

# McGladrey & Pullen

Certified Public Accountants

## South Dakota Public Assurance Alliance

Financial Report

12.31.2007

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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 statements of net assets of the South Dakota Public Assurance Alliance (Pool) as of December 31, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years 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 audits.

We conducted our audits 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 audits provide 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 the South Dakota Public Assurance Alliance as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Schedules of Claims Development Information on pages 16 and 17 and the Combining Schedules of the Liability for Losses and Loss Adjustment Expense Reserves on page 18 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.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Pool's basic financial statements. The combining schedules listed in the table of contents as other supplementary information are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

*McGladrey & Pullen, LLP*

Sioux Falls, South Dakota  
July 2, 2008

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## South Dakota Public Assurance Alliance

### Statements of Net Assets December 31, 2007 and 2006

Assets	2007	2006
Current Assets		
Cash and cash equivalents	\$ 2,013,545	\$ 749,233
Receivables:		
Contributions	3,462,956	3,182,972
Investment income	157,320	183,435
Reinsurance recoverable on paid losses (Note 5)	53,543	10,834
Prepaid expenses	104,407	118,834
Investments (Note 2):		
Certificates of deposit	675,511	445,336
Debt securities	2,466,012	1,430,377
<b>Total current assets</b>	<b>8,933,294</b>	<b>6,121,021</b>
Noncurrent Assets		
Investments (Note 2):		
Certificates of deposit	3,893,498	2,956,383
Debt securities	13,024,226	14,187,255
Contributed surplus and member equity in NLC Mutual Insurance Company (Note 5)	526,331	526,331
	<b>17,444,055</b>	<b>17,669,969</b>
	<b>\$ 26,377,349</b>	<b>\$ 23,790,990</b>
<b>Liabilities and Net Assets</b>		
Current Liabilities		
Losses and loss adjustment expense reserves (Note 3)	\$ 2,504,625	\$ 2,331,162
Accounts payable and accrued expenses	54,440	196,291
Unearned contributions	6,545,123	5,811,506
<b>Total current liabilities</b>	<b>9,104,188</b>	<b>8,338,959</b>
Noncurrent Liabilities		
Losses and loss adjustment expense reserves (Note 3)	11,204,887	11,244,152
Unearned contributions, capitalization contributions	222,187	299,536
	<b>11,427,074</b>	<b>11,543,688</b>
<b>Total liabilities</b>	<b>20,531,262</b>	<b>19,882,647</b>
Net Assets - Unrestricted	5,846,087	3,908,343
	<b>\$ 26,377,349</b>	<b>\$ 23,790,990</b>

See Notes to Financial Statements.

South Dakota Public Assurance Alliance

Statements of Revenues, Expenses and Changes in Net Assets  
Years Ended December 31, 2007 and 2006

	2007	2006
Operating revenues:		
Contributions:		
Operating, net of renewal, loss control and loss ratio credits of \$345,825 and \$372,331 in 2007 and 2006, respectively (Note 6)	\$ 8,433,611	\$ 7,907,052
Reinsurance premiums ceded (Note 5)	(1,484,018)	(1,230,543)
<b>Net operating revenues</b>	<b>6,949,593</b>	<b>6,676,509</b>
Operating expenses:		
Losses and loss adjustment expenses incurred (Notes 3 and 4)	4,648,463	4,785,909
General and administrative expenses:		
Marketing and administrator's fees (Note 4)	1,678,631	1,483,885
Other (Note 4)	250,521	253,600
<b>Total general and administrative expenses</b>	<b>1,929,152</b>	<b>1,737,485</b>
<b>Total operating expenses</b>	<b>6,577,615</b>	<b>6,523,394</b>
<b>Operating income</b>	<b>371,978</b>	<b>153,115</b>
Nonoperating revenues (expenses):		
Net investment income (Notes 2 and 4)	1,342,794	850,085
Earned member equity, NLC Mutual Insurance Company, net of penalties (Note 5)	-	88,962
<b>Total nonoperating revenues</b>	<b>1,342,794</b>	<b>939,047</b>
<b>Income before capitalization     contributions and distributions</b>	<b>1,714,772</b>	<b>1,092,162</b>
Capitalization contributions	240,176	317,475
Capitalization distributions	(17,204)	-
<b>Change in net assets</b>	<b>1,937,744</b>	<b>1,409,637</b>
Net assets:		
Beginning of year	3,908,343	2,498,706
End of year	<b>\$ 5,846,087</b>	<b>\$ 3,908,343</b>

See Notes to Financial Statements.

South Dakota Public Assurance Alliance

Statements of Cash Flows

Years Ended December 31, 2007 and 2006

	2007	2006
<b>Cash Flows From Operating Activities</b>		
Operating contributions received	\$ 8,887,244	\$ 7,882,862
Reinsurance premiums paid	(1,484,018)	(1,230,543)
Losses and loss adjustment expenses paid	(4,556,974)	(3,799,882)
General and administrative expenses paid	(2,056,576)	(1,593,633)
<b>Net cash provided by operating activities</b>	<b>789,676</b>	<b>1,258,804</b>
<b>Cash Flows From Noncapital Financing Activities</b>		
Cumulative reserve contributions received	162,827	272,030
Cumulative reserve contributions paid	(17,204)	-
<b>Net cash provided by noncapital financing activities</b>	<b>145,623</b>	<b>272,030</b>
<b>Cash Flows From Investing Activities</b>		
Debt securities:		
Purchases	(6,273,687)	(6,376,076)
Maturities and calls	5,890,761	3,524,551
Repayments on mortgage-backed securities	929,689	1,258,274
Proceeds from maturities of certificates of deposit	449,824	781,453
Purchases of certificates of deposit	(1,612,627)	(1,890,621)
Investment income received, net of investment expenses	945,053	770,767
Capital contributions to NLC Mutual Insurance Company	-	(41,383)
<b>Net cash provided by (used in) investing activities</b>	<b>329,013</b>	<b>(1,973,035)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>1,264,312</b>	<b>(442,201)</b>
<b>Cash and Cash Equivalents</b>		
Beginning of year	749,233	1,191,434
End of year	<b>\$ 2,013,545</b>	<b>\$ 749,233</b>
<b>Reconciliation of operating income to net cash provided by operating activities:</b>		
Operating income	\$ 371,978	\$ 153,115
(Increase) decrease in assets:		
Contributions receivable	(279,984)	(230,478)
Reinsurance recoverable on paid losses	(42,709)	(10,834)
Prepaid expenses	14,427	(29,842)
Increase (decrease) in liabilities:		
Losses and loss adjustment expense reserves	134,198	996,861
Accounts payable and accrued expenses	(141,851)	173,694
Unearned contributions	733,617	206,288
<b>Net cash provided by operating activities</b>	<b>\$ 789,676</b>	<b>\$ 1,258,804</b>
<b>Supplemental Disclosure of Noncash Investing and Financing Activity</b>		
Net increase in the fair value of investments	\$ 423,856	\$ 32,423
Earned member equity, NLC Mutual Insurance Company	-	88,962

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 362 members are various governmental entities throughout 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 statements 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, 2007 and 2006, the Operating Fund had a deficiency of \$(4,572,904) and \$(6,364,994), respectively, and the Cumulative Reserve Fund had a balance of \$10,418,991 and \$10,273,337, respectively. 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.

The Pool is exposed to various risks of loss related to torts and errors and omissions. The Pool has 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.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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

Basis of presentation (continued): 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 primarily 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.

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 calculation of realized gains and losses is independent of the calculation of the net increase (decrease) in the fair value of investments. Realized gains and losses on investments that had been held for more than one year and sold in the current year may have been recognized as an increase or decrease in the fair value of investments reported in the prior year.

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.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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

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, 2007 and 2006.

Capitalization contributions and unearned contributions: 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 contributions, then amortizing them into revenue over an appropriate period not to exceed 10 years. Unearned contributions resulting from the application of Interpretation No. 4 are being amortized pro rata over a six-year period, the period over which capitalization contributions are allocated.

Operating contributions and unearned contributions: 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 contributions. 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, 2007 and 2006.

Recent accounting pronouncements: The GASB and FASB have issued certain accounting standards, which have required effective dates occurring after the Pool's December 31, 2007 year end. The Pool's financial statements are not expected to be materially affected by those accounting pronouncements.

Reclassifications: Certain reclassifications have been made to prior year amounts to conform to the current year presentation. Such reclassifications had no impact on the change in net assets.

South Dakota Public Assurance Alliance

Notes to Financial Statements

**Note 2. Deposits and Investments**

The Pool's cash and cash equivalents are comprised of a money market account and a checking account. Custodial credit risk is the risk that in the event of a bank failure, the Pool's deposits may not be returned to it. The Pool does not have a deposit policy for custodial credit risk. As of December 31, 2007 and 2006, \$2,007,992 and \$743,631 was exposed to custodial credit risk as uninsured and uncollateralized, respectively,

As of December 31, 2007, the Pool had the following investments:

Investment Type	Fair Value/ Carrying Value	Effective Duration (In Years)
U.S. government corporations and agencies	\$ 8,339,984	2.28
Mortgage-backed securities	7,150,254	3.88
Certificates of deposit	4,569,009	2.68
	\$ 20,059,247	2.69

As of December 31, 2006, the Pool had the following investments:

Investment Type	Fair Value/ Carrying Value	Effective Duration (In Years)
US treasury issues	\$ 635,869	0.02
U.S. government corporations and agencies	8,138,609	3.13
Mortgage-backed securities	6,843,154	4.21
Certificates of deposit	3,401,719	2.89
	\$ 19,019,351	3.37

As of December 31, 2007, the Fund had the following investments (other than those explicitly guaranteed by the U.S. government) which exceed 5% of the total investment portfolio:

	Percentage of Portfolio
Federal Home Bank	6.3
Federal Home Bank	6.0
Federal National Mortgage Association	6.2

The net increase in the fair value of investments was \$423,856 and \$32,423 during 2007 and 2006, respectively. These amounts take into account all changes in fair value (including purchases and sales) that occurred during the year.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 2. Deposits and Investments (continued)

Interest rate risk: The Pool's investment policy provides for the avoidance of undue concentration in the maturity of bonds in the portfolio and the effective duration of the portfolio is limited to no longer than 4 years. The investment policy also provides that at least \$300,000 or more of investments should mature within 20 days or less.

Credit risk: The Pool's investment policy provides that all investments be federally insured, protected against loss as provided in SDCL 4-6A-9 as "public deposits" in qualified public depositories, or meet the requirements of SDCL 4-5-6, which allows investments in (a) securities of the United States and securities guaranteed by the United States government either directly or indirectly; or (b) repurchase agreements fully collateralized by securities described in (a) above; or in shares of an open-end, no-load fund administered by an investment company whose investments are in securities described in (a) above and repurchase agreements described in (b) above. The Pool has no investment policy that would further limit its investment choices other than as described in its investment footnote disclosures. The credit rating for all U.S. government corporations and agencies and mortgage-backed securities held by the Pool is AAA as of December 31, 2007 and 2006.

Concentration of credit risk: The Pool's investment policy provides that securities issued directly by or indirectly guaranteed by the United States Government (including, but not limited to U.S. treasury securities and securities issued by or guaranteed by the Government National Mortgage Association) may be owned without limit. The aggregate market value of all unsecured obligations issued by or guaranteed by government sponsored enterprises which are not direct or indirect obligations of the U.S. Treasury (including, but not limited to Fannie Mae, Freddie Mac, and the Federal Home Loan Bank) are limited to 60% of the market value of the portfolio. This limitation does not apply to collateralized obligations guaranteed by these government sponsored enterprises (including, but not limited to mortgage-backed pass-through securities). The aggregate market value of all certificates of deposit owned in the portfolio cannot exceed 75% of the market value of the portfolio. The use of leverage and direct investment in derivative securities is prohibited.

South Dakota Public Assurance Alliance

Notes to Financial Statements

**Note 3. 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 years ended December 31, 2007 and 2006.

	2007	2006
Unpaid losses and loss adjustment expense reserves at beginning of year	\$ 13,575,314	\$ 12,578,453
Less reinsurance recoverable at beginning of year	(10,834)	-
Net unpaid losses and loss adjustment expense reserves at beginning of year	<u>13,564,480</u>	<u>12,578,453</u>
Net incurred losses and loss adjustment expenses:		
Current year provision	5,949,780	5,354,623
Decrease in prior years' provisions	(1,301,317)	(568,714)
Net provision	<u>4,648,463</u>	<u>4,785,909</u>
Net losses and loss adjustment expense payments attributable to:		
Current year	(2,287,455)	(1,562,007)
Prior years	(2,269,519)	(2,237,875)
Net payments	<u>(4,556,974)</u>	<u>(3,799,882)</u>
Net unpaid losses and loss adjustment expense reserves at end of year	13,655,969	13,564,480
Plus reinsurance recoverable at end of year	53,543	10,834
Unpaid losses and loss adjustment expense reserves at end of year	<u>\$ 13,709,512</u>	<u>\$ 13,575,314</u>

As a result of changes in estimates of insured events in prior years, the provision for losses and loss adjustment expense reserves decreased by approximately \$1,300,000 and \$569,000 in 2007 and 2006, respectively. The change in incurred losses was primarily attributable to new information regarding claim development that became known during each period.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### Note 4. Agreements

Hagan Benefits, Inc. (HBI) performs the program administration, marketing, underwriting, billing and collection services for the Pool. Total fees incurred under the HBI agreements were \$1,678,631 and \$1,483,885 in 2007 and 2006, respectively, and are included in general and administrative expenses in the statements of revenues and expenses.

The administration agreement with HBI provides for fees for 2006 of \$154,000, with a 10% increase annually thereafter through the term of the agreement, which expires December 31, 2009. The marketing agreement with HBI provides for fees of 15.6% of member contributions. The marketing agreement expires December 31, 2009.

The Pool has agreements with Claims Associates, Inc. (CAI) to provide administrative, investigative, and adjustment services for claims incurred. The agreements provide for a flat fee for claims administration services with varying fees for claims adjustment expenses incurred. The agreements expire December 31, 2009. Total fees incurred under these agreements in 2007 and 2006 were \$881,778 and \$949,329, respectively, and are included in losses and loss adjustment expenses in the statements of revenues and expenses.

The Pool has 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 agreement expires December 31, 2009. Fees incurred in 2007 and 2006 were \$192,150 and \$265,504 respectively, and are included in losses and loss adjustment expenses in the statements of revenues and expenses.

The Pool maintains agency accounts with the First National Bank of Sioux Falls (FNB) under a custodial agreement. Fees incurred to FNB in 2007 and 2006 were \$55,349 and \$49,527, respectively, and are netted against investment income in the statements of revenues and expenses.

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 2007 and 2006 were \$70,240 and \$68,224, respectively, and are included in general and administrative expenses in the statements of revenues and expenses.

**Note 5. Reinsurance**

The Pool has a casualty reinsurance agreement in which the Pool retains casualty risks up to \$500,000 and \$250,000 per claim in 2007 and 2006, respectively, and claims exceeding the retention are reinsured in an amount not to exceed \$6,000,000 and \$4,750,000 of loss per occurrence in 2007 and 2006, respectively.

The Pool also has property reinsurance in which the Pool retains property risks up to \$250,000 per claim in an amount not to exceed \$250,000,000 and \$500,000,000 per occurrence in 2007 and 2006, respectively.

In a prior year, the Pool had property and casualty reinsurance coverages with NLC Mutual Insurance Company (NLC Mutual), and has since placed these coverages with other companies. 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. Such distributions by NLC Mutual cannot be made without the prior approval of the Vermont Department of Banking, Insurance, Securities and Health Care Administration. Effective December 31, 2006, the Pool withdrew from the property and casualty coverages of NLC Mutual. The Pool made capital contributions to NLC Mutual related to the casualty line of \$0 and \$41,383 in 2007 and 2006, respectively. NLC Mutual has generally been returning profits back to its members each year from underwriting and investment activities.

The Pool's share of NLC Mutual's net worth is comprised of contributed surplus and retained surplus. In accordance with NLC Mutual's by-laws, contributed surplus including interest earned thereon, will be returned to the Pool approximately 4 years after withdrawal notice is submitted to NLC Mutual. Retained surplus will be returned to the Pool no later than 10 years for the casualty line and no later than 6 years for the property line after withdrawal notice is submitted to NLC Mutual, however, the Pool may elect to receive such retained surplus prior to 10 and 6 years, respectively, with such amounts reduced on a percentage basis depending on when the amounts are requested by the Pool (35% and 80% of such amounts would be received for casualty and property, respectively, if requested 2 years after the computation date, with such percentage increasing over the period to 100% after 10 and 6 years, respectively). It is the Pool's intention to request that its retained surplus under the property and casualty lines be returned to the Pool no later than two years after the withdrawal date, and accordingly, \$84,833 of early withdrawal penalty in 2006 is included in earned member equity of NLC Mutual in the statement of revenues and expenses.

Contributed surplus and retained surplus are subject to adjustment for the period between the Pool's date of notice of withdrawal and the actual payment date of such amounts, to include adjustments applicable to the related accounts during such period in accordance with NLC Mutual's by-laws. As of December 31, 2007, the Pool's share of NLC Mutual's net worth was \$262,694 for the casualty line, of which \$226,278 relates to contributed surplus, \$104,045 relates to retained surplus and \$(67,629) relates to early withdrawal penalty. As of December 31, 2007, the Pool's share of NLC Mutual's net worth was \$263,637 for the property line, of which \$194,823 relates to contributed surplus, \$86,018 relates to retained surplus and \$(17,204) relates to early withdrawal penalty.

The Pool would be liable for any obligations that the reinsurance companies are unable to meet under the reinsurance agreements. Reinsurance amounts of \$4,796,056 and \$3,217,502 were deducted from the estimated liability for losses and loss adjustment expense reserves in 2007 and 2006, respectively. During 2007 and 2006, the Pool received \$428,876 and \$719,569 of recoveries from the reinsurance companies under contract.

## South Dakota Public Assurance Alliance

### Notes to Financial Statements

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#### **Note 6. Member Contributions**

Renewal credits were \$91,645 and \$147,149 under the casualty line and \$16,141 and \$23,017 under the property line during the years ended December 31, 2007 and 2006, respectively. Loss control credits were \$112,797 and \$116,702 under the casualty line and \$19,394 and \$17,972 under the property line during the years ended December 31, 2007 and 2006, respectively. Loss ratio credits were \$86,685 and \$57,602 under the casualty line and \$19,163 and \$9,889 under the property line during the years ended December 31, 2007 and 2006, respectively. Renewal, loss control and loss ratio credits are reported as a reduction of member contributions earned in the year in which the member renews.

South Dakota Public Assurance Alliance

Required Supplementary Information - Schedule of Claims Development Information (Casualty) - Unaudited  
For the Ten Years Ended December 31, 2007

	*1998	*1999	*2000	*2001	*2002	*2003	2004	2005	2006	2007
Net earned member contributions and investment income:										
Earned	\$ 6,202,816	\$ 6,146,717	\$ 5,294,578	\$ 5,877,161	\$ 5,117,873	\$ 7,085,676	\$ 4,647,134	\$ 5,566,726	\$ 5,598,882	\$ 6,019,919
Ceded	491,904	527,771	439,011	478,288	605,861	882,528	610,059	637,369	732,588	935,998
<b>Net earned</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>4,037,075</b>	<b>4,929,357</b>	<b>4,866,294</b>	<b>5,083,921</b>
Unallocated expenses	1,193,278	1,213,829	1,508,810	1,676,017	1,375,632	1,463,841	1,342,455	1,068,062	1,165,105	1,273,123
Estimated claims and expenses, end of policy year:										
Incurred	4,061,716	3,983,173	2,800,028	3,225,428	2,933,838	4,890,788	4,821,603	4,835,473	4,323,271	4,429,774
Ceded	384,294	343,961	265,691	344,124	456,183	722,756	-	-	-	-
<b>Net incurred</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>	<b>4,835,473</b>	<b>4,323,271</b>	<b>4,429,774</b>
Net paid (cumulative) as of:										
End of policy year	342,800	517,566	325,428	520,345	458,055	617,802	874,169	861,770	823,766	1,004,961
One year later	677,472	834,311	660,531	948,277	1,010,479	1,175,258	1,523,325	1,449,117	1,277,056	
Two years later	1,276,008	1,208,626	792,480	1,652,279	1,669,320	1,593,084	1,911,996	1,712,797		
Three years later	1,444,709	2,019,738	1,101,185	1,933,209	2,479,592	1,913,479	2,519,100			
Four years later	1,779,424	2,428,582	1,185,566	2,020,956	2,669,911	2,049,265				
Five years later	1,894,981	2,514,858	1,295,934	2,046,821	2,914,859					
Six years later	1,969,439	2,562,548	1,435,822	2,069,799						
Seven years later	1,952,202	2,624,892	1,445,219							
Eight years later	2,086,971	2,658,775								
Nine years later	2,245,067									
Reestimated ceded claims and expenses	329,203	392,675	217,722	184,776	335,894	334,595	1,696,987	1,585,000	-	208,813
Reestimated net incurred claims and expenses:										
End of policy year	3,677,422	3,639,212	2,534,337	2,881,304	2,477,655	4,168,032	4,821,603	4,835,473	4,323,371	4,429,774
One year later	2,670,972	3,172,004	2,281,228	2,708,859	3,029,003	3,624,157	4,110,676	4,318,049	3,560,032	
Two years later	2,322,589	2,703,223	1,734,768	2,497,852	4,001,195	2,659,094	4,044,965	3,380,071		
Three years later	2,392,433	2,868,655	1,667,816	2,528,159	4,062,162	2,493,561	4,240,673			
Four years later	2,118,513	2,886,501	1,650,581	2,189,273	4,342,696	2,381,851				
Five years later	2,172,933	3,842,157	1,671,114	2,165,723	4,367,531					
Six years later	2,185,083	3,792,579	1,462,017	2,108,148						
Seven years later	2,177,909	3,836,053	1,506,163							
Eight years later	2,159,977	3,815,940								
Nine years later	2,314,927									
Increase (decrease) in estimated net incurred claims and expenses from end of policy year	\$ (1,362,495)	\$ 176,728	\$ (1,028,174)	\$ (773,156)	\$ 1,889,876	\$ (1,786,181)	\$ (580,930)	\$ (1,455,402)	\$ (763,239)	\$ -

\* 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) - Unaudited  
December 31, 2007

	*1999	*2000	*2001	*2002	*2003	2004	2005	2006	2007
Net earned member contributions and investment income:									
Earned	\$ 553,629	\$ 847,812	\$ 1,152,068	\$ 5,422,862	\$ 1,336,102	\$ 2,811,931	\$ 2,754,020	\$ 3,125,832	\$ 3,332,630
Ceded	47,945	93,624	50,232	4,016,000	980	731,758	771,872	497,955	548,020
<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>	<b>1,982,148</b>	<b>2,627,877</b>	<b>2,784,610</b>
Unallocated expenses	279,699	376,120	410,052	647,198	811,557	887,489	565,369	572,380	656,029
Estimated claims and expenses, end of policy year:									
Incurred	270,708	469,392	718,209	4,766,502	513,742	1,072,448	1,455,634	1,750,821	1,948,882
Ceded	47,945	93,624	50,232	4,016,000	980	129,164	362,367	719,569	428,876
<b>Net incurred</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>	<b>1,093,267</b>	<b>1,031,252</b>	<b>1,520,006</b>
Net paid (cumulative) as of:									
End of policy year	201,346	247,588	399,772	766,912	391,142	561,722	704,946	738,241	1,282,494
One year later	251,874	297,662	538,043	936,288	500,070	777,522	1,103,923	926,907	
Two years later	256,160	305,731	697,971	903,386	499,760	781,245	1,108,535		
Three years later	256,241	493,588	698,921	753,350	500,248	786,593			
Four years later	317,271	493,588	700,932	753,350	500,247				
Five years later	315,926	493,588	700,932	753,350					
Six years later	312,284	493,588	699,045						
Seven years later	312,284	493,628							
Eight years later	312,324								
Reestimated ceded claims and expenses	73,449	30,882	25,030	3,033,462	7,536	15,268	146,825	1,768,764	184,021
Reestimated net incurred claims and expenses:									
End of policy year	222,763	375,768	667,977	750,502	512,762	943,284	1,093,267	1,031,252	1,520,006
One year later	267,119	348,033	553,811	2,289,767	555,461	803,280	1,150,800	974,124	
Two years later	256,791	305,815	710,620	912,756	513,159	800,174	1,128,045		
Three years later	256,615	493,588	713,117	753,722	500,248	789,006			
Four years later	317,416	493,588	700,932	753,349	500,247				
Five years later	315,931	493,588	700,932	753,350					
Six years later	312,284	493,588	699,045						
Seven years later	312,284	493,628							
Eight years later	312,324								
Increase (decrease) in estimated net incurred claims and expenses from end of policy year	\$ 89,561	\$ 117,860	\$ 31,068	\$ 2,848	\$ (12,515)	\$ (154,278)	\$ 34,778	\$ (57,128)	\$ -

\* 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

Combining Schedules of the Liability for Losses and Loss Adjustment Expense Reserves  
Years Ended December 31, 2007 and 2006

	2007			2006		
	Casualty	Property	Total	Casualty	Property	Total
Unpaid losses and loss adjustment expense reserves at beginning of year	\$ 13,222,209	\$ 353,105	\$ 13,575,314	\$ 12,167,148	\$ 411,305	\$ 12,578,453
Less reinsurance recoverable at beginning of year	-	(10,834)	(10,834)	-	-	-
Net unpaid losses and loss adjustment expense reserves at beginning of year	13,222,209	342,271	13,564,480	12,167,148	411,305	12,578,453
Net incurred losses and loss adjustment expenses:						
Current year provision	4,429,774	1,520,006	5,949,780	4,323,371	1,031,252	5,354,623
Increase (decrease) in prior years' provisions	(1,129,505)	(171,812)	(1,301,317)	(609,857)	41,143	(568,714)
Net provision	3,300,269	1,348,194	4,648,463	3,713,514	1,072,395	4,785,909
Net losses and loss adjustment expense payments attributable to:						
Current year	(1,004,961)	(1,282,494)	(2,287,455)	(823,766)	(738,241)	(1,562,007)
Prior years	(2,338,443)	68,924	(2,269,519)	(1,834,687)	(403,188)	(2,237,875)
Net payments	(3,343,404)	(1,213,570)	(4,556,974)	(2,658,453)	(1,141,429)	(3,799,882)
Net unpaid losses and loss adjustment expense reserves at end of year	13,179,074	476,895	13,655,969	13,222,209	342,271	13,564,480
Plus reinsurance receivable at end of year	-	53,543	53,543	-	10,834	10,834
Unpaid losses and loss adjustment expense reserves at end of year	\$ 13,179,074	\$ 530,438	\$ 13,709,512	\$ 13,222,209	\$ 353,105	\$ 13,575,314

South Dakota Public Assurance Alliance

Combining Schedules of Net Assets  
December 31, 2007

Assets	2007		
	Casualty	Property	Total
<b>Current Assets</b>			
Cash and cash equivalents	\$ 1,429,576	\$ 583,969	\$ 2,013,545
Receivables:			
Contributions	2,462,022	1,000,934	3,462,956
Investment income	157,320	-	157,320
Reinsurance recoverable on paid losses	-	53,543	53,543
Interdivisional accounts receivable	-	2,812,119	- *
Prepaid expenses	74,119	30,288	104,407
Investments:			
Certificates of deposit	675,511	-	675,511
Debt securities	2,466,012	-	2,466,012
<b>Total current assets</b>	<b>7,264,560</b>	<b>4,480,853</b>	<b>8,933,294</b>
<b>Noncurrent Assets</b>			
Investments:			
Certificates of deposit	3,893,498	-	3,893,498
Debt securities	13,024,226	-	13,024,226
Contributed surplus and member equity in NLC Mutual Insurance Company	262,694	263,637	526,331
	<u>17,180,418</u>	<u>263,637</u>	<u>17,444,055</u>
	<u>\$ 24,444,978</u>	<u>\$ 4,744,490</u>	<u>\$ 26,377,349</u>
<b>Liabilities and Net Assets</b>			
<b>Current Liabilities</b>			
Losses and loss adjustment expense reserves	\$ 2,134,910	\$ 369,715	\$ 2,504,625
Accounts payable and accrued expenses	39,616	14,824	54,440
Unearned contributions	4,418,054	2,127,069	6,545,123
Interdivisional accounts payable	2,812,119	-	- *
<b>Total current liabilities</b>	<b>9,404,699</b>	<b>2,511,608</b>	<b>9,104,188</b>
<b>Noncurrent Liabilities</b>			
Losses and loss adjustment expense reserves	11,044,164	160,723	11,204,887
Unearned contributions, capitalization contributions	222,187	-	222,187
	<u>11,266,351</u>	<u>160,723</u>	<u>11,427,074</u>
<b>Total liabilities</b>	<b>20,671,050</b>	<b>2,672,331</b>	<b>20,531,262</b>
Net Assets - Unrestricted	3,773,928	2,072,159	5,846,087
	<u>\$ 24,444,978</u>	<u>\$ 4,744,490</u>	<u>\$ 26,377,349</u>

\* Eliminated during combination

South Dakota Public Assurance Alliance

Combining Schedules of Revenues, Expenses and Changes in Net Assets  
Year Ended December 31, 2007

	2007		
	Casualty	Property	Total
Operating revenues:			
Contributions:			
Operating, net of credits	\$ 5,414,312	\$ 3,019,299	\$ 8,433,611
Reinsurance premiums ceded	(935,998)	(548,020)	(1,484,018)
<b>Net operating revenues</b>	<b>4,478,314</b>	<b>2,471,279</b>	<b>6,949,593</b>
Operating expenses:			
Losses and loss adjustment expenses incurred	3,300,269	1,348,194	4,648,463
General and administrative expenses:			
Marketing and administrator's fees	1,109,123	569,508	1,678,631
Other	164,000	86,521	250,521
<b>Total general and administrative expenses</b>	<b>1,273,123</b>	<b>656,029</b>	<b>1,929,152</b>
<b>Total operating expenses</b>	<b>4,573,392</b>	<b>2,004,223</b>	<b>6,577,615</b>
<b>Operating income (loss)</b>	<b>(95,078)</b>	<b>467,056</b>	<b>371,978</b>
Nonoperating revenues (expenses):			
Net investment income	1,329,713	13,081	1,342,794
<b>Total nonoperating revenues</b>	<b>1,329,713</b>	<b>13,081</b>	<b>1,342,794</b>
<b>Income before capitalization contributions and distributions</b>	<b>1,234,635</b>	<b>480,137</b>	<b>1,714,772</b>
Capitalization contributions	240,176	-	240,176
Capitalization distributions	(17,204)	-	(17,204)
<b>Change in net assets</b>	<b>1,457,607</b>	<b>480,137</b>	<b>1,937,744</b>
Net assets:			
Beginning of year	2,316,321	1,592,022	3,908,343
End of year	<b>\$ 3,773,928</b>	<b>\$ 2,072,159</b>	<b>\$ 5,846,087</b>

South Dakota Public Assurance Alliance

Combining Schedules of Cash Flows

Year Ended December 31, 2007

	2007		
	Casualty	Property	Total
<b>Cash Flows From Operating Activities</b>			
Operating contributions received	\$ 5,784,932	\$ 3,102,312	\$ 8,887,244
Reinsurance premiums paid	(935,998)	(548,020)	(1,484,018)
Losses and loss adjustment expenses paid	(3,343,404)	(1,213,570)	(4,556,974)
General and administrative expenses paid	(1,273,836)	(782,740)	(2,056,576)
<b>Net cash provided by operating activities</b>	<b>231,694</b>	<b>557,982</b>	<b>789,676</b>
<b>Cash Flows From Noncapital Financing Activities</b>			
Cumulative Reserve Fund contributions received	162,827	-	162,827
Cumulative reserve contributions paid	(17,204)	-	(17,204)
<b>Net cash provided by noncapital financing activities</b>	<b>145,623</b>	<b>-</b>	<b>145,623</b>
<b>Cash Flows From Investing Activities</b>			
Debt securities:			
Purchases	(6,273,687)	-	(6,273,687)
Maturities and calls	5,890,761	-	5,890,761
Repayments on mortgage-backed securities	929,689	-	929,689
Proceeds from maturities of certificates of deposit	449,824	-	449,824
Purchases of certificates of deposit	(1,612,627)	-	(1,612,627)
Interdivisional amounts	236,137	(236,137)	-
Investment income received, net of investment expenses	931,972	13,081	945,053
<b>Net cash provided by (used in) investing activities</b>	<b>552,069</b>	<b>(223,056)</b>	<b>329,013</b>
<b>Net increase in cash and cash equivalents</b>	<b>929,386</b>	<b>334,926</b>	<b>1,264,312</b>
<b>Cash and Cash Equivalents</b>			
Beginning of year	500,190	249,043	749,233
End of year	\$ 1,429,576	\$ 583,969	\$ 2,013,545
<b>Reconciliation of operating income (loss) to net cash provided by operating activities:</b>			
Operating income (loss)	\$ (95,078)	\$ 467,056	\$ 371,978
(Increase) decrease in assets:			
Contributions receivable	(238,050)	(41,934)	(279,984)
Reinsurance recoverable on paid losses	-	(42,709)	(42,709)
Prepaid expenses	3,306	11,121	14,427
Increase (decrease) in liabilities:			
Losses and loss adjustment expense reserves	(43,135)	177,333	134,198
Accounts payable and accrued expenses	(4,019)	(137,832)	(141,851)
Unearned contributions	608,670	124,947	733,617
<b>Net cash provided by operating activities</b>	<b>\$ 231,694</b>	<b>\$ 557,982</b>	<b>\$ 789,676</b>
<b>Supplemental Disclosure of Noncash Investing and Financing Activity</b>			
Net increase in the fair value of investments	\$ 423,856	\$ -	\$ 423,856