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**TESTIMONY BEFORE THE INTERIM  
INDUSTRY BUSINESS AND LABOR COMMITTEE**  
July 9, 2008

Testimony Presented By: Robert R. Peterson

Chairman Berg and members of the Industry, Business and Labor Committee

Thank you for the opportunity to appear before your committee to address my office's concerns expressed in our request for a formal Attorney General's opinion as to WSI's compliance with North Dakota Century Code Section 65-04-02 relating to the agency's financial reserves plus surplus. The section of the code specifically states the "level of financial reserves plus surplus must be at least one hundred twenty percent but may not exceed one hundred forty percent of the established discounted reserve." The section goes on to require the annual financial report of WSI to report the financial reserves.

WSI has acknowledged it has been in violation of the law since it was passed by the 2005 Legislature (April 28, 2008 meeting of this committee). The 2007 financial audit report conducted by an independent CPA firm (Brady Martz & Associates) concluded that WSI was in violation of the law and indicated WSI was approximately \$174.4 million over the amount allowed by law. The 2008 financial audit and the audit follow-up of the performance audit of WSI are both scheduled to begin this summer. This issue is relevant to both the 2008 financial audit and the performance audit follow-up.

WSI has not taken sufficient action to come into compliance with this statute and did not make any meaningful effort during the 2007 legislative session to clarify the law or to change it to allow certain offsets to the amount of reserves and surplus allowed. WSI's Board of Directors and its management team are asserting that it is legal to offset certain items (i.e. unrealized gains, and amounts set aside for safety grants and a loan program) from the calculation of the reserves plus surplus. WSI has asserted that Generally Accepted Accounting Principles (GAAP) also permit these offsets. This rationale was absent from WSI's response to the finding in the 2007 financial audit relating to WSI violating this statute. (attachment)

As a result of the above circumstances, I determined it was necessary to seek a formal Attorney General's opinion in order to resolve the issue of whether certain offsets are permitted by state law. This opinion will assist the CPA firm as well as my office in conducting our audit follow up for the 2006 performance audit.

We do not believe that the current language in statute provides authority to WSI to offset the reserves plus surplus. In addition, we do not believe any relevant, applicable GAAP permits these offsets. Instead we agree that the CPA firm was correct in concluding that WSI was violating the statute.

WSI has not provided us with any relevant, applicable Generally Accepted Accounting Principle, nor any statutory authority that allows for the offset of items in the calculation of the reserves plus surplus. Once WSI has provided this we will conduct the necessary research to arrive at our conclusion relating to their specific assertions.

As part of my testimony I've included a comparison of WSI's assets, liabilities and net assets to those of the Bank of North Dakota. While each has their own unique risks, they are in the same financial sector of our economy and they are both large state agencies. I think this comparison is useful to put the WSI reserves and surplus question in perspective. (attachment)

When looking at how much surplus WSI needs we should remember that 100% is basically what the actuary determines to be the breakeven point. In 2005 the legislature decided 20 to 40 percent more than that would be a fiscally responsible level for WSI's surplus. I believe this is where the debate should be focused. Is 20 to 40 percent more than what the actuary determines necessary fiscally responsible or not?

**2007 WSI Finding and Recommendation Relating to Illegal Fund Surplus  
(From Brady Martz & Associates Financial Statement Audit).**

*Finding 07-2*

*Criteria:* The NDCC 65-04-02. Reserves - Surplus states that the organization shall maintain adequate financial reserves to ensure the solvency of the fund and the payment of future benefit obligations, based upon actuarially sound principles. The discount rate used in evaluating the financial reserves may not exceed six percent. The level of financial reserves plus surplus must be at least one hundred twenty percent but may not exceed one hundred forty percent of the actuarially established discounted reserve. The independent annual financial audit of the organization must report the organization's financial reserves.

*Condition:* The organization's financial reserves plus surplus as of June 30, 2007 are in excess of the maximum allowed by approximately \$174.4 million.

*Cause:* The positive results of the organization's operations continue to increase the Net Assets above the statutory limit.

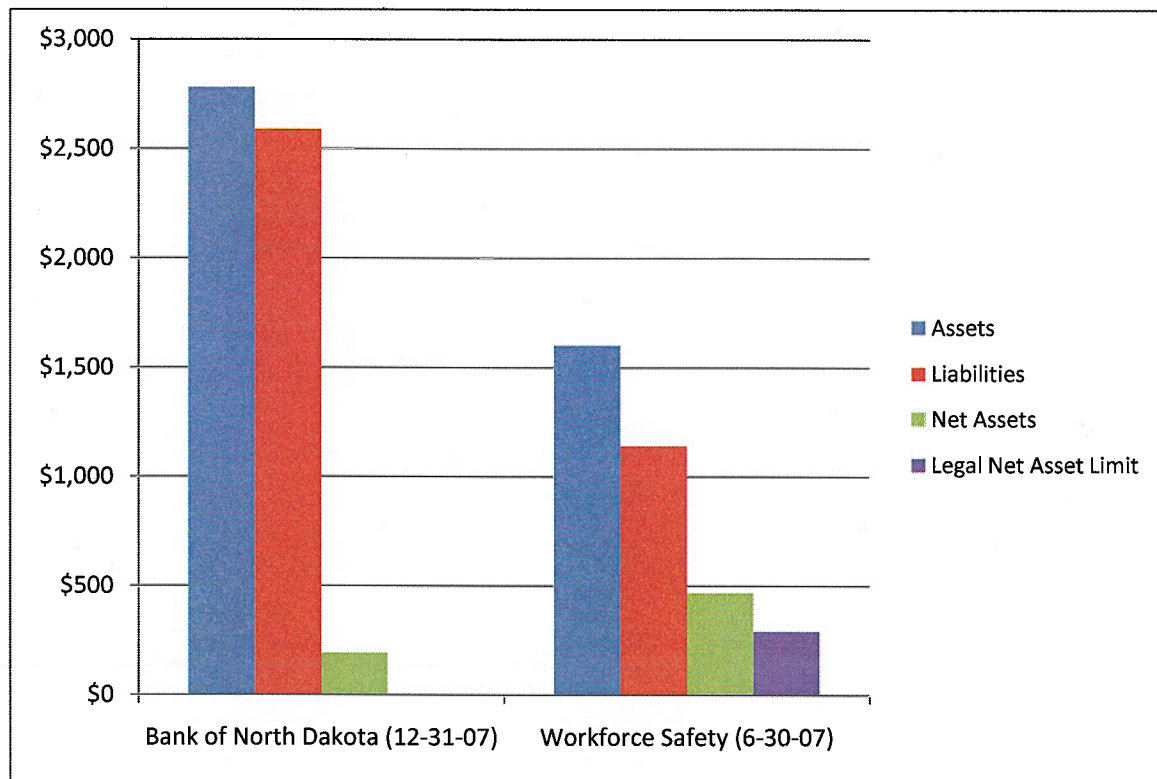
*Effect:* The organization continues to be out of compliance with the above state statute.

*Recommendation:* The organization should monitor this balance in relation to anticipated future earnings and determine an appropriate means of bringing the Net Asset balance into compliance with state law.

*Agency Response:* WSI monitors the fund surplus on a consistent basis. The WSI Board of Directors has declared a 40% dividend credit to qualified policyholders the past two years and has declared a 50% dividend credit to qualified policyholders in the current year. The WSI's Board of Directors dividend declaration is a direct attempt to align the fund balance to comply with legislative directives.

WSI considers many factors while monitoring the fund's surplus balance. WSI must maintain ample reserves to pay future losses. Legislative changes and Supreme Court rulings have the ability to greatly affect WSI liabilities. While the past year has provided ample investment revenue, future returns are uncertain. Economic conditions within the state are not static. WSI is investing more funds into safety training and education. WSI will continue working to balance the fund surplus to legislatively mandated levels while safeguarding the purpose of the agency.

### Comparison of BND and WSI Assets and Net Assets (Assets in Excess of Liabilities)



(Amounts shown in Millions)

To put the WSI reserves and surplus question in perspective:

The BND had assets of **\$2.78** billion, liabilities of **\$2.59** billion and net assets (assets in excess of liabilities) of **\$192.5** million as of December 31, 2007. The Bank's current statutory minimum capital structure is \$175 million.

WSI had assets of **\$1.6** billion, liabilities of **\$1.14** billion and net assets (assets in excess of liabilities) of **\$466.8** million, which is \$174.4 million more than allowed by NDCC 65-04-02, as of June 30, 2007. WSI's legal range for that date was \$146.2 million to **\$292.4** million.