant, with the expectation of operating losses. These losses were "planned" to spend down or reduce accumulated cash reserves, at the direction of State budget writers, because even with losses, cash reserves were expected to remain within statutory parameters. Beginning in Plan Year 1999, claims expenses began to surge unexpectedly. This dramatic change in claims trend was not unique to the State Health Plan, but rather one that was experienced throughout the health insurance industry.

The State's budget process calls for budget requirements for the upcoming calendar year to be estimated at the outset of the prior year. Because of this timing, 2000 contribution rates were estimated and 1999 rates already established based on 1998 claims data, not knowing that the surge was about to occur.

Following is a look at employer and enrollee contribution increases which have been implemented since Plan Year 1999.

	<u>Employer</u>	<u>Enrollee</u>
1999	18.00%	no increase
2000	10.00%	no increase
2001	20.00%	\$5/subscriber/month
2002	9.50%	\$12/subscriber/month

In addition to annual contribution increases, material provider reimbursement cuts and reductions in benefits were implemented for Plan Years 2000 and 2001, respectively. Despite provider cuts and benefit reductions, claims trend continues to rise. Analysis of Plan payout growth per person during the period 1994 through 1998 averaged 5.3%. In 1999, the payout growth reached 8.9%, and 2001 data estimates growth at 11.3%. Prescription drugs are responsible for roughly half of the growth in expense from 1997 through 2001. With the exception of prescription drugs and physician office visits, payment per service episode has either declined or remained virtually static. Even so, payments for these services are increasing as well, because of service volume growth. The Plan is also experiencing accelerated claims growth in certain disease categories in comparison to others and prescription drug expense continues to balloon. Prescription drugs accounted for 23% of total claims expense in 2001 compared to 13% in 1997. The growth in prescription drugs is attributed to the substantial increase in users per enrollees, prescriptions per enrollee, and cost per prescription. A major factor driving this growth the result of heavily marketed drugs by the pharmaceuticals. These marketed drugs account for the highest State Health Plan volume.

State Health Plan 2002 Initiatives:

Several State Health Plan cost containment initiatives were implemented during Plan Year 2002. One initiative includes the “Blue Card” program, in which the Plan benefits from local Blue Cross and Blue Shield provider contracting arrangements throughout the country. Blue Card is expected to garner the most savings for the Plan (approximately \$5M. annually). Other initiatives include complex case management designed to assist the sickest Plan members in healthcare decision making and new disease management programs geared towards educating and promoting health care compliance for members living with chronic diseases. A provider-profiling project is also under way, in which claims data is analyzed in an effort to identify cost effective providers. This data will be useful in the event the State elects to develop and implement a restrictive provider network made up of providers with “best practices”. Prescription drug initiatives for 2002 included a generic “pay-the-difference” policy which limits Plan payments for brand drugs to their generic equivalent and a voluntary mail service pharmacy, providing shared savings between the Plan and the member. In addition, prescription drug co-payments were increased by \$2/prescription for 2002 and the annual co-payment maximum was raised to \$1,100/person.

State Health Plan 2003:

§ 1-11-710 (A) (2) of the South Carolina Code of Laws requires that the Budget and Control Board approve by August 15, the State Health Plan benefits and contributions for the upcoming year. No new employer funding was appropriated for Plan Year 2003. \$24, per subscriber, per month in Plan “impact” was deemed necessary in order to maintain a zero reserve balance during 2003. Proviso 63.15 eliminated any reserve requirement for the Plan in 2002 and 2003. This proviso stipulates “Notwithstanding any other provision of law, the State Health Plan is only required to seek a zero day reserve fund by the end of calendar year 2002.” After consulting with participants and stakeholder groups, it was determined that this impact be achieved entirely through an increase in enrollee contributions, without changes to the Plan of Benefits. Effective January 2003, the State Health Plan will increase enrollee contributions an average of \$24/subscriber/month.

Senior Drug Program:

The Senior Drug Program (SilverCard) continues to be administered by the Employee Insurance Program. This program provides financial assistance for purchasing prescription drugs to senior citizens who are ineligible for or do not have prescription drug coverage or other assistance through federal, state, or private programs. The Senior Drug Program is funded through direct appropriations. These funds were received by the State in the settlement agreement and related documents, between the State and leading US tobacco manufactures dated November 23, 1998. The fiscal year 2001-2002 budgeted amount for the Senior Drug Program was \$24M. Expenditures were within budgeted projections for the Senior Drug Program. Proviso 63.18 allows a carry-forward of Senior Drug Program funds from one fiscal year to the next. Effective July 1, 2002 the Silver Card Program was transferred from EIP to Health and Human Services.

Capital Asset and Debt Administration:

Due to a change in the capitalization threshold mandated by the Comptroller General’s Office of the State of South Carolina, a restatement of net assets was required. This restatement resulted in a reduction in asset cost of \$637,005 and a reduction in accumulated depreciation of \$156,559. In addition the EIP purchased \$39,402 in fixed assets funded through operational revenues. Also, \$147,245 in fixed assets was transferred to the Insurance Reserve Fund as part of the reorganization that occurred July 1, 2001. The EIP has no debt outstanding as of year-end.

Reorganization:

In early 2002, the South Carolina Budget and Control Board reorganized the Employee Insurance Programs. This reorganization, however, did not become effective from an accounting and budgetary basis until July 1, 2002. In this reorganization, EIP was transferred to the Division of Insurance and Grants Services.

Contact Information:

Questions related to the Management Discussion & Analysis and the accompanying financial statements should be directed to Phyllis Buie, Chief Financial Officer, at 734-0326.