West Virginia Board of Risk and Insurance Management

Notes to Financial Statements

June 30, 1998

1. General

The West Virginia Board of Risk and Insurance Management (the Board) was established in 1957 to provide for the development of the State of West Virginia's (the State) property and liability self-insurance program. Approximately 150 State agencies participate in the program. Beginning in 1980, county boards of education were authorized to participate in the liability portion of this program, with 55 county boards currently participating in the program. In 1987, Senate Bill No. 3 was enacted allowing local governmental entities and non-profit organizations to participate in the entire program. There are approximately 1,340 such entities participating in the program. In 1982, legislation was also enacted requiring the Board to establish and administer a coal mine subsidence reinsurance program which makes available to the general public dwelling insurance covering damage up to a specific maximum caused by the collapse of underground coal mines.

The Board operates under the authority granted by the Legislature in Chapter 29, Article 12 and Chapter 33, Article 30 of the West Virginia Code and the provisions of Executive order 12-86. The Board is an agency of the State of West Virginia (the State and primary government), operating within the Department of Administration, and is governed by a three-person board of directors appointed by the Governor. Accordingly, the Board is reported as an enterprise fund operating as a single business segment and is included in the State's Comprehensive Annual Financial Report (CAFR).

The Board uses a "modified" paid retrospective rating plan for its liability insurance program. Under the current plan, the Board pays a "premium" deposit to an insurance company to fund initial losses. As claims are reported, they are paid from the cash reserves established by the premium deposit. When paid losses exceed the amount of the "premium" deposit, the Board pays the insurance company an additional "premium" deposit estimated to be sufficient to fund any estimated remaining claims and claims adjustment expenses expected to be paid during the ensuing twelve month period. These payments are calculated through retrospective rating adjustments that are made during the year. Therefore, the "premiums" paid by the Board are deposits and the Board is not indemnified by the insurance company for any losses. Under this plan, the insurance company is compensated for its claim handling services by a fixed fee negotiated on a yearly basis.

From January 1, 1971 through July 1, 1976, the liability coverage provided by the Board is limited to $25,000 per occurrence on general liability, automobile liability and medical malpractice claims. From July 1, 1976 through June 30, 1980, the liability coverage provided by the Board is limited to $100,000 per occurrence. From July 1, 1980 through June 30, 1985, the liability coverage provided by the Board is limited to $500,000 per occurrence. Since July 1, 1985, the liability coverage provided by the Board is limited to $1,000,000 indemnity per occurrence. In addition, the county boards of education are covered by an excess insurance policy providing up to

$5,000,000 of coverage in excess of the underlying $1,000,000 limit. These limits only apply to incurred indemnity claim losses. The Board pays all allocated loss adjustment expense (ALAE). ALAE are the costs incurred in the reporting, investigation, adjustment, defense and settlement of claims that are attributable to a specific, individual claim.

Prior to July 1, 1990, the Board retained the first $25,000 of loss per event on property insurance claims. Losses in excess of $25,000 per event were also retained within an annual aggregate limit. From July 1, 1990 through June 30, 1991, the exposure retained by the Board was $1,000,000 per event. From July 1, 1991 through June 30, 1996, the exposure retained by the Board was $2,000,000 per event. Since July 1, 1996, the exposure retained by the Board is $1,000,000 per event. The Board has obtained excess coverage, through insurance companies, covering losses in excess of $1,000,000 up to $200,000,000 per occurrence subject to various sublimits for particular types of claims as specified in the policy.

In 1985, the coal mine subsidence program was legislatively expanded to include all types of building structures and the maximum amount of insurance available was increased from $50,000 to $75,000 per dwelling.

In the normal course of business, the Board seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable operating results by reinsuring levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Reinsurance permits recovery of a portion of losses from reinsurers, however, it does not discharge the primary liability of the Board as direct insurer of the risks insured. The Board does not report reinsured risks as liabilities unless it is probable that those risks will not be covered by reinsurers.

The funding of the property and liability insurance program for the State agencies comes from two sources: general revenue appropriation for those agencies operating with general revenue funding or direct premium assessments on those agencies operating with special revenue funds. The Senate Bill No. 3 entities are charged a premium to participate in the program. Under the mine subsidence portion of the program, the ceding insurers pay the Board a reinsurance premium.

Pursuant to the West Virginia State Code, the Board submits a detailed budgetary schedule of administrative expenses to the Secretary of the Department of Administration prior to the beginning of each fiscal year. The fundamental purpose of budgetary control is to plan for the expected level of operations and to provide management with a tool to control deviation from such plan. The budgetary schedule is prepared on a modified cash basis, which is a comprehensive basis of accounting other than generally accepted accounting principles (GAAP). Expenditures related to the general revenue appropriation amount are monitored by the State’s budgetary review process in total on an unclassified basis. Each year’s appropriation lapses at year end. The remaining operations of the Board are subject to a nonappropriated budgetary review process.

GAAP defines component units as legally separate organizations for which the elected officials of the primary government are financially accountable, or other organizations for which the nature and significance of their relationship with the State's financial statements would cause them to be misleading. The Board has considered whether it has any component units as defined by GAAP and has determined that no such organizations meet the criteria set forth above.

2. Significant Accounting Policies

Basis of Accounting

As an enterprise fund, the Board's financial statements are presented on the accrual basis in conformity with generally accepted accounting principles. Under this method of accounting, revenues are recorded when earned and expenses are recorded when incurred. Revenues mainly are derived from premiums collected, general revenue appropriations, and interest income. Premium contributions received covering future contract periods are deferred and recognized as revenue over the related contract period. Expenses consist primarily of claims, claims adjustment, excess insurance premiums, premium taxes, commissions, and various general and administrative costs.

In September 1993, the Governmental Accounting Standards Board (GASB) issued Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. As permitted by the Statement, the Board has elected not to adopt Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989, unless the GASB specifically adopts such FASB statements or interpretations.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from management's estimates.

Cash and Cash Equivalents

Cash equivalents are short-term investments with original maturities of 90 days or less. Cash and cash equivalents principally consist of interest-earning deposits in certain investment pools maintained by the West Virginia Investment Management Board (IMB). Such funds are available to the Board with overnight notice. Interest income from these investments is pro-rated to the Board at rates specified by the IMB based on the balance of the Board's deposits maintained in relation to the total deposits of all state agencies participating in the pool. The carrying values of the amounts on deposit with the IMB, which approximate estimated fair market value, were $7,430,000 and $7,859,000 at June 30, 1998 and 1997, respectively. Such amounts are exempt from GASB 3 risk classification.

Advance Deposits with Insurance Companies

Advance deposits with insurance companies consist of monies on deposit with such companies that are utilized to fund claims and claims adjustment expenses as they are paid by the insurance companies.

Investments

In 1997, the Board began temporarily investing certain funds in the Enhanced Yield Fund of the IMB's consolidated investment pool. The fund is invested in longer term securities and subject to market fluctuation due to changes in interest rates. Investments are reported by the IMB at fair value and are accounted for by the Board accordingly, with changes in the fair value included in investment income. Income from these investments is pro-rated to the Board at rates specified by the IMB based on the balance of the Board's deposits maintained in relation to the total deposits of all state agencies participating in the pool. Such amounts are exempt from GASB 3 risk classification.

Furnishings and Equipment

In accordance with the West Virginia statewide capitalization policy, all fixed asset purchases below $5,000 per unit are expensed at the time of purchase. Purchases greater than $5,000 are recorded at historical cost and depreciated over their estimated useful lives of five years using the straight-line method. Depreciation expense was $8,000 in 1998 and $11,000 in 1997.

Compensated Absences, Including Postretirement Benefits

Employees fully vest in all earned but unused annual leave and the Board accrues for obligations that may arise in connection with compensated absences for vacation at the current rate of employee pay. In accordance with State personnel policies, employees vest in any remaining unused sick leave only upon retirement, at which time any unused compensated absence time can be converted into employer paid premiums for post-retirement health care coverage through the Public Employees Insurance Agency, or be converted into a greater retirement benefit under PERS.

Unpaid Claims and Claims Adjustment Expense

The Board establishes the unpaid claims and claims adjustment expense liability based on estimates of the ultimate cost of claims, including future claims adjustment expenses, that have been reported but not settled, and of claims that have been incurred but not reported (IBNR). The length of time for which such costs must be estimated varies depending on the coverage involved. Estimated amounts of salvage and subrogation and reinsurance recoverable on unpaid claims are deducted from the liability. Because actual claims costs depend on such complex factors as inflation, changes in doctrines of legal liability, and damage awards, the process used in computing estimates of claims liability does not necessarily result in an exact amount, particularly for coverages such as general liability. Claims liabilities are recomputed periodically 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. Adjustments to claims liability estimates are charged or credited to expense in the periods in which they are made.

The claims and claims adjustment expense category on the statement of revenues, expenses, and changes in retained earnings (deficiency) includes estimated incurred claim costs, allocated loss adjustment expenses, and unallocated claims adjustment expenses.

Premium deficiency is defined as the amount by which expected claims costs (including IBNR), and all expected claim adjustment expenses exceed related unearned premiums. The Board has determined that a premium deficiency does not exist. In making this determination, management has taken into consideration anticipated investment income.

3. Investments

The following represents a calculation of the net increase in the fair value of investments during the years ended June 30, 1998 and 1997:

	1998	**1997**
	(in thousands)	
Fair value at end of year	**$ 61,517**	$42,400
Add proceeds of investments sold during year	**10,039**	–
Less cost of investments purchased during year	**(28,719)**	(41,934)
Less fair value at beginning of year	**(42,400)**	–
Change in fair value of investments during year	**$ 437**	$ 466

4. Unpaid Claims and Claims Adjustment Expense Liability

The Board establishes an estimated liability for both reported and unreported insured events, which includes estimates of both future payments of losses and related claims adjustment expenses. The following represents changes in the estimated liability for the two fiscal and policy years ending June 30:

	1998	**1997**
	(in thousands)	
Unpaid claims and claims adjustment expense liability at beginning of year	**$117,314**	$126,859
Incurred claims and claims adjustment expense:		
Provision for insured events of the current year	**30,501**	38,294
Increase (decrease) in provision for insured events of prior years	**4,600**	(4,370)
Total incurred claims and claims adjustment expense	**35,101**	33,924
Payments:		
Claims and claims adjustment expense attributable to insured events of the current year	**8,553**	8,085
Claims and claims adjustment expense attributable to insured events of prior years	**41,728**	35,384
Total payments	**50,281**	43,469
Total unpaid claims and claims adjustment expense liability at end of year	**$102,134**	$117,314

If the unpaid claims and claims adjustment expense liability was discounted using a 6% discount factor for 1998 and 1997 to take into consideration the time value of money, the result would be decreases in the liability and retained earnings (deficiency) of approximately $12 million and $16 million for fiscal years 1998 and 1997.

5. Employee Benefit Plans

All full-time Board employees are eligible to participate in the State of West Virginia Public Employees Retirement System (PERS), a cost-sharing multiple-employer public employee retirement system. Employees who retire at or after age sixty with five or more years of contributory service or who retire at or after age fifty-five and have completed twenty-five years of credited service are eligible for retirement benefits as established by state statute. Retirement benefits are payable monthly for life, in the form of a straight-line annuity equal to two percent of the employee's final average salary, multiplied by the number of years of the employee's credited service at the time of retirement. The PERS also provides deferred retirement, early retirement, and death and disability benefits and issues an annual report which can be obtained by contacting the PERS.

Covered employees are required to contribute 4.5% of their salary to PERS. The Board is required to contribute 9.5% of covered employees' salaries to PERS. The required employee and employer contribution percentages are determined by actuarial advisement within ranges set by statute. The Board and employee contributions for the three years ended June 30 are as follows:

	1998	1997	1996
Board contributions (9.5%)	**$42,000**	$42,000	$40,000
Employee contributions (4.5%)	**20,000**	20,000	19,000
Total contributions	**$62,000**	$62,000	$59,000

Upon retirement, an employee may apply unused sick leave and/or annual leave to reduce their future insurance premiums paid to the Public Employees Insurance Agency to obtain a greater benefit under PERS. The estimated liability for sick leave post-retirement benefits approximating $49,000 and $139,000, respectively, is included in accrued expenses and other liabilities in the balance sheets.

6. Transactions with Primary Government and Component Units

State "General Revenue Fund" appropriations approximating $15,304,000 and $16,304,000 for the years ended June 30, 1998 and 1997, respectively, are included in premium revenue in the statements of revenues, expenses, and changes in retained earnings (deficiency). Premium revenues derived from billings to entities funded with "special revenue" accounts and component units of the primary state government approximated $10,413,000 and $11,118,000 for the years ended June 30, 1998 and 1997, respectively.

At June 30, 1997, premiums receivable due from component units included $1,171,000 due from the State's various medical schools as a result of a dispute regarding the conformity of the Board's premium determination and billing practices with legislative intent. This matter was settled pursuant to the passage of the 1996 Budget Bill wherein the West Virginia Legislature established intent to appropriate certain amounts from the various Health Sciences (Schools of Medicine) budgets to pay a substantial portion of the balance due. As of the report date, the schools have paid all amounts required under this agreement. There were no premiums receivable from component units at June 30, 1998.

7. Extraordinary Gain From Change in Legislation

On April 20, 1997, the West Virginia Legislature passed Senate Bill Number 1002 effective immediately. This legislation eliminated the collection of premium tax by insurers for policies placed with the Board. Accordingly, the Board's premium tax liability was reduced to zero resulting in an extraordinary gain of $3,811,000 from the reversal of the liability recognized prior to the passage of the new legislation during the fiscal year ended June 30, 1997.

Senate Bill Number 1002 also requires that an amount equal to the gross premium tax attributable to premiums collected by the Board should be placed in a separate account known as the "Premium Tax Savings Fund". As of June 30, 1998, amounts deposited or required to be deposited by the Board into the fund appreciated approximated $1,421,000 in the aggregate. Subsequent to June 30, 1998, the Board has deposited all such amounts required by this legislation with the Treasurer of State. This fund is not included in the Board's financial statements and is included in the General Fund of the State of West Virginia.

8. Year 2000 (Unaudited)

The Board is working to resolve the potential impact of the Year 2000 on the ability of the Board's computerized information systems to accurately process information that my be date-sensitive. Any of the Board's computer programs that recognize a date using "00" as the year 1900 rather than the year 2000 could result in miscalculations or systems failures.

The Board has begun its assessment of potential internal hardware and software affected by the Year 2000 and currently believes the costs of addressing this issue will not have a material adverse financial impact on the Board. The Board presently believes that with modifications to existing software and hardware, the Year 2000 issue will not pose significant operational problems for its computer systems. As part of its Year 2000 assessment, the Board has initiated formal communications with all of its significant suppliers to determine the extent to which the Board's interface systems are vulnerable to those third parties' failure to remediate their own Year 2000 issues. However, there can be no guarantee that the systems of other companies on which the Board's systems rely will be timely converted and would not have an adverse effect on the Board's systems.

The Board's total Year 2000 project cost and estimates to complete include the estimated costs and time associated with the impact of third-party Year 2000 issues based on presently available information. The Board anticipates completing the Year 2000 project during fiscal year 1999. The costs of the project and the date on which the Board believes it will complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources, third-party modification plans and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties.

Required Supplemental Schedules