



COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND
SCRANTON, PENNSYLVANIA

AUDIT REPORT
FOR THE YEAR ENDED DECEMBER 31, 2012
(WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2011)

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**DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND
DECEMBER 31, 2012**

BACKGROUND

The State Workers' Insurance Fund (SWIF) is a self-sustaining fund operating within the Department of Labor and Industry for the purpose of providing worker's compensation insurance to employers, including those refused policies by private insurance firms. SWIF is subject to underwriting rules, classifications and rates promulgated by rating bureaus authorized by the State Insurance Commissioner. A board consisting of the Secretary of Labor and Industry, the State Treasurer, and the Insurance Commissioner oversees operations of the fund.



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EUGENE A. DePASQUALE
AUDITOR GENERAL

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

Report on the Financial Statements

We have audited the accompanying Statement of Admitted Assets, Liabilities and Surplus-statutory basis of the State Workers' Insurance Fund (SWIF) as of December 31, 2012, and the related Statement of Operations and Changes in Surplus-statutory basis and the Statement of Cash Flows-statutory basis for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with statutory accounting practices as prescribed or permitted by the Insurance Department of Pennsylvania. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and surplus of SWIF as of December 31, 2012, and the results of its operations and its cash flows for the year then ended in accordance with statutory accounting practices as prescribed or permitted by the Insurance Department of Pennsylvania as described in Note A.

Basis of Accounting

We draw attention to Note A of the financial statements, which describes the basis of accounting. As described in Note A to the financial statements, the financial statements are prepared by SWIF in accordance with statutory accounting practices as prescribed or permitted by the Insurance Department of Pennsylvania, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of the Insurance Department of Pennsylvania. The effects on the financial statements of the variances between these regulatory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material. Our opinion is not modified with respect to this matter.

Emphasis of Matter

As discussed in Note E, the insurance loss liability of SWIF is based on actuarial analysis of historical experience adjusted to estimate the impact of Act 44 of 1994 and Act 57 of 1996 and changes in claims management practices adopted by SWIF management. Because of the length of time required for the actual insurance loss liability to be determined and the uncertainty regarding whether the adjusted data will be supported by future claim payments, the actual liability may vary significantly from the estimated amount provided for in the Statement of Admitted Assets, Liabilities and Surplus-statutory basis.

Report on Comparative Information

We have previously audited the SWIF's 2011 financial statements, and we expressed an unmodified audit opinion on those audited financial statements in our report dated December 5, 2012. In our opinion, the comparative information presented herein as of and for the year ended December 31, 2011 is consistent, in all material respects, with the audited financial statements from which it has been derived.

Other Matters

Supplementary Information

Our audit was conducted for the purposes of forming an opinion on the statutory financial statements as a whole. The management's discussion and analysis is presented for purposes of additional analysis and is not a required part of the statutory financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the statutory financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Information

The background has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 5, 2013, on our consideration of SWIF's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering SWIF's internal control over financial reporting and compliance.



December 5, 2013

EUGENE A. DEPASQUALE
Auditor General

**DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)**

SWIF MANAGEMENT'S DISCUSSION AND ANALYSIS

Assets and Liabilities

The State Workers' Insurance Fund (SWIF) disclosed total admitted assets of \$1.492 billion as of December 31, 2012. This was an increase of \$7 million or 0.5% from 2011. Cash and invested assets decreased from \$1.421 billion in 2011 to \$1.420 billion in 2012 or a \$1 million decrease. Although the value of the bond portfolio decreased \$19 million or 1.5%, it was offset by a \$16 million increase in the short-term investments.

Total unpaid losses increased as of year-end 2012 to \$1.372 billion, from \$1.293 billion, an increase of \$79 million or 6.1%. SWIF's total liabilities increased to \$1.695 billion, an increase of \$105 million or 6.6% from the prior year. These increases were the result of unfavorable development of reserves, and a decrease in the discount rate used to calculate SWIF's net loss reserves from 2.75% to 2.00%.

Surplus

Surplus as regards policyholders declined to (\$202) million, a decline of \$97.7 million or 93.4% for 2012 as compared to the reported deficit of (\$105) million in 2011. SWIF's net loss before other changes in surplus for 2012 was \$108 million versus a net loss in 2011 of \$59 million. The decline in surplus as well as increase in net loss was due in large part to the above mentioned change in discount rate from 2.75% to 2%. This change in discount rate accounted for approximately \$85 million of the change. The fund had a change in unrealized capital gain of \$3 million in 2012 compared to a change in unrealized capital loss of \$6 million in 2011. This was due to an increase in the market value of SWIF's portfolio. SWIF also had a \$7 million decrease in non-admitted assets, resulting in an addition to surplus.

SWIF continues to address this reduction in surplus and has implemented several initiatives to address this issue, as outlined below in the section titled future initiatives. These initiatives have also allowed SWIF to achieve positive cash flow for 2012, by growing its cash and short-term investments by \$17 million or 22% from 2011.

**DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)**

SWIF MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)

Operational Results

SWIF recorded a net loss before other changes in surplus of \$108 million for 2012. This is an additional loss of \$49 million as compared to the 2011 net loss of \$59 million. Earned premiums rose by \$21 million, to \$178 million from \$157.4 million, or 13%. Accompanying this premium increase was a \$67 million, or 32.5% increase in incurred losses from \$206.8 million in 2011 to \$273.8 million in 2012. The net underwriting loss was \$174.7 million as compared with \$97.2 million in 2011.

Net investment income earned (excluding realized capital gains/losses) decreased to \$44 million in 2012 from \$49 million in 2011. SWIF recorded net realized capital gains of \$38 million in 2012, an increase of \$17 million from the prior year. This is a result of the stabilization of global market conditions during 2012. Loss adjustment expenses incurred increased \$23 million or 71.9% from \$32.6 million in 2011 to \$56.0 million in 2012. The increase was due in a large part to a \$10.9 million increase in salaries and employee relations and a \$7.6 million increase in claim adjustment services from 2011 to 2012 per the Annual Statement.

During 2012, SWIF also had \$16 million in charged off premium that was included in SWIF's net loss. This premium was ruled uncollectible and charged off through the Pennsylvania Attorney General's Office.

Future Initiatives

SWIF's Compromise & Release (C&R) Initiative continued to produce savings in future reserves. During 2012, seven hundred seventeen (717) claims were settled that resulted in loss reserve savings of \$63 million.

Successful Implementation of Claims Re-organization during 2012 resulting in the furlough of Claim staff and reductions through attrition throughout SWIF from January 2011 combined will result in annual savings of \$4.5 million in salary and benefits.

SWIF developed and implemented a streamlined Claims business process flow between Home and District Offices; trained District Office personnel in new job functions and responsibilities, streamlined workflows, all in an effort to increase efficiencies in claims handling and processing Workers' Compensation Decisions and Orders.

**DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)**

SWIF MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)

Full implementation of the MedRisk Bill Review and Preferred Provider Organization project took place on September 4, 2009. The full implementation allowed bills to be repriced and processed by MedRisk and interfaced directly in SWIF's PowerComp system for payment. As part of this project SWIF also offered the Cypress Care Prescription drug program to further increase savings in claimant prescription bills. From September 2009 to year end 2012, SWIF has realized \$30.6 million in medical savings below medical fee schedule due to provider network savings.

SWIF completed the selection of a new provider (Hoover Rehabilitation Inc.) for their Medical Bill Repricing, Preferred Provider Organization (PPO), Pharmacy Benefit Management (PBM) and Durable Medical Equipment (DME). The current provider's contract expired on 4/30/13. Early results from the new provider through the first half of 2013, show medical bill savings due to network discounts have increased from 8.6% to 14.9% an additional savings of possibly \$5 million for the year.

During 2012, SWIF's Customer Service Unit handled 80,182 of the 99,269 calls received or 80.7% of all calls. This unit eliminated the need to transfer calls to the Underwriting, Claims, Auditing, and Accounting Divisions. This unit also handled 7,046 first report of injury calls.

SWIF's current Computer System went live in 2005. In 2013 SWIF will complete gathering requirements in order to prepare an RFP for a new system. It is anticipated that the new system will allow for enhanced use of online capability to provide expanded customer service features for SWIF policyholders and claimants.

During 2012 SWIF managed its non-admitted assets to \$58 million, a decrease of \$6.8 million or 10% from year end 2011.

STATE WORKERS' INSURANCE FUND
STATEMENT OF ADMITTED ASSETS, LIABILITIES AND SURPLUS
STATUTORY BASIS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

	(Expressed in Thousands)	
ADMITTED ASSETS	2012	2011
<u>Investments</u>		
Bonds	\$ 1,216,479	\$ 1,235,289
Stocks	108,895	108,011
Short-term investments	89,861	73,519
Total investments - Note B	\$ 1,415,235	\$ 1,416,819
<u>Cash</u>		
On deposit in Treasury Department	\$ 4,573	\$ 3,818
<u>Receivables</u>		
Uncollected premiums in course of collection	\$ 5,748	\$ 6,144
Premiums, agents' balances, and installments booked but deferred and not yet due	56,898	48,115
Reinsurance recoverable on loss payments	81	104
Interest due and accrued on investments	9,823	10,149
Funds held by or deposited with reinsurance companies	14	14
Total receivables	\$ 72,564	\$ 64,526
Total Admitted Assets	\$ 1,492,372	\$ 1,485,163
<u>LIABILITIES AND SURPLUS</u>		
<u>Liabilities</u>		
Net unpaid losses – Notes C and E	\$ 1,372,426	\$ 1,293,353
Unpaid loss adjustment expenses	214,800	196,691
Reinsurance payable	50	56
Premium deficiency reserve	191	0
Ceded reinsurance premiums payable	86	0
Accrued administrative expenses	7,915	4,597
Unearned premiums	77,438	65,007
Policyholders' premium credit balances	11,499	10,071
Restricted account – Commonwealth Self Insurance	2,202	2,270
Policyholder deposits	3,334	2,661
Net payable for securities	3,296	12,561
Other liabilities	1,504	2,522
Total liabilities	\$ 1,694,741	\$ 1,589,789
<u>Surplus</u>		
Unassigned surplus (deficit) – Note F	\$ (202,369)	\$ (104,626)
Surplus (deficit) as regards policyholders	\$ (202,369)	\$ (104,626)
Total Liabilities and Surplus	\$ 1,492,372	\$ 1,485,163

- The notes to the financial statements are an integral part of this statement. -

STATE WORKERS' INSURANCE FUND
STATEMENT OF OPERATIONS AND CHANGES IN SURPLUS
STATUTORY BASIS
FOR THE YEAR ENDED DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS
FOR 2011)

	<u>(Expressed in Thousands)</u>	
	<u>2012</u>	<u>2011</u>
<u>Underwriting Income</u>		
Premiums earned	\$ 177,986	\$ 157,448
<u>Underwriting Expenses</u>		
Losses incurred	\$ 273,846	\$ 206,751
Loss adjustment expenses	56,011	32,581
Other	22,685	23,732
Change in premium deficiency reserve	191	(8,410)
Total underwriting expenses	<u>\$ 352,733</u>	<u>\$ 254,654</u>
Net Underwriting Gain (Loss)	<u>\$ (174,747)</u>	<u>\$ (97,206)</u>
<u>Investment Income</u>		
Investment income earned	\$ 48,064	\$ 52,593
Net realized capital gains (losses)	38,319	21,045
Total investment income	<u>\$ 86,383</u>	<u>\$ 73,638</u>
<u>Investment Expenses</u>	<u>\$ 3,648</u>	<u>\$ 3,723</u>
Net Investment Income	<u>\$ 82,735</u>	<u>\$ 69,915</u>
<u>Other Income/Expenses</u>		
Other income/(expenses)	\$ 72	\$ 131
Net loss from premium balances charged off	(15,688)	(31,591)
Total other income/expenses	<u>\$ (15,616)</u>	<u>\$ (31,460)</u>
<u>Net Income (Loss) Before Other Changes in Surplus</u>	<u>\$ (107,628)</u>	<u>\$ (58,751)</u>
<u>Other Changes in Surplus</u>		
Change in net unrealized capital gain (loss)	\$ 3,090	\$ (5,640)
Change in nonadmitted assets	6,795	22,079
Total other changes in surplus	<u>\$ 9,885</u>	<u>\$ 16,439</u>
Net change in surplus during the year	\$ (97,743)	\$ (42,312)
Surplus (deficit) at beginning of year	<u>\$ (104,626)</u>	<u>\$ (62,314)</u>
Surplus (deficit) at end of year	<u><u>\$ (202,369)</u></u>	<u><u>\$ (104,626)</u></u>

- The notes to the financial statements are an integral part of this statement. -

STATE WORKERS' INSURANCE FUND
STATEMENT OF CASH FLOWS
STATUTORY BASIS
FOR THE YEAR ENDED DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS
FOR 2011)

	<u>(Expressed in Thousands)</u>	
	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Premiums collected net of reinsurance	\$ 189,088	\$ 178,753
Benefit and loss related payments	(194,756)	(219,211)
Commissions, expenses paid and aggregate write-ins	(57,428)	(58,279)
Investment income (net of investment expenses)	45,547	47,281
Miscellaneous income (uses)	(14,586)	(40,431)
	<hr/>	<hr/>
Net cash from operating activities	\$ (32,135)	\$ (91,887)
Cash flows from investing activities:		
Proceeds from sale of bonds	\$ 894,766	\$ 1,067,530
Proceeds from sale of stocks	82,664	62,436
Payments for purchase of bonds	(846,339)	(987,966)
Payments for purchase of stocks	(72,593)	(63,322)
Miscellaneous applications	(9,266)	(6,253)
Cash provided from other sources (net of cash applied)	0	3,732
	<hr/>	<hr/>
Net cash from investing activities	\$ 49,232	\$ 76,157
Net change in cash and short-term investments	\$ 17,097	\$ (15,730)
Cash and short-term investments at beginning of year	\$ 77,337	\$ 93,067
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Cash and short-term investments at end of year	\$ 94,434	\$ 77,337
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- The notes to the financial statements are an integral part of this statement. -

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The State Workers' Insurance Fund (SWIF) prepares its statutory financial statements in accordance with statutory accounting practices as prescribed or permitted by rules and regulations promulgated by the Insurance Department of Pennsylvania. These statutory practices are primarily designed to demonstrate solvency and differ from generally accepted accounting principles (GAAP) in certain significant areas:

- Certain assets, designated as nonadmitted, are not permitted to be reported in the statutory financial statements and are charged directly to surplus. Major nonadmitted assets include premiums due in excess of statutory limitations (three months); expenses for furniture, fixtures and supplies; and unrealized gains or losses on investments. Under GAAP, these items would be treated as assets net of the related contra accounts of allowance for doubtful accounts, depreciation, and valuation allowances for investments.
- Certain disclosures required under GAAP are not required under SWIF's statutory accounting practices as follows:
 - Securities lending transactions involving the receipt of cash collateral (or securities that may be pledged or sold without default) with an asset and a liability related to the receipt of the collateral reported on SWIF's Balance Sheet.
 - A Statement of Cash Flows which includes a reconciliation of operating income to net cash provided by (used for) operating activities and which excludes short-term investments.
 - Reporting certain investments at fair value in the Balance Sheet with the current year change in fair value recognized as an element of investment income in the Operating Statement.
 - Reporting the annual required contribution, unfunded actuarial liability and other information regarding postemployment benefits other than pensions.

Investments

Investments are stated on the basis adopted by the National Association of Insurance Commissioners (NAIC) and are recorded based on trade date. The book/adjusted carrying value of bonds is stated at amortized cost. The book/adjusted carrying value of common stock is reported at market value with market value rates taken from the custodian statement. Preferred stock is reported at cost/amortized cost. Realized investment gains or losses are included in the Operating Statement. Unrealized investment gains or losses from revaluation of investments (i.e., stocks) are charged directly to surplus. Short-term investments are recorded at cost which approximates fair value.

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Premium and Revenue Recognition

Premiums earned and assessments billed to policyholders are recorded as income. Unearned premiums and assessments are recorded as a liability and earned as the policy term expires. Premiums and assessments are booked as written on the effective date of the policy. Assessments paid are classified as expenses.

Loss and Loss Adjustment Expense Reserves

The liability for unpaid losses is based upon individual case estimates adjusted for incurred but not reported losses based on past experience, a probable loss reserve, and statutory minimum requirements as determined by SWIF's Actuarial Committee and independent review by outside actuaries. Loss reserves ceded by the National Workers' Compensation Reinsurance Pool and the Pennsylvania Workers' Compensation Reinsurance Pool and assumed by SWIF are included in loss reserves. The liability for loss adjustment expense is determined by SWIF's Actuarial Committee as a percentage of loss reserves based on past experience.

Use of Estimates

The preparation of the accompanying Statement of Admitted Assets, Liabilities and Surplus-statutory basis requires management to make estimates and assumptions that affect the reported amounts of admitted assets, liabilities, and surplus and disclosure of contingent liabilities at the date of this statutory financial statement. Actual results could differ from those estimates.

NOTE B - INVESTMENTS

GAAP (per Governmental Accounting Standards Board Statement No. 40) requires certain disclosures regarding policies and practices with respect to investments and the risks associated with them. Although these disclosures are not required for the statutory financial statements of SWIF, similar informative disclosures have been provided as follows:

SWIF categorizes investments according to the level of investment risk assumed by the Commonwealth. SWIF has formally adopted a written investment policy. Provisions of the written investment policy and current management of the investments consider custodial credit risk, concentration of credit risk, credit risk, interest rate risk, and foreign currency risk. The identified risks are discussed in detail below.

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

Custodial Credit Risk - Custodial credit risk for investments is the risk that, in the event of the failure of the counter-party to a transaction, SWIF would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. In accordance with a contractual relationship between SWIF and its custodial agents, substantially all investments, where securities are used as evidence of the investment, are held by the Custodians in book entry form in the name of the Commonwealth or the Custodian. These investments are defined as insured or registered investments for which the securities are held by SWIF or its agent.

Concentration of Credit Risk - Concentration of credit risk is the risk of loss attributed to the magnitude of the government's investment in a single issuer. SWIF's investment policy does not place a limit on the concentration of investments in any one issuer.

Credit Risk - Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally-recognized statistical rating agencies such as Moody's Investors Services (Moody's). SWIF requires fund assets to be invested in investment grade bonds rated BBB/Baa (or equivalent) or better except that investment managers assigned to a high yield index may invest in non-investment grade bonds. The investments rated NR and WR represent not rated and withdrawn ratings respectively, and approximate 2.15 percent of the fixed income portfolio at December 31, 2012, excluding share balances of \$59.6 million in Treasury's unrated short-term investment pools, and include US agency securities, mortgage-backed securities, asset-backed securities, and corporate obligations. The following tables disclose aggregate fair value, by major Moody's credit quality rating category at December 31, 2012 and 2011 (amounts in thousands):

December 31, 2012

<u>Investment Type</u>	<u>Amount</u>	<u>Moody's Rating</u>	<u>% Portfolio</u>
US Agency	\$ 5,204	A1	0.34%
US Agency	1,094	A2	0.07%
US Agency	756	A3	0.05%
US Agency	5,736	AA1	0.38%
US Agency	9,042	AA2	0.59%
US Agency	10,976	AA3	0.72%
US Agency	86,765	AAA	5.70%
US Agency	290	BAA2	0.02%
US Agency	3,211	NR	0.21%
US Agency	818	WR	0.05%
Total US Agency Securities	\$ 123,892		

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

December 31, 2012 (Continued)

<u>Investment Type</u>	<u>Amount</u>	<u>Moody's Rating</u>	<u>% Portfolio</u>
US Government	\$ 490,589	AAA	32.23%
Total US Government Securities	\$ 490,589		
Mortgage-Backed Securities	\$ 762	A1	0.05%
Mortgage-Backed Securities	2	A2	0.00%
Mortgage-Backed Securities	120	AA2	0.01%
Mortgage-Backed Securities	1,525	AA3	0.10%
Mortgage-Backed Securities	178,078	AAA	11.70%
Mortgage-Backed Securities	31	B2	0.00%
Mortgage-Backed Securities	102	BA3	0.01%
Mortgage-Backed Securities	180	BAA1	0.01%
Mortgage-Backed Securities	36	CAA1	0.00%
Mortgage-Backed Securities	72	CAA3	0.00%
Mortgage-Backed Securities	11,235	NR	0.74%
Total Mortgage-Backed Securities	\$ 192,143		
Asset-Backed Securities	\$ 37	A2	0.00%
Asset-Backed Securities	890	AA3	0.06%
Asset-Backed Securities	36,871	AAA	2.42%
Asset-Backed Securities	4,515	NR	0.30%
Total Asset-Backed Securities	\$ 42,313		
Corporate Obligations	\$ 63,603	A1	4.18%
Corporate Obligations	71,820	A2	4.72%
Corporate Obligations	77,301	A3	5.08%
Corporate Obligations	4,573	AA1	0.30%
Corporate Obligations	18,000	AA2	1.18%

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

December 31, 2012 (Continued)

<u>Investment Type</u>	<u>Amount</u>	<u>Moody's Rating</u>	<u>% Portfolio</u>
Corporate Obligations	\$ 27,577	AA3	1.81%
Corporate Obligations	18,966	AAA	1.25%
Corporate Obligations	8,636	B1	0.57%
Corporate Obligations	3,609	B2	0.24%
Corporate Obligations	3,629	B3	0.24%
Corporate Obligations	5,558	BA1	0.37%
Corporate Obligations	9,239	BA2	0.61%
Corporate Obligations	16,117	BA3	1.06%
Corporate Obligations	60,185	BAA1	3.95%
Corporate Obligations	80,696	BAA2	5.30%
Corporate Obligations	21,485	BAA3	1.41%
Corporate Obligations	384	CAA1	0.03%
Corporate Obligations	356	CAA2	0.02%
Corporate Obligations	8,844	NR	0.58%
Corporate Obligations	4,120	WR	0.27%
Total Corporate Obligations	\$ 504,698		
Treasury Investment Program	\$ 59,590	NR	3.91%
Total Fixed Income Securities	\$ 1,413,225		
Equity Securities	\$ 108,771	NR	7.15%
Preferred Securities	\$ 124	NR	0.01%
Total Portfolio at December 31, 2012	\$ 1,522,120		100.00%

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

December 31, 2011

<u>Investment Type</u>	<u>Amount</u>	<u>Moody's Rating</u>	<u>% Portfolio</u>
US Agency	\$ 1,092	A1	0.07%
US Agency	1,244	A2	0.08%
US Agency	1,189	A3	0.08%
US Agency	5,673	AA1	0.37%
US Agency	7,102	AA2	0.47%
US Agency	12,552	AA3	0.82%
US Agency	105,995	AAA	6.95%
US Agency	2,477	NR	0.16%
US Agency	839	WR	0.05%
Total US Agency Securities	<u>\$ 138,163</u>		
US Government	\$ 479,442	AAA	31.42%
Total US Government Securities	<u>\$ 479,442</u>		
Mortgage-Backed Securities	\$ 10,307	NR	0.68%
Mortgage-Backed Securities	333	A2	0.02%
Mortgage-Backed Securities	21	A3	0.00%
Mortgage-Backed Securities	387	AA2	0.03%
Mortgage-Backed Securities	2,673	AA3	0.18%
Mortgage-Backed Securities	205,715	AAA	13.48%
Mortgage-Backed Securities	272	B2	0.02%
Mortgage-Backed Securities	260	BAA3	0.02%
Mortgage-Backed Securities	41	CAA1	0.01%
Mortgage-Backed Securities	52	CAA3	0.00%
Total Mortgage-Backed Securities	<u>\$ 220,061</u>		
Asset-Backed Securities	\$ 6,348	NR	0.42%
Asset-Backed Securities	953	A3	0.06%
Asset-Backed Securities	62	AA2	0.01%
Asset-Backed Securities	36,583	AAA	2.40%
Asset-Backed Securities	304	BAA2	0.02%
Total Asset-Backed Securities	<u>\$ 44,250</u>		

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

December 31, 2011 (Continued)

<u>Investment Type</u>	<u>Amount</u>	<u>Moody's Rating</u>	<u>% Portfolio</u>
Corporate Obligations	\$ 49,424	A1	3.24%
Corporate Obligations	73,249	A2	4.80%
Corporate Obligations	69,193	A3	4.53%
Corporate Obligations	5,383	AA1	0.35%
Corporate Obligations	35,910	AA2	2.35%
Corporate Obligations	33,457	AA3	2.19%
Corporate Obligations	28,552	AAA	1.87%
Corporate Obligations	5,840	B1	0.38%
Corporate Obligations	2,367	B2	0.16%
Corporate Obligations	4,419	B3	0.29%
Corporate Obligations	7,030	BA1	0.46%
Corporate Obligations	13,183	BA2	0.86%
Corporate Obligations	12,546	BA3	0.82%
Corporate Obligations	54,171	BAA1	3.55%
Corporate Obligations	54,519	BAA2	3.57%
Corporate Obligations	21,943	BAA3	1.44%
Corporate Obligations	246	CAA1	0.02%
Corporate Obligations	6,134	NR	0.40%
Corporate Obligations	4,869	WR	0.32%
Total Corporate Obligations	\$ 482,435		
Treasury Investment Program	\$ 53,461	NR	3.50%
Total Fixed Income Securities	\$ 1,417,812		
Equity Securities	\$ 108,011	NR	7.08%
Total Portfolio at December 31, 2011	\$ 1,525,823		100.00%

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

Interest Rate Risk - Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. SWIF measures interest rate risk using duration. As means for limiting SWIF's exposure to fair value losses arising from rising interest rates, SWIF requires investments to have maturities consistent with SWIF's liabilities. SWIF's long-term asset allocation diversifies its fixed income core segment between intermediate duration and longer duration strategies. Duration is a measure of an investment's sensitivity to changes in interest rates. The higher the duration, the greater the changes in fair value when interest rates change. For reporting purposes, SWIF elects to use option-adjusted duration, which takes into account embedded options affecting cash flows. At December 31, 2012 and 2011, SWIF's fixed income portfolio had the following option-adjusted durations by fixed income sector:

<u>December 31, 2012</u> <u>Investment Type</u>	<u>Amount</u>	<u>Duration</u> <u>(in years)</u>
US Agency Securities	\$ 123,892	7.09
US Government Securities	490,589	10.91
Mortgage-Backed Securities	192,143	2.75
Asset-Backed Securities	42,313	2.23
Corporate Obligations	504,698	5.50
Treasury Investment Program	59,590	N/A
Total Fixed Income Securities	\$ 1,413,225	
Equity Securities	108,771	N/A
Preferred Securities	124	N/A
Total Portfolio Securities	\$ 1,522,120	

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

<u>December 31, 2011</u> <u>Investment Type</u>	<u>Amount</u>	<u>Duration</u> <u>(in years)</u>
US Agency Securities	\$ 138,163	6.71
US Government Securities	479,442	10.40
Mortgage-Backed Securities	220,061	2.27
Asset-Backed Securities	44,250	0.79
Corporate Obligations	482,435	5.44
Treasury Investment Program	53,461	N/A
Total Fixed Income Securities	<u>\$ 1,417,812</u>	
Equity Securities	108,011	N/A
Total Portfolio Securities	<u>\$ 1,525,823</u>	

N/A – Indicates duration is not applicable to investment.

Foreign Currency Risk - Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. All SWIF investments are denominated in US dollars, issued under US laws and regulations, designed for US investors, and traded in US markets.

Securities Lending Program

The Fiscal Code provides the Treasury Department with numerous custodial responsibilities; the securities lending program (SLP) is an integral part of the custodial function. A contract between the Treasury Department and its custodian, acting as lending agent, provides that the custodian lends securities owned by SWIF to independent brokers, dealers and banks, acting as borrowers.

Lending agreements between the custodian and the borrowers require that the custodian receive collateral from the borrowers in exchange for the securities lent. For collateral received which is not denominated in United States dollars or whose primary trading market is located outside the United States, the fair value of the collateral received must be at least 105 percent of the fair value of the securities lent. The fair value of all other collateral received must be at least 102 percent of the fair value of the securities lent. Securities lent consist of both domestic and foreign equity securities and United States Treasury and foreign debt obligations. Almost all collateral received consists of cash; a very small portion of collateral received consists of letters of credit, United States Treasury, corporate and/or foreign debt obligations. Collateral is priced to market daily. Additional collateral from borrowers is required if the fair value of the collateral received declines below lending agreement requirements. The lending agent cannot

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

pledge or sell collateral securities received unless the borrower defaults. Accordingly, neither collateral securities received from borrowers nor the related obligations to borrowers are reported.

To the extent collateral received consists of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Treasury Department. Either the participant or the borrower may terminate lending agreements on demand. Lending agreements are typically of very short duration – usually overnight. Therefore, the duration of lending agreements does not generally match the maturities of the investments made with cash collateral. The resulting interest rate risk is mitigated by the lending agent's ability to reallocate lending agreements among SLP participants.

The SLP requires that the lending agent indemnify the Treasury Department for all claims, liabilities and costs resulting from the lending agent's negligence or intentional misconduct. During the fiscal year ended December 31, 2012, there were no failures by any borrower to return securities lent or pay distributions thereon. Also, there were no losses resulting from a lending agent or borrower default, and there were no Treasury Department restrictions on the amount of the loans that could be made.

At December 31, 2012 and 2011 there was no credit risk to the borrowers because the fair value of collateral received was greater than the fair value of the securities lent, consistent with the lending agreements outstanding. The carrying amount and fair value (in thousands) of the securities lent was \$80,081 and \$67,325, respectively.

SWIF's investment securities owned at December 31, 2012 and 2011, were as follows (amounts in thousands):

	<u>December 31, 2012</u>	
	<u>Book/Adjusted Carrying Value</u>	<u>Market Value</u>
<u>Bonds</u>		
Government	\$ 515,011	\$ 567,771
States, Territories and Possessions	15,525	17,620
Political Subdivisions of States, Territories, and Possessions	11,119	12,573
Revenue & Special Obligations	58,114	63,644
Residential Mortgage-Backed Securities	120,970	125,955
Industrial & Miscellaneous	495,740	535,801
<u>Total Bonds</u>	\$ 1,216,479	\$ 1,323,364
<u>Common Stocks</u>	\$ 108,771	\$ 108,771
<u>Preferred Stocks</u>	\$ 124	\$ 124
<u>Short-Term Investments</u>	\$ 89,861	\$ 89,861

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE B – INVESTMENTS (Continued)

<u>December 31, 2011</u>	<u>Book/Adjusted Carrying Value</u>	<u>Market Value</u>
<u>Bonds</u>		
Government	\$ 543,203	\$ 608,637
States, Territories and Possessions	6,238	6,832
Political Subdivisions of States, Territories, and Possessions	6,062	6,655
Revenue & Special Obligations	23,718	25,808
Residential Mortgage-Backed Securities	150,568	157,105
Industrial & Miscellaneous	505,500	539,256
<u>Total Bonds</u>	\$ 1,235,289	\$ 1,344,293
<u>Common Stocks</u>	\$ 108,011	\$ 108,011
<u>Short-Term Investments</u>	\$ 73,519	\$ 73,519

In accordance with the Fiscal Code, cash balances of most Commonwealth funds, including SWIF, are pooled by the Treasury Department. SWIF's short-term investments were also pooled for the calendar years ended December 31, 2012 and 2011. Pertaining to marketable equity securities, both December 31, 2012 and December 31, 2011 showed net unrealized capital gains (in thousands) of \$15,382 and \$12,291 respectively.

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE C - COMPOSITION OF LOSS RESERVES AND INCURRED BUT NOT REPORTED (IBNR) LOSSES

	December 31, 2012		
	(Amounts in Thousands)		
	<u>Coal</u>	<u>Commercial</u>	<u>Total</u>
<u>Loss Reserves</u>			
Indemnity	\$ 25,750	\$ 530,293	\$ 556,043
Medical	3,967	141,763	145,730
Bulk	13,126	896,965	910,091
Total Loss Reserves	<u>\$ 42,843</u>	<u>\$ 1,569,021</u>	<u>\$ 1,611,864</u>
<u>IBNR Loss Reserves</u>	<u>\$ 415</u>	<u>\$ 77,565</u>	<u>\$ 77,980</u>
<u>Net Losses</u>			<u>\$ 1,689,844</u>
Add:			
Assumed Outstanding Loss Reserves (Including IBNR)			2,352
Less:			
Discount of Reserves			(318,622)
Recoverable Reinsurance (Including IBNR)			(1,148)
<u>Net Unpaid Losses</u>			<u>\$ 1,372,426</u>

	December 31, 2011		
	(Amounts in Thousands)		
	<u>Coal</u>	<u>Commercial</u>	<u>Total</u>
<u>Loss Reserves</u>			
Indemnity	\$ 25,391	\$ 580,955	\$ 606,346
Medical	2,522	134,809	137,331
Bulk	14,545	852,246	866,791
Total Loss Reserves	<u>\$ 42,458</u>	<u>\$ 1,568,010</u>	<u>\$ 1,610,468</u>
<u>IBNR Loss Reserves</u>	<u>\$ 1,194</u>	<u>\$ 89,507</u>	<u>\$ 90,701</u>
<u>Net Losses</u>			<u>\$ 1,701,169</u>
Add:			
Assumed Outstanding Loss Reserves (Including IBNR)			2,644
Less:			
Discount of Reserves			(409,536)
Recoverable Reinsurance			(924)
<u>Net Unpaid Losses</u>			<u>\$ 1,293,353</u>

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE D - PENSION AND OTHER POSTEMPLOYMENT BENEFITS

Plan Description: To provide pension benefits for employees of state government and certain other organizations, the State Employees' Retirement System (SERS) administers a cost-sharing multiple-employer defined benefit retirement plan. The plan, covering substantially all Commonwealth employees, is a contributory defined benefit pension plan as established by Commonwealth laws.

Retirement Benefits: Under the plan, for most employees hired prior to January 1, 2011, retirement benefits vest after 5 years of credited service. Generally, employees who retire at age 60 or, if under age 60, with 35 years of service are entitled to a normal (unreduced) annual retirement benefit. The general annual benefit is 2 percent of a Class A member's highest three-year average salary multiplied by years of service. This annual benefit is 2.5 percent for Class AA members.

Act 2010-120 (Act 120), which preserved all benefits in place for members, mandated a number of benefit reductions for new members effective January 1, 2011. The benefit reduction included a new class of membership that accrues benefits at 2 percent of their final average salary instead of the previous 2.5 percent. The new vesting period changed from five to ten years of credited service, and the option to withdraw lump sum accumulated employee contributions was eliminated. The new normal retirement age is 65 for most employees. Act 120 created a new A-3 class of service and an optional A-4 class for most employees that entered SERS membership for the first time on or after January 1, 2011. The general annual benefit for Class A-3 members is 2 percent of the member's highest three-year average salary times years of service while the Class A-4 benefit accrual rate is 2.5 percent.

Summary of Significant Accounting Policies: The SERS financial statements are prepared on the accrual basis of accounting, whereby expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of the related trade date. Member and employer contributions are recognized in the period in which employee salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

SERS issues stand-alone financial statements which are available at www.sers.state.pa.us. Written requests for financial statements should be directed to the following address:

State Employees' Retirement System
30 North Third Street, Suite 150
Harrisburg, PA 17101-1716

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE D - PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

Funding Policy: All member contribution rates are determined by Commonwealth law. The active plan member contribution rate is 6.25 percent of covered payroll for employees in Class AA; for Class A members, the contribution rate is 5 percent. The general membership contribution rate under Act 120 for A-3 and A-4 members is 6.25 percent and 9.3 percent of salary, respectively. The SERS Board has the authority to establish or amend periodic employer contributions at actuarially determined rates, expressed as a percentage of annual covered payroll.

During each of the three years ended December 31, the annual required employer contribution and the related percentage of that amount actually contributed are as follows:

<u>Year Ended</u> <u>December 31</u>	<u>Annual Required</u> <u>Contribution (ARC)</u> <u>(in thousands)</u>	<u>Percentage of ARC</u> <u>Contributed</u>
2012	\$1,044,632	53.9%
2011	\$913,778	42.8%
2010	\$866,822	31.4%

The SWIF's contributions (in thousands) for the fiscal years ended December 31, 2012 and 2011 were \$1,410 and \$962, respectively.

Additional pertinent information regarding SERS, outside the scope of SWIF reporting, is published each year as part of the Commonwealth of Pennsylvania's Basic Financial Statements included in the Comprehensive Annual Financial Report.

Postemployment Health Care Benefits: The Commonwealth established and sponsors a Retired Employees Health Program (REHP) plan which provides postemployment benefits other than pensions (OPEB). This plan is administered by the Pennsylvania Employee Benefits Trust Fund (PEBTF), which acts as a third-party administrator and administers the REHP under an administrative agreement with the Commonwealth. The plan is a single employer defined benefit OPEB plan. The SWIF participates in the REHP, which provides a variety of healthcare benefits to eligible retirees. The OPEB plan and benefit provisions therein have been established under pertinent statutory authority. The OPEB plan does not issue a stand-alone financial report nor is it included in the financial statements of a public employee retirement system.

REHP contribution requirements are established by the Office of Administration and the Governor's Budget Office. During the period January 1, 2012 to June 30, 2012, the SWIF contributed \$240 for each active employee paid and reported as part of biweekly payroll expenses for its employees. During the period July 1, 2012 to December 31, 2012, the SWIF

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE D - PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

contributed \$265 for each active employee paid and reported as part of biweekly payroll expenses for its employees. SWIF recognizes the cost of providing these benefits, which for the fiscal years ended December 31, 2012 and 2011 totaled \$2,413 and \$2,240, respectively, as paid (in thousands).

Additional pertinent information on the REHP, outside the scope of SWIF reporting, including overall actuarial liabilities and assumptions related to the Commonwealth as a whole, are published each year as part of the Commonwealth of Pennsylvania's Basic Financial Statements included in the Comprehensive Annual Financial Report.

NOTE E - INSURANCE LOSS LIABILITY

The reported insurance loss liability is primarily based on historical claims experience. One of the assumptions used to determine the reported liability amount includes using a discount rate of 2.00 and 2.75 percent at December 31, 2012 and December 31, 2011, respectively. There is uncertainty as to whether the reported liability will be supported by future claim experience, including payments; this uncertainty must be considered when evaluating the reported insurance loss liability. Like other private insurance carriers authorized to transact and provide workers' compensation insurance in the Commonwealth, SWIF is required to pay assessments into the Pennsylvania Workers' Compensation Security Fund, a separate special revenue fund established by the Pennsylvania Department of Insurance to authorize and account for the payment of workers' compensation claims to individuals who are insured by insurance carriers that become insolvent.

For the two calendar years ended December 31, 2012 and 2011, the following summary provides information on prior year reported insurance loss liability, incurred claims and payments, and current year reported insurance loss liability (amounts in thousands):

Year Ended December 31	Prior Year Liability	Incurred Claims		Payments		Current Year Liability
		Current	Prior	Current	Prior	
2012	\$1,490,099	\$201,992	\$127,860	\$37,674	\$195,001	\$1,587,276
2011	\$1,509,814	\$185,750	\$53,695	\$37,358	\$221,802	\$1,490,099

NOTE F – SURPLUS AS REGARDS POLICYHOLDERS

By statute, the State Workers' Insurance Board (board) is required to set aside a percentage of premiums to sufficiently maintain the surplus to cover the catastrophe hazard of all the subscribers in the fund and to guarantee the solvency of the fund. The statute also provides that the board shall have the power to reinsure any risk which they may deem necessary. Accordingly, with the assistance of Guy Carpenter and Company until October 2012 and

STATE WORKERS' INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2012 (WITH COMPARATIVE TOTALS FOR 2011)

NOTE F – SURPLUS AS REGARDS POLICYHOLDERS (Continued)

Towers Watson thereafter, SWIF entered into contracts with several reinsurers to provide catastrophe coverage to its policyholders. The reinsurance is intended to protect and enhance SWIF's capital base.

As a result of this reinsurance program, SWIF's catastrophe reserve is not required as a set aside of the fund's unassigned surplus.



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EUGENE A. DePASQUALE
AUDITOR GENERAL

**Report on Internal Control Over Financial Reporting and on Compliance and Other
Matters Based on an Audit of Financial Statements Performed in Accordance With
*Government Auditing Standards***

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Statement of Admitted Assets, Liabilities and Surplus-statutory basis of the State Workers' Insurance Fund (SWIF), the related Statement of Operations and Changes in Surplus-statutory basis and the Statement of Cash Flows-statutory basis as of and for the year ended December 31, 2012, and the related notes to the financial statements and have issued our report thereon dated December 5, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered SWIF's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SWIF's internal control. Accordingly, we do not express an opinion on the effectiveness of SWIF's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented,

or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify a certain deficiency in internal control, described in the accompanying Finding Section as Finding No. 1, that we consider to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the SWIF's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

SWIF's Response to the Finding

SWIF's response to the finding identified in our audit is described in the accompanying Finding Section. SWIF's response was not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the SWIF's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the SWIF's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



December 5, 2013

EUGENE A. DEPASQUALE
Auditor General

FINDING
DECEMBER 31, 2012

DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND

Finding No. 1 – General Computer Controls in SWIF Need Improvement (A Similar Condition Was Noted in Prior Year Finding No. 1)

Condition: Our review of general computer controls at SWIF for the calendar year ended December 31, 2012 disclosed the following internal control deficiencies that need to be addressed by SWIF management:

1. Management remediated a prior year weakness in which a vendor within the PowerComp application (workers compensation policy and claim software) lacked segregation of duties between application development and promotion of program changes into production. Corrective action was implemented in March 2013.

Agency Response: Remediation is acknowledged.

2. Management remediated a prior year weakness in which a monitoring process had not been fully implemented over the production environment to detect changes moved into production that did not follow the standard process. Corrective action was implemented in September 2012.

Agency Response: Remediation is acknowledged.

3. There are no formal reconciliation procedures in place to ensure that data migrates successfully and accurately when new or upgraded software applications are implemented.

Agency Response: Finding is acknowledged. At this time the area responsible for defining this process has not provided the formal procedures. It is expected that a procedure will be developed as part of any future data migration effort.

4. Management remediated a prior year weakness in which password requirements for the Onbase application did not fully comply with Commonwealth Policy, i.e., were not configured to enforce adequate complexity settings such as: inadequate settings for minimum length, password complexity, password expiration, and user lockout after multiple failed login attempts. Corrective action was implemented in January 2013. This weakness continues to exist within the PowerComp, Freedom Financial and Iworks applications.

Agency Response: Remediation is acknowledged.

FINDING
DECEMBER 31, 2012

DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND

Finding No. 1 – General Computer Controls in SWIF Need Improvement (A Similar Condition Was Noted in Prior Year Finding No. 1) (Continued)

5. PowerComp users logon to the application using their CWOPA user ID, which is also their password.

Agency Response: Finding is acknowledged. Users are required to be logged in with their CWOPA credentials to access PowerComp.

6. Management remediated a prior year weakness in which they had not implemented periodic access reviews to determine the appropriateness of users with privileged access within the Freedom Financial application. Corrective action was taken in June 2013.

Agency Response: Remediation is acknowledged.

7. There is no written system development life cycle established to outline requirements for planning, designing, developing, testing, approving, and implementing new applications and upgrades to existing applications, including vendor-developed software.

Agency Response: Finding is acknowledged. A standard System Development Life cycle is currently being developed to be used for all Labor and Industry system development projects.

8. There is no formal methodology or written policies regarding end-user computing.

Agency Response: Finding is acknowledged. It is our understanding that a formal policy regarding end user computing is to come from the Office of Administration to cover all agencies under the Governor's jurisdiction.

Criteria: A well-designed system of internal controls dictates that sound general computer controls be established and functioning to best ensure that overall SWIF operations are conducted as closely as possible in accordance with management's intent.

Cause: SWIF management has been working to implement segregation of duties and monitoring procedures. However, weaknesses related to user IDs and passwords have not been corrected due to limitations in vendor-provided software. Further, SWIF management is waiting for policies on system development life cycle and data migration from the Department of Labor and Industry. Finally, SWIF continues to wait for policy guidance from the Office of Administration in the area of end user computing.

FINDING
DECEMBER 31, 2012

DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND

Finding No. 1 – General Computer Controls in SWIF Need Improvement (A Similar Condition Was Noted in Prior Year Finding No. 1) (Continued)

Effect: If general computer control areas are not improved, computer and other agency operations may not be conducted in accordance with SWIF management's intent.

Collectively, we consider the above exceptions to be a significant deficiency under generally accepted auditing standards. The auditing standards define a significant deficiency as a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Recommendation: We recommend that SWIF management review the general computer control deficiencies noted above and take the necessary actions to resolve them.

Auditors' Conclusion

Based on the agency's response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

**COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF LABOR AND INDUSTRY
STATE WORKERS' INSURANCE FUND DISTRIBUTION LIST
DECEMBER 31, 2012**

This report was initially distributed to the following:

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