

**SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND**

COLUMBIA, SOUTH CAROLINA

June 30, 2004

State of South Carolina



Office of the State Auditor

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October 7, 2004

The Honorable Mark Sanford, Governor
and
Members of the Board of Governors
South Carolina Medical Malpractice Patients' Compensation Fund
Columbia, South Carolina

This report on the audit of the financial statements of the South Carolina Medical Malpractice Patients' Compensation Fund for the fiscal year ended June 30, 2004, was issued by Wilkes & Company, Certified Public Accountants, under contract with the South Carolina Office of the State Auditor.

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

Respectfully submitted,

A handwritten signature in black ink that reads "Tom Wagner".

Thomas L. Wagner, Jr., CPA
State Auditor

TLWjr/trb

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

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INDEPENDENT AUDITORS' REPORT

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

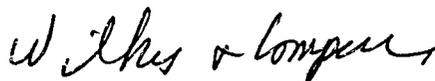
We have audited the accompanying financial statements of the South Carolina Medical Malpractice Patients' Compensation Fund as of and for the year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 described in Note 1, the financial statements present only the South Carolina Medical Malpractice Patients' Compensation Fund and do not purport to, and do not, present fairly the financial position of the State of South Carolina primary government or financial reporting entity as of June 30, 2004, and the changes in its position and cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States..

In our opinion the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the South Carolina Medical Malpractice Patients' Compensation Fund as of June 30, 2004, and changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of presentation of the supplementary information. However, we did not audit the information and express no opinion on it.



Columbia, South Carolina
September 24, 2004



South Carolina Medical Malpractice
PATIENTS' COMPENSATION FUND

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Edward W. Catalano, Jr., M.D.
 Chairman of the Board

Management's Discussion and Analysis

Overview of the Financial Statement and Financial Analysis

This report is prepared in accordance with Governmental Accounting Standards Board Statement 34, *Basic Financial Statements and Management's Discussions and Analysis for State and Local Governments*. This financial statement is presented in three parts: Statement of Net Assets, Statement of Revenues, Expenses and Changes in Net Assets and Statement of Cash Flows. This discussion and analysis of the South Carolina Patients' Compensation Fund's (PCF) financial statements provide an overview of its financial activities for the year.

Statement of Net Assets

The Statement of Net Assets presents the assets, liabilities and equity of the PCF as of the end of the 2004 fiscal year. The statement of Net Assets presents end-of-year data concerning assets as well as liabilities (current and non-current). Our current assets are those, which are reasonably expected to be, realized in one year. Current liabilities are obligations whose liquidation is expected to require the use of current assets.

Condensed Statement of Net Assets

	<u>FY 2004</u>	<u>FY 2003</u>	<u>Variance</u>
<i>Assets:</i>			
Total Cash:	\$ 6,975,727	\$ 3,821,326	\$ 3,154,401
Interest Receivable and prepaid expenses	<u>101,084</u>	<u>125,825</u>	<u>(24,741)</u>
Total Assets	<u>\$ 7,076,811</u>	<u>\$ 3,947,151</u>	<u>\$ 3,129,660</u>
<i>Liabilities:</i>			
Current Liabilities	\$ 49,879,833	\$ 47,142,514	\$ (2,737,319)
Non-current liabilities	<u>166,101,697</u>	<u>175,318,301</u>	<u>9,216,604</u>
Total Liabilities	<u>\$ 215,981,530</u>	<u>\$ 222,460,815</u>	<u>\$ 6,479,285</u>
<i>Net Assets (Deficit):</i>			
Deficit	<u>\$ (208,904,719)</u>	<u>\$ (218,513,664)</u>	<u>\$ 9,608,945</u>

Statement of Revenues, Expenses and Changes in Net Assets (Deficit)

Changes in total net assets as presented in the statement activities are based on the activity presented in the statement of revenues, expenses and changes in net assets. The purpose of the statement is to present the revenues earned by the PCF, operating and non-operating and the expenses incurred by the PCF. Non-operating revenues are those for which goods or services are not provided.

The Statement of Revenues, Expenses and Changes in Net Assets (deficit) is prepared on the accrual basis of accounting. Accrual accounting attempts to record the financial effects of transactions on an entity in the period in which those transactions occur, rather than in the period in which cash is received. Revenues are recognized when goods or services are provided. Expenses are recognized when resources are utilized in order to produce goods or services.

Condensed Statement of Revenues, Expenses and Changes in Net Assets

	<u>FY 2004</u>	<u>FY 2003</u>	<u>Variance</u>
Operating revenues	\$ 40,290,909	\$ 37,855,337	\$ 2,435,572
Operating expenses	<u>(30,732,469)</u>	<u>(50,118,109)</u>	<u>19,385,640</u>
Operating income or loss	9,558,440	(12,262,772)	21,821,212
Non-operating revenues	<u>50,505</u>	<u>343,954</u>	<u>(293,449)</u>
Transfer to SC General Fund	<u>-</u>	<u>(1,499,559)</u>	<u>1,499,559</u>
Increase (Decrease) in Net Assets	9,608,945	(13,418,377)	23,027,322
Net Assets (Deficit) - Beginning of year	<u>(218,513,664)</u>	<u>(205,095,287)</u>	<u>(13,418,377)</u>
Net Assets (Deficit) - End of Year	<u>\$ (208,904,719)</u>	<u>\$ (218,513,664)</u>	<u>\$ 9,608,945</u>

Statement of Cash Flows

The final statement presented by the PCF is the Statement of Cash Flows. The Statement of Cash Flows presents detailed information about the cash activity during the year. The statement is divided into three parts. The first part deals with operating cash flows and shows the net cash used by the operating activities of the Fund. The second section reflects cash flows from investing activities and shows the interest received from investing activities. The third section reconciles the net cash used to the operating income or loss displayed on the Statement of Revenues, Expenses and Changes in Net Assets.

Condensed Statement of Cash Flows for the Year Ended June 30, 2002

	<u>FY 2004</u>	<u>FY 2003</u>	<u>Variance</u>
Cash provided (used) by:			
Operating activities	\$ 3,067,357	\$ (5,373,758)	\$ 8,441,115
Non-capital financing activities	-	(1,499,559)	1,499,559
Investing activities	<u>87,045</u>	<u>366,855</u>	<u>(279,810)</u>
Net change in cash	3,154,402	(6,506,462)	9,660,864
Cash and cash equivalents - beginning of year	<u>3,821,325</u>	<u>10,327,787</u>	<u>(6,506,462)</u>
Cash and cash equivalents - end of year	<u>\$ 6,975,727</u>	<u>\$ 3,821,325</u>	<u>\$ 3,154,402</u>

Assessment and Rate Increases

The PCF Board of Governors determined that a deficit assessment was not necessary during this fiscal year. The last deficit assessment was in June 2000. The statute grants the Board the authority to make assessments under Section 38-79-450 of the Code of Laws of South Carolina, 1976.

Following the previous actuarial review, which was conducted by a national actuarial firm, at the direction of the South Carolina Department of Insurance, the PCF Board of Governors voted to implement an average membership fee increase of 22.8% on June 1, 2004. This increase was based on the actuary's recommendation and was approved by the South Carolina Department of Insurance. The Board of Governors considered a number of factors in their deliberations for a rate increase, including reducing the PCF deficit, competitive place in the commercial market and actuarial review.

Business Overview

The Patients' Compensation Fund functions with a staff of four full-time equivalent employees and one part-time employee. One FTE position was approved in December 2003 and the position has been filled. The part-time individual serves as an administrative assistant. The position of Executive Director has now been filled. This position has been vacant for approximately four years and is being filled by Terry Coston, previously the program manager. The program manager position is currently vacant.

At the close of the fiscal year, the PCF had a membership of 7,450. This includes one nursing home, 27 clinics, 13 hospitals, 994 professional associations, 4,198 physicians, 1313 dentist & oral surgeons, 31 pharmacists and 873 other healthcare providers. The PCF paid a total of \$36,520,344.39 for claims, settlements and judgments during the fiscal year. The PCF collected \$40,637,327.94 in membership fees.

Leadership

The Board of Governors is composed of three physicians, two dentist, two hospital representatives, two insurance representatives, two attorneys and two representatives of the general public, all appointed by the Governor. The appointed members serve a term of six years. The Board develops a Plan of Operations for efficient administration of the Fund, consistent with the provisions of the plan of operations and Article 5 of the enabling legislation.

The Board is engaged in extensive strategic planning throughout the fiscal year, which included the continual review and revision of the PCF Plan of Operations, Underwriting Manual of Rules & Rates and claims handling procedures. The board has reviewed and is considering legislative changes, which will allow for the more efficient operation and management of the Fund. The Plan of Operations details procedural information that provides for economic, fair and nondiscriminatory administration and for prompt and efficient provisions of excess medical malpractice insurance. The Plan contains other provisions including, but not limited to, assessment of all members for expenses, deficits, losses, reasonable underwriting standards, acceptance and cession of the reinsurance, appointment of servicing carriers and procedures for determining the amounts of insurance to be provided by the Fund. The Plan of Operation and any amendments to the Plan are subject to the approval of the Board.

The Fund provides customer services to its members through enrollment of new members, renewal of current members, collection of fees and assessments and payment of claims. It provides credentialing information to hospitals and managed care organizations.

The board has authorized the revision of the membership agreement and the development of applications to better serve its members. The board continues to allow its members to pay their annual membership fee on a quarterly basis, with a small administrative fee.

Physicians and dentists that attend the South Carolina Medical Association and the South Carolina Dental Association Risk Management Seminar, which is sponsored by the South Carolina Medical Malpractice Liability Insurance Joint Underwriting Association (JUA), receive a discount in their annual membership fee. The discount is equivalent to a maximum of 25% of the base premium, up to a maximum of \$2,000. It is a one-time discount fee. The discount does not apply to a physician's professional association.

As previously stated, the PCF consists of four full-time employees and one part-time employee. The Executive Director, along with the Board of Governors, is closely monitoring the employee's ability to meet the demands and needs of its members, which continue to increase. The PCF is a highly complex organization that works extensively with legal counsel for claims defense, expert witnesses and claims investigations, all in conjunction with the primary carrier. The effective selection, coordination and management of these professionals are critical to the success of the PCF. It requires employees with special skills and a high work ethic.

The Agency continues to make improvements in computer software to ensure that its members are receiving efficient and accurate information. There is a tremendous need to continue to explore and expand technological capabilities that will allow the agency to meet future needs of its members.

The principal challenge of the PCF is to retain current members and at the same time, increase premiums to reduce the loss reserve liability. Revenue is needed to maintain agency solvency, but it is a delicate balance, as a significant loss in members would result in a dramatic increase in premiums for those members who remain in the Fund. The other significant challenge is to manage the claims process effectively and coordinate with the primary carriers for satisfactory resolution of all claims. The PCF's ultimate goal is to provide medical professionals with effective medical malpractice liability coverage, while ensuring that the PCF is in a financial sound position to pay all of its liabilities.

Economic Outlook

The South Carolina Patients' Compensation Fund shows an overall deficit due to the fact that it records the actuarial liability for unpaid claims as well claims that are "incurred but not reported." The actuarial review for this fiscal year shows improvement in the overall financial condition of the fund. We anticipate that this trend will continue. The PCF continues to meet its obligations in a timely manner. And there has been a drastic reduction of pending judgments against the members of the Fund. To date there is only one judgment pending on appeal.

We feel the South Carolina Patient's Compensation Fund's overall financial positions are sound. The Fund is not aware of any facts, decisions, or conditions that can reasonably be expected to have a material impact on the Fund's economic outlook during the fiscal year beginning July 1, 2004.

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

STATEMENT OF NET ASSETS

JUNE 30, 2004

ASSETS

Current Assets:	
Cash and cash equivalents	\$ 6,975,727
Prepaid expenses	71,492
Interest receivable	<u>29,592</u>
 Total Current Assets	 <u>7,076,811</u>
 Total Assets	 <u>7,076,811</u>

LIABILITIES

Current Liabilities:	
Accounts payable	21,268
Accrued salaries and employer contributions	21,065
Accrued compensated absences	12,500
Claims payable – current	37,500,000
Unearned fees	<u>12,325,000</u>
 Total Current Liabilities	 <u>49,879,833</u>
Noncurrent Liabilities:	
Accrued compensated absences	1,697
Claims:	
Claims payable	196,505,000
Claims discount	<u>(30,405,000)</u>
 Net Claims Liability	 <u>166,100,000</u>
 Total Noncurrent Liabilities	 <u>166,101,697</u>
 Total Liabilities	 <u>215,981,530</u>

NET DEFICIT

Net Assets (deficit)	<u>\$ (208,904,719)</u>
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THE ACCOMPANYING NOTES ARE AN
INTEGRAL PART OF THIS FINANCIAL STATEMENT

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

**STATEMENT OF REVENUES, EXPENSES AND CHANGES
IN NET ASSETS**

FOR THE YEAR ENDED JUNE 30, 2004

Operating Revenues:	
Members fee income (Net of refunds)	\$ 39,351,466
Deficit assessment income	12,787
Administrative fees	<u>926,656</u>
Total Operating Revenues	<u>40,290,909</u>
Operating Expenses:	
Claims (net of discounts)	29,812,344
Administration	<u>920,125</u>
Total Operating Expenses	<u>30,732,469</u>
Net Operating Income (Loss)	9,558,440
Nonoperating Revenues:	
Interest earned	<u>50,505</u>
Total Nonoperating Revenues	<u>50,505</u>
Net Income	9,608,945
Net Assets (Deficit) - July 1	<u>(218,513,664)</u>
Net Assets (Deficit) - June 30	<u>\$ (208,904,719)</u>

THE ACCOMPANYING NOTES ARE AN
INTEGRAL PART OF THIS FINANCIAL STATEMENT

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2004

Cash Flows From Operating Activities:	
Fees and other income received	\$ 41,801,771
Refunds	(1,015,862)
Claims paid	(36,792,575)
Administrative expenses paid	<u>(925,977)</u>
Net Cash Provided by Operating Activities	<u>3,067,357</u>
Cash Flows From Investing Activities:	
Interest income received	<u>87,045</u>
Net Cash Provided by Investing Activities	<u>87,045</u>
Net Increase in Cash and Cash Equivalents	3,154,402
Cash and Cash Equivalents, Beginning of Year	<u>3,821,325</u>
Cash and Cash Equivalents, End of Year	<u>\$ 6,975,727</u>
Reconciliation of Operating Income (Loss) to Net Cash Provided (Used) by Operating Activities:	
Cash Flows From Operating Activities:	
Operating income (Loss)	\$ 9,558,440
(Increase) decrease in prepaid expenses	(11,798)
Increase (decrease) in liabilities:	
Accounts payable	4,070
Claims liabilities, net of discount	(6,712,000)
Accrued salaries and employer contributions	4,249
Accrued compensated absences	(604)
Unearned fees	<u>225,000</u>
Total Adjustments	<u>(6,491,083)</u>
Net Cash Provided by Operating Activities	<u>\$ 3,067,357</u>

THE ACCOMPANYING NOTES ARE AN
INTEGRAL PART OF THIS FINANCIAL STATEMENT

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

**NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004**

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The core of the financial reporting entity is the primary government, which has a separately elected governing body. As required by generally accepted accounting principles, the financial reporting entity includes both the primary government and all 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. The Organization is identified herein as the primary entity.

The primary 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 bonded debt without approval by another government.

Based on the application of the above criteria, no component units are included in the reporting entity.

The South Carolina Medical Malpractice Patients' Compensation Fund was established by Section 38-79-420 of the Code of Laws of South Carolina on July 1, 1976. The South Carolina Medical Malpractice Patients' Compensation Fund is part of the primary government of the State of South Carolina and is included in the Comprehensive Annual Financial Report of the State of South Carolina.

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

(Continued)

The Board of Governors, whose members are appointed by the Governor, is the governing body of the South Carolina Medical Malpractice Patients' Compensation Fund. The Board was created to manage and operate the Fund. The Board has the authority to set annual membership fees and to make deficit assessments when insufficient money is available to pay the Fund's liabilities. The Board also has the authority to approve and pay claims liabilities and to actively defend the Fund against claims.

The coverage is available to any public or private health care provider in the State. The Fund is responsible for payment of that portion of any covered medical malpractice claim, settlement, or judgment, which is in excess of \$100,000 per incident or in excess of \$300,000 in the aggregate for one year. Effective November 26, 2000, excess coverage thresholds increased to \$200,000 and \$600,000. Although the reporting entity operates somewhat autonomously it lacks full corporate powers. The accompanying financial statements present the financial position, results of operations, and cash flows solely of the South Carolina Medical Malpractice Patients' Compensation Fund and do not include any component units or other agencies or funds of the State of South Carolina.

Fund Accounting

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

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

Enterprise Fund – used to account for business-like activities provided to the general public. These activities are financed primarily by user charges and the measurement of financial activity focuses on net income measurement similar to the private sector.

The South Carolina Medical Malpractice Patients' Compensation Fund was created by act of the General Assembly for the purpose of providing funds for payment of that portion of any medical malpractice claim, settlement or judgment against a health care provider which until November 26, 2000, was in excess of \$100,000 per incident, and \$300,000 in the aggregate, and which thereafter is in excess of \$200,000 per incident or in excess of \$600,000 in the aggregate for one

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

(Continued)

year. The Fund is liable only for payment of claims against "licensed health care providers", which includes physicians and surgeons, directors, officers, and trustees of hospitals; nurses; oral surgeons; dentists; pharmacists; chiropractors; hospitals; nursing homes; or any similar category of licensed health care providers. All providers licensed in South Carolina are eligible to participate in the Fund upon remitting the annual assessment fees in amounts as determined by the governing board of the Fund.

Basis of Accounting

All proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of those funds are included on the balance sheet. Proprietary fund-type operating statements present increases and decreases in net total assets.

The financial statements are presented on the accrual basis of accounting for measuring financial position and results of operations. Proprietary fund type revenues and expenses are recognized on the accrual basis of accounting. Revenues are recognized in the accounting period in which they are earned and become measurable; expenses are recognized in the period incurred, if measurable.

The Government Accounting Standards Board (GASB) is the recognized standard setting body for generally accepted accounting principles in the United States of America applicable to governmental proprietary activities. The Fund applies all applicable Government Accounting Standards Board (GASB) pronouncements and all applicable Financial Accounting Standards Board (FASB) pronouncements issued on or before November 30, 1989 when not in conflict with (GASB) pronouncements. In accordance with GASB Statement 20, the Fund has elected not to implement FASB Statements 103 and after. As discussed later, the Fund uses FASB 60, guidance to record unpaid claims liabilities.

Budget Policy

The South Carolina Medical Malpractice Patients' Compensation Fund is granted an annual appropriation for administrative operating purposes by the General Assembly. The appropriation as enacted becomes the legal operating budget for the Fund for its budgeted activities. The Appropriation Act authorizes expenditures from funds appropriated from the General Fund of the State and expenditures of total funds. None of the funding of the South Carolina Medical Malpractice Patients' Compensation Fund is provided from State General Fund appropriations. The General Assembly enacts the budget through passage of line-item appropriations by program within budgetary unit. Budgetary control is maintained at the line-item level of the budgetary entity. Agencies may process disbursement vouchers in the State's budgetary accounting system only if enough cash and appropriation authorization exist.

SOUTH CAROLINA MEDICAL MALPRACTICE
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NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

(Continued)

Transfers of funds may be approved by the State Budget and Control Board under its authority or by the agency as set forth in the 2004 Appropriation Act Proviso 72.10 as follows: Agencies are authorized to transfer appropriations within programs and within the agency with notification to the Division of Budget and Analyses and the State Comptroller General. No such transfer may exceed twenty percent of the program budget. Transfers from personal services accounts or from other operating accounts may be restricted to any level set by the Board.

During the fiscal year-end closeout period in July, agencies may continue to charge vendor, interagency, and interfund payments for the fiscal year to that fiscal year's appropriation. For the Fund, any unexpended funds as of June 30, automatically carry over to the ensuing fiscal year. State law does not require the use of encumbrance accounting.

State law does not precisely define the budgetary basis of accounting. The current Appropriation Act states that the General Assembly intends to appropriate all State funds and to authorize and/or appropriate the use of all other monies to operate State government for the current fiscal year. The State's annual budget is prepared primarily on the modified accrual basis of accounting with several exceptions, principally the cash disbursements basis for payroll expenditures.

Cash and Cash Equivalents

The amounts shown in the financial statements as "*cash and cash equivalents*" represent cash on hand and cash on deposit with the State Treasurer and cash invested in various investments by the State Treasurer as part of the State's internal cash management pool.

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 pool includes some long-term investments such as obligations of the United States and certain agencies of the 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. Most State agencies participate in the State's internal cash management pool; however, some agency accounts are not included in the pool because of restrictions on the use of funds. For those accounts, cash equivalents included investments in short-term, highly liquid securities having a maturity at the time of purchase of three months or less.

The State's internal cash management pool consists of a general deposit account and several special deposit accounts. The State records each agency's equity interest in the general deposit account; however, all earnings on that account are credited to the General Fund of the State. Agencies record and report their deposits in the general deposit account at cost. However, agencies report their deposits in the

SOUTH CAROLINA MEDICAL MALPRACTICE
PATIENTS' COMPENSATION FUND

NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

(Continued)

special deposit accounts at fair value. Investments in the pool are recorded at fair value. Interest earned by the agencies' 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 undistributed interest received by the pool. Reported interest income includes interest earnings, realized gains/losses and unrealized gains/losses on investments in the pool arising from changes in fair value. The South Carolina Medical Malpractice Patients' Compensation Fund only has special deposit accounts. Realized gains and losses are allocated daily and are included in the accumulated income receivable. Unrealized gains and losses are allocated at year-end based on the agency's percentage of ownership in the pool.

Although the State's internal cash management pool includes some long-term investments, it operates as a demand deposit account; therefore, for credit risk information pertaining to the internal cash management pool see the deposits disclosures in Note 2.

Capital Assets

Equipment acquisitions require the use of fund financial resources and are for amounts in excess of \$5,000 capitalized at cost in the Fund upon acquisition. Depreciation of equipment is charged as an expense against operations, and accumulated depreciation is reported on the Fund's statement of net assets. There are no capital assets or depreciation recorded as of June 30, 2004.

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 a maximum of 180 days sick leave and 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 of 45 days, but are not entitled to any payment for unused sick leave. The South Carolina Medical Malpractice Patients' Compensation 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 as a current liability. The net change in the liability is recorded in the current year in the applicable administrative expense categories.

Statement of Cash Flows

For purposes of this statement the South Carolina Medical Malpractice Patients' Compensation Fund considers investments with the State of South Carolina's internal

SOUTH CAROLINA MEDICAL MALPRACTICE
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NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

(Continued)

cash management pool to be cash equivalents because they are readily convertible to cash with an insignificant risk of loss in value.

Unpaid Claims Liabilities

In years prior to July 1, 1993, the Fund had been classified as risk sharing, public entity risk pool (PERP), Governmental Accounting Standards Board's Statement Number 10 *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*. Effective July 1, 1993, the Fund is considered an insurance enterprise which follows the guidance of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*. This change was due to the fact that the Medical Malpractice Patients' Compensation Fund is primarily composed of non-governmental entities, and one of the key characteristics of (PERP) is that it is composed of primarily governmental entities. This change had no effect on the method of accounting for unpaid claims liabilities. Certain supplemental disclosures required by GASB 10 are not required under FASB 60, therefore they are not included in this report.

The Fund actuarially establishes claims liabilities based on estimates of the ultimate cost of claims that have been reported but not settled, and of claims that have been incurred but not reported. The Fund, because it carries only excess liability coverage does not incur claim adjustment expenses. The length of time for which claims costs must be estimated varies depending on the coverage involved. Because actual claims costs depend on such complex factors as medical technology changes in doctrines of legal liability, and damage awards, the process used in computing claims liabilities does not necessarily result in an exact amount. Claims liabilities are recomputed annually using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation in the calculation of estimated future claims costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. An independent actuary performs an actuarial study annually with the latest done in September, 2004 for the current year. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made. Claims liabilities are discounted based upon the Fund's payment experience and interest rates on cash equivalents held. The discounted liabilities provides the amount needed at the date of computation to fund liabilities that are expected to be paid in future years.

Revenue Recognition

The Fund receives fees from members; the fee pays for coverage for a year. Due to the various effective anniversary dates a provision for unearned fees at the end of every year is estimated. The fees may be paid annually or quarterly. The

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computation of unearned fees is based upon the amount of the fees, period of payment, and the effective membership dates for participants. This is done to recognize revenue during the coverage period.

When warranted, the Fund may make deficit assessments, which are recognized as revenue on the date of the assessment.

Due to the nature of the coverage of the members refunds are often warranted. These occur because of policyholder change of personnel and/or change of information provided by the policyholders relating to employees and their ratings. Refunds are recognized in the year of the refund. These adjustments are taken into consideration in computation of the unearned fees liability.

Operating Revenues and Expenses

Operating revenues and expenses for proprietary funds are those that result from providing services and producing and delivering goods and/or services. It also includes all revenue and expenses not related to capital and related financing, noncapital financing, or investing activities.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2 - DEPOSITS AND INVESTMENTS

All deposits of South Carolina Medical Malpractice Patients' Compensation Fund are under the control of the State Treasurer who, by law, has sole authority for investing State Funds.

State law requires full collateralization of all State Treasurer bank balances. The State Treasurer must correct any deficiencies in collateral within seven days. At June 30, 2004, all State Treasurer bank balances were fully insured or collateralized with securities held by the State or by its agents in the State's name.

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 agent in the State's name. Information

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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.

NOTE 3 - CLAIMS LIABILITIES

Because medical malpractice liability insurance covers claims occurring during the coverage period and claims emerge over a long period of time and because the Fund has limited claims experience history, provisions for estimated losses incurred but not reported and claims reported but not settled are based on an actuarial formula which is used to estimate the ultimate incurred losses. An independent actuary does an actuarial study each year to determine these liabilities. As a result of the actuarial study as of June 30, 2004 net discounted liabilities for claims at June 30, 2004 were \$6,712,000 less than those at June 30, 2003.

The actuarial study establishes a low, medium and high range for the estimated net claims liability. Management's best judgment is that the low range is the best representation of the Fund's net claims liability. The medium and high ranges are \$242,495,000 and \$281,391,000 respectively as opposed the low of \$203,600,000.

As discussed in Note 1, the Fund establishes a liability for both reported and unreported insured events, which includes estimates of future payment of losses. The following represents changes in those aggregate liabilities for the last two years.

Reconciliation of Claims Liabilities

	<u>2004</u>	<u>2003</u>
Unpaid claims at beginning of the fiscal year	\$ 241,367,000	\$ 235,638,000
Incurred Claims:		
Provision for insured events of the current fiscal year	39,329,000	40,260,000
Increases (decreases) in provisions for insured events of prior fiscal years	<u>(9,898,425)</u>	<u>7,175,741</u>
Total Incurred Claims	<u>29,430,575</u>	<u>47,435,741</u>
Payments of claims:		
Attributable to events of prior fiscal years	<u>(36,792,575)</u>	<u>(41,706,741)</u>
Unpaid claims at end of the fiscal year	<u>\$ 234,005,000</u>	<u>\$ 241,367,000</u>

The schedule above is the undiscounted liabilities for both years. The total discount in 2004 was \$30,405,000, and was \$31,055,000 in 2003. The claims liabilities were discounted at a 4% rate for 2003 and 2004.

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NOTE 4 – LONG TERM LIABILITIES

The following is a summary of changes in long-term liabilities of the Fund.

	<u>July 1, 2003</u>	<u>Increase</u>	<u>Decrease</u>	<u>June 30, 2004</u>	<u>Due Within One Year</u>
Claims, net	\$ 210,312,000	\$ 30,080,575	\$ 36,792,575	\$ 203,600,000	\$ 37,500,000
Compensated Absences	<u>14,801</u>	<u>15,556</u>	<u>16,160</u>	<u>14,197</u>	<u>12,500</u>
	<u>\$ 210,326,801</u>	<u>\$ 30,096,131</u>	<u>\$ 36,808,735</u>	<u>\$ 203,614,197</u>	<u>\$ 37,512,500</u>

NOTE 5 - PENSION PLAN AND OTHER EMPLOYEE BENEFITS

Pension Plan

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

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

Under 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. 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.

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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.

Since July 1, 1988, employees participating in the SCRS have been required to contribute 6.0 percent of all compensation. Effective July 1, 2003, the employer contribution rate was 10.85 percent, which included a 3.30 percent surcharge to fund retiree health and dental insurance coverage. The Fund's actual contributions to the SCRS for the fiscal year ended June 30, 2004 were \$12,819 and equaled the required contributions of 7.55 percent (excluding the surcharge) for the year. Employer contributions for fiscal year 2003 were \$12,819 and for fiscal year 2002 were \$11,352. Also, the Fund paid employer group-life insurance contributions of \$255 in the current fiscal year at the rate of .15 percent of compensation.

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, benefits, and employee/employer contributions for each pension plan. Employee and employer contribution rates to SCRS are actuarially determined. The surcharges to fund retiree health and dental insurance are not part of the actuarially established rates. Annual benefits, payable monthly for life, are based on length of service and on average final compensation (an annualized average of the employee's highest 12 consecutive quarters of compensation).

The System does not make separate measurements of assets and pension liabilities for individual employers. Under Title 9 of the South Carolina Code of Laws, the Fund's liability under the plan is limited to the amounts 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 plan is limited to the contribution requirements for the applicable year from amounts appropriated therefore in the South Carolina Appropriation Act and amounts from other applicable revenue sources. Accordingly, the Fund recognizes no contingent liability for unfunded costs associated with participation in the plan.

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

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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 active and certain retired State employees and certain surviving dependents of retirees. All permanent full-time employees of South Carolina Medical Malpractice Patients' Compensation 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 requirement, 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 the Fund's applicable revenue sources for active employees and the State Budget and Control Board for all participating State retirees except the portion funded through the pension surcharge and provided from other applicable revenue 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 24,000 State retirees meet these eligibility requirements.

The South Carolina Medical Malpractice Patients' Compensation Fund recorded employer contribution expenses for these insurance benefits for active employees in the amount of \$11,112 for the year ended June 30, 2004. As discussed above, the Fund paid \$5,603 applicable to the retiree health/dental benefits surcharge described above, which is included with the employer contributions for South Carolina Retirement Systems benefits. These amounts were remitted to the South Carolina Retirement Systems for distribution to the Office of Insurance Services for retiree health and dental insurance benefits.

Information regarding the cost of insurance benefits applicable to the South Carolina Medical Malpractice Patients' Compensation Fund retirees is not available. By State law, the South Carolina Medical Malpractice Patients' Compensation 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 System's earnings; however, a portion of the required amount is appropriated from the State General Fund annually for the SCRS benefits.

Deferred Compensation Plans

Several optional deferred compensation plans are available to State employees and employers of its political subdivisions. Certain employees of the agency have elected to participate. The multiple-employer plans, created under Internal revenue

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

NOTE 6 - TRANSACTIONS WITH STATE ENTITIES AND RELATED PARTIES

The South Carolina Medical Malpractice Patients' Compensation Fund (PCF) has significant transactions with the State of South Carolina and various other State agencies.

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

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

The South Carolina Medical Malpractice Patients' Compensation Fund also had financial transactions with various State agencies during the fiscal year. Significant payments were made to divisions of the State Budget and Control Board for office supplies, telephone, interagency mail, and data processing services. The amounts of 2004 expenses applicable to related party transactions are not readily available.

The South Carolina Medical Malpractice Patients' Compensation Fund provided no services free of charge to other State agencies during the fiscal year.

The Fund is related to the South Carolina Medical Malpractice Liability Joint Underwriting Association (JUA) as both were created by South Carolina Statute and substantially all members of the JUA are also PCF members. The JUA is responsible for payment of that portion of any covered medical malpractice claim, settlement, or judgment up to \$100,000 per incident or in excess of \$300,000 in the aggregate for one year. Effective November 26, 2001 coverage thresholds were increased to \$200,000 and \$600,000. PCF is responsible for payments exceeding those thresholds. JUA by state law is responsible for defense costs if all claims, however PCF has the right to review and approve all awards that are ultimately made on cases. PCF reimburses JUA for management oversight, per a three-year agreement signed

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October 10, 2001. The fee for the first year was \$200,000, which is adjusted annually for increases in the consumer price index. The fee for the third year was \$208,890 of which \$58,375 is included in prepaid expenses. The JUA is considered a discrete component unit of the State of South Carolina and is included in the State's Comprehensive Annual Financial Report.

Also see Note 8 regarding a sublease of office space by PCF from JUA.

NOTE 7 - RESTRICTION ON PAYMENT OF CLAIMS

In the event the South Carolina Medical Malpractice Patients' Compensation Fund incurs a liability exceeding \$200,000 to any person under a single occurrence, the South Carolina Medical Malpractice Patients' Compensation Fund may not pay more than \$200,000 per year until the claim has been paid in full. However, the Board of Governors of the South Carolina Medical Malpractice Patients' Compensation Fund may authorize payments in excess of \$200,000 per year so as to avoid payment of interest.

NOTE 8 - LEASES

The South Carolina Medical Malpractice Patients' Compensation Fund leases its office space under an operating lease. In July 1999 a lease was extended obligating South Carolina Medical Malpractice Patients' Compensation Fund to a five-year rental for commercial office space. The monthly payments required under the lease were \$2,515 per month, for fiscal year 2004. Effective February 1, 2003 the Fund signed a sublease agreement with the South Carolina Medical Malpractice Liability Joint Underwriting Association to lease additional office space. The lease payments are \$679 a month and the lease expired on June 30, 2004. Effective July 1, 2004 a new lease was negotiated for a three year period. The obligations under this lease as of June 30, 2004, is as follows:

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2005	\$	34,092
2006		35,121
2007		36,176

During fiscal year 2004, the South Carolina Medical Malpractice Patients' Compensation Fund recorded payments under these operating leases of \$38,325.

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NOTE 9 - UNEARNED MEMBERS FEES

Unearned fees liability at June 30, 2004 is \$12,325,000 for unearned fees based on advance payment of fees. Effective June 1, 2001, the Fund began allowing members to pay their fees quarterly. Effective June 1, 2002 the Fund began charging a 1 percent per month administrative charge for those members who elect to pay quarterly. Effective June 1, 2003 this was changed to a minimum of \$30 or 1/2 percent per month on the unpaid balance.

NOTE 10 - RISK MANAGEMENT

The Fund is exposed to various risks of loss and maintains State or commercial insurance coverage for certain risks. Management believes such coverage is sufficient to preclude any significant uninsured losses to the Fund. The Fund has not had any claims in the past three years. There were no significant reductions in insurance coverage from coverage in the prior year. The Fund pays insurance premiums to certain other State agencies and commercial insurers to cover risk that may occur in normal operations. The insurers promise to pay to or on behalf of the insured for covered premium losses sustained during the policy period in accord with the insurance policy and benefit program limits. Several State funds accumulate assets and the State itself assumes substantially all risks for the following:

1. Claims of covered employees for health and dental insurance benefits (Office of Insurance Services); and
2. Claims of covered public employees for long-term disability and group-life insurance benefits (Office of Insurance Services).
3. Claims of covered public employees for workers' compensation insurance benefits (State Accident Fund).
4. Claims of covered public employees for unemployment compensation insurance benefits (Employment Security Commission).

The Fund and other entities pay premiums to the states Insurance Reserve Fund (IRF) which issues policies, accumulate assets to cover the risks of loss and pays claims incurred for covered losses related to the following Fund assets, activities, and/or events.

1. Personal property and equipment - Eighty percent of each loss is covered by the IRF. Losses are subject to a \$250 deductible.
2. Data processing equipment - Coverage is up to \$100,000 per loss with a \$250 deductible.
3. Torts

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The IRF is a self-insurer and purchases reinsurance to obtain certain services and specialized coverage and to limit losses in the areas of property, boiler and machinery, and automobile liability. The IRF's rates are determined actuarially.

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

The Fund does not purchase insurance coverage for employee fidelity bond insurance coverage arising from theft or misappropriations. Management believes based on exposure and likelihood of loss that this coverage is not necessary. The Fund has not incurred any expenditures for the past three years for losses from employee theft or misappropriations.

The Fund has not recorded any estimated losses or expense related to the deductible or policy limits because there is no evidence of asset impairment or other information to indicate a loss should be recorded.

NOTE 11 - RETAINED EARNINGS DEFICIT

The Fund has experienced large operating losses in prior years, which has resulted in a net deficit. The operating losses have been attributable to large increases in paid and reported claims, which has substantially effected the actuarial determination of claims liabilities. Contributing factors are that the Funds coverage was unlimited and the fund does not purchase reinsurance to help defray the effect of large individual claims. As a result the Fund has substantially increased fees over the last five years. Also, the Fund if needed can assess members additional fees. This authority was exercised in April, 1998. The April 1998 special assessment approximated \$7,450,000. Also in September, 2000, the Fund did another special assessment, which amounted to approximately \$16,000,000. To conserve cash, if necessary, the Fund can restrict payment of claims as discussed in Note 8. Also as noted in Note 1, the threshold for covered losses has increased to \$200,000 and \$600,000. In 2003 the fund began allowing members to purchase, at lower rates, policies with reduced coverage limits of up to \$10,000,000, instead of unlimited coverage. Also fees were increased in the current year and it is estimated that collections in the fiscal year ending June 30, 2005 should approximate \$50,000,000.

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NOTE 12 – ENTERPRISE FUND INFORMATION

Charges for services	\$ 40,290,909
Operating contributions	50,505
Less: expenses	<u>(30,732,469)</u>
Change in net assets	9,608,945
Net assets - beginning	<u>(218,513,664)</u>
Net assets - ending	<u>\$ (208,904,719)</u>

This information is included only for the State of South Carolina GAAP reporting purposes and includes terminology and classifications which are not consistent with the financial statements.