Report 05-17
December 2005

An Audit

State Life Insurance Fund

Office of the Commissioner of Insurance

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State Auditor - Janice Mueller

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Janice Mueller
State Auditor

December 8, 2005

Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

We have completed an audit of the financial statements of the State Life Insurance Fund for the years ending December 31, 2004, 2003, and 2002, as required by s. 13.94 (1)(de), Wis. Stats. The Fund provides low-cost life insurance policies to Wisconsin residents, is self-funded through premiums and investment earnings, and is administered by the Office of the Commissioner of Insurance. As of December 31, 2004, it had 29,713 life insurance policies in effect, and $223.5 million of life insurance in force. The Fund operates under specific statutory restrictions, including a prohibition on advertising and a limitation on coverage of $10,000 to any insured person.

The Fund prepares its financial statements in accordance with insurance accounting practices prescribed by the Commissioner of Insurance. We found its financial statements to be fairly presented in accordance with these accounting practices.

State statutes require the Fund's net profits to be distributed annually as policy dividends, except that the Fund's surplus must be maintained at a level between 7.0 and 10.0 percent of assets, insofar as is feasible. However, the actual, audited surplus-to-assets ratio as of December 31, 2004, was only 2.7 percent, compared to 8.1 percent as of December 31, 2001. This decline occurred primarily because the Office of the Commissioner of Insurance did not take timely steps to lower the dividends paid to policyholders. However, significant financial reporting errors that were detected during our audit also reduced the Fund's surplus. The Office worked with its actuary to lower the level of policy dividends effective August 2005. Additional adjustments to policy dividends and other changes are anticipated in January 2006. The Office believes these actions will allow the surplus-to-assets ratio to reach the statutory guideline by the end of calendar year 2008.

The decline in the Fund's surplus-to-assets ratio and the financial reporting errors are discussed in detail in a separate management letter, dated December 8, 2005, which also presents several other areas of internal control, our recommendations for improvement, and the Office's responses.

We appreciate the courtesy and cooperation extended to us by the staff of the Office of the Commissioner of Insurance in completing our audit.

Respectfully submitted,

Janice Mueller

Janice Mueller
State Auditor

JM/BN/ss

Audit Opinion ▪

Independent Auditor's Report on the Financial Statements of the Wisconsin State Life Insurance Fund

We have audited the accompanying financial statements of the Wisconsin State Life Insurance Fund as of and for the years ending December 31, 2004, 2003, and 2002, as listed in the table of contents. These financial statements, which are prepared in accordance with the basis of accounting prescribed or permitted by the Commissioner of Insurance, are the responsibility of the management of the State Life Insurance 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 described in Note 2A, the financial statements present only the State Life Insurance Fund and do not purport to, and do not, present fairly the financial position of the State of Wisconsin and the results of its operations and changes in financial position and its cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

As described more fully in Note 2, the State Life Insurance Fund presents these financial statements using accounting practices that are prescribed or permitted by the Commissioner of Insurance of the State of Wisconsin, as authorized by Wisconsin Statutes. This comprehensive basis of accounting differs from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to in the first paragraph do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the State Life Insurance Fund as of December 31, 2004, 2003, and 2002, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to in the first paragraph do present fairly, in all material respects, the financial position of the State Life Insurance Fund as of December 31, 2004, 2003, and 2002, and the results of its operations and changes in fund surplus and its cash flows for the years then ended in conformity with the accounting practices prescribed or permitted by the Commissioner of Insurance of the State of Wisconsin.

Our audit was conducted for the purpose of forming an opinion on the financial statements of the State Life Insurance Fund. The supplementary information included as Management's Discussion and Analysis on pages 5 through 12 is presented for purposes of additional analysis and is not a required part of the financial statements. 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 December 1, 2005, on our consideration of the State Life Insurance Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report, which is included in a separate management letter to the Office, 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

December 1, 2005 by Bryan Naab

Bryan Naab
Audit Director

Management's Discussion and Analysis ■

Prepared by the State Life Insurance Fund's Management

This section presents management's discussion and analysis of the financial performance of the Wisconsin State Life Insurance Fund during the calendar years ending December 31, 2004, 2003, and 2002. 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 Office of the Commissioner of Insurance, which manages the Fund.

Overview of the Fund

The Fund was established in 1911 in response to a national scandal over the improper practices of some life insurance companies. The Fund is a state-sponsored life insurance program for the benefit of the residents of Wisconsin but receives no subsidies from the State. It is not permitted to use commissioned agents, does not advertise, and is exempt from federal income tax. As a result, overhead expenses are minimal. The purpose of the Fund is to provide low-cost life insurance for residents of Wisconsin under ch. 607, Wis. Stats. The maximum amount of coverage per individual is $10,000. The Fund offers five different policy plans, which all pay dividends.

The Fund operates on a calendar year (CY) basis. Administrative costs and operating costs, including claim payments, are funded through premiums collected from policyholders, policy loan interest, and investment earnings.

Financial Statements

The Fund prepares its financial statements on the basis of accounting practices prescribed or permitted by the Wisconsin Commissioner of Insurance, which include practices recommended by the National Association of Insurance Commissioners (NAIC).

The Fund's financial statements comprise two components: 1) the financial statements, and 2) notes to the financial statements that explain in more detail some of the information in the financial statements.

Following this section are the financial statements and notes as they relate to the Fund. The financial statements include:

- the Balance Sheet, which provides information on the assets and the liabilities of the Fund, with the difference reported as fund surplus;

- the Statement of Operations and Changes in Fund Surplus, which presents the revenues earned and the expenses incurred during the year on an accrual basis, as well as the changes in fund surplus; and

- the Statement of Cash Flows, which presents information related to cash inflows and outflows summarized by operating, investing, and financing activities and helps measure the Fund's ability to meet financial obligations as they mature.

In this discussion and analysis, the reasons for the changes in financial activity between CY 2004, CY 2003, and CY 2002 are reviewed.

Assets

As shown in Table A, the largest portion of the Fund's assets, 88.5 percent in CY 2004, is in the form of bonds invested through the State of Wisconsin Investment Board (SWIB). Fund investments are managed by SWIB pursuant to statutory requirements and in accordance with established investment guidelines. All mortgage-backed and asset-backed securities are carried at amortized cost using the scientific method to amortize any bond premiums or discounts. All other bonds are carried at amortized cost using the straight-line method of amortization.

Table A

Fund Assets

	December 31, 2004	December 31, 2003	December 31, 2002
Total Assets	$81,197,487	$79,749,014	$77,479,447
Bonds	$71,881,259	$70,058,778	$66,475,860
Percentage of Assets that Are Bonds	88.5%	87.8%	85.8%

Generally, the turnover in the portfolio is very low due to the long duration of the investments in the portfolio, which is the result of an effort to match the future maturities of investments with expected future payouts of benefits. Only $3.1 million (4.3 percent) of the Fund's bonds mature during the State's fiscal years ending June 30, 2006 and 2007.

Activity during 2002 and 2003 was unusually high in the investment portfolio due to the liquidation of SWIB's national private placement portfolio. As part of this liquidation, SWIB sold approximately $14.0 million of the Fund's private placement bonds and replaced them with publicly issued bonds.

As required by NAIC accounting standards, the Fund's Statement of Operations and Changes in Fund Surplus reported realized losses on bond sales totaling $1,372,888 in CY 2002, including $823,256 for Worldcom bonds, $214,290 for Lucent Technologies bonds, and $335,342 for Xerox bonds. In CY 2003, a realized loss of $499,085 was reported on the sale of a Jet Equipment Trust senior bond. Other realized gains and losses of the Fund are accounted for in the Interest Maintenance Reserve and amortized into income over the life of the bonds sold.

The Fund's remaining assets consist of contract loans, receivables, cash, and cash equivalents.

Liabilities

The largest area of the Fund's liabilities is the aggregate reserves for life insurance contracts, as shown in Table B.

Table B

Fund Liabilities

	December 31, 2004	December 31, 2003	December 31, 2002
Total Liabilities	$79,025,141	$76,376,560	$73,246,141
Aggregate Reserves for Life Insurance Contracts	$56,610,600	$55,069,758	$53,437,583
Percentage of Total Liabilities	71.6%	72.1%	73%

The reserves are the amount required by law to be reported on the Balance Sheet to show the ability to pay all future claims on the Fund's insurance policies. Because the average age of the policyholders is increasing, additional reserves are necessary to fund expected benefit payments upon death.

In addition to the policy reserves, liabilities consist of deposit accounts held by the Fund for the benefit of the policyholders. The liability for deposit-type contracts includes proceeds held on deposit, consisting of the value of matured policies and proceeds from death claims left in the Fund with interest paid annually, and dividends left in the Fund to accumulate.

As shown in Table C, the liability for deposit-type contracts increased from $13.3 million as of December 31, 2002, to $15.9 million as of December 31, 2004. In CYs 2002 through 2004, the Fund paid interest annually at a rate of 5.0 percent on deposit accounts, and interest expense increased from nearly $624,000 in CY 2002 to $749,000 in CY 2004.

Table C

Deposit Accounts

	December 31, 2004	December 31, 2003	December 31, 2002
Liability for Deposit-type Contracts	$15,937,610	$14,551,145	$13,256,268
Percentage Change from Prior Year	9.5%	9.8%	8.9%

	CY 2004	CY 2003	CY 2002
Interest Expense on Deposit-type Contracts	$749,017	$682,674	$623,987
Percentage Change from Prior Year	9.7%	9.4%	9.2%

During this time period, interest rates available to investors were generally lower than the 5.0 percent paid on the Fund's deposit accounts. The Fund's relatively high interest rate contributed to the increase in the liability for deposit-type contracts.

Revenues

There were 29,713 Fund policies as of December 31, 2004, a decrease of 1.0 percent from the December 31, 2003 policy count of 29,988. Along with the decline in the number of policyholders, as well as a decline in investment earnings, revenues declined by 8.8 percent during CY 2004, as shown in Table D.

Table D

Changes in Fund Revenues

	December 31, 2004	December 31, 2003	December 31, 2002
Revenue	$7,188,403	$7,884,284	$7,398,583
Percentage Change from Prior Year	-8.8%	6.6%	-2.0%

The increase in CY 2003 revenue was due to increased investment income, primarily as the result of interest income received from a bond called by the issuer.

Expenses

The Fund pays benefits to policyholders in the event of death, maturity of the policy, upon surrender of the policy, or in the event the covered individual becomes disabled. While, as shown in Table E, the policy benefit expense decreased slightly in 2003, the claim experience of the Fund has been increasing due to the number of older policies maturing and claims arising due to the aging clientele.

Table E

Policy Benefits

	December 31, 2004	December 31, 2003	December 31, 2002
Policy Benefits	$1,374,921	$1,323,961	$1,354,978
Percentage Change from Prior Year	3.8%	-2.3%	1.6%

The Fund reduced general expenses over the last three years, as shown in Table F. In CY 2002, the Fund had audit expenses, system upgrade costs, and additional state accounting charges. The reduction in CY 2004 expenses is attributed to the reduction of one staff position and a new and more cost efficient actuarial contract. Effective January 1, 2004, one Fund position was deleted as part of the vacant position reduction under s. 9101(9x) of 2003 Wisconsin Act 33.

Table F

General Expenses

	December 31, 2004	December 31, 2003	December 31, 2002
General Expenses	$531,955	$567,310	$742,472
Percentage Change from Prior Year	-6.2%	-23.6%	18.0%

In addition, as noted in Table C, interest expense on deposit-type contracts increased in CYs 2002 through 2004.

Dividends and Surplus

Annually, the Fund pays dividends on all active policies. According to state statute, "The net profits of the life fund shall be distributed annually among the policyholders, except that so far as is practicably possible, the ratio of surplus to assets shall be kept between 7% and 10%." Dividends paid over the last three years are reflected in Table G:

Table G

Dividends

	2004	2003	2002
Dividends	$4,123,485	$4,044,964	$3,952,345
Percentage Change from Prior Year	1.9%	2.3%	1.4%

As shown in Table H, the surplus balance has been declining for the last several years even though the assets have been increasing. This is due to the fact that new business had been declining, the Fund realized investment losses, and dividend payments had been increasing.

Table H

Surplus-to-Assets Ratio

	December 31, 2004	December 31, 2003	December 31, 2002
Surplus	$2,172,346	$3,372,454	$4,233,306
Total Assets	$81,197,487	$79,749,014	$77,479,447
Surplus-to-Assets Ratio	2.7%	4.2%	5.5%

Fund management is working with the contracting actuary to address alternatives to increase the surplus. A dividend restructuring was implemented effective August 1, 2005. A new dividend scale was developed based on a projected investment yield of 6.8 percent, as opposed to the previous scale that was based on a yield of 9.71 percent. The savings in CY 2006 due to the dividend decrease are expected to be approximately $1.4 million.

Effective January 1, 2006, the dividend scale will be readjusted to reflect a projected investment earnings rate of 6.0 percent. In addition, management is considering a possible future decrease in the interest rate of 5.0 percent per year paid on dividends left on deposit. The Commissioner of Insurance will be deciding the future interest rate for dividends left on deposit based on actuarial assumptions by year-end. These efforts are expected to bring the surplus back within the statutory guidelines by the end of calendar year 2008.

Contacting the Fund's Financial Management

The financial report is designed to provide the Legislature, the Executive Branch of government, policyholders, 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 Wisconsin State Life Insurance Fund director at the Office of the Commissioner of Insurance, 125 South Webster Street, Post Office Box 7873, Madison, Wisconsin 53707-7873.

General information relating to the Fund can be found at the Fund's Web site, *http://www.oci.wi.gov/slif.htm.*

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Financial Statements ■

Balance Sheet—Statutory Basis
December 31, 2004, December 31, 2003, and December 31, 2002

	December 31, 2004	December 31, 2003	December 31, 2002
ASSETS			
Bonds (Note 3)	$ 71,881,259	$ 70,058,778	$ 66,475,860
Cash, Cash Equivalents, and Short-Term Investments (Note 3)	4,219,982	4,142,623	5,810,838
Contract Loans	3,703,089	3,694,764	3,774,523
Receivable for Securities	0	456,168	0
Other Receivables	0	1,066	24,038
Investment Income Receivable	1,272,243	1,269,395	1,285,216
Deferred Premiums and Uncollected Premiums (Note 9)	120,914	119,886	102,271
Amounts Recoverable from Reinsurers	0	6,334	6,701
TOTAL ASSETS	**$ 81,197,487**	**$ 79,749,014**	**$ 77,479,447**
LIABILITIES AND FUND SURPLUS			
Aggregate Reserves for Life Insurance Contracts (Note 7)	$ 56,610,600	$ 55,069,758	$ 53,437,583
Liability for Deposit-type Contracts (Note 8)	15,937,610	14,551,145	13,256,268
Contract Claims (Note 2)	151,607	154,500	139,731
Dividends Due and Unpaid, Plus Those Payable in the Following Year (Note 5)	4,171,917	4,097,885	4,010,192
Premiums Received in Advance	41,420	34,739	39,883
Interest Maintenance Reserve (Note 2)	1,823,800	2,175,495	2,125,432
General Expenses Payable	54,796	82,147	57,299
Asset Valuation Reserve (Note 2)	68,286	0	0
Other Liabilities	165,105	210,891	179,753
Total Liabilities	79,025,141	76,376,560	73,246,141
Fund Surplus (Note 5)	2,172,346	3,372,454	4,233,306
TOTAL LIABILITIES AND FUND SURPLUS	**$ 81,197,487**	**$ 79,749,014**	**$ 77,479,447**

The accompanying notes are an integral part of this statement.

Statement of Operations and Changes in Fund Surplus—Statutory Basis for the Years Ended December 31, 2004, December 31, 2003, and December 31, 2002

	Year Ended December 31, 2004	Year Ended December 31, 2003	Year Ended December 31, 2002
REVENUES			
Premiums (Note 2)	$ 2,258,361	$ 2,378,580	$ 2,361,404
Net Investment Income (Note 4)	4,506,852	5,173,408	4,841,297
Amortization of Interest Maintenance Reserve	422,190	320,514	194,176
Miscellaneous Income	1,000	11,782	1,706
Total Revenues	**7,188,403**	**7,884,284**	**7,398,583**
OPERATING EXPENSES			
Benefits:			
Death benefits	825,637	813,474	844,366
Matured endowments	272,500	241,000	243,500
Surrender benefits	265,718	258,505	256,537
Disability benefits	11,066	10,982	10,575
Interest and adjustments on contract or deposit-type contract funds	749,017	682,674	623,987
Increase in aggregate reserves for life insurance contracts	1,540,842	1,632,175	1,505,716
Total Benefits	3,664,780	3,638,810	3,484,681
General Expenses	531,955	567,310	742,472
Total Operating Expenses	**4,196,735**	**4,206,120**	**4,227,153**
Net Income from Operations before Dividends and Net Realized Capital Gain (Loss)	**2,991,668**	**3,678,164**	**3,171,430**
Dividends to Policyholders (Note 5)	(4,123,485)	(4,044,964)	(3,952,345)
Net Realized Capital Gain (Loss)	(5)	(494,052)	(1,372,888)
NET INCOME (LOSS)	**$ (1,131,822)**	**$ (860,852)**	**$ (2,153,803)**
CHANGES IN FUND SURPLUS			
Surplus at Beginning of Period	$ 3,372,454	$ 4,233,306	$ 6,133,150
Prior-Period Adjustment (Note 11)	0	0	(128,966)
Adjusted Beginning Surplus	3,372,454	4,233,306	6,004,184
Net Income (Loss)	(1,131,822)	(860,852)	(2,153,803)
Change in Asset Valuation Reserve	(68,286)	0	382,925
NET CHANGE IN SURPLUS ACCOUNT	**(1,200,108)**	**(860,852)**	**(1,770,878)**
Surplus at End of Period	$ 2,172,346	$ 3,372,454	$ 4,233,306

The accompanying notes are an integral part of this statement.

Statement of Cash Flows—Statutory Basis for the Years Ended December 31, 2004, December 31, 2003, and December 31, 2002

	Year Ended December 31, 2004	Year Ended December 31, 2003	Year Ended December 31, 2002
CASH FROM OPERATIONS			
Premiums Collected Net of Reinsurance	$ 2,263,011	$ 2,358,547	$ 2,375,029
Net Investment Income	4,631,210	5,296,307	4,908,567
Miscellaneous Income	1,000	11,782	1,706
Total Receipts	6,895,221	7,666,636	7,285,302
Benefit and Loss Related Payments	2,120,497	1,991,499	2,023,984
Commissions, Expenses Paid, and Aggregate Write-ins for Deductions	600,770	601,006	804,932
Dividends Paid to Policyholders	4,049,453	3,957,271	3,877,333
Total Benefits and Expenses	6,770,720	6,549,776	6,706,249
Net Cash Provided by Operating Activities	**124,501**	**1,116,860**	**579,053**
CASH FROM INVESTMENTS			
Cash Received from Sale of Bonds	5,883,838	16,231,942	16,130,161
Cash Paid for Purchase of Bonds	(7,263,256)	(20,422,774)	(17,179,968)
Decrease (Increase) in Contract Loans	(8,325)	79,759	40,167
Net Cash Used in Investing Activities	**(1,387,743)**	**(4,111,073)**	**(1,009,640)**
CASH FROM FINANCING AND MISCELLANEOUS SOURCES			
Net Deposits on Deposit-type Contract and Other Insurance Liabilities	1,386,465	1,294,877	1,087,594
Other Cash Provided (Applied)	(45,864)	31,121	44,887
Net Cash Provided by Financing and Miscellaneous Activities	**1,340,601**	**1,325,998**	**1,132,481**
NET CHANGE IN CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS	**77,359**	**(1,668,215)**	**701,894**
Cash, Cash Equivalents, and Short-Term Investments at January 1	4,142,623	5,810,838	5,108,944
Cash, Cash Equivalents, and Short-Term Investments at December 31	$ 4,219,982	$ 4,142,623	$ 5,810,838

The accompanying notes are an integral part of this statement.

Notes to the Financial Statements ▪

1. Description of the Fund

The State Life Insurance Fund, which is part of the State of Wisconsin financial reporting entity and is reported as an enterprise fund in the State's Comprehensive Annual Financial Report, was created in 1911 to provide life insurance policies to Wisconsin residents at the lowest possible cost. The Fund is administered by the Office of the Commissioner of Insurance.

The Fund's operation is similar to that of a mutual life insurance company, and the Fund is subject to the same regulatory requirements as any life insurance company licensed to operate in Wisconsin. The Fund is also subject to unique statutory restrictions, such as a prohibition on advertising and a maximum coverage of $10,000, designed to limit the competitive advantage the Fund may have over private insurance companies. The Fund offers two basic policies: whole life insurance and term insurance. As of December 31, 2004, the Fund had 29,713 life insurance policies in effect, including 26,837 whole life insurance policies and 2,876 term policies. The total amount of insurance in force as of December 31, 2004, was $223,492,000.

2. Summary of Significant Accounting Policies

A. Accounting Practices

The financial statements present the financial position and results of operations of only the activity of the State Life Insurance Fund and are not intended to present the financial activity for the State of Wisconsin as a whole. The Fund's financial statements are presented on the basis of statutory accounting practices prescribed or permitted by the

Wisconsin Commissioner of Insurance. The National Association of Insurance Commissioners' (NAIC's) *Accounting Practices and Procedures Manual* (commonly referred to as the Codification) has been adopted as the prescribed and permitted practices for the Fund, as permitted by s. 623.02, Wis. Stats. Statutory accounting practices and procedures required by the Commissioner of Insurance and NAIC vary in some respects from generally accepted accounting principles. The following table shows the most significant differences between the codified statutory accounting practices and generally accepted accounting principles.

Financial Statement Area	Codified Statutory Accounting Practices	Generally Accepted Accounting Principles
Bond Valuation	NAIC category 1 to 5 at amortized cost; NAIC category 6 at lower of amortized cost or fair value. A permanent impairment should be recorded as a realized loss, with the cost basis written down to fair value.	Fair value.
Asset Valuation Reserve (AVR)	Formula-driven reserve balance. Established to mitigate potential credit-related investment losses. Changes are charged or credited directly to surplus.	Not applicable.
Interest Maintenance Reserve (IMR)	Captures interest-related realized gains and losses on sale of investments and amortizes these to income over the remaining life of the investment sold.	Not applicable.
Realized Investment Gains (Losses)	Only non-IMR gains and losses are reported in income.	Reported as income.
Unrealized Investment Gains (Losses)	Recorded directly to surplus for assets recorded at fair value.	Reported as income.
Due and Deferred Premiums	Due premiums recorded as asset, except that certain balances over 90 days due would be nonadmitted; deferred premiums recorded as asset.	Due premiums reported as asset; deferred premiums offset against liabilities for future policy benefits.

Financial Statement Area	Codified Statutory Accounting Practices	Generally Accepted Accounting Principles
Dividends	Provision for dividends expected to be paid over the year subsequent to the date of the financial statements, whether or not declared or apportioned.	Provision made for accumulated earnings expected to be paid to policyholders, including pro rata portion of dividends incurred to valuation date; future dividends are accrued over the premium-paying period of the contract.
Contract Acquisition Costs	Charged to expense in current operations when incurred.	Deferred and amortized in relation to the premium revenue recognized.

B. Use of Estimates

The preparation of the financial statements in conformity with statutory accounting practices requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. Actual results could differ from those estimates.

C. Accounting Policies

Premiums—Premiums are reported as earned on the policy anniversary date.

New Business Expenses—Expenses incurred in connection with acquiring new insurance business, including acquisition costs, are charged to operations as incurred.

Dividends—The amount of dividends to be paid to policyholders is determined by the contracted actuary and the Fund's management at the Office of the Commissioner of Insurance. The aggregate amount of policyholders' dividends is determined based on interest earnings, mortality, and expense experience for the Fund and judgment as to the appropriate level of statutory surplus to be retained by the Fund in order to be in accordance with the requirement of s. 607.15, Wis. Stats., which requires that the ratio of surplus to assets be kept between 7.0 and 10.0 percent, insofar as is practicably possible.

Contract Loans—Policyholders may borrow from the Fund amounts up to the cash surrender value of their insurance policies. Such contract loans are reported at outstanding indebtedness to the Fund.

Bonds—NAIC requires bonds to be reported at amortized cost using the scientific method to amortize bond premiums and discounts, which recognizes the time-value of money and amortizes principal receipts on a pro rata basis, using the securities' current information as opposed to the initial amortized value. NAIC category 6 bonds are to be reported at the lower of amortized cost or fair value. The Fund reports all mortgage-backed and asset-backed securities at amortized cost using the scientific method. However, all other bonds held by the Fund are reported at amortized cost using the straight-line method of amortization, rather than the scientific method. The effects of this departure from statutory accounting practices on surplus and net income are unknown but are believed to be immaterial.

Interest Maintenance Reserve—The interest maintenance reserve (IMR) accumulates interest-related realized gains and losses and amortizes them into income over the remaining life of the investments sold. The State Life Insurance Fund uses the IMR method that amortizes groups of assets based on the average maturity dates using standard amortization tables developed by NAIC.

Contract Claims—The liability for unpaid claims includes reported claims that were not paid at year-end and estimates of claims that were incurred but not reported, based on claims reported in January.

3. CASH AND INVESTMENTS

All cash is deposited with the State of Wisconsin and is invested by the State of Wisconsin Investment Board through the State Investment Fund, a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees as authorized in ss. 25.14 and 25.17, Wis. Stats. Balances pooled are restricted to legally stipulated investments. 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 carried at the cost of the participating shares, which is also the realizable value as of December 31. Interest income, gains, and losses of the State Investment Fund are allocated monthly.

The State Life Insurance Fund's investments, both long and short-term, are managed by the Investment Board with a current investment objective to maintain a diversified portfolio of high-quality publicly issued fixed-income obligations that will preserve principal, maximize income while minimizing costs to policyholders, and approximate the expected life of the Fund's insurance contracts. The Fund's investments include public bonds that consist of U.S. government obligations and public utility, railroad, industrial, and miscellaneous corporate obligations. In addition, some privately negotiated fixed-income securities, purchased by the Fund under prior investment guidelines, continue to be held by the Fund.

As of December 31, 2004, the Fund held one short-term note, with a book and fair value of $990,548, which is included as cash, cash equivalents, and short-term investments in the financial statements.

The book and fair values of the Fund's investments as of December 31, 2004, are as follows:

	Book Value	Fair Value
Government:		
Issuer obligations	$31,512,018	$34,455,128
Mortgage-backed and asset-backed	91,973	98,809
Total Government	31,603,991	34,553,937
Utilities	6,773,753	7,164,394
Industrials and Others	33,503,515	35,574,539
Total	$71,881,259	$77,292,870

The book and fair values of the Fund's investments as of December 31, 2003, are as follows:

	Book Value	Fair Value
Government:		
Issuer obligations	$30,938,209	$33,270,155
Mortgage-backed and asset-backed	170,021	182,480
Total Government	31,108,230	33,452,635
Utilities	7,288,884	7,422,795
Industrials and Others	31,661,664	32,709,569
Total	$70,058,778	$73,584,999

The book and fair values of the Fund's investments as of December 31, 2002, are as follows:

	Book Value	Fair Value
Government:		
Issuer obligations	$29,923,282	$33,011,215
Mortgage-backed and asset-backed	1,267,504	1,304,771
Total Government	31,190,786	34,315,986
Utilities	5,008,052	4,843,111
Industrials and Others	30,277,022	31,340,445
Total	$66,475,860	$70,499,542

Book values represent the bonds' amortized costs using the methods of amortization discussed in Note 2. Fair values were obtained from information provided by NAIC's Securities and Valuation Office and the State of Wisconsin Investment Board.

The book and fair value of bonds, by contractual maturity, at December 31, 2004, are shown below. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Book Value	Fair Value
Due in One Year or Less	$ 526,423	$ 535,097
Due after One Year through Five Years	8,363,385	8,700,270
Due after Five Years through Ten Years	4,306,697	4,504,168
Due after Ten Years	58,684,754	63,553,335
Total	$71,881,259	$77,292,870

Proceeds from the sales of securities during 2004, 2003, and 2002 were $5.4 million, $16.7 million, and $16.1 million, respectively. The sales resulted in gross realized gains of $364,000, $748,000, and $1.7 million, respectively, and gross realized losses of $293,000, $872,000, and $1.4 million, respectively. Realized investment gains and losses are determined by specific identification. Generally, realized gains and losses are credited or charged to the Interest Maintenance Reserve and amortized into income over the remaining life of the investments sold. However, realized gains and losses related to bonds that had certain changes in their credit ratings are reported in the financial statements in the year that the bonds are sold.

Excluding investments in U.S. Treasury securities and obligations to the U.S. government, the Fund is not exposed to any significant concentration of credit risk in its investments.

4. NET INVESTMENT INCOME

Net investment income for calendar years 2004, 2003, and 2002 consisted of the following components:

	2004	2003	2002
Bonds and Private Placements	$4,264,389	$4,923,492	$4,553,026
Contract Loans	249,997	250,843	249,537
State Investment Fund	35,001	38,779	73,136
Subtotal	4,549,387	5,213,114	4,875,699
Less Investment Expenses	42,535	39,706	34,402
Net Investment Income	$4,506,852	$5,173,408	$4,841,297

Net investment income does not include the reported net realized capital gain (loss), which is reported separately on the Statement of Operations and Changes in Fund Balance.

5. SURPLUS AND POLICYHOLDERS' DIVIDEND RESTRICTIONS

All policies are participating. Dividends payable in the following year are charged to current operations. Of the amounts reported on the Balance Sheet, the amounts paid out between January 1 and March 31 of the following year were $1,060,023 for 2004, $1,042,680 for 2003, and $1,019,394 for 2002.

Section 607.15, Wis. Stats., requires that the surplus be maintained at a level between 7.0 and 10.0 percent of assets, so far as is practicably possible. The dividend formula was last changed in 1998, primarily to comply with illustrative NAIC regulations requiring an accurate reflection of investment earnings; to incorporate service fees paid to the Wisconsin Department of Administration (statutes require a service fee of 2.0 percent of net premiums); and to reflect gains made due to favorable mortality. This change resulted in a decrease in dividends paid on each unit of insurance. The Fund's surplus-to-assets ratio was 2.68 percent as of December 31, 2004; 4.23 percent as of December 31, 2003; and 5.46 percent as of December 31, 2002.

6. REINSURANCE

The State Life Insurance Fund currently has a contract with Optimum Reinsurance Company for insuring those applicants considered high-risk by the Fund. This company is not affiliated, owned in excess of 10.0 percent, or controlled, either directly or indirectly, by the Fund or any representative of the Fund. In addition, no policies issued by the Fund have been reinsured with a company chartered in a country other than the United States (excluding U.S. branches of such companies) that is owned in excess of 10.0 percent or controlled directly or indirectly by an insured, a beneficiary, a creditor of an insured, or any other person not primarily engaged in the insurance business.

Under its reinsurance agreement, the Fund retains the reserves and related assets; pays the reinsurer premiums for the ceded business; and is reimbursed for benefits, unusual expenses, and adjustments to required reserves. The reinsurer has no obligation for the reimbursement of dividends related to the ceded business. The Fund does not have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits. Neither does the Fund have any reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in payment to the reinsurer of amounts that, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies.

The following table contains the total life insurance in force and the amount of reinsurance ceded as of the end of each calendar year:

As of:	Total Life Insurance in Force	Reinsurance Ceded
December 31, 2004	$223,492,000	$2,616,000
December 31, 2003	224,728,000	2,674,000
December 31, 2002	225,361,000	2,703,000

The Fund is contingently liable with respect to ceded insurance should the reinsurer be unable to meet its assumed obligations.

Payments to the reinsurer are treated as a reduction of premium income; claim payments received from the reinsurer are treated as a reduction of benefit expense. Reinsurance transactions reported in the Fund's operations are as follows:

	Premiums	Claims
2004	$40,889	$28,804
2003	40,316	40,662
2002	45,709	14,545

7. RESERVES FOR LIFE INSURANCE CONTRACTS

The Aggregate Reserve for Life Insurance Contracts for policies issued prior to April 1977 is determined in accordance with the Net Level Premium Method, using the American Experience or 1958 Commissioners Standard Ordinary (CSO) mortality tables and an interest rate of 3.0 percent. Aggregate reserves for policies issued from April 1977 through March 1986 are based on the Commissioners Reserve Valuations Method, using the 1958 CSO mortality tables and an interest rate of 4.0 percent. Reserves for policies issued from April 1986 through December 1994 are based on a modified version of the Commissioners Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 5.0 percent. Reserves for policies issued since January 1, 1995, are based on the Commissioners Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 4.0 percent.

The Fund waives deduction of deferred fractional premiums upon the death of the insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

Extra premiums are charged for policies for individuals with high-risk factors issued after April 1, 1977, plus the gross premium for a rated age. The Fund cedes 100 percent of the risk on substandard policies to its reinsurer. The Fund holds the standard reserve in its financial statements and does not take reserve credits related to reinsurance. Therefore, the actual reserve held by the Fund for substandard policies exceeds the minimum reserve that is required for such policies.

The State Life Insurance Fund had the following amounts of insurance in force for which gross premiums were less than net premiums determined according to the standard valuation set by the State of Wisconsin, and the following amounts of reserves to cover this deficiency as of December 31, 2004, 2003, and 2002:

	December 31, 2004	December 31, 2003	December 31, 2002
Insurance in Force for which Gross Premiums Were Less than Net Premiums	$24,381,500	$8,221,500	$8,335,500
Portion of Aggregate Reserves to Cover Deficiency	188,348	55,523	59,832

Tabular interest, tabular less actual reserve released, and tabular cost have been determined by NAIC formulas. Tabular interest on funds not involving life contingencies is also determined by a separate NAIC formula.

8. LIABILITY FOR DEPOSIT-TYPE CONTRACTS

All of the deposit-type contracts of the Fund are subject to discretionary withdrawal without adjustment. They are reported at book value and are not affected by reinsurance. The liability accounts reported for calendar years 2004, 2003, and 2002 include:

	2004	2003	2002
Supplementary Contracts without Life Contingencies	$ 896,941	$ 667,277	$ 401,668
Dividends Left to Accumulate	13,294,147	12,251,214	11,306,062
Accrued Deposits	1,746,522	1,632,654	1,548,538
Total Liability for Deposit-type Contracts	$15,937,610	$14,551,145	$13,256,268

9. DEFERRED PREMIUMS AND UNCOLLECTED PREMIUMS

As of December 31, the Fund reported deferred life insurance premiums and uncollected life insurance premiums, all of which were for ordinary life insurance. The total gross and net premiums were:

	2004	2003	2002
Gross Premium:			
Ordinary new business	$ 2,846	$ 3,528	$ 2,494
Ordinary renewal	148,014	145,301	131,446
Total	$150,860	$148,829	$133,940
Net Premium:			
Ordinary new business	$ 1,809	$ 1,916	$ 1,403
Ordinary renewal	119,105	117,970	100,868
Total	$120,914	$119,886	$102,271

Gross premium is the premium charged to the policyholder. Net premium is the amount of premium used in the calculation of the statutory reserves and represents the amount needed to provide contract benefits based on statutory interest and mortality reserve assumptions. The difference between the gross and net premium represents the amount available for expenses.

10. WISCONSIN RETIREMENT SYSTEM

Permanent, full-time employees of the State Life Insurance 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 report is also available on the Department of Employee Trust Funds' Web site, *http://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 liquidated its prior service liability balance as of January 2003. The liquidation of the State's prior service liability resulted in credits being granted to state agencies for amounts already paid in 2003. State agencies will be required to make future contributions to fund 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 State Life Insurance Fund's contributions to the plan were $22,022, $24,713, and $22,941 for the years ended December 31, 2004, 2003, and 2002, respectively. The relative position of the State Life Insurance Fund in the Wisconsin Retirement System is not available, since the system is a statewide, multiple-employer plan.

11. PRIOR-PERIOD ADJUSTMENT

The prior-period adjustment for calendar year 2002 is primarily the result of a restatement of the Fund's cash balance to agree with the cash balance recorded on the State's central accounting system.

12. 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. The effect of these adjustments on net income and Fund surplus for 2004, 2003, and 2002 include:

Account Balance	Unaudited Balance	Audited Balance	Difference
Net Income (Loss)			
2004	($ 852,574)	($1,131,822)	($ 279,248)
2003	(641,519)	(860,852)	(219,333)
2002	(1,061,357)	(2,153,803)	(1,092,446)
Fund Surplus			
2004	3,764,953	2,172,346	(1,592,607)
2003	4,688,661	3,372,454	(1,316,207)
2002	5,131,418	4,233,306	(898,112)

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