

**SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS**

AUDITED FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2006

WITH

REPORT OF INDEPENDENT AUDITORS

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

AUDITED FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2006

WITH
REPORT OF INDEPENDENT AUDITORS

State of South Carolina



Office of the State Auditor

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September 27, 2006

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, 2006, 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,

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

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

RHGjr/cwc

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EMPLOYEE INSURANCE PROGRAMS

AUDITED FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2006

WITH
REPORT OF INDEPENDENT AUDITORS

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REPORT OF INDEPENDENT AUDITORS

Mr. Richard H. Gilbert, Jr., CPA
Deputy State Auditor
Office of the State Auditor
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, 2006, 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, 2006 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.

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, 2006, 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, 2006, on our consideration of the Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and 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, 2006

Management Discussion and Analysis

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. 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, 2006. This discussion should be read in conjunction with the financial statements and the notes, which follow this section.

Financial Highlights:

Business Type activities report a change in net assets of positive \$141,428,545 and total net assets at year end of positive \$159,004,362 for the year ended June 30, 2006. In comparison, a change in net assets of positive \$93,082,423 was reported for the year ended June 30, 2005 with total positive net asset balance of \$ 17,575,817 at the 2005 year end.

Overview of Financial Statements:

The Employee Insurance Program is an internal service fund proprietary type engaged in Governmental Activities. 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 unrestricted net assets. Net assets are one indicator of the current financial condition of EIP, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. The improvement seen in the net asset balance for the last two fiscal years is the result of 2004 plan design changes, rate increases, alleviation of growth in health care spending, and management actions undertaken by the Employee Insurance Program to address plan spending.

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, 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.

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Current Assets	\$349.8	\$192.2
Non-Current Assets	13.8	15.8
Total Assets	<u>363.6</u>	<u>208.0</u>
Current Liabilities	204.1	189.9
Non-Current Liabilities	0.5	0.5
Total Liabilities	<u>204.6</u>	<u>190.4</u>
Net Assets:		
Investment in Capital Assets	0.1	0.2
Unrestricted	<u>158.9</u>	<u>17.4</u>
Total Net Assets	<u>\$159.0</u>	<u>\$17.6</u>

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

Statements of Activities
(In millions)

	<u>Year Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
Governmental Activities:		
Program Revenues	\$1,485.6	\$1,364.0
Expenses	<u>(1,356.0)</u>	<u>(1,277.4)</u>
Total governmental activities	<u>129.6</u>	<u>86.6</u>
General Revenue and Transfers:		
Earnings on Investment	12.1	6.7
Transfers to other agencies	<u>(0.3)</u>	<u>(0.2)</u>
Total general revenue and transfers	<u>11.8</u>	<u>6.5</u>
Change in net assets	141.4	93.1
Net assets, beginning of year	<u>17.6</u>	<u>(75.5)</u>
Net assets, end of year	<u>\$159.0</u>	<u>\$17.6</u>

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

Condensed Statement of Cash Flows
(In millions)

	<u>Year Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
Cash Flows from Operating Activities	\$130.1	\$88.9
Cash Flows from Capital Financing Activities	-	(0.1)
Cash Flows from Noncapital Financing Activities	(0.4)	(0.4)
Cash Flows from Investing Activities	<u>14.0</u>	<u>10.6</u>
Net increase/(decrease) in cash and cash equivalents	<u>143.7</u>	<u>99.0</u>
Cash and cash equivalents, beginning of year	<u>156.0</u>	<u>57.0</u>
Cash and cash equivalents, end of year	<u>\$299.7</u>	<u>\$156.0</u>

Overview of the Employee Insurance Program:

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, as well as the long-term care program authorized in § 1-11-740, and the Employee Adoption Assistance Program, pursuant to Proviso 63.27 of the 2006-2007 General Appropriations Act.

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

Self-Insured Programs

- State Health Plan:
 - Standard Plan (PPO)
 - Medicare Supplement
 - Savings Plan (HDHP)
- MUSC Options (POS)
- BlueChoice (HMO)
- 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 all State agencies and public school districts, and many local governments. Currently over 560 employers participate in the Employee Insurance Program. The State Health Plan, which encompasses medical, prescription drug, and behavioral health coverage, is the significant driver of EIP's financial activity, accounting for approximately 81% of all medical revenue.

Overview of State Health Plan:

The State Health Plan (Plan) consists of the Standard Plan, the Medicare Supplement Plan, and the Savings Plan. The majority of Plan subscribers (83%) are enrolled in the Standard Plan, a PPO option available to non-Medicare and Medicare enrollees. Of the remaining subscribers, 15% are enrolled in the Medicare Supplement, a retiree option for those enrolled in Medicare, and 2% are enrolled in the Savings Plan. The Savings Plan is a qualified high deductible health plan (HDHP) available to non-Medicare enrollees.

The State Health Plan remains competitive with other southern state health plans in terms of plan deductibles, coinsurance, and prescription drug coverage. Following is a look at total enrollment in the State's medical insurance programs and enrollment in the State Health Plan (as of June 2006).

	<u>Program</u>	<u>State Health Plan</u>
Total Insured Persons:	411,469	342,349
Subscribers:	237,040	193,812
Spouses:	66,140	58,046
Children:	108,289	90,491
Total Subscribers:	237,040	193,812
Employees:	174,608	133,977
Retirees:	58,473	56,095
Survivors:	2,718	2,675
COBRA:	1,241	1,065
Active Employees:	174,608	133,977
State Agencies:	61,718	45,594
School Districts:	80,108	65,458
Local Government:	32,782	22,925

State Health Plan Premiums:

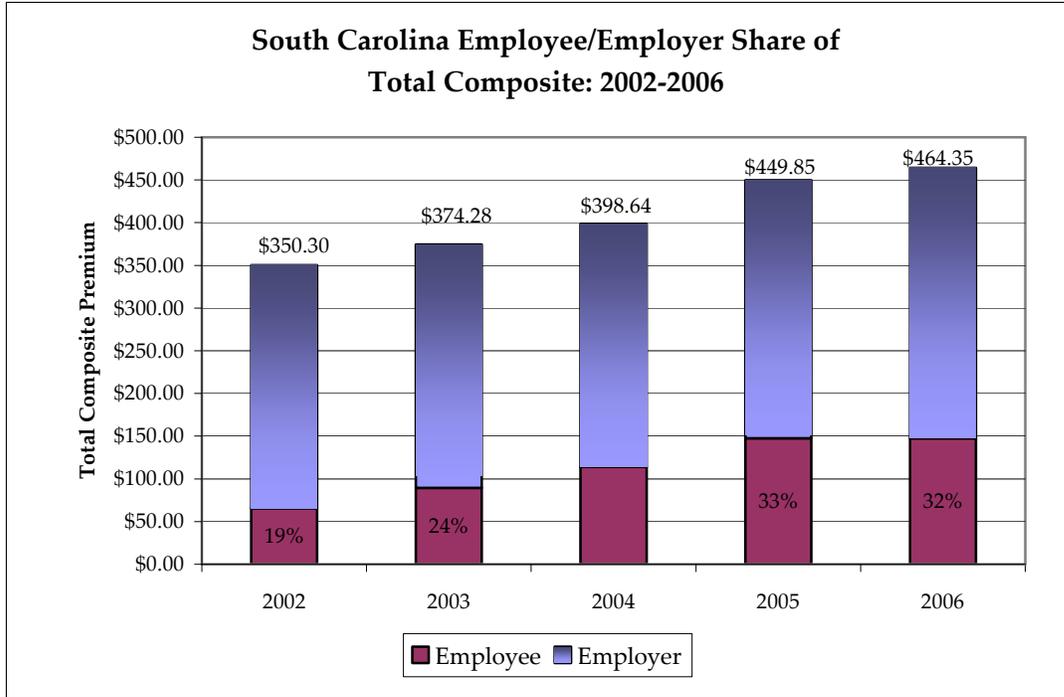
The State Health Plan operates under a 4-tier premium structure, varying contribution levels according to level of coverage. The coverage levels include Employee Only, Employee/Spouse, Employee/Child, and Full Family. As of June 30, 2006, 56% of subscribers had Employee Only coverage, and the remaining 46% covered at least one dependent.

Premiums range from \$325.30 for Employee Only coverage to \$823.58 for Full Family coverage. Following are the 2006 State Health Plan employee and employer rates.

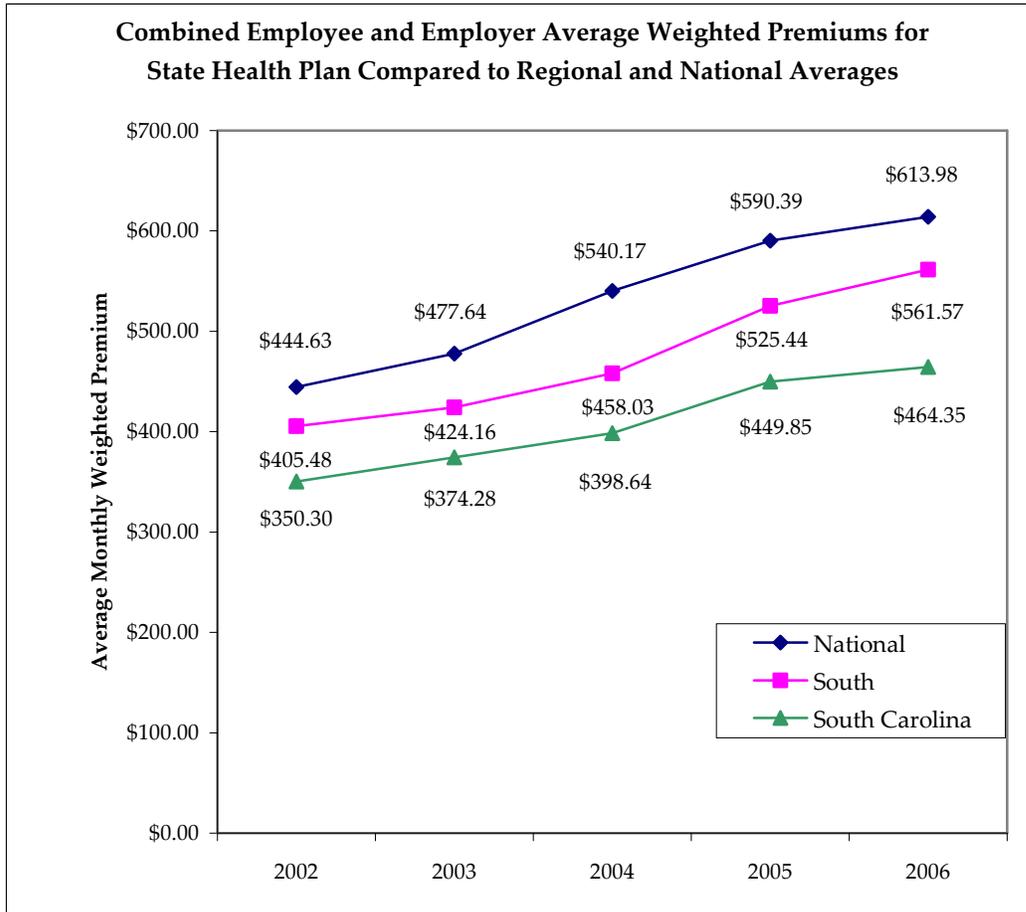
**2006 State Health Plan
(Standard Plan)
Premiums**

	<u>Employee</u>	<u>Employer</u>	<u>Total</u>
Employee Only	\$ 93.46	\$ 231.84	\$ 325.30
Employee/Spouse	\$ 237.50	\$ 453.02	\$ 690.52
Employee/Child	\$ 142.46	\$ 327.18	\$ 469.64
Full Family	\$ 294.58	\$ 529.00	\$ 823.58
Composite Rate	<u>\$ 147.71</u>	<u>\$ 316.64</u>	<u>\$ 464.35</u>

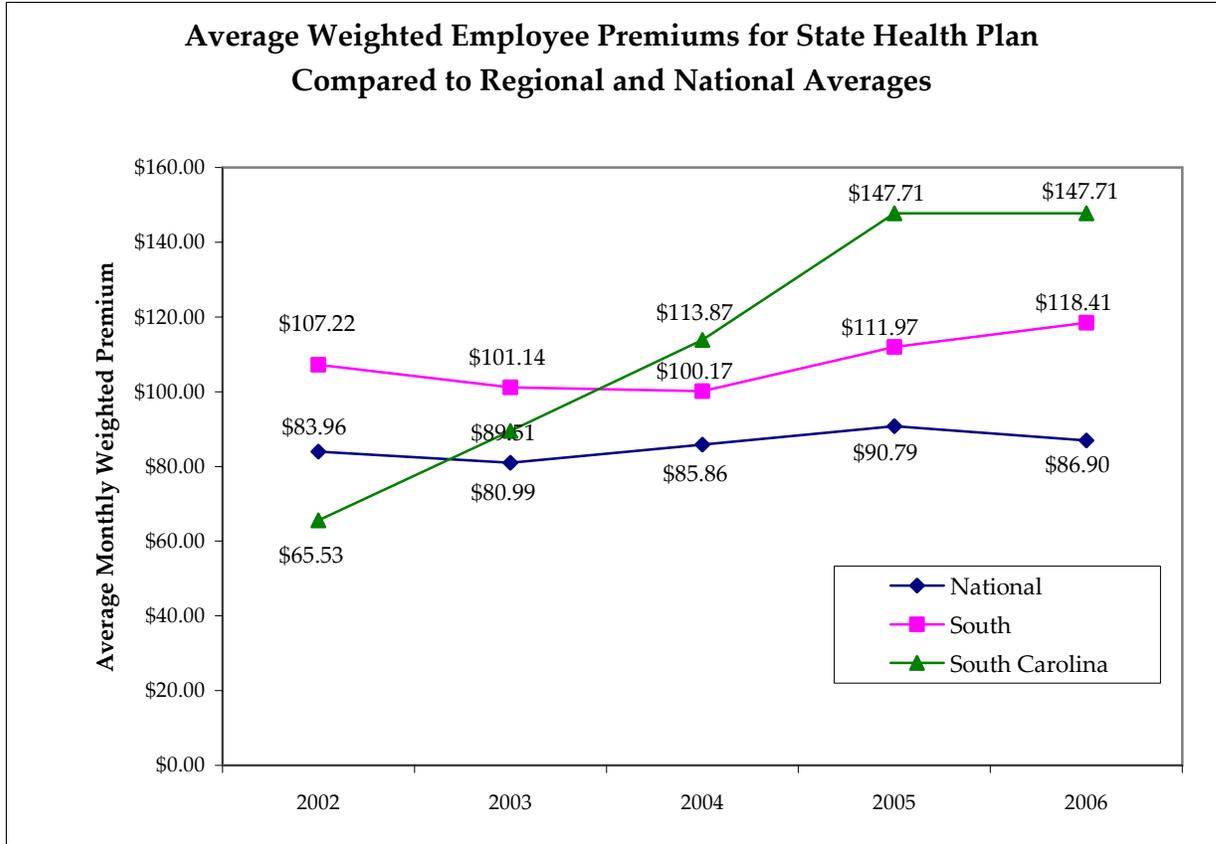
Premium revenue is shared between the employer and the employee (or retiree). For 2006, the employer absorbed the entire required rate increase. For 2006, the employee share represents 32% of the total premium, compared to 33% for 2005.



While State Health Plan premiums continue to rise, the composite total premium remains below both the southern and national levels. For 2006, the State Health Plan composite total premium was approximately 83% of the southern premium and 76% of the national premium.



After five years of double-digit premium increases, employees saw no increase for 2006. Even so, the SHP employee composite remains above both the regional and national composite, due to prior years of employer contribution levels remaining either stagnant or increasing at levels insufficient to sustain claims expense.



State Health Plan Contribution Increases:

Since 1999, the State Health Plan has implemented annual rate increases in an effort to meet its current financial obligations. Contribution increases since 1999 are outlined below.

**State Health Plan
Contribution Increases**

	<u>Employer Rate Increase</u>	<u>Employee Rate Increase</u>	<u>Total</u>
1999	18.0%	-0-	14.0%
2000	10.0%	-0-	8.0%
2001	20.0%	10.4%	18.3%
2002	9.5%	22.6%	11.7%
2003	-0-	36.9%	6.9%
2004	-0-	27.6%	6.6%
2005	6.1%	29.7%	13.0%
2006	4.8%	-0-	3.2%

Current Year Plan Initiatives:

The General Assembly fully funded the requested budget requirements for 2006. Employer contributions increased an average 4.8% effective January 1, 2006, and for the first time since 2000, employees did not incur a premium increase. Because of the State Health Plan's relatively sound financial condition, and full funding by the General Assembly, minimal Plan changes were enacted. For the Savings Plan, a separate, out-of-network, coinsurance maximum was added effective January 2006 (\$4,000/single and \$8,000/family). A new tobacco cessation benefit, *Free & Clear*, was added to the State Health Plan, through its behavioral health administrator. This new benefit combines counseling and nicotine replacement therapy, and is fully funded by the Plan. Tobacco related conditions contribute substantially to the Plan's claims expense, and this new benefit is projected to bring about a positive return on investment to the Plan, in addition to improving the overall wellness of those employees and dependents that are able to successfully quit tobacco use. Last, the contribution rate for retirees enrolled in the Medicare Supplement option was reduced such that this premium is consistent with the non-Medicare Standard Plan option (retirees in the carve-out option received an equivalent rate decrease). This change addressed an inconsistency in the rate structure that has existed since the Medicare Supplement option was initially offered, and reduced rates for all retirees 3.6%.

Claims Trend and Looking Forward:

The State Health Plan has seen a marked improvement in its financial condition. The Plan's cash balance at June 30, 2006 was \$234.2 M., which is over two times its current outstanding liability (IBNR). Following is a look at the Plan's cash balance and corresponding IBNR since 2003.

<u>Date</u>	<u>Cash Balance</u>	<u>IBNR</u>
12/31/2003	(\$ 14.7) M.	\$105.4 M.
12/31/2004	\$ 34.9 M.	\$119.6 M.
12/31/2005	\$157.0 M.	\$121.6 M.
06/30/2006	\$234.2 M.	\$105.7 M.

The underlying cause of the Plan's improved financial condition is the alleviation of growth in health care expenditures in the past two years. Following are the changes in growth rate in payments per subscriber since 2003.

<u>Plan Year</u>	<u>Change in Payout/Subscriber</u>
2003	+ 12.9%
2004	- 0.6%
2005	+ 4.5%

The change in payout/subscriber from 2003 to 2004 reflects a *decrease* of 13.5% (12.9% to -0.6%). Some of this decrease is attributable to *increased* patient liability. The “benefit effectiveness” measure of the Plan indicates the percentage of Plan payout to total covered charges. Following are the benefit effectiveness percentages since 2003.

<u>Plan Year</u>	<u>Benefit Effectiveness</u>
2003	78.2%
2004	73.5%
2005	73.9%

Looking at the benefit effectiveness difference between 2003 and 2004, the 4.7% *decrease* (78.2% to 73.5%) indicates increased patient liability. The remaining 8.8% *decrease* in payout/subscriber (13.5% - 4.7%), can be attributed to overall healthcare spending reductions observed nationally, and, more significantly, decreased utilization trends stemming from Plan design changes implemented in 2004 and positive outcomes from management actions taken in recent years to address Plan spending.

Plan design changes implemented in 2004 have contributed to the moderation/reduction of key service volume indicators. Following are the medical utilization rates (and growth rates) per 100 insured persons (SHP primary) from 2000 through 2005 for office visits, ER visits, inpatient cases, and outpatient surgery.

	<u>Office Visits</u>	<u>ER Visits</u>	<u>I/P Cases</u>	<u>O/P Cases</u>
2000	5492.54	253.76	67.76	105.54
2001	5856.76 +6.6%	254.99 +0.5%	69.27 +2.2%	101.11 - 4.2%
2002	5944.00 +1.5%	252.27 -1.1%	69.01 -.04%	102.71 +1.6%
2003	6233.93 +4.9%	253.85 +0.6%	69.05 +0.1%	114.47 +11.4%
2004	6121.94 -1.8%	236.11 -7.0%	68.91 -0.2%	115.32 +0.7%
2005	6273.60 +2.5%	238.76 +1.1%	63.70 -7.6%	106.55 -7.6%

Prescription drug utilization has also moderated, as well as shifted to more cost effective delivery channels, as indicated below.

	<u>Rx/Insured</u>	<u>Generic Share</u>	<u>Mail Service Share</u>
2000	13.12	34.9%	n/a
2001	14.75 +12.5%	34.8%	n/a
2002	15.75 +6.9%	37.1%	3.8%
2003	17.10 +8.5%	39.1%	4.7%
2004	16.81 -1.7%	43.3%	9.6%
2005	17.46 +3.9%	47.1%	9.5%

Management actions undertaken by EIP have also positively influenced claims trend. A few of those actions are outlined below.

Two preventive measures include the *Managing for Tomorrow* program implemented in June 2002, and the new tobacco cessation program, *Free & Clear*. The *Managing for Tomorrow* program, administered through the State Health Plan's medical administrator, provides management of six chronic diseases: asthma, coronary artery disease, diabetes, heart failure, hyperlipidemia, and hypertension. Members are identified based on claims data indicative of chronic disease, and are then invited to participate by mail. As of June 30, 2006, the program had 41,484 persons enrolled. Total estimated savings attributable to the program during the time period June 2002 through May 2005 is \$25 M. Savings are actuarially computed based on a reduction in hospital admissions, ER visits, and office visits for the six chronic conditions (greater than the overall service volume reductions noted above). Another preventive measure is the *Free & Clear* program, available to SHP subscribers and their dependents as of January 2006. To date, the program has enrolled 1,655 persons, and the first set of outcomes data indicates 89% of program participants attempted to quit tobacco, and 49% of participants reported actually quitting tobacco use. Strong efforts will continue to encourage Plan members who use tobacco to enroll in this program to address the single greatest cause of preventable health problems.

Another management action includes increased Coordination of Benefits (COB) opportunities. Through the identification and update of Medicare eligibility for hundreds of retirees (under 65), claims are now being paid primary by Medicare, rather than by the SHP. This has resulted in significant Medicare COB savings, which will benefit the Plan on an ongoing basis. Following is a look at Medicare COB dollars in the 12 months completed in March 2006, compared to the preceding 12 months.

Medicare COB-Medical

April 2004-March 2005	\$688.46 M.	
April 2005-March 2006	\$867.99 M.	+26.1%

The Plan also implemented COB with its pharmacy benefit effective the beginning of 2005. Total commercial and Medicare COB savings for pharmacy claims for the Plan through March 2006 was \$4.1 M.

One other management action concerns the new Medicare Part D prescription drug benefit that became effective January 2006. The Plan elected to maintain primary coverage for pharmaceuticals for its Medicare eligible retirees. By providing drug coverage at least as valuable as that in the standard Medicare Part D program, the Plan qualifies for the Retiree Drug Subsidy (RDS), an incentive provided in the federal Part D law to encourage employers to retain good prescription benefits for retirees. It is estimated that the Plan will receive around \$26 M. in RDS funding for all of 2006 to help fund the program.

Looking forward to Plan Year 2007, the General Assembly has fully funded the budget requirement, with no material Plan design changes. Effective January 1, 2007, employer premiums will increase approximately 3.1% (2.1% total), and for the second consecutive year, employees will not see a premium increase.

Contact Information:

Please direct questions related to the Management Discussion & Analysis and the accompanying financial statements 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, 2006

Assets

Current assets:

Cash and cash equivalents <i>(Note 2)</i>	\$ 299,729,760
Premiums receivable <i>(Note 3)</i>	1,132,238
Prescription Drug Rebate receivable	9,597,367
Medicare Part D subsidy receivable <i>(Note 15)</i>	9,062,344
Accrued interest	356,751
Due from South Carolina Division of Retirement <i>(Note 4)</i>	29,911,470

Total current assets	349,789,930
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Non-current assets:

Investments <i>(Note 2)</i>	13,683,657
Capital assets, net of accumulated depreciation <i>(Note 5)</i>	122,949

Total non-current assets	13,806,606
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Total assets	363,596,536
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Liabilities

Current liabilities:

Accounts payable	425,511
Accrued payroll	407,764
Claims payable	59,814,443
Deferred premium revenue	9,476,068
Claims incurred but not reported	133,945,525
Accrued compensated absences - current portion <i>(Note 14)</i>	20,401

Total current liabilities	204,089,712
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Long-term liabilities:

Contingencies <i>(Note 11)</i>	
Accrued compensated absences - long term <i>(Note 14)</i>	502,462

Total long-term liabilities	502,462
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Total liabilities	204,592,174
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Net Assets

Investment in capital assets	122,949
Unrestricted	158,881,413

Total net assets	\$ 159,004,362
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See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF REVENUE, EXPENSES,
AND CHANGES IN NET ASSETS

(CONTINUED)

Operating Revenue

Insurance premiums:	
Active employees:	
Health	\$ 807,276,176
Dental	52,447,266
Life	736,689
Long-term disability	12,856,481
Dependent/optional life	32,039,340
HMO-point of service	212,376,797
Retirees:	
Health	110,119,102
Dental	6,004,897
Retiree surcharge	206,968,073
HMO-point of service	4,843,337
Other premium revenues	1,080,057
Prescription drug rebates	24,276,597
Medicare Part D subsidy	14,545,079
Other	78,772
Total operating revenue	1,485,648,663

Operating Expenses:

Premiums	63,570,887
Claims:	
Health	677,949,738
Dental	48,352,209
Life	36,000
Long-term disability	7,449,639
HMO-point of service	187,239,329
Prescription drug	301,800,066
Salaries and benefits	5,523,150
Professional services	51,590,278

(CONTINUED)

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF REVENUE, EXPENSES,
AND CHANGES IN NET ASSETS

(CONTINUED)

Telephone and utilities	126,344
Supplies	708,450
Other services	11,298,452
Printing and publication	128,555
Postage and shipping	185,792
Depreciation	39,356
Total operating expenses	<u>1,355,998,245</u>
Operating income	129,650,418
Non-operating revenue:	
Income from deposits and investments	<u>12,153,186</u>
Income before transfers	141,803,604
Interfund transfers	<u>(375,059)</u>
Change in net assets	141,428,545
Net assets, beginning of year	<u>17,575,817</u>
Net assets, end of year	<u><u>\$ 159,004,362</u></u>

See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF CASH FLOWS

YEAR ENDED JUNE 30, 2006

Cash Flows from Operating Activities

Insurance premiums from customers	\$ 1,449,274,030
Other receipts	28,141,457
Payments to employees	(5,429,643)
Payments to suppliers	(1,341,604,265)
Other operating payments	(219,564)
Net cash provided by operating activities	130,162,015

Cash Flows from Capital Financing Activities

Loss on disposal of capital assets	15,587
Net cash provided by capital financing activities	15,587

Cash Flows from Noncapital Financing Activities

Transfers to other state agencies	(375,059)
Net cash used in noncapital financing activities	(375,059)

Cash Flows from Investing Activities

Purchases of investments	3,013,807
Proceeds from sales and maturity of investments	(1,049,849)
Interest received-deposits and investments	11,993,041
Net cash provided by investing activities	13,956,999

Net increase in cash and cash equivalents	143,759,542
Cash and cash equivalents, beginning of year	155,970,218
Cash and cash equivalents, end of year	\$ 299,729,760

(CONTINUED)

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

STATEMENT OF CASH FLOWS

(CONTINUED)

Reconciliation of income to net cash provided by operating activities

Operating income	\$	129,650,418
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense		39,356
Change in assets-(increase) decrease:		
Premiums receivable		(645,257)
Due from South Carolina Division of Retirement		(2,291,821)
Prescription drug rebate receivable		(1,696,647)
Medicare Part D subsidy receivable		(9,062,344)
Change in liabilities-increase (decrease):		
Accounts payable, accrued payroll and compensated absences		(126,056)
Deferred premium revenue		5,462,893
Claims payable and incurred but not reported		8,831,473
Net cash provided by operating activities	\$	<u><u>130,162,015</u></u>

Supplemental Information

Unrealized loss on investments	\$	<u><u>(854,179)</u></u>
Increase in investments for amortization/accretion	\$	<u><u>19,835</u></u>

See accompanying notes.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

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 five self-insured health plans. The State Health Plan offers a High Deductible Health Plan (SHP Savings Plan) and a Preferred Provider Organization (SHP Standard Plan). The Traditional HMOs offered are the BlueChoice HMO and CIGNA HMO. The HMO with the Point of Service Option is MUSC Options. All dental coverage is through the State's self-insured plan, which is available to eligible employees and retirees. An additional dental option is offered to subscribers, Dental Plus, which is a fully insured product. The Basic Long-Term Disability Plan is a self-insured group long-term disability plan available to eligible active employees enrolled in a State health plan. Supplemental long-term disability, a fully insured product, is also offered to subscribers. Optional Life and Dependent Life are fully insured products offered to eligible employees. Long-term care insurance, a fully insured program, is also available to eligible employees. For active employees, the employee share of premiums is paid through payroll deductions. The respective employer pays the employer's premium portion for active employees. For retirees of the State and School Districts, the employee portion of the premiums is withheld from the individual retirement check. The employer premium share for retirees of the State and School Districts is paid through retiree insurance surcharge (*see Note 4*). For Local Subdivisions, the employer is responsible for collecting the retiree premium and remitting the entire premium to the Employee Insurance Program.

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 and adjusted as considered necessary after actuarial calculation.

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

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*.

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)

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

Employee Insurance Programs 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. 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 Fund reports claims liabilities when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated.

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.

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)

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.

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.

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)

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.

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

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)

(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 2006 compounded annually.

Claims Payable

Claims payable represents claims related to health claims, dental claims and long-term disability claims payable at June 30, 2006. The claims payable balance is based on claims that have been paid by the third party administrators on behalf of the Fund.

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.

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)

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.

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.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

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.

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, 2006.

	Amortized	Unrealized		Market
	Cost	Gains	Losses	Value
U. S. Government agencies securities	\$ 1,499,313	\$ -	\$ (5,558)	\$ 1,493,755
Collateralized mortgage-backed obligations	4,827,377	11,453	(45,014)	4,793,816
Other Governmental guaranteed investments	200,972	-	(12,750)	188,222
Repurchase agreement	9,110,000	-	-	9,110,000
Corporate bonds	5,191,048	253,079	(62,333)	5,381,794
Financial paper	1,752,695	91,942	(18,567)	1,826,070
Total	\$ 22,581,405	\$ 356,474	\$ (144,222)	\$ 22,793,657

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

2. Investments and Deposits (Continued)

At June 30, 2006, 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. Government agencies	\$ 1,500,000	\$ -	\$ (687)	\$ 1,499,313
Collateralized mortgage- backed obligations	4,840,137	-	(12,760)	4,827,377
Other Government guaranteed investments	200,972	-	-	200,972
Repurchase agreement	9,110,000	-	-	9,110,000
Corporate bonds	5,275,524	28,572	(113,048)	5,191,048
Financial paper	1,750,000	10,033	(7,338)	1,752,695
Total	<u>\$ 22,676,633</u>	<u>\$ 38,605</u>	<u>\$ (133,833)</u>	<u>\$ 22,581,405</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, 2006. 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, 2006. Short-term investments held during the fiscal year 2006 consisted of U.S. Government agency and government-insured securities whose amortized cost approximates fair value at June 30, 2006.

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, 2006. Due to higher cash flows at certain times during the year, the Fund's investment in repurchase agreements fluctuated significantly. The maximum amounts held in this classification during the year ended June 30, 2006, was as follows:

Repurchase agreements	\$ 9,110,000
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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, 2006, the Fund had no deposits with financial institutions. The Fund had cash and pooled investments of \$18,001,762 and \$272,617,998, respectively, held by the State Treasurer as of June 30, 2006.

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	\$ 12,988,907
Discount accretion	(41,846)
Premium amortization	22,011
Realized gains (losses)	38,293
Change in unrealized gains (losses)	(854,179)
Investment earnings	\$ 12,153,186

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.

	Statements	Note Disclosure
Held by State Treasurer:		
Cash and cash equivalents	\$ 299,729,760	\$ 18,001,762
Pooled investments	-	272,617,998
Specifically identified investments	13,683,657	22,793,657
Total	\$ 313,413,417	\$ 313,413,417

3. Premiums Receivable

Premiums receivable at June 30, 2006, consist of the following:

Local government	\$ 360,791
State government (<i>Note 10</i>)	270,514
Other	500,933
	\$ 1,132,238

As of June 30, 2006, all of the receivables are considered 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, 2006.

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, 2006, a total of \$29,911,470 consisting of \$29,348,114 from South Carolina Retirement System and \$563,356 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 3.25% from July 1, 2005 to June 30, 2006.

5. Capital Assets

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

	Balance July 1, 2005	Additions	Deletions	Balance June 30, 2006
Furniture and equipment	\$ 321,133	\$ -	\$ (124,353)	\$ 196,780
Accumulated depreciation	(143,240)	(39,356)	108,765	(73,831)
Capital assets, net	\$ 177,893	\$ (39,356)	\$ (15,588)	\$ 122,949

Depreciation expense for the year ended June 30, 2006 was \$39,356.

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 was amended effective July 1, 2006, with a base charge of \$6.85 per square foot. This lease expires on June 30, 2008. Rental expense under this lease for the year ended June 30, 2006 was \$383,937.

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, 2006, expenses under these leases were approximately \$24,857.

The following schedule summarizes the Fund's obligations under noncancelable operating leases having remaining terms in excess of one year as of June 30, 2006:

<u>Ending June 30,</u>	<u>Total</u>
2007	\$ 314,617
2008	314,617
Total	<u>\$ 629,234</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 earned 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. TERI participants with an effective TERI date prior to July 1, 2005 do not make employee contributions to SCRS. TERI participants with an effective TERI date on or after July 1, 2005 make employee contributions to SCRS. All TERI participants 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, 2005, employees participating in the SCRS have been required to contribute 6.25 percent of all compensation. For the year ended June 30, 2006, the employer contribution rate was 10.80 percent (including a surcharge to fund retiree health and dental insurance coverage of 3.25 percent). The Fund's actual contributions to the SCRS were approximately \$414,264, 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, 2006.

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 27,000 State retirees are enrolled in health and/or dental.

The Fund recorded employer contributions expenditures within the applicable administrative expenditure categories for these insurance benefits for active employees of approximately \$287,000, for the year ended June 30, 2006. The Fund paid approximately \$124,000 for the year ended June 30, 2006, applicable to the surcharge included with the employer contributions for retirement benefits (7.55% for 2006).

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.

This Fund made no contributions for the fiscal year ending June 30, 2006.

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.

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, 2006:

SC State Senate - Clerical	\$ 370,589
SC State Senate - Senators	231,421
House of Representatives - Clerical	321,144
House of Representatives - Senators	427,835
Legislative Council	109,871
Legislative Printing and Information	73,056
Legislative Audit Council	58,816
SC Education Oversight Committee	25,632
Judicial Department	1,998,530
SC Administrative Law Judge Division	96,165
Governor's Office - Executive Control of State	35,628
State Law Enforcement Division	1,738,682
Governor's Office - Executive Policy & Programs	892,492
Governor's Office - Mansion & Grounds	29,003
Lt. Governor's Office	144,691
Secretary of State	98,157
Comptroller General's Office	230,959
State Treasurer	231,377
Retirement System Investment Commission	4,881
Attorney General	522,030
SC Commission on Prosecution Coordination	163,165
SC Commission of Appellate Defense	37,736
Commission on Indigent Defense	19,253
Adjutant General's Office	810,923
State Election Commission	49,399
SC Budget & Control Board	4,116,542
SC Budget & Control Board - State Auditor	145,169
Commission on Higher Education	161,571
Higher Education Tuition Grants Commission	16,440

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

The Citadel	2,198,875
Clemson University	15,603,844
College of Charleston	4,501,939
Coastal Carolina University	2,866,357
Francis Marion University	1,650,581
Lander University	1,285,872
SC State University	2,656,211
University of South Carolina	22,444,771
Winthrop University	2,780,577
Medical University of South Carolina	14,550,834
State Board for Technical & Comprehensive Education	332,105
Trident Technical College	2,082,026
Northeastern Technical College	351,625
Florence-Darlington Technical College	925,417
Greenville Technical College	2,553,626
Horry-Georgetown Technical College	1,106,153
Midlands Technical College	2,120,121
Orangeburg-Calhoun Technical College	683,991
Piedmont Technical College	1,044,193
Spartanburg Technical College	983,470
Central Carolina Technical College	671,312
Tri County Technical College	1,044,769
York Technical College	1,004,105
Aiken Technical College	501,953
Technical College of Low Country	505,465
Denmark Technical College	338,841
Williamsburg Technical College	212,344
Department of Education	3,932,241
SC Educational Television Commission	861,522
Wil Lou Gray Opp School	171,031
Vocational Rehabilitation	3,869,054
SC School for the Deaf & Blind	1,511,254
Department of Archives & History	252,597
SC State Library	158,525
SC Arts Commission	99,144

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

SC Museum Commission	121,275
Health & Human Services Financial	4,039,776
Department of Health & Environmental Control	16,345,952
Department of Mental Health	16,849,134
SC Department of Disabilities & Special Needs	7,904,151
SC Department of Alcohol & Other Drug Abuse Services	111,136
SC Department of Public Safety	5,664,105
Department of Social Services	12,306,336
John De La Howe School	313,685
SC Commission for the Blind	364,616
SC State Housing Finance & Development Authority	388,023
SC Human Affairs Commission	140,410
State Commission for Minority Affairs	20,397
SC Department of Corrections	18,659,541
SC Department of Probations, Parole & Pardon Services	2,600,366
SC Department of Juvenile Justice	4,907,156
Forestry Commission	1,519,816
Department of Agriculture	491,226
Department of Natural Resources	3,073,678
Sea Grant Consortium	46,219
Department of Parks, Recreation & Tourism	1,772,921
SC Department of Commerce	430,538
SC Jobs - Economic Development Authority	10,982
Business Carolina, Inc.	43,430
Patriots Point Development Authority	240,462
Public Service Commission	160,633
Office of Regulatory Staff	221,414
SC Workers' Compensation Commission	206,536
State Accident Fund	267,185
Patients Compensation Fund	18,420
Second Injury Fund	71,533
SC Department of Insurance	283,376
State Board of Financial Institutions	126,385
SC Department of Consumer Affairs	148,521
Department of Labor, Licensing, & Regulation	1,346,664

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

10. Transactions with State Entities (Continued)

SC Department of Motor Vehicles	3,600,972
Department of Revenue and Taxation	2,191,882
State Ethics Commission	25,146
Employment Security Commission	3,551,838
Procurement Review Panel	6,926
Department of Transportation	18,484,414
Aid to Subdivisions	248,195
South Carolina Education Lottery	487,869
	487,869
	\$ 240,831,142

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 2006 expenses applicable to related party transactions are as follows:

South Carolina Retirement Division	\$ 414,264
State Accident Fund	14,789
South Carolina Employment Security Commission	7,873
South Carolina Budget and Control Board	434,277
	434,277
	\$ 871,203

In addition, interfund transfers include the following:

State Budget & Control Board - General Services -	\$ 375,059
	375,059

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, 2006 were:

SC State Senate - Senators	\$ 13,944
House of Representatives - Clerical	1
Legislative Printing & Info TC	50
SC Judicial Department	79,790
SC Administrative Law Court	38
State Law Enforcement Division	727
Governor's Office - Executive Policy & Programs	416
Secretary of State	793
Comptroller Generals Office	153
SC Commission on Prosecution Coordination	252
SC Comm of Appellate Defense	17,076
SC Commission on Indigent Defense	1,446
Adjutant General's office	104
State Election Commission	711
SC Budget & Control	67
Commission on Higher Education	10,700
State Board for Technical & Comprehensive Education	22
Department of Education	126
SC Educational Television	984
Vocational Rehabilitation	237
SC Museum Commission	21
Health & Human Services Finance	2,741
Department of Health & Environmental Control	5,230
Department of Mental Health	12,479
SC Department of Disabilities & Special Needs	5,820
SC Department of Alcohol & Other Drug Abuse Svcs	8
SC Department of Public Safety	51
Department of Social Services	12,963
SC Commission for the Blind	64
SC State Housing Finance & Dev Authority	131
State Commission for Minority Affairs	6
SC Department of Corrections	22,009
SC Dept of Probation Parole & Pardon Svcs	1,927

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	11,856
Forestry Commission	226
Department of Agriculture	295
Department of Natural Resources	2,949
Sea Grant Consortium	103
Department of Parks, Recreation & Tourism	10
SC Department of Commerce	370
Patriot's Point Development Authority	1,736
Public Service Commission	991
SC Workers' Compensation Commission	94
State Accident Fund	297
Patients Compensation Fund	2,366
Second Injury Fund	44
SC Department of Consumer Affairs	12,701
Department of Labor, Licensing and Regulation	15
SC Department of Motor Vehicles	5,115
Department of Revenue and Taxation	27,510
State Ethics Commission	254
Employment Security Commission	2,188
Department of Transportation	8,678
South Carolina Education Lottery	1,629
Total State Institutions	<u>\$ 270,514</u>

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 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, 2006, \$2,686,933 was collected from state agencies and disbursed to the State Life and Long-Term Disability carrier.

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 subscribers 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.

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

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.

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 (Employee Insurance Programs).
5. Claims of covered property damage, theft, collision (automobile), liability, and general tort (Insurance Reserve Fund).

Employees elect health coverage through the State Health Plan, a health maintenance organization, or Tricare Supplement. All health plans offered through the Fund are self-insured products except Tricare Supplement.

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

SOUTH CAROLINA STATE BUDGET AND CONTROL BOARD
EMPLOYEE INSURANCE PROGRAMS

NOTES TO FINANCIAL STATEMENTS

(CONTINUED)

12. Risk Management/Reinsurance (Continued)

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.

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, 2006, 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 offers HMO products through BlueChoice and Cigna, which are self-insured. The basic long-term disability product is a self-insured product. The Fund also offers Dental Plus and State Life products, which are fully insured. The Fund purchases coverage for basic life, optional life, dependent life, supplemental long-term disability, and long-term care from commercial carriers.

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)	
	2006	2005
Unpaid claims and claim adjustment expenses at beginning of the fiscal year	\$ 184,929	\$ 179,872
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current fiscal year	878,713	914,409
Increases (decreases) in provision for insured events of prior fiscal years	344,113	247,578
Total incurred claims and claim adjustment expenses	1,222,826	1,161,987
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current fiscal year	\$ 761,868	\$ 804,254
Claims and claim adjustment expenses attributable to insured events of prior fiscal years	452,127	352,676
Total payments	1,213,995	1,156,930
Total unpaid claims and claim adjustment expenses at end of the fiscal year	\$ 193,760	\$ 184,929
The above totals are comprised of the following:		
Claims payable	\$ 59,814	\$ 48,055
Claims incurred but not reported	133,946	136,874
Total	\$ 193,760	\$ 184,929

The HMO self-insured managed care plan liability at June 30, 2006 and 2005 was \$7,728,048 and \$4,241,931, 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, 2006, were as follows:

	<u>Beginning Balance July 1, 2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance June 30, 2006</u>	<u>Due Within One Year</u>
Compensated absences payable	\$ 476,628	\$ 57,315	\$ (11,080)	\$ 522,863	\$ 20,401

15. Medicare Part D Subsidy

The new Medicare Part D prescription drug benefit became effective in January 2006. The Plan elected to maintain primary coverage for pharmaceuticals for its Medicare eligible retirees. By providing drug coverage at least as valuable as that in the standard Medicare Part D program, the Plan qualifies for the Retiree Drug Subsidy (RDS), an incentive provided in the federal Part D law to encourage employers to retain good prescription benefits for retirees. The Plan earned and recorded \$14,545,079 in RDS funding for January through June 2006. As of June 30, 2006, the Plan had a receivable of \$9,062,344.

DELOACH & WILLIAMSON, L.L.P.

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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

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

Dear Mr. Gilbert:

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, 2006, and have issued our report thereon dated September 15, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not

express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

* * * * *

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

Rebeck & Williamson, L.L.P.

September 15, 2006