

# McGladrey & Pullen

Certified Public Accountants

## **South Dakota Public Assurance Alliance**

Financial Report

12.31.2004

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# McGladrey & Pullen

Certified Public Accountants

## Independent Auditor's Report

To the Board of Directors  
South Dakota Public Assurance Alliance  
Pierre, South Dakota

We have audited the accompanying statement of net assets of South Dakota Public Assurance Alliance (Pool) as of December 31, 2004, and the related statements of revenues and expenses, changes in net assets, and cash flows for the year then ended, which collectively comprise the Pool's basic financial statements. These financial statements are the responsibility of the Pool's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of South Dakota Public Assurance Alliance as of December 31, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, the net assets as of January 1, 2004 have been restated to correct the previous years' application of accounting principles related to the Pool's method of accounting for operating contributions and casualty losses and loss adjustment expense reserves.

The Schedules of Claims Development Information on pages 18 and 19 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it. The Pool has not presented a management's discussion and analysis that accounting principles generally accepted in the United States of America require to supplement, although not to be a part of, the basic financial statements.

*McGladrey & Pullen, LLP*

Sioux Falls, South Dakota  
April 29, 2005

**South Dakota Public Assurance Alliance**

**Statement of Net Assets**

**December 31, 2004**

<b>Assets</b>	Casualty	Property	Total
<b>Current Assets</b>			
Cash and cash equivalents	\$ 61,764	\$ 1,567,509	\$ 1,629,273
Receivables:			
Contributions	348,593	134,858	483,451
Investment income	125,393	-	125,393
Deductibles	51,108	-	51,108
Reinsurance recoverable on paid losses (Notes 4 and 6)	-	197,895	197,895
Prepaid expenses	211,741	44,263	256,004
Investments (Note 3):			
Certificates of deposit	699,000	-	699,000
Debt securities	1,444,327	-	1,444,327
<b>Total current assets</b>	<b>2,941,926</b>	<b>1,944,525</b>	<b>4,886,451</b>
<b>Noncurrent Assets</b>			
Investments (Note 3):			
Certificates of deposit	1,222,565	-	1,222,565
Debt securities	11,286,786	-	11,286,786
Contributed capital and member equity in NLC Mutual Insurance Company (Note 6)	47,368	119,654	167,022
	12,556,719	119,654	12,676,373
	<b>\$ 15,498,645</b>	<b>\$ 2,064,179</b>	<b>\$ 17,562,824</b>
<b>Liabilities and Net Assets</b>			
<b>Current Liabilities</b>			
Losses and loss adjustment expense reserves (Note 4)	\$ 4,714,588	\$ 223,968	\$ 4,938,556
Accounts payable and accrued expenses	118,429	68,148	186,577
Unearned premiums (Note 2)	1,824,904	1,115,494	2,940,398
<b>Total current liabilities</b>	<b>6,657,921</b>	<b>1,407,610</b>	<b>8,065,531</b>
<b>Noncurrent Liabilities</b>			
Losses and loss adjustment expense reserves (Note 4)	7,633,040	266,460	7,899,500
Unearned premiums (Note 2)	308,289	-	308,289
	7,941,329	266,460	8,207,789
<b>Total liabilities</b>	<b>14,599,250</b>	<b>1,674,070</b>	<b>16,273,320</b>
Net Assets - Unrestricted	899,395	390,109	1,289,504
	<b>\$ 15,498,645</b>	<b>\$ 2,064,179</b>	<b>\$ 17,562,824</b>

See Notes to Financial Statements.

South Dakota Public Assurance Alliance

Statement of Revenues and Expenses  
Year Ended December 31, 2004

	Casualty	Property	Total
Operating revenues:			
Contributions:			
Operating	\$ 4,645,657	\$ 2,799,691	\$ 7,445,348
Reinsurance premiums ceded (Note 6)	(610,059)	(731,758)	(1,341,817)
<b>Net operating revenues</b>	<b>4,035,598</b>	<b>2,067,933</b>	<b>6,103,531</b>
Operating expenses:			
Losses and loss adjustment expenses incurred (Note 4)	5,784,364	1,011,638	6,796,002
General and administrative expenses:			
Marketing and administrator's fees (Note 5)	1,150,772	856,001	2,006,773
Other (Note 5)	191,683	31,488	223,171
<b>Total general and administrative expenses</b>	<b>1,342,455</b>	<b>887,489</b>	<b>2,229,944</b>
Member distributions (Note 7)	543,620	-	543,620
<b>Total operating expenses</b>	<b>7,670,439</b>	<b>1,899,127</b>	<b>9,569,566</b>
<b>Operating (loss) income</b>	<b>(3,634,841)</b>	<b>168,806</b>	<b>(3,466,035)</b>
Nonoperating revenues (expenses):			
Net investment income	545,097	12,240	557,337
Net decrease in fair value of investments	(194,824)	-	(194,824)
Earned member equity, NLC Mutual Insurance Company (Note 6)	7,473	52,714	60,187
<b>Total nonoperating revenues</b>	<b>357,746</b>	<b>64,954</b>	<b>422,700</b>
<b>Income (loss) before capitalization contributions</b>	<b>(3,277,095)</b>	<b>233,760</b>	<b>(3,043,335)</b>
Capitalization contributions	230,914	-	230,914
<b>Change in net assets</b>	<b>\$ (3,046,181)</b>	<b>\$ 233,760</b>	<b>\$ (2,812,421)</b>

See Notes to Financial Statements.

**South Dakota Public Assurance Alliance**

**Statement of Changes in Net Assets  
Year Ended December 31, 2004**

	Casualty	Property	Total
Balance, beginning, as previously reported	\$ 13,529,830	\$ 879,527	\$ 14,409,357
Subtract adjustment applicable to prior years resulting from the retroactive change of accounting for operating contributions and casualty losses and loss adjustment expense reserves (Note 2)	(9,584,254)	(723,178)	(10,307,432)
Balance, beginning, as restated	3,945,576	156,349	4,101,925
Change in net assets	(3,046,181)	233,760	(2,812,421)
Balance, ending	\$ 899,395	\$ 390,109	\$ 1,289,504

See Notes to Financial Statements.

## South Dakota Public Assurance Alliance

### Statement of Cash Flows Year Ended December 31, 2004

	Casualty	Property	Total
<b>Cash Flows From Operating Activities</b>			
Operating contributions received	\$ 5,054,529	\$ 3,181,422	\$ 8,235,951
Reinsurance premiums paid	(610,059)	(766,580)	(1,376,639)
Losses and loss adjustment expenses paid	(1,664,556)	(684,350)	(2,348,906)
General and administrative expenses paid	(1,569,687)	(749,733)	(2,319,420)
Member distributions paid	(543,620)	-	(543,620)
<b>Net cash provided by operating activities</b>	<b>666,607</b>	<b>980,759</b>	<b>1,647,366</b>
<b>Cash Flows From Noncapital Financing Activities</b>			
Cumulative Reserve Fund contributions received	284,615	-	284,615
<b>Cash Flows From Investing Activities</b>			
Debt securities:			
Purchases	(6,691,812)	-	(6,691,812)
Maturities and calls	2,913,204	-	2,913,204
Repayments on mortgage-backed securities	565,996	-	565,996
Proceeds from maturities of certificates of deposit	1,717,711	-	1,717,711
Purchases of certificates of deposit	(741,442)	-	(741,442)
Investment income received, net of investment expenses	533,002	12,240	545,242
Capital contributions to NLC Mutual Insurance Company	(39,895)	(66,940)	(106,835)
<b>Net cash (used in) investing activities</b>	<b>(1,743,236)</b>	<b>(54,700)</b>	<b>(1,797,936)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(792,014)</b>	<b>926,059</b>	<b>134,045</b>
<b>Cash and Cash Equivalents</b>			
Beginning of year	853,778	641,450	1,495,228
End of year	\$ 61,764	\$ 1,567,509	\$ 1,629,273
<b>Reconciliation of operating income (loss) to net cash provided by operating activities:</b>			
Operating income (loss)	\$ (3,634,841)	\$ 168,806	\$ (3,466,035)
(Increase) decrease in assets:			
Contributions receivable	(33,347)	(10,585)	(43,932)
Due from American Public Entity Excess Pool	-	17,189	17,189
American Public Entity Excess Pool Guarantee Fund	-	49,105	49,105
Deductibles recoverable	(32,450)	-	(32,450)
Reinsurance recoverable on paid losses	1,584,518	949,270	2,533,788
Prepaid expenses	(211,741)	(44,263)	(256,004)
Increase (decrease) in liabilities:			
Losses and loss adjustment expense reserves	2,555,290	(621,982)	1,933,308
Accounts payable and accrued expenses	(3,042)	(48,991)	(52,033)
Unearned premiums	442,220	522,210	964,430
<b>Net cash provided by operating activities</b>	<b>\$ 666,607</b>	<b>\$ 980,759</b>	<b>\$ 1,647,366</b>
<b>Supplemental Disclosure of Noncash Investing and Financing Activity</b>			
Net (decrease) in the fair value of investments	\$ (194,824)	\$ -	\$ (194,824)
Earned member equity, NLC Mutual Insurance Company	7,473	52,714	60,187

See Notes to Financial Statements.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 1. Nature of Business and Significant Accounting Policies

Nature of business: The South Dakota Public Assurance Alliance (Pool) is a local government risk-sharing pool whose 324 members are various governmental entities throughout the State of South Dakota. The Pool was formed in December 1986 for the primary purpose of managing and funding third-party claims against its members. An Intergovernmental Contract governs the operations of the Pool. The administration of the Intergovernmental Contract and management of the Pool are performed by a Board of Directors of not more than 9 members.

The Board of Directors has designated an "Operating Fund" and a "Cumulative Reserve Fund", the sum of these amounts comprise Net Assets – Unrestricted in the Pool's statement of net assets. Amounts in the Operating Fund are adjusted by changes in net assets resulting from other than capitalization contributions, which are net of distributions of capitalization contributions. As of December 31, 2004, the Operating Fund had a deficiency of \$(8,391,892) and the Cumulative Reserve Fund had a balance of \$9,681,396. In the event that the Operating Fund is exhausted during any Pool fiscal year, any funds required to fulfill the purpose of the Operating Fund will be allocated from the Cumulative Reserve Fund. The sum so allocated constitutes a deficiency in the Cumulative Reserve Fund. This deficiency in the Cumulative Reserve Fund will be allocated to the members at the time withdrawn, on a pro rata basis determined by the Board of Directors. This deficit in the Cumulative Reserve Fund will be made up in subsequent years with any excess of income over expenses in the Operating Fund being transferred to the Cumulative Reserve Fund.

Members with casualty risk coverage provided by the Pool, agree to make annual operating contributions to the Pool, a portion of which are deemed "capitalization contributions" and are made in six annual installments according to the following schedule:

	<u>Percent of "basis rate"</u>
Initial contribution	100%
First anniversary	75
Second anniversary	50
Third anniversary	30
Fourth anniversary	25
Fifth anniversary	20

Subsequent to the fifth anniversary, additional capitalization contributions are required only if the Pool's Board of Directors determine that such contributions are necessary to maintain the Cumulative Reserve Fund at a level equal to 300% of the total current basis rates of all members or to comply with the requirements of any applicable regulatory authority having jurisdiction over the Pool. Capitalization contributions do not apply to members with property risk coverage.

"Basis rate" is that amount annually promulgated by the administrator of the Pool which is deemed necessary to provide the scope of coverage afforded to a member for the period of one year corresponding to the risk sharing certificate effective date, with due consideration to the member's individual characteristics.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 1. Nature of Business and Significant Accounting Policies (continued)

Nature of business (continued): Members agree to continue membership for a period of not less than one full year. At the conclusion of such period, or anniversary thereof, a member who has given sixty days prior written notice to the Pool may withdraw. Within 120 days following withdrawal, or as soon thereafter as the next annual budget is completed, the Pool will refund to the withdrawing member that percentage of those capitalization contributions made to the Pool under casualty risk coverage, according to the following schedule:

End of member's first full year	50%
End of member's second full year	60%
End of member's third full year	70%
End of member's fourth full year	80%
End of member's fifth full year	90%
End of member's sixth full year and thereafter	100%

The Pool will deduct from such refund the member's contribution, which the withdrawing member would have made for the one-year period following withdrawal together with the withdrawing member's proportionate share (determined in accordance with the Intergovernmental Contract) of any deficiency in the Cumulative Reserve Fund.

A member cannot obtain property risk coverage without having casualty risk coverage and a member's election to cease participation in the Pool for property risk coverage does not constitute a withdrawal under any other terms and conditions of the Intergovernmental Contract. Property risk coverage applies only to losses or claims, which occur prior to the termination date. All rights for reimbursement or any right to claim against the Pool terminate for property risk losses, which occur after the termination date.

Effective on the date of withdrawal, payments for all known and unknown casualty risk coverage claims and claims expense thereafter become the sole responsibility of the withdrawing member without regard to whether a claim occurred or was reported prior to the withdrawal of the member's participation in the Pool.

Effective on the date of withdrawal, payments for all property risk claims and claims expense which occurred thereafter, become the sole responsibility of the withdrawing member. The Pool will cover any property claim reported in a timely manner not to exceed sixty days after its occurrence, if the claim occurred during the period the risk sharing certificate was in effect and if coverage was otherwise available under the risk sharing certificate.

The Pool may, by a two-thirds (2/3) majority of the Board of Directors and by providing a member sixty days prior written notice, cancel that member's participation in the Pool and terminate its Intergovernmental Contract effective at the end of any risk sharing certificate year. Thereafter, it is the responsibility of the Pool to defend, settle and pay claims within the scope and limits set forth in the cancelled member's risk sharing certificate in effect on the date of the occurrence out of which such claim arose. This provision applies solely to claims, which occurred during a member's participation and evidenced by the member's risk sharing certificate. The cancelled member has the right, prior to the actual date of cancellation, to withdraw from the Pool by giving notice of such withdrawal. Electing to withdraw, the member shall be subject to the withdrawal provisions of the Intergovernmental Contract. Failing to elect to give notice of withdrawal, the cancelled member forfeits all rights to refund of those capitalization contributions made to the Pool by said cancelled member.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 1. Nature of Business and Significant Accounting Policies (continued)**

Nature of business (continued): Any member failing to make payments when due as required by the Intergovernmental Contract, will be terminated from the Pool effective on the date the payment was due and upon that effective date of termination all coverages and benefits thereunder cease. All known and unknown claims and claims expenses thereafter become the sole responsibility of the terminated member without regard to whether a claim occurred or was reported prior to the termination of the member's participation in the Pool. The terminated member also forfeits all rights to any return of contributions including its vested interest in the Cumulative Reserve Fund. The Pool will apply any or all of the terminated member's forfeited funds to the Operating Fund. If the member subsequently submits its payment, the administrator may, in its discretion, reinstate such membership.

In the event that a claim or a series of claims exceeds the amount of risk sharing protection provided by the member's risk sharing certificate, or in the event that a claim or a series of claims should exhaust the Operating Fund, the Cumulative Reserve Fund and any reinsurance, then payment of valid claims are the sole and separate obligation of the individual member or members against whom the claim was made and perfected by litigation or settlement.

The Pool will terminate at such time as two-thirds (2/3) of the members vote for such termination. After a vote to terminate, the Board of Directors will commence with the orderly liquidation of the Pool's business and will complete the same as promptly as possible. During such period of liquidation the Pool will continue to pay claims and losses incurred within the scope of coverage and pursuant to the risk sharing certificate until all funds of the Pool are exhausted. After payment of all claims and losses, any remaining funds held by the Pool will be paid to all members of the Pool at the time of the vote of termination, on a pro rata basis determined by the Board of Directors.

To the extent of the existence of funds in the Operating Fund and Cumulative Reserve Fund, no member shall be responsible for any claim, claims, judgment or judgments against any other member or members. If upon termination of the Pool the remaining assets of the Pool are insufficient to satisfy indebtedness of the Pool (excluding claims or judgments against the members), such deficiency will be made up by assessments against members of the Pool on a pro rata basis determined by the Board of Directors.

American Risk Pooling Consultants, Inc. (ARPCO) functioned as the administrator of the Pool through December 31, 2004. The duties of the administrator were defined in an administrative agreement between ARPCO and the Pool and generally included those powers and duties necessary and incident to managing the operations of the Pool. Pursuant to an agreement between ARPCO and Hagan Benefits, Inc. (HBI), HBI provided marketing, underwriting, billing and collection services. Claims Associates, Inc. (CAI) performed claims adjustment services. Risk Services of South Dakota (RSSD), an ARPCO affiliate, performed loss control services. ARPCO and HBI were compensated for their respective services based on percentages of the members' basis rates. CAI was compensated based on a flat fee; and RSSD was compensated based on a flat fee approved annually by the Board of Directors of the Pool. The South Dakota Municipal League, which provides information and support services of the Pool, was compensated based upon mutual agreement with the Pool.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 1. Nature of Business and Significant Accounting Policies (continued)**

Nature of business (continued): Effective January 1, 2005, HBI became the administrator of the Pool and will perform those duties similar to which ARCPO performed during 2004 and as defined in the administrative agreement between HBI and the Pool. In 2005, HBI also continues to perform the marketing for the Pool as defined in its marketing agreement with the Pool. Effective January 1, 2005, Safety Benefits provides loss control services for the Pool and CAI continues to provide claims adjustment services and SDML continues to provide information and support services to the Pool.

The Pool is exposed to various risks of loss related to torts and errors and omissions. The Pool has not purchased commercial insurance to mitigate its risks.

A summary of the Pool's significant accounting policies follows:

Basis of presentation: The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. The Pool prepares its financial statements primarily following the guidance of Governmental Accounting Standards Board (GASB) Statement No. 10, "Accounting and Financial Reporting for Risk Financing and Related Insurance Issues" (as amended by subsequent GASB statements) along with other applicable standards issued by the GASB as well as applicable standards issued by the Financial Accounting Standards Board (FASB), except those that conflict with or contradict GASB pronouncements. GASB Statement No. 10 establishes accounting and financial reporting standards for risk financing and insurance-related activities of public entity risk pools.

The Pool operates as a single proprietary fund, more specifically as an enterprise fund. The Pool distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the Pool's principal ongoing operations. Nonoperating revenues and expenses result from investment activities.

Use of estimates: 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. Material estimates that are particularly susceptible to significant change in the near-term relate to the estimated liability for losses and loss adjustment expense reserves.

Cash and cash equivalents: For purposes of reporting the statements of cash flows, the Pool includes as cash equivalents all cash accounts and money market mutual funds which are not subject to withdrawal restrictions or penalties. Certificates of deposit are considered investments as all have been purchased with maturities in excess of ninety days.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 1. Nature of Business and Significant Accounting Policies (continued)

Investments: Investment securities are accounted for under the provisions of GASB Statement No. 31. Under GASB No. 31, the Pool is required to report investments (other than certificates of deposit) at fair value in the statement of net assets with changes in the fair value of investments reported as investment income. Certificates of deposit are stated at cost.

Dividend and interest income are recognized when earned.

The Pool's Board of Directors has authorized investments in certificates of deposit, United States Treasury and government agency issues, mortgage-backed securities and mutual funds, among other investments.

Member equity in NLC Mutual Insurance Company: The Pool records its share of net increases (decreases) in net assets - unrestricted as income (loss) in the Pool's statement of revenues and expenses and adds (deducts) such amounts to (from) the investment account.

Reinsurance: In the normal course of business, the Pool seeks to reduce the loss that may arise from events that cause unfavorable underwriting results, by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers.

Amounts recoverable from reinsurers under excess loss coverages are estimated in a manner consistent with the development of the estimated liability for losses and loss adjustment expense reserves.

Losses and loss adjustment expense reserves: The Pool establishes loss reserves based upon estimates of the ultimate cost of losses, including future loss adjustment expenses related to claims that have been reported but not settled and of claims that have been incurred but not reported. The length of time for which such costs must be estimated varies depending on the type of coverage involved.

The estimated liability for losses and loss adjustment expenses is based upon data developed by the Pool's administrator. Industry experience and statistics were used to develop the estimated liability. The claims history of the Pool was also considered.

As adjustments to this estimated liability become necessary, such adjustments are reflected in current operations. Management of the Pool believes the estimated liability for losses and loss adjustment expense reserves is sufficient to cover the ultimate net cost of incurred claims, but such reserves are necessarily based on estimates and the ultimate liability may be greater or less than the amounts estimated. An independent actuary assisted management with the establishment of estimated claims liabilities at December 31, 2004.

Capitalization contributions and unearned premiums: Casualty capitalization contributions are accounted for under the provisions of GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools* (Interpretation No. 4). Under Interpretation No. 4, capitalization contributions to pools to which risk is transferred must be accounted for as revenue by initially recording such contributions as unearned premiums, then amortizing them into revenue over an appropriate period not to exceed 10 years. Unearned premiums resulting from the application of Interpretation No. 4 are being amortized pro rata over a six-year period, the period over which a member makes capitalization contributions.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 1. Nature of Business and Significant Accounting Policies (continued)**

Operating contributions and unearned premiums: Members are billed annually in advance for operating contributions. Income from such contributions is recorded as earned during the coverage period. Contributions received in advance for coverage in the following year are recorded as unearned premiums. Revenue is reduced by reinsurance premiums ceded to the reinsurance companies.

Income taxes: The Pool has received a private letter ruling from the Internal Revenue Service, dated December 7, 1987, to the effect that the Pool's income is excludable from gross income under Section 115 of the Internal Revenue Code and is thus exempt from federal income taxes. Management believes that the Pool continues to operate in a manner whereby it continues to be tax exempt.

Premium deficiency: A premium deficiency exists when the sum of expected claims costs (including an estimated liability for unreported claims) and all expected claims adjustment expenses, expected dividends, and policy acquisition costs exceed related unearned premiums. The Pool anticipates investment income in determining if a premium deficiency exists. No premium deficiency existed as of December 31, 2004.

#### **Note 2. Retroactive Change in the Method of Recognizing Operating Contributions and Casualty Losses and Loss Adjustment Expense Reserves**

In prior years, the Pool recognized income from operating contributions when billed for financial statement purposes without recording unearned premiums. During the year ended December 31, 2004, management determined that this method was not in accordance with generally accepted accounting principles. As a result, the Pool retroactively changed its method of accounting for premium income to the accrual basis in accordance with generally accepted accounting principles.

In prior years, a receivable for unpaid claims to be billed in the future was recorded to completely offset casualty losses and loss adjustment expense reserves after reinsurance recoverable on unpaid losses was taken into account. Management also concluded that this method was not in accordance with generally accepted accounting principles. As a result, the Pool retroactively changed its method of accounting for losses and loss adjustment expense reserves in accordance with generally accepted accounting principles.

The financial statements for the year ended December 31, 2004 have been retroactively restated for these changes and this retroactive restatement had the effect of decreasing the net assets as of January 1, 2004 by \$10,307,432 and decreasing the change in net assets by \$10,307,432 for the year ended December 31, 2003 as compared to the amounts previously reported.

**South Dakota Public Assurance Alliance**

**Notes to Financial Statements**

**Note 3. Investments**

The Pool's deposits and investments are categorized below to indicate the level of risk at year end, as required by GASB Statement No. 3. For deposits, category 1 includes deposits insured or collateralized with securities held by the Pool or its agent in the Pool's name, category 2 includes deposits collateralized with securities held by the pledging financial institution's trust department or agent in the Pool's name, and category 3 includes uninsured and uncollateralized deposits. For investments, category 1 includes investments that are insured or registered or that are held by the Pool or its agent in the Pool's name, category 2 includes uninsured and unregistered investments that are held by the counterparty's trust department or agent in the Pool's name, and category 3 includes uninsured and unregistered investments that are held by the counterparty's trust department or agent, but not in the Pool's name.

	Category	Casualty	
		Bank Balance	Carrying Amount
Deposits - financial institutions:			
Insured	1	\$ 475,816	\$ (1,090,746)
Uninsured and uncollateralized money market accounts	3	1,152,510	1,152,510
		<u>\$ 1,628,326</u>	<u>\$ 61,764</u>
Investments:			
Certificates of deposit	1		<u>\$ 1,921,565</u>
U.S. treasury issues	1		\$ 637,949
U.S. government corporations and agencies	1		8,824,973
Mortgage-backed securities	1		3,268,191
			<u>\$ 12,731,113</u>
	Category	Property	
		Bank Balance	Carrying Amount
Deposits - financial institutions:			
Insured	1	\$ 68,873	<u>\$ 1,567,509</u>

**South Dakota Public Assurance Alliance**

**Notes to Financial Statements**

**Note 3. Investments (continued)**

Investments in securities at December 31, 2004 are as follows:

	2004			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Debt securities:				
U.S. treasury issues	\$ 606,306	\$ 31,643	\$ -	\$ 637,949
U.S. government corporations and agencies	8,777,057	97,492	(49,576)	8,824,973
Mortgage-backed securities	3,248,521	38,604	(18,934)	3,268,191
	<u>\$ 12,631,884</u>	<u>\$ 167,739</u>	<u>\$ (68,510)</u>	<u>\$ 12,731,113</u>

The amortized cost and fair value of debt securities, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2004	
	Cost	Fair Value
Due in one year	\$ 1,430,404	\$ 1,444,327
Due after one year through five years	7,001,592	7,043,392
Due after five years through ten years	951,367	975,203
	<u>9,383,363</u>	<u>9,462,922</u>
Mortgage-backed securities	3,248,521	3,268,191
	<u>\$ 12,631,884</u>	<u>\$ 12,731,113</u>

There were no sales of investments during 2004.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 4. Liability for Losses and Loss Adjustment Expense Reserves

The Pool establishes liabilities for both reported and unreported covered events, which includes estimates of both future payments of claims and related claims adjustment expenses. The following is a summary of the changes in those aggregate liabilities for the year ended December 31, 2004.

	<u>Casualty</u>	<u>Property</u>
Unpaid losses and loss adjustment expense reserves at beginning of year	\$ 9,792,338	\$ 1,487,893
Less reinsurance recoverable at beginning of year	(1,584,518)	(1,522,648)
Net unpaid losses and loss adjustment expenses at beginning of year	<u>8,207,820</u>	<u>(34,755)</u>
Net incurred losses and loss adjustment expenses:		
Current year provision	4,821,603	943,284
Increase in prior years' provisions	962,761	68,354
Net provision	<u>5,784,364</u>	<u>1,011,638</u>
Net losses and loss adjustment expense payments attributable to:		
Current year	(874,169)	(561,722)
Prior years	(770,387)	(122,628)
Net payments	<u>(1,644,556)</u>	<u>(684,350)</u>
Net unpaid losses and loss adjustment expenses at end of year	12,347,628	292,533
Plus reinsurance recoverable at end of year	-	197,895
Unpaid losses and loss adjustment expense reserves at end of year	<u>\$ 12,347,628</u>	<u>\$ 490,428</u>

The 2004 increase for casualty and property in prior years' provisions of incurred losses and loss adjustment expense reserves resulted from loss development experience.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 5. Agreements**

During 2004, the Pool had an agreement with ARPCO to provide program administration for the Pool. The agreement provided for an annual fee in an amount equal to 13.1% per annum of the members' basis rates as defined in the Intergovernmental Contract. ARPCO also subcontracted certain services to HBI to aid ARPCO in marketing and underwriting for the Pool for which HBI was entitled to an annual fee ranging between 18% to 20% of the members' basis rates as defined in the Intergovernmental Contract and per the terms of the agreement. Effective December 31, 2004, the agreement with ARPCO was terminated and effective January 1, 2005, HBI performs the program administration for the Pool and continues to perform the marketing for the Pool. Total fees incurred in 2004 under the ARPCO and HBI agreements were \$824,789 and \$1,181,984, respectively.

The administration agreement with HBI that was effective January 1, 2005 provides for fees for 2005 of \$140,000, with a 10% increase annually thereafter through the term of the agreement, which expires December 31, 2009. The marketing agreement with HBI was effective January 1, 2005 and provides for fees of 15.6% of member contributions. The marketing agreement expires December 31, 2009.

Effective April 1, 2004, the Pool entered into an agreement with CAI to provide administrative, investigative, and adjustment services for claims incurred, which were previously provided by ARPCO. The agreement provides for a flat fee for claims administration services with varying fees for claims adjustment expenses incurred. The agreement expires on December 31, 2009. Total fees incurred under this agreement in 2004 were \$108,000.

Effective January 1, 2005, the Pool also entered into an agreement with Safety Benefits, Inc. to provide a loss control program for members. The agreement states that Safety Benefits, Inc. be compensated based on a flat fee. The term of the contract is continuous from its effective date for a period of one year. The agreement expires December 31, 2009. During 2004, these services were performed by RSSD, in which fees of \$174,783 were incurred.

The Pool maintains agency accounts with the First National Bank of Sioux Falls (FNB) under a custodial agreement. Fees incurred to FNB during 2004 were \$42,018.

The South Dakota Municipal League (SDML) is the sponsoring organization of the Pool. SDML provides information and support services to the Pool. Fees incurred to SDML in both 2004 and 2003 were \$60,000.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 6. Reinsurance**

The Pool utilizes reinsurance agreements to limit maximum loss and minimize exposures on larger risks. The Pool was a member of APEEP, which was also administered by ARPCO. APEEP provided a casualty risk-sharing pooling arrangement and administered a non-risk-sharing property program for its member pools. Effective December 18, 2003, the Pool terminated its membership in APEEP. In accordance with the APEEP Joinder Agreement, the Pool was assessed a portion of the 2004 APEEP budget, which was \$503,012. The Pool also was entitled to receive a refund of its vested cumulative reserve fund payments to APEEP in the amount of \$1,612,001. The net of these amounts was received by the Pool in 2004.

As of December 18, 2003, the Pool obtained reinsurance through NLC Mutual Insurance Company (NLC Mutual), among other reinsurance carriers. NLC Mutual is a mutual captive insurance company. NLC Mutual provides workers' compensation, general liability, and property reinsurance to state municipal league sponsored pools. The Pool retains casualty risks up to \$250,000 per claim. Claims exceeding \$250,000 are reinsured in an amount not to exceed \$4,750,000 in aggregate per year. The Pool also retains property risks up to \$100,000 per claim. Claims exceeding \$100,000 are reinsured in an amount not to exceed \$499,000,000 per claim.

In connection with the Pool's termination of its membership with APEEP, the Pool is responsible for all known casualty claims with reported dates on or before December 18, 2003. The Pool's reinsurance carriers provide coverage for casualty claims incurred but not reported prior to December 18, 2003.

The by-laws of NLC Mutual provide that each member of NLC Mutual, upon withdrawal, is to receive a share of NLC Mutual's net worth. The withdrawal of surplus would be paid to the former member within 10 years following the fiscal year in which the notice is received by NLC Mutual. The Pool made capital contributions to NLC Mutual of \$39,895 for casualty and \$66,940 for property in 2004. NLC Mutual has been returning profits back to its members each year from underwriting and investment activities. Amounts not used earn investment income at NLC Mutual's portfolio rate. As of December 31, 2004, the Pool's share of NLC Mutual's net worth was \$167,022.

The Pool would be liable for any obligations that the reinsurance companies are unable to meet under the reinsurance agreements. Reinsurance recoverables under reinsurance agreements on paid losses for 2004 were \$197,895. Reinsurance amounts of \$375,483 were deducted from the estimated liability for losses and loss adjustment expense reserves in 2004. During 2004, the Pool received \$129,164 of recoveries from the reinsurance companies under contract.

#### **Note 7. Member Distributions**

Member distributions are based on members' basis rates for the calendar year in which they are approved and are payable in the calendar year following approval to those members who fulfill their contribution obligation prior to renewal in that calendar year. Distributions of \$543,620 were paid during 2004 and distributions of approximately \$547,000 were approved for payment in 2005.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 8. New Governmental Accounting Standards**

The GASB has issued the following statements:

Statement No. 40 - "Deposit and Investment Risk Disclosures, an amendment to certain provisions of GASB Statement No. 3," requires certain disclosures of investments that have fair values that are sensitive to changes in interest rates.

Statement No. 42 - "Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries," requires governments to report the effects of capital asset impairment in their financial statements when it occurs. It also provides guidance for accounting for insurance recoveries.

Statement No. 43 - "Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans". This Statement establishes uniform financial reporting standards for other postemployment benefit plans (OPEB plans) and supersedes existing guidance.

Statement No. 45 - "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension", establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and if applicable, required supplementary information.

Statement No. 46 - "Net Assets Restricted by Enabling Legislation - an amendment of GASB Statement No. 34". This Statement clarifies the definition of legally enforceable legislation and specifies the accounting and financial reporting requirements. It also gives guidance in circumstances where new enabling legislation replaces existing legislation. The Statement requires separate disclosures of net assets restricted by enabling legislation.

Statement No. 40 will become effective for the year ending December 31, 2005. Statement No. 42 will become effective for the year ending December 31, 2005. Statement No. 43 will be become effective for the year ending December 31, 2007. Statement No. 45 will become effective for the year ending November 30, 2008. Statement No. 46 will become effective for the year ending December 31, 2006. Management has not yet completed its assessment of these Statements, however, these Statements are not expected to have a material effect on the overall financial statement presentation of the Pool.

South Dakota Public Assurance Alliance

Required Supplementary Information - Schedule of Claims Development Information (Casualty)  
For the Ten Years Ended December 31, 2004

	*1995	*1996	*1997	*1998	*1999	*2000	*2001	*2002	*2003	2004
Net earned member contributions and investment income:										
Earned	\$ 5,926,491	\$ 7,577,504	\$ 8,261,221	\$ 6,202,816	\$ 6,146,717	\$ 5,294,578	\$ 5,877,161	\$ 5,117,873	\$ 7,085,676	\$ 5,190,754
Ceded	458,283	1,859,816	928,775	491,904	527,771	439,011	478,288	605,861	882,528	610,059
<b>Net earned</b>	<b>5,468,208</b>	<b>5,717,688</b>	<b>7,332,446</b>	<b>5,710,912</b>	<b>5,618,946</b>	<b>4,855,567</b>	<b>5,398,873</b>	<b>4,512,012</b>	<b>6,203,148</b>	<b>4,580,695</b>
Unallocated expenses	1,251,913	1,324,955	1,330,747	1,193,278	1,213,829	1,508,810	1,676,017	1,375,632	1,463,841	1,342,455
Estimated claims and expenses, end of policy year:										
Incurred	3,875,822	5,296,994	5,936,864	4,061,716	3,983,173	2,800,028	3,225,428	2,933,838	4,890,788	4,821,603
Ceded	336,965	1,707,355	775,288	384,294	343,961	265,691	344,124	456,183	722,756	-
<b>Net incurred</b>	<b>3,538,857</b>	<b>3,589,639</b>	<b>5,161,576</b>	<b>3,677,422</b>	<b>3,639,212</b>	<b>2,534,337</b>	<b>2,881,304</b>	<b>2,477,655</b>	<b>4,168,032</b>	<b>4,821,603</b>
Net paid (cumulative) as of:										
End of policy year	408,162	528,346	535,168	342,800	517,566	325,428	520,345	458,055	617,802	874,169
One year later	904,091	1,079,719	1,090,548	677,472	834,311	660,531	948,277	1,010,479	1,175,258	
Two years later	1,213,600	1,523,491	1,455,268	1,276,008	1,208,626	792,480	1,652,279	1,669,320		
Three years later	1,725,246	1,830,499	1,618,087	1,444,709	2,019,738	1,101,185	1,933,209			
Four years later	2,186,969	1,952,689	1,678,248	1,779,424	2,428,582	1,185,566				
Five years later	2,194,405	2,002,606	1,711,133	1,894,981	2,514,858					
Six years later	2,198,576	2,036,670	1,744,043	1,969,439						
Seven years later	2,198,576	2,239,398	1,784,221							
Eight years later	2,205,401	2,240,433								
Nine years later	2,320,732									
Reestimated ceded claims and expenses	228,953	1,421,059	215,858	329,203	367,675	217,722	184,776	85,894	96,136	40,737
Reestimated net incurred claims and expenses:										
End of policy year	3,538,587	3,589,639	5,161,576	3,677,422	3,639,212	2,534,337	2,881,304	2,477,655	4,168,032	4,821,603
One year later	2,833,085	3,695,573	3,747,217	2,670,972	3,172,004	2,281,228	2,708,859	3,029,003	3,624,157	
Two years later	3,098,931	2,588,929	2,432,967	2,322,589	2,703,223	1,734,768	2,497,852	4,001,195		
Three years later	2,803,920	2,471,091	2,059,795	2,392,433	2,868,655	1,667,816	2,528,159			
Four years later	2,408,777	2,265,423	1,893,410	2,118,513	2,886,501	1,650,581				
Five years later	2,276,780	2,205,559	1,806,855	2,172,933	3,842,157					
Six years later	2,248,127	2,278,597	1,904,505	2,185,083						
Seven years later	2,246,340	2,340,496	1,949,640							
Eight years later	2,307,867	2,240,433								
Nine years later	2,320,732									
Increase (decrease) in estimated net incurred claims and expenses from end of policy year	\$ (1,218,125)	\$ (1,349,206)	\$ (3,211,936)	\$ (1,492,339)	\$ 202,945	\$ (883,756)	\$ (353,145)	\$ 1,523,540	\$ (543,875)	\$ -

\* Amounts related to 2003 and prior years were derived from amounts presented in audited financial statements from the Pool's previous auditors, and such information has not been modified in this table.

South Dakota Public Assurance Alliance

Required Supplementary Information - Schedule of Claims Development Information (Property)  
December 31, 2004

	*1999	*2000	*2001	*2002	*2003	2004
Net earned member contributions and investment income:						
Earned	\$ 553,629	\$ 847,812	\$ 1,152,068	\$ 5,422,862	\$ 1,336,102	\$ 2,811,931
Ceded	47,945	93,624	50,232	4,016,000	980	731,758
<b>Net earned</b>	<b>505,684</b>	<b>754,188</b>	<b>1,101,836</b>	<b>1,406,862</b>	<b>1,335,122</b>	<b>2,080,173</b>
Unallocated expenses	279,699	376,120	410,052	647,198	811,557	887,489
Estimated claims and expenses, end of policy year:						
Incurred	270,708	469,392	718,209	4,766,502	513,742	1,072,448
Ceded	47,945	93,624	50,232	4,016,000	980	129,164
<b>Net</b>	<b>222,763</b>	<b>375,768</b>	<b>667,977</b>	<b>750,502</b>	<b>512,762</b>	<b>943,284</b>
Net paid (cumulative) as of:						
End of policy year	201,346	247,588	399,772	766,912	391,142	561,722
One year later	251,874	297,662	538,043	936,288	500,070	
Two years later	256,160	305,731	697,971	903,386		
Three years later	256,241	493,588	698,921			
Four years later	317,271	493,588				
Five years later	315,926					
Reestimated ceded claims and expenses	73,449	30,882	25,030	2,518,861	7,536	15,268
Reestimated net incurred claims and expenses:						
End of policy year	222,763	375,768	667,977	750,502	512,762	943,284
One year later	267,119	348,033	553,811	2,289,767	555,461	
Two years later	256,791	305,815	710,620	912,756		
Three years later	256,615	493,588	713,117			
Four years later	317,416	493,588				
Five years later	315,931					
Increase (decrease) in estimated net incurred claims and expenses from end of policy year	\$ 93,168	\$ 117,820	\$ 45,140	\$ 162,254	\$ 42,699	\$ -

\* Amounts related to 2003 and prior years were derived from amounts presented in audited financial statements from the Pool's previous auditors, and such information has not been modified in this table.