

**The North Carolina Health Insurance
Risk Pool, Inc. d/b/a Inclusive Health**

Financial Statements
Years Ended June 30, 2011 and 2010

Performed under Contract with the North Carolina
Office of the State Auditor

Beth A. Wood, CPA
State Auditor



DIXON HUGHES GOODMAN^{LLP}
Certified Public Accountants and Advisors

**The North Carolina Health Insurance Risk Pool, Inc.
d/b/a Inclusive Health**

TABLE OF CONTENTS

| | Page No. |
|--|-----------------|
| Independent Auditors' Report | 1 |
| Management's Discussion and Analysis | 3 |
| Basic Financial Statements | |
| Statements of Net Assets | 6 |
| Statements of Revenues, Expenses and Changes in Net Assets..... | 7 |
| Statements of Cash Flows | 8 |
| Notes to Financial Statements..... | 9 |
| Required Supplementary Information | |
| Three-Year Claims Development Information | 19 |
| Other Financial Information | |
| Schedules of Other Expenses | 21 |
| Statement of Net Assets by Program as of June 30, 2011..... | 22 |
| Statement of Revenues, Expenses, and Changes in Net Assets by Program for the Year-Ended June 30, 2011 | 23 |
| Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with <i>Government Auditing Standards</i> | 24 |



DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

INDEPENDENT AUDITORS' REPORT

Board of Directors
The North Carolina Health Insurance Risk Pool, Inc.
d/b/a Inclusive Health
Raleigh, North Carolina

We have audited the accompanying statements of net assets of The North Carolina Health Insurance Risk Pool, Inc. d/b/a Inclusive Health (the Pool), a component unit of the State of North Carolina, as of June 30, 2011 and 2010, 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 Pool'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 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 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 Pool as of June 30, 2011 and 2010, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 1, 2011, on our consideration of the Pool's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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 audits.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 5 and the supplemental schedule of three-year claims development information on pages 19 and 20 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of the Pool, taken as a whole. The Schedule of Other Expenses and the Statements of Net Assets by Programs in the accompanying supplementary information are presented for purposes of additional analysis and are not a required part of the basic financial statements of the Pool. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole.

Dixon Hughes Goodman LLP

November 1, 2011

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2011 and 2010

This section of the annual financial report of The North Carolina Health Insurance Risk Pool, Inc. d/b/a Inclusive Health (the Pool) presents a discussion and analysis of the financial performance of the Pool as of and for the years ended June 30, 2011 and 2010. Please read it in conjunction with the basic financial statements, which follow this section.

Overview of the Financial Statements

The Pool's basic financial statements are prepared in accordance with U.S. generally accepted accounting principles for governmental entities. The Pool was created by the North Carolina General Assembly in 2007 to provide affordable individual health insurance coverage for residents of North Carolina who do not have access to an employer health plan. The Pool also offers coverage to individuals who are federally defined HIPAA eligible or qualify under the Health Coverage Tax Credit due to loss of employment due to effects of international trade. The basic financial statements are presented on the accrual basis of accounting. The three basic financial statements presented within the financial statements are as follows:

Statements of Net Assets - This statement presents information reflecting the Pool's assets, liabilities and net assets. Net assets represent the amount of total assets less total liabilities. The statement of net assets is categorized as to current and noncurrent assets and liabilities. For purposes of the basic financial statements, current assets and liabilities are those assets and liabilities with immediate liquidity or which are collectible or become due within 12 months of the statement date.

Statements of Revenues, Expenses and Changes in Net Assets - This statement reflects the operating revenues and expenses, as well as nonoperating revenues and expenses of the Pool. The Pool's major source of operating revenues is premium income, with the major source of operating expenses being claims expense. The change in net assets is similar to net profit or loss for any other insurance company.

Statements of Cash Flows -The statement of cash flows is presented on the direct method of reporting which reflects cash flows from operating, capital and related financing, noncapital and related financing, and investing activities. Cash collections and payments are reflected in this statement to arrive at the net increase (decrease) in cash and cash equivalents for the fiscal year. Due to timing differences associated with accrual accounting, net cash (used) provided by operating activities is different than the amount of operating loss reported on the statement of revenues, expenses and changes in net assets; therefore, a reconciliation is also provided.

FINANCIAL SUMMARY

The following table summarizes the financial position of the Pool at June 30, 2011 and 2010, respectively.

Summary of Net Assets

| | <u>2011</u> | <u>2010</u> |
|------------------------------------|-------------------|-------------------|
| Assets | | |
| Cash and cash equivalents | \$ 29,858,124 | \$ 17,366,284 |
| Fixed income and equity securities | 13,755,239 | 17,746,839 |
| Other assets | 3,064,993 | 1,167,768 |
| Capital assets | <u>6,150</u> | <u>8,231</u> |
| Total assets | <u>46,684,506</u> | <u>36,289,122</u> |
| Liabilities | <u>9,356,623</u> | <u>4,464,842</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2011 and 2010

Summary of Net Assets (Continued)

| | <u>2011</u> | <u>2010</u> |
|----------------------------|----------------------|----------------------|
| Net assets | | |
| Invested in capital assets | \$ 6,150 | \$ 8,231 |
| Unrestricted | <u>37,321,733</u> | <u>31,816,049</u> |
| Total | <u>\$ 37,327,883</u> | <u>\$ 31,824,280</u> |

Total Assets

Total assets consisted of a range of asset classes led by cash and cash equivalents, fixed income and equity securities and federal grant receivables, which are included in other assets. The change in total assets of \$10,395,384 from 2010 to 2011 was driven by an increase of \$12,491,840 in cash and cash equivalents and an increase of \$1,897,225 in other assets. Other Assets include accrued pharmaceutical rebates which increased \$734,530 as a result of increased enrollment in both the State and Federal Pool; Grants Receivable which increased \$941,823 as a result of receiving a Federal grant for subsidizing premiums; and prepaid expenses that increased by \$228,299 because of a payment for the July 2011 administrative fee and small changes in prepaid insurance and rent. The increase in cash and cash equivalents resulted from the addition of cash accounts for the operation of the Federal Risk Pool and an increase in money market funds coinciding with the decrease in mutual funds and bonds held in the investment account.

Total Liabilities

The most significant components of the Pool's liabilities are unpaid claims and claims adjustment expenses which totaled \$7,728,087 in 2011. That represents an increase of \$4,183,949 over 2010. The increase is commensurate with the increased enrollment and claims activity in 2011 and the addition of the operations of the Federal Risk Pool.

The following table summarizes the changes in net assets for fiscal year ended June 30:

Summary of Revenues, Expenses and Changes in Net Assets

| | <u>2011</u> | <u>2010</u> |
|--------------------------------|----------------------|----------------------|
| Operating revenues | | |
| Premiums earned | <u>\$ 33,102,921</u> | <u>\$ 15,323,244</u> |
| Total operating revenues | <u>33,102,921</u> | <u>15,323,244</u> |
| Operating expenses | | |
| Claims expenses | 38,010,996 | 13,713,729 |
| Contractual expenses | 4,130,066 | 1,691,721 |
| Personnel expenses | 348,693 | 237,400 |
| General expenses | <u>82,229</u> | <u>87,651</u> |
| Total operating expenses | <u>42,571,984</u> | <u>15,730,501</u> |
| Operating loss | <u>(9,469,063)</u> | <u>(407,257)</u> |
| Nonoperating revenues | | |
| State aid | 6,581,804 | 8,953,118 |
| Federal aid | 7,923,936 | 1,500,000 |
| Investment | <u>466,926</u> | <u>342,675</u> |
| Total non-operating revenues | <u>14,972,666</u> | <u>10,795,793</u> |
| Change in net assets | 5,503,603 | 10,388,536 |
| Net assets – beginning of year | <u>31,824,280</u> | <u>21,435,744</u> |
| Net assets, end of year | <u>\$ 37,327,883</u> | <u>\$ 31,824,280</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2011 and 2010

RESULTS OF OPERATIONS

Revenues

Total revenues increased \$21,956,550 or 84% from \$26,119,037 at June 30, 2010 to \$48,075,587 at June 30, 2011. This was driven by an increase in operating revenues of \$17,779,677, and an increase in nonoperating revenues of \$4,176,873. The increase of operating revenue was comprised solely of earned premiums, which increased commensurate with the Pool's increased enrollment in 2011 and the addition of the Federal Risk Pool. The increase in nonoperating revenues was comprised of two key components, a decrease in premium tax revenue from the North Carolina Department of Insurance of \$2,366,814 and an increase in Federal Aid of \$6,419,436 as a result of the operation of the Federal Risk Pool. In addition, investment income increased by \$124,251.

Expenses

Operating expenses are comprised of claims expense and the Pool's general and administrative expenses.

Operating expenses totaled \$42,571,984 in 2011 representing an increase of \$26,841,483 over the prior year. The operating loss increased by \$9,061,806 to \$9,469,063 with the rise in claims and expenses related to increased enrollment and the addition of the Federal Risk Pool.

Future Conditions and Facts

The rate of Inclusive Health-State Option enrollment growth continues to increase on a monthly basis as we enter the 2011-2012 fiscal year. Increasing awareness generated by the Pool's outreach efforts is taking both expenses and revenues to new levels. At the same time, the medical loss ratio is trending upward due in part to lower than expected state premium tax revenues with the expectation that we may see a significant decline in the Net Asset balance starting in the current fiscal year. The long term impact will depend on the economy's continuing effect on insurance industry sales and tax collections. The Pool will need to continue to closely monitor the long-term impact on Net Assets and the ability of the Pool to cover its expenses through the end of its expected life in December 2013.

Funding for Inclusive Health – Federal Option includes a significant portion of federal funds from the Affordable Care Act. Due to low enrollment, the federal pool has not used as much of its original federal allocation as expected. At the same time, federal debt reduction negotiations may place some of that funding at risk as Congress is forced to sequester expenditures to meet negotiated reduction targets. The outcome of that is contingent on that process which is playing out this fall.

Both options continue to proceed toward December 2013 with an eye on the Affordable Care Act implementation timetable. It is unclear what this transition's impact will be on Pool enrollment between now and then. Both options are expecting to transition their members to the new health insurance exchange as of January 2014.

Information Requests

This financial report is designed to provide the members of the Pool and General Assembly of the State of North Carolina with a general overview of the Pool's finances, and to demonstrate the Pool's accountability for the money it receives. Questions concerning this report or requests for additional financial information should be addressed to Michael Keough, Executive Director; North Carolina Health Insurance Risk Pool, Inc., 3739 National Drive; Suite 228; Raleigh, North Carolina 27612-4844; (919) 783-5766.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
STATEMENTS OF NET ASSETS
June 30, 2011 and 2010

| | <u>2011</u> | <u>2010</u> |
|--|-----------------------------|-----------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 29,858,124 | \$ 17,366,284 |
| Fixed income securities | 1,000,388 | 3,637,426 |
| Equity securities | 5,934,675 | 9,366,860 |
| Accrued interest | 97,058 | 97,939 |
| Premiums receivable, net of allowance of \$5,000 and \$75,000 in 2011 and 2010, respectively | 5,053 | 11,599 |
| Grants receivable | 1,779,366 | 837,543 |
| Rebates receivable | 935,116 | 200,586 |
| Other assets | 248,400 | 20,101 |
| Total current assets | <u>39,858,180</u> | <u>31,538,338</u> |
| Noncurrent assets: | | |
| Fixed income securities | 6,820,176 | 4,742,553 |
| Capital assets, net of accumulated depreciation of \$6,473 and \$4,392 in 2011 and 2010, respectively | 6,150 | 8,231 |
| Total noncurrent assets | <u>6,826,326</u> | <u>4,750,784</u> |
| TOTAL ASSETS | <u><u>\$ 46,684,506</u></u> | <u><u>\$ 36,289,122</u></u> |
| LIABILITIES AND NET ASSETS | | |
| LIABILITIES | | |
| Unpaid claims and claims adjustment expenses | \$ 7,728,087 | \$ 3,544,138 |
| Accounts payable | 39,738 | 194,602 |
| Unearned federal grant revenue: | | |
| Obligated grant | 970,284 | - |
| Unobligated grant | 129,138 | - |
| Advance premiums | 466,597 | 587,453 |
| Unapplied premiums | 2,855 | 125,188 |
| Other liabilities | 19,924 | 13,461 |
| Total current liabilities | <u>9,356,623</u> | <u>4,464,842</u> |
| NET ASSETS | | |
| Invested in capital assets | 6,150 | 8,231 |
| Unrestricted | 37,321,733 | 31,816,049 |
| Total net assets | <u>37,327,883</u> | <u>31,824,280</u> |
| TOTAL LIABILITIES AND NET ASSETS | <u><u>\$ 46,684,506</u></u> | <u><u>\$ 36,289,122</u></u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Years Ended June 30, 2011 and 2010

| | <u>2011</u> | <u>2010</u> |
|-------------------------------|----------------------|----------------------|
| OPERATING REVENUES | | |
| Premiums earned, net | \$ 33,102,921 | \$ 15,323,244 |
| TOTAL OPERATING REVENUES | <u>33,102,921</u> | <u>15,323,244</u> |
| OPERATING EXPENSES | | |
| Claims expense | 37,923,445 | 13,713,729 |
| Contractual expenses | 4,217,617 | 1,691,721 |
| Personnel expenses | 348,693 | 237,400 |
| General expenses | 82,229 | 87,651 |
| TOTAL OPERATING EXPENSES | <u>42,571,984</u> | <u>15,730,501</u> |
| NET OPERATING LOSS | (9,469,063) | (407,257) |
| NONOPERATING REVENUES | | |
| State aid | 6,581,804 | 8,953,118 |
| Federal aid | 7,923,936 | 1,500,000 |
| Investment income | 466,926 | 342,675 |
| TOTAL NONOPERATING REVENUES | <u>14,972,666</u> | <u>10,795,793</u> |
| CHANGE IN NET ASSETS | 5,503,603 | 10,388,536 |
| NET ASSETS, BEGINNING OF YEAR | <u>31,824,280</u> | <u>21,435,744</u> |
| NET ASSETS, END OF YEAR | <u>\$ 37,327,883</u> | <u>\$ 31,824,280</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
STATEMENTS OF CASH FLOWS
Years Ended June 30, 2011 and 2010

| | <u>2011</u> | <u>2010</u> |
|--|-----------------------|----------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Premiums received | \$ 32,867,343 | \$ 15,610,452 |
| Claims paid | (34,670,754) | (12,472,810) |
| Payments to employees and benefits | (347,153) | (238,283) |
| Payments to vendors and suppliers | (4,574,951) | (1,740,832) |
| | <u>(6,725,515)</u> | <u>1,158,527</u> |
| NET CASH (USED) PROVIDED BY OPERATING ACTIVITIES | | |
| | <u>(6,725,515)</u> | <u>1,158,527</u> |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES | | |
| State and federal aid received | <u>14,758,529</u> | <u>14,520,958</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of fixed income securities | (7,522,094) | (9,274,132) |
| Purchases of equity securities | (1,800,000) | (9,300,000) |
| Proceeds from the sale of fixed income securities | 13,200,049 | 800,000 |
| Investment income received | 580,871 | 272,025 |
| | <u>4,458,826</u> | <u>(17,502,107)</u> |
| NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES | | |
| | <u>4,458,826</u> | <u>(17,502,107)</u> |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 12,491,840 | (1,822,622) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | <u>17,366,284</u> | <u>19,188,906</u> |
| CASH AND CASH EQUIVALENTS, END OF YEAR | <u>\$ 29,858,124</u> | <u>\$ 17,366,284</u> |
| RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| Net operating loss | \$ (9,469,063) | \$ (407,257) |
| Adjustments to reconcile net loss to net cash provided by operating activities | | |
| Bad debt recoveries | (70,000) | (25,000) |
| Depreciation | 2,081 | 2,081 |
| Decrease (increase) in operating assets: | | |
| Premiums receivable | 76,546 | 66,952 |
| Rebates receivable | (829,139) | 32,110 |
| Other assets | (228,299) | (2,579) |
| Increase (decrease) in operating liabilities: | | |
| Unpaid claims and claims adjustment expenses | 4,183,949 | 1,102,832 |
| Accounts payable | (154,864) | 170,002 |
| Advance premiums | (120,856) | 54,131 |
| Unapplied premiums | (122,333) | 157,501 |
| Other liabilities | 6,463 | 7,754 |
| | <u>6,463</u> | <u>7,754</u> |
| NET CASH (USED) PROVIDED BY OPERATING ACTIVITIES | <u>\$ (6,725,515)</u> | <u>\$ 1,158,527</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

The North Carolina Health Insurance Risk Pool, Inc. d/b/a Inclusive Health (the "Pool") was created by the North Carolina General Assembly in 2007 to provide affordable individual health insurance coverage for residents of North Carolina who do not have access to an employer health plan. It also offers coverage to individuals who are federally defined as HIPAA eligible, or qualify under the Health Coverage Tax Credit due to loss of employment due to the effects of international trade.

The Pool is a non-profit entity organized under IRC section 501(c)(26) and is deemed a component unit of the State of North Carolina. The Pool is governed by its own Board of Directors.

In July 2007, the Pool contracted with the Centers for Medicare and Medicaid Services to administer the newly established Pre-Existing Condition Insurance Plan (PCIP) or federal risk pool that was the first major initiative under the Affordable Care Act. This is a separate pool with strict rules on non-commingling of funds that the Pool runs parallel to the state high risk pool. Funding is provided by the federal government to supplement member premiums. As opposed to the state pool, eligibility is limited to individuals who have been without creditable coverage for at least 6 months.

Financial Reporting Entity

The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. The Pool is a component unit of the State of North Carolina and is an integral part of the State's *Comprehensive Annual Financial Report*.

Component units are legally separate entities for which the State is financially accountable. Accountability is defined as the State's substantive appointment of a majority of the component unit's governing board. Furthermore, the State must be able to impose its will upon the component unit or there must be a possibility that the component unit may provide specific benefits to, or impose specific financial burdens on, the State.

The Pool is governed by a 12-member board. As required by General Statute, the Commissioner of Insurance serves as an ex-officio, nonvoting member, one member is appointed by the Governor, two members are appointed by the General Assembly, and eight members are appointed by the Commissioner of Insurance. The State has obligated itself to provide significant funding to the Pool, creating a financial benefit/burden relationship. Because of the State's appointment of the board and the benefit/burden relationship, the Pool is a component unit of the State of North Carolina and the Pool's financial statements are included in the State's *Comprehensive Annual Financial Report*.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Financial Reporting Entity (Continued)

The accompanying financial statements for the Pool are separate and apart from those of the State of North Carolina and do not present the financial position of the State nor changes in the State's financial position and cash flows.

Basis of Presentation

The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America using the accrual method of accounting as it relates to proprietary fund activities of governmental entities.

The Pool's financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *"Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments."* The financial statement presentation provides a comprehensive look at the total entity.

GASB Statement No. 34 identified three types of special-purpose governments (SPG): 1) those engaged only in governmental activities, 2) those engaged only in business-type activities, and 3) those engaged in both governmental and business-type activities. Business-type activities are financed in whole or in part by fees charged to external parties for goods and services.

The Pool adopted the financial reporting model required of SPG's engaged in business-type activities (BTA). Entities reporting as BTAs follow GASB standards applicable to proprietary (enterprise) funds. The BTA model requires the following financial statement components:

- Management's Discussion and Analysis
- Statements of Net Assets
- Statements of Revenues, Expenses and Changes in Net Assets
- Statements of Cash Flows
- Notes to Financial Statements

The financial statements of the Pool have been prepared on the accrual basis of accounting whereby all revenues are recorded when earned and all expenses are recorded when they have been reduced to a legal contractual obligation to pay. The statements are intended to report the Pool as an economic unit that includes all measurable assets and liabilities and capital of the Pool.

The Statement of Revenues, Expenses, and Changes in Net Assets for special-purpose governments engaged in business-type activities (BTA) requires an operating/nonoperating format to be used. The Statement of Cash Flows is presented under the direct method, which depicts cash flows from operating activities and a reconciliation of operating cash flows to operating income.

GASB Statement No. 20, *"Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,"* as amended by GASB Statement No. 29, *"The Use of Not-For-Profit Accounting and Financial Reporting Principles by Governmental Entities,"* permits such entities to apply all those Financial Accounting Standards Board (FASB)

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Basis of Presentation (Continued)

Statements and Interpretations issued after November 30, 1989 that are developed for business enterprises except for those that conflict with or contradict GASB pronouncements. The Pool has elected not to implement FASB pronouncements issued after that date for any proprietary fund type activity. One of the primary purposes of financial reporting is to account for resources received and used, as well as accounted for and reported. In certain situations, both restricted and unrestricted net assets may be available to cover an expense incurred. In those few cases, as long as the expense meets all of the requirements of the restricted net assets, restricted resources would be applied first.

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that directly affect the results of reported amounts and disclosures. Accordingly, actual results may differ from these estimates.

Net Assets

The Pool's net assets are classified as Invested in capital assets, which represents the Pool's total investment in capital assets, and Unrestricted net assets, which include all resources not invested in capital assets.

Cash and Cash Equivalents

Cash and cash equivalents include demand deposits and highly liquid financial instruments with an original maturity of three months or less at the date of acquisition. The Pool's cash equivalents consist of a money market account with a bank.

Investments

The Pool's investments with a maturity of more than one year at acquisition and non-money market investments are reported at fair value as determined by quoted market prices. The net change in the fair value of investments is recognized as a component of investment income.

Premiums Receivable

The Pool grants credit to policyholders for premiums. Collateral is not required to secure receivables. Premiums receivable are recorded at their net realized values. Management accounts for bad debts using the allowance method. Management reviews all outstanding accounts receivable and estimates an allowance based on the age of the accounts, credit worthiness of the member, and historical payments. The allowance for doubtful accounts at June 30, 2011 and 2010 was \$5,000 and \$75,000, respectively.

Amounts billed to members are generally due upon receipt and are contractually past due after 30 days. The Pool does not accrue finance charges on past due accounts. Premiums receivable net of allowance for doubtful accounts at June 30, 2011 and 2010 was \$5,053 and \$11,599, respectively.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Grants Receivable

The Pool receives funding in the form of grants from federal government agencies as discussed in Note 9. The Pool accrues grant revenue pursuant to the respective agreements. Accrued but not received grant revenue is disclosed as grants receivable in the Statements of Net Assets.

Rebates Receivable

The Pool provides pharmaceutical coverage to its policyholders. As a result, some of the pharmaceutical claim payments are for brand name drugs. The pharmaceutical benefit manager ("PBM") receives rebates from the pharmacies when some of these drugs are purchased. Pursuant to the service agreement between the Pool and the PBM, these rebates are passed on to the Pool. There is currently a two-quarter lag in the remittance of the rebates to the Pool. The Pool currently estimates the rebates related to the prior two quarters, and discloses this amount as rebates receivable in the Statements of Net Assets.

Capital Assets

Capital assets are recorded at cost or fair value at the date of donation. Depreciation is computed on a straight-line basis over the estimated useful lives of the assets, which vary between five and seven years. Depreciation expense for the years ended June 30, 2011 and 2010 was \$2,081 and \$2,081, respectively.

Expenditures for repairs and maintenance are charged to expense as incurred. The costs of major renewals and betterments in excess of \$500, and a life in excess of one year, are capitalized. The cost and related accumulated depreciation of property and equipment are removed from the books upon retirement or other disposition; any resulting profit or loss is reflected in the Statements of Revenues, Expenses and Changes in Net Assets.

Unpaid Claims and Claims Adjustment Expenses

Unpaid claims and claims adjustment expenses are charged to operations as incurred. The Pool does not discount the liabilities for unpaid claims and claims adjustment expenses. Liabilities for unpaid claims and claims adjustment expenses are actuarially determined based on historical experience and include both reported but not paid and incurred but not reported claims. Those estimates are subject to the effects of trends in claim severity and frequency. Although considerable variability is inherent in such estimates, management believes the liabilities for unpaid claims and claim adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Unearned Federal Grant Revenue

The Pool receives funding from CMS to provide premium subsidies for policyholders and applicants that qualify. The obligated unearned grant revenue represents the Pools estimate for the amount of premium subsidy payments current policy holders would receive through the end of the grant year,

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Unearned Federal Grant Revenue (Continued)

December 31, 2011. The unobligated unearned grant revenue is the difference between the amount obligated for current policy holders and the maximum funds available through December 31, 2011 per the grant agreement.

Revenue Recognition

Premiums are generally recognized as revenue during the month coverage is afforded to the member. The portion of premiums that are collected in advance of their effective dates are deferred and reported as advance premiums in the Statements of Net Assets.

The Pool classifies its revenues as operating or nonoperating in the accompanying Statements of Revenues, Expenses and Changes in Net Assets. Operating revenues generally result from providing services in connection with the Pool's ongoing operations. Operating revenues include activities that have characteristics of exchange transactions. Nonoperating revenues are from public funding sources of the State of North Carolina and the Federal government. For the years ended June 30, 2011 and 2010, nonoperating revenue sources accounted for 31% and 40% of all revenues, respectively.

Reinsurance

The Pool limits the maximum net loss that can arise from large claims by reinsuring (or ceding) certain levels of risk with a reinsurer under a reinsurance treaty. Ceded reinsurance is treated as the risk and liability of the reinsuring company. Amounts recoverable from the reinsurer are estimated and recognized in a manner consistent with the claim liabilities arising from reinsured policies including incurred but not reported claims.

Income Taxes

The Pool is exempt from payment of income taxes under the provision of Section 501(c)(26) of the Internal Revenue Code, except to the extent of taxes on any unrelated business income. The Pool had no unrelated business income during the years ended June 30, 2011 and 2010.

Reclassifications

Certain amounts in the 2010 financial statements have been reclassified to conform to the 2011 presentation.

NOTE 2 - INVESTMENTS

The Pool's investment policy was adopted by the Board of Directors in August 2009 and is designated to protect the Pool's capital, while providing liquidity for disbursement needs and maximizing investment returns. The Pool is invested in fixed income securities and mutual funds.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 2 - INVESTMENTS (CONTINUED)

As of June 30, 2011 and 2010, the Pool had the following investments and maturities:

| Investment Type | 2011 | | | 2010 |
|-------------------------|----------------------|---------------------|---------------------|----------------------|
| | Fair Value | Less than 1 Year | Over 1 Year | Fair Value |
| Mutual funds | \$ 5,934,675 | \$ 5,934,675 | \$ - | \$ 9,366,860 |
| Certificates of deposit | 2,749,625 | 750,000 | 1,999,625 | - |
| Corporate bonds | 4,706,509 | 250,388 | 4,456,121 | 4,979,979 |
| Municipal bonds | 364,430 | - | 364,430 | 3,400,000 |
| | <u>\$ 13,755,239</u> | <u>\$ 6,935,063</u> | <u>\$ 6,820,176</u> | <u>\$ 17,746,839</u> |

Interest Rate Risk

The Pool uses the duration method as a means of limiting its exposure to fair value losses arising from rising interest rates. The Pool's investment policy limits the duration of investments in fixed income securities to securities maturing no more than five years from the date of purchase. All corporate bonds have a maturity within five years of the date of purchase; however, the municipal bond category contains variable rate demand notes ("VRDN"). These issues can be put back to the issuers with a seven-day notice. This liquidity provision is backed by letters of credit from independent banks, assuring the Pool can redeem the bonds at par plus accrued interest within the seven-day period. The legal maturity dates for the VRDN's are more than five years from date of purchase.

Credit Risk

The Pool's investment policy requires that all investments in corporate bonds maintain a rating of BBB or better by Standard and Poor's, or Baa2 or better by Moody's. Investments in state and local government obligations must maintain a MIG1, SPI, AAA or Aaa from the applicable rating agencies.

The ratings of the corporate and municipal bonds as of June 30, 2011 are as follows:

| Type of Bonds | S&P | Moody | Market Value |
|---------------|-----------------|-------|--------------|
| Corporate | A+ | A2 | \$ 266,168 |
| | A | A2 | 1,307,390 |
| | A | A1 | 266,695 |
| | AA- | A1 | 263,773 |
| | A- | N/R | 210,932 |
| | BBB | Baa2 | 530,678 |
| | BBB+ | Baa1 | 1,011,558 |
| | A- | A3 | 584,313 |
| | BBB+ | A3 | 265,002 |
| | Total corporate | | |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 2 - INVESTMENTS (CONTINUED)

Credit Risk (Continued)

| <u>Type of Bonds</u> | <u>S&P</u> | <u>Moody</u> | <u>Market Value</u> |
|----------------------|----------------|--------------|---------------------|
| Municipal | AA/-1+ | Aa2 | \$ 127,852 |
| | AA-/A-1 | Aa2 | 130,158 |
| | AA+/-1+ | Aa2 | <u>106,420</u> |
| Total municipal | | | <u>364,430</u> |
| Total | | | <u>\$ 5,070,939</u> |

NOTE 3 - CASH AND CASH EQUIVALENTS

The Pool maintains its cash balances in a federally insured banking institution. The Pool had cash balances at June 30, 2011 as follows:

| | <u>Carrying Amount</u> | <u>Bank Balance</u> |
|------------------------------|----------------------------|-------------------------|
| Cash | \$ 4,407,291 | \$ 6,361,747 |
| Money market account at bank | 4,468,946 | 4,468,946 |
| Money market fund | <u>20,981,887</u> | <u>20,981,887</u> |
| | <u>\$ 29,858,124</u> | <u>\$ 31,812,580</u> |

Custodial credit risk is the risk that, in the event of a bank failure, the Pool's deposits may not be returned. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are (a) uncollateralized, (b) collateralized with securities held by pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent, but not in the Pool's name.

At June 30, 2011, \$250,000 of the cash bank balance was covered by FDIC insurance. However, the money market account was not covered by FDIC insurance or collateralized, and as such, was exposed to custodial credit risk. In addition, the Pool had certificates of deposit with a bank and book balance of \$2,749,625 in a banking institution. At June 30, 2011, \$2,749,625 of these certificates of deposit were covered by FDIC insurance.

The Pool may only invest unspent funds in interest-bearing bank accounts.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Pool's policy for managing its exposure to fair value loss arising from increasing interest rates is to maintain its cash and cash equivalents in savings and money market accounts.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 4 - CHANGE IN CAPITAL ASSETS

| | <u>Beginning Balance</u> | <u>Additions and Transfers</u> | <u>Deletions and Transfers</u> | <u>Ending Balance</u> |
|-----------------------------|------------------------------|--|--|---------------------------|
| Depreciable capital assets: | | | | |
| Furniture and equipment | \$ 12,623 | \$ - | \$ - | \$ 12,623 |
| Accumulated depreciation | <u>(4,392)</u> | <u>(2,081)</u> | <u>-</u> | <u>(6,473)</u> |
| Net | <u>\$ 8,231</u> | <u>\$ (2,081)</u> | <u>\$ -</u> | <u>\$ 6,150</u> |

NOTE 5 - LIABILITY FOR UNPAID CLAIMS AND CLAIMS ADJUSTMENT EXPENSES

Activity in the liability for unpaid claims is summarized as follows:

| | <u>2011</u> | <u>2010</u> |
|----------------------|---------------------|---------------------|
| Balance at July 1 | <u>\$ 3,544,138</u> | <u>\$ 2,441,306</u> |
| Incurred related to: | | |
| Current year | 39,193,297 | 15,473,911 |
| Prior years | <u>(1,269,852)</u> | <u>(1,760,182)</u> |
| Total incurred | <u>37,923,445</u> | <u>13,713,729</u> |
| Paid related to: | | |
| Current year | 31,942,348 | 11,944,083 |
| Prior years | <u>1,797,148</u> | <u>666,814</u> |
| Total paid | <u>33,739,496</u> | <u>12,610,897</u> |
| Balance at June 30 | <u>\$ 7,728,087</u> | <u>\$ 3,544,138</u> |

The changes in estimates are generally the result of ongoing analysis of claim development trends. Original estimates are adjusted as additional information becomes known regarding individual claims. As a result of changes in estimates of insured events in prior years, the liability for unpaid claims and claim adjustment expenses decreased by \$1,269,852 in fiscal 2011 and \$1,760,182 in fiscal 2010.

NOTE 6 - REINSURANCE ACTIVITY

The Pool cedes a portion of its direct business to a reinsurance company. Such reinsurance includes excess of loss on certain coverages. The Pool retains a maximum of \$300,000 of coverage per covered person, subject to a 90% coinsurance. The liability to the reinsurer is also limited to \$630,000 per covered person, subject to a lifetime limit of \$1,000,000. This reinsurance contract does not relieve the Pool from its obligations to policyholders. Failure of the reinsurer to honor its obligations could result in losses to the Pool; consequently, allowances are established for amounts deemed uncollectible. No such allowances were considered necessary for 2011 or 2010. The Pool does not generally require collateral to secure reinsurance recoverables, but periodically evaluates the financial condition of the reinsurer and monitors concentrations of credit risk arising from similar

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 6 - REINSURANCE ACTIVITY (CONTINUED)

geographic regions, activities, or economic characteristics of the reinsurer to minimize its exposure to significant losses from reinsurer insolvency.

Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy. At June 30, 2011 and 2010, there were no net reinsurance recoverables, funds held, reinsurance treaties or "pre-pays" from the reinsurance company.

The effect of reinsurance on premiums written and earned for the years ended June 30 are as follows:

| | 2011 | | 2010 | |
|--------|----------------------|----------------------|----------------------|----------------------|
| | Written | Earned | Written | Earned |
| Direct | \$ 33,820,238 | \$ 33,820,238 | \$ 15,795,228 | \$ 15,795,228 |
| Ceded | <u>(717,317)</u> | <u>(717,317)</u> | <u>(471,984)</u> | <u>(471,984)</u> |
| Net | <u>\$ 33,102,921</u> | <u>\$ 33,102,921</u> | <u>\$ 15,323,244</u> | <u>\$ 15,323,244</u> |

There were recoveries related to claims incurred under the reinsurance contracts of \$136,232 and \$0, which were deducted from claims expense for 2011 and 2010, respectively.

NOTE 7 - LEASE COMMITMENTS

The Pool has entered into an operating lease for its office space. The lease expires December 31, 2013. Lease expense for the year ended June 30, 2011 was \$18,042. Future minimum rental payments at June 30, 2011 are:

| | |
|------|------------------|
| 2012 | \$ 18,584 |
| 2013 | <u>9,810</u> |
| | <u>\$ 28,394</u> |

NOTE 8 - RETIREMENT PLAN

The Pool has established a 401(k) plan for its employees. Employees who meet age and length of service requirements are eligible to participate. The Pool matches employee contributions at 100% to a maximum of 6% of eligible salary. For the years ended June 30, 2011 and 2010, the Pool's contributions to the plan were \$16,221 and \$11,494 based on eligible salaries of \$270,347 and \$191,570, respectively.

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE 9 - PUBLIC FUNDING

The State Pool’s major source of nonoperating revenue was funding from the State of North Carolina based on premium taxes assessed on health insurance policies issued throughout the State and funding through the Department of Health and Human Services (“HHS”) to reimburse allowable expenses incurred to operate the high risk health pool.

It is uncertain as to the level of premium tax revenue that will be received in the future. General economic and insurance market conditions throughout the State of North Carolina will negatively or positively affect the amount of premium tax collected in a given year. Without continued future State revenues, there exists the possibility that premium revenue will not be sufficient in future years to cover all claims and other expenses of the Pool.

The State Pool also utilizes grant income from the Federal Centers for Medicare and Medicaid Services (“CMS”) to provide premium subsidies to applicants who qualify based on income. Future grant income is dependent upon annual reauthorization in the federal budget and thus is subject to uncertainty given the current budgetary situation. As a result, estimated yearly options may differ from actual funding allowable from HHS.

Federal pool premiums are supplemented with federal funding from CMS that is provided in response to invoiced reasonable costs from the Pool. Although the federal pool identified an initial per capita based allocation for North Carolina, this allocation is not guaranteed and is also subject to the federal budget process and to the reallocation to other state as needs require.

NOTE 10 - RISK MANAGEMENT

The Pool is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets; errors and omissions; injuries to employees; employees’ health and life; and natural disaster. The Pool manages these various risks of loss as follows:

| <u>Type of Loss</u> | <u>Method Managed</u> | <u>Risk of Loss Retained</u> |
|--|--------------------------------|------------------------------|
| Torts, errors and omissions, health and life | Purchased commercial insurance | None |
| Workers Compensation – employee injuries | Purchased commercial insurance | None |
| Physical property loss and natural disasters | Purchased commercial insurance | None |

Management believes such coverage is sufficient to preclude any significant losses to the Pool. Settled claims have not exceeded this insurance coverage in any of the past three fiscal years.

REQUIRED SUPPLEMENTARY INFORMATION

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
THREE-YEAR CLAIMS DEVELOPMENT INFORMATION (UNAUDITED)
June 30, 2011 and 2010

The table below illustrates how the Pool's earned premiums (net of reinsurance) and investment income compare to related costs of loss (net of loss assumed by reinsurers) and other expenses assumed by the Pool as of the end of each of the three years since inception. The rows of the table are defined as follows: (1) This line shows that the total of each fiscal year's earned and ceded premiums, administrative fees, other operating, and investment revenues. (2) This line shows each fiscal year's other operating costs of the Pool including overhead and unallocated claims expenses not allocable to individual claims. (3) This line shows the Pool's incurred and ceded 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 occurred (called accident year). (4) These lines show the cumulative amounts paid as of the end of successive years for each accident year. (5) This line shows the most current estimate of losses assumed by reinsurers for each accident year. (6) These lines show how each accident year's incurred claims increased or decreased as of the end of successive years. This annual re-estimate results from new information received on known claims, re-evaluation of existing information on known claims, as well as emergence of new claims previously known. (7) This line compares the latest re-estimated net incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of net claims cost is greater or less than originally thought. As data for individual accident 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 accident years. The columns of the table show data for successive accident years.

| | <u>2009</u> | <u>2010</u> | <u>2011</u> |
|--|----------------|----------------|------------------|
| 1) Premiums, investment, and other revenues | | | |
| Premiums earned, net | \$ 2,607,553 | \$ 15,323,244 | \$ 33,102,921 |
| State and federal aid revenue | 22,871,880 | 10,453,118 | 14,505,740 |
| Investment income | <u>212,195</u> | <u>342,675</u> | <u>466,926</u> |
| Net earned | 25,691,628 | 26,119,037 | 48,075,587 |
| 2) Unallocated expenses | 1,220,826 | 2,208,772 | 4,939,988 |
| 3) Estimated incurred claims and allocated claims adjustment expenses, end of accident year: | | | |
| Gross | 4,337,287 | 15,473,911 | 39,329,529 |
| Ceded | <u>-</u> | <u>-</u> | <u>(136,232)</u> |
| Net incurred | 4,337,287 | 15,473,911 | 39,193,297 |
| 4) Paid (cumulative) claims and allocated claims adjustment expense as of: | | | |
| End of accident year | 1,895,981 | 11,944,083 | 31,942,348 |
| One year later | 2,562,795 | 13,733,970 | - |
| Two years later | 2,570,056 | - | - |
| 5) Reestimated ceded claims and expenses | - | - | 136,232 |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
THREE-YEAR CLAIMS DEVELOPMENT INFORMATION (UNAUDITED)
June 30, 2011 and 2010

| | <u>2009</u> | <u>2010</u> | <u>2011</u> |
|--|--------------|---------------|---------------|
| 6) Reestimated net incurred claims and allocated claims adjustment expense: | | | |
| End of accident year | \$ 4,337,287 | \$ 15,473,911 | \$ 39,193,297 |
| One year later | 2,667,105 | 14,208,798 | - |
| Two years later | 2,662,366 | - | - |
| 7) Decrease in estimated net incurred claims and allocated claims adjustment expense from end of accident year | (1,674,921) | (1,265,113) | - |

Note: Only three years of information is presented as the Pool, which represents inception through June 30, 2011. The above financial data is summarized for individual contract periods. Subsequent premium and related expense adjustments and reserve developments are recorded in the year incurred for fiscal year financial reporting, but are included in the applicable contract year for purposes of the above schedule. Accordingly, components of change in net assets as determined on a contract-year basis will differ from that included in the Pool's fiscal-year financial statements.

OTHER FINANCIAL INFORMATION

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
SCHEDULE OF OTHER EXPENSES
June 30, 2011 and 2010

| | <u>2011</u> | <u>2010</u> |
|------------------------------|---------------------|---------------------|
| CONTRACTUAL EXPENSES | | |
| Accounting | \$ 70,716 | \$ 48,543 |
| Actuarial services | 64,214 | 64,079 |
| Administrative services | 2,642,723 | 1,111,283 |
| Audit services | 38,424 | 27,936 |
| Communication/Outreach | 661,071 | 143,983 |
| Legal | 45,028 | 25,806 |
| PBM procurement | 5,513 | 35,644 |
| Producer compensation | 686,789 | 220,550 |
| Other contractual expenses | 3,139 | 13,897 |
| | <u>4,217,617</u> | <u>1,691,721</u> |
| PERSONNEL EXPENSES | | |
| Insurance | 20,373 | 10,712 |
| Payroll taxes | 19,505 | 12,209 |
| Retirement plan contribution | 16,221 | 13,349 |
| Salaries | 270,347 | 177,540 |
| Travel | 15,095 | 13,141 |
| Other personnel expenses | 7,152 | 10,449 |
| | <u>348,693</u> | <u>237,400</u> |
| GENERAL EXPENSES | | |
| Bad debts | (70,000) | (25,000) |
| Insurance | 18,790 | 15,574 |
| Postage and delivery | 4,953 | 8,266 |
| Rent | 18,042 | 17,766 |
| Telephone | 9,893 | 8,205 |
| Other general expenses | 100,551 | 62,840 |
| | <u>82,229</u> | <u>87,651</u> |
| | <u>\$ 4,648,539</u> | <u>\$ 2,016,772</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
STATEMENTS OF NET ASSETS BY PROGRAM
June 30, 2011

| | <u>State</u> | <u>Federal</u> | <u>Eliminations</u> | <u>Total</u> |
|--|-----------------------------|----------------------------|---------------------------|-----------------------------|
| ASSETS | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | \$ 26,693,166 | \$ 3,164,958 | \$ - | \$ 29,858,124 |
| Fixed income securities | 1,000,388 | - | - | 1,000,388 |
| Equity securities | 5,934,675 | - | - | 5,934,675 |
| Accrued interest | 97,058 | - | - | 97,058 |
| Premiums receivable, net of allowance of \$2,500 and \$2,500 in State and Federal Pool, respectively | 2,265 | 2,788 | - | 5,053 |
| Grants receivable | 1,099,422 | 679,944 | - | 1,779,366 |
| Rebates receivable | 841,972 | 93,144 | - | 935,116 |
| Due from federal risk pool | 88,559 | - | (88,559) | - |
| Other assets | 248,400 | - | - | 248,400 |
| Total current assets | <u>36,005,905</u> | <u>3,940,834</u> | <u>(88,559)</u> | <u>39,858,180</u> |
| Noncurrent assets: | | | | |
| Fixed income securities | 6,820,176 | - | - | 6,820,176 |
| Capital assets, net of accumulated depreciation \$6,473 and \$0 in State and Federal Pool, respectively | 6,150 | - | - | 6,150 |
| Total noncurrent assets | <u>6,826,326</u> | <u>-</u> | <u>-</u> | <u>6,826,326</u> |
| TOTAL ASSETS | <u>\$ 42,832,231</u> | <u>\$ 3,940,834</u> | <u>\$ (88,559)</u> | <u>\$ 46,684,506</u> |
| LIABILITIES AND NET ASSETS | | | | |
| LIABILITIES | | | | |
| Unpaid claims and claims adjustment expenses | \$ 5,054,674 | \$ 2,673,413 | \$ - | \$ 7,728,087 |
| Accounts payable | 11,004 | 28,734 | - | 39,738 |
| Unearned federal grant revenue | | | | |
| Obligated grant | 970,284 | - | - | 970,284 |
| Unobligated grant | 129,138 | - | - | 129,138 |
| Advance premiums | 466,016 | 581 | - | 466,597 |
| Unapplied premiums | 1,483 | 1,372 | - | 2,855 |
| Due to state risk pool | - | 88,559 | (88,559) | - |
| Other liabilities | 18,613 | 1,311 | - | 19,924 |
| Total current liabilities | <u>6,651,212</u> | <u>2,793,970</u> | <u>(88,559)</u> | <u>9,356,623</u> |
| NET ASSETS | | | | |
| Invested in capital assets | 6,150 | - | - | 6,150 |
| Unrestricted | 36,174,869 | 1,146,864 | - | 37,321,733 |
| Total net assets | <u>36,181,019</u> | <u>1,146,864</u> | <u>-</u> | <u>37,327,883</u> |
| TOTAL LIABILITIES AND NET ASSETS | <u>\$ 42,832,231</u> | <u>\$ 3,940,834</u> | <u>\$ (88,559)</u> | <u>\$ 46,684,506</u> |

THE NORTH CAROLINA HEALTH INSURANCE RISK POOL, INC.
d/b/a INCLUSIVE HEALTH
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS BY PROGRAM
Year Ended June 30, 2011

| | <u>State</u> | <u>Federal</u> | <u>Eliminations</u> | <u>Total</u> |
|-------------------------------|----------------------|---------------------|---------------------|----------------------|
| OPERATING REVENUES | | | | |
| Premiums earned, net | \$ 30,279,529 | \$ 2,823,392 | \$ - | \$ 33,102,921 |
| TOTAL OPERATING REVENUES | <u>30,279,529</u> | <u>2,823,392</u> | <u>-</u> | <u>33,102,921</u> |
| OPERATING EXPENSES | | | | |
| Claims expense | 30,849,034 | 7,074,411 | - | 37,923,445 |
| Contractual expenses | 2,902,392 | 1,315,225 | - | 4,217,617 |
| Personnel expenses | 162,595 | 186,098 | - | 348,693 |
| General expenses | 44,163 | 38,066 | - | 82,229 |
| TOTAL OPERATING EXPENSES | <u>33,958,184</u> | <u>8,613,800</u> | <u>-</u> | <u>42,571,984</u> |
| NET OPERATING LOSS | (3,678,655) | (5,790,408) | - | (9,469,063) |
| NONOPERATING REVENUE | | | | |
| State aid | 6,581,804 | - | - | 6,581,804 |
| Federal aid | 986,664 | 6,937,272 | - | 7,923,936 |
| Investment income | 466,926 | - | - | 466,926 |
| TOTAL NONOPERATING REVENUE | <u>8,035,394</u> | <u>6,937,272</u> | <u>-</u> | <u>14,972,666</u> |
| CHANGE IN NET ASSETS | 4,356,739 | 1,146,864 | - | 5,503,603 |
| NET ASSETS, BEGINNING OF YEAR | <u>31,824,280</u> | <u>-</u> | <u>-</u> | <u>31,824,280</u> |
| NET ASSETS, END OF YEAR | <u>\$ 36,181,019</u> | <u>\$ 1,146,864</u> | <u>\$ -</u> | <u>\$ 37,327,883</u> |



DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

***Independent Auditor's Report on Internal Control over
Financial Reporting and on Compliance and Other Matters
Based on an Audit of the Financial Statements Performed in
Accordance with Government Auditing Standards***

Board of Directors
The North Carolina Health Insurance Risk Pool, Inc.
d/b/a Inclusive Health
Raleigh, North Carolina

We have audited the basic financial statements of The North Carolina Health Insurance Risk Pool, Inc. d/b/a Inclusive Health (the Pool), a component unit of the State of North Carolina, as of and for the years ended June 30, 2011 and 2010, and have issued our report thereon dated November 1, 2011. 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 Pool's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Pool's internal control over financial reporting. Accordingly we do not express an opinion on the effectiveness of the Pool's internal control over financial reporting.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified.

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

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following significant deficiencies in the Company's internal controls:

Recognition of Federal Contract Revenue

During the course of the audit, we noted the Pool was not accruing contract revenue related to the reimbursable expenses for operating a temporary high risk health insurance pool as allowable between the Department of Health and Human Services (HHS) and the Pool on a timely basis. All HHS reimbursable expenses should be accrued as incurred in accordance with the matching principle. The matching principle dictates revenues and expenses are recorded in the period they are incurred. At times, these expenses are paid out of the State funds, and if so, the Pool needs to properly reconcile the inter-pool receivable/payable for expenses paid by the State, but reimbursed by HHS to the Federal Pool. We recommend management perform monthly reconciliations of the inter-pool receivable/payable accounts. This approach should allow for the Pool to identify reimbursable expenses, accrue revenue as earned, and accurately reflect the inter-pool receivable/payable.

Management's Response:

The Pool accrued federal high risk pool revenue in two places on the Combined Balance Sheet during the 2010-2011 fiscal year. Under Other Current Assets is an entry entitled "Due from Federal Risk Pool" that includes the monthly amount payable by the federal risk pool to the state pool for the former's share of fixed overhead. Under Liabilities is an offsetting entry "Due to the State Pool". Each of these are updated monthly based on actual expenses. We believe this satisfies the matching principle in that both expenses and revenues are recorded in the period they are incurred.

To be clear, all federal expenses including the federal share of fixed overhead are reported monthly to the federal government in the period in which they are incurred. Based on this, a drawdown is done and payment is transferred to the federal Pool account within 48 to 72 hours. In the past fiscal year, a reconciliation was then conducted on a quarterly basis involving a transfer of funds from the federal to the state pool account to cover the federal share of fixed expenses from the prior quarter.

Going forward, these monthly accrual entries will be reflected in the newly split state and federal balance sheets. The Pool will also reconcile the fixed overhead on a monthly rather than a quarterly basis to replenish the state pool account more frequently.

Improved Coordination between Management and Third-Party Administrators

The Pool outsources the majority of daily functions to various external parties. During the course of the audit, we noted that the Pool's external accountant ("accountant") used several reports from various third-party administrators ("TPA") to record claims. There appears to be a lack of communication between the TPAs and the accountant. This lack of communication has led to unidentified differences between the reports provided by the TPAs and the

amounts recorded as claims expense. We suggest management facilitate regular meetings with all external parties to ensure all information is being recorded as intended and that all parties have access to all relevant information needed to perform their duties.

Management's Response:

Following last year's audit, the Pool convened the accountant, premium collection, and for the first few meetings, the actuary as well on a monthly and then a quarterly basis. The main focus of these meetings was the discussion and regular reconciliation of outstanding premium accounts receivable balances. This led to an immediate and steady decline in the ongoing balance.

Following the success of this effort, the Pool will expand the scope of these meetings to cover claims reporting and reconciliation as well. Regular comparisons of reports to the amounts recorded in the general ledger will be conducted no less than quarterly with the Pool accountant, CoreSource claims and premium collection, and MedTrak claims to ensure proper reconciliation and classification of expenses.

Compliance and Other Matters

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

We noted certain matters that we reported to management of the Pool in a separate letter dated November 1, 2011.

Pool management's response to the significant deficiencies in internal control is described above. We did not audit their response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Board of Directors, management, the Governor, and the General Assembly of North Carolina and is not intended to be and should not be used by anyone other than these specified parties.

Dixon Hughes Goodman LLP

November 1, 2011