STATE OF WEST VIRGINIA

FULL PERFORMANCE EVALUATION
OF THE

DIVISION OF WORKERS' COMPENSATION

Compliance Review of
Independent Auditor's Findings

OFFICE OF LEGISLATIVE AUDITOR
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First Report, July 1996
Second Report, September 1996

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September 5, 1996

The Honorable A. Keith Wagner
State Senate
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The Honorable Joe Martin
House of Delegates
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Gentlemen:

Pursuant to the West Virginia Sunset Law, we are transmitting this Full Performance Evaluation of the Division of Workers' Compensation, which will be reported to the Joint Committee on Government Operations on Sunday, September 15, 1996. The issue covered herein is "Compliance Review of Independent Auditor's Findings."

Please let me know if you have any questions regarding this report.

Sincerely,

Antonio E. Jones

AEJ/Ahs

Enclosure

TABLE OF CONTENTS

TABLE OF TABLES

EXECUTIVE SUMMARY

In 1991, Ernst and Young (E & Y) was employed by the Bureau of Employment Programs to audit the Workers' Compensation Division's financial statements for fiscal year 1991. In lieu of issuing financial statements for the Division, ***E & Y issued a final draft management letter on March 16, 1992 that represents the most comprehensive and up-to-date independent audit of the Workers' Compensation Division. The Performance Evaluation and Research Division is conducting a compliance review to measure the responsiveness of management to the E & Y recommendations, as well as the Division's progress toward reestablishing the security and solvency of the fund.*** Generally Accepted Government Auditing Standards (GAGAS) requires following-up the work of other auditors and places emphasis on the importance of management controls (the final draft management letter raised many management controls issues). For these reasons, as well as a desire to avoid duplication of efforts, the compliance review format was adopted.

Reported to Joint Committee on Government Operations July 14, 1996

PART 1 - GENERAL

Self-Insurance

Issue Area 1:	Approval for self-insurance was being granted on a case-by-case basis at the sole discretion of the Commissioner.
Level of Compliance:	**<u>In compliance.</u>** All applications for self-insurance must be approved by the Compensation Programs Performance Council.
Issue Area 2:	The Division should develop and implement standard procedures for reviewing the information supplied by employers.
Level of Compliance:	**<u>Partial compliance.</u>** The Division has developed a comprehensive self-insurance application process in collaboration with Ernst and Young. Full implementation of the new applications process has been achieved. However, the re-application process has not been implemented due to vacancies in key positions in the Self-Insurance Unit.

Issue Area 3:	The application/re-application reviews should be adequately documented and conclusions should be reached as to whether employers should be allowed to maintain self-insured status.
Level of Compliance:	**<u>In compliance.</u>** The Self-insurance Unit presents appropriately detailed reports to the Compensation Programs Performance Council (CPPC) which include the recommendations of management.
Issue Area 4:	The Division should change its surety policy to avoid putting the fund in a liability position.
Level of Compliance:	**<u>Partial compliance.</u>** The Division has developed a policy which requires all self-insured employers to provide surety equal to the larger of one-million dollars or the actuarially-determined liability of the firm. Other than new self-insurers, the policy has only been enforced on six employers because of vacancies in key positions in the Self-Insurance Unit.
Issue Area 5:	The Division should require self-insured employers to submit audited financial statements and proof of required amount of surety bond within 90 days of their fiscal year end.
Level of Compliance:	**<u>Partial compliance.</u>** Because of staffing difficulties, the Division is currently not requesting self-insured employers to submit re-application materials. Proof of surety issues are being adequately addressed. The Division's new processes, policies and procedures manuals adequately address this issue.

Issue Area 6:	The Division should develop a plan for the timely transition from self-insured to subscriber status prior to any bankruptcy petition to facilitate adequate premiums commensurate with insured risk.
Level of Compliance:	**<u>In compliance.</u>** The Division has developed a process for the revocation of self-insured status and has revoked the self-insured status of one employer. At the time the employer was transitioned to subscriber status, the Division calculated its experience modified subscriber premium rate by figuring what its rate would have been had the employer been a regular subscriber during the period of self-insurance.

Underwriting/Risk Management Initiatives

Issue Area 7:	The Division should obtain the necessary computer systems and employ experience rating formulas to increase premiums commensurate with incurred losses.
Level of Compliance:	**<u>Partial compliance.</u>** New computer systems have been installed that will enable the Division to make premiums commensurate with incurred losses. Rate making methodologies are being explored and the Division has completed a considerable amount of planning to this end. An employee of the Self-Insurance Unit is being trained to serve as a Rate making specialist.
Issue Area 8:	The Division should establish a comprehensive risk management program to work with employers to reduce exposure to injuries.
Level of Compliance:	**<u>Planned compliance.</u>** The Compensation Programs Performance Council has created a Safety and Loss Control Advisory Committee. Two administrative rules (exempt from the legislative review process) have been proposed which provide both positive and negative incentives to require or encourage employers to take certain measures to develop/maintain safe workplaces. Efforts are being made to hire a Safety Director.

Reported to Joint Committee on Government Operations September 15, 1996

Organizational Structure and Personnel Requirements

Issue Area 9:	Accounting department is grossly understaffed.
Level of Compliance:	**In Compliance.** The 1992 Final Draft Management Letter noted that the Division's accounting department "consists only of two bookkeepers." The Financial Accounting Section is now staffed up to a level of 12 employees, excluding the vacant accounting director position.
Issue Area 10:	The Division should establish a controllership function.
Level of Compliance:	**In Compliance.** The Division has fulfilled the controllership function through establishment of the Director of Financial Accounting position and WCIS Review Committee.
Issue Area 11:	The Division should hire a qualified in-house actuary.
Level of Compliance:	**In Dispute.** The Division has not hired an in-house actuary. All actuarial services are being provided under contract with Milliman and Robertson, Inc. Management is currently considering hiring an Actuary-in-training and has drafted a tentative position description to that end.
Issue Area 12:	The Division should evaluate its human resource pool.
Level of Compliance:	**Partial compliance.** The Division regularly conducts employee performance evaluations and with the assistance of consultants has performed detailed human resource studies of Financial Accounting and the Claims Teams. However, the Division has not engaged in a comprehensive needs assessment and skills inventory.
Issue Area 13:	The Division should create a program for orderly staff development.

Level of Compliance:	**Partial compliance.** The Division's Training Department has been actively engaged in staff development programs. The Division lacks a comprehensive needs assessment/skills inventory to guide the development effort. In addition, training efforts have waned in first 7 months of 1996.
Issue Area 14:	The Division should actively recruit skilled employees.
Level of Compliance:	**In compliance.** Newspaper advertisements and related RFP's substantiate that recruiting efforts have been made for certain skilled positions.
Issue Area 15:	The Division should create formal job descriptions, including responsibilities and experience requirements.
Level of Compliance:	**In compliance.** The Personnel Policy and Procedures Manual includes a generic Division of Personnel position description for each job title employed by the Bureau. These descriptions include job responsibilities and required credentials. The Division has also created job-specific job descriptions for employees of the Division.
Issue Area 16:	The Division should establish an internal audit section reporting directly to the commissioner or executive director.
Level of Compliance:	**Partial compliance.** The Division has provided for limited internal audit projects through its Financial Accounting unit and the Bureau of Employment Programs' Management Analysis unit. However, neither unit provides regular, ongoing internal audit services. To the extent these units do conduct audit activities, the nature of the work is often consistent with "quality control" versus traditional internal audit work.

Financial Statement Reporting

Issue Area 17:	The Division should make necessary changes to move from cash based accounting to an accrual-based system.

Level of Compliance: **<u>In compliance.</u>** Ernst and Young issued an unqualified opinion on the combined financial statements for FY 1995. In the accompanying notes Ernst and Young confirmed the use of an accrual-based accounting system.

PART II - INTERNAL CONTROLS

Cash and Investments

Issue Area 18: The Division should provide for adequate segregation of duties for cash transactions.

Level of Compliance: **<u>Partial compliance.</u>** The division has resolved the internal control issues related to segregation of incompatible duties, as addressed in the 1992 Final Draft Management Letter. However, new segregation of duties concerns have been conceived with the reorganization of Benefits Management. Over the course of this review other cash control problems surfaced.

Issue Area 19: The Division should tighten controls over the mailroom.

Level of Compliance: **<u>Partial compliance.</u>** Mailroom controls are notably better than they were at the time the Final Draft Management Letter was issued. A few control problems persist.

COMPLIANCE SCORECARD		
Level of Compliance	**Issues**	**Percent of Total**
In Compliance	8	42.1%
Partial Compliance	9	47.4%
Planned Compliance	1	5.3%
In Dispute	1	5.3%
Non-Compliance	0	0%
Total	19	100.0%

OBJECTIVE, SCOPE AND METHODOLOGY

This full performance evaluation of the West Virginia Workers' Compensation Division was conducted in accordance with the West Virginia Sunset Law, Chapter 4, Article 10 of the *West Virginia Code.* A full performance evaluation is a means to determine for an agency whether or not the agency is operating in an efficient and effective manner and to determine whether or not there is a demonstrable need for the continuation of the agency. The evaluation will help the Joint Committee on Government Operations determine the following:

- if the agency was created to resolve a problem or provide a service;
- if the problem has been solved or the service has been provided;
- the extent to which past agency activities and accomplishments, current projects and operations and planned activities and goals are or have been effective;
- if the agency is operating efficiently and effectively in performing its tasks;
- the extent to which there would be significant and discernable adverse effects on the public health, safety or welfare if the agency were abolished;
- if the conditions that led to the creation of the agency have changed;
- the extent to which the agency operates in the public interest;
- whether or not the operation of the agency is impeded or enhanced by existing statutes, rules, procedures, practices or any other circumstances bearing upon the agency's capacity or authority to operate in the public interest, including budgetary, resource and personnel matters;
- the extent to which administrative and/or statutory changes are necessary to improve agency operations or to enhance the public interest;
- whether or not the benefits derived from the activities of the agency outweigh the costs;
- whether or not the activities of the agency duplicate or overlap with those of otheragencies, and if so, how the activities could be consolidated;
- whether or not the agency causes an unnecessary burden on any citizen by its decisions and activities;
- what the impact will be in terms of federal intervention or loss of federal funds if the agency is abolished;

The evaluation of the Division covers the period of January 1, 1992 to the present. However, events prior to this period may be included when necessary. The evaluation included a planning process and the development of audit steps necessary to collect competent, sufficient and relevant evidence to answer the audit objectives. Physical, documentary, testimonial and analytical evidence used in the evaluation was collected through interviews, review of records, and site visitations.[1] The evaluation was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States.

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[1] *Documentary evidence is created information such as letters, contracts and records. Physical evidence is the direct observation of the activities of people, property or events. Testimonial evidence consists of statements received in response to inquiries or from interviews, and analytical evidence includes the separation of information into components such as computations, comparisons and reasoning.*

Mission of the Workers' Compensation Division

...to accurately, fairly and promptly administer quality workers' compensation services through the collection of premiums from employers and the payment of benefits to injured workers and to dependents of fatally injured workers, with the intent of hastening the workers return to work.

The Workers' Compensation Division (WCD), codified in Chapter 23 of the *West Virginia Code,* was created in 1913 for the purpose of offering workers' compensation insurance. Initially an optional plan, the program became compulsory in 1974. The purpose of the program is "to provide workers with a simple method of securing immediate relief from the physical and economic effects of job related injury and disease." Further, the state is the sole provider of workers' compensation insurance. However, those employers that are eligible may opt to self-insure their workers' compensation risk. ***Although the Division is a public entity it operates like a private insurance company, collecting premiums, investing the funds, and paying benefits to injured workers making compensable claims.*** The Division administers several funds including the Workers' Compensation Fund, the Coal Workers' Pneumoconiosis Fund, Employers' Excess Liability Fund, the Disabled Workers' Relief Fund and a Surplus Fund which is made up of a Catastrophe Reserve, a Second Injury Reserve, and a Supersedeas Reserve. See APPENDIX 1 for fund administered by the Division. APPENDIX 2 contains an organizational chart of the Division.

The financial condition of the Division has eroded over many years. For FY 1989 the Division was believed to have a $404 million to $504 million deficit.[2] By FY 1995 the deficit was believed to be $1,910 million. In 1990, the Division transferred $210 million declared to be an actuarially determined surplus from the Coal Workers' Pneumoconiosis Fund to the Workers' Compensation Fund. While the assets transferred cannot be used to satisfy the debts of the Workers' Compensation Fund until all other assets of the Fund have been expended, the interest earnings may be used for this purpose.

In 1991, Ernst and Young (E & Y) was engaged in a $45,000 contract by the Bureau of Employment Programs to audit the Workers' Compensation Division's financial statements for fiscal year 1991. In lieu of issuing financial statements for the Division, ***E & Y issued a draft management letter on March 16, 1992 that found the Workers' Compensation Division to have "an overall lack of internal controls resulting in what we [Ernst and Young] consider to be a pervasive material weakness situation..."*** E & Y defined a material weakness as

[2] *Financial audits indicate the reliability of financial information pre-dating FY 1995 is highly suspect. In addition, a change in the methodology of calculating the estimated liability for unpaid claims beginning FY 1993 was made as required by GAAP. This new methodology increased the deficit, as reported, by over $565 million.*

> a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions.

The final draft management letter detailed the material weaknesses of the Division, which rendered the Division impossible to audit. In subsequent financial audits for FY 1993 and FY 1994, Ernst and Young continued to find the Division's records to be

> generally inadequate to produce reliable financial information with respect to premiums receivable from subscribers and self-insurers; premium advance deposits; and the estimated liability for unpaid claims and claim adjustment expenses, including contingent liabilities for self-insured employers who have defaulted or who may reasonably be expected to default. Additionally, weaknesses in the internal control structure are of an extent that cannot be overcome by auditing procedures.

Generally, the purpose of a financial audit is to provide the users of the resulting financial statements assurance that the financial statements do accurately represent the financial status of the auditee (an "unqualified opinion"). Because of the pervasive material weakness situation, E & Y was unable to express an opinion on the Division's financial statements. The 1993 and 1994 reports of E & Y also stated "the Division's recurring losses and deficit raise substantial doubt about its ability to continue as a going concern in its present form," meaning the Workers' Compensation Division would not be able to meet its obligations to claimants in the foreseeable future if problems were not corrected.

During the 1995 Legislative Session, the West Virginia Legislature passed S.B. 250 which made many reforms to the workers' compensation system. As a result of the legislation, the efforts of the management and employees of the Bureau and Division, and several consulting firms involved in the Division's Total Quality Initiative (TQI), the Workers' Compensation Division received its first unqualified audit opinion from Ernst and Young for fiscal year 1995. More importantly, the 1995 financial audit also marked the end of the "going concern" paragraph.

Because the 1992 Ernst and Young final draft management letter represents the most comprehensive and up-to-date independent audit of the Workers' Compensation Division, the Performance Evaluation and Research Division is conducting a compliance review to measure the responsiveness of management to the E & Y recommendations. The approach will enable us to evaluate the Division's progress toward reestablishing the security of the fund and resolving the unfunded liability. Other justifications for the selection of a compliance audit format include a desire not to duplicate the work Ernst and Young had already conducted, the 1992 final draft management letter's primary focus on management controls and the GAGAS standards requiring the following up of the work of other auditors. Excerpts of the GAGAS standards relating to the importance of management controls and the importance of checking compliance with previous audits have been included in TABLE 1.

TABLE 1
Generally Accepted Government Auditing Standards Relating to Management Controls and Compliance Reviews

Importance of Management Controls

6.39 Auditors should obtain an understanding of management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls.

6.40 Management is responsible for establishing effective management controls. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for effective management controls.

6.41 Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Standards on follow up and work of others

6.12 Auditors should follow up on significant findings and recommendations fom previous audits that could affect the audit objectives. They should do this to determine whether timely and appropriate corrective actions have been taken by auditee officials. The audit report should disclose the status of uncorrected significant findings and recommendation from prior audits that affect the audit objectives.

6.13 Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having aprocess to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to significant findings and recommendations can help auditors assure that the benefits of their work are realized.

6.14 Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. Whether other auditors have done performance audits or financial audits, they may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' section of objectives. The availability of other auditors' work may also influence the selection of methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

To assess and report on the degree of compliance by the Workers' Compensation Division with the findings and recommendations considered in the 1992 Ernst and Young final draft management letter, compliance measures have been adopted. These compliance measures are defined in TABLE 2.

TABLE 2 **Levels of Compliance**
In Compliance - The Division has corrected the problems identified in the final draft management letter.
Partial Compliance - The Division has partially corrected the problems identified in the final draft management letter.
Planned Compliance - The Division has not corrected the problem but has provided sufficient documentary evidence to find that the agency will do so in the future.
In Dispute - The Division does not agree with either the problem identified or the proposed solution.
Non-Compliance - The Division has not corrected the problem identified in the final draft management letter.

Reported to Joint Committee on Government Operations

July 14, 1996

PART 1 - GENERAL

Self-Insurance

West Virginia Code §23-2-9 provides that employers meeting certain statutory criteria may be permitted to self-insure their workers' compensation risk, including their risk of catastrophic injuries. In 1995, this authority was narrowed by S.B. 250 which eliminated self-insurance of *second injury* coverage for new self-insurers. According to Milliman and Robertson, Inc. in its *Rate Level Projections: Fiscal Year Ending 1996*, self-insured second injury coverage "generated a substantial portion of the Division's overall unfunded liability," approximately $400 million or 22% of the overall unfunded liability of $1.84 billion as of June 30, 1994. Statutory prerequisites to granting self-insured status require each such employer to:

- demonstrate sufficient financial capability and responsibility,
- provide a health and safety program in its workplaces,
- submit security or bond sufficient to balance the employer's financial condition against its existing and expected liability, and
- satisfy any liability that is in excess of premiums paid to the Division.

Currently, there are about 300 self-insured accounts, about 150 of which are active. The statute requires the Division to review each self-insured employer annually to ensure that each self-insured employer is providing adequate levels of surety and continuing to meet its financial obligations and all other statutory requirements. Created in 1994, the Self-insurance Unit is a relatively new entity of the Division that was established to provide for the processing of new applications and review of existing self-insured employers.

Ernst and Young's Subscriber/Self-insurance Equity issue focused on the *prevention* of losses incurred as a result of unfit employers being permitted to self-insure. In the past, regular subscribers have shared such losses. While the 1992 final draft management letter did not address the problem of how to assign the losses that do occur, it provided guidance for the prevention of their occurrence.

ISSUE AREA 1: APPROVAL FOR SELF-INSURANCE WAS BEING GRANTED ON A CASE-BY-CASE BASIS AT THE SOLE DISCRETION OF THE COMMISSIONER

Level of WCD Compliance: IN COMPLIANCE

All applications for self-insurance must be approved by the Compensation Programs Performance Council.

Analysis

Legislative Rule §85-9-4 contemplates that self-insurance application approval/denial decisions are to be made at the discretion of the Commissioner. However, the Compensation Programs Performance Council, of which the Commissioner is the statutory chair, adopted a resolution transferring this authority from the Commissioner to the Performance Council. The authority to do so is provided in *West Virginia Code* §21A-3-7, powers and duties of the Compensation Programs Performance Council, and provides that

> [t]he council should have the following powers and duties:
> (a) Assist the governor and the commissioner in the development of overall administrative policy for the unemployment compensation and workers' compensation systems of the state.
> (b) Recommend legislation and establish regulations designed to ensure the effective administration and financial viability of the unemployment compensation system and the workers' compensation system of West Virginia...
> (l) Consider such other matters regarding the unemployment compensation system or the workers' compensation system as the commissioner or any other appointed member of the performance council may desire...

Furthermore, a proposed rewrite of §85-9 substitutes references to the *Commissioner* with *Division*. The self-insurance policies and procedures dictate that the decision of whether to approve or deny applications for self-insurance rests with the Compensation Programs Performance Council. Reports from the Division's Self-insurance Unit to the Performance Council as well as minutes from Performance Council meetings demonstrate a systematic, case-by-case method for making these determinations.

Conclusions and Recommendations

By allowing the Performance Council to make approval/denial decisions as a body through a systematic and well documented process, the WCD has introduced controls that significantly reduce the hypothetical risks associated with biased decision making. ***The revision of §85-9 will be necessary to eliminate ambiguities in the administrative law.***

ISSUE AREA 2: **<u>THE DIVISION SHOULD DEVELOP AND IMPLEMENT STANDARD PROCEDURES FOR REVIEWING THE INFORMATION SUPPLIED BY EMPLOYERS</u>**

Level of WCD Compliance: PARTIAL COMPLIANCE

The Division has developed a comprehensive self-insurance application process in collaboration with Ernst and Young. Each new application is reviewed on an individual basis and includes the steps outlined in TABLE 3.

TABLE 3 Self-Insurance Application Process
Request for Application - Appropriate application materials are sent along with an "informational supplement" explaining the process and specific filing requirements.
Receipt and Review of Application - Application is checked for completeness and request for additional information is sent if necessary. Employer is notified of receipt and file is established.
In Good Standing Audit - An audit is conducted to determine if the employer's WC account is current.
Pre-audit - Employer's account is audited to determine if claims payments have exceeded premium taxes collected from the employer. The employer must repay any excess liability, or enter a repayment agreement with the Commissioner (not to exceed 3 years).
Buy-out Audit - Division's actuary projects the future cost of awards and medical benefits granted after the effective date of SI status for all injuries that occurred while the employer was a regular subscriber. The employer must either repay the present value of the liability, enter a payback agreement for this amount (not to exceed 3 years), or agree to assume the liability. If the employer chooses repayment agreement or assumption of liabilities options, the employer must post additional security.
Financial Review - Financial statement analysis (including footnotes), Z-score analysis, and other financial ratio analyses are completed, and the authenticity of the information is evaluated. A comprehensive review of other financial information, such as federal income tax return, SEC Form 10-K, SEC Form 10-Q, SEC Form 8-K, organization chart, corporate structure, ownership history, company description and presence/lack of excess insurance coverage. A review of the third party administrator and the employer's standing with other governmental agencies are also completed.
Conclusion - A conclusion is then made concerning approval or denial of the application. The appropriate level of surety is then determined.
Reporting - The self-insurance section then compiles information and prepares a standard report including its recommendation.
Supervisory Review - The Director of the self-insurance section completes an extensive final review of the entire file before submission to the Performance Council (all stages of the process also require adequate review of work).
Performance Council Approval - The Compensation Programs Performance Council approves or disapproves the applicant by vote.

Comparable policy and procedures have been developed for the re-application or review process. Re-application involves many of the same steps as the new application process with the addition of pay order compliance audits and surety reviews.

Analysis

While comprehensive procedures have been developed for the application and re-application processes, staffing problems have precluded full implementation. As of April 30, 1996, only 1 of the 4 Account Manager positions (those responsible for the analysis of new applications and re-applications) was filled, and the one existing account manager spent only 20% of her time on self-insurance work due to her planning and training for a position in a new underwriting/rate making section. ***During this period, the self-insurance section was effectively staffed at only 5% the planned level with respect to Account Managers.*** The Division initiated the hiring process in October of 1995. In May of 1996, two Account Managers were hired, one position remained vacant, and the other Account Manager had yet to transfer to the planned underwriting/rate making section.

As of May 1, 1996, the new procedures had only been applied to the processing of initial applications for self-insurance. At that time, thirteen self-insurance applications had been approved since the conversion to the new process. ***While a small backlog has mounted, due to the staffing problem, the Division has achieved full compliance with Ernst and Young's issue with new applications.*** However, in the history of the Division, a systematic and comprehensive review of self-insured employers has never occurred.

Each self-insured employer is required to maintain a level of surety equal to the greater of one-million dollars or the actuary's estimate of the Division's exposure to liability for the employer's outstanding and future claims. A surety review completed in 1995, using 1994 information, found the Division's surety shortage to be nearly $650 million (see TABLE 4). Firms denoted as representing "severe financial risk" constituted a shortage of $148.8 million. Five of the employers classified as "severe financial risks" represented surety shortages of $20.5 million, $18.9 million, $20.1 million, $54.2 million and $25.8 million respectively. Several of the employers classified as "severe financial risks" were in bankruptcy at the time Ernst and Young completed the surety project. Bankrupt employers represented $20.8 million of these surety shortages. Firms classified as being "high financial risks" represented a shortage of $42.2 million collectively. Employers classified as having "moderate financial risk" comprised $368.8 million collectively, with one firm and its affiliates representing a $174.6 million potential liability to the division. The remaining shortage is divided between companies representing "low financial risk" and those whose risks were unclassified at $41.1 million and $47.4 million, respectively. ***Following the surety study, the Self-insurance Unit pursued collateral adjustments with only six employers because of the staffing shortage.***

TABLE 4
Surety Shortages by Classification of Financial Risk
(1994)

FINANCIAL RISK	SHORTAGE BY CLASSIFICATION	PERCENTAGE OF TOTAL SHORTAGE
Extreme	$148.8 million	23%
High	42.2 million	7%
Moderate	368.8 million	57%
Low	41.1 million	6%
Unclassified	47.4 million	7%
TOTAL SHORTAGE	**$649.9 million**	**100%**

Source: Ernst and Young surety study dated May 1, 1995.

Because of the lack of standardization of the self-insurance application process in prior years; mergers, acquisitions and divestitures; the lack of re-application reviews; and the volatility of most businesses, many self-insured employers may not meet the financial or other requirements provided in statute. This increases the likelihood of the Division incurring some of the losses these surety shortages represent.

Conclusions and Recommendations

In light of the potential liabilities that could be realized by the Division, ***management should continue to work to bring the Self-insurance Unit up to an optimal staffing level.*** The re-application/surety review process should be given top priority by the Division as it is imperative to solvency of the fund and is required by statute. It should be abundantly clear that if each self-insured employer is properly collateralized, even firms representing extreme risks for bankruptcy hold no real risk to the Division. ***The Division should establish time line goals of 50%, 60%, 70%, 80%, 90%, and 100% collateralization by future dates, allowing for maturation of workout plans but still driving aggressive resolution of the surety shortage.***

ISSUE AREA 3: **<u>THE APPLICATION/RE-APPLICATION REVIEWS SHOULD BE ADEQUATELY DOCUMENTED AND CONCLUSIONS SHOULD BE REACHED AS TO WHETHER EMPLOYERS SHOULD BE ALLOWED TO MAINTAIN SELF-INSURED STATUS</u>**

<u>Level of Compliance:</u> IN COMPLIANCE

The Self-insurance Unit presents appropriately detailed reports to the Compensation Programs Performance Council (CPPC) which include the recommendations of management.

<u>Analysis</u>

The reports to the CPPC summarizing eight applications processed under the new system were analyzed as to their content. The reports are in a standardized format, which includes a description of the company, the results of the in-good-standing audit, the results of the pre-audit, the buy-out process, the financial analysis, recommended surety amount, a section for other information/concerns, the company's standing with other state agencies, and a conclusion containing the recommendation to the Performance Council. The *Information Summary* is consistent with the format set forth in the application policies and procedures manual developed in collaboration with Ernst and Young.

<u>Conclusions and Recommendations</u>

The reporting standard specified in the re-application policies and procedures manual should be employed when the Self-insurance Unit implements its re-application process.

ISSUE AREA 4: THE DIVISION SHOULD CHANGE ITS SURETY POLICY TO AVOID PUTTING THE FUND IN A LIABILITY POSITION

Level of Compliance: PARTIAL COMPLIANCE

The Division has developed a policy which requires all self-insured employers to provide surety equal to the larger of $1,000,000 or the actuarially-determined liability of the firm. The actuarially-determined liability of a firm is comprised of the accrued and contingent liability for the past, current and future operations. The new formula was introduced by rule §85-9-9 in 1993. However, as of May 1, 1996, the policy has only been enforced on six existing employers and the thirteen new self-insurers, thus the Division is only in partial compliance with the issue.[3]

Analysis

The Division and Ernst and Young completed a self-insurance surety project in April 1995. The project culminated in a comprehensive surety review process, a surety database and an up-to-date surety status report detailing each self-insured employer's financial condition and surety position. Due to the staffing shortage, the unit did not aggressively pursue these surety amounts. The Self-insurance Unit has requested additional surety of six employers in total. Five of these six shortages were addressed as other self-insurance issues arose, such as mergers of self-insured employers, parental guarantees, and acceptable surety language, etc. The other was pursued because of the relative size and risk associated with the shortage.[4] As of May 31, 1996, the Division has received or accepted work-out-plans for $46.7 million in surety shortages. The thirteen new self-insured employers were also required to provide appropriate surety.

Conclusions and Recommendations

Enforcement of the revised surety requirements should be a high priority of the Self-insurance Unit, now that the Unit is moving toward its optimal staffing level.

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[3] *This is not to suggest that all other self-insurers areunder-collateralized. Several employers are properly collateralized. A few employers have provided surety in excess of the Division's requirements. E & Y noted in the 1992 final draft management letter, "that there [was] no specific methodology to follow in determining the required amount of security."*

[4] *Such cases must be considered on individual bases. Impact on citizen-employees, the cost of un-employment compensation and other benefits that must be provided, lost tax revenue, etc. often make it difficult to force employers to correct collateral shortages immediately.*

ISSUE AREA 5: THE DIVISION SHOULD REQUIRE SELF-INSURED EMPLOYERS TO SUBMIT AUDITED FINANCIAL STATEMENTS AND PROOF OF REQUIRED AMOUNT OF SURETY BOND WITHIN 90 DAYS OF THEIR FISCAL YEAR END

Level of Compliance: PARTIAL COMPLIANCE

Due to the staffing problems discussed in earlier sections of this report, the Division has not required employers to submit audited financial statements and other information on an annual basis. The policies and procedures manual does however, adequately address the Division's needs for information by specifying that audited financial statements and other materials be requested on an annual basis. With respect to the collection of annual proof of surety, the Division has changed language on these instruments to include "evergreen clauses" (versus specific coverage dates), which cause such instruments to be effective perpetually, until 60 days after receipt of cancellation notice from the guarantor.[5] New surety instruments must be provided to the Division when surety adjustments are required. The Division does require annual proof of surety from the 15 employers maintaining surety instruments having the antiquated, finite period language.

Analysis

The Division's processes, policies and procedures document adequately addresses materials that should be requested in the re-application process on an annual basis. The document does not require that these items be provided by 90 days before the employers' fiscal year end or specify a due date, other than requiring that these documents be provided to the Division within 30 days of the letter of request's date. The policy does however satisfy the primary intent of the E & Y recommendation at the planning level, by addressing the need for annual collection of this information.

In 1995, while Ernst and Young was assisting with the development of re-application procedures, the exercise of collecting 1994 financial statements and other information was executed as set forth in the process manual. The information was compiled in three-ring binders to facilitate the re-application process. Due to the lack of staff, this information was not collected the following year.

Prior to September 1, 1994, the Division accepted bond language restricted to coverage of specific periods of time. This language led to a situation where multiple bonds could cover multiple periods of time for a single employer. This language also allowed lapses in coverage periods to occur. It was under this environment that the E & Y recommendation to require annual proof of surety was made. Since September 1, 1994, the Division has required that all *new* surety instruments contain "evergreen" language. This language obligates an instrument to cover all time periods relating to an employer's self-insured status. The adoption of a bond language template

[5] *In the event of a cancellation by the guarantor, the Division has 60 days to draw on the full penal value of the letter of credit, if the self-insured employer fails to provide replacement surety.*

has eliminated the need for the Division to require self-insured employers to provide proof of surety other than at times new surety instruments are submitted.

There are however surety instruments held by 15 employers which contain the antiquated, finite period language, which require annual proof of their existence. The Division requires these employers to provide proof of renewal before the instrument expires.

Conclusions and Recommendations

The Division should fully implement the policies and procedures it has developed for the re-application process as soon as possible. Re-applications and related information should be requested even if the unit lacks the resources to complete the evaluations. The threat of enforcement is better than no enforcement. With the recent filling of two of the three vacant Account Manager positions, the Self-insurance Unit should be better equipped to meet its statutory requirements.

ISSUE AREA 6: <u>THE DIVISION SHOULD DEVELOP A PLAN FOR THE TIMELY TRANSITION FROM SELF-INSURED TO SUBSCRIBER STATUS PRIOR TO ANY BANKRUPTCY PETITION TO FACILITATE ADEQUATE PREMIUMS COMMENSURATE WITH INSURED RISK</u>

Level of Compliance: IN COMPLIANCE

The Division has developed a process for the revocation of self-insured status. The Division has revoked the self-insured status of one employer. At the time the employer was transitioned to subscriber status, the Division calculated its experience modified subscriber premium rate by figuring what its rate would have been had the employer been a regular subscriber during the period of self-insurance.

Analysis

The Division's revocation process consists of the following steps:

- Self-insurance Unit compiles and reviews all relevant data, meets with the subject employer, determines exposure/risk, and makes recommendation to executive management.
- Executive management reviews recommendation and relevant data and makes final recommendation to Performance Council.
- Performance Council reviews recommendation to revoke employer's self-insured status and approves or rejects it.
- Employer is notified of revocation.
- Workout plan is negotiated for claims and surety.

Because the re-application process has not been implemented, the Division has revoked the self-insured status of only one employer to date. In that case, the company returned to the regular fund at the base rate applicable to its class which was modified by a factor that was calculated by examining the premiums the company would have paid had they been a regular subscriber during a three year "look back" period and the expected loss rates, limited charges and composite loss limit computed as if the fund paid the claims on behalf of the company during the same three year period. The resulting rate was the same as it would have been had the company been a regular subscriber.

The Division has also subscribed to a Dunn and Bradstreet service which will provide monthly reports on companies having self-insured status. The service should help the staff to identify those companies representing substantial risks to the Division. This should enable the Division to transition struggling firms to subscriber status before the health of the business is too precarious to absorb the high costs associated with continuing to meet liabilities incurred while self-insured and paying full subscriber premiums for the immediate quarter.

Conclusions and Recommendations

Transitioning self-insured employers to regular subscriber status prior to failure is a difficult but important task. The Division appears to have the policy in place to fulfill this responsibility. Once the Division embarks on its re-application process, transition to subscriber status may be necessary in some cases in order for the Division to protect the solvency of the fund.

Underwriting/Risk Management Initiatives

Underwriting is the process of selecting and classifying exposures to risk. The term *underwriting* is also commonly applied to the closely related, overlapping science, *rate making*. Such is the case with the E & Y final draft management letter. Ernst and Young recommended that the Division work to make rates commensurate with losses. This results in a more equitable distribution of costs, but more importantly, it creates an incentive structure under which employers that succeed in preventing losses pay lower rates and employers not effectively managing risks pay higher rates.

Risk management or *loss control* in the context of workers' compensation insurance involves the prevention of deaths or injuries by identifying hazards in the workplace and providing remedies for them. Examples of hazards are unstable storage shelves, heavy lifting without support belts, slippery floors, high levels of respirable dust and personnel lacking safety training. Ernst and Young recommended the development of a comprehensive risk management program, including inspections of employer sites. Underwriting, rate making and risk management are core functions of any insurance entity.

ISSUE AREA 7: <u>THE DIVISION SHOULD OBTAIN THE NECESSARY COMPUTER SYSTEMS AND EMPLOY EXPERIENCE RATING FORMULAS TO INCREASE PREMIUMS COMMENSURATE WITH INCURRED LOSSES</u>

<u>Level of Compliance:</u> PARTIAL COMPLIANCE

New computer systems have been installed that will enable the Division to make premiums commensurate with incurred losses. Rate making methodologies are being explored and the Division has completed a considerable amount of planning to this end. An employee of the Self-Insurance Unit is being trained to serve as a rate making specialist.

<u>Analysis</u>

The most critical component in the development of a rate making system is quality information with which to calculate experience modification factors. The Workers' Compensation Insurance System, also known as WCIS, was installed in stages during October 1995 and April 1996. WCIS is a database tool that can sort claim information by employer, class code, accident year, and other critical information. In March 1996, the Micro Insurance Reserve Analysis system or MIRA, an automated case reserving system capable of generating reserves for each individual claim, was established. In its simplest form, WCIS stores claims information for which MIRA establishes *reserves*. The *reserves* are liabilities for the past, present and future cost of each claim. Reserving allows for the calculation of actual and expected losses, which provide the fundamental elements for calculating *experience modification factors*. An experience modification factor is equal to actual losses *divided by* expected losses *times* a weight factor to give consideration to the employer's size or variance of its actual losses.[6] Thus, WCIS and MIRA have provided the foundation on which to build an experience-based rate making system.

S.B. 250 passed by the 1995 Legislature granted the Division authority under §23-2-4 to develop by rule:

> a system for determining the classification and distribution into classes of employers subject to [Chapter 23], a system for determining rates of premium taxes applicable to criteria for subscription thereto, and criteria for an annual employer's statement providing both benefits liability infomation and rate determination information.

Under this authority, a rewrite of Exempt Legislative Rule §85-9 is being drafted to address underwriting issues and is expected to be released for public comment in November. The proposed rule provides for implementation of a more diverse product line, experience-based rates, receivables management, employer payroll/classification audits, employer classification and other critical underwriting matters. The Division had originally planned to finalize this underwriting rule in two phases. However, the first phase of this rule was released and subsequently

[6] *This is a highly simplified illustration of how modification factors are calculated by the Workers' Compensation Division's methodology.*

withdrawn following the public comment period. Because of the complexity of these issues and public comments indicating a need for more information, the decision has been made to abandon the phase-in approach and release a comprehensive version in November.

The underwriting, rate making and risk management vision is the centerpiece for the Division's TQI project that is ongoing. Two phases of deliverables have been provided by the Ernst and Young consultants to date. The underwriting vision contemplates a variety of product lines within the workers' compensation system. Some of the products being considered are outlined in TABLE 5.

The Division is currently in the process of planning for a payroll audit blitz that will help to ensure that employers are assigned to the appropriate classes. A recent Workers' Compensation Division audit project indicates that approximately one-third of the State's employers are currently assigned to the wrong class. This severely undermines the integrity of the underwriting process, because one misplaced employer causes two insurance classes to be in error, the class in which the employer is erroneously included and the one from which the employer is erroneously excluded.

The Division has been training an employee of the Self-Insurance Unit to specialize in rate making. This employee is currently working with management and the consultants in the development of a specific rate making process.

TABLE 5 Insurance Products Under Consideration	
Plan Type	**Description**
Assigned Risk Plan	Employers with substandard performance levels are assigned to this plan and additional premium taxes are imposed on them. Purposes for the assigned risk plan include encouraging employers to improve their performance and allowing high risk employers to share their losses with other high risk employers.
Deductible Rating Plan	A plan that allows employers to pay a portion of the lost wages for injured employees up to a specified limit, in exchange for receiving a discount on their premium.
Group Rating Plan	A plan that modifies a group of employers' base rates based on the claims experience of the group. Employers retain separate risk identity, but are pooled and grouped for rating purposes only, specifically with respect to experience modification.
Guaranteed Cost Plan	Similar to conventional subscriber plan. The employer receives coverage for a fixed premium, determined by class of employment and experience modification.
Retrospective Rating Plan	A loss-sensitive rating option which allows an employer to pay premiums based on losses. At the end of the retro-rated policy year, the employer faces either a refund or additional premium based on losses. The amount an employer can gain depends on the employer's capacity to pay.
Self-insurance Plan	Plan allows employers meeting certain qualifications to insure their own compensation and catastrophic risk.
Source: Workers' Compensation Division.	

Conclusions and Recommendations

Although much work remains to be completed to bring the underwriting/rate making/risk management vision to fruition, ***the Division's aggressive approach in re-inventing its underwriting/rate making/risk management structure is commendable.*** While the goal of experienced-rated premiums is yet to be obtained, the breadth of the Division's plan to address the concerns raised by E & Y in 1992 vastly exceeds the recommendations of the final draft management letter.

ISSUE AREA 8: <u>THE DIVISION SHOULD ESTABLISH A COMPREHENSIVE RISK MANAGEMENT PROGRAM TO WORK WITH EMPLOYERS TO REDUCE EXPOSURE TO INJURIES</u>

Level of Compliance: PLANNED COMPLIANCE

The Compensation Programs Performance Council has created a Safety and Loss Control Advisory Committee. Two exempt legislative rules have been proposed which provide both positive and negative incentives to require or encourage employers to take certain measures to develop/maintain safe workplaces. Management and the Safety and Loss Control Advisory Committee are working to hire a Safety Director.

Analysis

In December 1994, the Finance Committee of the Compensation Programs Performance Council formed a Safety and Loss Control Advisory Committee to promote workplace health and safety programs while encouraging compliance with occupational safety and health laws, regulations and standards. The eight member committee represents both labor and business concerns.

Two exempt legislative rule proposals, §85-23 and 24, have completed the rule making process and need only to be filed in their final forms with the Secretary of State in order to become effective within 30 days. West Virginia Code §21A-3-7© provides the Compensation Programs Performance Council authority to promulgate such rules and exempts it from legislative review. The statutory authority with respect to the objectives of the proposed rules §85-23 and 24 is provided by §23-2A-2 and 3 as per H.B. 2802, enrolled Regular Session 1993.

Proposed rule §85-23, entitled *Loss Prevention*, provides for the implementation of mandatory safety programs for certain employers who fall within certain risk categories as determined by their experience modification factor and annual premium size. This rule creates three tiers of employers who fall within the mandatory program range. The requirements for each tier are progressive. The first two tiers are determined by an examination of the experience modification factor and annual premium size. Tier One requirements consist of a basic safety education component for the employer. Tier Two requirements consist of the basic safety education component, a safety plan, the establishment of a joint labor management safety committee, quarterly reports and discretionary safety inspections. Tier Three employers are determined as a result of their non-participation at Tier One and Tier Two levels or non-compliance with Tier Two requirements. In addition to the requirements of Tier Two, Tier Three employers may be subject to premium surcharges.

Proposed rule §85-24, *Qualified Loss Management Programs*, provides for a prospective credit to the premium tax rate of a subscribing employer who participates in a qualified loss management program with a private loss management vendor. The prospective credit is provided for a period of up to three years. The proposed rule specifies the qualifications of loss management service providers. The rule provides that the amount of credit against premium rates shall vary from firm to firm based upon the loss reduction success experienced by all of the subscribing employers of the sponsoring loss management firm.

Efforts are being made to hire a Safety Director. However, differences between the Workers' Compensation Division and the Division of Personnel need to be resolved with respect to the appropriate civil service classification of the Safety Director position before it can be filled.

Conclusions and Recommendations

Because the Loss Prevention and Qualified Loss Management Programs are driven by experience modification factors, these risk management strategies are heavily dependent upon the implementation of the planned rate making strategy. The implementation of the planned rate making and underwriting overhaul should lead to a successful risk management program.

While the Division appears to be giving appropriate emphasis to the prevention of deaths and injuries, its mission statement does not address the importance of this proactive approach. ***The Performance Council should amend the mission statement to incorporate language reflecting its commitment to the prevention of deaths and injuries.***

Reported to Joint Committee on Government Operations

September 15, 1996

Organizational Structure and Personnel Requirements

The 1992 Final Draft Management Letter notes, "Management believes that a major contributing factor to the material weaknesses in the internal control structure is the overall lack of qualified personnel, both in numbers and in strategic placement within the organization." In addition, the management letter specifically identified the need for improvement in the human resources as well as organizational components relating to a number of key business functions of the Division. The areas of concern included the need for a controllership function, an actuarial function as well as attention to staff in accounting, underwriting, claims processing, premium billings, quality review, internal audit and information systems.

Attention to structure and personnel in an organization helps to establish and clarify lines of authority and responsibility. Second, proper organizing and staffing helps management in their efforts to improve efficiency and quality of the day to day work of the Division. Third, good organization provides for an environment with open and effective communication. Finally, a properly designed organizational structure and adequate human resource pool allows for optimal division of labor. As a result of successful efforts in these areas, the Division should benefit from more efficient and effective operations with fewer skills required per person, work proficiency, the ability to have concurrent operations, more conformity in the final work product and ease in recruitment and training. This section of the report measures the compliance with organizational and staffing recommendations made by Ernst and Young.

ISSUE AREA 9: ACCOUNTING DEPARTMENT IS GROSSLY UNDERSTAFFED

Level of WCD Compliance: IN COMPLIANCE

The 1992 Final Draft Management Letter noted that the Division's accounting department "consists only of two bookkeepers." Today the Financial Accounting Section is staffed up to a level of 12 employees, excluding the vacant accounting director position (the Division has posted the position and is proceeding with the hiring process).

Analysis

Financial Accounting is in place to provide for the day-to-day functioning of the accounting system. Examples of such operating responsibilities are financial reporting, monitoring and preparing investment of funds, and designing and implementing cash controls. Employees of Financial Accounting also provide consultation to management on issues requiring technical research. Financial Accounting has also functioned as an internal audit group on four occasions (see ISSUE AREA 16 for more information on the internal audit function).

The Financial Accounting staff is highlighted in TABLE 6. The director position became vacant June 24, 1996, and a replacement has not yet been made. The educational qualifications of existing staff include 5 accounting professionals with baccalaureate degrees, four of which are Certified Public Accountants, one employee working toward a baccalaureate degree in accounting (86 credit hours completed), and 5 of the remaining 6 employees have completed training beyond the high school level. The unit also has considerable work experience (see TABLE 6).

Interviews of Financial Accounting staff members provided insight into the adequacy of the unit's staffing level. Some staff members felt that the section could use more clerical support and expressed sentiments that work flows could be allocated more equitably. In addition, the Special Claims sub-section expressed concern that additional responsibilities will be imposed on its staff of four. However, from staff interviews, it is readily apparent that the staff is adequate to meet more than the basic needs of the accounting system. Outputs of the Financial Accounting staff have also been reviewed throughout the course of the audit. In general, the outputs of the unit are of a high quality. Activity reports and direct observation indicate that essential accounting functions are being met and many special projects are being pursued. In sum, interviews, outputs, activity reports, and direct observation of the unit indicate that Financial Accounting has a sufficient number of qualified professionals. However, a considerable work backlog exists within the sub-unit of the section known as "Special Claims."

Among the sub-unit's responsibilities is the duty for recording credits for certain transactions, specifically returned or refunded checks for medical benefits, returned or refunded

TABLE 6
Financial Accounting Education and Experience Roster

Job Title	CPA	Education	Experience
Director of Financial Accounting	--	*(position vacant)*	*(position vacant)*
Financial Reporting Specialist II	Yes	BBA--accounting	2 years experience in public accounting 9 years experience in private industry 1 year governmental experience
Financial Reporting Specialist II	Yes	BBA--accounting & management	5 years private industry experience 1 year governmental experience
Financial Reporting Specialist II	Yes	BBA--accounting	4 years governmental experience
Financial Reporting Specialist II	No	BBA--accounting	5 years experience in public accounting 4 years banking experience 1 year governmental experience
Financial Reporting Specialist I	Yes	BA--psychology accounting curriculum	4 years governmental experience
Accounting Assistant III	No	86 credit hours toward BBA--accounting	12 years private industry experience 10 years governmental experience
Administrative Service Assistant	No	H.S. graduate, adult education classes	14 years private industry experience 10 years self-employed experience 14 years governmental experience
Employment Programs Manager	No	H.S. graduate, some college course work	33 years governmental experience
Deputy Claims Manager III	No	H.S. graduate, 6 months business college	9 years private industry experience 15 years governmental experience
Deputy Claims Manager III	No	H.S. graduate, some college course work	11 years acct./clerical experience in private industry 8.5 years governmental experience
Claims Manager II	No	H.S. graduate	12 years governmental experience 13 years retail office experience 6 months experience billing & collection
Cashier	No	H.S. graduate college course work	10 years governmental experience 4.5 years management experience in private industry additional years private industry experience

checks for benefits overpayments, and *Financial Accounting checks*.[7] The Special Claims Unit was created in May 1996 to provide for the recording of these credits and to manage the outstanding credit backlog which accumulated while under the responsibility of the Claims Managers.[8] As of July 29, 1996, Performance Evaluation and Research Division's audit staff noted that the outstanding credits dated back as late as October 4, 1994. Financial Accounting's approach toward managing this backlog has been to process all in-coming work first, thus preventing further growth of the backlog, and pursue the remaining backlog when time allows. Employees of the Special Claims section believe that the backlog can be eliminated in two to three months if given priority by management.

The backlog has the effect of making certain injuries appear to be more costly than they really are. This causes employers' premium rates to be somewhat higher than they would be had the credits been properly recorded. Because the Division has yet to implement a meaningful experienced-rated rate making system, as discussed in ISSUE AREA 7, and because Ernst and Young provided an unqualified opinion on the Division's FY 1995 financial statements, it is unlikely that the resulting premium errors are material to this review. However, it is of paramount importance that the Division ensure the integrity of its premium rates by maintaining current financial information.

Conclusions and Recommendations

Staffing of the Financial Accounting section has improved vastly since 1992. However, management should work quickly to find a qualified Financial Accounting Director (Controller, see ISSUE AREA 10). Management should also aggressively pursue elimination of the outstanding credit backlog. The backlog should be closely monitored and alternative resolution strategies should be considered, if warranted.

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[7] *Financial Accounting checks are checks that were issued by the Division to itself to cope with limitations of the legacy computer system. With the implementation of the new computersystem (WCIS), this practice has ceased, though a backlog of old outstanding credits remains.*

[8] *Between April 1994 and the present the Division has been implementing a massive reorganization project whereby the Division's focus has changed from a "claims processing" or task-oriented approach to a "claims management" or claim-oriented approach. It was originally planned that Claims Managers would be posting these credits to accounts, as well as, managing the other aspects of each claim. As the work flows evolved, these postings were not being completed and the backlog mounted.*

ISSUE AREA 10: THE DIVISION SHOULD ESTABLISH A CONTROLLERSHIP FUNCTION

Level of WCD Compliance: IN COMPLIANCE

The Division has fulfilled the controllership function through establishment of the Director of Financial Accounting position. However, controllership responsibilities are somewhat of a shared responsibility with respect to computer controls. A WCIS (Workers' Compensation Insurance System) Review Committee has been established to design, maintain and implement computer controls.[9] The Director of Financial Accounting position was vacated June 24, 1996 and has not yet been filled (the Division has posted the position and is proceeding with the hiring process).

Analysis

As defined by Ernst and Young (E&Y),

> The controllership function accounts for the design, installation, operation, and control of a unified financial management information system. Such a system would coordinate the financial systems of the operating divisions and identify missing links or duplication of efforts in the Fund's financial accounting system.

The position description for the Director of Financial Accounting (Financial Reporting Specialist III) closely mirrors the E & Y definition (see APPENDIX 4 for full job description).

> Under limited supervision, performs professional accounting work at the advanced level overseeing a wide variety of complex statewide financial systems and financial reporting services. Plans and directs internal and external meetings related to financial reporting or systems work. Designs and reviews procedures to be followed in staff performance of accounting or systems tasks. May supervise and review work of Financial Reporting Specialists and other staff. Performs specialized work in areas such as preparation of governmental financial statements, issuance of statewide policy statements related to systems or financial reporting, technical research, training, design, developing and implementation of statewide accounting system. Performs related work as required.

A WCIS Review Committee has been established to review requests for systems changes. Members of this Committee include the Executive Assistant (to the Executive Director), who serves as chair, and eight departmental Directors (including the Director of Financial Accounting, who serves as vice-chair). The Committee is charged with prioritizing all change requests for the Software Manager and ensuring that the most meritorious change requests are implemented.

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[9] *WCIS or the Workers' Compensation Insurance System is a client-server computer system and represents an integral part of the Workers' Compensation Division's financial management system.*

Conclusions and Recommendations

Between the Director of Financial Accounting and the WCIS Review Committee, management has provided for a unified system of controls. Again, the need to promptly hire a qualified successor to the Director of Financial Accounting position cannot be overemphasized, given the gravity of the associated responsibilities.

ISSUE AREA 11: <u>THE DIVISION SHOULD HIRE A QUALIFIED IN-HOUSE ACTUARY</u>

<u>Level of WCD Compliance:</u> IN DISPUTE

The Division has not hired an in-house actuary. All actuarial services are being provided under contract with Milliman and Robertson, Inc. Management is currently considering hiring an Actuary-in-training and has drafted a tentative position description to that end.[10]

<u>Analysis</u>

Actuaries are individuals who calculate insurance and annuity premiums, reserves and dividends, as well as provide high level mathematical and statistical analyses relating to the operation of insurance entities. There are two broad categories of actuaries. One group is trained and qualified to provide analyses relating to life and health insurance, pensions and investments. A second group is trained and qualified to provide analyses of casualty issues such as workers' compensation. Further, there are two types of certificates (for both groups), an Associate and a Fellow. The current contract for actuarial services with Milliman and Robertson became effective during FY 1995, and is due to expire March 31, 1997. There are no remaining renewal options, however, the Director of Purchasing has the authority to extend the contract. The Division has not yet submitted an RFP (request for purchase) for future actuarial services nor has an actuary been hired. Under the current contract, the maximum charges by Milliman and Robertson totaled $741,600 by FY 1997 (see TABLE 7).

TABLE 7
Contract for Actuarial Services

State Fiscal Year	Maximum Charge
FY '95 (7-1-94 to 6-30-95)	$247,200
FY '96 (7-1-95 to 6-30-96)	$247,200
FY '97 (4-1-96 to 3-31-97)	$247,200
Total	$741,600

Source: Milliman and Robertson contract and change orders.

TABLE 8 provides a breakdown of how the actuarial work is allocated by the consultant. TABLE 8 is based on the "Schedule of Total Professional Fees and Expenses for Casualty Actuarial Consulting and Analytical Services" included in the vendor's original bid. The original

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[10] *In some cases, a plan to hire an individual, if sufficiently documented, could constitute a "Planned Compliance." However, if management were to hire an Actuary-in-training it would only constitute a "Partial Compliance" with the E & Y recommendation to hire a qualified actuary, hence the "In Dispute" score.*

bid of $85,000 was for a package of services which constituted only a portion of the services provided for in the final contract for $247,200.

As provided by the bid document, the $85,000 includes 220 hours of work to be provided by Fellows of the Casualty Actuarial Society and 100 hours by Associates. A full-time salaried employee working a 35 hour work-week and a 48 week year will work 1,680 hours, assuming no overtime. In contrast, if we hold the proportions of work constant at the current contract level of $247,200, that would approximate a total of 931 hours worked by the consulting Fellows and Associates. ***Thus, a full-time in-house actuary would be available to work 1.8 times as many hours.***

TABLE 8
Schedule for Professional Fees for Consulting Actuary

Professional Staff	Initial Bid Estimated Hours	Initial Bid Hourly Rates	Initial Bid Total Charges	Contract Imputed Hours*	Contract Estimated Total Charges*	Annualized Salary*†
Senior FCAS #1	200	$250	$50,000	582	$145,412	$420,000
Senior FCAS #2	20	$250	$5,000	58	$14,541	$420,000
Other FCAS	0	$190	$0	0	$0	$319,200
ACAS	100	$140	$14,000	291	$40,715	$235,200
Support Staff						
Actuarial Analyst	50	$120	$6,000	145	$17,449	$201,600
Actuarial Technician	100	$75	$7,500	291	$21,812	$126,000
Support Staff	50	$50	$2,500	145	$7,271	$84,000
Total	**520**	**$85,000**	**$85,000**	**1,512**	**$247,200**	**$1,806,000**

Source: Milliman and Robertson contract
***Based on Performance Evaluation and Research Division analysis**
†Annual terms based on 35 hour work week, 48 week year

Another worthwhile comparison can be made by annualizing the hourly fees consumed by the consultant's staff. To hire one of the Fellows as a consultant for a full year would cost approximately $420,000. According to the Managing Director of the Society of Actuaries, Associates' salaries generally range from $40,000 to $70,000, while Fellows' salaries generally range from $60,000 to $125,000. Assuming the high range of $125,000, Social Security, Medicare, Public Employees Retirement System, Workers' Compensation premium, and Public Employees Insurance Agency benefits would cost an approximate $26,199 per year.[11] ***Adding $40,000 for administrative support, office supplies, utilities and other expenses, the state would***

[11] *Assuming matching FICA = 7.65%, matching PERS = 9.5%, matching PEIA = $177/month, and Workers' Compensation premium = $2.11 per $100 of payroll.*

save $56,001 per year over the current contract ($247.2M-$125M-$26.199M-40M=$56.001M) and have a well-qualified FCAS in-house for the entire year, or 1.8 times as many hours provided by Fellows and Associates of the consulting group combined. The value of the additional work that could be completed by a full-time in-house actuary is unquantifiable. In addition, because fees would no longer be paid to hire consultants from California if services are provided in-house, state businesses, workers and tax bases would reap the benefits of the multiplier effect. (If the money multiplier is assumed to be 7, spending $247,200 to staff an in-house actuarial services unit would result in $1,730,400 in economic activity).

Management is considering hiring an Actuary-in-training to perform certain actuarial functions

> including class rates, reserves, merit ratings, self-insurance buyouts, preparation of actuarial inputs to financial statements, **assistance to the consulting actuary**, preparation of studies and analysis in loss costs and cost estimates, and assistance to other processes (emphasis added by Performance Evaluation and Research Division).

The candidate is to have a minimum of one to three years experience in casualty actuarial projects for insurance or consulting firms; a bachelor's degree in mathematics, statistics, or related field; passage of a minimum of three (of a possible ten) examinations of the Casualty Actuarial Society (CAS); and intention to complete Fellowship in CAS. In addition the MIRA system (Micro Insurance Reserve Analysis) will provide for the automation of case reserving and other tasks, which have been traditionally performed by the Division's consulting actuary. Perhaps a para-professional will be able to perform many of the tasks currently outsourced to Milliman and Robertson, given the new tools available, i.e. WCIS and MIRA.

Conclusions and Recommendations

While there may be occasions when it is necessary to hire a consulting actuary on contractual bases, for example to obtain a second opinion on the work of an in-house actuary when considering an important policy matter, management should conduct a study of the costs and benefits of developing an actuarial presence within the Division. Possible barriers to the Division may include classifying, compensating and recruiting a qualified actuary. However, having an actuary involved in the day-to-day operations of the Workers' Compensation Division could yield unprecedented benefits. Few insurance entities of the Division's size and complexity operate without an in-house actuary. Funds expended to retain either Senior FCAS for just 15 weeks may be sufficient to cover the salary of an in-house FCAS for an entire year. ***The Division should report the results of its study and plan for action to the Joint Committee on Government Operations at its January 1997 interim meeting.***

ISSUE AREA 12: <u>THE DIVISION SHOULD EVALUATE ITS HUMAN RESOURCE POOL</u>

Level of WCD Compliance: PARTIAL COMPLIANCE

The Division regularly conducts employee performance evaluations and with the assistance of consultants has performed detailed human resource studies of several of its functional units. In addition, management performed a study of the attitudes and abilities of its mid-level managers, identified critical human resource needs in terms of delivering its vision, and identified personnel needs associated with the implementation of S.B. 250. While the Division has complied with this objective at an organizational level, it lacks a comprehensive Division-wide assessment of its human resource skills at the individual employee level.

Analysis

Along with Division-wide employee performance evaluations, the Division has made detailed studies of the personnel of its Financial Accounting Department and Claims Teams. The effort put forth on the Financial Accounting and Claims Teams projects serve as good examples of what the Ernst and Young Final Draft Management Letter recommended

> Because of the magnitude of the problem, the Fund's **existing human resource pool must be evaluated in terms of current and future personnel requirements to facilitate the orderly development of qualified people in all critical functional areas**, most notably accounting, underwriting/risk analysis, claims processing, premium billings, quality review, internal audit and information systems (emphasis added by Performance Evaluation and Research Division).

Management has provided evidence that other TQI (total quality initiative) deliverables similar to those for Financial Accounting and Claims exist for the topics of Receivables Management and Technology. The groundwork for the TQI program was the Issues Confirmation project which provided organizational-level evaluation of the human resource pool, as did the Division's Vision Document, and other efforts. In addition, executive management completed an evaluation of the attitudes and skills of its middle managers.

The Division also has a process for conducting common employee performance evaluations. Supervisors solicit self-evaluations of employees and conduct their own assessments of employee performance on Bureau of Employment Programs rating forms. The forms are forwarded for the Executive Director's review and sent to the Bureau's Personnel Office to be filed. While the forms may contain useful information, the format of the information does not readily lend it to recruitment and training uses. In addition, the information is geared to measure performance in current job, not the employee's skill-set and potential in other capacities.

Except for the individual level analyses completed for a few of the Division's functional areas, middle management, and employee performance evaluations, detailed evaluations of the organization's individual employees have not occurred. A Division-wide baseline analysis of employee skills in the various business areas of the Division would help to develop a more detailed training plan for the Division's employees. While it is a natural tendency in any management environment to acquire individual skills based information through less direct and less formal channels, a structured approach facilitates planning and implementation of a human resource reform strategy that is tangible and measurable for performance. Most importantly, it provides greater continuity for operations across time, an especially important attribute given the nature of public organizations and history of turnover in executive management positions.

Conclusions and Recommendations

The Division's Total Quality Initiative has a trilateral focus: people, processes and technology. Management and consultants have worked hard to improve on each front, however, the people issues are the most enigmatic. Executive management has expressed concerns about the skill level and motivation of personnel, its limited abilities to renew its human resource pool and the difficulties of retraining its existing human resource pool. Because human resource issues play such a vital role in the rehabilitation of the Division, management should perform a Division-wide inventory of individual skills and deficiencies to guide its training program and recruitment efforts. Such an effort with regular updates would help to ensure long-term continuity of operations.

ISSUE AREA 13: <u>THE DIVISION SHOULD CREATE A PROGRAM FOR ORDERLY STAFF DEVELOPMENT</u>

Level of WCD Compliance: PARTIAL COMPLIANCE

The Division's Training Department has been actively engaged in staff development programs. A minimum goal of 40 hours of training per employee per year was established by a training plan implemented in 1994. Traditionally, the Division's approach to training has been delivering on a "just-in-time" basis. Much of the training completed has occurred in the critical functional areas outlined in the Final Draft Management Letter. A score of "Partial Compliance" has been awarded because of the lack of a Division-wide inventory of individual skills and deficiencies to guide the development effort (see ISSUE AREA 12). ***Lack of such a baseline has caused the Division's training program to be more reactive to problems and changes than proactive to needs. In addition, training efforts have waned during the first 7 months of 1996*** (see TABLE 9).

Analysis

In 1994 the Division implemented a training plan that established a minimum goal of 40 hours of training per employee per year. Training topics considered were:

> skill and knowledge needed to effectively and efficiently perform assigned duties in accordance with the Bureau's mission, core principles, and goals;
>
> total quality initiatives which require staff to learn and adapt to new ways of operating and interacting to create a total quality environment; and
>
> inconsistencies or inadequacies in performance identified by managers and/or line staff.

The Division has maintained a training database for each calendar year 1994-present. The database includes each employee's record of all training conducted by in-house staff, consultants, external sources, the Division of Personnel and the Bureau of Employment Programs. The record demonstrates training in many of the functional areas outlined by Ernst and Young as a focus for development activity. TABLE 9 highlights the hours dedicated to training in 1994, 1995 and the first seven months of 1996.

According to the data provided by the Division, the training effort was strong in 1994, peaked in 1995, and dropped sharply in 1996. If the 1996 training pace remains constant for the remainder of the year, employees of the Division will be expected to average only 6 training hours for the entire year, down from the average of the previous year by 39 hours.[12]

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[12] *The 1996 data may have its limitations, however. There is a lag between the time taining occurs and the time training is recorded in the database. Occasionally employees forget to notify the Director of Training of completion of a program, which is usually resolved by Training Director's cross checking training requests with training reported and following-up appropriately.*

TABLE 9 **Summary of Training Records** (1994 through August 9, 1996)			
Calendar Year	**Number of Employees**	**Total Training Hours**	**Average Hours of Training per Employee**
1994	374	14,825	40
1995	446	19,897	45
1996 up to Aug. 9	465	1,656	4
1996 pace projected*	*465*	*2,839*	*6*
Source: Workers' Compensation Division Training Database *1996 pace projected based upon first 7 months experience			

Conclusions and Recommendations

In absence of a Division-wide inventory of individual skills to guide the development effort (see ISSUE AREA 12), the training effort is lacking guidance needed to be optimally effective. Training is often provided in response to changes in processes or technology or to problems that have occurred in functional areas of the Division. A well designed training plan based on an individual level needs assessment or skill inventory would facilitate the creation and maintenance of a human resource pool capable of providing the complex work product envisioned in the Division's reform strategy. In general, completely trained employees are more capable of preventing or resolving problems. A well designed training plan could provide effectiveness and efficiency gains not being guaranteed in the present approach. Management should design a training plan based upon findings of a Division-wide inventory of individual skills.

ISSUE AREA 14: THE DIVISION SHOULD ACTIVELY RECRUIT SKILLED EMPLOYEES

Level of WCD Compliance: IN COMPLIANCE

The Workers' Compensation Division has actively recruited skilled employees to fill several vacant positions by advertising in major state newspapers.

Analysis

The Division has advertised for 4 vacant professional-level positions. The advertisements were carried in various newspapers. See TABLE 10 for newspapers selected to advertise vacant positions.

TABLE 10
Employment Advertisements

Newspaper(s)	City	Vacant Position			
		#1	#2	#3	#4
The Journal	Martinsburg		X	X	X
Charleston Newspapers	Charleston	X	X	X	X
Wheeling Intelligencer News	Wheeling		X	X	X
The Herald-Dispatch	Huntington	X	X	X	X
Exponent-Telegram	Clarksburg		X	X	X
Bluefield Daily Telegraph	Bluefield			X	X
Beckley Newspapers	Beckley		X	X	X
Herald Mail	Hagerstown, MD			X	X

Source: Advertisements and RFPs supplied by Bureau of Employment Programs Personnel Office

Executive management of the Division has provided audit staff with copies of correspondence requesting the Personnel Office of the Bureau of Employment Programs to advertise 12 other vacant positions.

Conclusions and Recommendations

Management should continue to actively recruit qualified employees. Alternative recruiting strategies should also be employed where appropriate. A Division-wide inventory of individual skills and deficiencies will assist the division's recruiting efforts (see ISSUE AREA 12).

ISSUE AREA 15: <u>THE DIVISION SHOULD CREATE FORMAL JOB DESCRIPTIONS, INCLUDING RESPONSIBILITIES AND EXPERIENCE REQUIREMENTS</u>

Level of WCD Compliance: IN COMPLIANCE

The Bureau of Employment Programs maintains a Personnel Policy and Procedures Manual which includes a generic Division of Personnel position description for each job title held by the Bureau. These descriptions include job responsibilities and required credentials.

Analysis

A sample of 3 positions from the FY 1997 personal services expenditure schedule was cross-checked with the job descriptions contained in the Bureau of Employment Programs Personnel Policy and Procedures Manual to ensure the document is up-to-date. The positions were selected by audit staff on the basis of being relatively new positions. The Personnel Policy and Procedures Manual contained position descriptions for each new position sampled. In addition, many of the position descriptions were dated March 21, 1996, indicating the manual is up-to-date. Further, the Division has also created its own job-specific job descriptions for employees of the Division.

Conclusions and Recommendations

Management should continue to maintain the Personnel Policy and Procedures Manual and job-specific job descriptions.

ISSUE AREA 16: THE DIVISION SHOULD ESTABLISH AN INTERNAL AUDIT SECTION REPORTING DIRECTLY TO THE COMMISSIONER OR EXECUTIVE DIRECTOR

Level of WCD Compliance: PARTIAL COMPLIANCE

The Division has provided for limited internal audit projects through its Financial Accounting unit and the Bureau of Employment Programs' Management Analysis unit. However, neither unit provides regular, ongoing internal audit services. To the extent these units do conduct audit activities, the nature of the work is often consistent with "quality control" versus traditional internal audit work for the Division.

Analysis

A considerable amount of quality audit activity has been occurring at the Division over the past few years. Most audit services have been provided by consultants. However, the Financial Accounting section of the Division and the Management Analysis section of the Bureau of Employment Programs have contributed limited internal audit services. Yet, no portion of either entity exists for the exclusive purpose of providing internal audit services.

Both Financial Accounting and Management Analysis have qualified personnel for these activities. However, their resources are also committed to other concerns. For Financial Accounting, it is the day-to-day operation of the accounting system and technical research projects. Management Analysis performs certain regular quality control functions, and dedicates some of its resources to each Division under the Bureau of Employment Programs.

To date, Financial Accounting has conducted 3 audits since the section's reorganization in June 1995. These audits consisted of a payroll review to ensure that paychecks were only being issued to active employees, a review of Temporary Total Disability calculation procedures and a mailroom audit which involved the study of work flows and other concerns. The Financial Accounting section also developed a list of 10 potential audit objectives and time estimates for completion of each objective. Of the 10 potential audit objectives, 2 are among the 3 completed by the Division. The remaining 8 have not been ordered.

Management Analysis has conducted a greater number of audits of the Division. Most of the work conducted is field office quality control reviewing. The unit has an audit guide containing several programmed audit tests. These tests involve ensuring

- all equipment has appropriate inventory tags,
- the physical security of computers and other office equipment,
- safety of work areas and compliance with OSHA,
- timeliness of supervisory visits,
- proper maintenance of bulletin boards,
- adequacy of building accessability,

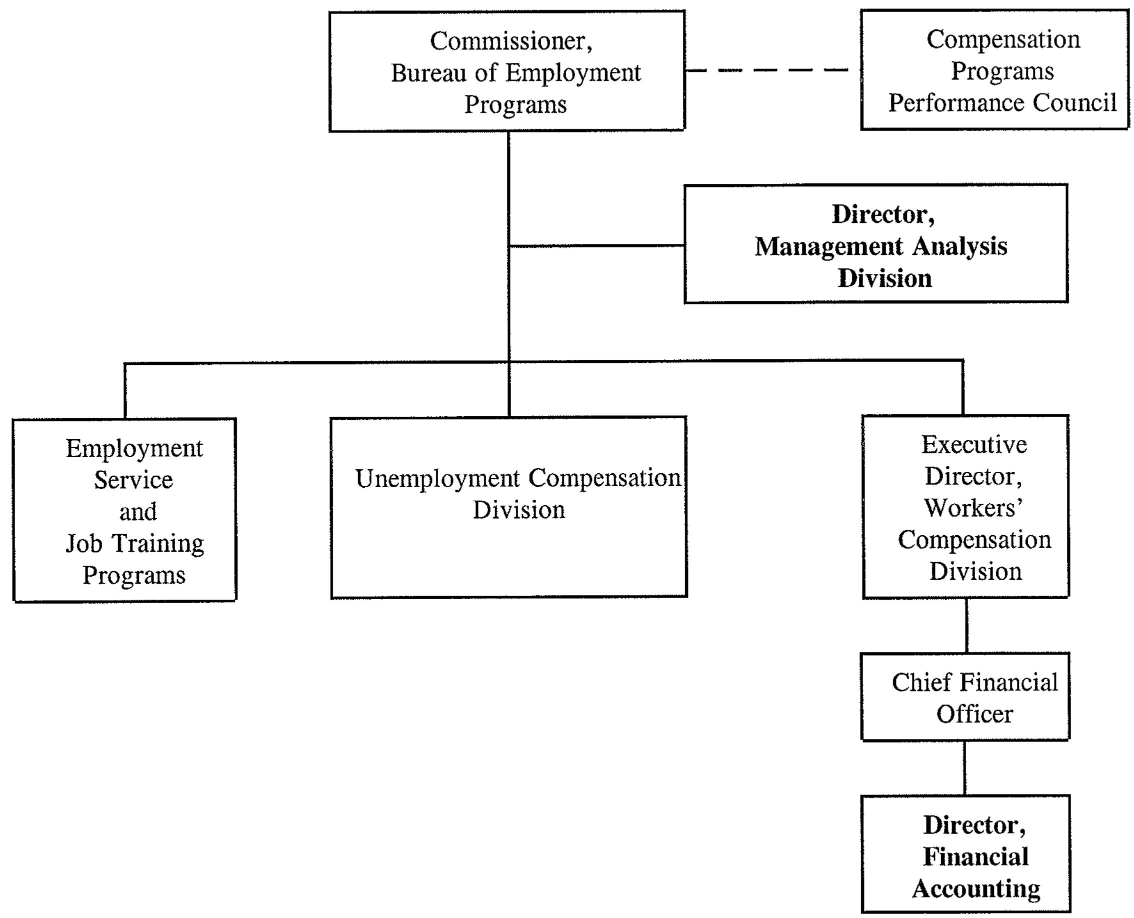
- proper maintenance of time and attendance records, and
- whether petty cash/postage funds are properly maintained and accounted for.

Clearly these are essential quality control functions, but not internal auditing in the traditional sense, which involves scoping, developing of risk assessments, audit planning, etc., on audit-by-audit bases. These are programmed checks and balances. Of the Financial Accounting audit work, the TTD calculation audit is an example of a traditional internal audit, while the payroll review and mailroom audits could be considered quality control oriented objectives. The Management Analysis group has conducted occasional work of a more "internal audit nature." However, these projects are exception rather than rule, and no examples of such work have occurred since 1995. According to the Director of the Management Analysis group, his unit performs a greater degree of traditional internal auditing for the Unemployment Compensation Division. Management Analysis has also provided the Executive Director of the Workers' Compensation Division technical assistance concerning both audit and investigation concerns.

Employees of Financial Accounting are under the control of the unit's Director, who answers to the CFO, who is under the control of the Executive Director (see TABLE 11). Ideally an internal audit group should answer directly to executive management. By placing internal audit under the command of executive management there is less opportunity for censorship and other biases, more direct input and feedback by executive management (management is the party accountable for performance), and because motivation is such an important factor in audit work, a greater sense of importance of the work. The Director of Management Analysis reports directly to the Commissioner. For example, as a basis of comparison two banks were contacted and asked to provide insight into how each has structured its internal audit activities. The CFO of one bank, a $2.2 billion entity, explained that his bank's internal audit department consists of 8 employees. The group reports to the Director of Internal Audit at the bank's corporate headquarters. The Director of Internal Audit reports directly to the bank's Board of Directors. He also indicated that prior to the bank's sale to an out-of-state holding company, the bank had an internal audit group. That group reported to a special subcommittee of the Board of Directors and was completely discrete from management. The Vice President of the second bank, a $4 billion entity, explained that his unit employs 14 persons. His internal audit group reviews financial, compliance and data processing concerns for the bank. The internal audit group reports to an Audit Subcommittee of the Board of Directors. In addition, they also report to the bank's president and chief financial officer. The Workers' Compensation Division's total assets as of June 30, 1995 were $1.3 billion.

Finally, it should be noted that Financial Accounting has not adopted formal auditing standards. To the extent possible, Management Analysis follows Generally Accepted Government Auditing Standards (GAGAS) and American Institute of Certified Public Accountants (AICPA) standards, according to the unit's Director.

TABLE 11
Organizational Placement of Internal Audit Functions



NOTE: Units performing as an internal audit function are shown in **bold**.

Conclusions and Recommendations

Management should develop an internal audit function. This function should be distinct from quality control functions, and should answer directly to the Commissioner, Executive Secretary or the Compensation Programs Performance Council. Work should be conducted in compliance with Generally Accepted Government Auditing Standards (GAGAS) or American Institute of Certified Public Accountants (AICPA) standards.

Financial Statement Reporting

Annual financial statements are documents prepared to provide information to both internal and external users. Internal users include members of management (Governor, Commissioner, Executive Director, etc.) and other employees and boards and commissions having control over the entity, such as the Compensation Programs Performance Council. External users include those outside the Division having either a present or potential direct financial interest (Legislature, claimants, employers, attorneys, physicians, etc.) or an indirect financial interest (labor unions, business groups, citizens, etc.).

Within any government, there are a variety of types of funds. For example, there are general operating funds, special funds and enterprise funds. The Workers' Compensation Division is an enterprise fund, which are categorically known as proprietary funds. A proprietary fund's operation is similar to that of a commercial venture where the intent of the entity is that the costs of providing services to the public on a continuing basis be financed or recovered primarily through user charges. According to Generally Accepted Accounting Principles (GAAP) each of the different governmental fund types must use a particular basis of accounting suitable for that fund type. There are three basis of accounting for the financial performance of an entity: a cash basis; an accrual basis; and the modified accrual. The three vary depending on when financial transactions are recorded. For example, under the accrual basis of accounting, revenues are reported when earned and expenses are reported when incurred.

The Division was required to comply with GAAP in 1991. In order for the Division to comply with GAAP it needed to change from cash based accounting to an accrual system. The 1992 Final Draft Management Letter states that the "necessary records and accrual accounting entries required to produce the financial statements in conformity with GAAP do not exist within the Fund."

ISSUE AREA 17: DIVISION SHOULD MAKE NECESSARY CHANGES TO MOVE FROM CASH BASED ACCOUNTING TO AN ACCRUAL-BASED SYSTEM

Level of WCD Compliance: IN COMPLIANCE

Ernst and Young issued an unqualified opinion on the combined financial statements for FY 1995. In the accompanying notes Ernst and Young ***confirmed*** the use of an accrual-based accounting system.

Analysis

In a cash-based accounting system, expenses and revenues are recognized when a payment is made or cash is received. Conversely, an accrual-based accounting system recognizes expenses and revenues when incurred or realized. The notes accompanying the audited financial statements include,

> As an enterprise fund, the Division uses the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded when incurred.

Conclusions and Recommendations

The Division should continue its compliance with Generally Accepted Accounting Procedures (GAAP) by using accrual-based accounting.

PART II - INTERNAL CONTROLS

Internal controls have a number of components. First, internal controls include the agency's objectives or the positive effects that management is trying to obtain. Second, internal controls include the procedures used to provide reasonable assurance that: goals and objectives are being met; resources are being adequately safeguarded and efficiently used; reliable data are obtained, maintained and fairly disclosed in reports; and laws and regulations are complied with by agency personnel. Third, the agency's accounting system is used to identify, assemble, analyze, classify, record and report transactions and maintain accountability for assets, liabilities, revenues and expenses. Finally, internal controls include management's system for monitoring the agency's activities and performance. The need for public accountability and the lack of administrative continuity in government increases the need to have sound systems in place.

Cash and Investments

The Ernst and Young Final Draft Management Letter was written in response to the Division not being "auditable," because of "pervasive weaknesses in internal controls." The management letter addressed and provided many recommendations for improving the control environment. This section of the report measures the Division's compliance with respect to internal controls.

ISSUE AREA 18: <u>THE DIVISION SHOULD PROVIDE FOR ADEQUATE SEGREGATION OF DUTIES FOR CASH TRANSACTIONS</u>

Level of WCD Compliance: PARTIAL COMPLIANCE

The Division has resolved the internal control issues related to segregation of incompatible duties, as addressed in the 1992 Final Draft Management Letter. However, new segregation of duties concerns have been conceived with the reorganization of Benefits Management. The new claims management approach involves one person having direct contact with claimants and employers on a regular basis, making compensability decisions and financial recording of benefits. Over the course of this review other cash control problems surfaced.

Analysis

Most of the review was conducted by direct observation of the cash controls system. All segregation of duties concerns raised by E & Y in the 1992 Final Draft Management Letter were found to be vastly improved. With the exception of the responsibilities of the Claims Managers, no conflicting duties were found.

Implementation of a reorganization plan for the current claims management unit began in April 1994. The change shifted the focus from a "claims processing" or task-oriented approach to a "claims management" or claim-oriented approach. The "quarterbacks" of this claims management approach are the Claims Managers. The change has created a situation where each Claims Manager is responsible for: 1) having direct contact with claimants and employers; 2) making compensability decisions; and 3) recording benefit awards. None of these three responsibilities are compatible from a cash control point of view. While claims management may be more efficient and effective than the claims processing approach, it is an inherently weak cash control system.

When it is impractical or inappropriate to provide for the segregation of incompatible duties, there must be a robust system of controls to counterbalance the conflict. Management has worked to address the problem through WCIS (Workers' Compensation Insurance System) controls. For example, the computer system will only allow the Claims Manager assigned to manage a given claim or a member of the same Claims Team, to do any work on that particular claim. WCIS records the Claims Manager's identification number for any action taken on a given claim. Another control requires Claims Managers to enter the employer's policy number before an award can be made. If the employer is unknown or uninsured, the injury will be charged to the I-20 account, which will prompt further investigation. Other computer controls exist. In addition, claimants and employers can appeal the decisions of a Claims Manager and usually will in the event of an unjust ruling. An appeal will prompt a review by the Office of Law Judges. However, because of the weaknesses associated with the lack of segregation of duties of the Claims Manager, these controls are not impervious to employee dishonesty. For example, it may be possible for a Claims Manager to collude with an employer and submit bogus claims. Regular quality control checks of awards made by Claims Managers may be sufficient to remedy the control weakness. A full-time internal audit function could assist with the development of additional controls (see ISSUE AREA 16).

A weakness in cash controls was identified with respect to the handling of deposits to be made with the State Board of Investments. Following the preparation of daily deposits, a Financial Accounting designee routinely delivered the daily deposit to the mailroom for immediate delivery to the State Board of Investments. The checks and cash would be paper clipped to the FIMS (Financial Information Management System) coversheets and deposit slips and stored inside an open-topped accordion folder. The cash would be contained in a small unsealed cash envelope. These deposits often contain large amounts of cash as well as checks (the audit team witnessed preparation of a deposit including $7,650 in large bills). There was no counting of the cash or checks or formal change of custody as the deposits were passed from the Financial Accounting designee to a mailroom employee. Custody could change numerous times before reaching the hands of the delivery person. At the recommendation of the Performance Evaluation and Research Division, the Workers' Compensation Division has drafted and implemented a written policy to remedy the situation. A lockbag has been procured from the State Board of Investments which safeguards the deposit from the time the Financial Accounting designee has prepared the deposit to the time the bag is opened by a designee of the State Board of Investments. Custody changes only occur under the signature of the receiver, and needless changes of custody have been eliminated.

The Division operates a cashier's window at which employers can make payments to the Division. At the recommendation of the Performance Evaluation and Research Division the Division has provided a $250 cash drawer to allow for the making of change. Previously, the cashier would have to either call a Financial Accounting employee having access to the safe on the seventh floor to hand-carry the exact change needed to the cashier's window on the first floor while the customer, cashier and Office of Employer Account's employee waited, or face the temptation to make change out of her own purse (not a good internal control practice). The Division should provide for at least weekly reconciliation of the cash drawer.[13]

While auditing the Division's cash controls, an uncashed check for $915.20 and a new employer application dated February 9, 1996 were found in the vacated office of the former Financial Accounting Director. The check was subsequently logged on July 22, 1996. After thorough investigation, the Performance Evaluation and Research Division is satisfied that the check was misplaced as the result of an honest mistake and a breakdown in the internal control system. In this case, a new employer wishing to apply for regular subscriber coverage was received by an employee in the new applications section of the Office of Employer Accounts (OEA) on a Friday, at approximately 4:55 p.m. Because the Division has a statutory obligation to remain open for business until 5:00 p.m. the customer was allowed to proceed with the application process. By the time the application was complete, the cashier had gone home for the

[13] *More frequent reconciliations, or individual cash drawers for the cashier and relief cashier can be implemented if problems are experienced.*

week, so the OEA employee accepted the check herself. After noticing that the rest of the Financial Accounting staff had also left, the OEA employee gave the check and application to the Director of Financial Accounting to give to the appropriate Financial Accounting employee the following Monday. It is presumed that the Director secured the check in his filing cabinet, since he did not have access to the safe and subsequently forgot about the matter over the weekend. The check was ultimately found in the Financial Accounting activity reports folder, more than five months after it was received. To eliminate the potential for recurrence, the Division should ensure that a cashier be available to properly receive and log checks in the event of a last-minute customer. OEA staff should be instructed to never accept direct payment from an employer. Doing so constitutes a violation of the segregation of incompatible duties and, as this case illustrates, can lead to bigger problems.

Conclusions and Recommendations

Because Claims Managers routinely perform incompatible duties, management should provide for regular quality control reviewing of awards made by Claims Managers. Human review is an essential deterrent to employee dishonesty, a good method for detecting any fraud that may occur, and an excellent way to provide feedback concerning the effectiveness and need for improvement and enforcement of processes and procedures to management. ***The Division should report its plan for implementing regular quality control reviews and any other management controls to compensate for the unsegregated incompatible duties of Claims Managers to the Joint Committee on Government Operations at its November 1996 interim meeting.***

The Division should continue with its new control policy to safeguard and provide accountability for daily deposits. The State Board of Investments is in position to provide for statewide guidelines for the handling of its deposits. For example, the State Board of Investments could provide lockbags to all agencies which make physical deposits of cash and checks.

Management should develop and implement appropriate controls over the cashier's cash drawer. In addition, management should ensure that a cashier is available to provide services for last-minute customers. This could be accomplished by either adjusting the work schedules of the cashiers, or development of a policy, providing for employees of the Office of Employer Accounts to notify the cashier prior to 5:00 p.m. to request the cashier to stay late. In addition, employees of the Office of Employer Accounts should be forbidden from accepting payment from employers.

ISSUE AREA 19: <u>THE DIVISION SHOULD TIGHTEN CONTROLS OVER THE MAILROOM</u>

<u>Level of WCD Compliance:</u> PARTIAL COMPLIANCE

Mailroom controls are notably better than they were at the time the Final Draft Management Letter was issued. A few control problems persist.

<u>Analysis</u>

In the 1992 Final Draft Management Letter, Ernst and Young made several recommendations for improvement of mailroom controls. The recommendations include

- Establishing a single point of entry for all mail which contains a sort room whereby sorters open mail together at one large table or at several tables without drawers.
- Limiting access to the sort room to authorized personnel.
- Continuing the practice of logging all checks for comparison to the bank deposit total.
- Making copies of checks in the sort room for purposes of distribution to the necessary departments (i.e. Employer accounts, Accounting).
- Placing all checks in a locked box along with the Check Control Listing (log) and transferring them to Internal Audit for immediate deposit.

Each of these recommendations is addressed categorically below.

The mailroom, under the control of the Director of Benefits Management, is the single point of entry for all Division mail. Sorters open mail together at one large table area (three adjoining tables in a "T" pattern). The primary sorting tables are located in the center of the room and contain no drawers or other compartments which could provide a convenient cache to an employee wanting to steal a check. The center of the table top contains various binders, books, logs and other clutter related to the work of the mailroom. It is conceivable that an unscrupulous employee could stash a check in the clutter. Materials permitted to be stored on the sorting tables should be limited to bare essentials, such as the Check Control Listings.

Access to the sort room is controlled, but not "off-limits" to unauthorized personnel. The mailroom area has two entry points, an internal door and an external door. Employees of the Division seemed to understand that the mailroom is not a shortcut to the parking lot. However, employees of the Division are allowed to come and go through the interior door when picking-up mail or dropping-off items. In some cases employees are allowed to serve themselves when picking-up mail. The external door was being propped open to provide ventilation and easier access for delivery personnel. However, this practice has ceased since Performance Evaluation and Research Division expressed concerns. Given the volume of checks which are being sorted on the mailroom table, and the many sensitive documents, a higher level of security should be achieved.

The mailroom is maintaining adequate check logs. However, it is apparent that some checks are leaving the mailroom without first being logged. An example is a $3,766.47 cashier's check dated April 27, 1996 that was sent to the Bureau's Legal Division by an employer to replace a non-sufficient funds check. The document was sent via Express Mail and receipt of the package was logged by the mailroom. It is policy that overnight and Express Mail packages, as well as the mail of certain other Division/Bureau employees and departments, and all interdepartmental mail not be opened by the mailroom. Because of this policy the check was not logged and forwarded to Financial Accounting, as it would have been had the package been opened. The Express Mail package, including the cashier's check has never been found. A new check was issued and payment was stopped on the previous check.

Checks are now being copied by the Financial Accounting section. This control has eliminated the practice of sending checks to different sections of the Division. From a control perspective, the present arrangement appears to be working well.

Mailroom staff has made a practice of sending all checks to Financial Accounting as soon as they are logged. As long as access to the mailroom is controlled, the checks should be adequately safeguarded under the present arrangement. While auditing the mailroom another significant problem surfaced. The mailroom is not notified of personnel changes and personnel name changes. This situation could lead to major problems if important documents are improperly routed as a result.

Conclusions and Recommendations

Management should limit materials being stored on the sorting tables to essentials only. The interior door of the mailroom should be modified to allow mailroom employees to hand Division employees their mail through a window, and signs restricting access to the mailroom should be procured and affixed to the doors. Access controls to the mailroom should be strictly enforced. Management should adopt an "open all mail" policy including overnight and Express Mail parcels, holding possible exceptions for the Fraud/Abuse Prevention unit and all interdepartmental mail. This will ensure the logging and proper handling of all checks received by the Division. In addition, the mailroom should require any person assuming custody of overnight/Express Mail-type packages to sign the appropriate log in verification of receipt. Cash and checks should never be left unattended or idle for long periods of time. Employees should forward checks to Financial Accounting or secure them in the mailroom safe when appropriate. Any cash received should be carried to the Cashier to be properly logged. The Bureau of Employment Programs Office of Personnel should send notifications of personnel and name changes to the mailroom and other key departments of the Division. Because mailroom control issues are significant and numerous, management should consider relocating the mailroom organizationally from the control of the Director of Benefits Management to the Director of Financial Accounting. Also, moving the mailroom to Financial Accounting will improve management's span of control over the unit.

APPENDIX 1
Funds Administered by the Division

Workers' Compensation Fund:

Consists of premiums, deposits, the Coal Workers' Pneumoconiosis Fund Transfer Reserve and earnings thereto, and any other moneys or funds which may be given, appropriated or otherwise designated or accruing thereto. Disbursements include medical, temporary and permanent partial, permanent total, fatal, and miscellaneous disability benefit payments (i.e. attorney, funeral, etc.), as well as salaries and other expenses related to the fund's administration.

Surplus Fund:

Funding from a percentage of premiums paid into the Workers' Compensation Fund and certain interest earnings attributable to the Surplus Fund. The Surplus Fund consists of three reserves, Catastrophic, Second-Injury, and the Supersedeas Reserve. The Supersedeas Reserve was established to cover losses resulting from overpayments and benefits paid for injuries later ruled to be non-compensable, which, as required by statute §23-4-1c(I), can only be recovered from claimants by withholding future permanent partial disability benefits.

Coal Workers' Pneumoconiosis Fund:

A fund created to insure the liability of employers subject to the provisions of Title IV of the Federal Coal Mine Health and Safety Act of 1969. Consists of premiums and other funds paid thereto by employers.

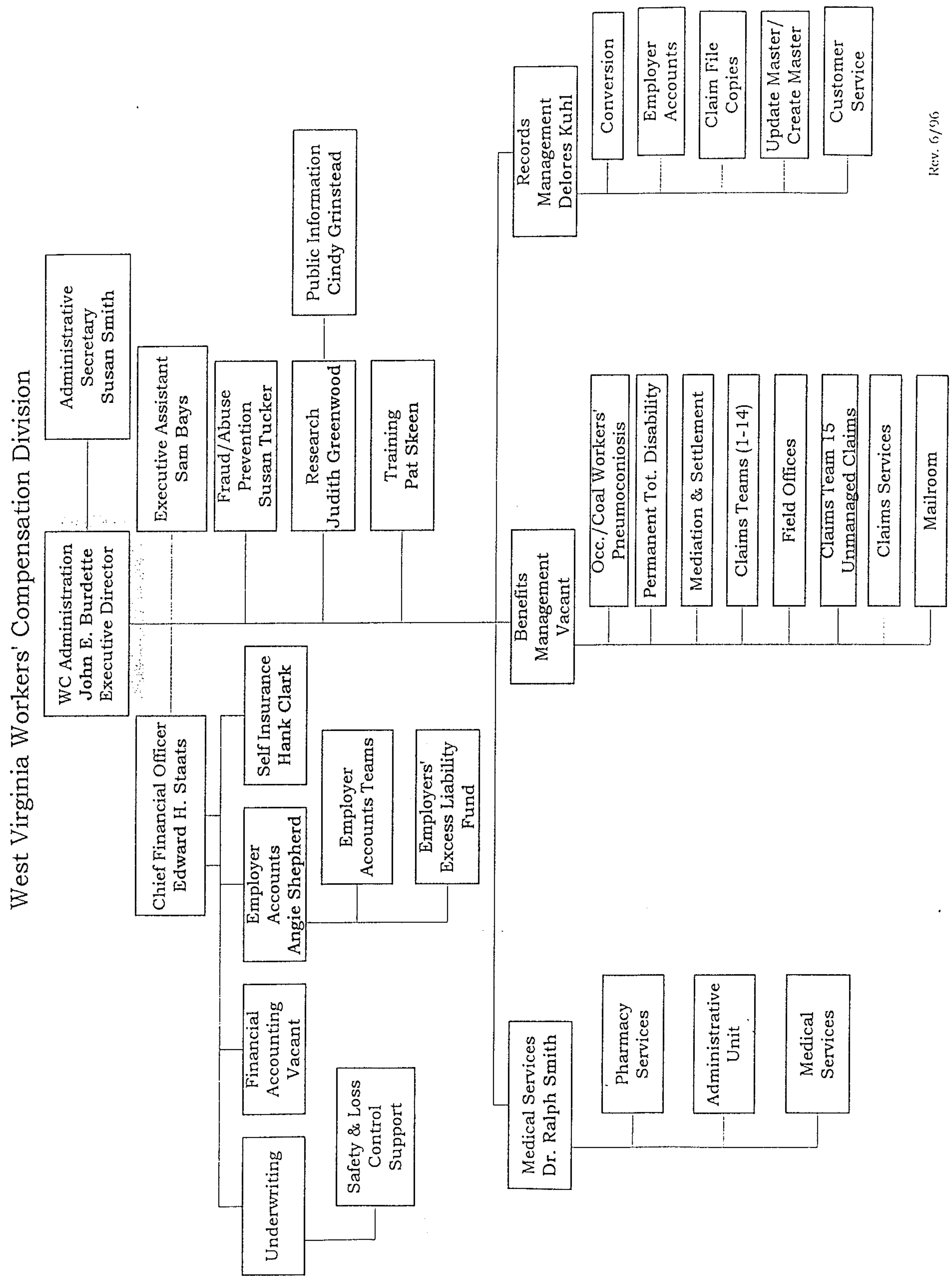
Disabled Workers' Relief Fund:

Funding by transfer of certain interest earnings of the Workers' Compensation Fund and an assessment from self-insured employers. The fund provides relief to persons who are receiving benefits pursuant to a permanent total disability or death benefit awards in amounts less than 33-1/3% of the average weekly wage for the State per month.

Employers Excess Liability Fund:

A voluntary insurance product established to provide coverage for employers who may be subjected to liability for excess damages over the amounts received or receivable under the statute. Funding by employers who elect to subscribe.

APPENDIX 2
Workers' Compensation Division Organizational Chart



APPENDIX 3
Agency Response

Agency's Response to Issue Areas 1-8

Bureau of Employment Programs
112 California Avenue
Charleston, West Virginia 25305-0112

Gaston Caperton, Governor
Andrew N. Richardson, Commissioner of Employment Programs

July 9, 1996

Mr. Antonio Jones, Ph.D., Director
Performance Evaluation and Research Division
West Virginia Legislature
Building 5, Room 75 1A
1900 Kanawha Boulevard East
Charleston, West Virginia 25305-0592

Dear Dr. Jones:

Thank you for sharing with us a copy of the Performance Evaluation of Workers' Compensation, which you plan to report to the Joint Committee on Government Operations at the July interims.

We have reviewed the draft report, and are in agreement with the substance of the conclusions and findings contained in that report. There are some minor factual points that need clarification such as on Page 12 in the 2nd paragraph in the section entitled "Analysis", there have actually been 13 applications processed since the conversion to the new process. This same item appears on Page 17 in the 1st paragraph.

We believe it is important to point out that the revised Self-Insurance process has resulted in an improvement in the division's balance sheet in the amount of $9,954,000. In addition, the surety held has increased by $32,000,000. It is also important to note that we have concentrated our efforts in the surety area on those accounts that have been identified as being in the "extreme financial risk" classification.

We have enjoyed the working relationship and the objective review of this program area, and look forward to continuing this relationship through the remainder of the audit.

Sincerely,

Andrew N. Richardson

Andrew N. Richardson
Commissioner

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Agency's Response to Issue Areas 9-19

Bureau of Employment Programs
112 California Avenue
Charleston, West Virginia 25305-0112

Gaston Caperton, Governor
Andrew N. Richardson, Commissioner of Employment Programs

September 6, 1996

Antonio Jones, Ph. D., Director
Performance Evaluation and Research Division
West Virginia Legislature
Building 5, Room 75 1A
1900 Kanawha Boulevard East
Charleston, West Virginia 25305-0592

Dear Dr. Jones:

Thank you for sharing with us a copy of the Performance Evaluation of the Workers' Compensation Division, which you plan to report to the Joint Committee on Government Operations at the September interims.

We are generally in agreement with the substance of the conclusions and findings contained in the report. Clearly, the Workers' Compensation Division has made significant strides toward improving the effectiveness of our services for West Virginia's injured workers and employers - but much remains to be done. After reviewing the draft report, I am prepared to offer several comments on behalf of the Workers' Compensation Division.

First, regarding hiring an in-house actuary (Issue Area 11), the Workers' Compensation Division disputes the position taken in the 1992 draft management letter that an in-house actuary inherently provides significant operational improvements. The current consulting actuary has served the Workers' Compensation Division for most of the past 15 years, providing a significant level of continuity and institutional memory to the Workers' Compensation Division. This stability has played a major role in the total quality management process that the Workers' Compensation Division has instituted and pursued over the past six years. Nevertheless, the Auditors raise legitimate points on this issue, and the Workers' Compensation Division will aggressively consider a selection of an in-house actuary-in-training as a means of transitioning toward better services in this area. As you know, attracting and retaining highly-qualified staff has been an area of difficulty for the Workers' Compensation Division.

Second, the evaluation of the human resource pool at the Workers' Compensation Division (Issue Area 12) is being pursued as an element of our effort to establish performance measurements. The results of the performance measurements project will provide management with standards to establish a baseline of performance deficiencies to be addressed through targeted training. This accomplishes much of the training needs assessment in a different manner.

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Third, regarding staff development (Issue Area 13) we believe the Auditors raise legitimate concerns about the pace of training being tracked in our training database. We have employed a "just in time" training delivery approach as training had to be timed to occur very near the time of hardware and computer system installation. As timelines were periodically adjusted, we learned that if the training was conducted too far in advance, memory retention would suffer. We had to balance the need to train almost 400 employees with the need for them to carry out their daily activities.

Thus, much of the training offered in 1996 has occurred at the trainee's work station through a variety of prescribed exercises and individual instruction. This was part of a planned training curriculum. However, the database does not reflect the extensive desk-top training received by Workers' Compensation Division employees in 1996 as part of a planned training curriculum.

The technology changes have dramatically changed the world of work at the Workers' Compensation Division in 1996, and I am confident that continuous learning is more and more becoming a regular part of each employee's workday. Training is a vital element of the continuous improvements process and we appreciate the insights offered by the Auditors.

Lastly, we would also like to comment briefly on Issue Area 18, where the Division should provide for adequate segregation of duties for cash transactions.

We have been discussing this issue with our Management Analysis group and have asked them to begin a regular quality control sampling of claims in the claims management process which we should be able to report to the Joint Committee during the November interims.

We also note that the cash window which was established January 16, 1996, has captured for early deposit $4,944,390.60, resulting in considerable increased earnings for the Division.

We believe this report demonstrates significant improvements that have been made since the draft management letter was issued in March 1992. We are continuing on our efforts to address all issues in the management letter. We appreciate the constructive suggestions and the professional approach used by the staff of Office of Legislative Auditor, the Performance Evaluation and Research Division.

Sincerely,

Andrew N. Richardson

Andrew N. Richardson
Commissioner