

**Washington State Auditor's Office**  
**Financial Statements and Actuarial Reviews**  
**Audit Report**

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**Workers' Compensation Program**

Audit Period  
July 1, 2008 through June 30, 2009

Report No. 1002832

Issue Date  
**December 31, 2009**



WASHINGTON  
**BRIAN SONNTAG**  
STATE AUDITOR



**Washington State Auditor  
Brian Sonntag**

December 31, 2009

The Honorable Christine Gregoire, Governor  
The Honorable Ed Murray, Senate Democrat Caucus Chair  
The Honorable Linda Evans Parlette, Senate Republican Caucus Chair  
The Honorable Dawn Morrell, House Democrat Caucus Chair  
The Honorable Dan Kristiansen, House Republican Caucus Chair  
Victor Moore, Director, Office of Financial Management  
Judy Schurke, Director, Department of Labor and Industries

***REPORT ON ACTUARIAL REVIEWS AND FINANCIAL STATEMENT AUDIT***

Please find attached our report on the Workers' Compensation Program actuarial reviews and financial statement audit as required by state law (RCW 51.44.115).

Sincerely,

**BRIAN SONNTAG, CGFM**  
STATE AUDITOR

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# Description of the Workers' Compensation Program

## State of Washington Workers' Compensation Program

### AUDIT AUTHORITY

State law (RCW 51.44.115) requires the State Auditor's Office to annually audit the financial statements of Workers' Compensation Funds administered by the State Department of Labor and Industries. The law also requires us to contract with independent actuaries to obtain actuarial assessments and opinions on the funds. This is our fourth audit of the Workers' Compensation Funds.

### ABOUT THE WORKERS' COMPENSATION FUNDS

The state's Workers' Compensation system provides medical and limited wage replacement coverage to workers with job-related injuries and illness.

- **The Medical Aid Fund** pays for medical care and related services, including some vocational rehabilitation.
- **The Accident Fund** pays non-medical claim costs such as wage replacement benefits, most vocational rehabilitation, disability pensions and survivor benefits.
- **The Pension Reserve Fund** pays benefits to all permanently disabled pensioners including disabled employees of self-insured employers.

The Workers' Compensation Program establishes claims payable liabilities (unpaid loss and loss adjustment expense liabilities) based on estimates of the ultimate cost of claims (including future claims adjustment expenses) that have been reported but not resolved, and claims that have been incurred but not reported. Insurance premium rates are set by the Department's Director, considering input from the Workers' Compensation Advisory Committee, the Governor, interest groups and the Department's actuaries. For calendar year 2009, the total hourly premium rate paid by the state's employers was \$0.556.

The State Investment Board invests the money in these funds under policies and procedures designed to maximize return at a prudent level of risk. Eligible investments include U.S. equities, international equities, U.S. treasuries and government agencies, credit bonds, mortgage backed securities, asset backed securities and non-U.S. dollar bonds. Investment allocation targets are as follows:

<u>Fund</u>	<u>Fixed Income Target</u>	<u>Equity Target</u>
Accident	90%	10%
Medical Aid	85%	15%
Pension Reserve	90%	10%

# Audit Summary

## State of Washington Workers' Compensation Program July 1, 2008 through June 30, 2009

### **AUDIT OVERVIEW**

We contracted with a certified public accounting firm to audit the Workers' Compensation financial statements. We also contracted with an actuarial firm to conduct actuarial assessments of the loss reserves in the Accident Fund, Medical Aid Fund and the Pension Reserve Fund. In addition, the firm assessed the financial effect of the 2010 rate level increase on the actuarial solvency of these funds, taking into consideration the risks inherent with insurance and the effect of the actuarial assumptions, discount rates, reserving, retrospective rating program, refunds and individual employer rate classes, as well as the standard accounting principles used for insurance underwriting purposes.

The actuarial firm was selected based on a competitive solicitation of independent qualified firms. The leader of the actuarial team is a member of the American Academy of Actuaries, a Fellow of the Casualty Actuarial Society, and meets qualification standards for statements of actuarial opinion.

### **AUDIT RESULTS**

#### **Financial statement opinion**

The certified public accounting firm issued an unqualified report concluding that the financial statements of the Workers' Compensation Program of the State of Washington were fairly presented in accordance with generally accepted accounting principles. The financial statements can be seen at:  
<http://www.lni.wa.gov/ClaimsIns/Insurance/Learn/StateFund/Reports/Default.asp>.

#### **Actuarial opinion on loss reserves**

The Actuarial firm issued an opinion stating the reported loss and loss adjustment expense reserves are consistent with reserves computed in accordance with Standards of Practice issued by the Actuarial Standards Board and that the reserves make a reasonable provision for all the unpaid loss and loss adjustment expense obligations of the Department under the terms of its policies and agreements.

#### **Assessment of the financial impact of the proposed rate level**

During the fiscal year ended June 30, 2009, the contingency reserves for both the Accident Fund and Medical Aid Fund declined substantially. The declines were primarily driven by three factors:

- The market value of investments declined dramatically in the second half of 2008 as a result of the financial crisis and accompanying economic recession.

- Loss and loss adjustment expense liabilities, particularly in the Accident Fund, increased significantly during the fiscal year.
- 2008 and 2009 premium rates were insufficient to fund the system.

For 2010, the Department will raise rates by 4.5 percent in the Accident Fund and by 8.4 percent in the Medical Aid Fund. Considering the rate increases, the Actuarial firm estimates:

- A 74.4 percent chance of insolvency in the Accident Fund within two years, 81.4 percent within three years and 89.5 percent within five years.
- A 3.9 percent probability of insolvency in the Medical Aid Fund in two years, 12.9 percent within three years and 26.5 percent within five years.

Insolvency is defined as liabilities in excess of the value of assets. It is important to note that in the event of insolvency, the Accident Fund and Medical Aid Fund would have sufficient assets to pay claims and perform day-to-day services; however, its contingency reserve funds have a potential of falling below zero. The Actuarial firm's conclusions are predicated on a number of assumptions on future conditions and events and estimates described in its report.

Unlike the Accident Fund and Medical Aid Fund, the Pension Reserve Fund does not assess premiums. It is funded in several different ways with contributions and transfers from the Accident Fund and self-insurers. The predominant method is to fully fund each pension annuity when the liability is transferred to the Pension Reserve Fund. Because of the way the Pension Reserve Fund is financed, its solvency is guaranteed as long as the Accident Fund and the self-insurance program remain solvent.

The Actuarial firm also calculated the rate level change that would be required for the funds to break even at various investment income yield rates.

The Actuarial firm calculated a range of break-even rate level changes using its estimated loss projections and investment rates of return. As illustrated in the chart below, the firm's "best" estimate is that a 33 percent rate increase would be necessary for the Accident Fund to break even. The Department estimates a 23.3 percent rate increase would be necessary for the Accident Fund to break even. The Actuarial firm believes the Department's estimate is outside a range of reasonable estimates.

For the Medical Aid Fund, the firm's "best" estimate is that a 24.5 percent rate increase would be necessary to break even. The Department estimates that a 21.5 percent rate increase would be necessary for the Medical Aid Fund to break even. The firm believes the Department's estimate is within a range of reasonable estimates.

<b>Accident Fund</b>			
Estimated Rate Level Change Required to Break-even			
Assumed Investment Yield	Actuarial Firm's Best Estimate	Department's Best Estimate	Department's actual 2010 rate increase
4.2%	33.0%	23.3%	4.5%

<b>Medical Aid Fund</b>			
Estimated Rate Level Change Required to Break-even			
Assumed Investment Yield	Actuarial Firm's Best Estimate	Department's Best Estimate	Department's actual 2010 rate increase
2.5%	24.5%	21.5%	8.4%

***CLOSING REMARKS***

We thank the Department's management and personnel for their assistance and cooperation during the audit.



## **ABOUT THE STATE AUDITOR'S OFFICE**

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The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work in cooperation with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver our services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service. We continue to refine our reporting efforts to ensure the results of our audits are useful and understandable.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

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