

**COLORADO COMPENSATION
INSURANCE AUTHORITY**

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

DECEMBER 31, 1998 AND 1997

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February 19, 1999

Members of the Legislative Audit
Committee and Board of Directors of the
Colorado Compensation Insurance Authority:

We have completed the financial audit of the Colorado Compensation Insurance Authority (the "Authority") for the year ended December 31, 1998. Except as discussed on page 2 of the audit report digest, our audit was conducted in accordance with generally accepted auditing standards.

We were engaged to conduct our audit pursuant to Colorado Revised Statutes Section 8-45-121(2), which authorizes the State Auditor to retain an auditor or firm of auditors to perform an annual audit of the Authority. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows. Included in the Findings and Recommendation on Internal Controls and Procedures are the responses of the Colorado Compensation Insurance Authority.

Very truly yours,

ARTHUR ANDERSEN LLP

COLORADO COMPENSATION INSURANCE AUTHORITY

AUDITED STATUTORY BASIS FINANCIAL STATEMENTS

DECEMBER 31, 1998 AND 1997

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COLORADO COMPENSATION INSURANCE AUTHORITY

AUDIT REPORT DIGEST

DECEMBER 31, 1998

DESCRIPTION OF COLORADO COMPENSATION INSURANCE AUTHORITY

The Colorado Compensation Insurance Authority ("CCIA" or the "Authority") was established under provisions of the Colorado Compensation Insurance Authority Act (Title 8, Article 45 of the Colorado Revised Statutes, as amended) for the benefit of injured employees and dependents of deceased employees in Colorado. The Authority provides an assured source of workers' compensation insurance to all Colorado employers at the lowest possible cost, consistent with maintaining a solvent Colorado Compensation Insurance Authority Fund.

PURPOSE AND SCOPE OF THE AUDIT

Authority

The authority for this audit comes from Colorado Revised Statutes Section 8-45-121(2) which states in part, "an annual audit of said fund shall be made by an auditor or firm of auditors having the necessary specialized knowledge and experience, retained by the state auditor with the consultation and advice of the manager and commissioner of insurance."

Purpose

The primary purpose of our engagement was to audit the financial statements of the Colorado Compensation Insurance Authority as of and for the year ended December 31, 1998, in accordance with generally accepted auditing standards and to express an opinion on the financial statements and the notes thereto. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

The financial statements of the Authority were prepared in accordance with statutory accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (herein after referred to as "statutory basis" financial statements, or in accordance with "statutory accounting principles"). Accordingly, they are not designed to present, and do not present, the financial position or results of operations in accordance with generally accepted accounting principles.

Our audit included a review of the related system of internal accounting and administrative controls as required by generally accepted auditing standards for the purpose of determining our audit procedures, not to provide assurance on the internal control structure. Our recommendations with respect to internal accounting and administrative controls as well as other matters are found on pages 9 to 20 in this report.

In conjunction with our audit, we also evaluated the progress made by the Authority in implementing the recommendations resulting from our previous audits. Refer to pages 17 to 20 in this report for our findings.

Standards

Except as discussed below, we conducted our audit in accordance with generally accepted auditing standards. When financial statements are prepared in conformity with accounting practices prescribed by a regulatory agency, generally accepted auditing standards require that an auditor's report on them state whether they are presented in conformity with generally accepted accounting principles. The accounting practices used by the Authority to prepare the financial statements vary from generally accepted accounting principles. We did not determine or audit the effects on the Authority's financial statements of the variances between the statutory accounting principles applicable to the Authority and generally accepted accounting principles.

Scope

We examined, on a test basis, evidence supporting the amounts and disclosures in the Authority's financial statements as of December 31, 1998. The accounting practices used by the Authority to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado ("Division of Insurance").

Government Accounting Standards Board ("GASB") Technical Bulletin 98-1, *Disclosures about Year 2000 issues* requires disclosure of certain matters regarding the Year 2000 issue. The Authority has included such disclosures in Note 8 to the financial statements. Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Authority's disclosures with respect to the Year 2000 issue made in Note 8 to the financial statements. Further, we do not provide assurance that the Authority's Year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Authority does business will be Year 2000 ready. As a result of this scope limitation, the American Institute of Certified Public Accountants requires a qualified opinion be issued.

FINANCIAL AUDIT REPORT

We have completed our audit of the Authority's financial statements and have issued our report thereon dated February 19, 1999 which states that the statutory statements of admitted assets, liabilities, and policyholders' deficit of the Authority, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the Year 2000 disclosure, present fairly the admitted assets, liabilities, and policyholders' deficit--statutory basis as of December 31, 1998 and 1997 and that the related statutory statements of operations and changes in policyholders' deficit and cash flows present fairly the results of its operations and cash flows for the years ended December 31, 1998 and 1997.

The accounting practices used by the Authority vary from generally accepted accounting principles as described in footnote 1 of the financial statements. The Authority has not determined the effects on the financial statements of such variances. As the financial statements referred to above do not purport to be a presentation in conformity with generally accepted accounting principles, we are not in a position to express, and do not express, an opinion on the financial

statements referred to above as to fair presentation of financial position, results of operations, or cash flows in conformity with generally accepted accounting principles.

MANAGEMENT JUDGMENTS AND ACCOUNTING ESTIMATES

Generally accepted auditing standards require that the independent accountant communicate to the audit committee or its equivalent, among other items, information regarding accounting estimates which are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The Authority's management has made judgments with respect to certain accounting estimates included in the audited financial statements. The major accounting estimates made by management with respect to the financial statements are summarized below.

Net Realizable Value of Premiums Receivable

Statutory accounting principles require the premium receivable balances be "equal to gross premium or premium deposits in the course of collection for in-force insurance coverage not more than 90 days past due, less commissions due thereon to agents; not exceeding in the aggregate the company's unearned premium reserve liability." In addition, statutory accounting principles require a 10% reserve be established on all earned but unbilled premium receivables. These requirements are not subject to management's judgments and estimates.

Premiums receivable balances must also be assessed for realizability. In connection therewith, management must determine whether an allowance should be established to provide for all reasonably anticipated losses inherent in the premium receivable balances. Factors which are considered in establishing reserves are: loss experience and trends; current overall aging of balances; economic conditions and trends; and evaluations of individual receivables.

In order for Arthur Andersen to satisfy the requirements of generally accepted auditing standards, we performed audit procedures to determine whether the premium receivable balances were reasonably stated at their net realizable value, subject to the statutory reserve requirements. At December 31, 1998, the net stated value of premiums receivable was estimated to be \$1,845,000. The fair market value of net premiums receivable was estimated to be \$5,395,000, net of ceded reinsurance of \$12,647,000.

Earned but Unbilled Premium Receivable

The Authority estimates audit and retrospective rating adjustments based on the prior audit and retrospective premium adjustments, compared with the prior earned premiums for the same policies. This prior year experience is used in projecting estimates for the current period, subject to recent influences such as inflation and other forces. Actuarial techniques must be used to model the prior experience to arrive at the estimates of audit and retrospective premiums. At December 31, 1998, the net unbilled audit premium amount was estimated to be approximately \$10,182,000, and the net retrospective premium was estimated to be approximately \$2,193,000.

Loss and Loss Adjustment Expense

Estimating loss and loss adjustment expense reserves of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance where the ultimate liability to a claimant will not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expense, the Authority retains the actuarial consulting services of Milliman & Robertson, Inc.

Milliman & Robertson, Inc. determined a range of \$551,972,000 to \$674,632,000 to be a reasonable estimate of the discounted liability for unpaid losses and allocated loss adjustment expenses at December 31, 1998. As described in footnote 2 of the financial statements, the Authority has accrued \$616,555,000 which management believes to be a reasonable estimate of discounted future amounts to be paid for claims incurred in 1998 or prior, net of ceded claims of \$66,382,000.

In order for Arthur Andersen to satisfy the requirements of generally accepted auditing standards when a specialist has been utilized, we had a consulting actuary from our staff obtain an understanding of the methods and assumptions used by the specialist to determine whether the findings were suitable to corroborate the representations of management in the financial statements. We concluded that the actuarial methods and assumptions utilized by Milliman & Robertson were reasonable given the uncertainties inherent in the environment. Changes occurring during the last several years impact the reasonable range of unpaid losses and loss adjustment expenses and the ultimate selection of the point estimate for reserves in 1998. These changes are: (1) introduction of cost containment and managed care procedures, including encouragement of early reporting of claims; (2) increased use of lump sum and structured settlements; (3) the introduction of the MIRA Loss Reserving System, an expert system that calculates a case-based reserve based on insured worker characteristics, implemented in July 1996; and (4) the increase in provider contracting through the Authority's preferred provider network, *SelectNet*. These changes tend to adjust the overall characteristics of claims data, which have been taken into account in the actuarial analysis. If the assumptions regarding these changes are too optimistic, the current estimate of reserves will be inadequate.

We believe there is uncertainty with respect to the actuarial process for the following reasons: (1) several significant adjustments have been made to standard actuarial techniques to recognize changes in claim handling and in the state law regarding workers' compensation. If the assumptions regarding these changes are too optimistic, the current estimate of reserves will be inadequate; (2) accurate closing rate information to validate the apparent speed-up in settlements was available for the first time in 1997; and (3) the reserves are discounted, as permitted by Colorado statute, which subjects the general uncertainties associated with projecting reserves to an additional risk of interest rate variability (refer to discussion below relating to statutory discount factor).

Reinsurance

During the year ended December 31, 1998, the Authority entered into a 30% quota share reinsurance agreement for losses up to \$50,000 and an excess of loss reinsurance agreement for losses from \$50,000 to \$500,000. Under the terms of these agreements, the Authority ceded approximately 22% and 19%, respectively, of the adjusted net earned premiums and received a commission on the ceded premium. To assist management in estimating the amount of premiums receivable and loss and loss adjustment expense, the Authority retained the actuarial consulting services of Milliman & Robertson, Inc.

In conjunction with Milliman & Robertson, Inc., the Authority determined the estimated amount of ceded premiums receivable to be approximately \$12,647,000 and the ceded unpaid loss and allocated loss adjustment expense to be approximately \$66,382,000. We again utilized the services of a consulting actuary from our staff to obtain an understanding of the methods and assumptions used by the Milliman & Robertson, Inc. to corroborate the actuarial methods used by Milliman & Robertson, Inc. and the representations made by management. We concluded that the actuarial methods used by Milliman & Robertson, Inc. and the representations made by management were reasonable given the uncertainties inherent in determining such estimates.

Statutory Discount Factor

Another estimate used by the Authority in the preparation of its financial statements is the statutory discount factor applied in the determination of the liability for unpaid losses and loss adjustment expenses. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. While State Law allows the use of a discount factor of up to 6%, the Authority discounted its actuarially determined unpaid balances by a factor of 4.25% and 5% in 1998 and 1997, respectively. The change in the statutory discount increased the reserves by approximately \$23.5 million on an absolute basis. The statutory discount was reduced due to a realized reduction in the Authority's investment yield.

SUMMARY OF KEY FINANCIAL INFORMATION

The following highlights some of the key financial information extracted from the financial statements. All information is presented in millions.

	<u>December 31,</u>	
	<u>1998</u>	<u>1997</u>
Investments	\$683	\$757
Other Assets	26	38
	----	----
Total Admitted Assets	<u>\$709</u>	<u>\$795</u>
Total Liabilities	\$716	\$826
Policyholders' Deficit	(7)	(31)
	----	----
Total Liabilities and Policyholders' Deficit	<u>\$709</u>	<u>\$795</u>

	Year Ended December 31,	
	1998	1997
Premiums Earned	\$ 176	\$ 243
Underwriting Expenses	(205)	(279)
Other Gains and Losses	53	52
	----	----
Net Income	\$ <u>24</u>	\$ <u>16</u>

This information should be read in conjunction with the audited financial statements and notes thereto appearing on pages 23 to 36 of this report.

REQUIRED COMMUNICATIONS TO THE LEGISLATIVE AUDIT COMMITTEE

In accordance with Statement on Auditing Standards (“SAS”) No. 61, *Communication with Audit Committees*, we must communicate to the Audit Committee or its equivalent certain matters noted during our audit. The following sets forth these required communications pursuant to SAS No. 61:

1. **Material errors, material irregularities or possible material illegal acts.**

In connection with our audit, we noted no material errors, irregularities or possible material illegal acts.

2. **Material weaknesses in internal accounting control.**

In connection with our 1998 audit, we noted no material weaknesses in internal accounting control.

3. Situations involving the **adoption of, or change in, an accounting principle** where the application of alternative principles would have a material effect on the financial statements.

There were no changes in accounting principles in 1998, however, the Authority adopted the required accounting principles to account for the reinsurance transaction more fully discussed in Note 6 to the financial statements.

4. Accounting and disclosure decisions with respect to **transactions that are unusual in nature** and have a material effect on the financial statements.

As more fully discussed in Note 2 to the financial statements and pages 2 through 5 of this Digest, the Authority decreased the statutory discount factor used in the determination of the liability for unpaid losses and loss adjustment expense from 5% to 4.25%. State law allows the use of a discount factor up to 6%.

Also, as more fully discussed in Note 6 to the financial statements and pages 2 through 5 of this Digest, the Authority entered into a 30% quota share reinsurance agreement for losses up to \$50,000 and an excess of loss reinsurance agreement for losses from \$50,000 to \$500,000.

5. Accounting and disclosure considerations associated with **material contingencies** together with the nature and reasonableness of the underlying assumptions and **estimates** of management.

We have reviewed, as part of our normal audit procedures, information regarding management's formulation of accounting estimates and have concluded that the estimates are reasonable in the context of the financial statements taken as a whole. See further discussion at pages 2 through 5 of this Digest and Note 8 to the financial statements in regards to the contingencies surrounding year 2000.

6. **Significant Audit Adjustments.**

There were audit adjustments resulting from our 1998 audit that, in aggregate, had an immaterial effect on net income and policyholders' deficit.

7. The nature of **disagreements with management** on financial accounting and reporting matters and auditing procedures, **whether or not satisfactorily resolved**, over any matters that individually or in the aggregate could be significant to the financial statements.

We had no significant disagreements with management on financial accounting and reporting matters in connection with the 1998 audit. All accounting and reporting matters discussed with management were satisfactorily resolved.

8. Opinions obtained by management from **other independent accountants** on the application of accounting principles that would affect the financial statements or the type of opinion that may be rendered on the financial statements.

We are not aware of any consultations of management with other accountants during 1998 with respect to accounting principles or the type of opinion rendered in connection with our audit.

9. Major issues discussed with management in connection with our **retention as auditors**.

There were no issues discussed with management relating to the application of accounting principles or auditing standards in connection with our retention as auditors.

10. **Serious difficulties** encountered in dealing with management related to the performance of the audit.

We encountered no difficulties working with management.

ANNUAL STATEMENT

In addition, we have reviewed the annual statement of the Authority for the year ended December 31, 1998, which was filed with the Division of Insurance. There were no reconciling items reflected in the annual statement to the amounts reflected in the statement of operations of the audited financial statements.

INTERNAL ACCOUNTING CONTROL STRUCTURE

In planning and performing our audit of the financial statements, it is our responsibility to perform certain limited procedures with respect to the Authority's internal control structure. The Report of Independent Public Accountants on Internal Accounting Control on page 37 of this report sets forth limitations inherent in such a review.

Findings and Recommendations on Internal Control and Procedures

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.

RECOMMENDATION LOCATOR

<u>Rec. No.</u>	<u>Page No.</u>	<u>Recommendation Summary</u>	<u>Authority Response</u>	<u>Implementation Date</u>
Current Year Recommendations				
1.	10	Improve the Quality of the Claims Processing Function	Agree	February 1, 1999
2.	11	Reconcile Outstanding Warrants on a Timely Basis	Agree	March 1, 1999
3.	11	Reconcile Claim Payments Between the Claims Payment System and the General Ledger	Agree	March 31, 1999
4.	12	Implement Claims Lag Cell Reconciliation Procedures	Agree	March 31, 1999
5.	13	Design and Implement New Medical Payments System	Agree	July 1, 1999
Prior Year Recommendations Repeated in Current Year				
6.	14	Manage Change in Employee Culture and Implement Performance Measures	Agree	January 1, 1999
7.	15	Review Year 2000 Transaction Implications	Agree	January 1, 2000

FINDINGS AND RECOMMENDATIONS ON INTERNAL CONTROLS AND PROCEDURES

1. IMPROVE THE QUALITY OF THE CLAIMS PROCESSING FUNCTION

Due to issues noted during our 1995 fieldwork associated with the claims processing, the scope of our testing in this area was expanded for the 1995 and subsequent audits. The error rate in 1995 was approximately 8%. During 1996 the error rate decreased slightly to approximately 7%. During 1997, substantial improvements were realized and the error rate decreased to approximately 3%. However, during our 1998 testing, we noted a significant increase in the number of claims which were processed with errors, especially in the first three quarters of 1998. The two basic issues identified in connection with this testing were: (1) incorrect payment amounts and (2) inconsistencies in the documentation included in the claim files. Based on statistical analysis, it was determined that the financial impact of these errors was immaterial, however an absolute processing error rate of approximately 10% for the first three quarters of 1998 was identified. The Authority implemented processing improvements in the fourth quarter of 1998 which decreased the overall error rate for the year to 8%.

The issues identified which resulted in incorrect payment amounts included improper calculations, processing errors in determining medical procedure codes, misapplication of the hospital conversion factors and issuing manual warrants which caused double payment. The issues resulting in inconsistencies in the documentation included in the claims files, but having no impact on the claims payment amount, included input errors, missing supporting documentation, adjusters bypassing controls within payment system and inconsistent reporting by claimants/policyholders (primarily incorrect Social Security numbers which is a critical data element to the claims file).

While there will always be some errors associated with the processing of claims payments, the current error rate of the Authority needs to be improved as the error rate has significantly increased over prior years testing. These exceptions in the processing of claims affect the Authority in many ways. Not only have the claims been improperly paid, but the Authority's reputation can also be affected. In addition, they can affect the actuarial estimates as this data is an integral component used in determining the loss reserves. However, the results of the 1998 testing ultimately did not have an impact on the actuarial valuation.

RECOMMENDATION

We recommend the Authority continue to review and enhance their current procedures for processing claims with emphasis on maintaining proper supporting information for the claim. In addition, we recommend manual reviews of claims processed continue until the error rate is reduced.

MANAGEMENT RESPONSE

We agree. Our improvement thrust in this area is two pronged:

First, we have initiated a "quality improvement initiative" to improve the quality of documentation and input at the initial contact point. The primary responsibility for this rests with the claims adjusters and related team members. This has been implemented effective March 1, 1999.

The second area of emphasis relates to the post-processing review audit done by our internal claims specialist. This post-processing review and audit is designed as an improvement tool and also a method to test for consistency across various processing units. This will also be utilized to develop a training needs assessment to be utilized as future training is designed. This has been implemented effective February 1, 1999.

2. **RECONCILE OUTSTANDING WARRANTS ON A TIMELY BASIS**

The Authority places significant reliance on interfaces with their financial institutions to reconcile their outstanding warrants account. These interfaces download information indicating the warrants that cleared the bank during the time period to the Authority's claims payments system ("WCIS"). In turn, WCIS updates the general ledger system with the cleared warrants. A journal entry is then generated within the general ledger to remove these warrants from the outstanding warrants account and reduce the respective cash account. During 1998, the Authority began experiencing problems with the bank's interface as EDI transmissions were not occurring on a timely basis and the transmissions were not all-inclusive of the cleared warrants. The Authority appropriately worked with the bank to resolve the issue, but was unable to solve it by December 31, 1998. Due to this problem, the Authority was required to manually reconcile the outstanding warrants in order to present the obligation correctly.

RECOMMENDATION

We recommend the Authority resolve the EDI problems identified with the bank and establish protocols which the bank must adhere to in order to avoid this issue in the future. In addition, we recommend reconciliations be performed on a timely basis so as to detect errors with the interface between the financial institutions, WCIS and the general ledger.

MANAGEMENT RESPONSE

We agree. We have resolved the EDI issues with the bank and are now receiving the data on a timely basis. As the EDI is received, the reconciliation process is also being performed in a timely manner.

3. **RECONCILE CLAIM PAYMENTS BETWEEN THE CLAIMS PAYMENT SYSTEM AND THE GENERAL LEDGER**

Since the implementation of WCIS in 1997, the Authority has not periodically reconciled the claim payments recorded in the general ledger to the claim payments recorded in the WCIS system. The WCIS system is the Authority's repository for all policyholder and claim information and handles approximately 600,000 transactions per year while the general ledger is the repository for company-wide financial information. Both systems are critical to the proper management of the Authority. Claim payments are initiated in the WCIS system, and then transferred nightly to the general ledger for recording in the Authority's financial records. The transactions are transferred to the general ledger based on a transaction mapping which was formulated during the implementation of WCIS and should be periodically updated if new transaction types are developed in the WCIS system. The original mapping was tested

during implementation, and was found to be accurate, but subsequent testing and reconciliations to the general ledger have not been performed. This presents a risk that not all transactions initiated in the WCIS system are properly being recorded in the Authority's general ledger or identified through a reconciliations process.

RECOMMENDATION

We recommend the Authority periodically reconcile the claims information recorded on the general ledger to the claims information on the WCIS system. This process will enhance the internal controls of the Authority and provide an added level of assurance that all financial transactions initiated on the WCIS system are properly being captured in the Authority's general ledger for inclusion in the financial records.

MANAGEMENT RESPONSE

We agree. Effective March 3, 1999, we have implemented a Financial Transaction Reconciliation System ("FTRS") that reconciles all transactions to specific claim numbers thus enabling us to be assured that all WCIS system transactions are properly accounted for in the general ledger and included correctly in the financial records.

4. IMPLEMENT CLAIMS LAG CELL RECONCILIATION PROCEDURES

The Authority has not reconciled the information provided by its actuary to the information contained in the claims system by lag cell. Lag cells are used to develop accident year information, a requirement with the Authority's annual filing with the Colorado Division of Insurance. The process of periodically reconciling selected lag cells from the actuary report to the information managed by the Authority would provide for an additional internal quality control check to verify that the information provided to the actuary is being accumulated properly and reported as stored on the Authority's claims systems. It could also provide insight into the manner in which the information is being reported and ultimately processed by the actuary.

RECOMMENDATION

We recommend the Authority implement procedures whereby random lag cells are reconciled to the information contained in the Authority's claims system on a quarterly basis. This process will enhance the internal controls over the management of claims information and the development of the Authority's loss reserves as described above.

MANAGEMENT RESPONSE

We agree. The process described in #3 above will enable us to reconcile detail transactions to specific claim numbers and specific claim numbers to lag cells used for reserves development. We have implemented a process to randomly select a test population of lag cells each quarter to validate this accumulation process.

5. **DESIGN AND IMPLEMENT NEW MEDICAL PAYMENTS SYSTEM**

During the 1997 audit, we made several recommendations regarding the functionality of the Authority's medical payments system. The recommendations included the following:

- Implement automated edit checks in the medical payments system
- Reduce the level of manual intervention required in the medical payments system
- Capture all discounts associated with the preferred provider network
- Improve access controls to the medical payments system

These recommendations were to be resolved in August 1998 when the Authority planned to implement a proprietary medical payments system. As of December 31, 1998, the Authority has not been successful in implementing the new medical payments system and has encountered several obstacles during the design phase. Due to the delays and the problems encountered with the previous system, the medical payments have been outsourced to a third party administrator thus increasing the cost of processing medical claims and further complicating the payment process.

The implementation of a quality, reliable medical payments system is critical to the Authority's operations and cost control. Without such a system, the Authority is dependent upon others to perform many of the tasks that could be performed in-house at a reduced cost and is susceptible to another entities processing constraints.

RECOMMENDATION

We recommend the Authority take the appropriate measures to complete the design and implementation of the new medical payments system as soon as possible or begin to research the purchase of a third party system which will accommodate the Authority's needs.

MANAGEMENT RESPONSE

We agree. We have installed strict project management of this project with executive oversight since January of 1999. We are now on track for a second quarter 1999 phase implementation.

The following recommendations were reported to the Legislative Audit Committee in connection with our December 31, 1997 report. These recommendations were not fully implemented and thus have been modified and are repeated herein.

6. **MANAGE CHANGE IN EMPLOYEE CULTURE AND IMPLEMENT PERFORMANCE MEASURES**

The Authority has undergone significant change internally recently. In 1996, the Authority implemented a new provider network, *SelectNet*, moved the claims processing department from a functional, hierarchical culture to a team oriented, process culture. In 1997, the Authority successfully implemented WCIS and completed a restructuring of their entire workforce. All of these changes are being made in order to make the Authority a more productive efficient provider of insurance benefits to its policyholders. We feel these are all positive steps to making the Authority more competitive in the current marketplace, and should prove beneficial over the next several years. While these changes look at the overall structure of the Authority, the implementation and personnel issues have not kept pace with the change. In particular, in order to maintain lasting change in the Authority, there must be a continual review of compensation and benefits for employees to better motivate them. There must also be specific performance measures set for these employees so that they are aware of the expectations the Authority has after the change. The current incentive program focuses on the whole organization and not on specific areas which would motivate individuals.

A report from the Hay Group, Inc., *The Hay Report: Compensation and Benefits Strategies for 1995 and Beyond*, suggests that the best companies typically follow eight steps to reengineer their compensation and benefit packages to employees when implementing strategic changes to the overall organization:

1. Understand the company's current operations, culture and compensation programs.
2. Picture where the company is going.
3. Reengineer the culture, processes, and compensation programs to allow the company to reach its vision.
4. Align the compensation programs with the culture and strategic goals.
5. Integrate compensation strategies with broader business strategies.
6. Lead the organization through the change process.
7. Communicate the reasons for the changes being made, as well as the details.
8. Continually refine compensation programs according to the company's changing needs.

These steps are meant to guide the implementation of change and to have employee commitment to the change before it happens. As compensation is one of the most effective change levers the Authority possesses, it should be a central focus of implementing these changes. This includes moving to incentive programs that are focused not only on the overall goals of the Authority, but also specific team oriented goals and performance. The performance measures must be communicated to each employee so that they are aware of the expectations of the Authority. Performance measures should be implemented on a team by team basis that focuses on the individual team performance, but is meant to achieve the overall goals of the Authority. Incorporating the performance measures into the employees overall compensation package is typically handled by the human resources function in conjunction with the appropriate team leader and should be reviewed on a frequent basis to make sure the measures are reasonable and fair.

RECOMMENDATION

Management is currently moving to address several of these issues. In an effort to address these issues, we recommend management focus their efforts on the individual employee's and teams contribution to the Authority, instead of the organization's progress as a whole.

MANAGEMENT RESPONSE

We agree. CCIA has implemented a Gainsharing Incentive Plan. Gainsharing will greatly improve employees' "line of sight" by linking award payouts to team performance. Team performance measures, short-term and long-term, will be linked with corporate objectives.

7. **REVIEW YEAR 2000 TRANSACTION IMPLICATIONS**

Many computer applications are based on a two-digit year and never considered the change to a four-digit year in 2000. As the year 2000 approaches, companies are beginning to update their computer systems to handle the transition to a four-digit year. This can potentially be a significant expense for companies that have in-house developed or modified vendor software. Programs, data files, system interfaces, electronic and written reports, networks and hardware can cause problems for functions that use or calculate dates, times and ages. Upgrading will involve, in many cases, the replacement of systems and/or extensive reprogramming. The Authority has begun their review and testing process and has represented that no significant issues have been identified to date. Although the Authority does not have a formal contingency plan with respect to Year 2000 issues, it expects to identify and resolve all Year 2000 issues that could materially affect its business operations and develop a plan in the first half of 1999. However, it may not be possible to determine with complete certainty that all Year 2000 issues will be identified or corrected in time or that Year 2000 problems will not impair the Authority's ability to perform critical business operations, limit access to critical data, cause the Authority to manually process information, or incur material expenses in responding to such problems or otherwise have a material adverse effect on the Authority's business, financial condition and results of operations. To the extent that such software and systems do not comply with Year 2000 requirements, the Authority's potential inability to meet its contractual obligations or the cost necessary to update such systems may have a material effect on the Authority's business, financial condition and results of operations.

RECOMMENDATION

"Year 2000" may not be an issue for the Authority as they have not identified any key problems in their initial review or testing phase. We recommend the Authority continue its review and testing of all systems to determine if they properly handle the Year 2000 problems identified above.

MANAGEMENT RESPONSE

We agree. We will continue the review of existing systems and third party exposure to determine the extent of the Year 2000 risk. Once our risk has been determined, if significant, we will develop an action plan to address identified problems.

SUMMARY OF PROGRESS IN IMPLEMENTING PRIOR AUDIT RECOMMENDATIONS

The disposition of prior audit recommendations as of February 19, 1999 was:

Implemented	5
Partially Implemented	9
Not Implemented	7

Total	<u>21</u>

Additional discussion regarding the status of prior audit recommendations is contained at pages 17 to 20 of this report.

COLORADO COMPENSATION INSURANCE AUTHORITY

DISPOSITION OF PRIOR YEAR RECOMMENDATIONS

Listed below are the recommendations included in the audit report of Arthur Andersen L.L.P. dated February 20, 1998, and the disposition or other status of such items as of February 19, 1999.

Recommendation	Implemen ted	Partially Impleme d	Not Impleme nted	Comments
1. Improve accuracy of open and closed claim data.		X		The Authority has redesigned WCIS to take proper action to open/close files upon the input of certain legal codes. This control is expected to be fully functional during the second quarter of 1999.
2. Consolidate multiple expenditures to a common medical provider into a single payment.			X	The Authority is currently in the process of designing and building a new medical payment system that will allow for the pooling of multiple provider payments.
3. Develop a method to quantify overpaid compensation, dedicate resources to collect overpayments, and investigate whether a claimant is eligible for and/or receiving offsetting disability benefits.		X		The Authority's benefits and data processing personnel review current "alerts" on the system for overpayments. Data retrieval programs are used to produce periodic reports of temporary total disability claims greater than 18 months old. These claims are reviewed to ensure they have been handled in accordance with departmental policies.

Recommendation	Implemen ted X	Partially Implemen ted X	Not Implemen ted X	Comments
4. Improve filing system for medical bills.	X			During 1998, the Authority developed a labeling system for all incoming medical bills that has facilitated the tracking of bills once in its offices.
5. Enhance the Claims Processing Function.			X	See current year recommendation 1.
6. Update important general ledger accounts monthly, including changes in the judgmental accounts.		X		Adjusting entries are now being recorded in the general ledger monthly. However, certain accounts are not properly recorded on an interim basis.
7. Develop and maintain a policies and procedures manual covering the Financial Services Department's Financial and Internal Controls.		X		The Authority has documented many job functions, corresponding responsibilities and routine accounting procedures, but the manual is not complete.
8. Number medical bills received by the Authority and implement tracking system to match numbered bills with related claims.	X			During 1998, the Authority developed a labeling system for all incoming medical bills that has facilitated the tracking of bills once in its offices.
9. Improve management of premiums receivable and collections. a. Take a proactive approach to managing premiums receivable by identifying performance measures and setting goals for collections and reduction in the amount of uncollectible accounts.	X			The Authority has implemented performance measures and set goals as part of the change in its employee culture.
10. Manage increased availability of data by producing reports which provide key statistics and financial ratios which decision makers can use in their day-to-day tasks.	X			The Authority has developed reports and access tools for employees to monitor the status of the business.
11. Manage change in employee culture.		X		See current year recommendation 6.

Recommendation	Implemen ted	Partially Implemen ted	Not Implemen ted X	Comments
12. Analyze per diem reimbursements versus discounted fees for service contracts.			X	No longer applicable. The statutory fee schedule currently mandates the per diem method of hospital reimbursement and when and how it is to be used.
13. Review year 2000 transaction implications.		X		See current year recommendation 7.
14. Effectively use the accounts payable system to track invoices as received or as known liabilities are incurred.		X		The Authority's Finance staff has been tasked with learning how to use the Lawson accounts payable software to its fullest extent and is in the process of implementing these enhancements.
15. Implement automated edit checks in the medical payment system.			X	The Authority is currently in the process of designing and building a new medical payment system that will allow for automated edit checks. See current year recommendation 5.
16. Reduce the level of manual intervention required in the medical payment system.			X	The Authority is currently in the process of designing and building a new medical payment system that will reduce the level of manual intervention required. See current year recommendation 5.
17. Capture all discounts associated with the preferred provider network.			X	The Authority is currently in the process of designing and building a new medical payment system that will capture all discounts associated with the preferred provider network. See current year recommendation 5.
18. Enhance the utilization management process to include a higher standard of professional medical oversight.	X			The Authority has developed a panel of community experts to assist with this oversight function.

Recommendation	Implemented	Partially Implemented	Not Implemented	Comments
19. Redesign the close-the-books process to improve the efficiency and effectiveness of closing the books and the finance function itself.		X		Improvements in closing the books have been made, however, the Authority is continually looking for ways to further improve the process.
20. Improve access controls to the medical payment and Lawson software systems.		X		The Authority is currently in the process of designing and building a new medical payment system that will capture all discounts associated with the preferred provider network. See current year recommendation 5. Access improvements to the Lawson system have been implemented.
21. Implement the new reporting rules from the NAIC regarding allocated and unallocated loss adjustment expense.			X	The Authority has been capturing the data during the year and will be compliant as to application to specific claims by the beginning of the third quarter.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

Members of the Colorado Legislative Audit
Committee and Board of Directors of the
Colorado Compensation Insurance Authority:

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' deficit of the Colorado Compensation Insurance Authority (the "Authority") as of December 31, 1998 and 1997, and the related statutory statements of operations and changes in policyholders' deficit, and cash flows for the years 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 audits.

Except as discussed in the following paragraphs, we conducted our audits 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 audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the Year 2000 issue. The Authority has included such disclosures in Note 8. Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Authority's disclosures with respect to the Year 2000 issue made in Note 8. Further, we do not provide assurance that the Authority's Year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Authority does business will be Year 2000 ready.

As described more fully in Note 1 to the financial statements, 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 ("statutory basis"), which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding Year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' deficit of Colorado Compensation Insurance Authority as of December 31, 1998 and 1997, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 1.

This report is intended solely for the information and use of the Members of the Colorado Legislative Audit Committee, the Board of Directors and the management of the Authority and for filing with state insurance departments to whose jurisdiction the Authority is subject and should not be used for any other purpose.

ARTHUR ANDERSEN LLP

Denver, Colorado,
February 19, 1999.

COLORADO COMPENSATION INSURANCE AUTHORITY
STATUTORY STATEMENTS OF ADMITTED ASSETS,
LIABILITIES AND POLICYHOLDERS' DEFICIT
AS OF DECEMBER 31, 1998 AND 1997

(In thousands)

<u>ASSETS</u>	<u>1998</u>	<u>1997</u>
ADMITTED ASSETS:		
Investments-		
Bonds, at amortized cost (Note 3)	\$663,967	\$744,401
Cash on hand and on deposit	18,608	12,279
	-----	-----
Total investments	682,575	756,680
Premiums receivable, net of allowance for uncollectible and non-admitted balances of \$12,219 and \$14,889 in 1998 and 1997, respectively	14,492	16,160
Less- Ceded reinsurance (Note 6)	(12,647)	-
	-----	-----
Net premiums receivable	1,845	16,160
Electronic data processing equipment, net of accumulated depreciation of \$10,365 and \$8,560 in 1998 and 1997, respectively	2,264	1,601
Interest receivable	9,884	11,425
Other assets, net of accumulated depreciation and non-admitted balances of \$7,629 and \$7,048 in 1998 and 1997, respectively (Note 1)	-	-
Earned but unbilled premiums	12,375	8,883
	-----	-----
	<u>\$708,943</u>	<u>\$794,749</u>
 <u>LIABILITIES AND POLICYHOLDERS' DEFICIT</u> 		
LIABILITIES:		
Unpaid losses and allocated loss adjustment expenses (Note 2)	\$616,555	\$720,400
Unpaid unallocated loss adjustment expenses (Note 2)	23,608	28,264
Premium taxes and other liabilities	25,801	28,801
Unearned premiums	44,680	43,906
Policyholders' deposits	2,050	-
Overpaid premiums	3,289	4,459
	-----	-----
Total liabilities	715,983	825,830
COMMITMENTS AND CONTINGENCIES (Notes 7 and 8)		
POLICYHOLDERS' DEFICIT (Note 2)	(7,040)	(31,081)
	-----	-----
	<u>\$708,943</u>	<u>\$794,749</u>

The accompanying notes to financial statements are
an integral part of these statements.

COLORADO COMPENSATION INSURANCE AUTHORITY

STATUTORY STATEMENTS OF OPERATIONS AND

CHANGES IN POLICYHOLDERS' DEFICIT

FOR THE YEARS ENDED DECEMBER 31, 1998 AND 1997

(In thousands)

	<u>1998</u>	<u>1997</u>
PREMIUMS EARNED (Note 6)	\$ 176,435	\$243,170
UNDERWRITING EXPENSES:		
<i>Losses incurred</i>	157,500	210,725
<i>Loss adjustment expenses</i>	22,017	29,723
<i>Other underwriting expenses</i>	25,405	38,144
	-----	-----
<i>Total underwriting expenses</i>	204,922	278,592
	-----	-----
<i>Underwriting loss</i>	(28,487)	(35,422)
NET INVESTMENT INCOME	52,046	56,266
NET REALIZED GAIN ON INVESTMENTS	6,674	2,187
PROVISION FOR UNCOLLECTIBLE PREMIUMS	(6,577)	(7,934)
OTHER GAINS	598	991
	-----	-----
<i>Net income</i>	24,254	16,088
(INCREASE) DECREASE IN NON-ADMITTED ASSETS	(213)	330
POLICYHOLDERS' DEFICIT AT BEGINNING OF YEAR	(31,081)	(47,499)
	-----	-----
POLICYHOLDERS' DEFICIT AT END OF YEAR	<u>\$ (7,040)</u>	<u>\$ (31,081)</u>

*The accompanying notes to financial statements are
an integral part of these statements.*

COLORADO COMPENSATION INSURANCE AUTHORITY
STATUTORY STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 1998 AND 1997
(In thousands)

	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
<i>Net income</i>	\$ 24,254	\$ 16,088
<i>Adjustments to reconcile net income to net cash used in operating activities-</i>		
<i>Depreciation</i>	2,211	2,241
<i>Provision for uncollectible premiums</i>	6,577	7,934
<i>Amortization of bond discount and premium</i>	(2,141)	(1,843)
<i>Net gain on sales of investments</i>	(6,674)	(2,187)
<i>Other changes in assets and liabilities-</i>		
<i>Decrease in premiums receivable</i>	7,483	2,841
<i>Decrease (increase) in interest receivable</i>	1,541	(22)
<i>Increase in other assets</i>	(364)	(160)
<i>(Increase) decrease in earned but unbilled premiums</i>	(3,492)	5,157
<i>Decrease in unpaid losses</i>	(103,845)	(53,000)
<i>Decrease in underwriting loss adjustment expense</i>	(4,656)	-
<i>Decrease in premium taxes and other liabilities</i>	(3,000)	(3,290)
<i>Increase (decrease) in unearned premiums</i>	774	(5,675)
<i>Increase (decrease) in policyholders' deposits</i>	2,050	(11,958)
<i>Decrease in overpaid premiums</i>	(1,170)	(409)
	-----	-----
<i>Total adjustments</i>	(104,706)	(60,371)
	-----	-----
<i>Net cash used in operating activities</i>	(80,452)	(44,283)
	-----	-----
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
<i>Purchase of electronic data processing equipment</i>	(2,468)	(192)
	-----	-----
<i>Net cash used for capital and related financing activities</i>	(2,468)	(192)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
<i>Proceeds from sale or redemption of bonds</i>	176,382	193,076
<i>Purchase of bonds</i>	(87,133)	(154,849)
	-----	-----
<i>Net cash provided by investing activities</i>	89,249	38,227
	-----	-----
NET INCREASE (DECREASE) IN CASH ON HAND AND ON DEPOSIT	6,329	(6,248)
CASH ON HAND AND ON DEPOSIT, beginning of year	12,279	18,527
	-----	-----
CASH ON HAND AND ON DEPOSIT, end of year	<u>\$ 18,608</u>	<u>\$ 12,279</u>

The accompanying notes to financial statements are an integral part of these statements.

COLORADO COMPENSATION INSURANCE AUTHORITY

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 1998 AND 1997

(1) ORGANIZATION, BASIS OF PRESENTATION
AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Colorado Compensation Insurance Authority (the "Authority") was established under provisions of the Workers' Compensation Act of Colorado (Title 8, Article 45 of the Colorado Revised Statutes [CRS], as amended) for the benefit of injured employees and dependents of deceased employees. The Authority provides insurance to employers operating within the State of Colorado (the "State") not otherwise insured through private carriers or self-insurance.

The Authority is controlled by a Governor-appointed, seven-member Board of Directors, in accordance with the applicable statutes of the State, with administration under the direction of the President. The State retains no liability on the part of the Authority, beyond the amount of any Authority surplus, and no State monies are used for Authority operations.

Basis of Presentation

The financial statements have been prepared on a comprehensive basis of accounting ("statutory accounting principles") prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State ("Division of Insurance"). Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners ("NAIC"), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. Such basis of accounting varies from generally accepted accounting principles in that non-current assets such as furniture and equipment, which are unavailable for the benefit of claimants, are non-admissible assets and, accordingly, are charged against policyholders' deficit; premiums receivable outstanding over 90 days which are determined to be collectible are non-admissible assets and are charged against policyholders' deficit; investments are accounted for at amortized cost rather than at fair market value; premium taxes are expensed during the period in which the related premiums are written rather than deferred and amortized over the related policy period; and reserves for future benefit payments are discounted at the statutory rate of 4.25% and 5% for the years ended December 31, 1998 and 1997, respectively. These statutes allow reserves to be discounted at a rate of up to 6%.

Use of Estimates in Preparation of Financial Statements

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

Basis of Valuation of Invested Assets

Investments

Investments in bonds are stated at amortized cost. Amortization is calculated using the effective interest method. Investment securities are held in custody by the Department of Treasury of the State and are registered in the Authority's name.

Statutes authorize the State Treasurer to invest the Authority's funds in deposits held at banks or savings and loan associations authorized to do business in the State, obligations of the U.S. Treasury and U.S. agencies, bankers' acceptances, repurchase agreements, commercial paper of prime quality, and certain high quality corporate notes and asset-backed securities.

Cash on Hand and on Deposit

Cash on hand and on deposit is held in custody by the Department of Treasury of the State and in depository accounts held by a single financial institution. Cash on hand and on deposit consists primarily of unrestricted deposits in interest-bearing accounts.

	<u>December 31, 1998</u>		<u>December 31, 1997</u>	
	<u>Carrying Amount</u>	<u>Bank Balance</u>	<u>Carrying Amount</u>	<u>Bank Balance</u>
	(In thousands)			
Insured (FDIC)	\$ 100	\$ 100	\$ 100	\$ 100
Uninsured 1,708	3,330	676	788	
State of Colorado, Treasury Cash Pool	16,800	15,272	11,503	11,921
	-----	-----	-----	-----
Total cash on hand and on deposit	<u>\$ 18,608</u>	<u>\$18,702</u>	<u>\$12,279</u>	<u>\$12,809</u>

Cash is reported at gross amounts with outstanding warrants reflected as a liability on the statutory statements of admitted assets, liabilities, and policyholders' deficit. At December 31, 1998 and 1997, the Authority had approximately \$6,216,000 and \$9,000,000, respectively, of outstanding warrants included in premium taxes and other liabilities.

Recognition of Premium Revenue

Premiums are recognized as earned on a pro rata basis over the period of coverage provided.

Premiums Receivable

Premiums receivable is reported net of allowances for uncollectible and non-admitted balances. Certain receivables are not admissible for statutory accounting purposes. These include receivables on canceled policies, billed receivables that have been outstanding for a period exceeding 90 days, and 10% of any remaining estimated receivable balances. The Authority independently estimates the ultimate realizable amounts of premiums receivable and establishes an allowance for uncollectible premiums for the difference between the gross receivable amount and the estimate of the amount to be ultimately realized. The Authority also establishes an additional allowance for non-admitted receivables for the amount by which non-admissible receivables, as defined above, exceeds the estimate of uncollectible receivables. At December 31, 1998 and 1997, the fair value of net premiums receivable was approximately \$5,395,000 and \$19,456,000, respectively.

During 1998 and 1997, the Authority made a provision or wrote off a total of \$6,577,000 and \$7,934,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of the Authority's premiums receivable balances at December 31, 1998 and 1997 were from companies operating in the construction industry in Colorado.

Audit and Retrospective Premiums

Audit and retrospective premiums represent amounts due from policyholders after the respective policy period has expired based either on audits performed by the Authority or the paid loss history of the policyholder. For 1998 and 1997, estimated unbilled audit premiums receivable of \$10,182,000 and \$8,061,000, respectively, and estimated unbilled retrospective premiums of \$2,193,000 and \$822,000, respectively, are included as earned but unbilled premiums.

Electronic Data Processing Equipment

Electronic data processing equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years.

Software Development Costs

In 1997, the Authority completed the development of a customized software program to be used in its daily operations. The cost of approximately \$2.9 million incurred in 1997 to develop this software was expensed as incurred and is included in other underwriting expenses on the statutory statements of operations and changes in policyholders' deficit.

Office Furniture and Equipment

Office furniture and equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. For statutory reporting, these are non-admitted assets. The net book value of these assets at December 31, 1998 and 1997 was \$333,000 and \$532,000, respectively.

Other Assets

At December 31, 1998 and 1997, the Authority had a \$1,000,000 certificate of deposit pledged as security pursuant to a letter of credit underlying the Authority's non-cancelable building lease (see Note 7). In accordance with the terms of the lease, the letter of credit would be drawn upon only in the event of the Authority's default on its existing lease obligations. The certificate of deposit is reported as a non-admitted asset.

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. No dividends were declared from surplus in 1998 or 1997.

Unearned Premiums

Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, but unearned at that date as they pertain to subsequent year policy periods.

Subrogation

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

Reinsurance

Reinsurance premiums are reflected as a reduction of premiums earned (see Note 6).

Taxes

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

Employee Benefits

All Authority employees are covered under the contributory retirement plan administered by the Public Employees' Retirement Association of Colorado. Retirement expense, which is based on salaries paid by the Authority, was \$2,098,000 and \$2,362,000 in 1998 and 1997, respectively.

Authority employees may accrue paid time off based on their length of service, subject to certain limitations on the amount which will be paid upon termination. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of \$1,224,000 and \$1,371,000 at December 31, 1998 and 1997, respectively, is included in premium taxes and other liabilities in the accompanying financial statements.

New Accounting Pronouncements

The National Association of Insurance Commissioners has codified statutory accounting principles that the Authority will be required to adopt on January 1, 2001. Management has not yet determined the impact of adopting these new statements of statutory accounting principles on the Authority's statutory statement of admitted assets, liabilities and policyholders' deficit or statutory statement of operations and changes in policyholders' deficit.

Reclassifications

Certain reclassifications have been made to the prior year statements to conform to the current year presentation.

(2) UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent actuarially derived estimates of the ultimate net cost of all losses and loss adjustment expenses which are incurred but unpaid at year end. The reserves for loss and loss adjustment expenses represent the estimated indemnity and medical cost and loss adjustment expenses necessary to cover the ultimate cost of investigating and settling claims. Such estimates are based on individual case estimates for reported claims and actuarial estimates for losses which have been incurred but not reported. Any change in probable ultimate liabilities is reflected in current operating results.

The estimated ultimate cost of losses is based on historical patterns and the expected impact of current socioeconomic trends. The ultimate settlement of claims will not be known in many cases for years after the time a policy expires. Court decisions and federal and state legislation, among other factors, may dramatically impact the ultimate cost between the time a policy is written and associated claims are ultimately settled.

Due to these factors, among others, the process to estimate loss and loss adjustment reserves at a point in time cannot provide an exact forecast of future payments. Rather, it produces a best estimate of liability as of a certain date. Management believes the reserves currently estimated to be adequate. While the ultimate liability may differ from the current estimate, management does not believe the difference will have a material effect, either adversely or favorably, on the Authority's financial position and results of operations.

An independent actuarial consulting firm determined a range of \$551,972,000 to \$674,632,000 to be a reasonable estimate of the discounted liability for unpaid losses and allocated loss adjustment expenses at December 31, 1998. The Authority has accrued \$616,555,000 which management believes is a reasonable estimate of future amounts to be paid for claims incurred in 1998 or prior. As permitted by state statute, a discount of \$189,792,000 (computed at 4.25%) has been applied in the actuarial calculation of these December 31, 1998 liabilities for unpaid losses and allocated loss adjustment expenses.

At December 31, 1997, the Authority accrued \$720,400,000 within the actuarially determined range. A discount of \$251,306,000 (computed at 5%) was applied in the actuarial calculation of this December 31, 1997 liability for unpaid losses and allocated loss adjustment expenses.

The Authority's discounted liability for unallocated loss adjustment expenses was \$23,608,000 and \$28,264,000 at December 31, 1998 and 1997, respectively, based on actuarial valuation.

Activity in the liability for unpaid losses and loss adjustment expenses is summarized as follows:

	1998		1997	
	<i>Unpaid losses and allocated loss adjustment expenses</i>	<i>Unallocated loss adjustment expenses</i>	<i>Unpaid losses and allocated loss adjustment expenses</i>	<i>Unallocated loss adjustment expenses</i>
	(In thousands)			
<i>Balance at January 1</i>	\$720,400	\$28,264	\$773,400	\$28,264
<i>Additional amounts incurred related to:</i>				
<i>Current year</i>	186,737	9,920	216,492	16,259
<i>Less - ceded</i>	(57,505)	-	-	-
	-----	-----	-----	-----
<i>Net current year</i>	129,232	9,920	216,492	16,259
<i>Prior years</i>	30,911	4,195	12,617	6,139
	-----	-----	-----	-----
<i>Total incurred</i>	160,143	14,115	229,109	22,398
	-----	-----	-----	-----
<i>Reductions relating to payments for:</i>				
<i>Current year</i>	47,606	10,084	50,834	12,097
<i>Less - ceded</i>	(8,877)	-	-	-
	-----	-----	-----	-----
<i>Net current year</i>	38,729	10,084	50,834	12,097
<i>Prior years</i>	225,259	8,687	231,275	10,301
	-----	-----	-----	-----
<i>Total paid</i>	263,988	18,771	282,109	22,398
	-----	-----	-----	-----
<i>Balance at December 31</i>	<u>\$616,555</u>	<u>\$23,608</u>	<u>\$720,400</u>	<u>\$28,264</u>

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses increased by \$30.9 million in 1998. The increase was due to the accretion of the statutory discount of approximately \$53.4 million and the change in the statutory discount rate to 4.25% of approximately \$23.5 million. These factors were offset by a \$46.0 million reduction in the actuarial estimates of the ultimate liability for older accident years.

As reflected in the accompanying financial statements, the Authority had a policyholders' deficit of \$7,040,000 and \$31,081,000 as of December 31, 1998 and 1997, respectively. This policyholders' deficit arose primarily from adverse developments reported during 1990 and 1989 in the amount of loss reserves required by the Authority for prior years' claims which will be paid in the future, and from the Authority's related estimate of the most likely amount of losses which will ultimately be paid. In response to these developments, management of the Authority has developed a long-range plan to strengthen its financial position. This plan focuses on reducing the Authority's loss ratios through an emphasis on underwriting and a greater internal emphasis on loss control and claims management, employer loss prevention, and cost containment, coupled with maintenance of rate adequacy. Management anticipates that this program will improve operations and increase cash generated from operating activities and will ultimately result in the elimination of the policyholders' deficit.

(3) **BOND INVESTMENTS**

The estimated market values of the Authority's bond investments are based on quoted NAIC market prices for those or similar investments. The amortized cost and estimated market values of investments in debt securities at December 31, 1998 and 1997, are as follows:

	1998				1997			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Market Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Market Value
	(In thousands)				(In thousands)			
U.S. Government obligations-								
Non-loan backed bonds on securities loan for securities collateral (Note 4)	\$ 190,445	\$ 20,504	\$ -	\$210,949	\$272,745	\$19,567	\$(157)	\$292,155
Loan backed bonds	118,630	-	-	118,630	156,632	-	-	156,632
Industrial and miscellaneous-								
Non-loan backed bonds	222,623	9,320	(6)	231,937	183,081	3,273	(109)	186,245
Loan backed bonds	132,269	-	-	132,269	131,943	-	-	131,943
	<u>\$663,967</u>	<u>\$29,824</u>	<u>\$ (6)</u>	<u>\$ 693,785</u>	<u>\$744,401</u>	<u>\$22,840</u>	<u>\$(266)</u>	<u>\$766,975</u>

The amortized cost and estimated market value of investments in debt securities at December 31, 1998, by contractual maturity, are shown below.

Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
	(In thousands)	
Due in one year or less	\$ 4,962	\$ 5,150
Due after one year through five years	140,506	145,991
Due after five years through ten years	272,498	294,241
Due after ten years	246,001	248,403
	-----	-----
	<u>\$663,967</u>	<u>\$ 693,785</u>

(4) SECURITIES LENDING TRANSACTIONS

In March 1997, the Authority began entering into transactions to lend its securities to a broker-dealer. The Authority's custodian lends securities to the broker-dealer in exchange for collateral in the form of A rated U.S. Domestic Corporate securities, equal to or exceeding 105% of the fair market value of the loaned securities.

At December 31, 1998 and 1997, the Authority had outstanding all non-loan based U.S. government securities with a fair market value of \$210,949,000 and \$292,155,000, respectively. The Authority has no additional credit risk exposure to borrowers. The contract with the broker-dealer requires them to indemnify the Authority if they fail to return the securities or fail to pay the Authority for income distributions by the securities' issuers while the securities are on loan. All security lending transactions can be terminated on demand by either the Authority or the broker-dealer. The Authority recognized \$265,000 and \$293,000 of additional investment income during the year ended December 31, 1998 and 1997, respectively, related to securities lending transactions.

(5) TRANSACTIONS WITH THE STATE

The State contracts with the Authority pursuant to its self-funded insurance program. The State reimburses the Authority for all workers' compensation claims and loss adjustment expenses as incurred, plus a premium for stop loss coverage. The Authority accounts for the State contract as an uninsured and partially insured accident and health plan whereby the Authority does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for State workers' compensation costs. Reimbursements billed to the State under this contract were \$19,862,000 and \$21,578,000 in 1998 and 1997, respectively.

(6) REINSURANCE

In 1998, the Authority entered into a 30% quota share reinsurance agreement for losses up to \$50,000 and an excess of loss reinsurance agreement for losses from \$50,000 to \$500,000. Should the reinsurer be unable to meet its obligations under the reinsurance contracts, the Authority would remain liable for amounts ceded to its reinsurer and could result in losses to the Authority. Under the terms of the quota share and excess loss agreements, the Authority cedes approximately 22% and 19%, respectively, of the adjusted net earned premiums and receives a commission on the ceded premium. For the year ended December 31, 1998, the Authority received commissions relating to reinsurance agreements of approximately \$10,720,000 which is included as a component of losses incurred in the accompanying statutory statements of operations and changes in policyholders' deficit.

The effect of reinsurance on premiums written and earned for 1998 is as follows (in thousands):

Premiums	\$243,347
Premiums ceded	(66,912)

Net Premiums	<u>\$176,435</u>

The amount of the recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 1998 was approximately \$66,382,000.

The Authority also purchases catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies 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, 1998 and 1997, the Authority had reinsurance coverage for individual workers' compensation accidents of up to \$20 million in excess of its retention of \$6 million and \$10 million on 1998 and 1997 accidents, respectively. The reinsurance expense associated with this coverage was \$76,000 and \$64,000 in 1998 and 1997, respectively. The Authority's management is not aware of any catastrophes that would result in penetration of these limits.

(7) COMMITMENTS

The Authority entered into an 11-year, non-cancelable operating lease effective July 1991. This lease represents the Authority's principal commitment. Rent expense associated with this lease was \$1,407,000 and \$1,775,000 for 1998 and 1997, respectively. During 1997, the Authority sublet one floor of their leased space for approximately \$234,000 per year through the end of the Authority's lease.

Future minimum payments, net of the sublease, under this and other operating commitments of the Authority are (in thousands):

	<u>Net Commitment</u>
1999	\$2,334
2000	2,103
2001	1,750
2002	1,469
2003	39

	<u>\$7,695</u>

(8) CONTINGENCIES

The Authority is a party to various claims and lawsuits which arise in the normal course of its business. Management of the Authority believes that liabilities which may arise due to the resolution of these matters, if any, will not have a material adverse effect on policyholders' deficit or the results of operations of the Authority.

The Authority is contingently liable for approximately \$67 million of claims closed by the purchases of annuities for structured settlements. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

Year 2000

The Authority utilizes software and related technologies within its business processes that may be impacted by the Year 2000 issue. The Year 2000 issue exists because many computer systems and applications currently use two-digit date fields to designate a year. Date-sensitive systems may recognize the year 2000 as 1900, or not at all. This inability to properly treat the Year 2000 could cause systems to process critical financial and operational information incorrectly.

As of December 31, 1998, the Authority is not fully compliant with the Year 2000 requirements although critical systems have been tested, validated and determined to be Year 2000 compliant. The Authority estimates that its total costs to convert its systems to be Year 2000 compliant, including primarily internal labor and third party hardware and software costs, will be approximately \$100,000, of which approximately 95% has been incurred. Although the Authority does not have a formal contingency plan with respect to Year 2000 issues, it expects to identify and resolve all Year 2000 issues that could materially affect its business operations and develop a plan in the first half of 1999. However, the Authority believes it is not possible to determine with complete certainty that all Year 2000 issues will be identified or corrected in time and no assurance can be given that unidentified Year 2000 problems will not impair the Authority's ability to perform critical business operations, limit access to critical data, cause the Authority to manually process information, or incur material expenses in responding to such problems or otherwise have a material adverse effect on the Authority's business, financial condition and results of operations. In addition, to the extent that such software and systems do not comply with Year 2000 requirements, there can be no assurance that potential systems interruptions, the Authority's

potential inability to meet its contractual obligations or the cost necessary to update such systems will not have a material adverse effect on the Authority's business, financial condition and results of operations.

(9) UNAUDITED RECONCILIATION OF FINANCIAL STATEMENTS TO ANNUAL FILING

The Authority is required to present a reconciliation of the statutory statement of admitted assets, liabilities and policyholders' deficit and the statutory statements of operations and changes in policyholders' deficit and statutory cash flows as reflected herein to the unaudited annual statement filed with the Division of Insurance as of and for the year ended December 31, 1998. There were no reconciling items reflected in the annual statement to the amounts reflected in the statement of operations herein. This information is presented for purposes of complying with Division of Insurance regulations and is not otherwise a required part of the basic financial statements.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS
ON INTERNAL ACCOUNTING CONTROL

To Management and the Board of Directors of
Colorado Compensation Insurance Authority,
The Auditor of the State of Colorado and
The Legislative Audit Committee:

Under generally accepted auditing standards, auditors are encouraged to report various matters concerning an entity's internal control structure noted during an audit, and are required to report certain of those matters. Under standards established by the American Institute of Certified Public Accountants, matters that are required to be reported are significant deficiencies in the design or the operation of the internal control structure that, in the auditor's 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.

As part of our audit of the financial statements of Colorado Compensation Insurance Authority (the "Authority") for the year ended December 31, 1998, we considered the Authority's internal control structure, but only to the extent we felt necessary for the purpose of providing a basis for reliance thereon in determining the nature, timing and extent of the audit tests applied in connection with our audit of the Authority's 1998 financial statements. Our consideration of the internal control structure did not entail a detailed study and evaluation of any of its elements and was not made for the purpose of making detailed recommendations or evaluating the adequacy of the Authority's internal control structure to prevent or detect all errors and irregularities.

The management of the Authority is responsible for establishing and maintaining the internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

The objectives of the internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with statutory accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk it may become inadequate because of changes in conditions or deterioration in its operating effectiveness.

While the purpose of our consideration of the internal control structure was not to provide assurances thereon, certain matters came to our attention that we want to report to you. These matters, which were considered by us during our audit and do not modify the opinion expressed in our auditors' report dated February 19, 1999, along with our recommendations, are described on pages 9 to 20 of this report.

Under standards established by the American Institute of Certified Public Accountants, a material weakness is a "significant deficiency 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 a reportable condition and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weakness as defined above. However, our audit disclosed the following conditions, which are detailed in the accompanying report, that we believe to be reportable conditions:

- The quality of the claims processing function has significantly declined in 1998. Refer to Recommendation 1 on page 10.
- Refer also to recommendations 2 through 5 on pages 11 to 13.

These matters were considered by us during our audit and do not modify the opinion expressed in our auditors' report, dated February 19, 1999. We noted no matters involving the internal control structure and its operations that we consider to be a material internal control weakness as defined above.

This report is intended solely for the use of the Members of the Colorado Legislative Audit Committee, the Auditor of the State of Colorado, management and the Board of Directors of the Authority. In addition, the Legislative Audit Committee and the Auditor of the State of Colorado should understand that the criteria used by us in considering the internal control structure could differ significantly from the criteria the Legislative Audit Committee and the Auditor of the State of Colorado may be using for its purpose.

ARTHUR ANDERSEN LLP

Denver, Colorado,
February 19, 1999.

COLORADO COMPENSATION INSURANCE AUTHORITY

DECEMBER 31, 1998

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