

THE STATE EMPLOYEES' INSURANCE BOARD

FINANCIAL STATEMENTS
and
SUPPLEMENTARY INFORMATION

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005
with
INDEPENDENT AUDITORS' REPORT

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Independent Auditors' Report

To the Board of Directors
The State Employees' Insurance Board

We have audited the accompanying statements of net assets of The State Employees' Insurance Board (the Board) as of September 30, 2006 and 2005, and the related statements of revenues, expenses, and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board as of September 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The State Employees' Insurance Board has not presented Management's Discussion and Analysis that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be a part of, the basic financial statements.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary ten-year claims development information is information required by the Governmental Accounting Standards Board for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

*Horton, Lee, Burnett, Peacock,
Cleveland & Grainger, P.C.*

December 22, 2006

THE STATE EMPLOYEES' INSURANCE BOARD

STATEMENTS OF NET ASSETS

September 30, 2006 and 2005

ASSETS

	<u>2006</u>	<u>2005</u>
Current assets:		
Cash and cash equivalents	\$ 134,784,672	\$ 112,465,962
Investments	32,048,421	30,521,260
Interest receivable	802,464	588,975
Premiums receivable	565,930	613,980
Accounts receivable	1,716,969	1,244,929
Prepaid expenses	1,808,528	717,393
Total current assets	<u>171,726,984</u>	<u>146,152,499</u>
Capital assets:		
Office furniture and equipment	432,042	373,382
Leasehold improvements	128,612	128,612
	<u>560,654</u>	<u>501,994</u>
Less accumulated depreciation	399,630	348,166
Net capital assets	<u>161,024</u>	<u>153,828</u>
Total assets	<u>171,888,008</u>	<u>146,306,327</u>

LIABILITIES

Current liabilities:		
Accounts payable and accrued expenses	1,356,179	1,217,778
Reported claims payable	12,176,819	12,852,019
Claims incurred but not reported	40,270,755	36,913,660
Premiums received in advance	33,731,701	31,919,149
Total current liabilities/ Total liabilities	<u>87,535,454</u>	<u>82,902,606</u>

NET ASSETS

Invested in capital assets, net of related debt	161,024	153,828
Unrestricted	<u>84,191,530</u>	<u>63,249,893</u>
Total net assets	<u>\$ 84,352,554</u>	<u>\$ 63,403,721</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Years Ended September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Premium contributions:		
Employer/subscriber	\$ 359,303,250	\$ 349,461,430
Employee/dependent	99,267,740	93,936,667
Refunds	(1,913,645)	(1,263,108)
Other revenues	<u>509,451</u>	<u>447,909</u>
Total operating revenues	<u>457,166,796</u>	<u>442,582,898</u>
Operating expenses:		
Medical claims expense	430,494,517	407,743,211
Consulting services	577,559	262,548
Utilization review services	3,459,080	3,252,528
Other participant related programs	4,922,300	3,797,131
Administrative expenses	3,235,852	2,762,225
Depreciation expense	<u>51,464</u>	<u>52,310</u>
Total operating expenses	<u>442,740,772</u>	<u>417,869,953</u>
Operating income	<u>14,426,024</u>	<u>24,712,945</u>
Nonoperating revenues (expenses):		
Investment income	7,084,781	3,759,599
Other income	-	1,832,250
Transfer to Flexible Employees' Benefits Board	<u>(561,972)</u>	<u>(347,195)</u>
Total nonoperating revenues (expenses)	<u>6,522,809</u>	<u>5,244,654</u>
Change in net assets	20,948,833	29,957,599
Net assets - beginning of year	<u>63,403,721</u>	<u>33,446,122</u>
Net assets - end of year	<u>\$ 84,352,554</u>	<u>\$ 63,403,721</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

STATEMENTS OF CASH FLOWS

For the Years Ended September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Cash receipts for premium contributions	\$ 458,517,947	\$ 445,188,616
Other cash receipts	509,451	447,909
Cash payments for medical claims	(429,279,514)	(398,115,288)
Cash payments to suppliers for goods and services	(12,152,673)	(10,099,378)
Net cash provided by operating activities	<u>17,595,211</u>	<u>37,421,859</u>
Cash flows from capital activities:		
Equipment additions	<u>(58,662)</u>	<u>(27,310)</u>
Cash flows from non-capital and related financing activities:		
Non-operating transfer to Flexible Employees' Benefits Board	<u>(561,972)</u>	<u>(347,195)</u>
Cash flows from investing activities:		
Proceeds from sale/maturities of investments	9,237,112	9,426,576
Purchase of investments	(10,057,676)	(9,155,466)
Investment income received	6,164,697	3,085,268
Other income	-	1,832,250
Net cash provided by investing activities	<u>5,344,133</u>	<u>5,188,628</u>
Net increase in cash and cash equivalents	22,318,710	42,235,982
Cash and cash equivalents - beginning of year	<u>112,465,962</u>	<u>70,229,980</u>
Cash and cash equivalents - end of year	<u>\$ 134,784,672</u>	<u>\$ 112,465,962</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 14,426,024	\$ 24,712,945
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	51,464	52,310
Changes in assets and liabilities:		
Premiums receivable	48,050	190,662
Accounts receivable	(472,040)	(346,991)
Prepaid expenses	(1,091,135)	(520,393)
Accounts payable and accrued expenses	138,401	(12,722)
Reported claims payable	(675,200)	4,728,916
Claims incurred but not reported	3,357,095	5,754,167
Premiums received in advance	1,812,552	2,862,965
Net cash provided by operating activities	<u>\$ 17,595,211</u>	<u>\$ 37,421,859</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

A. DESCRIPTION OF PLAN

General

The State Employees' Insurance Board (SEIB) is responsible for the establishment of the State of Alabama's health insurance plan and its general administration, including the determination of participant premiums, and operations.

The State Employees' Insurance Fund (SEIF) was established in 1965 under the provisions of Act 833 of the Legislature to provide health insurance benefits for employees of the State of Alabama and certain state agencies. Effective October 1, 1998, administrative responsibility for SEIF was transferred from the Retirement Systems of Alabama to separate staff employed by SEIB.

The Local Government Health Insurance Program (LGHIP) was established in 1992 amending Act 90-624 of the Legislature to provide health insurance benefits for employees of any participating local government unit within the State of Alabama. Effective April 1, 1993, LGHIP began operations and the administrative responsibility for the LGHIP was vested with the SEIB.

SEIB is governed by an eleven member Board of Directors consisting of five State Personnel Board members, Director of Finance, the Chief Executive Officer of the Retirement Systems of Alabama, two state employees and two retirees covered under the SEIB plans.

Participants should refer to the respective SEIF and LGHIP Plan agreements for a complete description of the Plans' provisions.

Reporting Entity

SEIB is a part of the State of Alabama's reporting entity. The SEIF is an internal service fund and the LGHIP is an enterprise fund of the State of Alabama.

Benefits

The Plans provide basic medical coverage for up to 365 days of care during each hospital confinement, outpatient care, physicians' benefits, and radiation therapy. Additionally, the Plans provide major medical benefits limited to \$1,000,000 for the lifetime of a state employee and \$1,000,000 for a local government unit employee. A group dental contract provides basic dental maintenance coverage with a maximum benefit amount of \$1,000 during each year for each eligible state employee that elects coverage. Dental coverage is optional for the LGHIP. SEIB also offers options to the medical and dental plans described above in the form of a managed care plan. The managed care plan provides basically the same coverage as the medical/dental plans.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**Contributions**

The Plans provide that the employers contribute monthly for the medical and dental insurance of participating employees. Coverage is also available to dependants of employees with their medical premiums typically being paid by the employee. Employee and dependant premium amounts are determined annually and are set at a rate necessary to provide sufficient funds to pay all claims and reasonable expenses of administering the plans.

Basis of Presentation and Accounting

The financial statements of SEIB have been prepared in conformity with accounting principles generally accepted in the United States of America as applied to government units.

SEIB applies all applicable Governmental Accounting Standards Board (GASB) pronouncements as well as Financial Accounting Standards Board (FASB) statements and interpretations, and the Accounting Principles Board (APB) opinions, issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

The financial statements and notes to financial statements include the combined accounts of SEIF and LGHIP, the two funds administered by SEIB. All significant interfund balances and transactions have been eliminated. The two funds utilize the full accrual method of accounting.

The activities of SEIF and LGHIP are accounted for within proprietary (internal service and enterprise) funds. Proprietary funds are used to account for operations that are (a) financed and operated in a manner similar to private business enterprises where the intent of the governing body is that the cost (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

The accounting and financial reporting treatment applied to SEIB is determined by its measurement focus. The transactions of the SEIB are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation are included on the Statement of Net Assets. Net assets (i.e., total assets net of total liabilities) are segregated into invested in capital assets, net of related debt; restricted for capital activity and debt service; and unrestricted components.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Highly liquid investments with a maturity of 90 days or less when acquired are classified as cash equivalents. Included in cash equivalents are commercial papers and money market funds. These are held in SEIB's name by a broker, dealer, or safekeeping agent.

Investment Securities

GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, issued March 1997, establishes accounting and financial reporting standards for investments held by governmental entities. It essentially requires all investments to be carried at fair value in the balance sheet, with all investment income, including changes in fair value, reported as revenue in the statements of revenues and expenses and changes in net assets. Therefore, all investments are reported at fair value for the years ended September 30, 2006 and 2005, and investment income includes changes in fair value.

Equipment

Equipment is capitalized at cost. Depreciation is provided over the assets' estimated useful lives using the straight-line method.

Unpaid Claims Liabilities

SEIB establishes claims liabilities based on estimates of the ultimate cost of claims (including future retroactive claims adjustments) that have been reported but not settled and of estimated claims that have been incurred but not reported. The estimation of claims costs depends on many factors including historical loss experience. Adjustments of the estimated claim liabilities based on actual results are charged or credited to expense in the periods in which such adjustments are determined.

Premiums

SEIB recognizes revenue from the receipt of premiums in the period in which the related coverage occurs. Premium payments received in advance of the coverage period are recorded as a liability. Premiums not received by the end of a coverage period are recorded as premiums receivable. Additionally, amounts paid to the administrator in excess of actual claims paid by the administrator are recorded as prepaid expense.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**Net Assets**

Net assets comprise the various net earnings from operating and non-operating revenues, expenses and contributions of capital. Net assets are classified in the following three components; invested in capital assets, net of related debt; restrict for capital activity and debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consists of all capital assets, net of accumulated depreciation and reduced by outstanding debt that is attributable to the acquisition, construction and improvement of those assets; debt related to unspent proceeds or other restricted cash and investments is excluded from the determination. Restricted for capital activity and debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted consists of all other net assets not included in the above categories.

Operating Revenues and Expenses

Operating revenues and expenses for proprietary funds are those that result from providing services and producing and delivering goods and/or services. It also includes all revenue and expenses not related to capital and related financing, noncapital financing, or investing activities.

Contract Administrator

Blue Cross/Blue Shield of Alabama (Blue Cross), under contract with SEIB, administers medical and dental claims in accordance with the Plans. The claims administrator's charges for the fiscal years ended September 30, 2006 and 2005 were limited to 3.05% of the total annual claims paid by Blue Cross.

United HealthCare, under contract with SEIB, also administers medical and dental claims for the Local Government Health Insurance Plan. The claims administrator's charges for the calendar year 2006 and 2005 were \$47.73 and \$42.01, respectively, for medical coverage and \$3.35 and \$3.10, respectively, for dental coverage per covered subscriber.

Total charges for claims administration for the fiscal years ended September 30, 2006 and 2005 were \$10,543,167 and \$10,753,641, respectively. The charges are included in the medical claims expense in the statements of revenues, expenses and changes in net assets.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS

During the year ended September 30, 2005, SEIB adopted GASB Statement No. 40, Deposit and Investment Risk Disclosures, which amends existing accounting guidance under GASB No. 3, Deposits with Financial Institutions, Investments (including repurchase agreements), and reverse repurchase agreements. GASB Statement No. 40 enhances the deposit and investment risk disclosures by updating the custodial credit risk disclosure requirements of GASB No. 3 and addressing other common risks, including concentrations of credit risk, interest rate risk, and foreign currency risk. Entities may not be exposed to all risks included in GASB Statement No. 40. Following "exception-based reporting," entities are not required to disclose risks that do not apply to them. The applicable risks are addressed below.

Deposits

As of September 30, 2006 and 2005, cash consisted of non-interest bearing deposits held by the State Treasurer and a financial institution in the name of SEIB.

SEIB's deposits were covered by federal depository insurance (FDIC) or by collateral held with the State Treasurer's office in the name of the State Treasurer under the Security for Alabama Funds Enhancement Act. Under the Act, financial institutions holding public deposits in excess of the amounts insured by FDIC must pledge collateral to a collateral pool in the name of the State Treasurer. The State Treasurer is responsible for monitoring compliance with the collateralization and reporting requirements of the Act. If any member financial institution fails, the entire collateral pool becomes available to satisfy claims of governmental entities. If the value of the pool's collateral were inadequate to cover the loss, additional amounts would be assessed on a pro rata basis to the members of the pool. Funds deposited in accordance with the requirements of the Act are considered fully secured.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS (continued)**Investments**

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The fair value of fixed-maturity investments fluctuates in response to changes in market interest rates. Increases in prevailing interest rates generally translate into decreases in fair value of those instruments. The fair value of interest sensitive instruments may also be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, and other general market conditions. Certain fixed maturity investments have call provisions that could result in shorter maturity periods. However, SEIB's intent is to hold all fixed maturity investments until maturity, and as such, fixed maturity investments are classified in the following table as if they were held to maturity. SEIB has no policy on interest rate risk.

The following represents interest rate risk as of September 30, 2006:

	Investment maturities at fair value (in years)				Total Fair Value
	Less than 1	1-5	6-10	More than 10	
<i>Fixed Maturity</i>					
Commercial Paper	\$ 113,827,514	\$ -	\$ -	\$ -	\$ 113,827,514
U.S. Treasury	-	-	1,280,427	-	1,280,427
U.S. Agency	-	2,799,417	2,296,687	58,517	5,154,621
Corporate Bonds	144,700	6,405,452	6,011,037	1,333,730	13,894,919
Private Placements	-	260,873	-	-	260,873
GNMAs	-	-	13,944	-	13,944
Total debt securities	<u>113,972,214</u>	<u>9,465,742</u>	<u>9,602,095</u>	<u>1,392,247</u>	<u>134,432,298</u>
<i>Domestic Equities</i>					
Common Stock					1,087,234
Mutual Funds					<u>10,356,403</u>
Total domestic equities					<u>11,443,637</u>
<i>Money market fund</i>					
					<u>12,967,176</u>
Total holdings					158,843,111
Less: Cash equivalents					<u>(126,794,690)</u>
Total investments					<u><u>32,048,421</u></u>

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS (continued)

The following represents interest rate risk as of September 30, 2005:

	Investment maturities at fair value (in years)				Total Fair Value
	Less than 1	1-5	6-10	More than 10	
<i>Fixed Maturity</i>					
Commercial Paper	\$ 99,937,949	\$ -	\$ -	\$ -	\$ 99,937,949
U.S. Agency	-	3,579,338	2,660,574	58,848	6,298,760
Corporate Bonds	445,410	5,725,840	6,130,224	1,146,513	13,447,987
Private Placements	-	-	296,862	-	296,862
GNMAs	-	-	15,251	-	15,251
Total debt securities	<u>100,383,359</u>	<u>9,305,178</u>	<u>9,102,911</u>	<u>1,205,361</u>	<u>119,996,809</u>
<i>Domestic Equities</i>					
Common Stock					1,110,735
Mutual Funds					9,351,665
Total domestic equities					<u>10,462,400</u>
<i>Money market fund</i>					<u>7,857,615</u>
Total holdings					138,316,824
Less: Cash equivalents					<u>(107,795,564)</u>
Total investments					<u>30,521,260</u>

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS (continued)

Concentration of Credit Risk – Concentration of credit risk is the result of investing 5% or more of total investments in any one issuer. SEIB has no policy for concentration of credit risk.

As of September 30, 2006, SEIB owned the following debt securities that comprised 5% or more of the investment holdings:

<u>Issuer</u>	<u>Investment Type</u>	<u>Fair Value</u>	<u>Fair Value as a Percent of Total Holdings</u>
Centex Corp.	Commercial Paper	\$ 29,999,060	18.89%
Alcoa, Inc.	Commercial Paper	14,000,493	8.81%
St. Paul Companies, Inc.	Commercial Paper	12,938,987	8.15%
John Deere Capital Corp.	Commercial Paper	7,999,696	5.04%
Daimler Chrysler N.A.	Commercial Paper	7,999,407	5.04%

As of September 30, 2005, SEIB owned the following debt securities that comprised 5% or more of the investment holdings:

<u>Issuer</u>	<u>Investment Type</u>	<u>Fair Value</u>	<u>Fair Value as a Percent of Total Holdings</u>
ITT Industries, Inc.	Commercial Paper	\$ 19,998,525	14.46%
Federated Retail Holdings	Commercial Paper	12,998,962	9.40%
Textron Financial Corp.	Commercial Paper	12,998,887	9.40%
General Mills, Inc.	Commercial Paper	8,033,412	5.81%
State Street STIF	Money Market	7,857,615	5.68%
AGL Capital Corporation	Commercial Paper	7,498,963	5.42%

Credit Risk – Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. Nationally recognized statistical rating organizations provide ratings of debt securities' quality based on a variety of factors, such as the financial condition of the issuers, which provide investors with some idea of the issuer's ability to meet its obligations. SEIB is authorized to invest in U.S. Government and Agency notes, mutual funds, mortgage-backed securities, corporate bonds, private placements, and repurchase agreements. SEIB has no policy on credit risk.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS (continued)

The following represents credit risk as of September 30, 2006:

Ratings of Fixed Maturities

<u>Moody's Ratings</u>	<u>Fair Value</u>	Fair Value as a Percent of Total Fixed <u>Maturity Fair Value</u>
Aaa	\$ 7,562,584	5.66%
Aa1	610,782	0.45%
Aa2	221,666	0.16%
Aa3	1,712,123	1.27%
A1	1,289,115	0.96%
A2	100,236	0.07%
A3	1,064,506	0.79%
Baa1	1,724,195	1.28%
Baa2	3,420,747	2.54%
Baa3	1,222,483	0.91%
Ba1	1,395,904	1.04%
Ba3	19,570	0.01%
P1	14,000,493	10.41%
P2	99,827,021	74.26%
Not rated **	260,873	0.19%
	<u>\$ 134,432,298</u>	<u>100.00%</u>

** Primarily consists of private placements

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

C. DEPOSITS AND INVESTMENTS (continued)

The following represents credit risk as of September 30, 2005:

Ratings of Fixed Maturities

<u>Moody's Ratings</u>	<u>Fair Value</u>	<u>Fair Value as a Percent of Total Fixed Maturity Fair Value</u>
Aaa	\$ 7,173,232	5.98%
Aa1	170,586	0.14%
Aa3	1,024,946	0.85%
A1	384,927	0.32%
A3	1,118,450	0.93%
Baa1	925,002	0.77%
Baa2	5,078,551	4.23%
Baa3	1,458,349	1.22%
Ba1	1,525,505	1.27%
Ba2	202,317	0.17%
B1	254,723	0.21%
B3	445,410	0.37%
P1	5,026,405	4.19%
P2	94,911,544	79.10%
Not rated **	296,862	0.25%
	<u>\$ 119,996,809</u>	<u>100.00%</u>

** Primarily consists of private placements

The SSGA Treasury Fund, which represents the money market fund, was rated Aaa by Moody's ratings. Other investment holdings not rated included common stock and equity mutual funds, for which credit risk disclosure is not required.

Mortgage-backed securities – As of September 30, 2006 and 2005, SEIB had investments in mortgage-backed securities. Embedded prepayment options cause these investments to be highly sensitive to changes in interest rates. Prepayments by the obligors of the underlying assets reduce the total interest payments to be received. Generally, when interest rates fall, obligors tend to prepay the mortgages thus eliminating the stream of interest payments that would have been received under the original amortization schedule. The resulting reduction in cash flow diminishes the fair value of mortgage-backed securities.

Realized losses on investments totaled \$50,467 and \$81,241 for the years ended September 30, 2006 and 2005, respectively.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

D. UNPAID CLAIMS LIABILITIES

As discussed in note B, SEIB establishes a liability for both reported and unreported insurance claims, which includes estimates of future payments of both medical claims and related retroactive claims adjustment expenses.

The following represents changes in those aggregate liabilities for SEIB during the years ended September 30:

	<u>2006</u>	<u>2005</u>
Reported claims payable and estimated claims incurred but not reported at beginning of year	\$ <u>49,765,679</u>	\$ <u>39,282,596</u>
Incurred claims and claims adjustment expense:		
Provisions for insured claims of the current year	427,137,422	401,989,044
Adjustment to estimated claims incurred but not reported at end of year	<u>3,357,095</u>	<u>5,754,167</u>
Total expense	<u>430,494,517</u>	<u>407,743,211</u>
Payments:		
Claims and claims adjustment expenses attributable to insured claims of the current year	398,959,174	372,056,561
Claims and claims adjustment expenses attributable to insured claims of the prior year	<u>28,853,448</u>	<u>25,203,567</u>
Total payments	<u>427,812,622</u>	<u>397,260,128</u>
Reported claims payable and estimated claims incurred but not reported at end of year	<u>\$ <u>52,447,574</u></u>	<u>\$ <u>49,765,679</u></u>

At year-end, unpaid claims liabilities are computed using the gross method without discounting the accrued claims payable.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

E. NET ASSETS

SEIB's Board of Directors has designated certain of its unrestricted net assets as of September 30, 2006 and 2005 totaling \$12,286,878 and \$11,987,012, respectively, for funding of future contingencies related to claims.

F. OPERATING LEASE

SEIB leases office space under a ten-year operating lease expiring in 2010, cancelable with six-month's written notice. The terms of the lease also call for additional monthly common area maintenance fees to be determined annually.

Future minimum rental payments required under this lease are:

Year ending September 30:

2007	\$	359,924
2008		365,461
2009		365,461
2010		393,148
2011		<u>66,448</u>
Total minimum future lease payments	\$	<u>1,550,442</u>

Rent expense for the years ended September 30, 2006 and 2005, totaled \$458,272 and \$419,168, respectively.

G. RETIREMENT PLAN

The employees of the Board participate in a retirement plan administered by the Retirement Systems of Alabama. During the years ended September 30, 2006 and 2005, the Board made contributions to the plan totaling \$149,060 and \$96,963, respectively. These contributions are included in administrative expenses in the Statements of Revenues, Expenses, and Changes in Net Assets.

THE STATE EMPLOYEES' INSURANCE BOARD

NOTES TO FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

H. ADMINISTRATION OF RELATED PROGRAMS

Alabama Health Insurance Program (AHIP)

Effective January 1, 1998, SEIB, through an interagency agreement with the Insurance Department, was charged with administering the Alabama Health Insurance Program (AHIP) in conformity with Section 27-52, Article 1, of the Code of Alabama 1975. AHIP, as a high-risk pool in the State of Alabama, provides health insurance coverage to eligible individuals as an alternative to federal oversight required in the Health Insurance Portability and Accountability Act of 1996. The SEIB provides services related to the administration of the AHIP, including accounting, billing, communications, eligibility, enrollment, and reporting. Administrative fees charged to AHIP totaled \$360,000 and \$348,000 for the fiscal years ended September 30, 2006 and 2005, respectively. The balance due from AHIP as of September 30, 2006 and 2005 is \$147,396 and \$92,713, respectively.

Flexible Employees' Benefits Board (FLEX)

The Flexible Employees' Benefits Board was established May 3, 1989 to provide benefits to employees of the State of Alabama pursuant to Code of Alabama 1975, Section 36-29-20 through 30 as last amended and Internal Revenue Code of 1986 Sections 105, 125, and 129. These regulations enable employees to pay insurance premiums and eligible health and dependent care expenses using pre-tax dollars. Effective October 1, 1996, the SEIB was charged with administering the FLEX Plan. For the fiscal years ended September 30, 2006 and 2005, administrative fees charged to the FLEX Plan totaled \$561,972 and \$347,195, respectively.

Alabama Department of Corrections Inmate Hospitalization

Effective December 1, 2005, SEIB, through an interagency agreement with the Alabama Department of Corrections (DOC), provides access to inpatient hospital networks, online claims information, comprehensive claims analyses software, and a variety of summary and detailed claims reports. SEIB acts as a pass-through entity for claim payments. SEIB is not liable for the claim expenses incurred as they are the responsibility of the Department of Corrections. Therefore, SEIB has not included the DOC claims incurred but not reported as a liability.

I. SUBSEQUENT EVENT

Subsequent to September 30, 2005, the State Employees' Insurance Board granted a credit of \$216 per employee to each agency for the state share of premium contributions.

SUPPLEMENTARY INFORMATION

THE STATE EMPLOYEES' INSURANCE BOARD

SUPPLEMENTARY TEN-YEAR CLAIMS

SEPTEMBER 30, 2006

The following table illustrates how SEIB's total revenues compare to related costs of loss and other expenses assumed by SEIB as of the end of each of the last ten years (exclusive of HMO medical and dental coverage subsequent to December 31, 1992 provided on a premiums paid basis). The rows of the table are defined as follows: (1) This line shows the total of each fiscal year's earned contribution revenues. (2) This line shows each fiscal year's other operating cost of SEIB including overhead and claims expense not allocable to individual claims. (3) This line shows SEIB's incurred claims and allocated claims adjustment expense (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called plan year). (4) This section of rows shows the cumulative amounts paid as of the end of successive years for each plan year. (5) This section of rows shows how each plan year's incurred claims increased or decreased as of the end of successive years. This annual re-estimation results from new information received on known claims, re-evaluation of existing information on known claims, as well as emergence of new claims not previously known. (6) This line compares the latest re-estimated incurred claims amount to the originally established (line 3) and shows whether this latest estimate of claims cost is greater or less than originally estimated. As data for individual plan years mature, the correlation between original estimates and re-estimated amounts is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature plan years. The columns of the table show data for successive plan years.

THE STATE EMPLOYEES' INSURANCE BOARD

SUPPLEMENTARY TEN-YEAR CLAIMS (IN THOUSANDS)

September 30, 2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
(1) Total revenues	\$ 184,945	\$ 159,521	\$ 206,852	\$ 228,654	\$ 262,927	\$ 305,200	\$ 347,873	\$ 378,205	\$ 442,236	\$ 457,167
(2) Unallocated expenses	3,165	3,613	3,553	4,084	2,542	5,301	5,642	5,649	6,330	7,324
(3) Estimated incurred claims and expense, end of plan year	156,326	170,428	196,397	207,591	242,584	298,213	350,442	378,577	407,743	430,495
(4) Paid (cumulative) as of:										
End of plan year	140,887	154,108	173,517	196,018	217,059	270,960	322,888	345,763	372,057	398,959
One year later	157,141	171,350	190,276	215,191	238,522	296,506	350,231	371,247	400,762	
Two years later	156,988	171,099	190,304	215,319	238,774	296,021	350,118	371,703		
Three years later	156,865	171,013	189,577	215,262	238,656	295,969	349,968			
Four years later	156,828	170,946	189,573	215,212	238,590	295,907				
Five years later	156,810	170,941	189,562	215,169	238,545					
Six years later	156,802	170,925	189,554	215,129						
Seven years later	156,785	170,917	189,552							
Eight years later	156,783	170,915								
Nine years later	156,778									
(5) Re-estimated incurred claims and expense:										
End of plan year	156,326	170,428	196,397	207,591	242,584	298,213	350,442	378,577	407,743	430,495
One year later	157,141	171,350	190,276	215,191	238,522	296,506	350,231	371,247	400,762	
Two years later	156,988	171,099	190,304	215,319	238,774	296,021	350,118	371,703		
Three years later	156,865	171,013	189,577	215,262	238,656	295,969	349,968			
Four years later	156,828	170,946	189,573	215,212	238,590	295,907				
Five years later	156,810	170,941	189,562	215,169	238,545					
Six years later	156,802	170,925	189,554	215,129						
Seven years later	156,785	170,917	189,552							
Eight years later	156,783	170,915								
Nine years later	156,778									
(6) Increase (decrease) in estimated incurred claims and expense from end of plan year	452	487	(6,845)	7,538	(4,039)	(2,306)	(474)	(6,874)	(6,981)	-

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

COMBINING SCHEDULE OF FUNDS
STATEMENT OF NET ASSETS

September 30, 2006

	<u>SEIF</u>	<u>LGHIP</u>	<u>Eliminations</u>	<u>Total</u>
<u>ASSETS</u>				
Current assets:				
Cash and cash equivalents	\$ 103,301,755	\$ 31,482,917	\$ -	\$ 134,784,672
Investments	20,999,027	11,049,394	-	32,048,421
Interest receivable	573,014	229,450	-	802,464
Premiums receivable	371,346	194,584	-	565,930
Accounts receivable	1,716,969	-	-	1,716,969
Prepaid expenses	1,488,528	320,000	-	1,808,528
Due from other funds	581,094	-	(581,094)	-
Total current assets	<u>129,031,733</u>	<u>43,276,345</u>	<u>(581,094)</u>	<u>171,726,984</u>
Capital assets:				
Office furniture and equipment	432,042	-	-	432,042
Leasehold improvements	128,612	-	-	128,612
	<u>560,654</u>	<u>-</u>	<u>-</u>	<u>560,654</u>
Less accumulated depreciation	399,630	-	-	399,630
Net capital assets	<u>161,024</u>	<u>-</u>	<u>-</u>	<u>161,024</u>
Total assets	<u>129,192,757</u>	<u>43,276,345</u>	<u>(581,094)</u>	<u>171,888,008</u>
<u>LIABILITIES</u>				
Current liabilities:				
Accounts payable and accrued expenses	1,260,728	95,451	-	1,356,179
Reported claims payable	8,500,353	3,676,466	-	12,176,819
Claims incurred but not reported	26,693,316	13,577,439	-	40,270,755
Premiums received in advance	28,113,937	5,617,764	-	33,731,701
Due to other funds	-	581,094	(581,094)	-
Total current liabilities/ Total liabilities	<u>64,568,334</u>	<u>23,548,214</u>	<u>(581,094)</u>	<u>87,535,454</u>
<u>NET ASSETS</u>				
Invested in capital assets, net of related debt	161,024	-	-	161,024
Unrestricted	64,463,399	19,728,131	-	84,191,530
Total net assets	<u>\$ 64,624,423</u>	<u>\$ 19,728,131</u>	<u>\$ -</u>	<u>\$ 84,352,554</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD
 COMBINING SCHEDULE OF FUNDS
 STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Year Ended September 30, 2006

	<u>SEIF</u>	<u>LGHIP</u>	<u>Eliminations</u>	<u>Total</u>
Operating revenues:				
Premium contributions:				
Employer/subscriber	\$ 281,492,460	\$ 77,810,790	\$ -	\$ 359,303,250
Employee/dependent	54,074,238	45,193,502	-	99,267,740
Refunds	(1,907,945)	(5,700)	-	(1,913,645)
Other revenues	264	509,187	-	509,451
Total operating revenues	<u>333,659,017</u>	<u>123,507,779</u>	<u>-</u>	<u>457,166,796</u>
Operating expenses:				
Medical claims expense	312,167,306	118,327,211	-	430,494,517
Consulting services	520,558	57,001	-	577,559
Utilization review services	2,367,877	1,091,203	-	3,459,080
Other participant related programs	3,731,744	1,190,556	-	4,922,300
Administrative expenses	817,592	2,418,260	-	3,235,852
Depreciation expense	51,464	-	-	51,464
Total operating expenses	<u>319,656,541</u>	<u>123,084,231</u>	<u>-</u>	<u>442,740,772</u>
Operating income	<u>14,002,476</u>	<u>423,548</u>	<u>-</u>	<u>14,426,024</u>
Nonoperating revenues (expenses):				
Investment income	5,179,299	1,905,482	-	7,084,781
Transfer to Flexible Employees' Benefits Board	(561,972)	-	-	(561,972)
Total nonoperating revenues (expenses)	<u>4,617,327</u>	<u>1,905,482</u>	<u>-</u>	<u>6,522,809</u>
Change in net assets	18,619,803	2,329,030	-	20,948,833
Net assets - beginning of year	<u>46,004,620</u>	<u>17,399,101</u>	<u>-</u>	<u>63,403,721</u>
Net assets - end of year	<u>\$ 64,624,423</u>	<u>\$ 19,728,131</u>	<u>\$ -</u>	<u>\$ 84,352,554</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

COMBINING SCHEDULE OF FUNDS
STATEMENT OF CASH FLOWS

For the Year Ended September 30, 2006

	<u>SEIF</u>	<u>LGHIP</u>	<u>Eliminations</u>	<u>Total</u>
Cash flows from operating activities:				
Cash receipts for premium contributions	\$ 335,806,210	\$ 122,711,737	\$ -	\$ 458,517,947
Other cash receipts	264	509,187		509,451
Cash payments for medical claims	(313,184,096)	(116,095,418)	-	(429,279,514)
Cash payments to suppliers for goods and services	(7,458,505)	(4,694,168)	-	(12,152,673)
Net cash provided by operating activities	<u>15,163,873</u>	<u>2,431,338</u>	<u>-</u>	<u>17,595,211</u>
Cash flows from capital activities:				
Equipment additions	<u>(58,662)</u>	<u>-</u>	<u>-</u>	<u>(58,662)</u>
Cash flows from non-capital and related financing activities:				
Non-operating transfer to Flexible Employees' Benefits Board	<u>(561,972)</u>	<u>-</u>	<u>-</u>	<u>(561,972)</u>
Cash flows from investing activities:				
Proceeds from sale/maturities of investments	6,488,352	2,748,760	-	9,237,112
Purchase of investments	(5,928,875)	(4,128,801)	-	(10,057,676)
Investment income received	4,482,780	1,681,917	-	6,164,697
Net cash provided by investing activities	<u>5,042,257</u>	<u>301,876</u>	<u>-</u>	<u>5,344,133</u>
Net increase in cash and cash equivalents	19,585,496	2,733,214	-	22,318,710
Cash and cash equivalents - beginning of year	<u>83,716,259</u>	<u>28,749,703</u>	<u>-</u>	<u>112,465,962</u>
Cash and cash equivalents - end of year	<u>\$ 103,301,755</u>	<u>\$ 31,482,917</u>	<u>\$ -</u>	<u>\$ 134,784,672</u>

See accompanying notes.

THE STATE EMPLOYEES' INSURANCE BOARD

COMBINING SCHEDULE OF FUNDS
STATEMENT OF CASH FLOWS

For the Year Ended September 30, 2006

	<u>SEIF</u>	<u>LGHIP</u>	<u>Eliminations</u>	<u>Total</u>
Reconciliation of operating income to net cash provided by operating activities:				
Operating income	\$ 14,002,476	\$ 423,548	\$ -	\$ 14,426,024
Adjustments to reconcile operating income to net cash provided by operating activities:				
Depreciation expense	51,464	-	-	51,464
Changes in assets and liabilities:				
Premiums receivable	(170,977)	219,027	-	48,050
Accounts receivable	(472,040)	-	-	(472,040)
Prepaid expenses	(1,091,135)	-	-	(1,091,135)
Accounts payable and accrued expenses	125,917	12,484	-	138,401
Reported claims payable	(961,713)	286,513	-	(675,200)
Claims incurred but not reported	1,411,815	1,945,280	-	3,357,095
Premiums received in advance	2,318,434	(505,882)	-	1,812,552
Due to/from other funds	(50,368)	50,368	-	-
Net cash provided by operating activities	<u>\$ 15,163,873</u>	<u>\$ 2,431,338</u>	<u>\$ -</u>	<u>\$ 17,595,211</u>

See accompanying notes.