Report 07-3
March 2007

An Audit

Injured Patients and Families Compensation Fund

Office of the Commissioner of Insurance

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State Auditor - Janice Mueller

Audit Prepared by

Diann Allsen, *Director and Contact Person*
Carrie Ferguson
Jeffrey Beckett
Desiree De Thier
Nathan Heimler

Director of Publications – Jeanne Thieme
Report Design and Production – Susan Skowronski

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From the Office of the Commissioner of Insurance

STATE OF WISCONSIN
Legislative Audit Bureau

22 E. Mifflin St., Ste. 500
Madison, Wisconsin 53703
(608) 266-2818
Fax (608) 267-0410
Leg.Audit.Info@legis.wisconsin.gov

Janice Mueller
State Auditor

March 22, 2007

Senator Jim Sullivan and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Sullivan and Representative Jeskewitz:

As required by s. 13.94(1)(de), Wis. Stats., we have completed a financial audit of the Injured Patients and Families Compensation Fund, which insures health care providers in Wisconsin against medical malpractice claims that exceed the primary malpractice insurance thresholds established in statutes. We have provided an unqualified auditor's report on the Fund's financial statements for the fiscal years ending June 30, 2006, 2005, and 2004.

The Fund continues to maintain a sound financial position. Its audited financial statements show net assets of $59.8 million as of June 30, 2006, the highest year-end balance reported since the Fund's inception. The Governor's 2007-09 Biennial Budget Proposal would transfer $175.0 million from the Fund to a newly created heath care quality fund. Although the Injured Patients and Families Compensation Fund has accumulated cash and investments of $737.4 million to pay estimated loss liabilities of $685.0 million as of June 30, 2006, a transfer of $175.0 million would place it in a deficit accounting position. In addition, 2003 Wisconsin Act 111 established the Fund as an irrevocable trust for the sole benefit of participating health care providers and proper claimants.

The Fund's computerized provider system, which tracks and accounts for its operations, is aging and experiencing errors that require regular manual reviews and adjustments to correct. The condition of the system presents increased risks to the Fund's financial operations. The Governor's 2007-09 Biennial Budget Proposal recommends additional funding of $600,000 for the development and implementation of a new system.

We appreciate the courtesy and cooperation extended to us by the staff of the Office of the Commissioner of Insurance and the contractors who assist in administering the Injured Patients and Families Compensation Fund program. A response from the Office of the Commissioner of Insurance follows the appendices.

Respectfully submitted,

Janice Mueller

Janice Mueller
State Auditor

JM/DA/ss

Report Highlights ■

The Fund maintains a sound financial position.

Recent court decisions and legislative action changed limits on noneconomic damages the Fund may be required to pay.

A 2005 actuarial audit concluded the Fund's loss liability estimates were reasonable, although conservative.

An aging computer system that maintains provider accounts is experiencing operational problems.

The Injured Patients and Families Compensation Fund insures participating physicians and other health care providers in Wisconsin against medical malpractice claims that exceed the coverage limits of their primary malpractice insurance. Statutes require most health care providers that operate or have permanent practices in Wisconsin to maintain primary malpractice coverage of $1 million for each incident and $3 million per policy year, and to participate in the Fund by paying assessments that help to fund claims.

The Fund has paid more than $633.6 million in claims from its inception through December 31, 2006. There is no limit to the compensation it will pay on behalf of participating providers for economic damages, such as medical costs and loss of income. Noneconomic damages, which include compensation for suffering, mental distress, and loss of companionship and affections, are limited by statutes.

Statutes require the Legislative Audit Bureau to perform financial audits of the Fund at least once every three years. Our audit report contains our unqualified opinion on the Fund's financial statements and related notes as of and for the years ending June 30, 2006, 2005, and 2004. In light of ongoing interest in the Fund's financial position, we also reviewed changes in provider assessments, annual claims payments, and the Fund's accumulated cash and investments; recent legislation and court decisions affecting the Fund; and the results of an actuarial audit completed in 2005. In addition, we reviewed the condition of the Fund's computer system for maintaining the accounts of participating providers.

Financial Position

Since its creation in 1975, the Fund has typically taken in more provider assessments and investment income than it has paid out in claims and administrative expenses. As a result, it has accumulated $737.4 million in cash and investments as of June 30, 2006.

However, the Fund's financial position is also significantly affected by its loss liabilities, which are based on estimates of what it may be required to pay for malpractice incidents that have occurred but may not yet have been settled or even reported. Both the uncertainty and the long-term nature of medical malpractice claims make it difficult to predict the size and timing of claims that will be settled and paid from the Fund. The Board of Governors, which manages the Fund, relies on a consulting actuarial firm to estimate the Fund's claims experience and related loss liabilities.

In the past, the Fund had reported accounting deficits because estimated loss liabilities exceeded the cash and investments available to pay them. However, it has maintained a positive accounting balance since June 30, 1999. The net asset balance reported in the audited financial statements for June 30, 2006, is $59.8 million. That is the highest year-end balance reported by the Fund since its inception.

Table 1

Audited Net Asset Balance[1]
As of June 30

Year	Amount (In Millions)
1997	$(38.4)
1998	(22.2)
1999	8.6
2000	27.2
2001	28.4
2002	6.6
2003	7.9
2004	24.6
2005	31.7
2006	59.8

[1] Represents the Fund's assets less its liabilities.

The Governor's 2007-09 Biennial Budget Proposal includes a one-time transfer of $175.0 million from the Fund to a newly created heath care quality fund. This new fund would support a variety of health care quality improvement activities, including the Governor's E-Health initiative.

However, we caution that such a transfer would place the Fund in a deficit accounting position and may result in future increases in provider assessment rates. The Legislature will also need to evaluate whether the proposed uses of the transfer meet the purposes and uses of the Fund set forth in s. 655.27(6), Wis. Stats., which states that the Fund is "held in irrevocable trust for the sole benefit of health care providers participating in the fund and proper claimants."

Noneconomic Damages

Legislative changes and legal challenges to statutory limits on noneconomic damages have affected the Fund's loss liabilities and provider assessment rates. Legislation enacted in 1985 limited noneconomic damages to $1 million from June 14, 1986, through December 31, 1990, when that limit expired. In 1995, the Legislature re-established a limit on noneconomic damages for incidents that occurred after May 25, 1995. That limit was initially $350,000 and was adjusted at least annually to reflect changes in the consumer price index.

The constitutionality of the limits on noneconomic damages has been challenged in many court cases. In July 2005, the Wisconsin Supreme Court ruled that the $350,000 inflation-adjusted limit was unconstitutional because it violated equal protection guarantees. Subsequently, 2005 Wisconsin Act 183 limited noneconomic damages to $750,000 for occurrences on or after April 6, 2006. However, as a result of the July 2005 court decision, there are no limits on noneconomic damages for incidents occurring from January 1, 1991, through April 5, 2006. The Fund's consulting actuary has estimated that undiscounted loss liabilities will increase by approximately $173.0 million for unsettled claims for this period. In response, provider assessment rates have been increased by 25.0 percent for fiscal year (FY) 2006-07.

Actuarial Audit

Estimating the Fund's loss liabilities is challenging because:

- a claim may be filed years after an incident occurs;
- there is no limit on the amount of economic damages the Fund may be required to pay; and
- limits on noneconomic damages have changed in response to changes in legislation and court decisions.

Over the past several years, the Fund's consulting actuary, Milliman, Inc., has regularly reduced past estimates of the Fund's loss liabilities because claims experience has been more favorable than originally expected. Consequently, some interested parties have expressed concerns that Milliman has been overly conservative in estimating the Fund's liabilities. We therefore recommended in 2001, and again in 2004, a comprehensive review of the methods and assumptions used by Milliman in estimating the Fund's loss liabilities. Such actuarial reviews or audits have become fairly common for critical and complex actuarial analyses, such as those completed for the Fund.

In July 2005, another actuarial firm reviewed Milliman's actuarial estimates of the Fund's liabilities and concluded they were reasonable, although conservative. That firm also recommended two changes to the process for estimating the Fund's loss liabilities. The first was for Milliman to develop best estimates and then explicitly specify a risk margin that would be added to address the risk of actual losses being higher than predicted. In the past, Milliman's actuarial estimates had included an implicit risk margin of 33.0 percent that had not been separately identified.

On Milliman's advice, the Board of Governors has approved an explicit risk margin of 5.0 percent. As a result, the Fund's estimated loss liabilities as of June 30, 2006, were approximately $240.4 million less than they would have been if the 33.0 percent implicit risk margin had again been used in the calculation. The new 5.0 percent risk margin will also make loss liability estimates less conservative in the future.

The actuarial audit also recommended reducing the Fund's investment return assumption, suggesting it be no more than 4.0 percent. However, with the Board of Governors' approval, the Fund's loss liabilities as of June 30, 2006, were estimated using a 5.7 percent return on a market-value basis.

Another actuarial audit is expected to be completed by the end of 2007. If the Governor's proposed transfer of $175.0 million from the Fund is approved as part of the State's 2007-09 biennial budget, closely monitoring actuarial assumptions will become increasingly important.

Provider System

A continuing challenge for the Fund is the decreasing effectiveness of an aging computer system that maintains the accounts of participating health care providers. The provider system was developed in the early 1990s to track medical malpractice claims. Since then, it was expanded for billing and maintaining information about health care providers' compliance with primary liability coverage requirements.

The system has not been able to easily accommodate these increasing demands. As a result, errors occur in provider accounts, including incorrect billing and noncompliance notices. Staff have implemented manual procedures to detect system problems but note that other errors may not be detected until providers contact the Fund.

The issues with the provider system have also limited the Fund's ability to ensure that data cannot be viewed or changed by unauthorized users. Staff indicate that making changes to address these concerns could result in system integrity issues or other unintended consequences. The regular occurrence of errors and the control weaknesses noted in the system increase the risk associated with the Fund's operations and, consequently, also require additional audit effort.

In light of the critical nature of the provider system, OCI has taken steps to begin developing a new provider system. The Governor's 2007-09 Biennial Budget Proposal recommends additional funding of $600,000 over the biennium for the services of two contract programmers, hardware, and software. If the additional funding is not approved, it is not clear when a new system could be implemented.

Recommendations

Our recommendations address the need for the Fund's Board of Governors to:

☑ require the next actuarial audit to again evaluate the appropriateness of the Fund's loss liability risk margin and investment return assumption, and report on the results in its annual report to the Legislature (*p. 20*).

We also include a recommendation for the Office of the Commissioner of Insurance to:

☑ closely monitor access to and the integrity of the data and processing of the Fund's provider system until a new system has been fully implemented (*p. 22*).

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Introduction ■

2003 Wisconsin Act 111 established the Fund as an irrevocable trust for the sole benefit of participating health care providers and proper claimants.

The Injured Patients and Families Compensation Fund insures health care providers in Wisconsin against medical malpractice claims that exceed the primary malpractice insurance thresholds established in statutes. It was created as the Patients Compensation Fund in Chapter 37, Laws of 1975, in response to concerns over the cost and availability of medical malpractice insurance. 2003 Wisconsin Act 111 changed the Fund's name to the Injured Patients and Families Compensation Fund and established it as an irrevocable trust for the sole benefit of health care providers participating in the Fund and proper claimants.

The Commissioner of Insurance chairs the 13-member Board of Governors that manages the Fund. The Office of the Commissioner of Insurance (OCI) has statutory responsibility for administering the Fund and contracts with Wausau Insurance Companies, which was paid $1,011,409 for claims administration in FY 2005-06, and Marsh USA, Inc., which was paid $68,362 for risk management services in FY 2005-06. Since 1978, the actuarial firm of Milliman, Inc., has served as a consultant, providing actuarial services for which it was paid $128,705 in FY 2005-06.

Most health care providers in Wisconsin are required to purchase secondary medical malpractice insurance from the Fund.

Statutes require most health care providers that operate or have permanent practices in Wisconsin to maintain primary malpractice coverage of $1 million for each incident and $3 million per policy year. In addition, they are also required to participate in the Fund, which provides unlimited liability coverage for economic damages that exceed the primary limits established in statutes. Health care providers that are insured by the Fund include individuals, such as physicians and nurse anesthetists; institutions such as hospitals, ambulatory surgery centers, and certain nursing homes; and entities that are owned or controlled by hospitals, as well as entities such as medical partnerships, corporations, and cooperatives. As of June 30, 2006, 84.4 percent of the 13,948 health care providers participating in the Fund were physicians.

Assessment rates vary by provider type.

Participating providers pay annual assessments based on their provider type and specialty. For example, among individual providers, assessment rates are higher for physicians than for nurses, and higher for physicians who perform surgery than for those who do not. Appendix 1 lists annual assessment rates for various providers from FY 2000-01 through FY 2006-07.

As shown in Table 2, assessment rates decreased for seven of the last ten years. The lowest amount of assessment revenue the Fund earned during that ten-year period was $18.9 million, during FY 2005-06. As an illustration of the change in rates over this period, a non-surgical family or general practice physician's rates steadily decreased 67.5 percent, from $2,647 for FY 1997-98 to $859 for FY 2005-06. In FY 2006-07, provider rates were increased by 25.0 percent, in response to a 2005 Wisconsin Supreme Court ruling on the constitutionality of limiting noneconomic damages in medical malpractice cases. As a result, a non-surgical family or general practice physician's rates increased to $1,074. New limits on noneconomic damages were enacted in 2006, and the Board of Governors recently approved a 5.0 percent increase in rates for FY 2007-08.

The Fund paid more than $633.6 million for 626 claims from its inception through December 31, 2006.

A medical malpractice claim may be filed years after an incident occurs. Coverage for providers is based on participation at the time an event that results in a claim occurred, rather than at the time the claim is made. The Fund has paid more than $633.6 million in claims from its inception through December 31, 2006.

Individual claim payments have ranged from $9,000 to just over $18.0 million. As shown in Table 3, three-quarters of paid claims have been for amounts less than $1.0 million. However, these 469 claims account for only one-quarter of the Fund's total claim payments through December 31, 2006. In contrast, the 23 claims with payments of $5.0 million or more represent 30.7 percent of total claim payments. Appendix 2 provides additional information about claims for which payments exceed $5.0 million.

Table 2

Annual Percentage Changes to Provider Assessment Rates

Policy Year	Overall Percentage Change in Assessment Rates Approved by Board	Assessments Revenues
FY 1997-98	(17.7)%[1]	$49,884,839
FY 1998-99	0.0	50,621,706
FY 1999-2000	(7.0)	47,879,282
FY 2000-01	(25.0)	36,795,064
FY 2001-02	(20.0)	29,555,966
FY 2002-03	(5.0)	29,463,735
FY 2003-04	5.0	32,064,990
FY 2004-05	(20.0)	26,547,016
FY 2005-06	(30.0)	18,930,808
FY 2006-07	25.0[2]	Not available

[1] Rates were reduced because statutes increased primary malpractice insurance coverage requirements from $400,000 per incident and $1 million per policy year to the current levels of $1 million per incident and $3 million per policy year.
[2] Rates were increased in response to a July 2005 Wisconsin Supreme Court ruling that the $350,000 inflation-adjusted limit on noneconomic damages in place since 1995 was unconstitutional.

Table 3

Paid Claims from the Fund's Inception through December 31, 2006

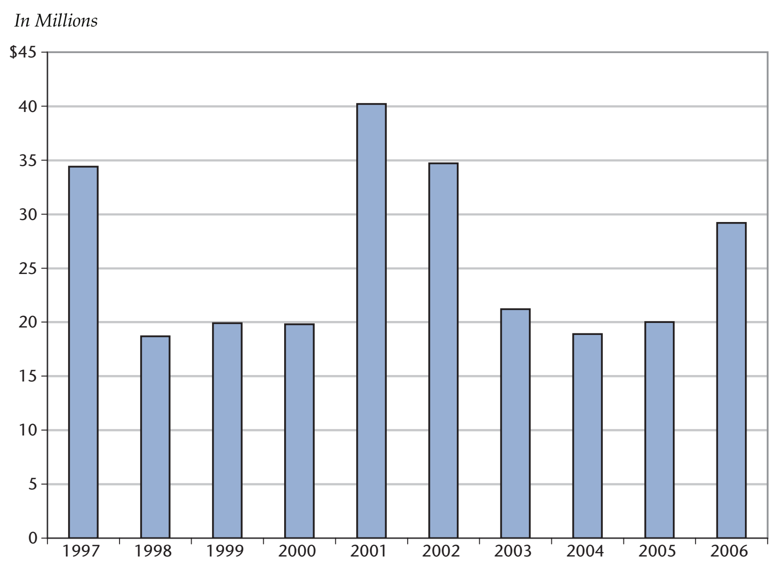
Claim Amount	Number of Paid Claims	Percentage of Paid Claims	Amount Paid for All Claims	Percentage of Total Paid for All Claims
$5 million or more	23	3.7%	$194,322,885	30.7%
At least $1 million but less than $5 million	134	21.4	276,577,910	43.6
Less than $1 million	469	74.9	162,741,495	25.7
Total	**626**	**100.0%**	**$633,642,290**	**100.0%**

A small number of large-value claims can significantly affect the Fund's operations and cash flow, but the uncertainty and long-term nature of medical malpractice claims makes it difficult to predict if or when large claims will be settled and paid from the Fund. More than one-half of the Fund's payments over $5.0 million were made at least five years after the incident date. For example, in October 2005, the Fund paid a $10.1 million claim for an incident that occurred more than eight years earlier.

The variability of annual claim payments is further illustrated in Figure 1. While annual claim payments averaged $25.7 million per year over the last ten years, they ranged from $18.7 million to $40.2 million.

Figure 1

Annual Claim Payments
For Fiscal Year Ending June 30



By law, the Legislative Audit Bureau is responsible for performing financial audits of the Injured Patients and Families Compensation Fund. As necessary parts of our financial audit, we reviewed the Fund's controls, assessed the fair presentation of its financial statements for FYs 2005-06, 2004-05, and 2003-04, and reviewed compliance with statutory provisions. We also reviewed the financial status of the Fund and followed up on prior audit recommendations.

■ ■ ■ ■

Financial Operations of the Fund ■

Although their interests and priorities differ, health care providers, patients and other consumers of health care services, and attorneys in malpractice cases all benefit by having confidence in the reliability and soundness of the Fund's financial operations. The Fund has maintained a positive financial position for several years. Recent legislative action, court decisions, and changes in its actuarial analysis will affect the Fund's future financial operations. Further, continuing problems with its computerized provider system present various operational risks for the Fund.

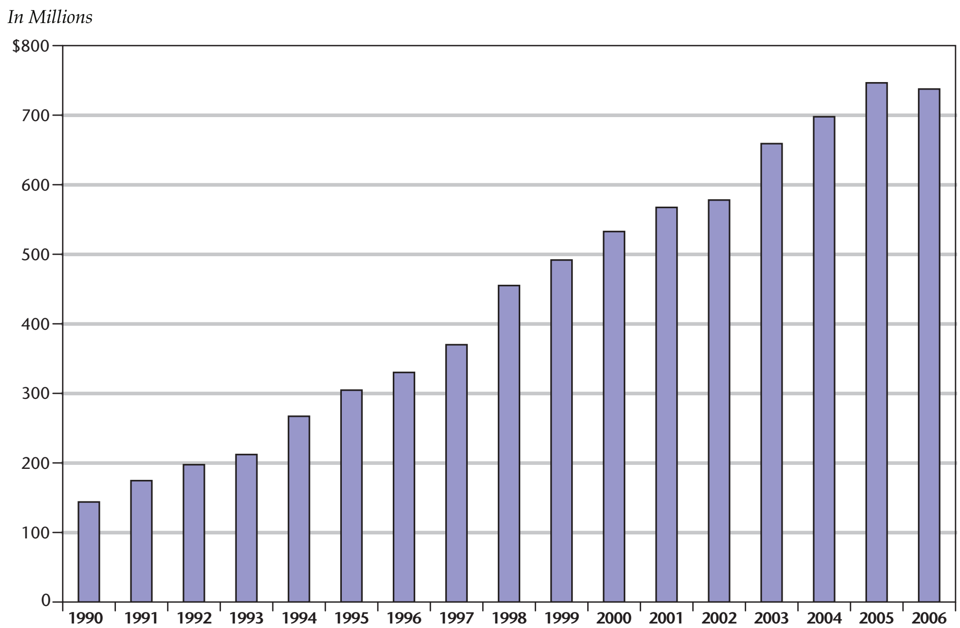
Financial Status of the Fund

The Fund has accumulated \$737.4 million in cash and investments as of June 30, 2006.

Since its creation in 1975, the Fund has typically taken in more provider assessments and investment income than it has paid out in claims and administrative expenses. As a result, the Fund has accumulated \$737.4 million in cash and investments as of June 30, 2006. Cash and investments totaled \$143.7 million as of June 30, 1990, and have grown steadily since then, as shown in Figure 2. Income earned on the Fund's accumulated cash and investments helps to reduce the provider assessments needed to pay current and future claims.

Figure 2

Accumulated Cash and Investments[1]
As of June 30



[1] Investments were reported on a cost basis through FY 1996-97. Beginning in FY 1997-98, investments are reported on a market value basis.

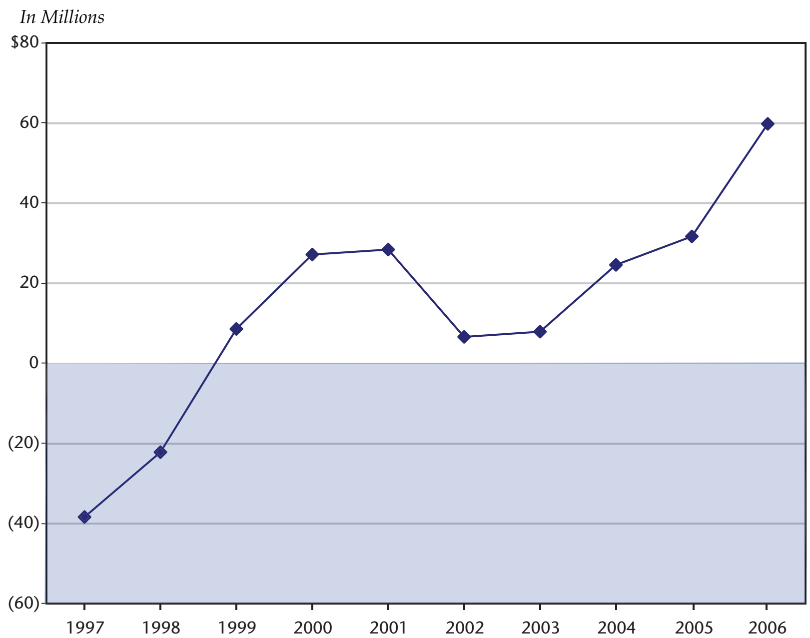
However, the Fund's financial position is also significantly affected by its loss liabilities, which are based on estimates of what it may be required to pay for malpractice incidents that have occurred but may not yet have been settled or even reported. The Board of Governors relies on the Fund's consulting actuarial firm, Milliman, to estimate loss liabilities and to provide analysis for the Board to consider in establishing the annual fees paid by health care providers.

The Fund has reported a positive financial position since June 30, 1999.

For several years, the Fund reported accounting deficits because estimated loss liabilities exceeded the cash and investments available to pay them. However, as shown in Figure 3, the Fund has maintained a positive accounting balance since June 30, 1999. The net asset balance reported in the audited Statement of Net Assets at June 30, 2006, which appears on page 37, is $59.8 million and the highest year-end balance ever reported by the Fund.

Figure 3

The Fund's Audited Year-End Net Asset Balances[1]
As of June 30



[1] Represents the Fund's assets less its liabilities.

The Governor's 2007-09 Biennial Budget Proposal includes a one-time transfer of $175.0 million from the Fund.

In response to ongoing budgetary challenges, the Governor's budgets for the last three biennia have proposed transfers to help support the State's Medicaid costs and other health initiatives. The Governor's 2007-09 Biennial Budget Proposal includes a one-time transfer of $175.0 million from the Fund to a newly created health care quality fund. Under the Governor's proposal, the transferred funds would be used to help fund the State's Medicaid costs while program reforms are pursued, to increase provider Medicaid reimbursement rates, and to support the Governor's E-Health initiative related to electronic medical systems. The Governor's 2003-05 Biennial Budget Proposal included a $200 million transfer, and his 2005-07 Biennial Budget Proposal included a $179.4 million transfer for similar initiatives. However, the proposed transfers for the previous biennia were not approved by the Legislature.

A transfer of $175.0 million would place the Fund in a deficit accounting position. Because liabilities are "discounted," or reduced, in the Fund's financial reports to take into account future investment returns, the effect of any transfer on the year-end accounting balance reported in the Fund's financial statements will likely be greater than $175.0 million, as less investment earnings will be available to fund the liabilities. Further, the need to liquidate long-term investments may negatively affect investment earnings, depending on the markets for the Fund's investments. The Board of Governors has a policy to maintain an accounting balance as close to zero as possible. Consequently, it may need to consider increasing provider assessment rates to again attain a positive accounting position.

The Legislature will also need to evaluate whether the Governor's proposed uses of the transfer meets the purposes and uses of the Fund set forth in statutes. Under s. 655.27(6), Wis. Stats., the purposes of the Fund are "to curb the rising costs of health care by financing part of the liability incurred by health care providers as a result of medical malpractice claims and to ensure that proper claims are satisfied." As noted, the Fund is established as an irrevocable trust for the sole benefit of participating health care providers and proper claimants. Statutes further state that "moneys in the fund may not be used for any other purpose of the state."

Legislation and Court Decisions

A number of legislative actions and court decisions have affected the Fund's financial operations since its inception. For example:

- Various legislative changes have increased investment flexibility, which has helped to increase investment returns. Statutory changes in 1990 allowed the State of Wisconsin Investment Board, which manages the Fund's investments, to make long-term investments for the Fund. Beginning in FY 1999-2000, the Board of Governors authorized the Investment Board to invest up to 20 percent of the Fund's portfolio in equity index funds.

- The statutory thresholds at which secondary coverage by the Fund is to begin have been raised as the primary insurance requirement has increased over time. Initially, primary medical malpractice coverage limits were $200,000 for each incident and $600,000 per policy year. As noted, the limits are currently $1 million for each incident and $3 million per policy year.

Among the most significant legislative actions and court decisions have been those affecting limits on awards for noneconomic damages, such as pain and suffering, embarrassment, mental distress, and loss of companionship and affections. Legislation enacted in 1985 limited noneconomic damages to $1 million from June 14, 1986, through December 31, 1990, when that limit expired. In 1995, the Legislature re-established a limit for incidents that occurred on or after May 25, 1995. That limit was initially $350,000 and was adjusted at least annually to reflect changes in the consumer price index.

A Wisconsin Supreme Court decision and recent legislation have affected the limit on noneconomic damages.

The constitutionality of the limit on noneconomic damages has been challenged in many court cases. In a July 2005 decision on *Ferdon* v. *Wisconsin Patients Compensation Fund*, the Wisconsin Supreme Court ruled that the $350,000 inflation-adjusted limit was unconstitutional because it violated equal protection guarantees. However, the majority opinion also concluded that not all noneconomic damage award limits were unconstitutional, just the one that was in place. In response to *Ferdon*, 2005 Wisconsin Act 183 was enacted to establish a new limit of $750,000 on noneconomic damages for occurrences on or after April 6, 2006. As the result of *Ferdon* and 2005 Act 183, there are no limits on the recovery of noneconomic damages for incidents occurring from January 1, 1991, through April 5, 2006. Milliman has estimated that undiscounted loss liabilities will increase by approximately $173.0 million for unsettled claims for this period, and that increase was reflected in the June 30, 2006 estimate of loss liabilities.

Wisconsin Statutes also establish limits for noneconomic damages in wrongful death awards. They are $350,000 for an adult and $500,000 for a minor child and could apply to medical malpractice cases. These limits were not affected by *Ferdon* or by 2005 Act 183. However, as part of a July 2006 decision on *Bartholomew* v. *Wisconsin Patients Compensation Fund*, the Supreme Court overturned its earlier ruling that when a victim of medical malpractice dies, all noneconomic damages are capped by the wrongful death limit.

Based on the *Bartholomew* decision, claimants can be awarded noneconomic damages for both pre-death pain and suffering from bodily injury as the result of medical malpractice and loss of society and companionship because of death from the same incident, each subject to any corresponding limits in place. Milliman has estimated that *Bartholomew* will increase undiscounted liabilities by approximately $14.0 million. The Fund's staff believe *Bartholomew* will affect primary insurers more significantly than it will affect the Fund.

Actuarial Estimates of Loss Liabilities

Estimating loss liabilities is challenging because of the unlimited and long-term nature of the Fund's medical malpractice claims.

Accurately estimating the Fund's loss liabilities is challenging because:

- a medical malpractice claim may be filed years after an incident;
- there is no limit on the amount of economic losses the Fund may be required to pay;
- recent legislation and court decisions have affected the Fund's liabilities for noneconomic damages; and
- a 2005 actuarial audit has ongoing implications for the methodology and assumptions used in estimating the Fund's loss liabilities, and the methodology and assumptions used by an actuary can significantly affect the results of its analyses.

The Fund's actuary, Milliman, reviews and revises individual and total loss liability estimates each year, based on subsequent experience and information. Over the past several years, Milliman has regularly reduced past estimates of the Fund's loss liabilities because claim experience has been more favorable than originally expected. For example, in estimating liabilities as of June 30, 2006, Milliman reduced previously reported liabilities for the years prior to FY 2005-06 by $79.0 million, based on the additional year of experience.

From both an actuarial and an accounting perspective, conservative estimates are considered more prudent than those that are overly optimistic.

Regular reductions of past actuarial estimates have suggested to some that Milliman has been overly conservative in estimating the Fund's loss liabilities. Interest groups representing patients and malpractice attorneys have asserted that conservative actuarial estimates have exaggerated medical malpractice costs and contributed to support for limits on noneconomic damages. However, from both an actuarial and an accounting perspective, conservative estimates are considered more prudent than those that are overly optimistic. The Fund's solid financial position provides it flexibility to readily respond to changes that may occur in the medical malpractice environment in the future.

Given the questions being raised about the actuarial estimates, we recommended in June 2001, and again in October 2004, that OCI contract for an audit of the reasonableness of the actuarial methods and assumptions for estimating the Fund's loss liabilities. Actuarial audits have become fairly common for critical and complex actuarial analyses, such as that completed for the Fund.

An actuarial audit concluded the Fund's loss liability estimates were reasonable, although conservative.

An actuarial audit completed in July 2005 concluded that Milliman's actuarial estimates of the Fund's loss liabilities were reasonable, although conservative. The report recommended two changes to the process for estimating the Fund's loss liabilities. The first was that Milliman develop best estimates of expected loss experience and then explicitly specify a risk margin to represent the risk that actual losses could be higher than predicted. Milliman indicated its loss liability estimates had been incorporating an implicit risk margin of 33.0 percent, but the implicit rate margin had not been separately identified in its analysis.

A less-conservative approach has been adopted in estimating the Fund's loss liabilities.

Milliman implemented the explicit risk margin recommendation in developing its estimates of the Fund's loss liabilities as of June 30, 2006. Milliman advised the Board of Governors to approve a risk margin lower than the implicit 33.0 percent margin, because *Ferdon* addressed some of the uncertainties that had been incorporated into the 33.0 percent margin, and the Board of Governors approved the addition of an explicit 5.0 percent risk margin to Milliman's best estimate of loss liabilities. As a result, the Fund's estimated loss liabilities as of June 30, 2006, were approximately $240.4 million less than they would have been if the implicit 33.0 percent risk margin had again been included in the estimate. However, the reduction was offset by the $173.0 million increase in estimated undiscounted loss liabilities in response to the Wisconsin Supreme Court's ruling in *Ferdon*.

The lower risk margin will also make loss liability estimates less conservative in the future. Further, the new $750,000 limit on noneconomic damages likely will contribute to lower future loss liability estimates. However, if the newly enacted limit is again challenged and overturned through the courts, there will be increased risk that current liability estimates could underestimate actual losses in the future. Consequently, it will be important for the Board of Governors to regularly consult with Milliman and evaluate the continuing appropriateness of the 5.0 percent risk margin.

The 2005 actuarial audit recommended a reduction to the Fund's investment return assumption.

The second recommendation made as part of the actuarial audit was to reduce the Fund's investment return assumption, suggesting that it be no greater than 4.0 percent. In the Fund's financial statements, the loss liabilities are discounted, or reduced, to take into account estimated future investment returns that will be available to help pay these liabilities. The Fund currently uses an assumption of 5.7 percent on a market-value basis for expected investment returns from interest income, gains and losses on the sale of investments, and the changes in the value of investments being held. Based on the 5.7 percent assumption, which was approved by the Board in December 2005, the Fund's loss liabilities as of June 30, 2006, were discounted by $223.1 million.

For several years, the Fund's investment performance compared closely to its investment assumptions. However, the recent and expected performance of the Fund's investments suggests the current investment assumption may be optimistic in the future. Again, it will be important for the Board of Governors to work closely with Milliman and the Investment Board in monitoring and establishing future investment return assumptions that reasonably reflect the Fund's current and future investments.

The Board of Governors has established a policy for the Fund to obtain an actuarial audit once every three years. The next actuarial audit, which Fund staff anticipate will be completed by the end of 2007, will provide the Board of Governors an opportunity to revisit the risk margin and investment return assumption issues raised in the 2005 actuarial audit and to evaluate whether they are being appropriately addressed. If the Governor's proposed transfer of $175.0 million from the Fund to help fund costs for Medicaid and other health initiatives is approved as part of the State's 2007-09 biennial budget, closely monitoring actuarial assumptions will become increasingly important.

☑ Recommendation

We recommend the Board of Governors' next request for an actuarial audit include specific provisions to evaluate the appropriateness of the Injured Patients and Families Compensation Fund's loss liability risk margin and investment return assumption, and that the Board report on the results of the actuarial audit in its annual report to the Legislature, which is required by s. 655.27(4)(f), Wis. Stats.

Provider System

Problems with the provider system result in errors with provider information.

A continuing challenge for the Fund is the decreasing effectiveness of an aging computer system. The system was developed in the early 1990s to track medical malpractice claims. Since that time, it has been expanded to maintain the accounts of participating health care providers, including billing and primary insurance coverage information. The existing provider system has not been able to accommodate the increasing demands of the Fund's operations, which have become more complex over time, particularly in areas related to compliance. As a result, errors occur in health care providers' accounts, and OCI cannot readily address control concerns related to system access without risking further problems.

In our 2004 audit (report 04-12), we noted that OCI had requested additional budgetary authority to develop a new provider system. That request, like many other budget requests for systems work at the time, was denied by the Legislature. OCI subsequently requested funding for a new provider system under s.13.10, Wis. Stats., which was denied by the Joint Committee on Finance because it was not considered an "unforeseen emergency," as required under s. 13.101, Wis. Stats.

OCI has continued to document problems with the provider system and Fund staff provided us with numerous examples during our current audit. For example:

- The system periodically generates messages indicating errors in provider accounts, which must be manually verified and/or corrected by staff.

- The system inappropriately generates noncompliance letters to some providers. Fund staff must manually ensure that providers who are in compliance do not receive these letters.

- The system periodically generates inappropriate additional charges to providers' accounts during the primary insurer certificate renewal process. These errors may be caused by the system incorrectly reading the start or end dates of exemptions or insurance certificates.

- The system does not always provide a complete account history. Staff must therefore refer to paper documents for missing information and then request programming changes to the system.

Fund staff estimate they spend 15 to 20 hours per week addressing these types of problems. They have implemented additional manual procedures to detect system problems but note that some errors, such as incorrect assessments, may not be detected until providers contact the Fund. The regular occurrence of errors and the need to identify and correct them increase the risks associated with the Fund's operations and also require additional audit effort.

OCI has begun initial steps to develop a new system.

In light of the critical nature of the provider system, OCI has taken steps to begin developing a new system using funding from its FY 2005-06 budget authority for Fund operations and its FY 2006-07 administrative and support services appropriation, which is intended for its supervision of the insurance industry. OCI indicated that funding became available in FY 2005-06 because of cost savings and the delay of certain expenditures to the next fiscal year. Those funds were used to hire a system analyst under contract with a private firm. Another systems analyst was hired in FY 2006-07.

The Department of Administration approved OCI's use of its administrative and support services appropriation because of the general scope of this appropriation, which funds other computer system costs at the agency. OCI anticipates that the Fund may be able to reimburse the administrative appropriation for a portion of these costs during FY 2006-07, but that a payable will be established at fiscal year-end for any outstanding amount. OCI is unsure of how long it will take for the Fund to fully pay for these costs.

The Governor's 2007-09 Biennial Budget Proposal recommends an additional $600,000 for the development and implementation of the new system.

According to OCI, the new system is currently in the late analysis and early development stages. The Governor's 2007-09 Biennial Budget Proposal recommends additional funding of $600,000 over the biennium for the services of two contract programmers, hardware, and software to continue the development and implementation of the new system. If the additional funding is not approved during the 2007-09 biennial budget deliberations, OCI is unsure of when the new system will be implemented.

System access concerns increase the risk of unauthorized access and compromised data integrity.

The issues with the current provider system have also limited the Fund's ability to address internal control weaknesses related to system access. Controlling access to the system is critical to ensure that data cannot be viewed or changed by unauthorized users. We found access concerns that increase the risk for unauthorized access and compromised data integrity. OCI staff indicated that making changes to address these control weaknesses could result in system integrity issues or unintended consequences. Instead, staff indicated they would address these concerns as they develop and implement the new system. Until a new system is fully developed and addresses the noted control weaknesses, our concerns with the current provider system remain.

☑ Recommendation

We recommend the Office of the Commissioner of Insurance closely monitor access to and the integrity of the data and processing of the Injured Patients and Families Compensation Fund's provider system until a new system has been fully implemented.

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Audit Opinion ■

Independent Auditor's Report on the Financial Statements of the Wisconsin Injured Patients and Families Compensation Fund

We have audited the accompanying financial statements of the Wisconsin Injured Patients and Families Compensation Fund as of and for the years ended June 30, 2006, 2005, and 2004. These financial statements are the responsibility of the management of the Wisconsin Injured Patients and Families Compensation Fund. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements referred to in the first paragraph present only the Wisconsin Injured Patients and Families Compensation Fund and do not purport to, and do not, present fairly the financial position of the State of Wisconsin and the changes in its financial position and its cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Wisconsin Injured Patients and Families Compensation Fund as of June 30, 2006, 2005, and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 11 to the financial statements, the Wisconsin Injured Patients and Families Compensation Fund implemented Governmental Accounting Standards Board Statement Number 40, *Deposit and Investment Risk Disclosures—an Amendment of GASB Statement No. 3*, for the fiscal years ended June 30, 2005, and June 30, 2006.

As discussed in Note 4 to the financial statements, the Wisconsin Injured Patients and Families Compensation Fund's projected ultimate loss liabilities are estimates based on recommendations of a consulting actuary. The Wisconsin Injured Patients and Families Compensation Fund's management and Board of Governors believe that the estimated loss liabilities are reasonable and adequate to cover the cost of claims incurred as of the end of the fiscal year. However, uncertainties inherent in projecting the frequency and severity of large medical malpractice claims, the Fund's unlimited liability coverage, and extended reporting and settlement periods make it likely that amounts paid will ultimately differ from the recorded estimated liabilities. These differences cannot currently be quantified.

Our audit was conducted for the purpose of forming an opinion on the financial statements of the Wisconsin Injured Patients and Families Compensation Fund. The supplementary information included as Management's Discussion and Analysis on pages 25 through 33 is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 14, 2007, on our consideration of the Wisconsin Injured Patients and Families Compensation Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

LEGISLATIVE AUDIT BUREAU

March 14, 2007 by Diann Allsen

Diann Allsen
Audit Director

Management's Discussion and Analysis ■

Prepared by Management of the Wisconsin Injured Patients and Families Compensation Fund

This section presents management's discussion and analysis of the financial performance of the Wisconsin Injured Patients and Families Compensation Fund during the fiscal years ended June 30, 2006, 2005, and 2004. This discussion should be read in conjunction with the accompanying financial statements and notes. The financial statements, notes, and this discussion are the responsibility of the management of the Fund.

Overview of the Fund

The Fund was created in 1975 to provide excess medical malpractice insurance for Wisconsin health care providers. Under broad authority granted to it by s. 655.27(2), Wis. Stats., the Fund is governed by a 13-member Board of Governors. The Board consists of three insurance industry representatives; a member named by the Wisconsin Academy of Trial Lawyers; a member named by the State Bar Association; two members named by the State Medical Society of Wisconsin; a member named by the Wisconsin Hospital Association; four public members appointed by the Governor; and the Commissioner of Insurance, who serves as the chair. The Fund's administrative staff is provided by the Office of the Commissioner of Insurance.

The Board is assisted by an Actuarial and Underwriting Committee; a Legal Committee; a Claims Committee; a Finance, Investment, and Audit Committee; a Risk Management and Patient Safety Committee; and a Peer Review Council. The Board and its committees meet quarterly.

The Fund operates on a July 1 through June 30 fiscal year basis. Administrative costs and operating costs, including claim payments, are funded through assessments on participating health care providers.

Financial Statements

The Fund's financial statements have been prepared in a format prescribed by the Board of Governors in accordance with accounting principles generally accepted in the United States of America. Financial statements for each of the past three years follow this discussion and analysis.

Assets

The Fund's assets consist primarily of investments, which are managed by the State of Wisconsin Investment Board (SWIB) in accordance with Wisconsin Statutes and the directives of the Board of Governors and its Investment Committee. The Board has established investment guidelines to be followed by SWIB. Compliance with these guidelines is reviewed quarterly by the Investment Committee.

The Fund's investment strategy is to invest at least 80 percent of its assets in fixed-income securities that have a reasonable degree of safety of principal, as well as income-paying ability. The remaining 20 percent may be invested in equities. High priority is given to matching the maturity of assets with the liquidity needs of the liabilities. Equities made up 19.8 percent of total investments as of June 30, 2006, 17.5 percent as of June 30, 2005, and 15.7 percent as of June 30, 2004, so the Fund was in compliance with the investment guideline that equities make up no more than 20 percent of total investments. Investments are reported at market value.

The Investment Committee has been working with SWIB regarding the possibility of hiring an outside manager to provide more in-depth, day-to-day management of the Fund's assets and maximize the Fund's return on investments. During the 2003-05 session, the Wisconsin Legislature approved a bill that would permit SWIB to hire a manager for the Fund's assets (2003 Wisconsin Act 299). The Investment Committee and SWIB have been working on asset allocation modeling to determine what types of investments might be best suited to the Fund and whether the use of an outside manager is the best course of action at this time.

As shown in Table A, there has been some fluctuation in total assets over the last three years. The increases from June 30, 2003 to 2004 and from June 30, 2004 to 2005, occurred because assessment revenue and investment income exceeded paid losses and other cash expenses. The small decrease from June 30, 2005, to June 30, 2006, occurred because amounts paid out for claims and expenses exceeded the assessments and investment income received. Some maturing securities were therefore used to pay claims.

Table A

Total Assets

As of:	Total Assets	Change from Prior Year
June 30, 2003	$667,448,545	–
June 30, 2004	741,274,513	11.1%
June 30, 2005	758,677,702	2.3
June 30, 2006	746,386,079	(1.6)

Loss Liabilities

Loss liabilities are the amounts expected to be paid in the future for incidents that have already occurred, and they account for nearly all of the liabilities of the Fund. Total loss liabilities, which are shown in Table B, include the total of individual case estimates for reported losses, the actuarially determined estimate for losses that have been incurred but have not yet been reported to the Fund, and a provision for the estimated future payment of claim adjustment costs associated with the outstanding claims.

Table B

Total Loss Liabilities

As of:	Total Loss Liabilities	Change from Prior Year
June 30, 2003	$656,315,300	–
June 30, 2004	668,485,367	1.9%
June 30, 2005	720,923,186	7.8
June 30, 2006	684,967,487	(5.0)

Section Ins. 17.27(3), Wis. Adm. Code, requires the liability for losses and loss adjustment expenses to be maintained on a present value basis. The discount factors for FYs 2003-04, 2004-05, and 2005-06 were 0.757, 0.817, and 0.752, respectively. Changes in the discount factor affect the amount representing interest liability account, and the change in that account, which is reflected as an underwriting expenditure, is affected not only by the change in the discount factor but also by the amount of the estimated liability being discounted.

Changes in loss liabilities from one year to the next reflect a combination of another year's loss expectations, plus or minus any change to prior years' loss liability estimates based on actuarial studies. The Fund's actuary performs an annual review of the outstanding estimated liabilities for each year and makes adjustments for each year as deemed appropriate.

In addition, recent Wisconsin Supreme Court decisions have had significant effects on the outstanding liabilities of the Fund. The most significant occurred in July 2005 with the *Ferdon* decision, which declared the cap on noneconomic damages to be unconstitutional. This decision resulted in an increase of $173.0 million in estimated undiscounted loss liabilities as of June 30, 2006. However, two other changes made in the actuarial estimates more than offset this increase. First, previous years' estimates of loss liabilities were decreased as a result of the Fund's additional year of experience. Second, the Board of Governors implemented a smaller risk margin for catastrophic claims. The change in the risk margin is discussed in greater detail in Note 4. The net effect of the court decisions and actuarial changes was a 5.0 percent decrease in loss liabilities as of June 30, 2006.

Subsequent to the *Ferdon* decision, 2005 Wisconsin Act 183 was enacted in April 2006. It established a new cap of $750,000 for noneconomic damages. That cap will affect claims arising out of incidents that occur on or after April 6, 2006. The new legislation does not affect claims with incident dates prior to April 6, 2006.

The uncertainties inherent in projecting the frequency and severity of claims because of the Fund's unlimited liability coverage, extended reporting and settlement periods, and the effect of court decisions and legislative initiatives make it likely that the amounts ultimately paid will differ from the recorded estimated liabilities. These differences cannot be quantified.

Net Assets

The Fund's net assets, or the balance of assets in excess of liabilities, for the past four years are shown in Table C. The changes in net assets are largely attributable to the difference between revenues collected and expenses paid, changes made to loss liability estimates for previous years as determined by the actuary, and unrealized investment gains and losses (changes in the market value of held investments).

Table C

Net Assets

As of:	Net Assets	Change from Prior Year
June 30, 2003	$ 7,935,026	–
June 30, 2004	24,606,759	210.1%
June 30, 2005	31,702,847	28.8
June 30, 2006	59,848,012	88.8

The Board of Governors has made a decision to maintain surplus levels as near to zero as possible, and that a need does not exist to maintain any significant surplus level within the Fund. This decision was based upon the nature of the Fund: it is a risk-sharing fund with no stockholders, and participation is mandatory. Therefore, assessments can be levied to make up any shortfalls should they occur in the future.

Revenues

The Fund's revenues consist primarily of assessments and investment income. All Fund participants are billed annually in accordance with an assessment rate determined annually by the Board of Governors. Investment income varies for reasons that include the economy in general, the operating experience of the Fund, and the amount of new money available for investing.

As shown in Table D, total revenues fluctuated a great deal over the last four years. Contributing factors included changes in assessment rates and in unrealized gains and losses in the value of investments because of market conditions.

Table D

Total Revenues

Fiscal Year	Total Revenues	Change from Prior Year
2002-03	$104,211,475	–
2003-04	52,799,464	(49.3)%
2004-05	84,737,693	60.5
2005-06	25,857,661	(69.5)

Assessment revenues, which are shown in Table E, depend on the number of each type of provider participating in the fund and the assessment rates in effect for each provider type. The Board of Governors authorized changes in assessment rates as follows: a 5.0 percent increase in FY 2003-04, a 20.0 percent decrease in FY 2004-05, and a 30.0 percent decrease in FY 2005-06.

Table E

Assessment Revenues

Fiscal Year	Assessment Revenues	Change from Prior Year
2002-03	$29,463,735	–
2003-04	32,064,990	8.8%
2004-05	26,547,016	(17.2)
2005-06	18,930,808	(28.7)

Physicians are classified into one of four classes based upon a risk assessment of their specialty. Hospitals are assessed based upon the number of beds and outpatient visits. As can be seen in Table F, as of June 30, 2006, the vast majority of Fund participants were physicians.

Table F

Providers by Type as of June 30, 2006

Provider Type	Number of Providers	Percentage of Total Providers
Physicians	11,779	84.4%
Corporations	1,385	9.9
Nurse Anesthetists	523	3.8
Hospitals	128	0.9
Partnerships	54	0.4
Hospital-affiliated Nursing Homes	32	0.2
Hospital-owned or -controlled Entities	24	0.2
Ambulatory Surgery Centers	22	0.2
Cooperatives	1	0.0
Total	**13,948**	**100.0%**

Investment income, which includes bond interest, stock dividends, and capital gains and losses, is shown in Table G. The Fund consistently earned approximately $32 million in interest income from its debt securities each year. In addition, the Fund realized gains of $9.7 million in FY 2003-04 and $1.6 million in FY 2004-05, and it realized losses of $1.6 million in FY 2005-06 from the sale of investments. The majority of the realized gains in FY 2003-04 and FY 2004-05 were the result of changes made to the Fund's equity mix. Most of the realized losses in FY 2005-06 resulted from the sale of Ford Motor Company bonds.

Table G

Investment Income

Fiscal Year	Investment Income	Change from Prior Year
2002-03	$74,502,092	–
2003-04	20,549,283	(72.4)%
2004-05	58,102,433	182.7
2005-06	6,832,841	(88.2)

Most of the change in investment income from year to year was the result of the changes in unrealized gains and losses associated with changes in the market value of the Fund's investments. While the Fund maintained net unrealized gains as part of its total investment balances each year, those gains decreased by $18.9 million in FY 2003-04, increased by $25.6 million in FY 2004-05, and then decreased again by $23.1 million in FY 2005-06. These changes in unrealized gains and losses were the result of the Fund's experience in the equities market, changes in the ratings of some of the bonds in the Fund's debt portfolio, and changes in the interest rate environment.

Underwriting Expenses

The Fund's underwriting expenses, which are shown in Table H, consist of loss and loss adjustment expenses paid, plus changes to the liabilities for unpaid claims. The changes to the liabilities can be either positive or negative amounts, depending upon the annual actuarial analysis of the outstanding loss liabilities on a year-by-year basis.

Table H

Underwriting Expenses

Fiscal Year	Underwriting Expenses	Change from Prior Year
2002-03	$101,935,410	–
2003-04	35,210,829	(65.5)%
2004-05	76,626,047	117.6
2005-06	(3,295,595)	(104.3)

The major cause of the significant changes in the underwriting expenses is changes in actuarial projections. These projections are related to the outstanding liabilities for unpaid losses and loss adjustment expenses. In addition, any changes to the interest rate used in the discounting of reserves will flow through to the underwriting expenses.

For FY 2005-06, the Fund reported negative underwriting expenses in total, because decreases to total loss liability estimates were greater than increases. As noted, the *Ferdon* decision increased liabilities by $173.0 million. In addition, as further discussed in

Note 4, the actuary implemented a change in its methodology and assumptions that significantly increased the loss adjustment expense liabilities. These increases to total loss liabilities were more than offset, however, by the decreases that resulted from the decrease in the Fund's risk margin and reductions to previous years' estimates as a result of an additional year's experience, which are also discussed further in Note 4.

Summary

The Wisconsin Injured Patients and Families Compensation Fund, a segregated fund administered by the Office of the Commissioner of Insurance, operates as a risk-sharing fund. Assessments are collected from participating health care providers and are used to pay underwriting and administrative expenses. The Fund's Board of Governors determines the assessment rates annually, based on actuarial advice in conjunction with the Board's philosophy to maintain net assets at or near zero.

Investments are predominantly conservative (approximately 80 percent in investment-grade bonds and 20 percent in equities), with the intent to match assets with liabilities while maximizing return.

Contacting the Fund's Financial Management

This financial report is designed to provide the Legislature, the executive branch of government, the public, and other interested parties with an overview of the financial results of the Fund's activities and to show the Fund's financial position. If you have questions about this report or need additional information, contact the director of the Wisconsin Injured Patients and Families Compensation Fund at:

Office of the Commissioner of Insurance
125 South Webster Street
P.O. Box 7873
Madison, WI 53707-7873

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Financial Statements

Statement of Net Assets
June 30, 2006, 2005, and 2004

	June 30, 2006	June 30, 2005	June 30, 2004
ASSETS			
Current Assets:			
Cash and cash equivalents (Note 3)	$ 13,903,734	$ 22,066,044	$ 24,488,711
Investments (Note 3)	69,732,703	49,489,535	25,693,330
Investment income receivable	8,908,410	8,632,770	8,565,984
Investment sales receivable	0	3,622,682	34,999,078
Assessments receivable	44,448	87,440	127,707
Other receivables	13,857	16,588	14,689
Supplies inventory and other assets	10,047	9,599	9,355
Total Current Assets	92,613,199	83,924,658	93,898,854
Noncurrent Assets:			
Investments (Note 3)	653,772,880	674,750,023	647,372,638
Capital assets, net of accumulated depreciation	0	3,021	3,021
Total Noncurrent Assets	653,772,880	674,753,044	647,375,659
TOTAL ASSETS	**746,386,079**	**758,677,702**	**741,274,513**
LIABILITIES			
Current Liabilities:			
Loss liabilities—current portion	83,234,000	55,250,000	54,716,000
Investment purchases payable	2,787	1,974	45,099,762
Assessments received in advance (Note 2E)	1,147,488	5,399,716	2,706,535
Provider refunds payable	246,056	312,217	210,493
General and administrative expense payable	112,227	113,018	61,619
Medical mediation panel fees payable (Note 7)	27,103	185,053	73,232
Compensated absences	9,088	15,069	8,808
Total Current Liabilities	84,778,749	61,277,047	102,876,449
Noncurrent Liabilities:			
Loss liabilities (Note 4):			
Loss liability for incurred but not reported losses	668,232,372	815,316,991	801,973,135
Loss liability for reported losses	80,205,847	21,614,068	33,070,728
Loss liability for loss adjustment expense	153,137,047	42,765,134	45,400,647
Estimated loss liabilities	901,575,266	879,696,193	880,444,510
Amount representing interest	(223,142,394)	(160,984,403)	(213,948,016)
Discounted loss liabilities	678,432,872	718,711,790	666,496,494
Liabilities for future medical expenses (Note 5)	5,534,615	1,811,396	1,588,873
Contributions being held liability (Note 6)	1,000,000	400,000	400,000
Total loss liabilities	684,967,487	720,923,186	668,485,367
Less: loss liabilities—current portion	(83,234,000)	(55,250,000)	(54,716,000)
Noncurrent loss liabilities	601,733,487	665,673,186	613,769,367
Compensated absences	25,831	24,622	21,938
Total Noncurrent Liabilities	601,759,318	665,697,808	613,791,305
TOTAL LIABILITIES	**686,538,067**	**726,974,855**	**716,667,754**
NET ASSETS			
Net Assets:			
Invested in capital assets, net of related debt	0	3,021	3,021
Restricted for injured patients and families	59,848,012	31,699,826	24,603,738
TOTAL NET ASSETS	**$ 59,848,012**	**$ 31,702,847**	**$ 24,606,759**

The accompanying notes are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets for the Years Ended June 30, 2006, 2005, and 2004

	Year Ended June 30, 2006	Year Ended June 30, 2005	Year Ended June 30, 2004
OPERATING REVENUES			
Assessments (Note 2E)	$ 18,930,808	$ 26,547,016	$ 32,064,990
Assessment Interest Income (Note 8)	51,725	46,253	82,647
Total Operating Revenues	**18,982,533**	**26,593,269**	**32,147,637**
OPERATING EXPENSES			
Underwriting Expenses:			
Net losses paid	29,198,526	20,016,451	18,880,983
Loss adjustment expenses paid	3,784,654	4,025,262	4,015,949
Risk management expenses	76,792	32,308	42,121
Medical expenses paid	200,133	114,206	101,709
Change in liability for incurred but not reported losses	(147,084,619)	13,343,856	1,946,302
Change in liability for reported losses	58,591,779	(11,456,660)	1,104,350
Change in liability for loss adjustment expense	110,371,912	(2,635,513)	4,254,706
Change in amount representing interest	(62,157,991)	52,963,613	4,336,772
Change in liability for future medical expense	3,723,219	222,524	527,937
Total Underwriting Expenses	(3,295,595)	76,626,047	35,210,829
General and Administrative Expenses	1,005,070	1,013,487	916,902
Total Operating Expenses	**(2,290,525)**	**77,639,534**	**36,127,731**
OPERATING INCOME (LOSS)	**21,273,058**	**(51,046,265)**	**(3,980,094)**
NONOPERATING REVENUES (EXPENSES)			
Investment Income	6,832,841	58,102,433	20,549,283
Administrative Fee Income	39,772	41,991	44,724
Miscellaneous Revenue	2,515	(2,071)	57,820
Loss on Disposal of Capital Assets	(3,021)	0	0
Total Nonoperating Revenues (Expenses)	**6,872,107**	**58,142,353**	**20,651,827**
CHANGE IN NET ASSETS	**28,145,165**	**7,096,088**	**16,671,733**
NET ASSETS			
Net Assets—Beginning of the Year	31,702,847	24,606,759	7,935,026
Net Assets—End of the Year	$ 59,848,012	$ 31,702,847	$ 24,606,759

The accompanying notes are an integral part of this statement.

Statement of Cash Flows
for the Years Ended June 30, 2006, 2005, and 2004

	Year Ended June 30, 2006	Year Ended June 30, 2005	Year Ended June 30, 2004
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash Received from Providers for Assessments	$ 15,245,524	$ 29,706,046	$ 33,042,140
Cash Received from Primary Malpractice Insurers	2,000,000	1,046,123	1,588,556
Cash Received from Other Sources	333,912	732,039	399,659
Cash Paid for Losses	(30,598,526)	(21,062,575)	(20,469,538)
Cash Paid for Loss Adjustment Expenses	(3,784,654)	(4,025,262)	(4,015,949)
Cash Paid for Other Expenses	(1,284,697)	(1,105,843)	(1,072,777)
Cash Paid to Providers for Refunds of Fund Fees	(590,071)	(325,957)	(1,053,608)
Cash Paid for Medical Mediation Panel Fees	(398,469)	(527,903)	(211,070)
Net Cash Provided by (Used for) Operating Activities	**(19,076,981)**	**4,436,668**	**8,207,413**
CASH FLOWS FROM INVESTING ACTIVITIES			
Interest Received	32,761,891	32,239,017	31,478,540
Cash Received as Proceeds from Sales of Investments	59,958,838	109,751,180	47,696,303
Cash Paid for Purchase of Investment Securities	(81,806,058)	(148,849,532)	(68,964,838)
Net Cash Provided by (Used for) Investment Activities	**10,914,671**	**(6,859,335)**	**10,210,005**
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	**(8,162,310)**	**(2,422,667)**	**18,417,418**
Cash and Cash Equivalents—Beginning of the Year	22,066,044	24,488,711	6,071,293
Cash and Cash Equivalents—End of the Year	$ 13,903,734	$ 22,066,044	$ 24,488,711
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES			
Operating Income	$ 21,273,058	$ (51,046,265)	$ (3,980,094)
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:			
Depreciation expense	0	0	3,020
Miscellaneous nonoperating income	42,287	39,920	103,232
Changes in assets and liabilities:			
Decrease (Increase) in assessments receivable	42,992	40,267	18,245
Decrease (Increase) in other receivables	2,731	(1,899)	10,074
Decrease (Increase) in supplies inventory and other assets	(448)	(244)	(1,537)
Increase (Decrease) in loss liabilities	(35,955,699)	52,437,819	12,170,067
Increase (Decrease) in other liabilities	(4,481,902)	2,967,070	(115,594)
Total Adjustments	(40,350,039)	55,482,933	12,187,507
Net Cash Provided by (Used for) Operating Activities	**$ (19,076,981)**	**$ 4,436,668**	**$ 8,207,413**
Noncash Activities:			
Net change in unrealized gains and losses	$ (23,077,556)	$ 25,617,651	$ (18,895,963)
Amortization of bond discounts	(1,419,232)	(1,712,789)	(1,716,129)

The accompanying notes are an integral part of this statement.

Notes to the Financial Statements ▪

1. Description of the Fund

The Injured Patients and Families Compensation Fund is part of the State of Wisconsin financial reporting entity and is reported as a major enterprise fund in the State's Comprehensive Annual Financial Report. The Fund, formerly the Patients Compensation Fund, was created in 1975 for the purpose of paying that portion of medical malpractice claims exceeding the legal primary insurance limits prescribed in s. 655.23(4), Wis. Stats., or the maximum liability limit for which the health care provider is insured, whichever limit is greater. Most health care providers permanently practicing or operating in the State of Wisconsin are required to pay annual assessments.

Management of the Fund is vested with the 13-member Board of Governors, which is chaired by the Commissioner of Insurance. The Board has designated the Commissioner of Insurance as the administrator of the Fund. Similarly, under s. 655.27(2), Wis. Stats., the Commissioner shall either provide staff services necessary for the operation of the Fund or, with the approval of the Board, contract for all or part of these services. During FY 2005-06, FY 2004-05, and FY 2003-04, the Board contracted for the Fund's actuarial, risk management, and claims administration services.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Fund Accounting and Basis of Presentation

The financial statements of the Injured Patients and Families Compensation Fund have been prepared in conformance with generally accepted accounting principles (GAAP) for proprietary funds. The accompanying financial statements were prepared based upon the flow of economic resources focus and full accrual basis of accounting, with revenues recognized when earned and expenses recognized when incurred.

The Statement of Revenues, Expenses, and Changes in Fund Net Assets classifies the Fund's fiscal year activity as either operating or nonoperating. Because the Fund is an enterprise fund, which is a type of proprietary fund, it accounts for operations in a manner similar to private businesses in which operating revenues are derived from exchange transactions. Assessments, which are received from health care providers in exchange for coverage under the Fund, represent a significant component of operating revenues. Operating expenses include underwriting and administrative expenses.

Certain revenues and expenses that are not related to the Fund's primary purpose, such as gain or loss on the disposal of capital assets, are reported as nonoperating revenues and expenses. The most significant source of the Fund's nonoperating income is investment income.

The Fund applies all applicable Governmental Accounting Standards Board (GASB) pronouncements. Financial Accounting Standards Board (FASB) statements effective after November 30, 1989, are not applied in accounting for the operations of the Fund.

B. Accounting Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Estimates that are particularly susceptible to significant change in future years are the liabilities for unpaid losses and loss adjustment expenses. In estimating these liabilities, management uses the methodology discussed in Note 4 on ultimate and discounted loss liabilities.

C. Cash and Cash Equivalents

Cash and cash equivalents include cash balances deposited with the State and shares in the State Investment Fund. The State Investment Fund is a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees. Shares in the State Investment Fund are purchased in $1,000 increments, and any remaining cash balance is deposited in the State's bank.

D. Investment Valuation

Investments of the Fund consist of fixed-income securities managed by the State of Wisconsin Investment Board, and shares in equity index funds. All investments are reported at fair value. Fair value information is determined using quoted market prices.

E. Assessments

Assessments are billed and recognized as revenues on a fiscal year basis, which is also the policy year. Assessments received for the next fiscal year are treated as deferred revenue and reported as assessments received in advance. Accounts of providers are automatically credited and reported as provider refunds payable when primary insurance lapses.

F. Loss Liabilities

Loss liabilities are estimated based on recommendations of a consulting actuary and are discounted to the extent that they are matched by cash and invested assets. The uncertainties inherent in projecting the frequency and severity of claims, the Fund's unlimited liability coverage for economic damages, and extended reporting and settlement periods make it likely that the amounts ultimately paid will differ from the recorded estimated liabilities.

G. Policy Acquisition Costs

Since the Fund has no marketing staff and incurs no sales commissions, acquisition costs are minimal and charged to operations as incurred.

H. Capital Assets

The Fund capitalizes all office furniture and equipment with a useful life of two or more years and a purchase price of $5,000 or more. Capital assets are depreciated under the straight-line method over the estimated useful lives of the assets. On June 30, 2005 and 2004, the Fund held capital assets that were fully depreciated to their salvage value of $3,021 ($30,202 less accumulated depreciation of $27,181). By June 30, 2006, the Fund had disposed of all of the assets it had classified as capital assets.

I. Employee Compensated Absences

The Fund's compensated absence liability consists of accumulated unpaid leave, compensatory time, personal holiday hours, and Saturday/legal holiday hours earned and vested as of June 30. Unused, earned compensated absences, other than accumulated sick leave, are accrued with a resulting liability. The liability and the expense for compensated absences are based on current rates of pay. The related employer's share of social security taxes, Medicare taxes, and contributions to the Wisconsin Retirement System is also accrued with a resulting liability. The compensated absences liability is classified as either a short-term or a long-term liability based upon an estimate determined by management. The long-term liability portion of the compensated absences liability generally is not paid out until retirement.

3. DEPOSITS AND INVESTMENTS

GASB Statement 40, *Deposit and Investment Risk Disclosures—an Amendment of GASB Statement No. 3*, which was first effective for FY 2004-05, amended several of the required disclosures previously required under GASB Statement 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. The reporting requirements affecting the Fund's deposits did not significantly differ between GASB Statements 3 and 40 and, therefore, deposit disclosures for all three years are reported together. Because there were more significant changes related to the investment disclosures, additional investments disclosures required by GASB Statement 40 for FYs 2004-05 and 2005-06 are included as a separate subsection of the investment portion of this note. Information for the additional disclosures was not readily available for FY 2003-04.

A. Deposits

The balance of cash and cash equivalents consists of cash deposited in the State's bank and cash invested by the State of Wisconsin Investment Board through the State Investment Fund. As of June 30, these balances at market value are as follows:

	June 30, 2006	June 30, 2005	June 30, 2004
Cash and Cash Equivalents:			
Deposits in the State's Bank	$ 288,734	$ 722,044	$ 388,783
State Investment Fund Shares	13,615,000	21,344,000	24,099,928
Total Cash and Cash Equivalents	$13,903,734	$22,066,044	$24,488,711

The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company. Shares in the State Investment Fund are reported as cash equivalents and are reported at fair value as of June 30. Interest income, gains, and losses of the State Investment Fund are allocated monthly. The various types of securities in which the State Investment Fund may invest are enumerated in ss. 25.17(3)(b), (ba), and (bd), Wis. Stats., and include direct obligations of the United States and Canada, securities guaranteed by the United States government, securities of federally chartered corporations, unsecured notes of financial and industrial issuers, Yankee/Eurodollar issues, certificates of deposit issued by banks in the United States and solvent financial institutions in this state, and bankers acceptances. The Investment Board's trustees may approve other prudent investments and have granted derivatives authority, subject to review and approval by the Investment Board's Investment Committee, limited to positions in finance futures, options, and swaps, and only if the purpose is to hedge existing positions, adjust portfolio duration within statutory guidelines, or reduce the interest rate risk.

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the Fund will not be able to recover deposits that are in possession of an outside party. The Fund does not have a deposit policy specifically for custodial risk. Shares in the State Investment Fund are not required to be categorized under either GASB Statement 3 or GASB Statement 40. For the remaining deposits in the State's bank, all of the deposits that are held in financial institutions are insured up to $100,000 by the Federal Deposit Insurance Corporation, and the State of Wisconsin Public Deposit Guarantee fund insures up to $400,000 above the amount of federal insurance. Therefore, only the amount of the Fund's June 30 bank balance in excess of $500,000 was exposed to custodial credit risk and considered uninsured and uncollateralized under both GASB Statement 3 and GASB Statement 40, as follows:

	June 30, 2006	June 30, 2005	June 30, 2004
Deposits in the State's Bank:			
Total Deposits in the State's Bank	$288,734	$722,044	$388,783
Less: Insured Deposits	(288,734)	(500,000)	(388,783)
Uninsured and Uncollateralized Deposits	$ 0	$222,044	$ 0

B. Investments

The Fund's investments are managed by the Investment Board, whose objective is to maintain a portfolio of investments with maturities and liquidity levels that are appropriate for the needs of the Fund. Section 25.17(3)(a), Wis. Stats., allows investments in loans, securities, and any other investments as authorized by s. 620.22, Wis. Stats. Classes of investments permitted by s. 620.22, Wis. Stats., include bonds of governmental units or private corporations, loans secured by mortgages, preferred or common stock, real property, and other investments not specifically prohibited by statute.

In addition, the Board of Governors approves a statement of investment policy, in which it can provide more specific investment guidelines. These guidelines limit equity investments to 20 percent of the Fund's total portfolio.

The market values of the Fund's investments at year-end are as follows:

	June 30, 2006	June 30, 2005	June 30, 2004
Fixed-Income:			
U.S. Government and Agency	$241,064,779	$231,640,424	$201,214,895
Industrial	178,534,480	197,361,385	201,673,401
Transportation	9,802,083	10,324,920	10,094,439
Finance	59,605,552	58,606,259	63,419,428
Utilities	71,530,540	79,276,162	70,105,799
Sovereign	19,959,141	20,527,529	21,015,178
Subtotal	$580,496,575	$597,736,679	$567,523,140

	June 30, 2006	June 30, 2005	June 30, 2004
Equities:			
Russell 3000 Index Fund	$ 83,207,651	$ 75,919,011	$ 56,319,383
Russell 2000 Index Fund	12,048,908	10,505,481	14,230,874
BGI Mid-cap B Lendable Fund	25,874,885	22,870,204	19,996,701
MSCI World Ex-US Index Fund	21,877,564	17,208,183	0
World Ex-US Strategy Fund	0	0	14,995,870
Subtotal	143,009,008	126,502,879	105,542,828
Total Investments	$723,505,583	$724,239,558	$673,065,968

All of the Fund's fixed-income investments required to be categorized by GASB Statement 3 at June 30, 2004, meet the criteria for risk category 1. Investments in risk category 1 are insured or registered, or are held by the State or its agent in the State's name. Shares in the equity index funds are not required to be categorized.

Additional GASB 40 Disclosures for FY 2004-05 and FY 2005-06

The Investment Board recognizes that risk issues permeate the entire investment process from asset allocation to performance evaluation. The Investment Board monitors risk through multiple forms of analysis and reporting. Inspection of level of diversification, nominal risk exposures, risk/return plots, and matching liabilities with assets forms the core of the monitoring process. In addition, portfolios and asset classes are reviewed monthly for compliance with investment guidelines. On a monthly basis, guideline exceptions, if any, are reported to the Investment Board's Compliance Committee.

Credit Risk—Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to the Fund. The Fund's investment guidelines provide that issues be rated "A-" or better at the time of purchase, based on the minimum credit ratings as issued by nationally recognized statistical rating organizations. As of June 30, 2005, and June 30, 2006, these credit ratings were as follows:

	June 30, 2006		June 30, 2005	
Credit Rating	Fair Value	Percentage	Fair Value	Percentage
US Treasury	$185,707,635	32.0%	$192,837,507	32.3%
AAA	90,947,029	15.7	77,585,847	13.0
AA	65,190,999	11.2	60,444,901	10.1
A	154,173,784	26.6	173,305,454	29.0
BBB	68,284,178	11.8	72,951,270	12.2
BB	4,792,950	0.8	16,174,200	2.7
B	7,650,000	1.3	4,437,500	0.7
CCC	3,750,000	0.6	0	0.0
Total	$580,496,575	100.0%	$597,736,679	100.0%

Custodial Credit Risk—Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the Fund will not be able to recover the value of investments that are in possession of an outside party. The Fund does not have an investment policy specifically for custodial credit risk. As of June 30, 2005, and June 30, 2006, the Fund did not have any investment securities exposed to custodial credit risk.

Concentration of Credit Risk—Concentration of credit risk is the risk of loss attributed to the magnitude of an organization's investment in a single issuer. The Fund's investment guidelines limit concentrations of credit risk by establishing maximum issuer and/or sector exposure limits. Generally, the guidelines provide that no single issuer may exceed 5.0 percent of the Fund's investments, with the exception of the U.S. Government and its agencies, which may be unlimited. As of June 30, 2005, and June 30, 2006, the Fund did not have more than 5.0 percent of its total investments in a single issuer.

Interest Rate Risk—Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Fund uses the duration method to identify and manage its interest rate risk. The Fund's investment guidelines related to interest rate risk provide that the average duration of the aggregate bond portfolio should be less than ten years.

As of June 30, 2005, and June 30, 2006, the following were the durations for each type of fixed-income security held, as well as for the State Investment Fund:

	June 30, 2006		June 30, 2005	
Type of Security	Fair Value	Duration (In Years)	Fair Value	Duration (In Years)
Government/Agency	$241,064,779	4.81	$231,640,424	5.37
Corporate	339,431,796	5.04	366,096,255	5.82
Subtotal	$580,496,575	4.94	$597,736,679	5.65
State Investment Fund[1]	13,615,000	0.06	21,344,000	0.08
Total	$594,111,575	4.83	$619,080,679	5.45

[1] State Investment Fund shares are classified as cash and cash equivalents.

Foreign Currency Risk—Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The Fund's investment guidelines do not specifically address foreign currency risk. As of June 30, 2005, and June 30, 2006, the Fund did not own any issues denominated in a foreign currency.

4. ULTIMATE AND DISCOUNTED LOSS LIABILITIES

A. Loss Liabilities

Loss liabilities include individual case estimates for reported losses and estimates for losses that have been incurred but not reported (IBNR), based upon the projected ultimate losses recommended by a consulting actuary. Individual case estimates of the liability for reported losses and net losses paid from inception of the Fund are deducted from the projected ultimate loss liabilities to determine the liability for IBNR losses as follows:

	June 30, 2006	June 30, 2005	June 30, 2004
Projected Ultimate Loss Liability	$1,361,409,276	$1,416,928,116	$1,394,692,134
Less:			
Net Losses Paid from Inception	(612,971,057)	(579,997,057)	(559,648,271)
Liability for Reported Losses	(80,205,847)	(21,614,068)	(33,070,728)
Liability for IBNR Losses	$ 668,232,372	$ 815,316,991	$ 801,973,135

Two significant changes affected the estimation of loss liabilities as of June 30, 2006. First, in July 2005, the Wisconsin Supreme Court ruled in *Ferdon* v. *Wisconsin Patients Compensation Fund* that the $350,000 inflation-adjusted limit was unconstitutional because it violated the equal protection guarantees of the Wisconsin Constitution. As a result, the actuaries increased their best estimate of loss liabilities as of June 30, 2006.

Second, the Fund implemented an explicit risk margin in its loss liabilities estimates. Previously, the Fund's actuary included an implicit risk margin of approximately 33.0 percent in its estimate of total loss liabilities. In response to a recommendation from an actuarial audit completed in July 2005, the Fund's actuary developed only a best estimate of the loss liabilities, and the Board of Governors approved the addition of an explicit 5.0 percent risk margin to the best estimate. The actuary considered the 5.0 percent margin reasonable because the *Ferdon* decision had addressed some of the uncertainties that had previously been incorporated into the implicit 33.0 percent risk margin. The change to a 5.0 percent risk margin resulted in a decrease in liabilities that largely offset the increase from the *Ferdon* decision.

Loss liabilities also include a provision for the estimated future payment of costs to settle claims. These ultimate loss adjustment expenses (LAE) are estimated at 6.25 percent of the projected ultimate loss liabilities as of June 30, 2005, and June 30, 2004. However, based on recent years' experience of increased paid LAE to paid losses, the actuaries changed their methodology to estimate unpaid LAE at 20.0 percent of the estimated unpaid loss liabilities as of June 30, 2006.

The LAE paid from inception of the Fund is deducted from the projected ultimate LAE provision to arrive at the liability for LAE as follows:

	June 30, 2006	June 30, 2005	June 30, 2004
Projected Ultimate LAE Liability	$202,714,574	$88,558,007	$87,168,258
Less:			
Net LAE Paid from Inception	(49,577,527)	(45,792,873)	(41,767,611)
Liability for LAE	$153,137,047	$42,765,134	$45,400,647

B. Re-estimated Loss Liabilities

Because of the uncertainties inherent in projecting medical malpractice claims with unlimited liability coverage, estimates of the Fund's loss liability and liability for LAE are continually reviewed and adjusted as the Fund gains additional experience. Such adjustments are reflected in current operations. Because of the changes in these estimates for prior years, the total underwriting expenses reported for the year are not necessarily indicative of the loss experience for that year.

C. Discounted Loss Liabilities

Section Ins. 17.27(3), Wis. Adm. Code, requires the liability for reported losses, liability for IBNR losses, and liability for LAE to be maintained on a present-value basis, with the difference from full value being reported as a contra account to the loss liabilities. The loss liabilities are discounted only to the extent that they are matched by cash and invested assets. Beginning with FY 1998-99, the Fund has held sufficient cash and invested assets to fully match the discounted loss liabilities. Therefore, the loss liabilities presented in the financial statements are fully discounted. The actuarially determined discount factor was 0.752 for FY 2005-06, 0.817 for FY 2004-05, and 0.757 for FY 2003-04.

D. Loss Liabilities Balances and Activities

Loss Liabilities	July 1	Additions	Deductions	June 30	Current Portion
FY 2003-04	$656,315,300	$ 35,168,708	$ 22,998,641	$668,485,367	$54,716,000
FY 2004-05	668,485,367	90,685,911	38,248,092	720,923,186	55,250,000
FY 2005-06	720,923,186	206,470,223	242,425,922	684,967,487	83,234,000

5. FUTURE MEDICAL EXPENSE LIABILITY

Section 655.015, Wis. Stats., requires accounts to be established for future medical expense awards in excess of $25,000 that were entered into or rendered before June 14, 1986, or in excess of $100,000 that were entered into or rendered on or after May 25, 1995.

6. CONTRIBUTIONS BEING HELD LIABILITY

A primary insurer may voluntarily present a nonrefundable payment to the Fund generally equal to the amount of primary coverage in effect for the related claim. This payment from the primary insurer is negotiable with the Fund in exchange for a release of payment for any future defense costs that may be incurred on the claim.

7. MEDICAL MEDIATION PANEL

Section Ins. 17.27(3), Wis. Adm. Code, requires the fees collected for administration of the Medical Mediation Panel to be included in the Fund's financial reports, but that they should not be regarded as assets or liabilities or otherwise taken into consideration in determining assessment levels to pay claims. The Fund collected $269,655 in fees in FY 2005-06, $618,860 in FY 2004-05, and $260,953 in FY 2003-04.

8. ASSESSMENT INTEREST INCOME

Fund participants choosing payment plans other than annual are assessed interest on the deferred assessment amounts. Section Ins. 17.28(4), Wis. Adm. Code, prescribes the daily interest rate to be assessed on the deferred assessments shall be the average annualized rate earned by the Fund on its funds in the State Investment Fund for the first three quarters of the preceding fiscal year, as determined by the Investment Board, divided by 360. Interest was assessed at the rate of 1.789 percent for FY 2005-06, 1.025 percent for FY 2004-05, and 1.550 percent for FY 2003-04.

9. CLAIM ANNUITIES

The settlement of a claim may result in the purchase of an annuity. Under specific annuity arrangements, the Fund may have ultimate responsibility for annuity payments if the annuity company and the reassignment company default on annuity payments.

One of the Fund's annuity providers defaulted on $93,982 in annuity payments through June 30, 2006, which the Fund subsequently paid. The annuity provider is currently making the majority of these annuity payments, but the Fund continues to make monthly annuity payments of $224, and additional lump sum payments due every five years through 2025, to cover defaulted payments. The Fund has received reimbursement for these payments, including interest, of $60,578 through June 30, 2006. It is unclear when the annuity provider will be able to make the remaining annuity payments and whether the Fund will be able to recover the remaining annuity payments made on the behalf of the annuity provider.

The total estimated replacement values of the Fund's annuities as of June 30, 2006, 2005, and 2004, were $145.6 million, $145.7 million, and $140.1 million, respectively.

10. EMPLOYEE RETIREMENT PLAN

Permanent full-time employees of the Injured Patients and Families Compensation Fund are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings; 2) years of creditable service; and 3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit.

The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued financial report that includes financial statements and required supplementary information may be obtained by writing to:

Department of Employee Trust Funds
P.O. Box 7931
Madison, WI 53707-7931

The most current financial report is also available on the Department of Employee Trust Funds' Web site, *www.etf.wi.gov.*

Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 1, 1990. However, in December 2003, the State issued bonds and subsequently fully liquidated its prior service liability balance as of January 2003. State agencies are required to make future contributions to fund the bond payments.

The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The Injured Patients and Families Compensation Fund's contributions to the plan were $49,081 for FY 2005-06, $47,821 for FY 2004-05, and $51,517 for FY 2003-04. The relative position of the Injured Patients and Families Compensation Fund in the Wisconsin Retirement System is not available because the Wisconsin Retirement System is a statewide, multiple-employer plan.

11. Change in Accounting Principle

The Fund implemented GASB Statement Number 40, *Deposit and Investment Risk Disclosures—an Amendment of GASB Statement No. 3*, beginning in FY 2004-05. Because the Fund did not implement this standard early, the deposit and investment disclosures for FY 2003-04 were prepared in accordance with the investment disclosure requirements previously in effect.

12. Subsequent Events

In July 2006, the State of Wisconsin Supreme Court issued a ruling in the *Bartholomew* v. *Wisconsin Patients Compensation Fund* case. The court reversed, in part, the *Maurin* decision in that it allowed for the stacking of caps, but upheld the wrongful death cap. Based on the *Bartholomew* decision, the ability to "stack caps" means that claimants can receive noneconomic damages awards both for the pre-death pain and suffering from bodily injury as the result of medical malpractice and for the post-death loss of society and companionship from the wrongful death as the result of medical malpractice. The effect of the decision, which was a split decision, on future cases is not fully clear. However, based solely on that portion allowing for the stacking of caps, the Fund's actuary estimates the decision would result in an increase to the Fund's outstanding undiscounted loss liabilities of $14.0 million (or discounted loss liabilities of $10.5 million).

13. Audit Adjustments

The unaudited financial statements presented in the Commissioner of Insurance's annual reports to the Governor and the Legislature have been adjusted to reflect recommended audit adjustments.

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Report on Control and Compliance ■

Independent Auditor's 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

We have audited the financial statements of the Wisconsin Injured Patients and Families Compensation Fund as of and for the years ended June 30, 2006, 2005, and 2004, and have issued our report thereon dated March 14, 2007. 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.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the Wisconsin Injured Patients and Families Compensation Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Specifically, as further discussed in the audit report section titled "Provider

System," the aging and decreasing effectiveness of the Fund's provider system is resulting in regularly occurring errors that require manual adjustment. The occurrence of the errors and the need to manually identify and correct them increase the risks associated with the Fund's financial operations.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe the problems with the Fund's provider system noted above are a material weakness.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the Wisconsin Injured Patients and Families Compensation Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, 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 that are required to be reported under *Government Auditing Standards*.

This independent auditor's report is intended for the information and use of the Wisconsin Injured Patients and Families Compensation Fund's management, the Board of Governors, and the Wisconsin Legislature. This independent auditor's report, upon submission to the Joint Legislative Audit Committee, is a matter of public record and its distribution is not limited. However, because we do not express an opinion on compliance or provide assurance on internal control over financial reporting, this report is not intended to be used by anyone other than these specified parties.

LEGISLATIVE AUDIT BUREAU

March 14, 2007 by Diann Allsen

Diann Allsen
Audit Director

Appendix 1

Annual Provider Assessments[1]

Provider Types	Fiscal Year						
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Physician Class 1[2]	$ 1,898	$ 1,538	$ 1,461	$ 1,534	$ 1,227	$ 859	$ 1,074
Physician Class 2[3]	3,606	2,769	2,630	2,761	2,209	1,546	1,933
Physician Class 3[4]	7,877	6,385	6,063	6,366	5,092	3,565	4,457
Physician Class 4[5]	11,388	9,231	8,766	9,204	7,362	5,154	6,444
Nurse Anesthetist	475	378	359	377	302	211	264
Hospital—per Occupied Bed	116	93	88	92	74	52	65
Nursing Home—per Occupied Bed	22	17	16	17	14	10	13
Employees of a Partnership or Corporation:							
Nurse Practitioner	475	385	365	384	307	215	269
Advanced Nurse Practitioner	664	538	511	537	429	301	376
Nurse Midwife	4,176	3,385	3,214	3,375	2,699	1,890	2,363
Advanced Nurse Midwife	4,365	3,538	3,360	3,528	2,822	1,976	2,470
Advanced Practice Nurse Prescriber	664	538	511	537	429	301	376
Chiropractor	759	615	584	614	491	344	430
Dentist	380	308	292	307	245	172	215
Oral Surgeon	2,847	2,308	2,192	2,301	1,841	1,289	1,611
Podiatrists—Surgical	8,067	6,538	6,209	6,520	5,215	3,651	4,565
Optometrist	380	308	292	307	245	172	215
Physician Assistant	380	308	292	307	245	172	215

[1] These rates apply to providers having Wisconsin as their primary place of practice. Other rates apply to providers for whom Wisconsin is not the primary place of practice.
[2] Includes family or general practice physicians not performing surgery, and nutritionists.
[3] Includes family or general practice physicians performing minor surgery, and ophthalmologists performing surgery.
[4] Includes most types of surgeons, such as plastic, hand, general, and orthopedic.
[5] Includes obstetric and neurological surgeons.

Appendix 2

Claims Payments Greater than $5 Million through December 31, 2006

Amount (In Millions)[1]	Calendar Year of Incident	Calendar Year of Payment	Claimant Allegations
$18.0	1986	1993	Diet pills prescribed without a complete physical evaluation, causing cardiac arrest and resulting in brain damage
15.6	1993	1996	Negligent treatment caused quadriplegia
13.6	1993	2000	Initial surgery and follow-up treatment of pinched nerve were negligent, causing continuing pain
10.1	1997	2005	Negligent treatment, resulting in brain injury
10.0	2002	2006	Negligent labor and delivery of twins, resulting in brain damage
9.6	1998	2001	Negligent prescriptions caused brain damage
9.5	1989	1990	Improperly administered anesthesia caused brain damage during cardiac surgery
8.8	2000	2006	Negligent labor and delivery, resulting in brain damage
8.7	1988	1999	Negligent treatment caused brain damage, and lack of informed consent
7.9	1985	1995	Failure to diagnose a hematoma caused brain damage, and lack of informed consent
7.3	1987	1992	Failure to identify high bilirubin level in a timely manner, resulting in brain damage
7.2	2001	2004	Failure to diagnose Strep A
7.1	1990	1995	Failure to promptly deliver baby, causing cerebral palsy
6.9	1992	2000	Negligent delivery caused brain damage
6.8	1992	1995	Negligent treatment of brain aneurysm
6.8	1999	2006	Negligent labor and delivery, causing brain damage
6.6	1992	2001	Failure to diagnose blood disorder in infant caused brain damage
6.0	1999	2002	Negligent delivery caused brain damage
5.9	1999	2002	Failure to restrain patient during psychiatric care resulting in quadriplegia
5.8	1990	1996	Surgery caused brain injury, and lack of informed consent
5.6	1995	1998	Negligent treatment caused brain damage
5.6	1993	1999	Negligent treatment caused brain damage
5.1	1982	1984	Failure to diagnose and treat meningitis

[1] Includes interest on losses paid.

State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, Governor
Sean Dilweg, Commissioner

Wisconsin.gov

125 South Webster Street • P.O. Box 7873
Madison, Wisconsin 53707-7873
Phone: (608) 266-3585 • Fax: (608) 266-9935
E-Mail: information@oci.state.wi.us
Web Address: oci.wi.gov

March 16, 2007

JANICE MUELLER STATE AUDITOR
LEGISLATIVE AUDIT BUREAU
22 EAST MIFFLIN STREET SUITE 500
MADISON WI 53703

Dear Ms. Mueller:

We are in receipt of the Legislative Audit Bureau's draft audit report of the Injured Patients and Families Compensation Fund and would like to respond to the following recommendations:

"It is recommended that the Office of the Commissioner of Insurance closely monitor access to and the integrity of the data and processing of the Fund's provider system until a new system has been fully implemented."

The Office of the Commissioner of Insurance (OCI) recognizes the significant concerns with the current aging provider system and will continue to closely monitor access to the system. OCI will continue to assist the Injured Patients and Families Compensation Fund in the development and implementation of a new provider system.

"It is recommended that the Fund's Board of Governors require the next actuarial audit to again evaluate the appropriateness of the Fund's loss liability risk margin and investment return assumptions, and report on the results in the annual report to the Legislature."

The Fund's Board of Governors passed a motion which will require such an audit to be conducted at least once every three years. An actuarial audit is expected to be completed by the end of 2007. The audit will include a review of the risk margin and investment return assumptions as well as an opinion as to the reasonableness of the methodologies used by the current actuarial firm. The findings of the audit will be included in the 2007 Functional and Progress Report to the Legislature which is due March 1, 2008.

Please let me know if you need any additional information.

Sincerely,

Eileen Mallow

Eileen Mallow
Assistant Deputy Commissioner
Office of the Commissioner of Insurance