STATE COMPENSATION
INSURANCE AUTHORITY

AUDITED STATUTORY BASIS
FINANCIAL STATEMENTS AND
COMMENTS ON
INTERNAL CONTROLS AND PROCEDURES

DECEMBER 31, 1988

Price Waterhouse

STATE COMPENSATION INSURANCE AUTHORITY

AUDITED STATUTORY BASIS FINANCIAL STATEMENTS AND COMMENTS ON INTERNAL CONTROLS AND PROCEDURES

DECEMBER 31, 1988

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COMMENTS ON INTERNAL CONTROLS AND PROCEDURES
DECEMBER 31, 1988

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Price Waterhouse

April 10, 1989

Members of the Legislative Audit Committee
State of Colorado

We have completed the financial audit of the State Compensation Insurance Authority for the year ended December 31, 1988. Our audit was conducted in accordance with generally accepted auditing standards.

We were engaged to conduct our audit pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct or otherwise contract to conduct post audits of all departments, institutions and agencies of state government. The reports we have issued as a result of this engagement are set forth in the table of contents which follows. Included in the Findings and Recommendations on Internal Controls and Procedures are the responses of the State Compensation Insurance Authority.

Yours very truly,

Price Waterhouse

STATE COMPENSATION INSURANCE AUTHORITY

AUDITED STATUTORY BASIS FINANCIAL STATEMENTS AND

COMMENTS ON INTERNAL CONTROLS AND PROCEDURES

DECEMBER 31, 1988

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STATE COMPENSATION INSURANCE AUTHORITY

AUDIT REPORT DIGEST

DECEMBER 31, 1988

DESCRIPTION OF STATE COMPENSATION INSURANCE AUTHORITY

The State Compensation Insurance Authority was established for the benefit of injured employees and dependents of deceased employees of the State of Colorado. The authority provides insurance to employers not otherwise insured through private carriers or self-insurance.

PURPOSE AND SCOPE OF THE AUDIT

AUTHORITY:

The authority for this audit comes from Colorado revised statutes Section 2-3-103 which states in part, "it is the duty of the state auditor to conduct or cause to be conducted post-audits of all financial transactions and accounts kept by or for all departments..."

PURPOSE:

The purposes of the audit were to:

Audit the statutory financial statements of the State Compensation Insurance Authority (the "Authority") for the year ended December 31, 1988 to the extent necessary to support an opinion on the statutory financial statements and the notes thereto. This audit included a review of the related system of internal accounting and administrative controls as required by generally accepted auditing standards.

Evaluate progress in implementing prior audit recommendations.

STANDARDS:

The audit was conducted in accordance with generally accepted auditing standards.

SCOPE:

We examined, on a test basis, evidence supporting the financial transactions and related balances as of December 31, 1988 for the Authority.

FINANCIAL AUDIT OPINION

We have completed our audit of the statutory financial statements and issued our report thereon dated April 10, 1989, which stated that the financial statements of the Authority present fairly the statutory admitted assets, liabilities and policyholders' surplus of the Authority at December 31, 1988, and the results of its statutory operations and its cash flows for the year.

SUMMARY OF AUDIT COMMENTS

This report includes recommendations to improve management and accounting procedures of the Authority. Following is a summary of the audit comments discussed in the report:

- The ADP payroll bank accounts should be reconciled to the general ledger each month;
- The listing of standard journal entries to be made at each month-end/year-end should be monitored to ensure its completeness and that all entries are properly made;
- Procedures should be implemented to record expense accruals at period-end and to identify and properly account for prepaid expenses;
- All files should be physically reviewed by the claims adjusters prior to closing any case;
- Current payroll and related information should be used in determining the policyholder premium and deposit;
- Controls surrounding the handling and recording of manually-maintained policyholder accounts should be improved and monitored;
- All unidentified checks should be followed-up in a timely manner for application or other disposition;
- The marketing department should be restricted from authorizing or making changes to the policyholders master files;
- Formal procedures should be established with respect to policyholder file maintenance;
- The parameters of the "Unused Portion of Cancelled Premiums" report should be modified to provide an accurate listing of the liability for cancelled policies;
- Investment ledgers should be automated;
- Detail fixed asset records should be properly updated and maintained for electronic data processing equipment;

- Establish a written fixed asset capitalization policy;
- Automate the general ledger and statutory annual statement preparation and modify the general ledger chart of accounts to facilitate preparation of the annual statement submitted to the Division of Insurance;
- Enforce and strengthen controls surrounding the removal of accident claim files from the secured area; and
- The Controller should be more proactive in carrying out his responsibilities.

SUMMARY OF PROGRESS IN IMPLEMENTING PRIOR AUDIT RECOMMENDATIONS

The disposition of prior audit recommendations at April 10, 1989 was:

Implemented	5
Partially Implemented	2
Not Implemented	5
No Longer Applicable	6
Total	18

We appreciate the cooperation extended to us during the course of this audit.

STATE COMPENSATION INSURANCE AUTHORITY

RECOMMENDATION LOCATOR

DECEMBER 31, 1988

REC NO.	PAGE NO.	RECOMMENDATION SUMMARY	AUTHORITY RESPONSE
1.	6	Reconcile payroll bank accounts.	Agree
2.	6	Monitor the listing of standard journal entries.	Agree
3.	7	Enhance procedures surrounding accruals and prepaids.	Agree
4.	7	Physically review all claim files prior to closing any case.	Agree
5.	8	Utilize the most current policyholder information in computing premiums and required deposits.	Agree
6.	8	Improve controls surrounding manually-maintained policyholder accounts.	Agree
7.	8	Provide underwriting with a listing of unidentified policyholder checks for investigation and timely disposition.	Agree
8.	9	Restrict the marketing department from authorizing or changing policyholder master files.	Agree
9.	9	Establish procedures for policyholder file maintenance.	Agree
10.	10	Modify the parameters of the "Unused Portion of Cancelled Premiums" report.	Agree
11.	10	Investment ledgers should be automated.	Agree
12.	10	Detail fixed asset records should be updated.	Agree
13.	11	Establish a written fixed asset capitalization policy.	Agree

14.	11	Automate the general ledger and statutory annual statement preparation and modify the general ledger chart of accounts to facilitate preparation of the annual statement submitted to the Division of Insurance.	Agree
15.	12	Improve controls surrounding the removal of accident claim files.	Agree
16.	12	The Controller should be more proactive in carrying out his responsibilities.	Agree

STATE COMPENSATION INSURANCE AUTHORITY
FINDINGS AND RECOMMENDATIONS ON INTERNAL
CONTROL AND PROCEDURES
DECEMBER 31, 1988

Finding: Payroll Reconciliations

The ADP payroll bank accounts at United Bank of Dènver which were established in August, 1988 have never been reconciled. Failure to reconcile bank accounts on a timely basis could allow misappropriations of Authority funds to go undetected.

RECOMMENDATION 1

Payroll bank accounts must be reconciled each month in a timely manner by a properly trained employee who is independent of the payroll function. Such reconciliations should also be reviewed and approved by the controller or his designee. In addition, reconciliations must be prepared for all months from August, 1988.

AUTHORITY'S RESPONSE

We agree. We have since reconciled the payroll accounts from August, 1988 to date, and will continue to do so on a monthly basis consistent with this recommendation.

Finding: Investments

The Authority did not record approximately $2.2 million of interest receivable and related income and amortization of discounts and premiums for short-term investments in its books and records as of December 31, 1988. There were also other instances whereby various entries had not been posted to the general ledger prior to the year-end closing. Failure to record such entries results in the misstatement of account balances and inaccurate financial information being used for management purposes.

RECOMMENDATION 2

Monitor the listing of standard journal entries to be made at each month-end/year-end to ensure its completeness and that all entries are properly made.

AUTHORITY'S RESPONSE

We agree. This information was available in our accounting records. As recommended by our previous audit firm, journal entries for short term money market investments were made semi-annually for ease of administration. This recommendation will be implemented by July 1, 1989.

Finding: Failure to record expenses in the proper period.

Year-end accruals failed to include certain expenses that pertained to 1988. Offsetting such unrecorded liabilities were expenses which should have been recorded as a prepaid expense but were incorrectly expensed in 1988. Recording expenses in the wrong period results in incorrect financial data.

RECOMMENDATION 3

The accounting department should implement procedures to ensure that accruals at year-end include all known or anticipated items attributable to the year and prepaid expenses include only items applicable to future periods.

AUTHORITY'S RESPONSE

We agree. We will revise our internal procedures to assure that proper accruals are included in year end financial records.

Finding: Premature Closing of Claim Files

Certain files are prematurely deleted from the case listing on the basis of being closed when, in fact, the case had not been. This apparently arises when claim adjusters sometimes close files based solely on information they receive. When a case is classified as "closed", it is deleted from the reserve report which could result in the understatement of loss reserves and premiums charged since premiums are calculated, in part, based on the estimate of necessary future loss reserves.

RECOMMENDATION 4

All files should be physically reviewed by the claims adjuster and approved for closing by a claims supervisor prior to the closing of any case.

AUTHORITY'S RESPONSE

We agree. We have implemented this recommendation by changing our computer system generated report on accidents with no activity by deleting permanent total and fatal accidents. We have also revised our internal claims procedures to preclude premature closure of claims.

Finding: Premiums Receivable

The most recent payroll and other identified information is not necessarily used to calculate policyholder deposits and policyholder premiums. This results in inaccurate billings of premiums and related deposits.

RECOMMENDATION 5

Procedures should be established to ensure that the most current information available is used to calculate policyholder premiums and deposits.

AUTHORITY'S RESPONSE

We agree. Our current procedures entail the use of the most recent payroll information available to calculate premiums and deposits. This procedure will be streamlined through on-line entry when our computer software is revised before the end of 1990.

Finding: Premiums Receivable

The Authority processes certain types of accounts on a manual basis; however, current period billings were noted which were not processed in a timely manner or were processed improperly. This resulted in the understatement of premiums receivable and related revenue at year-end.

RECOMMENDATION 6

Controls surrounding the handling of manually-maintained accounts should be revised to ensure that such accounts are properly recorded in the financial records.

AUTHORITY'S RESPONSE

We agree and will revise our controls.

Finding: Liabilities for Unidentified Checks

The general ledger account "Liability for Unidentified Checks" is comprised of payments which have not been identified as to policyholder. Although the general ledger account is reconciled, there does not appear to be an ongoing effort to identify and resolve the account to which such payments should be applied. Included in this account are checks received during 1985 not yet applied.

RECOMMENDATION 7

The accounting department should provide the underwriters with a listing of unidentified checks as well as support for each payment for investigation and timely disposition. If the check cannot be identified in a timely manner, the issuer of the check should be contacted.

AUTHORITY'S RESPONSE

We agree. We have centralized responsibility for routine follow-up on unidentified checks in one unit in Underwriting. We have a new piece of equipment which endorses and makes a film image of checks and our accounting department makes deposits twice daily.

Finding: Premiums Written

The marketing department is authorized to perform file maintenance on the master files of policyholders and can also submit requests to the underwriters for changes to customer accounts. This lack of segregation of duties can and did result in a duplicate billing to a policyholder.

RECOMMENDATION 8

The marketing department should be restricted from authorizing or making changes to the policyholders master files.

AUTHORITY'S RESPONSE

We agree. Effective immediately, Marketing Department personnel submit all requests for master file changes to a central source in our Underwriting Department for action.

Finding: Policyholder Documentation

Certain policyholders files are incomplete and/or inconsistent as to the type of information retained. Specific exceptions noted were the National Council rating form which indicates the calculation of the experience modification factor of a policyholder was missing from two files and changes had been made to the policyholders' payroll information without any documented support for such in the file. The absence of formalized policies regarding file documentation can cause underwriters to not be aware of file procedures. Inadequate policy documentation increases the risk of improperly calculated premiums and deposits.

RECOMMENDATION 9

Formal procedures should be established with respect to policyholder file maintenance and all relevant documents should be included in such files.

AUTHORITY'S RESPONSE

We agree. This recommendation will be implemented by July 31, 1989.

Finding: Liability on Cancelled Policies

While testing the report "Unused Portion of Advance Premiums" on cancelled policies, we noted that some of the policies which were cancelled during 1988 had an incorrect policy period and thus an incorrect calculation of unused premiums. The parameters of the report do not appear to be functioning as intended and, therefore, the report does not provide accurate information. These inaccuracies could result in misstatement of the liability for premiums paid on cancelled policies.

RECOMMENDATION 10

The parameters of the "Unused Portion of Cancelled Premiums" report should be modified to provide an accurate listing of the liability for cancelled policies.

AUTHORITY'S RESPONSE

We agree. Our computer system is being modified to improve the accuracy of these reports. This recommendation will be implemented by September 1, 1989.

Finding: Investment Ledgers

The Authority's investment ledgers are maintained on a manual basis which is a very cumbersome and time-consuming process.

RECOMMENDATION 11

The Authority should automate the investment ledgers to increase efficiency and facilitate the recording of the amortization of discounts or premiums, interest income, market values, and adjustments to book values.

AUTHORITY'S RESPONSE

We agree. This recommendation is being implemented with the redesign and development of all of our management information systems and will be implemented by January 1, 1990. We are coordinating this effort with the State Treasurer's Office.

Finding: Fixed Assets

Detailed fixed asset records were not properly updated during 1987 or 1988. The Authority purchased more than $1.2 million of electronic data processing equipment during 1988 and such purchases were not properly capitalized as admitted assets on the general ledger nor on the detail fixed asset listing.

RECOMMENDATION 12

The Authority should maintain current and complete detailed fixed asset records to safeguard the assets, substantiate insurance claims, and to facilitate the disposal of assets. The detailed fixed assets schedules should be updated for additions and dispositions and reconciled to the general ledger on a monthly basis.

AUTHORITY'S RESPONSE

We agree. This recommendation will be be implemented by December 31, 1989 for all assets.

Finding: EDP Equipment

The Authority expensed certain purchases of EDP equipment instead of capitalizing such as admitted assets.

RECOMMENDATION 13

A written capitalization policy should be established with respect to electronic data processing equipment. This policy should include a specified dollar amount of items to be capitalized.

AUTHORITY'S RESPONSE

We agree. Our Accounting Department is following the policy set forth in the State Fiscal Rules which provide that expenditures for equipment having a useful life of more than two years and an acquisition cost of $500.00 or more per unit are to be capitalized.

Finding: General Ledger Chart of Accounts

The general ledger is maintained on a manual basis and the present chart of accounts does not facilitate the preparation of the statutory annual statement submitted to the Division of Insurance. The lack of detail is particularly noticeable in the area of management expenses. Furthermore, the Authority's statutory annual statement is prepared manually, while many inexpensive automated software packages are available. Automation of the general ledger and annual statement preparation would dramatically increase accuracy and efficiency and allow for automated management reporting.

RECOMMENDATION 14

The Authority should automate the general ledger, develop a more detailed general ledger for purposes of preparing the statutory annual statement and automate the preparation of the statutory annual statement.

AUTHORITY'S RESPONSE

We agree. We currently have a software package from A. M. Best which will assist us in preparing the annual statement and automation of the general ledger is currently in the technical design stage. This recommendation will be implemented beginning January 1, 1990.

Finding: Accident Claim Files

The controls in place for documenting the removal of accident claim files from the secured area do not appear to be functioning as intended. In a few instances, the Authority had difficulties in locating the requested files during our 1988 examination.

RECOMMENDATION 15

The Authority should investigate potential weaknesses or abuses of the "check-out" system currently used. Specific procedures should be implemented and complied with to eliminate the misplacing of the accident claim files.

AUTHORITY'S RESPONSE

We agree. As a part of the redesign and development of all of our automated systems, we are evaluating the use of scanners or bar coding devices to better track file location. This recommendation will be implemented by March 31, 1990.

Finding: Responsibilities of the Controller

The Controller does not review or approve monthly journal entries or general ledger activity to ensure that all appropriate activity of the Authority is properly recorded. The completeness and accuracy of the accounting records and financial information generated therefrom for management information and control purposes is subject to material error without such involvement. In addition, we noted numerous instances where the efficiency and cost effectiveness of the accounting department could be enhanced through a proactive role of the Controller.

RECOMMENDATION 16

The Controller should review and approve the monthly journal entries and ascertain that all such entries are properly supported. In addition, the Controller should review the general ledger activity each month to ascertain its completeness and accuracy. Finally, the Controller should provide effective oversight and supervision to the accounting department to ensure it is functioning in an efficient and cost effective manner.

AUTHORITY'S RESPONSE

We agree. As a part of a reorganization of various administrative functions, the responsibilities of our Controller will be reviewed and revised appropriately. This recommendation will be implemented by December 31, 1989.

STATE COMPENSATION INSURANCE AUTHORITY

DISPOSITION OF PRIOR YEAR RECOMMENDATIONS

DECEMBER 31, 1988

Listed below are the recommendations included in the December 31, 1987 audit report of Ernst & Whinney dated March 4, 1988 and the disposition or other status of such items as of April 10, 1989.

IMPLEMENTED:

- We noted no instances in which a warrant was improperly issued for a return of an advance premium;
- A monthly reconciliation is now performed for each FHLMC pool. The FHLMC pools recorded on the Authority's bond register are currently being reconciled to the monthly investment recap report received from the State Treasurer. If differences are noted, they are resolved in a timely manner;
- The retroactive premiums appear to be aging properly;
- The aged premiums receivable report is now being reconciled to the general ledger on a regular basis; and
- During the 1988 examination, we did not note any instances in which a policy was assigned an incorrect group number.

PARTIALLY IMPLEMENTED:

- The responsibilities of the internal auditor had remained unchanged throughout 1988. However, we understand that the internal auditor's responsibilities have been modified in 1989 to include more internal audit functions with reporting responsibilities to the Board of Directors; and
- The liability on cancelled policies report did not correctly report the unused portion of advance premiums as discussed in the current year recommendation 10. However, we noted no instances in which the report incorrectly reflected a liability on a cancelled policy for which no premium had been received.

NOT IMPLEMENTED:

- The accounting department still maintains its investment ledgers on a manual basis. This practice is time consuming and subject to error and the Authority should automate the preparation of the investment ledgers (see current year recommendation 11);

- The detail fixed asset records had not been properly updated during 1988. The Authority purchased over $1.2 million of EDP equipment during 1988, and as of year-end, these items had not been recorded on the fixed asset listing (see current year recommendation 12);

- The Authority expensed certain 1988 equipment purchases which should have been capitalized as an admitted asset. A written capitalization policy should be established for EDP equipment (see current year recommendation 13);

- We noted no changes to the general ledger chart of accounts which presently does not facilitate the preparation of the statutory annual statement. The lack of detail is particularly noticeable in the area of management expenses. The Authority should develop a more detailed general ledger and purchase a software package specifically designed to prepare the statutory annual statement and provide more useful information for budgetary analyses (see current year recommendation 14); and

- No changes appear to have been made in the control procedures for removal of claim/accident files from the secured area. The controls do not appear to be functioning as intended; the Authority had difficulties in locating certain files requested during our 1988 examination (see current year recommendation 15).

<u>NO LONGER APPLICABLE</u>:

The following 1987 recommendations are no longer applicable since the Authority has ceased utilization of the Department of Labor and Employment's (the "DOLE") data processing facilities. The prior year recommendations were specific to weaknesses noted in conjunction with the use of the DOLE data processing systems. As of December 1, 1988, the data processing function was brought in-house.

- The application development and maintenance standards were not adequately documented;

- The DOLE was not utilizing the panvalet security features to restrict programmers' access;

- The programmers could execute production applications via TSO. The lack of control over production object code and data did not ensure that production program execution was authorized;

- Access to CIGS applications was not adequately controlled. Also the CIGS program contained no ID suspension capabilities and access violations were not reported;

- Certain programmers/analysts had authority to verbally authorize a move of data from test to production; and

- Access violations reported by Top Secret were not reviewed and investigated.

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REPORT OF INDEPENDENT ACCOUNTANTS

April 10, 1989

State Compensation Insurance Authority and
Members of the Legislative Audit Committee

We have audited the accompanying statements of statutory admitted assets, liabilities, and policyholders' surplus of the State Compensation Insurance Authority (the "Authority") as of December 31, 1988, and the related statements of statutory operations and changes in unassigned surplus and of cash flows for the year then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Authority for the year ended December 31, 1987 were audited by other independent accountants whose report dated March 4, 1988 expressed a qualified opinion on those statements due to an uncertainty pertaining to a potential class action and outrageous conduct suit against the Authority. As described in Note 4, the suit was never filed.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements audited by us present fairly, in all material respects, the statutory admitted assets, liabilities and policyholders' surplus of the State Compensation Insurance Authority at December 31, 1988, the results of its statutory operations and changes in unassigned surplus and its cash flows for the year, on the basis of accounting described in Note 1.

This report is intended solely for the information and use of the Auditor of the State of Colorado, the Legislative Audit Committee and management or for filing with regulatory agencies and should not be used for any other purpose.

Price Waterhouse

STATE COMPENSATION INSURANCE AUTHORITY
STATEMENTS OF STATUTORY ADMITTED ASSETS, LIABILITIES, AND POLICYHOLDERS' SURPLUS

	December 31, 1988	December 31, 1987
Admitted Assets		
Investments		
Bonds (market value: 1988 - $331,216,049; 1987 - $362,550,022)	$338,559,260	$367,301,076
Mortgage loans	20,191,572	22,417,215
Home office (less accumulated depreciation: 1988 - $382,694; 1987 - $326,690)	2,417,306	2,473,310
Cash and cash equivalents	33,952,196	27,414,257
Short-term investments	111,392,173	70,175,205
Total Investments	506,512,507	489,781,063
Premiums receivable (net of allowance for doubtful accounts of: 1988 - $5,171,533; 1987 - $3,130,117 and non-admitted balances of: 1988 - $21,276,978; 1987 - $17,991,381) - Note 2	34,139,268	34,359,722
Interest receivable	7,490,230	7,870,867
Electronic data processing equipment (less accumulated depreciation: 1988 - $415,828; 1987 - $71,539)	1,220,670	357,695
	$549,362,675	$532,369,347
Liabilities and Policyholders' Surplus		
Liabilities		
Unpaid losses	$416,267,635	$392,155,000
Loss adjustment expenses	18,732,365	17,845,000
Unearned premiums	17,822,178	19,978,255
Policyholders' deposits	37,995,517	41,195,861
Amounts withheld or retained for others	772,855	542,050
Premium taxes and other liabilities	4,735,946	2,491,955
Total Liabilities	496,326,496	474,208,121
Contingencies - Notes 3 and 4		
Policyholders' Surplus		
Statutory surplus - Note 5	500,000	500,000
Unassigned surplus	52,536,179	57,661,226
Total Policyholders' Surplus	53,036,179	58,161,226
	$549,362,675	$532,369,317

The accompanying notes are an integral part of the financial statements.

STATE COMPENSATION INSURANCE AUTHORITY
STATEMENTS OF STATUTORY OPERATIONS AND CHANGES IN UNASSIGNED SURPLUS

	Year ended December 31, 1988	1987
Premiums earned	$220,671,343	$191,640,131
Underwriting expenses:		
Losses incurred	229,981,633	198,328,707
Loss adjustment expenses	10,809,313	12,682,630
Other underwriting expenses	15,560,854	8,005,241
	256,351,800	219,016,578
Underwriting loss	(35,680,457)	(27,376,447)
Net investment income	38,521,032	35,186,334
Other loss	(5,007,002)	(2,343,025)
Income (loss) before realized gain	(2,166,427)	5,466,862
Gain (loss) on sale of investments	(194,367)	128,234
Net income (loss)	(2,360,794)	5,595,096
Change in dividends payable	521,344	
Change in nonadmitted assets	(3,285,597)	(3,730,147)
Unassigned surplus at beginning of year	57,661,226	55,796,277
Unassigned surplus at end of year	$ 52,536,179	$ 57,661,226

The accompanying notes are an integral part of the financial statements.

STATE COMPENSATION INSURANCE AUTHORITY

STATEMENT OF CASH FLOWS

	Year ended December 31, 1988	1987
Cash flows from operating activities:		
Net income (loss)	$ (2,360,794)	$ 5,595,096
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	400,293	127,543
Change in nonadmitted assets	(3,285,597)	(3,730,147)
(Increase) decrease in premiums receivable	220,454	(1,767,621)
(Increase) decrease in interest receivable	380,637	(883,942)
Purchase of electronic data processing equipment	(1,207,264)	(429,234)
Increase in unpaid losses and loss adjustment expenses	25,000,000	25,749,000
Increase (decrease) in unearned premiums	(2,156,077)	599,980
Increase (decrease) in policyholders' deposits	(3,200,344)	3,694,883
Increase (decrease) in other liabilities	2,996,140	(1,548,493)
Total adjustments	19,148,242	21,811,969
Net cash provided by operating activities	16,787,448	27,407,065
Cash flows from investing activities:		
Proceeds from sale or redemption of bonds	157,382,890	64,187,466
Mortgage loans principal payments	2,225,643	2,755,399
Purchase of bonds	(127,473,525)	(154,222,206)
Amortization of bond and mortgage loan discount and premium	(1,167,549)	(952,819)
(Increase) decrease in short-term investments	(41,216,968)	53,917,195
Net cash used for investing activities	(10,249,509)	(34,314,965)
Net increase (decrease) in cash and cash equivalents	6,537,939	(6,907,900)
Cash and cash equivalents at beginning of year	27,414,257	34,322,157
Cash and cash equivalents at end of year	$ 33,952,196	$ 27,414,257

The accompanying notes are an integral part of the financial statements.

STATE COMPENSATION INSURANCE AUTHORITY

NOTES TO STATUTORY FINANCIAL STATEMENTS

DECEMBER 31, 1988

NOTE 1 - ORGANIZATION, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization: The State Compensation Insurance Authority (the "Authority") was established under provisions of the Workmen's Compensation Act of Colorado (Title 8, Article 54 of the Colorado Revised Statutes, as amended) for the benefit of injured employees and dependents of deceased employees. The Authority provides insurance to employers not otherwise insured through private carriers or self-insurance.

Effective July 1, 1987, the State Compensation Insurance Fund, an enterprise fund within the Colorado Department of Labor and Employment, became the State Compensation Insurance Authority, a separate political subdivision of the State of Colorado. By statute, the Authority must comply with all reporting requirements of the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado ("Division of Insurance"), similar to all other workers' compensation insurance carriers in the State.

The Authority is controlled by an appointed, six-member Board of Directors, in accordance with the applicable statutes of the State of Colorado, with administration under the direction of the Manager. The State of Colorado retains no liability on the part of the Authority, beyond the amount of the Authority's surplus, and no State monies are used for Authority operations.

Basis of Reporting: The financial statements have been prepared on a comprehensive basis of accounting prescribed or permitted by the Division of Insurance. Such basis of accounting varies from generally accepted accounting principles in that furniture and equipment and premiums outstanding over 90 days are nonadmissible assets and, accordingly, are charged against unassigned surplus; estimated unbilled audit premiums receivable are not recorded as premiums receivable until billed; and premium taxes are expensed as paid rather than deferred and amortized over the related policy period.

Investments: As required by the Colorado Revised Statutes of 1973, all mortgages, which are carried at unpaid principal balances, represent first liens on the related property and are guaranteed by the United States Government. Investments in bonds are carried at amortized cost. Investment securities are held in custody by the Department of Treasury of the State of Colorado.

Cash, Cash Equivalents and Short-Term Investments: Cash, cash equivalents and short-term investments are held in custody by the

Department of Treasury of the State of Colorado. Cash and cash equivalents consist primarily of unrestricted deposits in interest-bearing accounts.

Short-term investments consist of commercial paper, certificates of deposit and bankers' acceptances, and are carried at cost, which approximates market.

Home Office: The home office is carried at cost and consists of land and a building used by the Authority in its operations. The building is being depreciated on a straight-line basis over an estimated useful life of 25 years.

Electronic Data Processing Equipment: Electronic data processing equipment is carried at cost less accumulated depreciation. The equipment is depreciated on a straight-line basis over an estimated useful life of 3 years.

Recognition of Premium Revenues: Premiums are recognized as earned on a monthly pro rata basis over the period of coverage provided.

Policyholders' Dividends: The Board of Directors, at its discretion, determines the amount of policyholder dividends to be declared, based on the Authority's overall experience. Dividends are paid, only after an audit, to policyholders who meet certain criteria established by the Authority. Policyholders whose losses exceed 90% of the premiums paid do not receive dividends for that policy year. No dividends were declared in 1988 or 1987. Dividends declared in prior years which have been determined will not be paid have been credited to unassigned policyholders' surplus.

Policyholders' Deposits: Policyholders billed on a quarterly basis are required to make an advance deposit which is approximately one-fourth or one-third of their estimated annual premium.

Unpaid Losses and Loss Adjustment Expenses: Unpaid losses and loss adjustment expenses represent actuarial derived estimates of the ultimate net cost of all losses and loss adjustment expenses which are incurred but unpaid at the balance sheet date. The unpaid losses and loss adjustment expenses are reviewed periodically and, as adjustments are determined to be necessary, such adjustments are reflected in current operations. As permitted by State statute, unpaid losses and loss adjustment expenses have been discounted by a factor of 4% per annum.

Subrogation: Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received.

Reinsurance: Reinsurance premiums and reimbursements for loss and loss adjustment expenses are reflected as reductions to the related premium, loss and loss adjustment expense balances.

Taxes: As a political subdivision of the State of Colorado, the Authority is not subject to federal or state income taxes. However, the Authority is subject to premium tax, as provided by the Colorado Revised Statutes of 1973, which is payable to the Major Medical Fund of the Department of Labor and Employment.

Employee Benefits: All Authority employees are covered under the contributory retirement plan administered by the State of Colorado. Retirement expense, which is based on salaries paid by the Authority, was $1,052,000 in 1988 and $800,000 in 1987.

Authority employees may accrue vacation and sick leave based on their length of service, subject to certain limitations on the amount which will be paid upon termination. The estimated liability for cumulative accrued vacations and sick leave, which is included in "premium taxes and other liabilities" in the accompanying financial statements, was $541,000 in 1988 and $710,000 in 1987.

Reclassifications: Certain 1987 amounts in the financial statements have been reclassified to conform to the presentation used in 1988.

NOTE 2 - TRANSACTIONS WITH STATE OF COLORADO AGENCIES

The Authority has issued workers' compensation insurance policies to various public agencies of the State of Colorado. Premiums billed to such agencies were $32,289,000 in 1988 and $27,561,000 in 1987. Premiums receivable at December 31, 1988 and 1987 include $1,803,000 and $819,000, respectively, for premiums billed to such agencies.

The Authority pays the Department of Labor and Employment (DOLE) for services DOLE provides to the Authority, and also pays a portion of DOLE costs and other agency statewide indirect costs. The total of these expenses were $1,378,000 in 1988 and $3,231,000 in 1987.

NOTE 3 - REINSURANCE

The Authority purchases reinsurance for risks in excess of its retention limits on workers' compensation insurance written. Should the reinsurer be unable to meet its obligations under the reinsurance contract, the authority would remain liable for amounts ceded to its reinsurer. At December 31, 1988, the Authority had reinsurance coverage for workers' compensation of up to $12 million in excess of its retention of $3 million on business written or renewed subsequent to July 1, 1987. The Authority's coverage had been $10 million in excess of $3 million for business written between July 1, 1985 and July 1, 1987 and $10 million in excess of $2 million for business written prior to July 1, 1985. The reinsurance expense associated with this coverage was $443,000 in 1988 and $460,000 in 1987.

NOTE 4 - CONTINGENCIES

The Authority is a party to various claims and lawsuits which arise in the normal course of business.

During 1984, the Authority received notice of a potential class action and outrageous conduct suit seeking damages of $680 million for the Authority's alleged failure to comply with the Colorado Supreme Court's decision in April 1984 disallowing the Authority to offset social security cost of living increases in determining the amount of workers' compensation benefits to be paid. Based upon the advice of the Colorado Attorney General, the Authority complied with the decision for all open and prospective claims, but not on a retroactive basis. In December 1987, the Colorado Supreme court ruled that such decision was to be applied retroactively. During 1988, the Authority complied with the decision for all claims. No such suit has been filed and management of the Authority believes that the ultimate liability, if any, that may actually result from any such suit will not have a material adverse affect on the Authority's financial position or results of operations.

NOTE 5 - STATUTORY SURPLUS

As a licensed insurer in Colorado, the Authority is required to maintain a minimum surplus of $500,000. At December 31, 1988, the Authority was in compliance with this requirement.

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REPORT OF INDEPENDENT ACCOUNTANTS

April 10, 1989

State Compensation Insurance Authority and
Members of the Legislative Audit Committee

In planning and performing our audit of the statutory financial statements of the State Compensation Insurance Authority (the "Authority") for the year ended December 31, 1988, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the statutory financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. All reportable conditions, as well as other internal accounting matters which came to our attention, are included in the "Findings and Recommendations on Internal Controls and Procedures" section of this report which begins on page 6.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions referred to above is believed to be a material weakness.

This report is intended solely for the information and use of management and members of the Legislative Audit Committee and should not be used for any other purpose. This restriction is not intended to limit distribution of this report which, upon release by the Colorado Legislative Audit Committee, is a matter of public record.

Price Waterhouse