

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

AUDITED FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2004

WITH
REPORT OF INDEPENDENT AUDITORS

State of South Carolina



Office of the State Auditor

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October 4, 2004

The Honorable Mark Sanford, Governor
and
Members of the South Carolina State Budget and Control Board
Columbia, South Carolina

This report on the audit of the financial statements of the South Carolina State Budget and Control Board Office – Employee Insurance Programs for the fiscal year ended June 30, 2004, was issued by DeLoach & Williamson, 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,


Thomas L. Wagner, Jr., CPA
State Auditor

TLWjr/trb

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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 financial statements of the governmental activities of the South Carolina State Budget and Control Board, Employee Insurance Programs (the "Fund") as of and for the year ended June 30, 2004, 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. They do not purport to, and do not, present fairly the financial position of the State of South Carolina as of June 30, 2004 and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in *Note 17*, the Fund has experienced a net reduction in equity of approximately \$158,706,035 over the past six years which has resulted in a significant equity deficit. See *Note 15* for additional information.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the governmental activities of the South Carolina State Budget and Control Board, Employee Insurance Programs, as of June 30, 2004, and the results of operations 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 15, 2004, 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 is not a part of the basic financial statements, but is supplementary information required by the *Governmental Accounting Standards Board (GASB)*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Releach & Williamson, L.L.P.

September 15, 2004

Management's Discussion and 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, 2004. This discussion should be read in conjunction with the financial statements and the notes, which follow this section.

Fiscal Year ending June 30, 2002 was 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

- Proprietary Fund Activities reported a change in net assets of negative \$10,300,236 for the year ended June 30, 2003 and negative net assets of \$79,914,830 at year end. For the year ended June 30, 2004, the Business Type Activities reported a change in net assets of \$4,408,224 and total net assets at year-end of negative \$75,506,606.

Overview of Financial Statements

The Employee Insurance Program is an internal service fund proprietary type engaged primarily in Governmental Activities. EIP administered the Senior Drug Program, a Governmental Activity, through February 2003. Following is a condensed Statement of Net Assets, a condensed Statement of Activities 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. EIP implemented State Health Plan changes effective January 1, 2004 which has slightly improved the net asset balance. Employee premiums were increased along with deductibles and co-payments.

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, 2004
(In millions)

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Current assets	\$ 88.7	\$ 92.8
Non-current assets	<u>19.5</u>	<u>22.6</u>
Total assets	108.2	115.4
Current liabilities	183.3	195.0
Non-current liabilities	<u>0.4</u>	<u>0.3</u>
Total liabilities	183.7	195.3
Net assets		
Restricted:		
Investment in capital assets, net of related debt	-	-
Unrestricted	<u>(75.5)</u>	<u>(79.9)</u>
Total net assets	<u><u>\$ (75.5)</u></u>	<u><u>\$ (79.9)</u></u>

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

Statements of Activities

(In millions)

	Years Ended June 30,	
	2004	2003
Governmental activities:		
Program revenues	\$ 1,245.7	\$ 1,178.5
Expenses	(1,245.5)	(1,198.9)
Total governmental activities	0.2	(20.4)
General revenue and transfers:		
Earnings on investment	4.6	7.3
Miscellaneous	-	0.2
Transfers to other agencies	(0.4)	(3.1)
Total general revenue and transfers	4.2	4.4
Change in net assets	4.4	(16.0)
Net assets, beginning of year	(79.9)	(64.0)
Net assets, end of year	<u>\$ (75.5)</u>	<u>\$ (80.0)</u>

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

Condensed Statement of Cash Flows

(In millions)

(Business-Type Activities)

	Years Ended June 30,	
	2004	2003
Cash Flows from Operating Activities	\$ (11.1)	\$ 11.2
Cash Flows from Noncapital Financing Activities	(0.4)	(0.9)
Cash Flows from Investing Activities	7.7	6.1
Net increase (decrease) in cash and cash equivalents	(3.8)	16.4
Cash and cash equivalents, beginning of year	60.8	44.4
Cash and cash equivalents, end of year	<u>\$ 57.0</u>	<u>\$ 60.8</u>

Overview of EIP:

The Employee Insurance Program (EIP) 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 and the Employee Adoption Assistance Program pursuant to Proviso 63.32 of the 2004-2005 General Appropriations Act.

Following is a listing of benefits offered by EIP differentiated according to self-insured versus insured status.

Self-Insured Programs

- ❑ State Health Plan (medical, prescription drug and behavioral health)
- ❑ MUSC Options (HMO)
- ❑ Companion (HMO)
- ❑ Companion (POS)
- ❑ CIGNA (HMO)
- ❑ State Dental Plan
- ❑ Basic Long Term Disability
- ❑ Adoption Assistance Program

Insured Programs

- ❑ Dental Plus
- ❑ State Life
- ❑ Optional Life
- ❑ Dependent Life
- ❑ Long Term Care
- ❑ Supplemental Long Term Disability
- ❑ TRICARE Supplement

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 (employee or retiree). For 2004, this split was 71% employer/29% enrollee, compared to 76% employer/24% enrollee and 82% employer/19% enrollee for 2003 and 2002 respectively.

Following is a look at total enrollment in the State's medical insurance programs and the enrollment in the State Health Plan (as of June 2004).

	<u>Program</u>	<u>State Health Plan</u>
Total Insured Persons:	415,661	351,112
Subscribers:	234,782	195,640
Spouses:	66,532	58,546
Children:	114,347	96,926
 Total Subscribers:	 234,782	 195,640
Employees:	175,657	138,303
Retirees:	54,776	53,220
Survivors:	2,790	2,753
COBRA:	1,559	1,364
 Active Employees:	 175,657	 138,303
State Agencies:	62,809	47,283
School Districts:	78,230	66,316
Local Government:	28,293	20,890
Enterprises:	6,325	3,814

A short historical review of the State Health Plan's financial experience on a Plan year basis (January through December) indicates six 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.

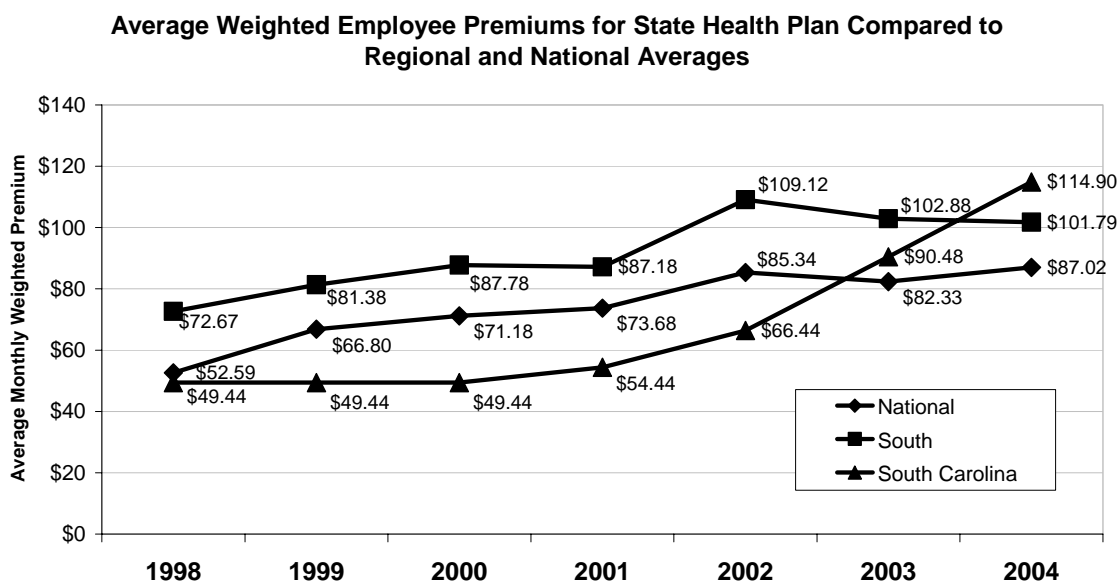
The State's budget process calls for budget requirements for the upcoming calendar year to be estimated at the outset of the prior year. Because of this timing, 2000 contribution rates were estimated and 1999 rates already established based on 1998 claims data, not knowing that the surge was about to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

Losses continued for Plan years 1999 and 2000. And, while Plan years 2001 and 2002 saw modest gains, the State Health Plan reserve balance has been depleted in its entirety and remains depleted in 2004.

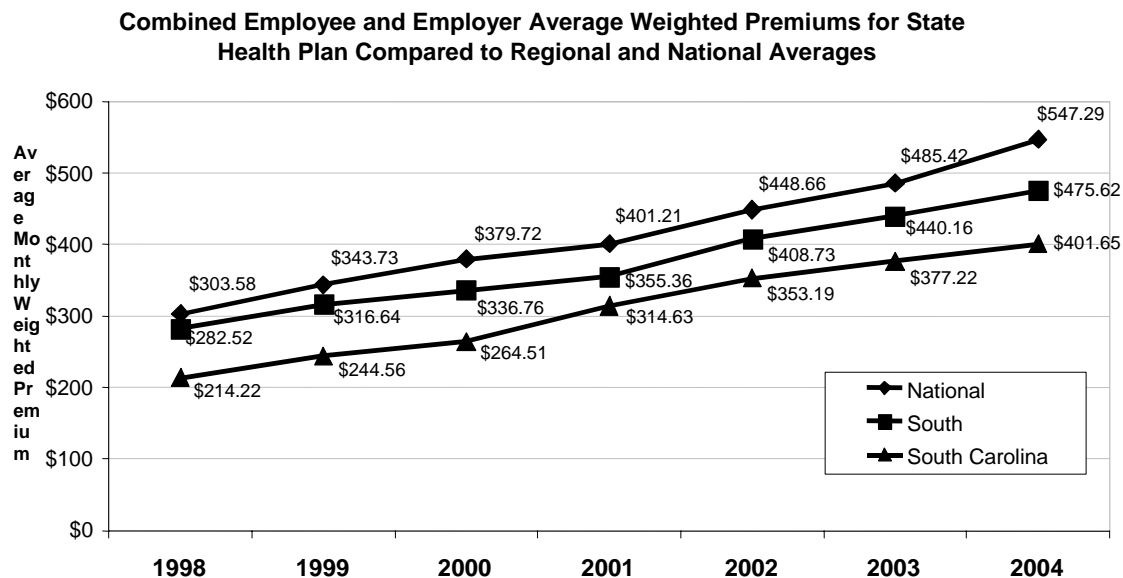
Following is a look at employer and enrollee contribution increases implemented since Plan year 1999.

	<u>Employer</u>	<u>Enrollee</u>	<u>Total</u>
1999	18.0%	-0-	14.0%
2000	10.0%	-0-	8.0%
2001	20.0%	10.3%	18.2%
2002	9.5%	22.4%	11.7%
2003	-0-	36.6%	6.8%
2004	-0-	27.2%	6.5%
2005	6.1%	29.5%	13.0%

The employee premium paid by State Health Plan enrollees is now higher than the national and regional average. Below is a comparative graph of the State Health Plan average weighted employee premiums compared to regional and national averages.



While rates have been rising, the combined employer and enrollee State Health Plan premiums continue to be below both regional and national averages. Below is a comparative graph of the combined enrollee and employer average weighted premium for the State Health Plan compared to regional and national averages.



In addition to annual contribution increases, material provider reimbursement cuts and reductions in benefits were implemented for Plan years 2000 and 2001, respectively. Despite these measures, 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 for 2001 growth was 11.5%. For the 2002 Plan year, growth was 9% and for 2003 growth was 11.6%. 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. Prescription drug expense continues to balloon. Prescription drugs accounted for 23% of total claims expense in 2001 compared to 13% in 1997 and continues to accelerate. Prescription drugs reached 25% of total claims expense for 2002 and 28.5% for 2003. The growth in prescription drugs is attributed to the substantial increase in users per enrollees, prescription per enrollee, and cost per prescription. A major factor driving this growth is the result of heavily marketed drugs by the pharmaceuticals. These marketed drugs account for the highest State Health Plan volume.

State Health Plan 2003 Initiatives:

No new employer funding was appropriated for Plan year 2003. This being the case, and in order to maintain a zero reserve balance during 2003, \$24 per subscriber per month in Plan “impact” was deemed necessary. Proviso 63.15 eliminated any reserve requirement for Plan years 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 2003.” 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 increased enrollee contributions an average of \$24 per subscriber per month.

State Health Plan 2004 Initiatives:

§ 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 2004. Again, this being the case, and in order to maintain a zero reserve balance during 2004, \$65 per subscriber per month in Plan “impact” was needed. Proviso 63.12 eliminated any reserve requirement for the Plan in 2004. 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 2003.” In contrast to 2003, responses from participants and stakeholders indicated financial viability be achieved not only through a contribution increase, but also through changes to the Plan of Benefits.

Effective January 2004, the State Health Plan increased enrollee contributions an average of \$25 per subscriber per month. Premiums increased \$19.04 for single and employee/child coverage and \$38.08 for employee/spouse and full family coverage.

A variety of Plan benefit changes were implemented January 2004. They include, increasing Plan annual deductibles to \$350 single/\$700 family for the Standard plan (from \$250 single/\$500 family) and \$500 single/\$1,000 family for the Economy plan (from \$350 single/\$700 family). Out-of-pocket maximums increased to \$2,000 single/\$4,000 family for both plans (from \$1,500 single/\$3,000 family). Also, per-occurrence deductibles increased to \$75 for outpatient hospital visits (from \$50) and \$125 for emergency room visits (from \$100). A new \$10 per-visit deductible was applied for all physician office visits beginning in 2004. Other benefit design changes included a 20% out-of-network fee and changes to the pharmacy benefit. A third tier drug co-payment was added and drug co-payments increased from \$7/generic and \$22/brand to a co-payment structure including \$10/generic, \$25/brand and \$40/ nonpreferred brand. The prescription drug out-of-pocket maximum increased from \$1,100 to \$2,500 and the State Health Plan participated in Medco Health’s Select Network, garnering a greater percentage of discounts off of prescription drug charges.

Effective July 1, 2004 was the application of experience rating for “optional” groups. These are groups, other than State agencies and school districts, who participate at their option as authorized under §1-11-720. Overall claims experience for these groups has been approximately 11% higher than mandatory State Health Plan participants. Employers were tiered according to enrollment and premiums are capped at 50% above the State Health Plan rate for “non-optional” groups.

State Health Plan 2005 Initiatives:

§ 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. Proviso 63.10 eliminated any reserve requirement for the Plan in 2005. 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 2004.”

Effective January 2005, the State Health Plan Standard Plan will increase enrollee contributions an average of \$34.55 per subscriber per month and employer contributions an average of \$17.30 per subscriber per month.

The State Health Plan will implement a separate out-of-network coinsurance maximum of \$4,000 for single coverage and \$8,000 for family coverage. Gastric bypass surgery coverage will be eliminated as a covered benefit and mail order co-payments will increase to \$25 from \$23 (generic), to \$62 to \$56 (preferred brand), and to \$100 from \$90 (non-preferred brand).

Effective January 2005, subscribers will have the option of selecting a qualified high deductible health plan, referred to as the “Savings Plan”. The Savings Plan replaces the Economy Plan. This new plan is part of EIP’s effort to continue to provide economical health insurance in the face of rising medical costs. The Savings Plan has significantly lower rates and deductible/coinsurance is \$3,000/\$2,000 for single coverage and \$6,000/\$4,000 for family coverage. Family coverage is any coverage other than single coverage. After the deductible is met, the Plan pays covered benefits at 80% in-network and 60% out-of-network (no coinsurance maximum for out-of-network services). Subscribers enrolled in the Savings Plan are eligible for establishing a Health Savings Account (HSA) for setting aside tax-free dollars to pay for qualified medical expenses. Eligibility is based on the subscriber not being covered in any other health coverage, which is not considered to be a high deductible health plan. The Internal Revenue Code governs maximum HSA contribution limits.

Senior Drug Program:

Effective July 1, 2002, the Senior Drug Program SilverCard was transferred from EIP to the Department of Health and Human Services as required under proviso 63.18. However, due to administrative consideration, EIP received funds from the Department of Health and Human Services to transfer to the Third Party Administrator (ASC) through February 18, 2003 for claims transactions incurred through December 31, 2002.

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 as of July 1, 2001. As of June 30, 2004 and 2003, Equipment, Net of Accumulated Depreciation is \$51,126 and \$75,132 respectively. The EIP has no debt outstanding as of year-end.

Contact Information:

Questions related to the Management Discussion and Analysis and the accompanying financial statements should be directed to Phyllis Buie, Chief Financial Officer, at (803) 734-0326.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF NET ASSETS

JUNE 30, 2004

Assets

Current assets:

Cash and cash equivalents (<i>Note 2</i>)	\$ 56,999,570
Premiums receivable (<i>Note 3</i>)	1,613,211
Prescription Drug Rebate receivable	3,552,384
Accrued interest	258,276
Due from South Carolina Division of Retirement (<i>Note 4</i>)	<u>26,244,876</u>
Total current assets	<u>88,668,317</u>

Non-current assets:

Investments (<i>Note 2</i>)	19,442,793
Capital assets, net of accumulated depreciation (<i>Note 5</i>)	<u>51,126</u>
Total non-current assets	<u>19,493,919</u>

Total assets	<u>108,162,236</u>
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Liabilities

Current liabilities:

Accounts payable	521,284
Accrued payroll	308,873
Claims payable	42,772,413
Deferred premium revenue	2,567,004
Claims incurred but not reported	137,099,655
Accrued compensated absences - current portion (<i>Note 14</i>)	<u>17,097</u>
Total current liabilities	<u>183,286,326</u>

Long-term liabilities:

Contingencies (<i>Note 11</i>)	
Accrued compensated absences - long term (<i>Note 14</i>)	<u>382,516</u>
Total long-term liabilities	<u>382,516</u>

Total liabilities	<u>183,668,842</u>
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Net assets (deficit)

Investment in capital assets	51,126
Unrestricted (deficit)	<u>(75,557,732)</u>
Total net assets (deficit)	<u><u>\$ (75,506,606)</u></u>

See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF REVENUE, EXPENSES,
AND CHANGES IN NET ASSETS

YEAR ENDED JUNE 30, 2004

Operating Revenue

Insurance premiums:	
Active employees:	
Health	\$ 721,604,197
Dental	48,610,287
Life	740,600
Long-term disability	12,643,584
Dependent/optional life	29,559,771
HMO-point of service	142,399,145
Retirees:	
Health	76,943,344
Dental	2,686,215
Retiree surcharge	192,297,637
HMO-point of service	2,383,322
Other premium revenues	1,138,383
Prescription drug rebates	14,385,981
Other	302,333
Total operating revenue	<u>1,245,694,799</u>

Operating Expenses:

Premiums	52,563,192
Claims:	
Health	693,876,492
Dental	42,760,772
Life	84,000
Long-term disability	8,066,492
HMO-point of service	122,261,004
Prescription drug	276,159,300
Salaries and benefits	3,806,176
Professional services	43,388,206

(CONTINUED)

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF REVENUE, EXPENSES,
AND CHANGES IN NET ASSETS

(CONTINUED)

Telephone and utilities	93,342
Supplies	711,055
Other services	1,367,250
Printing and publication	183,947
Postage and shipping	125,841
Depreciation	16,410
Total operating expenses	<u>1,245,463,479</u>
Operating income	231,320
Non-operating revenue:	
Income from deposits and investments	<u>4,538,242</u>
Income (loss) before transfers	4,769,562
Interfund-transfers	(361,338)
Change in net assets	4,408,224
Net assets (deficit), beginning of year	<u>(79,914,830)</u>
Net assets (deficit), end of year	<u><u>\$ (75,506,606)</u></u>

See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF CASH FLOWS

YEAR ENDED JUNE 30, 2004

Cash Flows from Operating Activities

Insurance premiums from customers	\$ 1,228,225,642
Other receipts	14,322,916
Payments to employees	(3,766,013)
Payments to suppliers	(1,249,917,974)
Net cash used in operating activities	<u>(11,135,429)</u>

Cash Flows from Noncapital Financing Activities

Transfers to other state agencies	<u>(357,686)</u>
Net cash used in noncapital financing activities	<u>(357,686)</u>

Cash Flows from Investing Activities

Purchases of investments	(3,860,546)
Proceeds from sales and maturity of investments	6,291,772
Interest received-deposits and investments	<u>5,277,865</u>
Net cash provided by investing activities	<u>7,709,091</u>

Net decrease in cash and cash equivalents	(3,784,024)
Cash and cash equivalents, beginning of year	<u>60,783,594</u>
Cash and cash equivalents, end of year	<u><u>\$ 56,999,570</u></u>

(CONTINUED)

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF CASH FLOWS

(CONTINUED)

Reconciliation of income to net cash used in operating activities

Operating income	\$ 231,320
Adjustments to reconcile operating income to net cash used in operating operating activities:	
Depreciation expense	16,410
Disposal of fixed assets	3,944
Change in assets-(increase) decrease:	
Premiums receivable	(976,875)
Due from South Carolina Division of Retirement	1,918,795
Prescription drug rebate receivable	(647,742)
Change in liabilities-increase (decrease):	
Accounts payable, accrued payroll and compensated absences	322,507
Deferred premium revenue	(3,722,763)
Claims payable and incurred but not reported	(8,281,025)
Net cash used in operating activities	<u>\$ (11,135,429)</u>

Supplemental Information

Unrealized loss on investments	<u>\$ (825,078)</u>
Increase in investments for amortization/accretion	<u>\$ 185,146</u>

See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004

1. Basis of Presentation and Summary of Significant Accounting Policies

The financial statements of all funds of the South Carolina State Budget and Control Board, Employee Insurance Programs (the "Fund") were prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental entities. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. The more significant of the Fund's accounting policies are described below.

Reporting Entity

The core of the financial reporting entity is the primary government which has a separately elected governing body. As required by accounting principles generally accepted in the United States of America, 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.

The 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 entity that holds one or more of the following powers:

- (1) Determine its budget without another government's having the authority to approve and modify that budget.
- (2) Levy taxes or set rates or charges without approval by another government.
- (3) Issue bond debt without approval by another government.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Reporting Entity (Continued)

Based on these criteria, the Fund has determined that it has no component units. This financial reporting entity includes only the Fund, a primary entity.

The South Carolina State Budget and Control Board (the “Board”), Employee Insurance Programs is a fund of the South Carolina State Budget and Control Board, which is a part of the State of South Carolina primary government. This report contains only the Fund and no other offices or funds of the South Carolina State Budget and Control Board or any other part of the State of South Carolina primary government are included.

All of the divisions of the Board reporting entity are under the control of the Executive Director of the State Budget and Control Board. The Board is composed of the Governor; the State Treasurer; the Comptroller General; the Chairman of the Senate Finance Committee; and the Chairman of the House Ways and Means Committee; all of whom serve in an ex-officio capacity.

The South Carolina State Budget and Control Board, formerly the Budget Commission, was established and created by Reorganization Plan No. 2 adopted by the General Assembly in 1950 pursuant to the terms and provisions of Act 621, Acts of 1948. Under the Act, ten state agencies were abolished as separate entities and their functions and duties were brought under the supervision of the Budget and Control Board. The funds of the Budget and Control Board are included in the Comprehensive Annual Financial Report of the State of South Carolina.

The Fund operates as a unit under the Board and its Executive Director. The laws of the State and the policies and procedures specified by the State for State agencies are applicable to the Fund’s activities. The accompanying financial statements present the financial position and results of operations solely of the Fund and do not include any other agencies or any component units of the State of South Carolina.

The group health, dental, life, accidental death and dismemberment and disability programs managed by the Fund are authorized in Sections 1-11-710 and 1-11-720 of the South Carolina Code of Laws of 1976, as amended. The long-term care program managed by the Fund is authorized in Section 1-11-740 of the South Carolina Code of Laws of 1976, as amended.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

The Employee Insurance Program provides health insurance to eligible employees and retirees of State agencies and its political subdivisions who elect coverage. Coverage elections include the State's self-insured health plan, two point of service plans, or three health maintenance organization (HMO) plans including the Medical University of South Carolina (MUSC) managed plan which are self-insured. Premiums are paid through payroll deductions. The Long-Term Disability Plan is a self-insured group long-term disability plan available to eligible active employees enrolled in a State health plan. The State Life Plan is fully insured. All dental coverage is through the State's self-insured plan which is available to eligible employees and retirees. Health and dental premiums are paid from State funds and through payroll deductions for eligible employees. Dental Plus is a fully insured plan. Premiums for participating retirees are paid by the Agencies and other eligible employers through the retirement system (employer share) and directly from the employee (employee share). State agencies and other eligible employers pay the premiums for the following insured plans which are available to eligible full-time employees enrolled in a State health plan: (1) basic group life, and (2) basic long-term disability plan. The dependent/optional life program is available to eligible employees. Premiums for the dependent/optional life program are paid through payroll deduction. Premiums and the retiree surcharge (see *Note 4*) for the self-insured health and dental plans are actuarially determined and approved by the South Carolina State Budget and Control Board. Long-term care insurance is also available to eligible employees. Premiums for long-term care insurance are paid through payroll deductions. The long-term care plan is fully insured. Details on eligibility requirements and coverage for all plans are contained in the *Insurance Benefits Guide*. Premium rates for all plans are reviewed on a calendar year basis annually and adjusted as considered necessary after actuarial calculation. Interest income is considered in the premium rate setting process.

The State as the predominant participant retains the risk of loss for the self-insured health, dental and basic long-term disability coverages.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Basis of Presentation

The financial statements present all funds of the South Carolina State Budget and Control Board, Employee Insurance Programs:

The financial statement presentation for the Fund meets the requirements of Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. As an internal service fund, the Fund in its stand-alone financial statements is considered a proprietary fund under the guidance of GASB Statement No. 34. However, the guidance requires internal service funds included in the basic financial statements of the primary government to be reported as part of the governmental activity. Therefore, presentation in the Comprehensive Annual Financial Report of the State of South Carolina will include this fund as a governmental activity. The financial statement presentation provides a comprehensive, entity-wide perspective of the Fund's net assets, revenue, expenses and changes in net assets and cash flows that replaces the fund-group perspective previously required.

Financial Statements

Insurance Reserve Fund is an internal service fund within the South Carolina Budget and Control Board as the State's managers have determined that the State is the predominant participant in the Fund.

Basis of Accounting

The Fund's financial statements have been presented using the economic resources measurement focus which is based upon a determination of net income, financial position, and cash flows. Under this method, all assets and all liabilities associated with the operation of the Fund are included on the statement of net assets. Net assets are segregated into investment in capital assets, net of related debt, restricted net assets and unrestricted net assets components.

The Fund uses the accrual basis of accounting. Revenue are recognized in the accounting period in which they are earned and become measurable; expenses are recognized in the period incurred, if measurable. The Fund reports claims liabilities when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

The accounting policies of the Fund conform to accounting principles generally accepted in the United States of America applicable to governmental and proprietary activities as prescribed by GASB. Accordingly, the Fund applies all applicable GASB pronouncements and its predecessors those applicable standards issued by the Financial Accounting Standards Board on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Fund considers all highly liquid securities with a maturity of three months or less at the time of purchase to be cash equivalents. Most State agencies including the Fund participate in the internal cash management pool; however, some agency accounts are not included in the pool because of restrictions on the use of funds. Because the State's internal cash management pool operates as a demand deposit account, amounts invested in the pool are classified as cash and cash equivalents. The State Treasurer administers the cash management pool. 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 of South Carolina and certain of its political subdivisions, certificates of deposit, collateralized repurchase agreements, and certain corporate bonds. For credit risk information pertaining to the internal cash management pool, see the deposits disclosures in *Note 2*.

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. Deposits in the general deposit account are recorded and reported at cost. However, the Fund reports its deposits in the special deposit accounts at fair value. Investments in the pool are recorded and reported at fair value. Interest earned by the agency's special deposit accounts is posted to the agency's account at the end of each month and is retained by the agency. Interest earnings are allocated based on the percentage of an agency's accumulated daily interest receivable to the total income receivable of the pool.

The amounts shown in the financial statements as "cash and cash equivalents" represent cash on deposit with the State Treasurer as a part of the State's internal cash management pool, and cash invested in various short-term instruments by the State Treasurer and held in separate agency accounts.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Investments

Investments, in accordance with Governmental Accounting Standards Board (GASB) Statement Number 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, are reported at fair value. Securities traded on a national exchange are valued at the last reported sales price.

Investment income consists of interest earned during the year, amortization of premiums and accretion of discounts, realized gains/losses on securities, and unrealized gains and losses resulting from changes in fair value. Earnings are posted to the agency's account at the end of each month. Securities and securities transactions are reflected in the financial statements on a trade-date basis. Realized gains/losses are calculated independently from the calculation of change in fair value therefore realized gains/losses reported in the current period may include amounts previously reported as change in fair value (unrealized gains/losses).

Premium Revenue

Premiums billed to employers, employees and retirees (premiums receivable) for insurance coverage are recorded as revenue when earned on a monthly basis. The retiree surcharge on employees is recognized as the liability is incurred by the various State agencies and school districts.

Deferred Premium Revenue

Premiums billed in advance of coverage, payments received in advance of coverage, or in excess of amounts billed and premiums collected but unearned are recorded as deferred premium revenue.

Capital Assets

Capital assets are capitalized at cost if purchased. Capital assets contributed by other State agencies or funds are recorded at the State's original acquisition cost less accumulated depreciation from the purchase date. Assets donated by other parties are valued at fair market value at the date of gift. The capitalization dollar threshold limit for capital assets is \$5,000. The Fund has one class of capital assets, equipment, which is depreciated on a straight-line basis over the estimated useful lives of 2-10 years. A full year of depreciation is taken the year the asset is placed in service and no depreciation is taken in the year of disposal.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Claims Liabilities Including Claims Incurred but not Reported (IBNR)

Losses are recorded at estimated amounts at the time they are reported and include a provision for expenses associated with claim settlements. Insurance claims are expensed as incurred over the period of coverage. The Fund establishes an unpaid claim liability for claims in the process of review, and for IBNR claims. The liability for IBNR claims is actuarially estimated based on the most current historical claims experience of previous payments, changes in number of members and participants, inflation, award trends, and estimates of health care trend (cost, utilization and intensity of services) changes. Estimates of liabilities for incurred claims are continually reviewed and revised as changes in these factors occur and revisions are reflected in the current year's operating statement in the applicable claims expense. Amounts for allocated and unallocated claims adjustment expenses have been included in the calculation of IBNR.

Claim costs for basic group life and long-term disability coverages are actuarially calculated using the one-year term cost method; the cost of coverage is the present value of all benefit payments that will be made on expected claims incurred during the year following the valuation date. Claim liabilities are equal to the present value, as of the valuation date, of all future payments to be made for disabilities and deaths up to that date. Actuarial assumptions include an interest rate of 6.25% for 2004 compounded annually.

Claims Payable

Claims payable represents claims related to health claims, dental claims and Long-Term Disability claims payable at June 30, 2004. The claims payable balance is based on claims that have been paid by the third party administrators on behalf of the Fund.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Compensated Absences

Generally all permanent full-time State employees and certain part-time employees scheduled to work at least one-half of the agency'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 earned for which the employees are entitled to paid time off or payment at termination. The leave liability also includes an estimate for unused sick leave and leave from the agency's leave transfer pool for employees who have been approved as leave recipients under personal emergency circumstances. The Fund calculates the gross compensated absences liability based on recorded balances of unused leave. The entire unpaid liability for which the employer expects to compensate employees through paid time off or cash payments, inventoried at fiscal year-end current salary costs and the cost of the salary-related benefit payments, is recorded in the Fund.

Net Assets

Net assets are recorded in three categories:

Investment in capital assets, net of related debt consists of capital assets net of accumulated depreciation and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction or improvement of those assets.

Restricted net assets result when constraints placed on net asset use are either imposed by creditors, grantors, contributors, and the like or imposed by law through constitutional provisions or enabling legislation.

Unrestricted net assets consist of net assets which do not meet the definition of restricted net assets or investment in capital assets, net of related debt.

The Fund applies expenses that can use both restricted and unrestricted resources against restricted resources then unrestricted resources.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

1. Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Classification of Revenue

The Fund has established the following criteria for reporting operating revenue or nonoperating revenue:

Operating revenue generally results from exchange transactions to provide the services authorized by State Statute. These revenue include (1) premiums for insurance coverage, (2) administrative fees, and (3) other receipts arising from services provided.

Nonoperating revenue includes activities that have the characteristics of nonexchange transactions. These revenue include appropriations, investment income, and contract revenue not classified as operating revenue or restricted by the provider to be used exclusively for capital purposes.

2. Investments and Deposits

As prescribed by Statute, the State Treasurer is the custodian and investment manager of all investments and deposits of the Fund.

Investments

In accordance with State Law, the Fund may invest in a variety of instruments including obligations of the United States and its agencies and securities fully guaranteed by the United States, certain corporate obligations, certain shares of Federal savings and loan associations and State chartered savings and loan associations, and collateralized repurchase agreements. All investments are required to be insured or registered, or held by the State or its agent in the name of the State Treasurer as custodian.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

2. Investments and Deposits (Continued)

The Fund's investments are categorized to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk.

- (1) Insured or registered in the agency's name, or securities held by the agency or its agent in the agency's name.
- (2) Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the agency's name.
- (3) Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the agency's name.

At June 30, 2004, all of the Fund's long-term investments were in Category (1).

With respect to investments in the State's internal 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 reported amounts, fair values, and credit risk of the State Treasurer's investments is disclosed in the Comprehensive Annual Financial Report of the State of South Carolina.

The following table presents the amortized cost and fair values of the investments of the Fund at June 30, 2004.

	Amortized Cost	Unrealized Gains	Losses	Market Value
U. S. Treasury notes	\$ 299,983	\$ -	\$ (544)	\$ 299,439
U. S. Government agencies securities	1,629,198	1,147	(9,229)	1,621,116
Collateralized mortgage-backed obligations	4,332,966	281,124	(7,093)	4,606,997
Other Governmental guaranteed investments	238,332	-	(8,477)	229,855
Repurchase agreement	4,840,000	-	-	4,840,000
Corporate bonds	9,780,532	523,322	(158,537)	10,145,317
Financial paper	2,403,294	154,580	(17,805)	2,540,069
Total	<u>\$ 23,524,305</u>	<u>\$ 960,173</u>	<u>\$ (201,685)</u>	<u>\$ 24,282,793</u>

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

2. Investments and Deposits (Continued)

At June 30, 2004, the amortized cost of the above investments was comprised of the following:

	<u>Par Value</u>	<u>Unamortized Premiums</u>	<u>Unaccrued Discounts</u>	<u>Amortized Cost</u>
U. S. Treasury notes	\$ 300,000	\$ -	\$ (17)	\$ 299,983
U. S. Government agencies	1,630,000	-	(802)	1,629,198
Collateralized mortgage- backed obligations	4,347,951	-	(14,985)	4,332,966
Other Government guaranteed investments	238,332	-	-	238,332
Repurchase agreement	4,840,000	-	-	4,840,000
Corporate bonds	9,921,188	95,712	(236,368)	9,780,532
Financial paper	2,400,000	12,374	(9,080)	2,403,294
Total	<u>\$ 23,677,471</u>	<u>\$ 108,086</u>	<u>\$ (261,252)</u>	<u>\$ 23,524,305</u>

The accounts classified as investments in the financial statements comprise investments held for the Fund and the State of South Carolina which are legally restricted and earnings thereon become revenue of the specific fund from which the investment was made. These investments are specific, identifiable investment securities, some of which may be included in one of the State Treasurer's investment pools.

The investment types listed above include all investment types in which monies were held as long-term investments throughout the fiscal year. For all investment classifications reported above, the balances therein fluctuated minimally in excess of the year-end balances throughout the year ended June 30, 2004. As discussed in *Note 1*, GASB Statement Number 31 required investments reported at fair value. Therefore, gains and losses recognized due to market fluctuations are recognized as income on deposits and investments. The Fund held no short-term investments at June 30, 2004. Short-term investments held during the fiscal year 2004 consisted of U.S. Government agency and government-insured securities whose amortized cost approximates fair value at June 30, 2004.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

2. Investments and Deposits (Continued)

The investment types listed above include all investment types in which monies were held throughout the year ended June 30, 2004. Due to higher cash flows at certain times during the year, the Fund's investment in repurchase agreements and short-term investments fluctuated significantly. The maximum amounts held in these classifications during the year ended June 30, 2004, were as follows:

Short-term investments	\$ 39,223
Repurchase agreements	\$ 4,840,000

Deposits

All deposits with financial institutions are required to be insured or collateralized with securities held by the State or its agent in the State Treasurer's name as custodian. At June 30, 2004, the Fund had no deposits with financial institutions. The Fund had cash and pooled investments of \$5,387,368 and \$46,772,202, respectively, held by the State Treasurer as of June 30, 2004.

Fair market value for cash and cash equivalents reported approximate the carrying value.

During the year, the following amounts (which apply to all investments) were included in investment earnings:

Interest earned	\$ 5,201,576
Discount accretion	39,838
Premium amortization	(224,984)
Realized gains (losses)	346,890
Change in unrealized gains (losses)	(825,078)
Investment earnings	\$ 4,538,242

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

2. Investments and Deposits (Continued)

The following schedule reconciles investments and deposits as reported in the statement of net assets to disclosures included in this note.

	<u>Statements</u>	<u>Note Disclosure</u>
Held by State Treasurer:		
Cash and cash equivalents	\$ 56,999,570	\$ 5,387,368
Pooled investments	-	46,772,202
Specifically identified investments	19,442,793	24,282,793
Total	<u>\$ 76,442,363</u>	<u>\$ 76,442,363</u>

3. Premiums Receivable

Premiums receivable at June 30, 2004, consist of the following:

Local government	\$ 317,668
State government (<i>Note 10</i>)	557,902
Other	737,641
	<u>\$ 1,613,211</u>

As of June 30, 2004, all of the receivables are deemed by management to be collectible. Therefore, no allowance for doubtful accounts has been recognized. In addition, the Fund has applied no discounts to its receivables as of June 30, 2004.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

4. Due to or from South Carolina Division of Retirement

At June 30, 2004, a total of \$26,244,876 consisting of \$25,745,582 from South Carolina Retirement System and \$499,294 from Police Officers Retirement System were due from the South Carolina Retirement Systems. In accordance with provisions of the Appropriations Act for each year, an additional employer contribution surcharge on covered payroll was added to the contribution rate applicable to entities covered by the State Health Insurance Plan. Accordingly, these amounts represent revenues collected on behalf of the Fund of a percentage of covered compensation from all State agencies and public school systems to be used for health and dental insurance benefits of State retirees. The percentage in effect was 3.3% from July 1, 2003 to June 30, 2004.

5. Capital Assets

The following are summaries of changes in capital assets for the year.

	Balance July 1, 2003	Additions	Deletions	Balance June 30, 2004
Furniture and equipment	\$ 250,171	\$ -	\$ (75,957)	\$ 174,214
Accumulated depreciation	(175,039)	(16,410)	68,361	(123,088)
Capital assets, net	<u>\$ 75,132</u>	<u>\$ (16,410)</u>	<u>\$ (7,596)</u>	<u>\$ 51,126</u>

Depreciation expense for the year ended June 30, 2004 was \$16,410.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

6. Lease Obligations

The Fund leases office space from a party outside of State government and is accounted for as an operating lease. The office space lease expires June 1, 2005. Rental expense under this lease for the year ended June 30, 2004 was \$393,021.

The Fund has also entered into an operating lease from a party outside of State government which will expire in 2006 for office equipment which contains a cancellation provision and is subject to annual appropriation. 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. For the year ended June 30, 2004, expenses under these leases were approximately \$16,498.

The following schedule summarizes the Fund's obligations under noncancelable operating leases having remaining terms in excess of one year as of June 30, 2004:

Fiscal Year Ending June 30,	Total
2005	\$ 327,264
Total	<u>\$ 327,264</u>

7. Pension Plans

The Retirement Division 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 South Carolina Retirement Division, Post Fund Box 11960, Columbia, South Carolina 29211-1960. Furthermore, the Division and the four pension plans are included in the CAFR of the State of South Carolina.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

7. Pension Plans (Continued)

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 of the State Budget and Control Board, 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 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 the 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.

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 earn service credit, and are ineligible to receive group life insurance benefits or disability retirement benefits.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

7. Pension Plans (Continued)

Since July 1, 1988, employees participating in the SCRS have been required to contribute 6 percent of all compensation. For the year ended June 30, 2004, the employer contribution rate was 11 percent (before a surcharge to fund retiree health and dental insurance coverage). The Fund's actual contributions to the SCRS was approximately \$319,000, respectively, and equaled the required contributions of 7.55 percent (excluding the surcharge) for each year. Also, the Fund paid employer group-life insurance contributions at the rate of .15 percent of compensation for the year ended June 30, 2004.

The amounts paid by the Fund for pension and group-life benefits are reported as employer contribution expenditures within the applicable administrative expenditure categories to which the related salaries are charged.

Article X, Section 16 of the South Carolina Constitution requires that all State-operated retirement systems be funded on a sound actuarial basis. Title 9 of the South Carolina Code of Laws of 1976, as amended, prescribes requirements relating to membership, benefit and employee/employer contributions for each retirement system. 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 benefit 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 amounts in which appropriations were included 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 the plans.

At retirement, employees participating in the SCRS receive additional service credit (at a rate of 20 days equals one month of services) for up to 90 days for accumulated unused sick leave.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

8. Post-Employment and Other Employee Benefits

In accordance with the South Carolina Code of Laws and the annual Appropriation Act, the State of South Carolina 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 post employment 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 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 portion funded through the pension surcharge and provided from other applicable 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. Currently, approximately 21,400 State retirees meet these eligibility requirements.

The Fund recorded employer contributions expenditures within the applicable administrative expenditure categories for these insurance benefits for active employees of approximately \$265,000, for the year ended June 30, 2004. The Fund paid approximately \$93,000 for the year ended June 30, 2004, applicable to the surcharge included with the employer contributions for retirement benefits (3.3% for 2004).

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 State General Assembly periodically directs the Retirement Systems to pay supplemental (cost of living) increases to retirees. Such increases are primarily funded from Systems' earnings; however, a portion of the required amount is appropriated from the State General Fund annually for the SCRS benefits.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

9. 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 of South Carolina. Compensation deferred under the plans is placed in trust for the contributing employee. 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.

The State authorized deferred compensation matching contributions for fiscal year 2000-2001. The contributions are funded from various funding sources based on the same percentages used for employees' salaries. The State appropriated funds from unspent fiscal year 1999-2000 appropriations for the portion of contributions paid from State General Funds to 401(k) accounts of eligible state employees. The 401(k) match is limited to \$300. To be eligible, an employee must be a permanent full-time state employee or temporary grant employee who is actively contributing to a 401(k), 457 or 403(b) account on the date of distribution. Permanent full-time employees making less than \$20,000 as of July 1, 2000, are not required to contribute in order to receive the match.

This Fund made no contributions for the fiscal year ending June 30, 2004.

10. Transactions with State Entities

The Fund has significant transactions with the State of South Carolina and various State agencies.

Services received at no cost include payroll processing, disbursement processing and maintenance of certain accounting records from the Comptroller General; check preparation, banking and investment functions from the State Treasurer; and legal services from the Attorney General.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

The following services are provided for a fee to various State agencies and within the South Carolina State Budget and Control Board. The fees are recorded as revenues in the financial statements for the Fund.

Insurance coverage for state agencies and local governments:

Health

Dental

Basic group-life and disability

State Life and Long-Term Disability

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

The following details the insurance premiums charged by the Fund to other state agencies and divisions of the South Carolina State Budget and Control Board during the year ended June 30, 2004:

SC State Senate - Clerical	\$ 345,533
SC State Senate - Senators	198,625
House of Representatives - Clerical	289,452
House of Representatives - Senators	417,570
Legislative Council	97,473
Legislative Printing and Information	92,910
Legislative Audit Council	55,462
SC Education Oversight Committee	25,123
Judicial Department	1,890,781
SC Administrative Law Judge Division	71,381
Governor's Office - Executive Control of State	36,264
State Law Enforcement Division	1,649,497
Governor's Office - Executive Policy & Programs	611,746
Governor's Office - Mansion & Grounds	34,599
Lt. Governor's Office	8,208
Secretary of State	96,779
Comptroller General's Office	244,608
State Treasurer	211,583
Attorney General	446,272
SC Commission on Prosecution Coordination	164,459
SC Commission of Appellate Defense	48,122
Commission on Indigent Defense	20,984
Adjutant General's Office	758,216
State Election Commission	48,290
SC Budget & Control Board	4,105,693
SC Budget & Control Board - State Auditor	153,347
Commission on Higher Education	166,915
Higher Education Tuition Grants Commission	14,295

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

The Citadel	2,121,570
Clemson University	14,301,741
College of Charleston	3,964,678
Coastal Carolina University	2,315,582
Francis Marion University	1,473,282
Lander University	1,117,671
SC State University	2,573,655
University of South Carolina	20,043,842
Winthrop University	2,566,231
Medical University of South Carolina	13,399,504
State Board for Technical & Comprehensive Education	345,023
Trident Technical College	1,968,955
Northeastern Technical College	316,616
Florence-Darlington Technical College	898,858
Greenville Technical College	2,239,907
Horry-Georgetown Technical College	993,293
Midlands Technical College	1,989,402
Orangeburg-Calhoun Technical College	635,976
Piedmont Technical College	958,616
Spartanburg Technical College	871,209
Central Carolina Technical College	642,755
Tri County Technical College	947,788
York Technical College	937,713
Aiken Technical College	467,524
Technical College of Low Country	476,392
Denmark Technical College	300,854
Williamsburg Technical College	198,642
Department of Education	3,802,482
SC Educational Television Commission	843,761
Wil Lou Gray Opp School	175,550
Vocational Rehabilitation	3,755,918
SC School for the Deaf & Blind	1,376,298
Department of Archives & History	257,881
SC State University	134,606
SC Arts Commission	105,423

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

SC Museum Commission	122,511
Health & Human Services Financial	4,091,152
Department of Health & Environmental Control	16,367,430
Department of Mental Health	16,996,895
SC Department of Disabilities & Special Needs	8,231,358
SC Department of Alcohol & Other Drug Abuse Services	214,956
SC Department of Public Safety	8,449,152
Department of Social Services	12,944,959
John De La Howe School	307,875
SC Commission for the Blind	393,826
SC State Housing Finance & Development Authority	379,993
SC Human Affairs Commission	145,894
State Commission for Minority Affairs	10,816
SC Department of Corrections	18,942,558
SC Department of Probations, Parole & Pardon Services	2,462,146
SC Department of Juvenile Justice	4,676,328
Forestry Commission	1,434,404
Department of Agriculture	488,819
Department of Natural Resources	2,961,557
Sea Grant Consortium	39,396
Department of Parks, Recreation & Tourism	1,702,550
SC Department of Commerce	374,022
SC Jobs - Economic Development Authority	10,942
Business Carolina, Inc.	42,170
Patriots Point Development Authority	226,494
Public Service Commission	308,718
SC Workers' Compensation Commission	189,862
State Accident Fund	262,174
Patients Compensation Fund	12,762
Second Injury Fund	75,911
SC Department of Insurance	318,720
State Board of Financial Institutions	122,124
SD Department of Consumer Affairs	114,348
Department of Labor, Licensing, & Regulation	1,325,098

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

South Carolina Department of Motor Vehicles	548,949
Department of Revenue and Taxation	1,830,605
State Ethics Commission	23,785
Employment Security Commission	3,684,075
Procurement Review Panel	2,664
Office of State Infrastructure Bank	17,647,086
Aid to Subdivisions	270,861
South Carolina Education Lottery	438,887
COBRA and Retirees of State Agencies	48,141
	<u>\$ 231,066,358</u>

The Fund had financial transactions with various State agencies during the fiscal year. Significant payments were made to Divisions (Funds) of the State Budget and Control Board for retirement and insurance plans contributions, vehicle rental, surplus property disposal fees, Fund supplies, printing, and telephone, interagency mail, data processing services, purchasing, record maintenance, internal audit, personnel services, unemployment, and workers' compensation coverage for employees. The identifiable amounts of 2004 expenses applicable to related party transactions are as follows:

South Carolina Retirement Division	\$ 315,335
State Accident Fund	10,191
South Carolina Employment Security Commission	5,125
South Carolina Budget and Control Board	267,127
	<u>\$ 597,778</u>

In addition, interfund-transfers include the following:

State Budget & Control Board - General Services - Insurance Reserve Fund	\$ 357,686
State Budget & Control Board - Insurance Reserve Fund	3,652
	<u>\$ 361,338</u>

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

A significant portion of the Fund's total insurance premium revenue is for insurance premiums charged to other state agencies and divisions of the South Carolina State Budget and Control Board. Premiums owed from these entities at June 30, 2004 were:

SC State Senate - Clerical	\$ 1
SC State Senate - Senators	1,273
Legislative printing and information	14
Judicial Department	435
SC Administrative Law Judge Division	323
State Law Enforcement Division	67
Governor's Office - Executive Policy & Programs	900
Secretary of State	657
State Treasurer	2
Attorney General	14
SC Commission on Prosecution Coordination	8
Commission on Indigent Defense	28
Adjutant General's office	75
State Election Commission	1,706
SC Budget & Control	697
Commission on Higher Education	10,126
The Citadel	3,661
Tri County Technical College	37,963
Department of Education	75
SC Educational Television Commission	2,336
Vocational Rehabilitation	24,645
SC State Library	4
SC Arts Commission	73
Health & Human Services Financial	13,999
Department of Health & Environmental Control	543
Department of Mental Health	12,833
SC Department of Disabilities & Special Needs	3,767
SC Department of Alcohol & Other Drug Abuse Services	127
SC Department of Public Safety	2,029
Department of Social Services	41,269
SC State Housing Finance & Development Authority	75
SC Human Affairs Commission	283
SC Department of Corrections	96,611
SC Department of Probation, Parole & Pardon Services	593

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

SC Department of Juvenile Justice	4,078
Forestry Commission	180
Department of Agriculture	16
Department of Natural Resources	77
Department of Parks, Recreation & Tourism	454
SC Department of Commerce	116
Patriots Point Development Authority	164
Public Service Commission	245
State Accident Fund	228
Patient's Compensation Fund	351
State Board of Financial Institutions	97
SC Department of Consumer Affairs	8,964
Department of Labor, Licensing, & Regulation	105
SC Department of Motor Vehicles	271,201
Department of Revenue and Taxation	3,526
State Ethics Commission	59
Employment Security Commission	3,838
Department of Transportation	1,459
Aid to Subdivisions	428
South Carolina Education Lottery	5,104
State Board of Financial Institutions	<u>\$ 557,902</u>

The following services are received from other Divisions (Funds) of the South Carolina State Budget and Control Board at no charge:

Division of Operations

Record storage

Division of Retirement

Collection of health and dental premiums from retirees

Retirement plan administration

Collection of retiree insurance surcharge from employers

The Fund acted as fiduciary for premiums collected from state agencies for State Life and Long-Term Disability. During the year ended June 30, 2004, \$2,459,509 was collected from state agencies and disbursed to the State Life and Long-Term Disability carrier.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

Additionally, refer to *Note 4* for a description of the amounts due from South Carolina Division of Retirement.

The Fund offers a managed care program to MUSC's employees living in Charleston, Dorchester, Colleton or Berkeley counties. Refer to *Note 1* for a complete description.

11. Contingencies

By the nature of its operations and responsibilities as an insurer, the Fund has been named in a number of lawsuits, many of which are pending. A provision has been made in the financial statements for the payment of routine claims. Management is not aware of any other claims that, in their opinion, would have a material effect on the financial statements and, therefore, no liability has been recorded.

12. Risk Management/Reinsurance

The Fund is exposed to various risks of loss and maintains State or commercial insurance coverage for each of those risks except for certain types of risks for which it is self-insured (these risks are further described herein). 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 coverage in the prior year. Settled claims have not exceeded this coverage in any of the past three years.

The Fund pays insurance premiums to itself and certain other State agencies and commercial insurers 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 accord with insurance policy and benefit program limits.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

12. Risk Management/Reinsurance (Continued)

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:

1. Claims of State employees for unemployment compensation benefits (Employment Security Commission);
2. Claims of covered employees for workers' compensation benefits for job-related illnesses or injuries (State Accident Fund);
3. Claims of covered public employees for health and dental insurance benefits (Employee Insurance Programs); and
4. Claims of covered public employees for long-term disability and group-life insurance benefits (Employee Insurance Programs).
5. Claims of covered property damage, theft, collision (automobile), liability, and general tort (Insurance Reserve Fund).

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 which are remitted to commercial carriers.

State agencies and other entities are the primary participants in the Fund.

The Fund obtains coverage of up to \$750,000 per loss through a commercial carrier for employee fidelity bond insurance for all employees for losses arising from theft or misappropriation.

The Fund has recorded insurance premium expense regarding its internal operations in the applicable administrative expense categories.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

12. Risk Management/Reinsurance (Continued)

The Fund has not transferred the portion of the risk of loss related to insurance policy deductibles and limits. The Fund has not reported an estimated claims loss expense, and the related liability at June 30, 2004, based on the requirements of GASB 10 because information at June 30 did not indicate that an asset had been impaired or a liability had been incurred. GASB 10 states 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 and the amount of loss is reasonably estimable.

The Fund self-insures health and dental insurance for all participating governmental employees, including those of the Fund. Additionally, effective January 1, 1999, the Fund began offering a self-insured HMO point of service plan to certain employees in the service area of MUSC. The Fund also purchases HMO products through Companion and Cigna which are self-insured. The Fund also offers Dental Plus and State Life products which are fully insured. The Fund purchases coverage for basic group life, dependent life, optional supplemental life, group optional life and basic disability from commercial carriers. The Long-Term Disability program is also self-insured.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

13. Reconciliation of Claims Liabilities by Fund

The schedule below presents the changes in claims liabilities for the past two years for the Fund.

	(in thousands)	
	2004	2003
Unpaid claims and claim adjustment expenses at beginning of the fiscal year	\$ 188,153	\$ 155,169
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current fiscal year	905,812	853,222
Increases (decreases) in provision for insured events of prior fiscal years	237,396	222,263
Total incurred claims and claim adjustment expenses	1,143,208	1,075,485
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current fiscal year	\$ 775,279	\$ 751,055
Claims and claim adjustment expenses attributable to insured events of prior fiscal years	376,210	291,346
Total payments	1,151,489	1,042,401
Total unpaid claims and claim adjustment expenses at end of the fiscal year	<u>\$ 179,872</u>	<u>\$ 188,253</u>
The above totals are comprised of the following:		
Claims payable	\$ 42,772	\$ 60,387
Claims incurred but not reported	137,100	127,766
Total	<u>\$ 179,872</u>	<u>\$ 188,153</u>

The HMO self-insured managed care plan liability at June 30, 2004 and 2003 was \$3,440,483 and \$3,601,178, respectively, and is included in the claims liability listed above.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

14. Changes in Long-Term Liabilities

Changes in long-term obligations for the year ended June 30, 2004, were as follows:

	<u>Beginning Balance July 1, 2003</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance June 30, 2004</u>	<u>Due Within One Year</u>
Compensated absences payable	<u>\$ 366,177</u>	<u>\$ 49,485</u>	<u>\$ (16,049)</u>	<u>\$ 399,613</u>	<u>\$ 17,097</u>

15. Discussion of Fund Deficit in FY 2003-2004

During 2003-2004 fiscal year, the Employee Insurance Program reported an increase in net assets of \$4,408,224. This gain combined with losses in recent years, resulted in liabilities exceeding assets of \$75,506,606. Changes in funding and coverage resulted in an increase in equity in 2000-2001 and 2001-2002 reducing the deficit by approximately \$13,000,000. For 2002-2003, additional changes in funding and coverage were initiated. However, the economic trends of the cost of the coverage offered by the Fund, health, dental, life, and disability, exceeded the measures initiated by the Fund. The plan year 2004 premium increases and changes in benefits have initiated a small reduction in the net deficit. Additional premium increase and plan changes have been established for plan year 2005. However, there is no guarantee that they will be able to protect the Fund from future operating losses. To guarantee the continuation of the coverage offered by the Fund, the deficit position must be reversed through sustained increases in equity. To provide for these increases, additional funding sources, State Appropriations, or other increases in fees and charges may be required.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL

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

Dear Mr. Wagner:

We have audited the 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, 2004, and have issued our report thereon dated September 15, 2004. 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.

Compliance

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 grants, 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 that are required to be reported under *Government Auditing Standards*.

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 assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions identified are as follows:

During 2003-2004 fiscal year, the Employee Insurance Program reported an increase in net assets of \$4,408,224. This gain combined with losses in recent years, resulted in liabilities exceeding assets of \$75,506,606. Changes in funding and coverage resulted in an increase in equity in 2000-2001 and 2001-2002 reducing the deficit by approximately \$13,000,000. For 2002-2003, additional changes in funding and coverage were initiated. However, the economic trends of the cost of the coverage offered by the Fund, health, dental, life, and disability, exceeded the measures initiated by the Fund. The plan year 2004 premium increases and changes in benefits have initiated a small reduction in the net deficit. Additional premium increase and plan changes have been established for plan year 2005. However, there is no guarantee that they will be able to protect the Fund from future operating losses. To guarantee the continuation of the coverage offered by the Fund, the deficit position must be reversed through sustained increases in equity. To provide for these increases, additional funding sources, State Appropriations, or other increases in fees and charges may be required.

We recommend that the management of the Fund review this situation and take steps to return the Fund to profitable operations.

A material weakness is a 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 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

* * * * *

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

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

Rebeck & Williamson, L.L.P.

September 15, 2004