RSM McGladrey

# California Department of Insurance

## State Compensation Insurance Fund

### 2008 Operational Review Report

December 2008

RSM McGladrey, Inc. is a member firm of RSM International – an affiliation of separate and independent legal entities.

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San Francisco, California
December 12, 2008

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, a follow-up Operational Review was made of the

STATE COMPENSATION INSURANCE FUND

at its home office located at 1275 Market Street, San Francisco, California 94103.

## Introduction

RSM McGladrey, Inc. (RSM McGladrey) was appointed by the California Insurance Commissioner to conduct an operational review of the State Compensation Insurance Fund (State Fund) pursuant to California Insurance Code Section 733(g) in 2007. The 2007 review was initiated by the California Department of Insurance (CDI) in response to the CDI's preliminary financial examination findings related to corporate governance and other management issues, as well as issues publicly disclosed regarding State Fund's Group Association Programs (Group Program), internal investigations and management changes. The 2007 review resulted in several significant findings. In June 2008, the Commissioner requested that a follow-up operational review be completed to determine the progress State Fund has made in remediating the 2007 operational review findings and implementing suggested recommendations.

Since the 2007 operational review, legislation was passed in 2008 that allows State Fund to add six exempt positions to its overall management structure. At the time of the 2007 review, State Fund was only allotted one exempt position. This made it very difficult for State Fund to compete for key management resources that are present at comparable insurance companies.

Legislation effective in 2009 will allow State Fund to increase its Board size from five members to 11 voting members, and to increase compensation for its Board to a more competitive rate.

The internal controls and corporate governance subject to this 2008 operational review conducted by RSM McGladrey are representative of the controls in place at State Fund as of December 12, 2008. While certain findings from the 2007 operational review have not been remediated, State Fund has indicated that it should have the majority of the open matters addressed by June 2009. Where applicable, we have indicated the status of each open finding. RSM McGladrey obtained State Fund

responses contained in this report from status updates prepared by State Fund for the California Department of Insurance's use. Overall, in the past 12 months, State Fund has taken many steps to improve corporate governance and internal controls.

# Executive Summary

## Introduction

As a result of the December 2007 Operational Review Report issued by the California Department of Insurance (CDI), RSM McGladrey was appointed to conduct a follow-up 2008 operational review to test the progress made in the control environment and overall corporate governance at State Compensation Insurance Fund (State Fund). The scope of our 2008 operational review included reviewing specific programs at State Fund that were not examined in the 2007 operational review and testing the initial 110 findings to determine if the suggested recommendations from the December 2007 Operational Review Report had been implemented.

## Background

RSM McGladrey was appointed by the California Insurance Commissioner to conduct the 2007 operational review of State Fund in May 2007. The 2007 operational review was initiated by the CDI in response to corporate governance and management issues identified in the 2006 statutory financial examination, as well as issues surrounding State Fund's Group Association Program. A report was issued in December 2007 that contained 110 findings and recommendations covering State Fund's operations. During 2008, the CDI has been monitoring certain programs and administrative functions at State Fund.

The State Fund Board of Directors (Board) initiated an independent review of State Fund in December 2006 to review the Group Association Program and related internal controls. As a result of that investigation, a referral was made to the California Highway Patrol (CHP), which has jurisdiction over state agencies. In April 2007, the CHP, the CDI and the San Francisco District Attorney's Office formed a task force to investigate allegations of potential misconduct by former State Fund employees.

In September 2008, legislation was passed to enable State Fund to add six additional exempt positions to its management structure. Legislation effective January 1, 2009 provides for an increased number of board members, establishes an audit committee, states criteria and guidelines for board member selection and appointment, and authorizes an enhanced compensation structure for board members.

## Scope and Approach

The 2008 operational review of State Fund consisted of several procedures including interviewing the executive management team and key personnel involved in the management of day-to-day operations of the programs under review, updating and/or conducting process walk-throughs of critical systems and functions such as claims, underwriting, invoice processing, and vendor contract procedures; reviewing, analyzing and testing certain internal controls for each respective scope area, and performing limited testing of underwriting and claims processing at select district offices.

Specifically, the review focused on the following areas:

- **Governance and Management Practices**, includes a review of State Fund's risk management activities which encompasses the governance structure over the management positions as well as an assessment of the internal audit function and human resources function.

- **Group Association Program**, includes a general review of the Group Association Program components.

- **Information Technology (IT)**, includes a follow-up assessment of the general IT controls identified in the 2007 Operational Review Report. A complete IT general controls review was not conducted in 2008.

- **District Offices and Claims Processing Centers (CPC)**, includes an operational review of five district offices and analyzing the outstanding findings at the CPCs, which included the late penalty payments.

- **Business Services,** includes a limited review of the newly formed Business Services Operations (BSO) and Contracts and Purchasing (C&P) Departments which are responsible for purchasing and fleet operations.

In addition to the review and update of the 2007 operational findings, RSM McGladrey was asked to perform a review of certain additional functions at State Fund in 2008. This review consisted of the following areas and resulted in 35 new findings and recommendations that are included in this report:

- **Corporate Governance**, includes an assessment of the Board's meeting practices and approval process, the Legal Department's contract review procedures and State Fund's overall strategic plans.

- **Fiscal and Administrative Programs**, includes a review of certain aspects of the following fiscal programs: Management Information and Budget (MIB) program, Fiscal Accounts Payable (Fiscal AP), Project Services Office (PSO), and Brokerage. Two administrative areas were reviewed: manual spreadsheets and the Electronic Claims File (ECF) System.

- **Business Services**, includes a follow-up review of the information technology vendor contracts and fleet operations.

## State Compensation Insurance Fund History

State Fund is California's leading writer of workers' compensation insurance. State Fund employs approximately 8,000 staff. State Fund serves as California's insurer of last resort for workers' compensation insurance. Established by the California Legislature in 1914 State Fund is a self-supporting enterprise that provides workers' compensation insurance to California employers. State Fund's creation in 1914 occurred concurrently with the enactment of the first compulsory workers' compensation laws in California to assure California employers of the availability of workers' compensation coverage. State Fund's organization and powers are defined by the California Insurance Code.

### *State Fund's Remediation Efforts to the 2007 Operational Review*

The State Fund 2008 operational review included verifying the progress made towards addressing the 110 findings and recommendations included in the 2007 Operational Review Report issued in December 2007. The 2007 Operational Review Report contained specific findings and recommendations for the following areas: Governance and Management Practices, Human Resources, Internal Audit, Group Association Program, Information Technology, District Offices, CPCs and Business Services. The table below provides a summary of the progress made on the 110 findings by functional area:

**Status of Remediation Efforts**

| Functional Area | 2007 Findings | Finding(s) Remediated | Finding(s) Partially Remediated | Finding(s) Not Yet Remediated |
|---|---|---|---|---|
| **Governance & Management Practices** | **9** | **1** | **7** | **1** |
| **Human Resources** | **8** | **0** | **8** | **0** |
| **Internal Audit** | **14** | **6** | **7** | **1** |
| **Group Association Program** | **14** | **10** | **4** | **0** |
| **Information Technology** | **24** | **15** | **9** | **0** |
| **District Offices** | **13** | **8** | **2** | **3** |
| **Claims Processing Centers** | **8** | **6** | **1** | **1** |
| **Business Services** | **20** | **7** | **2** | **11** |
| | | | | |
| **Total** | **110** | **53** | **40** | **17** |

For a detailed status of finding remediation see *Exhibit 1: State Fund's Remediation Efforts to the 2007 Operational Review*.

***Governance and Management Practices***

The 2007 Operational Review Report had 31 Governance and Management Practices findings and recommendations of which seven have been remediated and 22 have been partially remediated.

In 2007, State Fund's executive management team made decisions for oversight of programs based upon what programs were open and who had availability to oversee these functions. In certain instances, State Fund executives did not manage programs that aligned with their particular backgrounds and expertise.

Chief Officer Positions

In 2008, legislation was adopted to enable State Fund to add six key exempt management positions to the organization. This change in management will allow State Fund to have "C" level positions similar to other insurance entities that are comparable in size and function. Since September 2008, State Fund has hired a Chief Risk Officer, Chief Information Officer (CIO), Chief Financial Officer (CFO), General Counsel and Chief Operating Officer (COO). Prior to the 2008 legislation, the General Counsel position had not been an exempt position. The only exempt position that is open as of the issuance of this report is the Chief Investment Officer. State Fund should hire a Chief Investment Officer.

State Fund has discontinued the use of key management consultants with the creation of the exempt positions. The former consulting Chief Financial Officers that were utilized in 2007 have been replaced by a permanent CFO. One consultant completed work at State Fund as of December 2007 while the other consultant was retained through June 2008.

State Fund appointed a General Counsel in October 2008. The State Fund General Counsel position was open since June 2007. During the General Counsel vacancy, the needs of the organization and the Board were filled by external legal counsel. The new General Counsel should continue to work with the Board and President to define priorities for the General Counsel and overall Legal Department.

As State Fund is now subject to the Bagley-Keene Open Meeting Act of 2004, the legal needs of State Fund and its Board have increased. There are several reforms that need to be addressed in the Legal Department to ensure that other programs are able to complete planned initiatives and control remediation.

Board of Directors

Legislation has been passed, effective January 1, 2009 that will enable State Fund to increase its five member Board to eleven voting members. With the Board expansion, emphasis should also be placed on obtaining members with diverse qualifications, including investment and insurance-specific expertise. The new legislation also provides board members with an enhanced compensation package designed to help State Fund attract board members that have the necessary expertise. State Fund anticipates that when the Board expands, the Board will form additional subcommittees. In 2008, the Board formed an Investment Committee and an Audit Committee. However, due to the limited current Board size, most members must sit on all committees. It is important that the Board meeting packages be manageable in size and contain value-added, high-level information so the Board is able to act in an efficient and effective manner. A formal policy should be created to provide criteria on what should be included in Board reporting packages.

State Fund has made an effort to develop a draft training program outline for new board members. Board training should be a high priority with the emergence of new board members in 2009.

## Governance Framework

State Fund has taken steps in the past year to enhance the overall governance of the organization by hiring key executive positions such as the Chief Financial Officer, Chief Risk Officer, and Chief Operations Officer; establishing a Code of Ethics for its Board members, adopting a Code of Conduct for its employees; and expanding the Conflict of Interest Code; forming the Ethics and Compliance Program; and creating Audit and Investment Subcommittees. However, a formal governance framework should be adopted to enable future progress on control remediation and monitoring. A sound governance framework will provide State Fund employees with a foundation to reference when establishing internal controls and implementing monitoring processes. The governance framework should support current existing corporate guidelines. State Fund has made a significant effort to update policies and procedures for most programs during the past 12 months.

As of November 2008, State Fund created a new managerial role to monitor ethics and compliance within the organization. There are also plans to implement a full time corporate governance management position. State Fund had approved the hire of a specialist to provide high-level enterprise risk assessments throughout the organization and assist with internal control mapping. However, this project has not commenced at this time.

The newly appointed Ethics and Compliance Manager and Chief Risk Officer should play an integral role in the development and maintenance of the governance framework. The Corporate Compliance Committee's purpose should be communicated organization-wide. The Corporate Compliance Committee should take responsibility to set the appropriate tone for compliance at State Fund and establish proper rules of conduct for other State Fund committees. The Corporate Compliance Committee and Ethics and Compliance Manager should ensure that accurate minutes of committee meetings are maintained. The Enterprise Risk Assessment Committee should be significantly involved in developing the Annual Financial Reporting Model Regulation compliance plan of action and providing status updates to the Board.

## General Management Practices

Discussions surrounding consultant use and the review of consultant usage reports should be documented in the Project Review Board (PRB) minutes. Use of consultants should be consistently challenged by executives to ensure that all available resources are utilized effectively.

During the past year, State Fund implemented "Town Hall" meetings at select locations to provide employees with updates on organizational issues and to establish a formal Communication Policy. State Fund should place emphasis on providing employees with timely updates during periods of time between "Town Hall" meetings.

## Internal Audit

The Audit Committee and Board minutes include evidence of the Internal Audit Plan approval and should also include Audit Committee and Board approval of subsequent revisions to the plan. Internal Audit should continue to refine its policies ensuring that staff follows the policies in the State Fund Internal Audit Manual. Internal Audit staff should pursue appropriate designations to demonstrate expertise in their field.

## Human Resources

Human Resources (HR) should implement the plans they have established for succession planning and leadership training. At the time of the review, no formal succession plans had been implemented nor were detailed plans documented for any of the 149 key employees identified in the succession planning initiative. The HR presence at the district offices should continue to be enhanced and monitored.

***Group Association Program***

The 2007 Operational Review Report had 14 findings and recommendations for the Group Association Program. There were ten findings that were remediated and four which were partially remediated. All four partially remediated findings are substantially complete.

State Fund has completely restructured its Group Program. It has tightened the controls around the underwriting and contract process for the Group Program. Various policies and procedures were established to control approvals of and payments to group associations, advertising with group associations and underwriting requirements of group policies.

At the time of our review, State Fund's Group Program internal review resulted in the cancellation of 23 sub-groups out of a total of 245 sub-groups. Additionally, 15 sub-groups decided independently to discontinue business with State Fund. Specifically, Western Insurance Administrators, which was administered by a former board member of State Fund, was cancelled by State Fund. Two sub-groups of Golden State Builders Exchange, also administered by a former board member of State Fund, decided to discontinue business with State Fund, while two sub-groups of the same group association were cancelled by State Fund. Another large group association, which was one of the top four group associations at State Fund, decided to discontinue business with State Fund in November 2007.

Conflicts of Interest statements have been established and are now signed by board members and reviewed by HR. No conflicts of interest were noted for Group Associations. State Fund needs to continue to ensure that as its Board grows in size, conflicts of interest statements are reviewed closely for Group Association involvement. State Fund created a Code of Conduct, Code of Ethics and Incompatible Activities Policy, which addresses financial conflicts of interest. State Fund has stated that all three codes are pending Department of Personnel Administration approval.

The group contracts have been revised to include specific performance measures to benchmark contract compliance standards. Additionally, revised contract language states that the new contracts supersede any previous contract; therefore, there are no multiple contracts in place for groups. The new group contract templates identify services to be performed by group associations. Types of safety activities are separated into four levels in the new contract. Group associations are required to perform a certain number of each level of safety activities depending on premium volume for the year (i.e., the more premium volume a group association has, the greater the number of safety services the group association must provide). During the first eight months of 2008, approximately $32 million had been paid to group associations, of which an estimated $23 million pertained to the new contract terms and approximately $9 million was based upon in-force contracts prior to the new contract terms.

State Fund strengthened the group contracts by enhancing the audit provision contained within the contract agreement. State Fund also strengthened the process of verifying group membership at the district offices through issuance of an Underwriting Advisory Policy, which specifically identifies the membership requirements when a group policy quote is issued. State Fund has begun exercising the audit provision; however, at the time of our review only one audit had been completed.

State Fund should increase the Legal Department's role in reviewing group contracts that deviate from the standard template. The Legal Department's group contract review should be documented, and procedures should be established for the Legal Department's role in the review of group contracts. The Group Program underwriting team should continue to complete compliance audits of group associations, adhere to a schedule for audit completion and incorporate areas noted for improvement into formal State Fund procedures.

State Fund increased transparency in their 2007 Annual Statement by reporting group administrative fees as a separate write-in item.

Internal Audit began a review of the Group Program in January 2008; a report on this review was not completed as of the date of this report. An audit of Group Administrative Fees is also planned for 2010.

***Information Technology***

The 2007 Operational Review Report had 24 findings and recommendations for IT of which 15 have been remediated and nine have been partially remediated.

State Fund is continuing to improve its IT Governance and the control environment. A new CIO was hired as of September 30, 2008. Policies and procedures have been implemented and are generally being followed as evidenced by the results of testing procedures. State Fund has stated that it is restructuring its IT function to be more "flat" in nature. There will be many more direct reports to the CIO, which State Fund hopes will create more opportunities for direction and support. There is a project in process to centralize the data center in Vacaville. State Fund has stated that they have begun moving the production applications and are planning the Home Office mainframe migration for January 2009. July 2009 is the target date for migration of all the production systems.

State Fund has created the Audit Compliance Oversight Team to monitor internal and external audit IT exceptions. Several new corporate guidelines and security policies were updated in early 2008, including Access Control, Anti-Malware, Application, Change Management, Compliance, Data Center, Encryption, Incident Management, Network, Operating System, Password and Remote Access Policies. The Enterprise Security Group is now an independent group within IT and reports directly to the CIO. Security best practices have been integrated into the IT Policies on an enterprise-wide basis.

State Fund has removed the 'super user' responsibility and re-evaluated all user settings. Oracle audit logs have been enabled to track users and review of the audit logs is being performed, including investigation into any exceptions. In addition, a new process was implemented to allow for separation of duties for requisition preparers, approvers and receivers.

State Fund should continue remediation efforts in the area of IT. Analysis and identification of IT General Controls should be performed for State Fund offices. State Fund has created standard templates for the Business Continuity and Disaster Recovery Plans. State Fund has indicated that these plans will be revised based upon changes to current operating architecture by year-end 2008. Current development plans should include specific duties for the systems staff. Once migration to the Vacaville Data Center is complete, the plans will need to be updated within a reasonable timeframe. State Fund has specified that encryption on back-up tapes at the Home Office and the Fairfield District Office will be enabled by year-end 2008.

Physical access controls should be reviewed and improved at the district offices. There were no water detection sensors or alarms at the Glendale Data Center to protect against water leakage.

***District Offices and Claims Processing Centers***

The 2007 Operational Review Report had 21 findings and recommendations regarding District Offices and CPCs of which 14 findings have been remediated and three have been partially remediated.

In June 2008, State Fund district offices were functionally realigned. The changes related to this alignment are still on-going. State Fund was effective in revising staffing at the CPCs to address findings identified in the 2007 Operational Review Report related to late penalty payments at the CPCs.

Remediation efforts for the district offices should emphasize increasing ECF functionality to ensure accurate reporting. State Fund Internal Audit conducted ECF implementation reviews at the San Diego, San Bernardino, Glendale and Riverside District Offices in 2007. State Fund stated that additional ECF modules will be implemented that will add to the capability and functionality of ECF.

State Fund should highlight the importance of timely establishment of initial claim reserves. Existing procedures established for creating reserves for known claims should be revised to stress the importance of reviewing all medical reports on file, as well as outstanding bills that have been received on a claim. Controls over manual check processing and premium payment handling should be strengthened.

The medical bill payment function for all district offices was moved to three CPCs located in Fresno, Fairfield and Burbank in late 2006. Upon transition of bill payments to the three CPCs, medical and indemnity bill penalties paid for all district offices increased significantly to $19.5 million in penalties from January 2007 through July 2007, with $4.7 million occurring in July alone. In December 2006 and December 2007, penalty payments were approximately $600,000 and $2.8 million respectively for all district offices combined. The staffing situation at the processing locations was inadequate to handle the volume of bill payments processed in those offices. State Fund hired a consultant in August 2007 to identify opportunities to reduce late payment penalties. Additionally, staffing was increased at the CPCs to address the backlogs.

Total penalty payments for July 2008 were approximately $500,000 in comparison with July 2007 penalty payments of $4.7 million. Based upon our analysis, the backlog situation has improved significantly since July 2007 when penalties were $4.7 million. Even when compared to July 2006 penalty payments of approximately $1.7 million prior to the transition of bill payments to the CPCs, penalties are considerably lower. The efficiencies of the automated reports to capture high-dollar bills, establishment of business rules in the system that allows auto-adjudication, additional training and increased staff all appear to have played a role in the reduction of late payment penalties.

***Business Services***

The 2007 Operational Review Report had 20 findings and recommendations regarding Business Services of which seven have been remediated and two have been partially remediated.

Business Services has undergone various organizational and leadership changes since the 2007 operational review was performed. Prior to September 2007, Business Services was comprised of four units, consisting of Operations, Purchasing/Transportation/Supply, Telecommunications and Business Applications. In September 2007, the Business Applications unit was moved to the Fiscal and Investment Services Program (Fiscal) and renamed Fiscal Accounts Payable. Upon the transition of the Fiscal AP function to Fiscal, Fiscal conducted an initial review of the current Fiscal AP processes in order to assess the risks. This review emphasized determining whether adequate controls exist over the Fiscal AP function, including segregation of duties, adequate level of approvals, and appropriate reconciliations.

Business Services went through another round of significant changes from June 2008 through October 2008. On June 1, 2008, a reorganization of the Business Services Program was implemented. Business Services was separated into two primary departments, C&P and BSO. BSO oversees fleet operations, employee services and mail services. C&P is responsible for all purchases, contract management and contract administration.

In September and October 2008, the Vice President overseeing Business Services retired and the newly created COO position was filled. The new COO immediately began oversight of C&P and BSO. C&P and BSO are overseen by two separate managers who report directly to the newly appointed COO.

With this new leadership and structure in place, State Fund has made efforts to update and/or draft new policies and procedures pertaining specifically to fleet operations and C&P functions. State Fund paid approximately $49 million for vendor services related specifically to IT from October 1, 2007 to September 30, 2008.

BSO, with the assistance of an outside consulting firm, compiled its first complete fleet vehicle inventory as of June 30, 2008. The external consultant compiled an analysis detailing future options for the fleet vehicle program at State Fund. BSO staff determined that a reduction of the fleet vehicles was appropriate. The fleet was reduced by approximately 200 vehicles from January 2008 to October 2008 (out of approximately 2,380 reported as of the close of the 2007 operational review). However, it appears that the majority of these vehicles were removed due to age and/or condition. Only 16 State Fund employees had their fleet vehicle privileges removed based on a lack of business necessity. State Fund Internal Audit did not perform an audit of fleet operations in 2008. An audit of fleet operations is scheduled to be conducted by Internal Audit in July 2009.

Our testing performed during 2008 did not reveal instances of payments without proper support. Fiscal AP Policy does allow for the expense payment to a limited group of vendors without an invoice or contract (i.e., the United States Postal Service). A listing of such vendors is maintained by Fiscal AP. However, this listing is very general. A more detailed log should be maintained on a transactional level as opposed to a vendor level. Executive Committee members should review the listing of the payments that are processed without the support of an invoice or contract on at least a quarterly basis.

The C&P Policies and Procedures have been drafted. The Executive Committee should review the draft policies when they are final. The draft policies and procedures provided did not include criteria related to IT contracts or specific criteria that would warrant Legal or HR review. A recommendation was communicated to State Fund regarding the inclusion of specific criteria that would prompt a Legal or HR review of a contract in the updated policies and procedures.

IT consultants' contracts are entered on a six-month term based upon State Fund policy. In many cases, the IT consultants' contracts undergo subsequent extensions without defining key objectives or the final completion date. Transition plans discussing the usage of IT consultants do not appear to provide specific metrics detailing when the usage of IT consultants will be terminated.

State Fund does not formally track deviations in actual payments compared to contract terms. Fiscal AP personnel have made efforts to implement a manual control to reconcile actual payments made to the contract terms. However, this control is inadequate in design.

### *2008 Operational Review*

Other areas of review in the State Fund 2008 Operational Review included: Board, Legal, General Management Practices, Management Information and Budget, Fiscal AP, Project Services Office, Brokerage, Manual Spreadsheets, ECF System, Information Technology Vendor Contracting (ITVC), Fleet Operations (Fleet), Contracts and Purchasing, General Ledger*(GL), and Group Associations*. The table below provides a summary of the findings identified during our review by functional area and subsection:

**Summary of Findings**

| Functional Area | Findings |
|---|---|
| **Corporate Governance** | **13** |
| Board** | 4 |
| Legal | 5 |
| General Management Practices | 4 |
| | |
| **Fiscal and Administrative** | **15** |
| MIB | 3 |
| Fiscal AP | 3 |
| PSO | 5 |
| Brokerage | 1 |
| Manual Spreadsheets | 2 |
| ECF System | 1 |
| | |
| **Business Services** | **7** |
| ITVC | 2 |
| Fleet | 4 |
| Contracts and Purchasing | 1 |
| | |
| **Total 2008 Operational Findings** | **35** |

* No findings were identified in the review of the GL or the additional review of the Group Association Program.
** Board findings reflect issues identified through review of general Board minutes, management interviews and review of Board packets. Executive session minutes are not maintained.

For a detailed synopsis of the findings see *2008 Operational Review Findings and Recommendations.*

***Corporate Governance***

Board

As a result of previous findings related to the Board in the 2007 Operational Review Report, RSM McGladrey obtained and reviewed bi-monthly Board minutes from January 2003 through November 2008 and agenda packages from the January 2007, May 2007, January 2008, May 2008, September 2008 and November 2008 meetings. The minutes did not include necessary information regarding incoming and outgoing Board members, and key action items did not have a motion or vote for approval until November 2008.

The Board minutes through May 2008 demonstrate that the Board did not spend sufficient time discussing high-level strategy, the direction of State Fund, or threats to State Fund that are appropriate Board business. A number of operational plans were provided to the Board; however, these plans were in the form of proposed plans presented to the Board for approval. More strategic discussions were held and an appropriate level of feedback was provided to management at the Board and Committee level in the September and November 2008 meetings.

In March 2008, State Fund management developed and presented to the Board a mechanism to facilitate the presentation and approval of pertinent financial information, including budget information and other related matters of importance, on a regular basis. Additionally, in 2008 the Board began to approve State Fund's significant resignations, retirements, and other major staffing related issues through Board resolutions. At the request of the State Fund Board Chair, benchmark standards for minutes' production were also implemented in early 2008.

The Board should continue to ensure that items of significance are voted on and captured in the minutes. In addition, the Board should spend sufficient time discussing high-level strategy of the organization, with appropriate consideration given to changes in the market, industry conditions and regulation. The minutes should adequately reflect these discussions. The Board should continue to place emphasis on reviewing corporate governance standards.

Legal

The Legal Department is responsible for providing legal services, including review of contracts, subrogation cases, court appeals and decisions, civil litigation cases and workers compensation cases. The Legal Department solicits external counsel assistance when needed and utilizes a case management system to manage legal case activity. The Chief Counsel retired in June 2008 and a new Chief Counsel was promoted in August 2008. The General Counsel position was filled in October 2008. The Chief Counsel provides legal counsel and guidance to program managers in areas requiring specialized legal expertise and legal representation to policyholders pursuant to insurance contracts.

The Legal Department is going through a transition period with a newly promoted Chief Counsel and the transition of legal case activities to the new case management system. The Legal Department should continue to refine and finalize its policies and procedures for the contract review process. The revised guidelines should address the existing deficiencies in the process. Contracts should be reviewed and copies retained within the Legal Department. Requests for contract reviews should be initiated by the C&P Department. There should be a tracking system configured within the case management system to track outstanding contracts that have not been reviewed. The case management system should also be configured to provide an audit trail when a supervisory review is performed on contracts. The Legal Department should also ensure that material contracts are reviewed by two or more supervisory level legal staff with the appropriate contract expertise. Peer review audit reports should be provided to the Internal Audit Department and outstanding issues from the peer reviews should be presented to the Audit Committee or the Board to promote transparency.

General Management Practices

State Fund does not develop strategic plans in a comprehensive format. State Fund should adopt a consistent, all-inclusive format for their strategic plan to ensure that all critical aspects of the plan are easily accessible for management.

Realignment of functional areas and consistent reporting of information to the Board is necessary regarding current PSO projects, associated budgets and timelines, as well as project status to keep the members of the Board apprised of significant State Fund projects. Currently, the PSO and MIB Programs report to two different Vice Presidents and there appears to be limited interaction and coordination between them. If the program managers were moved under the CFO some efficiency may be achieved.

***Fiscal and Administrative***

Management Information and Budget

MIB is responsible for the budgeting process which includes planning and implementing the budgeting process by assembling all relevant management reports and delivering them to the appropriate managers and executives in order to facilitate the budget decision making process. MIB also maintains the central repository of financial budgeting data utilized to produce the reports provided to management. While MIB continues to implement new budgeting software in an effort to standardize the budget reporting process, improvements are still necessary.

The budgeting process should be driven by a strategic plan; however, there is currently no strategic plan in place. Support for budgeted items needs to be standardized, contain an increased level of detail and be required to be submitted to MIB. The budget variance monitoring process lacks the necessary metrics and guidelines for providing significant budget variance explanations.

Fiscal Accounts Payable

The Fiscal AP function within Fiscal is responsible for processing payments of vendor invoices as well as employee reimbursements. This process includes ensuring that invoices are properly authorized, have adequate support and are paid in a timely manner to avoid any penalties or loss of discount.

Several changes have occurred in the Fiscal AP environment since September 2007, including the transition of the function and reporting relationship from Business Services to Fiscal. Although Fiscal AP is continuing to refine its processes and implement changes to the program, there are still some improvements needed.

Fiscal AP should continue to refine its policies. The President’s payment authority level should be researched using internal payment history for a more appropriate level. Executive Vice President signing authority should be lowered accordingly and dual signatures for large payments should be required. The process of providing timely review and approval of large dollar recurring invoices should be changed to ensure that all such payments are reviewed prior to payments being made.

Project Services Office

The PSO is responsible for managing projects, monitoring and reporting on projects, acting as a liaison between the functional steering committees and the Executive Committee, and facilitating a consistent and timely information stream throughout the organization. Although the PSO is continuing to refine its processes and implement standardized templates for proposals, there are still some improvements needed.

There is no consistent reporting of PSO projects to the Board. Project status reports have been made to the Board in the past on various projects of interest, but not on a regular basis. In addition to the lack of consistent reporting to the Board, there is little documentation provided to the steering committees in support of the financials submitted in project proposals. There is currently no ongoing monitoring of projects after completion to ensure that projects meet the expected cost savings identified in the initial proposal. Moreover, the PSO Policies and Procedures are outdated and not applicable to the current operating environment at State Fund.

The PSO should continue to improve its proposal process to ensure that adequate support is provided to the steering committees for all IT related projects considered. In addition, quality assurance practices should be developed to ensure the accuracy and completeness of submitted information.

State Fund has communicated that significant changes are occurring in this program. The restructuring changes should be completed in mid 2009.

Brokerage

The Commissions Brokerage Unit is responsible for the monthly calculation of broker commissions and the annual Special Incentive Payment Plan (SIPP). The SIPP is a contingent commission plan available to preferred and select brokers which represents the top 450 State Fund brokers. The preferred brokers are the top 250 brokers, the select brokers are the next 200 brokers and all others are deemed standard brokers. This brokerage ranking is based upon annual premium volume. State Fund aggregates the premiums of commonly owned brokers for ranking and classification purposes. The brokerage ranking is determined based on the amount of premium written for the prior year's book of business.

There are 19 Brokerage Corporate Guidelines and Procedures (Brokerage Guidelines) that support and direct the Broker Commission Unit's processes. The Brokerage Guidelines have not been reviewed since 2006. There should be a periodic review of the Brokerage Guidelines to ensure that the procedures continue to be in line with State Fund's objectives and operating procedures. The periodic review and approval process should be formally documented.

Manual Spreadsheets

The controls surrounding the updating and maintenance of key manual spreadsheets in relation to the actuarial function are not adequate. Key spreadsheets are not cell or password protected. In addition, there are no formally documented procedures detailing the processes associated with the updating and maintenance of these spreadsheets and workbooks. State Fund staff appears to be placing heavy reliance on the planned implementation of the Executive Decision Support System (EDSS) in 2009 and has prepared for such by compiling a limited inventory of spreadsheets scheduled for automation. However, an all-inclusive inventory of manually maintained actuarial spreadsheets has not been compiled. Additionally, title adjustment(s) may be warranted in Fiscal AP to accurately reflect the roles certain staff are filling in relation to the completion of the Statutory Annual Statement Schedule P.

Electronic Claims File System

ECF is the systems application that is used by the State Fund to process claims. This application is capable of storing information and documentation associated with a claim electronically. It also facilitates the authorization of medical claim payments. The current ECF version is only capable of processing medical payments. Compensation payments continue to be processed utilizing the Wang Interchange System Processor (WISP). WISP is the application that was used to process all claims payments prior to ECF implementation. ECF's functionality should be programmed for several enhancements to maximize its capabilities.

State Fund is accounting for late payment penalties in Defense and Cost Containment for statutory reporting purposes. These penalty payments should be accounted for in Adjusting and Other per statutory accounting guidance.

***Business Services***

Information Technology Vendor Contracting

The Business Services Department is responsible for the review, execution and control of ITVC. The follow-up review focused on the information technology contract procedures. The ITVC process is not being adequately documented or monitored. The new State Fund "model" contract package consists of three distinct documents; a contract agreement, a consulting agreement and a Statement of Work (SOW). New "model" contract package documents need to be consistently referenced and specify which document prevails when there is conflicting information. Documentation supporting vendor review and selection should be maintained. Vendor work product specifications should be strengthened and work activity monitored in accordance with the best practices included in the new contract components.

State Fund management should develop and document IT vendor bidding and selection processes that clearly outline the criteria and allow for an independent vendor selection process. State Fund should enhance its contract maintenance procedures to ensure that all critical contract components are retained.

Fleet

The Business Services Department is responsible for the operation of the fleet vehicles assigned to State Fund. As of September 2008 the State Fund fleet was comprised of 2,048 vehicles. The fleet operations review resulted in several findings that are not in compliance with established Corporate Guidelines and Procedures (Fleet Guidelines). The Fleet Guidelines have not been reviewed and updated by State Fund management since April 2002. Vehicle assignment procedures are not reflective of job travel requirements and State Fund's current operating environment.

The fleet operations should be centralized to ensure that all Fleet Guidelines and government regulations are consistently followed. In addition, Business Services should review and update the current policies and procedures. Once the review and update processes have been completed, the new policies should be disseminated to all employees to ensure that staff adhere to the current policies. State Fund should consider conducting a training related to the revised Fleet Guidelines. Internal Audit should review this area annually.

Contracts and Purchasing

No updated policies and procedures were established to perform contract reviews within the Legal Department. There was no established formal tracking system for review of contracts to ensure all contracts were going through this process. There was no policy whereby material contracts were reviewed by at least two individuals

from the Legal Department. There were no timelines for completing reviews so that appropriate follow-up could occur if reviews were not completed timely. There was no control process for ensuring that comments or revisions made by the Legal Department were incorporated into the final contracts by Business Services.

### *Overall Summary*

In the past 12 months, State Fund has made improvements that have strengthened corporate governance, internal controls and financial/business planning throughout the organization. During this time, State Fund remediated 53 findings from the 2007 Operational Review Report, of which 31 were considered critical. State Fund partially remediated an additional 40 findings. State Fund has indicated it will continue to address the remaining 17 outstanding findings from the 2007 Operational Review Report and will work to address the 35 additional findings identified in the 2008 operational review.

The new State Fund leadership team should move to formally adopt a formal governance framework to ensure that there is a structure for effective internal control development and monitoring.

## *2008 Operational Review Specific Findings and Recommendations*

### *Corporate Governance*

### Board

### Background

A Board's primary function is to provide management oversight. The Board is also responsible for evaluating the organization's strategic plans and objectives. State Fund currently has a five member Board, all appointed by the Governor who also designates the Chair.

Legislation was passed in September 2008, to increase State Fund's Board from five voting members to eleven. As the Board is expanded, emphasis will need to be placed on obtaining members with diverse qualifications, including investment and insurance-specific expertise. In September 2007, the Audit Committee held its first meeting and the newly formed Investment Committee met via conference call in June 2008. State Fund stated that upon Board expansion, budget, governance and compensation committees will also be formed.

### Findings and Recommendations

Based upon our review of the Board minutes and agenda packages, we identified the following findings and respective recommendations.

**08-1. Limited Discussion of Strategic Plans**

***Finding***
The Board minutes through May 2008 did not indicate that the Board spent sufficient time discussing high-level strategy, the direction of the company, or threats to the company that are appropriate Board business. A number of operational plans were provided to the Board; however these plans were in the form of proposed plans presented to the Board for approval. It appears that more strategic discussions were held at the Board and Committee level in the September and November 2008 Board meetings. In addition, an appropriate level of feedback was provided to management.

***Recommendation***
High-level strategy should be a recurring agenda item at least twice annually to ensure that appropriate consideration is given to changes in the market, industry conditions and regulation.

## 08-2. Excessive Payment Authorization Levels

***Finding***

Effective November 25, 2008, all payments over $100 million require the approval of the CEO, CFO and COO. The CEO can approve payments up to $100 million and a Chief Officer can approve payments up to $10 million. Based on a stratification report extracted from Oracle on requisition statistics indicating that there were no requisitions greater than $25 million and only one requisition greater than $10 million during a 10-month period, the authorization levels appear excessive.

***Recommendation***

Management should perform a review of the payment history over the last ten years, utilizing this research to establish more appropriate levels of authorization for approving payments. Additionally, the threshold for requiring dual EVP signatures should be reconsidered based on this analysis. Documented Board approval of executive authorization levels should be evidenced in the Board minutes.

## 08-3. Board Did Not Vote on Key Action Items

***Finding***

The Board did not vote to approve the several key State Fund officer appointment and/or resignations in minutes reviewed from 2003 through May 2008. There was also no evidence of a motion or vote to form the Audit Committee, whose first meeting was held September 13, 2007, or the appointment of the Audit Committee Chair and other committee members. In addition, the Board did not vote to approve changes to the investment policy. It appears that formal voting to approve changes to policies and make other key decisions was conducted in the November 2008 Board meeting.

***Recommendation***

The Board should make a motion and approve in a vote, at a minimum, the appointments and resignations of officers, the formation of committees, appointments of committee chairs and other committee members, changes to investment policies and the appointment of auditors.

After May 2008, the Board did approve resignations of long-term employees, appointments of new officers and formation of subcommittees through resolutions. In addition, formal voting to approve changes to policies was conducted in November 2008.

## 08-4. Board Minutes Do Not Contain Necessary Information

***Finding***

There is no mention in the minutes regarding when new board members are starting their terms or when outgoing members leave the Board.

***Recommendation***

Relevant information for an incoming or outgoing board member should be recorded in the minutes and include the date of appointment, execution oath date, term length, voting versus non-voting status and resignation date.

## Summary

The Board should continue to ensure that items of significance are voted on and captured in the minutes. In addition, the Board should spend sufficient time discussing high-level strategy of the organization, with appropriate consideration given to changes in the market, industry conditions and regulation. The minutes should adequately reflect these discussions. In March 2008, State Fund executive management presented to the Board a mechanism to facilitate approval of pertinent financial information, including budget information and other related matters of importance, on a regular basis. The Board should continue to place emphasis on reviewing this key information.

## Legal

## Background

At the time of this review, the Legal Department, which has approximately 870 employees, was headed by the Chief Counsel. The General Counsel was not appointed until October 2008. The Legal Department has eight Assistant Chief Counsels (ACC) covering Corporate & Appellate, Corporate Civil Litigation, Subrogation, Workers Compensation and State Contracts. The Legal Department is responsible for providing legal services, including contract reviews, to State Fund Programs and soliciting external counsel where needed.

The Legal Department uses a case management system to manage legal case activity. In order to better manage legal case activity and improve support documentation, the Legal Department is migrating legal case activity data from the old legal case management system to a web-based application. State Fund stated that it anticipated that the new case management system would go live for State Fund departments by May 2008; however, problems have been encountered with the workers' compensation modules and training has been delayed until October 2008. The training is estimated to take approximately six months to complete.

## Findings and Recommendations

Based upon our review of the Legal Department, we identified the following findings and respective recommendations.

### 08-5. Lack of Consistency in Contract Review

***Finding***

There appeared to be a lack of consistency in where final contracts are retained. In addition, final contracts are not always reviewed by the Legal Department to ensure the changes suggested by the Legal Department were included in the final contract.

***Recommendation***
Final contracts should be retained by the Legal Department in their legal case management system. This will provide legal counsel assurance that the final contracts include all recommended changes. Also, it will provide the Legal Department a starting point for any subsequent contract renewals. The Contracts and Purchasing Program Manager should be required to provide the final contracts to the Legal Department.

**08-6. Lack of Established Formal Tracking System for Contract Review**

***Finding***
There is no established formal tracking system for contract reviews to ensure contracts are being reviewed by the Legal Department.

***Recommendation***
A tracking system should be established to ensure all contracts are reviewed by the Legal Department. This will help State Fund reduce the legal and financial risks of entering into unfavorable contracts.

**08-7. No Procedure Established for Supervisory Reviews of Contracts**

***Finding***
Based upon the review of the new case management system, there is no procedure established in the system for a formal sign-off by supervisory legal staff. The system has not been configured to track supervisory review of contracts.

***Recommendation***
The new case management system should be configured to ensure that supervisor review and sign-off is enabled. This will provide evidence that the contracts were reviewed and demonstrate proper controls are in place.

**08-8. Peer Review Audits not Provided to the Board**

***Finding***
The results of peer review audits performed on an annual basis by the Legal Department are provided to the Chief Counsel, but are not shared in summary with the Board or Internal Audit.

***Recommendation***
The results of peer review audits performed should be provided to Internal Audit and the Audit Committee of the Board. Material audit findings should be shared with the Board.

**08-9. Enhance Selection Process for External Counsel**

***Finding***
Per the current State Fund Corporate Guidelines, the Risk Management Program Manager and the Chief Counsel are to confer on the decision and selection of external counsel. For the past 15 years, the Chief Counsel's authority has been informally delegated to an ACC. There was no documentation support available for review to determine if external counsel was selected based upon qualifications, expertise, case complexity, cost or limited State Fund legal resources.

***Recommendation***
The Corporate Guideline should be revised to delegate the selection of external counsel to a committee or group of high-level management members, including at least the Risk Management Program Manager, General Counsel and Chief Counsel.

## Summary

The Legal Department is going through a transition period with a newly promoted Chief Counsel and a newly appointed General Counsel. The Legal Department is also moving to an electronic case management system, and is revising its procedures for the contract review process. The Legal Department should continue to refine its policies and procedures for the contract review process. The revised guidelines should address the existing deficiencies in the process. Contracts should be reviewed and final contracts should be retained within the Legal Department. Requests for contract reviews should be initiated by the Contracts and Purchasing Department. There should be a tracking system configured within the case management system to keep track of outstanding contracts that have not been reviewed. The case management system should also be configured to provide an audit trail when a supervisory review is performed on contracts. Peer review audit reports should be provided to the Board and the Internal Audit Department to promote transparency.

## General Management Practices

## Background

Comprehensive strategic plans have not been developed. While strategic planning appears to be done informally between the Program Managers and Vice Presidents, this process should also be formalized so that programs are working towards a common State Fund goal.

## Findings and Recommendations

Based upon our review of General Management Practices, we identified the following findings and respective recommendations.

### 08-10. Strategic Plans Not Comprehensive or Updated Regularly

***Finding***
Strategic plans are not developed in a comprehensive format.

State Fund provided a forecast that included financial targets; however, no measurable targets for the other strategic initiatives were provided, such as operational, talent, distribution and governance. Strategic objectives had not been disseminated to program managers at the time of the review. Therefore, individual program goals could override or not be aligned with Company goals.

***Recommendation***
It is recommended that State Fund adopt a consistent, all-inclusive format for their strategic plan to ensure that critical aspects of the plan are easily accessible for management.

While strategic planning appears to be done informally between Program Managers and Vice Presidents, this process should also be formalized so that programs are working towards a common goal. Strategic goals should be clearly defined prior to the start of the budgeting process and shared with all levels of management.

The strategic plan should be updated at least annually, which is especially important in the current changing environment that State Fund operates.

**08-11. Realignment of Functional Budget Areas Necessary**

***Finding***
Currently, the PSO and Management Information and Budget Programs report to two different Vice Presidents and have limited interaction and coordination between them.

***Recommendation***
As the project proposals have budget components associated with them, coordination between the two programs could be facilitated by aligning the departments functionally to report to the CFO.

**08-12. Inconsistent Reporting of Information to the Board**

***Finding***
PSO project reports are not being consistently provided to the Board. There have been project reports provided to the Board in the past on various projects of interest or significance, but not on a regular basis.

***Recommendation***
State Fund should provide reports to the Board on a consistent basis regarding current PSO projects, associated budgets and timelines, as well as project status to keep the members of the Board apprised of significant State Fund projects. We recommend that the Board establish a project cost above which Board approval would be required.

**08-13. Untimely Executive Review**

***Finding***
Recurring monthly invoices are currently reviewed by the CFO during the monthly invoice review process after the invoices have already been paid. Non-recurring payments are generally reviewed by the CFO before payments are processed as part of the contract approval process or upon submission of an "Executive Authorization Request" for $50,000 and over payments.

***Recommendation***
This review should occur before payments are made to prevent any unauthorized payout, including recurring payments.

## Summary

State Fund should develop strategic plans in a comprehensive format that could be easily understood and shared within the organization. Strategic goals should be clearly defined prior to the start of the budgeting process and shared with various levels of management. Efficiencies may be achieved if the PSO and MIB Programs were strategically aligned under one Chief Executive Officer, such as the CFO.

### *Fiscal and Administrative*

## Management Information and Budget

## Background

MIB is responsible for the budgeting process, which includes planning and implementing the budgeting process by assembling all relevant management reports and delivering them to the appropriate managers and executives in order to facilitate the budget decision making process. MIB also maintains the central repository of financial budgeting data utilized to produce the reports provided to management.

The annual budget is made up of certain nondiscretionary items (corporate/centrally planned) and discretionary items that vary depending on the need of the programs. The 2008 budget was improved by increasing the number of nondiscretionary budget items.

State Fund Program Managers receive a monthly budget to actual report from Oracle, in order to monitor budget variances. On a quarterly basis, MIB creates a Cost Comparison Analysis report, which focuses on significant variances and is provided to the President.

## Findings and Recommendations

Based upon our review of MIB, we identified the following findings and respective recommendations.

**08-14. Interim Budgets Not Needed**

***Finding***
In the past, State Fund has prepared both a mid-year and annual budget. Going forward, State Fund stated that it plans to perform budget updates quarterly.

***Recommendation***
It is recommended that State Fund focus on performing an accurate budget on an annual or cost benefit basis, with a stronger focus on budget variance reporting throughout the year.

## 08-15. Budget Narratives Content and Exhibits Lacking

***Finding***

In the review of the 2008 budgeting process, the selection of budget narratives revealed that significant fluctuations (both annually and at mid-year) were not addressed. Changes were implemented in the 2009 budgeting process that have led to improvements in the detail provided in budget narratives. However, no standard format of budget narratives has been established. Additionally, no formal guidance is provided to budget preparers dictating if/when a budget narrative is required based on a defined metric.

In the review of the 2008 budgeting process, seven of the ten discretionary budget items shown in State Fund's budgeting software for individual programs do not require budget exhibits. Additionally, the information received from MIB regarding budget exhibits for a sample of non-discretionary (corporate/centrally planned) budget accounts was insufficient. Budget exhibits maintained by the various district office locations for accounts included simply a breakdown of the total budget by program. There was no support for how these budget amounts are allocated within a program, nor how the overall budget amount was determined.

In the review of the 2009 budgeting process, updates were implemented to require each program to complete a detailed exhibit to support its budget within the budget software. The detail, comprehensiveness, and ease of use of these exhibits varies significantly but overall improvement was noted in the selection of budget exhibits reviewed.

***Recommendation***

State Fund should establish a metric (i.e., a change of +/- 20% and over a certain dollar amount), over which the discretionary budget line item (budgeted for by individual programs, not corporate) must be included in the program/district office's budget narrative. Also, budget narrative guidance, including a standard format, should be developed and provided to the budget preparers to facilitate an efficient budget process.

## 08-16. Improve Budget Variance Process

***Finding***

Of the 27 accounts tested for 2007 budget variance explanations, only 16 accounts had adequate descriptions for the variances. Additionally, the explanations reviewed for a selection of significant budget to actual variances did not appropriately address the causes for the variances. Of the 25 programs tested for the 2008 budget variance reports, only three programs reviewed contained explanations for variances while only one program reviewed contained an adequate explanation. Follow up by MIB staff to obtain explanations is not being regularly performed.

***Recommendation***

State Fund should develop a policy, aside from only the budgeting software help guide, that requires programs with budget account variances greater than an established metric (i.e., +/-20%) to submit an explanation for the variance to MIB. Expectations regarding the form and content of variance explanations should be communicated to individuals responsible for the program/district office budgets. MIB staff should follow up with the appropriate budget preparers to determine and document the cause of variances that exceed the established threshold.

## Summary

MIB should continue to increase its effort to standardize budgetary information through the use of the recently implemented budgeting software. A focus should be placed on the use of defined metrics and standardized formats for both budget narratives and the explanations of budget variances. Overall, the increased use of budget exhibits in both discretionary and non-discretionary budget items will strengthen the budget process.

## Fiscal Accounts Payable

## Background

The Business Applications Unit (also known as the Accounts Payable Unit) was transitioned from Business Services into Fiscal on September 17, 2007. State Fund stated that the primary reasons for the transition were to improve internal controls by separating the Fiscal AP function from the Purchasing function, strengthen internal controls by consolidating the Fiscal AP function within Fiscal, align Fiscal AP staff with a program manager whose primary focus and expertise is fiscal matters, and provide Fiscal AP staff with more career development opportunities by combining most financial professionals into one overall program.

Upon the transition of the Fiscal AP function to Fiscal, Fiscal conducted an initial review of the current Fiscal AP processes in order to assess the risks. The focus was on reviewing whether adequate controls exist over the Fiscal AP function, including segregation of duties, adequate level of approvals, and appropriate reconciliations.

When requesting goods or services, personnel initiate the purchase requisition in the Oracle system, with the exception of emergency purchases up to $500 which can be processed without a requisition upon approval of the department's program manager. A buyer in the C&P Department is responsible for fulfilling an approved requisition by obtaining bids from an authorized list of vendors. Upon successful completion of the bidding process, the buyer creates either a contract or a purchase order. Effective November 25, 2008, purchase orders and contracts over $100,000 require approval from a Vice President or Chief Counsel and purchases over $5 million require approval of a Chief Officer. A Chief Officer can approve payments up to $10 million and the CEO can approve payments up to $100 million. All payments over $100 million require the approval of the CEO, CFO and COO. Appropriate levels of authorization for approving payments should be established based on an analysis of payment history.

Approximately 95% of the payments are processed through checks and the remaining payments are made through wire transfers. Checks over $250,000 require a manual signature of a Vice President (VP).

A review and testing was also performed of the employee user access granted to evaluate adequate authority levels in Oracle Financials for staff in Fiscal. This review was performed to determine whether the Fiscal employees that have access to various Oracle modules have proper segregation of duties.

The State Fund Internal Audit Department had scheduled a review of this area for September 2008; however, it was later removed from the Audit Plan to avoid duplication of CDI's review. It is included on the audit plan for 2009 and will be audited annually going forward.

## Findings and Recommendations

Based upon our review of Fiscal AP, we identified the following findings and respective recommendations.

### 08-17. Lack of Documented Formal Program Policies and Procedures

***Finding***

There are no documented program procedures for the vendor invoice payment process, employee reimbursements and advances. Additionally, there is not a program policy for the unit's interaction with the Interim CFO. There are several executive memoranda that explain high-level changes, but these have not been fully integrated into program policies.

***Recommendation***

The Fiscal AP invoice payment policies and procedures should be formally documented and updated to reflect current changes in State Fund infrastructure. Documenting standards formally will alleviate the risk of employee turnover. State Fund should not rely upon institutional knowledge to ensure that Fiscal AP invoice payments are being processed properly.

### 08-18. Lack of Documented Evidence for IProcurement Hierarchy of Reviews

***Finding***

HR provides authorization to Fiscal AP to enable an employee's authorization level to approve payments in Oracle using IProcurement hierarchy. This is an automated Oracle workflow process that allows authorization to circulate to authorizers for their approval of payment. There was not any evidence of these authorizations by HR. It was noted that the review of the authorization level granted to employees in IProcurement is performed periodically by the Program Managers; however no evidence of this review was provided.

For some of the Real Estate Management related expenditures, such as water leakage in the roof, broken window, or plumbing repairs that require immediate attention, the affected office receives verbal approval from the Program Manager and notifies Purchasing of the impending costs associated with such emergency repairs. Most of the time such costs exceed the $500 limit for emergency purchases. Requisitions and Purchase Orders are created after the costs have been incurred and the invoice is received. This is not in compliance with the State Fund requisition policy that requires expenditures over $500 to have an authorized requisition before goods or services are received.

***Recommendation***

Authorizations provided by HR to Fiscal to enable an employee's authorization level in IProcurement should be saved as support for such access. Also, a periodic review of the authorizations should be established and performed by the Program Managers using the Oracle automated workflow to ensure there are no unauthorized employees granted access to approve payments.

State Fund management should ensure that any non-emergency purchases follow the established purchase requisition policies. State Fund is currently not in compliance with their established policy. A report should be created that identifies invoices received prior to the purchase requisitions being created to monitor exceptions, and repeat offenders should be disciplined. State Fund should also consider increasing the limit for emergency related costs that require immediate

attention by the Real Estate Management group should be reviewed. The emergency purchases threshold should be in line with the prevailing emergency related costs for building repairs.

**08-19. Recurring Expenses at the District Offices are based on Obsolete Contracts**

***Finding***

There are recurring expenses incurred by the district offices that are based on contracts created in the late 1990s. For example, electrical, phone or lawn maintenance recurring expenses for some of the district offices are based on contracts that are no longer valid and are not established in the Oracle system. Purchasing has been working with Real Estate Management in trying to establish authorized contracts in the Oracle system.

***Recommendation***

Old contracts should be amended to meet the prevailing needs of the district office. Also, such new contracts should be maintained in Oracle. The Business Services Program Manager needs to ensure that district offices are utilizing current contracts as the contract process is controlled by Business Services.

## Summary

Fiscal AP should continue to refine its policies. Payment authorization levels and threshold for dual signatures should be re-evaluated using internal payment history. Management should ensure that goods and services received that are non-emergency related go through the purchase requisition process to ensure proper authorization is received. Management should create a report to monitor invoices received prior to a purchase requisition being created. A review of the emergency related dollar limit for Real Estate Management should also be performed to ensure it is consistent with the prevailing needs of the group. There should be a retention policy established to ensure authorizing documents received from HR are retained by Fiscal AP to provide assurance that proper authorization is granted. The process of providing timely review and approval of large dollar recurring invoices should be changed to ensure that such payments are reviewed prior to payments being made. Paid original vendor invoices should be retained within the Fiscal AP area until the invoices are shipped for record retention in accordance with the department policy.

## Project Services Office

## Background

The PSO is responsible for managing projects, monitoring and reporting on projects, acting as a liaison between the functional steering committees and the Executive Committee, and facilitating a consistent and timely information stream throughout the organization. Each PSO project has a Vice President assigned to it as a sponsor. There are currently three main steering committees that report to the PRB. The three reporting functional steering committees are Claims, Policies, and Financial and Administrative Services. The PRB, which is comprised of State Fund Vice Presidents, meets monthly to review projects of the PSO. The PSO Program Manager communicates to the PRB each month the status of current projects and new projects.

Each project must receive approval from the manager of the program for it to be considered by the PSO. The PSO sends the proposed project to the IT Program to receive cost estimates for research and development of the recommended system implementation or changes. Once this step is completed, the PSO adds the estimates

to the proposal and ensures that it is ready for submission to the applicable steering committee. The steering committee votes whether or not to fund the proposed project. The steering committee obtains its budget from the PRB and all unused funds are reported to the PRB each month.

State Fund is currently restructuring this program. Program enhancements are expected to be complete in mid 2009.

## Findings and Recommendations

Based upon our review of the PSO, we identified the following findings and respective recommendations.

### 08-20. Inconsistent Support for IT Project Related Costs

***Finding***
IT currently provides information on a monthly basis to the project sponsors of PSO projects for the purpose of tracking actual hours and costs incurred by IT personnel. Although IT project leads have access to a report that provides the hours and dollar amounts incurred by resources, the report has not been consistently provided to the business owners of the projects in the past.

***Recommendation***
IT personnel should be consistently providing supporting detail to the PSO and/or business owners with regards to actual hours and costs incurred by resources associated with PSO projects. Reporting actual hours and costs will make PSO status reports more relevant and assist in the overall project monitoring efforts.

### 08-21. Lack of Cost Comparisons, Monitoring of Completed Projects and Explanations for Cancellation of Projects

***Finding***
Multiple cost alternatives do not appear to be considered when reviewing the feasibility of a project. Estimated cost savings are sometimes based just on the project manager's best estimate.

There is currently no process in place to monitor completed projects to ensure the planned return on investment has been achieved and for adherence to expected time and cost savings promised in project proposals. In some cases, the reasons behind the cancellation of a project were not adequately explained.

***Recommendation***
The PSO should ensure that each project presents several alternative options with different price points. This would help to ensure that the most reasonable cost alternative is selected for the project.

Savings identified for projects should have adequate support such as Return on Investment (ROI) and/or other related relevant documentation.

The PSO should continue to monitor projects after completion to determine whether time and costs savings estimates were achieved. This could be a useful tool for monitoring the success of completed projects in quantitative terms.

The PSO should define and require management approval for project cancellation given the high costs associated with projects. The documentation should include a section outlining the reasons the project was cancelled. Additionally, the steering committee minutes should review the detailed reasons behind the cancellation.

### 08-22. Outdated Policies and Procedures

***Finding***
The PSO policies and procedures are outdated and not applicable to the current State Fund operating environment.

Currently, there is no consideration given to any changes in technology when a project charter is developed.

***Recommendation***
The PSO policies and procedures should be formally documented and updated to reflect the current environment. A review of the policies and procedures should be conducted annually.

The PSO should ensure that "what if" scenarios for changes in technology are part of the project charter so that a back-up plan may be included in the case that the existing technology becomes obsolete.

### 08-23. Lack of Supporting Documentation Provided to Steering Committees

***Finding***
The PSO has recently started requiring return on investment calculations for each project submitted for approval to the steering committees. However, the steering committees still do not receive detailed support for financial figures contained in the return on investment calculations.

In some instances, inaccurate information was presented to the steering committees and to the PRB.

***Recommendation***
The PSO should require that detailed support be provided along with return on investment calculations so that the steering committees can assess whether the calculation is reasonable.

The PSO office should develop quality assurance practices and measurable benchmarks to ensure that data in the project proposals and status reports is verified for completeness and accuracy before submitting to the steering committees.

### 08-24. Lack of Ownership for District Reorganization Project

***Finding***
The data consolidation project will result in millions of dollars in IT related expenditures. This project has not been approved by the PSO.

***Recommendation***
The PSO should elevate this issue to the PRB to ensure that someone assumes responsibility for this significant project.

## Summary

The Project Services Office should continue to refine its proposal process to ensure that adequate support is provided to the steering committees for IT related projects considered. Quality assurance practices should be developed to ensure the accuracy and completeness of submitted information. Realignment of functional areas and consistent reporting of information to the Board is also necessary regarding current PSO projects, associated budgets and timelines, as well as project status to keep the members of the Board apprised of significant State Fund projects.

## Brokerage

## Background

Prior to August 2007, the Broker Commission Unit was part of the State Fund Marketing Department and responsible for the calculation and payment of brokerage commissions. Subsequent to August 2007, the check writing and issuance processes were transferred to Fiscal. Effective December 2007, the complete Broker Commission Unit was assigned to and placed under Fiscal AP. Since the change in August 2007, controls were identified and implemented, which have improved and enhanced the process of calculating and paying brokerage commissions.

Annually, the Broker Commission Unit calculates the SIPP commission, which is a contingent commission available to the top 450 brokers based on their previous years' qualifying written premiums and certain aggregate loss ratios criteria. The top 450 brokers are classified as either Preferred or Select, and can receive up to a 2% SIPP commission. The SIPP commission payment is paid in two installments. The first calculation is completed 60 days after the end of the year where a 50% payout of the commission is paid. The second calculation is completed one year later, at which time the loss ratio and SIPP commission is recalculated.

## Findings and Recommendations

Based upon our review of Brokerage, we identified the following finding and respective recommendation.

### 08-25. Brokerage Procedures Not Reviewed or Updated Timely

***Finding***

Brokerage Guidelines and are not updated in a timely manner. Ten of the 19 Brokerage Guidelines supporting the brokerage operations have not been updated since 2006 or before. In addition, the Brokerage Guidelines have not been reviewed since the last update.

***Recommendation***

Brokerage Guidelines should be reviewed periodically and updated as needed to support State Fund's strategic plans and the current operating environment. In addition, a review of Brokerage Guidelines should be formally documented to evidence the assessment process.

## Summary

Since the Broker Commission Unit was assigned to report to Fiscal AP, controls have been identified and implemented that have improved and enhanced the process of calculating and paying brokerage commissions. Brokerage Guidelines should be reviewed periodically and updated as needed to support State Fund's strategic plans and the current operating environment. In addition, a review of Brokerage Guidelines should be documented.

## Manual Spreadsheets

## Background

Examiners noted the following two observations in review of the external consultant reports that were included in the scope of the operational review. The two observations included the following:

***End-User Computing in the Actuarial Function***
The updating of various actuarial reports and spreadsheets is a very manual process. General controls surrounding the updating and protection of these files are weak. State Fund management reported that an inventory of the key reports and spreadsheets maintained in the actuarial function would be compiled. This inventory would allow State Fund IT to automate the reports and store the files centrally. A new Management Information System would be purchased, which will provide for the automated production of the actuarial triangles.

***Proper Review of Schedule P***
Differences were noted in the source data used for the compilation of Schedule P and accounting records maintained by State Fund. State Fund management indicated that the errors were attributable to the software package programming for Schedule P. The preparation of Schedule P data has been assigned to a supervisor level with review performed by a peer or one level above.

## Findings and Recommendations

Based upon our review of the manual spreadsheets maintained by the actuarial function, we identified the following findings and respective recommendations.

### 08-26. Lack of Formalized Spreadsheet Review and Protection

***Finding***
Actuarial personnel were unable to provide any evidence of the peer review process completed on the identified key spreadsheets and workbooks.

Key spreadsheets and workbooks are not protected by cell protection or password protection.

There are currently no documented procedures established to guide State Fund actuarial personnel on the steps necessary for proper updating and maintenance of the key manual spreadsheets and workbooks.

***Recommendation***

Actuarial personnel should maintain a copy of the reviewed spreadsheets including the signature of the peer reviewer, the date the review was performed and appropriate documentation to illustrate the specific cells and amounts that were reconciled to source documents. This documentation will serve to demonstrate a more robust review of the key actuarial spreadsheets.

Actuarial personnel should add cell protection to key spreadsheets and workbooks they maintain. Cell protection will prevent inappropriate changes or deletions to formulas contained on a cell by cell basis. Additionally, actuarial personnel should password protect key spreadsheets and workbooks to prevent unauthorized access to this information. As the actuarial data can have a material impact on the financial statements and reserve methodology, it is important to implement safeguards when using spreadsheets of this nature.

Procedures detailing the maintenance and updating of the key actuarial spreadsheets and workbooks should be formally documented. Formal documentation of these procedures will ensure that the process is standardized in the event that different actuarial personnel must perform these duties.

**08-27. No Inventory of Manual Spreadsheets**

***Finding***

In preparation for the implementation of EDSS scheduled for 2009, State Fund has compiled a listing of key manual spreadsheets maintained in the actuarial area in order to prioritize the automation. However, a more general inventory of all regularly utilized manual spreadsheets for the actuarial area has not been compiled. A complete inventory of manual spreadsheets should include information on the primary owner, storage location, scheduled updates and general purpose.

***Recommendation***

The State Fund actuarial area should compile a complete inventory of its regularly utilized manual spreadsheets that includes the primary owner, storage location, scheduled updates and general purpose.

## Summary

State Fund should emphasize the implementation and maintenance of robust controls surrounding the updating of manual spreadsheets originating in the actuarial function. Procedures detailing these processes should be formally documented and clearly communicated to actuarial personnel. Controls protecting the integrity of spreadsheets and workbooks should be strengthened. EDSS is planned for implementation in 2009; however, the official timeframe for the automation of the key spreadsheets and workbooks currently updated and maintained by actuarial staff is yet to be determined. Given this uncertainty, recommendations made by this report should be implemented immediately. Fiscal AP should consider making the necessary title adjustments for individuals involved in the production and review of Schedule P information to more accurately reflect employee roles.

## Electronic Claims File System

## Background

***Penalty Classification Issue***
The California Labor Code requires workers' compensation insurers to pay late payment penalties under certain conditions to the claimant or health care providers. The district office claims testing completed in June 2007 revealed that these late payment penalties were classified under the loss expense classification on each individual claim within ECF.

It was determined that penalty payments are properly reclassified to the Adjusting and Other expense classification when reported to the Workers' Compensation Insurance Report Bureau's Uniform Statistical Reporting Plan. However, it appears that State Fund improperly classifies the penalty payments as Defense and Cost Containment expense for statutory reporting purposes.

## Findings and Recommendations

Based upon our review of the ECF issues discussed above, we identified the following finding and respective recommendation.

**08-28. Incorrect Accounting for Penalty Payments**

***Finding***
For statutory reporting purposes, the late penalty payments are incorrectly classified in Defense and Cost Containment expenses by State Fund. Per SSAP No. 55 and the *NAIC Annual Statement Instructions*, these penalty payments should be accounted for in the Adjusting and Other expense classification.

***Recommendation***
State Fund should change its statutory accounting treatment of these penalty payments to be included in Adjusting and Other expense as opposed to Defense and Cost Containment to conform to statutory accounting guidance.

## Summary

State Fund has stated that additional modules of ECF code will be implemented in 2009. These modules will add to the capability and functionality of ECF. Specifically, the most significant module will replace WISP so that compensation payments can be authorized and paid through ECF, similar to medical payments.

*Business Services*

## Information Technology Vendor Contracting

## Background

The Information Technology Vendor Contracting function resides within the Purchasing unit in Business Services. At the time of our initial review in 2007, Business Services was comprised of four units, consisting of Operations, Purchasing/Transportation/Supply, Telecommunications and Business Applications. The Business Applications unit was responsible for Fiscal AP functions including vendor payments and employee reimbursements. The Purchasing unit was responsible for purchasing goods/services and vendor contracting. As of September 11, 2007, the Business Applications unit was transferred to Fiscal.

Effective June 1, 2008, State Fund reorganized Business Services into two separate departments, Operations and Contracts and Purchasing. The Business Services Operations Department is now responsible for State Fund's fleet management, records management, printing services, forms management, employee travel services and mail services. The Business Services Contract and Purchasing Department is now responsible for purchasing; including capital equipment, contracting for services, and contract management and administration. Additionally, on September 5, 2008 a new Vice President assumed oversight responsibilities for these departments. An outside consultant has been hired to assist with the reorganization.

Purchasing, HR and IT each participate to varying degrees in the ITVC process. IT identifies the operational needs to augment the existing IT staffing requirements, prepares a purchase requisition for the current needs, selects proposals and/or qualified candidates presented to IT and monitors the IT vendor's activity. Purchasing selects qualified IT vendors, solicits request for proposals, negotiates contract terms and conditions, and awards contracts to selected vendors. HR monitors staffing augmentation needs, confirms that the need cannot be fulfilled internally and assures adherence to current union contract agreements.

Currently, there are approximately 30 different IT vendors providing various consulting services to State Fund. IT consultants are contracted to support normal operations, assist with capital implementation projects and/or the development and implementation of internally created software.

State Fund stated that IT is working to minimize the reliance on outside consultants by reducing the number of consultants from approximately 200 individuals to a range of 70 to 90 by 2009. State Fund indicated that no new consultants have been added over the past eight months in IT and only existing consultants' contracts have been extended or renewed.

A partial review of the ITVC operations was completed in September 2007. The findings and recommendations from this review are included in the December 2007 Operational Review Report issued by the CDI. The State Fund Internal Audit Department last reviewed this area in November 2006.

## Findings and Recommendations

We identified the following additional findings and respective recommendations.

## 08-29. Bid Documentation Lacking

***Finding***

No supporting documentation was provided for any of the 20 IT vendor contracts tested, indicating that a minimum of three bids were received prior to awarding the contract. State Fund Corporate Guidelines for Contracting for Personal Services state that three written bids are required for purchase orders or contracts over $25,000. State Fund is not in compliance with its corporate policy.

There is no documentation to support the method and criteria used for the IT consulting services bid awards. The Corporate Guidelines for Contracting for Personal Services does not specify a bid selection process. The Corporate Guidelines states that contracts will be awarded on the impartial basis of quality, timely delivery, past performance and best value, without defining any of the selection criteria.

***Recommendation***

Three written bids should be received for any contract or purchase order greater than $25,000. Written bids should be retained to support State Fund purchase policies and demonstrate State Fund's pursuit of an impartial and quality vendor selection process. State Fund's Internal Audit Department should conduct a review of this area within the next 12 to 18 months.

A bid selection process should be developed outlining the solicitation of the bid process, criteria for qualified vendors, independent review of bid and selection criteria for bids based upon price, quality, delivery and performance. State Fund should consider implementing a Request for Proposal (RFP) process similar to industry best practices. RFP's could be scored based upon documented criteria such as cost, references, proposed deliverables, and resources. A formal committee at State Fund could be established to review RFPs to ensure that the process is conflict free.

## 08-30. Contract Documentation Needs Enhancement

***Finding***

State Fund's IT vendor contracts are comprised of three components. The recently updated Consulting Agreement template, in addition to the 10 consulting agreement documents included in the packages tested, does not contain a reference to the Contract Agreement and its associated contract number to indicate it is a part of the final contract. Additionally, two samples of ten contract packages tested had inconsistencies between the SOW and the contract number on the Contract Agreement.

Seven of the 10 contract packages provided were not signed by the vendor. In addition, the Consulting Agreement signature page does not provide for the date signed by the contracting parties. State Fund does not currently have a policy requiring that signed contracts be retained.

Project deliverables included in the contract packages were often vague or unclear. Six of the 10 contract packages tested did not include language identifying the prevailing contract document in the event of a conflict. State Fund does not have a policy stating which contract document within a contract package should be the governing document.

***Recommendation***

Documents that comprise a contract package should contain a common contract reference number to support future contract dispute resolution.

To support future dispute resolutions, State Fund should maintain contract records evidencing the vendor's signature and date signed to document agreement of contracting terms.

The contract package documents should include language that identifies the prevailing contract document. Contract package documents should have the same contract terms. Future dispute resolution should be minimized if the prevailing contract document and all supporting documents have like terms.

## Summary

Management should develop and document IT vendor bidding and selection processes that clearly outline the criteria and allow for an independent vendor selection process. State Fund should enhance its contract maintenance procedures to ensure that critical contract components are retained. In addition, contract components should reference the contract number and be signed and dated by the vendor. The master IT contract should identify the prevailing document. The SOW should clearly define the deliverable requirements. Overall, the controls over retention of contract documentation and monitoring of IT consultants should be strengthened.

## Fleet Operations

## Background

Business Services is responsible for the overall management of State Fund's fleet vehicle operations. The Transportation unit in Business Services is responsible for the management of 2,381 vehicles. Of the 2,381 vehicles, 1,979 are permanently assigned to specific employees and 402 are either unassigned or pooled vehicles.

A partial review of the fleet car operations was conducted in August 2007. The findings and recommendations from that review are included in the December 2007 Report issued by the CDI. These findings resulted in the following: 1) a request for a fleet management internal audit, 2) the need for reasonable tests to compare miles driven with expenses charged, 3) a vehicle mileage audit and 4) inequalities among employee benefits regarding fleet vehicle assignments.

## Findings and Recommendations

Based upon our review of the Business Services fleet operations, we identified the following findings and respective recommendations.

### 08-31. Fleet Management Corporate Guidelines Not Consistently Reviewed or Defined

***Finding***

Fleet Guidelines are not updated in a timely manner. The Fleet Guidelines supporting the fleet service operations have not been updated or reviewed since April 2002.

The Fleet Management Corporate Guideline 35-20-008 specifies a 50% job travel requirement for field representatives, field supervisors and field engineer positions for purposes of assigning vehicles to those qualified positions. The remaining positions listed, such as managers and attorneys, contain no established

mileage or need basis criteria. Additional guidance for assigning vehicles states “that authorized automobiles will be issued on the basis of budgeted positions which primarily and regularly require the use of automotive transportation.” The Fleet Guideline does not define “regularly require”. Not properly defining the requirement and/or purpose for the issuance of an assigned vehicle for a specific position will impact the operational budget process.

Not all of the fleet management operations are centralized. The Business Services Transportation Unit is responsible for the purchase and disposal of State Fund vehicles, redistribution of vehicles, maintenance of vehicle records and the registration of vehicles. However, other departments are authorized to assign vehicles to qualified employees and oversee proper vehicle usage documentation. As a result of the fleet management decentralization, the operations process is not consistently performed within the established Fleet Guidelines and criteria.

***Recommendation***

Fleet Guidelines should be reviewed periodically and updated as needed to support State Fund’s strategic plans and the current operating environment. In addition, a review of guidelines should be documented to evidence the assessment process. Internal Audit should regularly examine this unit.

Positions that qualify for vehicles should be reviewed by the appropriate State Fund personnel to determine if their travel requirements or need basis satisfies the guidelines. The guideline and the job descriptions on file with HR should be updated to reflect the need basis criteria or the travel percentage required. In addition, both the guideline and job descriptions should be updated periodically to reflect changes in State Fund's operations. Other positions that are allowed vehicle assignment should be reviewed by State Fund management and HR to determine proper expense classification.

Fleet management operations should be centralized under the Business Services/ Transportation Unit. The centralization will allow for better controls over the following functions: monitoring of the assignment of vehicles, redistribution of vehicles, vehicle maintenance/usage reporting and pool car utilization.

## 08-32. Fleet Management Program Needs Enhancements

***Finding***

State Fund was not compliant with the Fleet Guideline requiring defensive driver training. Defensive driver training compliance could not be verified for three employees of the 30 tested. The certificate or attendance record could not be found. In addition, one driver had not attended training since 2002, which is in violation of the three-year requirement per State Fund Fleet Guidelines.

Employees’ Motor Vehicle Records (MVRs) are not reviewed in a consistent manner. Per State Fund Risk Management personnel, employees have their MVRs evaluated and reviewed at the time of hire and upon a promotion or change in their job status. Employees’ MVRs are not periodically checked and assessed which could unnecessarily increase State Fund’s liability exposure. Of the 30 employees tested, Risk Management had only 13 MVRs on file. Of these 13 records, the most recent MVR was from 2002 while the oldest was from 1973.

Employees, who have a fleet car, are not required to report traffic violations when off duty. Employees’ safety records are not monitored thoroughly. There is no policy or procedure in place requiring employees to notify State Fund of any moving traffic violations while using a fleet car. While Risk Management has implemented a Fleet Safety Program Point System, used to assess certain driver actions while on the job, employees are not required to notify Risk Management of any violations received off-duty.

The monthly travel logs are not completed in accordance with Corporate Guideline 35-20-011, which requires a log to be completed daily for each trip made. Of the 30 travel logs reviewed, 16 were not properly prepared and did not include required information.

Quarterly vehicle inspection reports were not completed in the Fairfield District Office for the third quarter of 2007. Quarterly inspection reports are mandated in Fleet Guidelines. Failure to complete the quarterly inspection reports indicates a non-compliance with Fleet Guidelines.

Gas card invoices are not reviewed by State Fund management prior to payment of invoices by the Fiscal Services Department. Testing revealed that six cards out of a sample of 30 had high non-fuel charges that were not consistent with other non-fuel charges.

***Recommendation***
Vehicle assignment exceptions should be approved and documentation of that approval should be maintained in the appropriate file.

State Fund should maintain complete defensive training records for employees who are assigned vehicles. In addition, employees' defensive training status should be monitored on a regular basis to make certain the employees are current with this requirement.

Employees' MVR should be reviewed periodically to ensure State Fund is not exposed to additional liability and to verify that the employees do not have driving offenses on their record that effect their ability to perform job responsibilities.

A policy should be developed and implemented that requires employees who are assigned vehicles to notify Risk Management of traffic violations within 30 days upon receipt of the traffic violation. This will ensure that Risk Management can accurately monitor the driving actions and the traffic violations of its employees while in the possession of company property.

The monthly travel log should be completed on a daily basis for each trip made and include the locations traveled with appropriate mileage recorded. The travel log should be reviewed by appropriate State Fund management. Additionally, employees should be trained to complete the forms properly to ensure accuracy and consistency with Fleet Guidelines. State Fund should consider conducting a training session for employees once the Fleet Guidelines are updated.

State Fund management should require employees with assigned vehicles to complete the quarterly vehicle inspection report.

State Fund management should review and investigate unusual gas card charges on a monthly basis prior to invoice payment by the Fiscal Services Department.

### 08-33. Job Descriptions Not Reviewed or Updated Timely Regarding Fleet Car Assignment

***Finding***
Job descriptions are not reviewed and updated in a timely manner. According to the HR Program Manager, job descriptions are modified as needed and are not reviewed periodically.

***Recommendation***
Job responsibilities should be reviewed and updated timely to ensure any changes in responsibilities are appropriately reflected in the job descriptions maintained by HR. Job responsibility changes may have an effect on the employee's eligibility for a fleet car.

### 08-34. Non Compliance with State Fund Guidelines and Government Regulations

***Finding***

Employees' assigned vehicles are required to prepare and submit to HR the personal use State Fund Form 8509, which details the monthly personal vehicle use. HR then compiles the State of California Non-USPS Adjustment Request, which calculates the taxable income of the personal use of the vehicle. For the months tested it was noted that two individuals did not complete State Fund Form 8509. Non-reporting of personal use of vehicles does not comply with IRS regulations and Fleet Guidelines.

State Fund Forms 37 and 594 are not retained by the Transportation Unit. Form 37 documents the authorization for vehicle disposal. Form 594 documents the authorization to replace the vehicle described on Form 37. Destruction of the approval forms does not allow for compliance with polices and procedures.

Pool Car Request Forms are not properly approved per State Fund Guideline 35-20-009. Of the seven Home Office vehicles tested, only one contained the proper approval on the Request Form.

***Recommendation***

Employees with assigned vehicles must submit State Fund Form 8509 to comply with IRS regulations and internal Fleet Guidelines. If not submitted by the employee, Form 8509 should be completed by HR who will calculate the maximum taxable income for that period.

Documentation regarding the replacement of a vehicle should be maintained either electronically or as a paper file at least two years after the final disposition of the new vehicle.

Pool Car Managers, Transportation Coordinators, and Garage Attendants should ensure that the Pool Car Request Forms are properly completed and approved before the assignment of pool cars to staff.

## Summary

Fleet operations should be centralized to ensure that Fleet Guidelines and government regulations are consistently followed. In addition, Business Services should review and update the current policies and procedures. Once the review and update processes have been completed, the new policies should be disseminated to employees to ensure that staff adhere to the current policies. State Fund should consider conducting a training related to the revised Fleet Guidelines. Also, Internal Audit should review this area annually.

## Contracts and Purchasing

## Background

The Business Services C&P Department is now responsible for purchasing; including capital equipment, contracting for services, and contract management and administration. The Legal Department is responsible for reviewing contracts.

## Findings and Recommendations

Based upon our review of the Contracts and Purchasing area, we identified the following findings and respective recommendations.

### 08-35. No Formal Policies and Procedures Established for the Contract Review Process

***Finding***

At the time of our review, there were no established policies and procedures to perform the contract review process. Due to this lack of policies and procedures there have been several procedures within the review process that have been inconsistently applied by legal counsel. Final contracts were not consistently being retained and the request for contract reviews were received from multiple departments instead of from the Contracts and Purchasing Department.

There is no established policy whereby material contracts are reviewed by at least two individuals from the Legal Department.

Currently there are no established timelines for completing reviews so that appropriate follow-up can occur timely.

***Recommendation***

There should be established policies and procedures that provide clarity to the legal staff when performing contract reviews. This will also ensure that the contract reviews are performed uniformly and that there is proper retention of final contracts. In addition, requests for contracts should be initiated by the Contracts and Purchasing Department.

According to the current Chief Counsel, established policies and procedures for the legal contract review process are in draft form and awaiting executive approval.

The Legal Department should perform an analysis of State Fund contracts over a period of several years. Based upon this documented analysis, the department should define several materiality dollar thresholds for contracts. Contracts with higher materiality thresholds should require at least two levels of supervisory reviews. This will provide State Fund executives assurance that contracts with high risk to the organization have been reviewed by multiple legal counsel staff. This will also help State Fund reduce the legal and financial risks of entering into an unfavorable contract.

The Legal Department should develop appropriate timelines for completing reviews. A log of contracts to be reviewed with key dates should be maintained to facilitate timely review.

## Summary

Contracts and Purchasing Policies should be refined to include guidelines for the contract review process by the Legal Department. No policy was in place that dictated that material contracts be reviewed by at least two supervisory level staff from the Legal Department. There were no appropriate timelines for completing reviews so that follow-up could occur timely.

# Exhibit 1: State Fund's Remediation Efforts to 2007 Operational Review

The State Fund 2008 operational review included a review of the progress made towards addressing the 110 findings and recommendations included in the Operational Review Report issued in December 2007. The 2007 Operational Review Report contained findings and recommendations for the following areas: Governance and Management Practices; Human Resources; Internal Audit; Group Association Program; Information Technology; District Offices; Claims Processing Centers; and Business Services. The below table provides a summary of the progress made on the 110 findings functional area:

See the matrix below for examiners' response to 2007 Findings.

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| 1. Chief Officer Position | State Fund Lacks Key Officer Positions | In order for State Fund to have an effective management structure, new exempt management positions need to be established. State Fund needs at least five additional exempt positions. These positions are Chief Financial Officer, Chief Information Officer, Chief Investment Officer, Chief Operating Officer and General Counsel. Legislation should be enacted to allow State Fund to create these five exempt positions in order for State Fund to compete with other firms to attract the most qualified individuals. It is important that duties for these executives be properly outlined. Other exempt positions may be needed as State Fund reorganizes other functions and enhances controls within the organization. | In September 2008, Senate Bill 1145 was chaptered. It provided for the addition of six exempt positions to State Fund's executive structure including Chief Financial Officer, Chief Information Officer, Chief Investment Officer, Chief Operating Officer, General Counsel and Chief Risk Officer. Positions except Chief Investment Officer have been filled. | ***This finding has been partially remediated.*** Senate Bill 1145 was signed on September 30, 2008 for the addition of six exempt positions. Positions with the exception of the Chief Investment Officer were filled as of September 30, 2008. |
| 2. Chief Officer Position | Use of Consultants | State Fund should retain a consultant to assume the CFO duties by year-end. The earliest that legislation could be adopted to provide for a permanent CFO position would be in 2008. Additionally, State Fund should appoint someone in the | As of June 2008, a Chief Financial Officer has been retained to fill the consultant position. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | Fiscal and Investment Program to work closely with the selected consultant to ensure that institutional knowledge is retained. | | |
| 3. Chief Officer Position | General Counsel Role and Reporting Structure Needs Revision | State Fund should revise the reporting structure and duties of the General Counsel position to report administratively to the President, but functionally to the Board of Directors. The Board should be ultimately responsible for this function. The General Counsel should attend all Board meetings and be permitted to have executive sessions with the Board members. The General Counsel should also help define what authority the Board delegates to committees from a legal perspective. The position should also assist the Board in identifying when outside specialists are needed. | In October 2008, the General Counsel position was filled. This position reports functionally to the Board of Directors and administratively to the President. Board meeting attendance is a function of this position. The General Counsel will provide recommendations to the Board regarding delegates to committees from a legal perspective, committee authorities and recommendations regarding appropriate use of outside specialists. Position description, reporting relationships and appropriate communications with involved parties for State Fund current General Counsel as well as for the proposed exempt General Counsel has been completed. | ***This finding has been partially remediated.*** State Fund has appointed a General Counsel as of September 30, 2008. Board meeting attendance is a primary function of responsibility and it appears that the General Counsel actively participated in the November 2008 Board meeting. The General Counsel has developed several forward-looking documents for the Legal Department; however, a documented process for engaging and monitoring external counsel has not yet been implemented. |
| 4. Board | Increase the Size of State Fund's Board, Review Director Qualifications, Training Curriculum, Compensation and Meeting Frequency | Significant changes should be made to the Board. The size of the Board should be expanded. Board terms and qualifications should also be reviewed and revised. The Board should ensure that conflicts of interest do not limit members' capacity to function effectively. It is important that the majority of Board members have diverse qualifications with base line insurance knowledge. State Fund should | In October 2008, Assembly Bill 1874 was chaptered to increase Board membership. Assembly Bill 1874 also provided compensation guidelines for Board members. Board terms and qualifications will be reviewed and documented, with an emphasis on the need for obtaining members with diverse qualifications, including investment and legal expertise.<br><br>Upon State Fund Board expansion, budget, | ***This finding has been partially remediated.*** Assembly Bill 1874, effective January 1, 2009, will increase the size of the Board from five to 11 members.<br><br>State Fund indicates that a New Board Member |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | consider having an investment expert represented on the Board as well as a legal expert. The appointment process should assure that only highly qualified individuals, without conflicts, are considered for appointment to the State Fund Board.<br><br>State Fund is a unique organization that operates in a specialized market. It is important that State Fund develop a training curriculum for Board members. This training program should be approved by the Board Chair. All Board members should be required to complete this training. Board training should include corporate governance and ethics. Additionally, Board members should participate in educational sessions annually related to trends in the workers' compensation market.<br><br>Once the expanded Board is filled, the Board should be divided into committees to conduct business more effectively. Earlier this year, State Fund formed an audit committee. Budget, governance and compensation committees should also be formed to address current issues and provide effective oversight.<br><br>In order to attract and retain qualified Board members, State Fund should review the Board members' current compensation structure to bring it in line with comparable organizations.<br><br>It is noted that these Board modifications | governance and compensation committees will be formed. | Assimilation memo identifies orientation to the State Fund Board, orientation to the State Fund organization, and board member reference manual, are scheduled to be implemented in January 2009. Currently, Board members receive an informational packet when appointed and spend time with the Executive Committee members to gain familiarity with State Fund operations. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | require changes in legislation. | | |
| 5. Board | Establish Benchmarks for Board Reporting | The Board should develop a mechanism to ensure that pertinent financial information, including budget information and other related matters of importance, is presented and approved by the Board on a regular basis. Set parameters for Board reporting should be approved and followed by State Fund executives. The Board should appoint one executive to be the responsible party for this information. It is recommended that the President or General Counsel assume this role. Additionally, the Board should ensure that information is received from an array of executive officers so that the entire management team's expertise is fully utilized. | As of March 2008, the Board appointed the State Fund President as the primary State Fund contact for the Board. Executive officers submit information as appropriate.<br><br>Financial and budget information will be included as a recurring agenda item for each board meeting. | ***This finding has been partially remediated.*** The President's job duties include ensuring that the Board receives operational summaries and other pertinent information in an effective and efficient manner. Out of five 2008 board packages reviewed, two contained no high-level summary information. It appears that more high-level summary information was presented at the September and November 2008 meetings. To promote effectiveness, board information should consistently contain value added information. |
| 6.Gov Framework | Adopt a Governance Framework | State Fund should adopt a framework for corporate governance that outlines a structure for effective internal controls. The NAIC Model Audit Rule or the Sarbanes Oxley Act of 2002 may serve as models for State Fund regarding monitoring and control over financial reporting. State Fund should consider objective standards such as COSO and COBIT. A plan for all internal controls, not just financial reporting controls, needs to be implemented. This framework should ensure that all risks are monitored. | On October 8, 2008, the Program Manager for Compliance & Ethics was announced. | ***This finding has been partially remediated.*** An Ethics and Compliance Manager was named November 1, 2008; however, he had not assumed any duties related to the position at the time of our review. Although State Fund has taken steps to enhance the overall governance, a framework for internal controls was not |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | If necessary, State Fund should consider another position for a Compliance Officer who would be responsible for compliance with state regulations. An annual compliance report, certified by State Fund executives, should be considered to make certain that adequate Board and management resources are dedicated to improving and maintaining an effective control environment at State Fund. | | implemented. The State Fund Board did approve the engagement of subject matter experts to provide high-level enterprise risk assessment and to assist with identification, mapping and testing of internal controls for Model Audit Rule (MAR) compliance; however, this work will not be completed until 2010. |
| 7. General Management Practices | Enhance Existing Internal Committees | It is recommended that State Fund retain the Enterprise Risk Assessment (ERA) Committee and the SOX Committee. The ERA Committee should be reviewing and monitoring potential prospective risks, as well as current risk indicators, while the SOX Committee should continue to focus on internal control enhancements. | As of June 2008, State Fund responded that the SOX Committee was renamed the Enterprise Risk Assessment Committee. The committee's role has expanded to include assessment of control activities, reviewing and monitoring potential prospective risks, as well as current risk indicators, and internal controls for financial reporting. The committee is sponsored by the Executive Vice President. | ***This finding has not yet been remediated.*** As minutes of the ERA Committee meetings are not maintained, an assessment of the committee's activities could not be determined. The ERA Committee should be significantly involved in developing the Model Audit Rule compliance plan of action and for providing status updates to the Board. |
| 8. General Mgmt Practices | Executives Should be Actively Involved in Monitoring Interim Consultants | The Board and the President should ensure that executives and staff working with consultants understand the scope of the consultant's engagement. Executives that have primary oversight responsibility for consultant use should have regular communication with the consultant, and apprise the President regularly on the | As of June 2008, the Project Services Office reports on the engagement and utilization of all project-based consultants and consultants retained for support and maintenance services. Reports are prepared for the PRB which consists of the entire Executive Committee. An initial report was presented at the January 31, 2008 PRB meeting. Executives are sponsors of all | ***This finding has been partially remediated***. Reports are prepared for the PRB detailing the number of consultants utilized per project. Although an executive sponsors each project, discussions |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | status. | major projects, and meet regularly with the project teams and consultants. Projects are reported monthly at PRB meetings. | surrounding consultant use were not evidenced in the PRB minutes. Use of consultants should be consistently challenged by executives to ensure that all available resources are utilized effectively. |
| 9. General Management Practices | Improve Communication Throughout the Organization | State Fund management should take an active role in communicating corporate changes, both formally and informally, as it interacts with staff. A formal communication strategy should be developed and approved by the Board. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** The State Fund President has been conducting Town Hall meetings, and a communications strategy is in draft form. A protocol has been established whereby information is communicated down the chain of command. For instance, State Fund is utilizing the employee intranet appropriately to communicate changes throughout the organization. |
| 10. Human Resources | Establish Formal Succession Planning | Strategic succession planning is critical for State Fund, as many of its staff near retirement in the next few years. HR should work with the Executive management team to develop a formal succession plan. | As of July 2008, a formal succession plan has been developed. | ***This finding has been partially remediated.*** State Fund has created a high-level succession planning policy. This policy identifies 149 positions in which succession plans should be developed. However, as of October 2008, no formal succession plans have been implemented nor |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
|---|---|---|---|---|
| | | | | have detailed plans been documented for any of the 149 key employees identified in the planning policy. State Fund should create a schedule that prioritizes, includes deadlines and detailed action steps for the timely completion of the succession planning policy implementation for all the 149 key employees identified in the initial overview. State Fund anticipates that this finding will be completely remediated in mid 2009. |
| 11. Human Resources | Accurate Recordkeeping for Vacation Accruals | State Fund employees must submit a form complete with the dates and hours of vacation requested with the employee's signature and the supervisor's signature. This policy should be followed by all staff in the organization. HR should perform a reconciliation to verify that accruals accurately reflect vacation time used by employees. State Fund should follow the state prescribed vacation and annual leave policies. If exceptions are made permitting employees to go over the designated accrual limit, proper approval and related documentation should be maintained. Significant deviations should be reviewed and documented from both a legal and business perspective. | As of July 2008, three separate procedures were developed to clarify employee, supervisor, timekeeper, Program Manager and Human Resources responsibilities for submitting and verifying information. Transactions Specialists currently reconcile Daily Activity Logs with attendance forms to ensure that all requested leave is entered into the Oracle database. An exception report is created and reconciliations are performed by Transactions Specialists. Timekeepers complete a Time and Attendance Report which reports all leave time used during the month. Each Program Manager is required to approve the report. Approval documentation for exceptions related to the accrual limits will be maintained in Human Resources. All accruals over the designated limit require Program Manager approval. | ***This finding has been partially remediated.*** While State Fund has taken steps to reduce the number of employees with accrued vacation balances in excess of limits by establishing individual plans to reduce accrued hours, there are still many employees over the established limit. Testing revealed that several retiring employees were paid out for accrued balances in excess of limits. |
| 12. Human | Procedures | HR should develop a written protocol to | As of July 2008, the State Fund Human | ***This finding has been*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| Resources | Should be Established to Safeguard Assets and Information | safeguard State Fund's assets and proprietary information when an employee is terminated, resigns or transfers to another position within the organization. It should be the Enterprise Security Department's role to ensure that employee access to systems has been terminated or revised timely. State Fund is enhancing procedures in this area. | Resources Department has implemented a mandatory process using the System Separation/Transfer Checklist. This mandatory checklist ensures that programs notify the IT Helpdesk or local systems administration unit of the separation/transfer. This alerts appropriate management to remove system access. The Enterprise Security Supervisor monitors request forms on a daily basis and follows up with the system liaison. This is to ensure that employee access to systems has been terminated timely. | ***partially remediated.*** State Fund is using a separation checklist for employees no longer employed with State Fund. However, during testing, no checklists were found for two separated employees. State Fund should ensure that separation checklists are completed and maintained in personnel files by continuing to strengthen their quality control checks around this process. |
| 13. Human Resources | Performance Management Standards Need to Be Enhanced | HR should enforce the State Fund policy that evaluations be conducted annually. State Fund should conduct training for supervisors on how to prepare an effective performance assessment. Job descriptions need to be updated on a rotational basis to accurately reflect position duties. | As of June 2008, State Fund Performance Appraisal updates will be distributed quarterly to Program Managers. In 2008, a training requirement for all new supervisors was implemented. Additionally, a workshop on performance appraisals has been offered twice a year for the last three years. HR Management Services also conducted workshops for supervisors in October, November and December of 2007 in offices throughout the state. HR will continue to work with appropriate programs to update standardized job descriptions such as those for Claims Adjusters and District Underwriters. As other positions become vacant, HR will work with the hiring manager to ensure that job descriptions are current. | ***This finding has been partially remediated.*** State Fund submits appraisal update listings to Program Managers quarterly and has implemented a training course on performance appraisals. State Fund should follow-up on delinquent performance appraisals for employees who have appraisals past due and ensure these are completed timely. Additionally, State Fund should continue to update job descriptions for programs. State Fund indicated that it anticipates this finding will be fully remediated in mid 2009. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 14. Human Resources | Improve Human Resources Function at the District Offices | HR should oversee all related matters that fall under its supervision, not just those that are at the State Fund home office. HR should visit district offices and participate in oversight. The State Fund Employee Handbook should be reinstituted as a tool for employees. | As of June 2008, State Fund HR has investigated best practices and procedures in use at other state agencies. State Fund research indicated that there was not a need for the timekeepers in the districts to be moved under the supervision of Human Resources.<br><br>State Fund reported that HR Management Services Consultants visit clients quarterly. | ***This finding has been partially remediated.*** Not every district offices was visited by HR Management Services Consultants in the first two quarters of 2008. Though improvement was noted, State Fund should monitor the HR quarterly visits to ensure district offices are visited at least quarterly. State Fund indicated that it anticipates that the HR function at the district offices will be fully reengineered by mid 2009. |
| 15. Human Resources | Improve File Retention and Maintenance of Human Resource Files | The HR personnel file maintenance system needs to be updated. A more secure file checkout process could be accomplished electronically with files linked to employee profiles in Oracle, or manually with increased HR employee oversight. Internal audit should also conduct a review of HR files within the next year to verify that file maintenance has improved. It is recommended that HR files be scanned and backed-up electronically. | As of June 2008, the official State Fund Personnel File room was locked and a file check-out process was implemented in October 2007. State Fund reported that installation of a keycard access to the room was complete in January 2008. | ***This finding has been partially remediated.*** While all personnel files requested were provided for testing, State Fund should ensure that files checked out by State Fund personnel are returned to HR within the 14-day requirement, and that the personnel file request log accurately reflects dates files were returned. As some personnel files were still missing some required forms, it is recommended that State Fund continue their quality assurance project of reviewing personnel files to ensure required forms are |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | included. Additionally, as of October 2008, key card access to the personnel file room has not yet been installed. As of October 2008, Internal Audit had begun a four-part review of HR; however, the audit was not yet complete. |
| 16. Human Resources | Develop Leadership Training | HR should work with the State Fund Board and executives to develop a comprehensive training program, including leadership training for future managers and additional soft skills training. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** State Fund developed a leadership training plan. State Fund should continue to implement the leadership training plan. State Fund should consider an application or database that would enable easy access to employee training records. Currently, HR does not have ready access to the training programs employees have attended throughout the years. State Fund indicated that it anticipates that the leadership training initiative will be complete by mid-year 2009. |
| 17. Human Resources | Re-Establish Exit Interview Process | An exit interview should be conducted for all employees. Exit interviews can be helpful in understanding the morale of employees and also serve as a useful tool in retention and measuring organizational | The State Fund Separations and Transfers Checklist was updated to include in an Exit Survey. The survey was distributed to Program Managers and Timekeepers in January 2008. To maintain confidentiality, HR will maintain | ***This finding has been partially remediated.*** State Fund added the option for a voluntary electronic exit interview for employees |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | changes. HR should administer all exit interviews, conducting phone interviews as appropriate for employees vacating positions located outside the home office. The exit interview should be maintained within the employee's personnel file with results shared with the respective program manager and the appropriate executive staff. | the exit survey separately from the Official Personnel File. Data will be compiled and shared with programs semi-annually or immediately in cases where there are substantial findings. | leaving State Fund. In August 2008, State Fund reported approximately four months of exit survey results to HR management and the President only to illustrate trends. State Fund should work to increase the number of respondents participating in the exit interviews. Information obtained from the exit interviews should be shared immediately with the employee's direct supervisor, as well as the level above the direct supervisor to ensure that valid information from the exit interview is reviewed by appropriate management on a timely basis. |
| 18. Internal Audit | Enhance Risk Planning Model | Internal Audit should continue to refine its risk planning model. Consideration should be given to regulatory issues and industry market conditions that may not be reflected in the responses collected from management. Internal Audit should conduct an independent assessment of these areas and factor this into the risk planning model. The Board should also ensure that Internal Audit resources are adequate to address the risks facing State Fund. | As of September 30, 2008 an Annual Audit Service Plan Procedure, which includes the risk planning model, was published in October 2007 and presented to Audit Committee in November 2007.<br><br>The State Fund Board approved hiring permanent experienced audit staff within CA State Civil Service and temporary contracted subject matter experts to append audit teams when specialized skills are needed. | ***This finding has been partially remediated.*** The 2008 Risk Planning Model includes assessments of regulatory issues and industry market conditions. However, as the 2009 Risk Planning Model was in process at the time of our review, it is difficult to assess the effectiveness of recent revisions.<br><br>The package for the Audit Committee contains the Board survey, proposed |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | weight factors, procedures for use, and summary of factors which may affect business in 2009. The State Fund Risk Planning Model should continue to be evaluated as industry and market conditions continue to change, and additional risks are identified. |
| 19. Internal Audit | Enhance Internal Auditor's Understanding of IT Standards | Although the newly formed unit, Special Projects/External Unit, in Internal Audit allows for the contracting of IT specialists when needed, State Fund should require additional training for existing IT auditors in the area of Information Systems and COBIT standards. | As of June 2008, Internal Audit attended training entitled "The Auditor's Guide to Information Security". The course provided a foundation in the basics of information technology as applied to audit and security concerns. Additional staff was hired that had specific information security auditor certification. | ***This finding has been partially remediated.*** The IT Internal Audit staff appears to have been provided appropriate training when additional expertise was needed. However, Internal Audit staff overall do not have appropriate designations for their field.<br><br>Fourteen of the 37 Internal Audit staff possess certifications; however, only six of the 14 hold CFE, CIA, or CISA designations. Currently, no Internal Audit staff holds the CPA designation. |
| 20. Internal Audit | Improve Audit Follow-up and Implement Central Repository for Open Findings | The implementation of post-audit follow-up is a useful step for Internal Audit in eliminating repeat findings and ensuring that recommendations are addressed by auditees. Internal Audit should create and maintain a central log of open findings. | In January 2008, the centralized Audit Committee Outstanding Issue Log to manage open findings was revised. Reports on open issues are published for each scheduled Audit Committee meeting. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | They should designate a staff member to track these findings for the entire department, and retain the applicable documents from the auditee such as newly created policies or procedures suggested in the audit report. Additionally, the Audit Committee of the Board should receive a copy of these logs to note which audit recommendations are still open or are in progress and to determine which audit issues have not been properly addressed. We also recommend that the Audit Committee adopt a formal policy on how open audit issues should be addressed. | | |
| 21. Internal Audit | Improve Workpaper Documentation | The Internal Audit Program Manager should ensure that Internal Audit staff is following standards set forth in the Internal Audit Manual. Specifically, internal audit workpapers should contain a heading, purpose, audit date and conclusion. Audit workpapers should be easy to interpret and provide support for the audit performed. | As of June 2008 Internal Audit has researched best practices. New management review forms for workpapers have been developed to assure workpaper quality and consistency. The approved 2008 Audit Plan includes a formal internal quality assessment of workpapers. | ***This finding has been partially remediated.*** Improvement was noted in workpaper documentation; however, some workpapers for the audits reviewed lacked headings, purposes, audit dates and conclusions.<br><br>Specifically, four out of 14 audits reviewed in 2008 did not contain sources, purposes and conclusions on workpapers and one audit contained a significant number of review notes in the form of post its. It should be noted that one of the audits had not received a final review. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 22. Internal Audit | Update Project Review Forms | Internal Audit management should ensure that it has adequate data so that internal audits can be completed in a timely manner and within budgeted hours. | Project Review Forms were revised and published in December 2007. | ***This finding has been partially remediated.*** Improvement was noted; however, of the 14 audits reviewed in 2008, five Project Review Forms were incomplete (missing actual hours, actual completion date or explanations for variances) while three audits included outdated versions of the Project Review Forms. |
| 23. Internal Audit | Strengthen Audit Recommendation and Monitor Management Responses and Repeat Findings | Audit recommendations should use stronger language, such as "implement," "complete" and "perform" in order to promote better responses with action plans and target dates.<br><br>Internal Audit should not accept responses that do not contain solid action plans, indicate target dates and identify responsible parties. Any responses lacking the appropriate language should be sent back to the auditee for revision. Internal Audit should also ensure that management responds to each and every recommendation.<br><br>Additionally, Internal Audit should consider incorporating management responses into the report as opposed to maintaining them in a separate document. This information should be reported to the Audit Committee in summary format. | In October 2007, Internal Audit initiated use of report language which promotes on-point responses, action plans, and target dates. State Fund revised the Auditor in Charge Report memo to request identification of responsible parties in all management responses. Internal Audit publishes management responses in audit report executive summaries. | ***This finding has been partially remediated.*** Significant improvement was noted for those reports issued in 2008; however, of the 21 audit reports reviewed in 2008, three reports lacked specific information regarding on-point responses, target dates, action plans or responsible personnel. |
| 24. Internal | Develop | Internal Audit should ensure that it is | As of June 2008, the State Fund Internal Audit | ***This finding has been*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| Audit | Sampling Documentation | documenting the selection and justification for its samples and that the samples are sufficient to support the conclusions. The Internal Audit Manual should be updated to include documentation of sampling methods. | Manual was updated to fully reference sampling methodology, policies and practices. | ***partially remediated.*** Improvement was noted; however, of the 14 audits reviewed in 2008, five audits did not contain adequate explanation of the sampling methodology. It should be noted that two of the three audits had not received a final review. |
| 25. Internal Audit | Provide Responses to Self-Reviews | Internal Audit management should provide responses to self-reviews to ensure that the department, as well as State Fund as a whole, benefits from the recommendations provided in these self reviews.<br><br>The Internal Audit Program Manager indicated that, going forward, she will be providing formal responses to be distributed to the Board of Directors and Executive Committee. | In January 2008, Internal Audit responded to the Institute of Internal Auditors Needs Assessment Report. The State Fund Board approved the 2008 Audit Plan, which contains an internal assessment of workpapers scheduled for August 2008. Internal Audit will review international accounting practice standards. | ***This finding has been remediated.*** |
| 26. Internal Audit | Monitor Corporate Underwriting and District Office Self-Reviews | Internal Audit should monitor these self-reviews to ensure they are being appropriately conducted and documented. In addition, Internal Audit should ensure that action plans and dates that are developed as a result of these self-reviews are strictly followed. Audits of these self-reviews are planned for 2008 and on a rotational basis every five years thereafter. If the audits in 2008 yield poor documentation and follow-up, Internal Audit should consider assigning a resource to follow-up on these self- | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** State Fund has indicated that self reviews will be provided to Internal Audit every six months and random testing will begin in early 2009. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | reviews. | | |
| 27. Internal Audit | Implement Consistency in Supervisory Reviews | Internal Audit should make certain that there is consistency in regards to supervisory workpaper review. Once Internal Audit starts utilizing the TeamMate Audit Management System (electronic workpapers), coaching notes will be directly linked to the workpaper with the exception, and will require a response from the auditor who performed the work, as well as review by the supervisor in order for the comment to be cleared. | As of June 2008, policies and procedures for capturing and retaining supervisor coaching notes were revised. Quality assurance review forms were also developed and published. | ***This finding has been remediated.*** |
| 28. Internal Audit | Standardize Audit Reports | In order to ensure reports contain complete information and are easy to follow, Internal Audit should require that auditors follow a standard format for reports. | As of June 2008, a revised format has been developed and approved for reporting audit results. The format will be adopted for all audit reports. | ***This finding has been remediated.*** |
| 29. Internal Audit | Include Explanations for Items Excluded from Audit Scope | If audit reports exclude certain items, an explanation should be provided. | As of June 2008, procedural changes to assure consistent capture of this information were published. | ***This finding has been remediated.*** |
| 30. Internal Audit | Implement Grading Within Reports | Internal Audit should utilize a grading or rating scale in order to track audit areas of greatest concern. These ratings could be a useful tool in developing future audit plans as this would direct the auditors to those areas that have had problems in the past. | As of June 2008, review of Standard 2410.A1 and Practice Advisory 2410-1 was completed. The Internal Audit Department Manual will be updated to assure that an overall opinion, dependent upon the type of audit, will include a risk rating.<br><br>In April 2008, risk ratings based on Professional Standards and Practice Advisory was developed. These forms were approved by senior management and the Audit Committee. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 31. Internal Audit | Maintain the Integrity of the Audit Plan | Deviations from the audit plan should be approved by the Board or the Audit Committee. | The State Fund Audit Plan was reviewed by the Audit Committee and recommended for approval. The Board reviewed and adopted the plan in January 2008. All proposed changes will be submitted to the Audit Committee for review and approval as needed. | ***This finding has been partially remediated.*** The 2008 Audit Plan was presented at the January 2008 Audit Committee meeting and revisions were discussed at the May 2008 Audit Committee meeting; however, no reference to the approval of the Audit Plan or subsequent revisions is contained in the minutes. The 2009 Audit Plan was approved by the Board in November 2008. |
| 32. Group Association Program | Group Administrative Fees – Directors | It is recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board.<br><br>State Fund indicated that corrective actions to be implemented by the Board include the development of a code of ethics policy for board members, officers and employees. This code of ethics will include, among other provisions, articles related to financial conflicts of interest and procedures for investigations of directors and officers concerning ethics complaints. State Fund also indicated that it is in the process of preparing an Employee Incompatibility Activities policy. The Board is scheduled to review and adopt this policy in the later part of 2007. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 33. Group Association Program | Excessive Administrative Fees Paid for Minimal Services | State Fund should develop contracts that require specific services to be performed commensurate with the administrative fees paid. In 2007 State Fund developed contracts that require specific performance of administrative and/or safety services. | State Fund developed new contract templates as of June 2008. | ***This finding has been remediated.*** |
| 34. Group Association Program | Contract Expense Review Provision Not Exercised | State Fund should enforce the contract provision that allows for a review of group expenditures. Additionally, a new contract should be developed for the groups that allow State Fund to periodically audit the group associations for contract compliance. | As of June 2008, State Fund responded that complete review of old files resides in the Marketing Department. Additionally, new contract templates have been developed. | ***This finding has been partially remediated.*** The new contract template outlines the requirements for the Groups to comply with the Records and Audit section of the contract; however, at the time of our review only one group audit had been finalized. Group Representative job descriptions have been updated to monitor compliance of Group performance with specific contract requirements. State Fund needs to ensure that the Group Audit Memo documentation improvements are formally incorporated into State Fund policies. Additionally, State Fund should create a schedule of Group audits to be performed and monitor the progress of completing these audits at least one year in advance to ensure groups are audited. State Fund should enhance |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | procedures that outline the frequency of Group audits. |
| 35. Group Association Program | No Internal Audits Completed on Group Association Program | State Fund should regularly include a review of the group programs in the Internal Audit Plan. A review should be completed at least once every three years, prioritized according to the program's significance. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** An audit of the Group Association Program began in January 2008 and was in the report writing phase at the time of our review. An audit of Group Administrative Fees is planned for 2010. As there were no completed audits of the Group Association Program at the time of our review, the internal audits of this program can not be reviewed for adequacy. |
| 36. Group Association Program | Multiple Contracts in-force for Group | State Fund should have the Legal Department retain copies of all contracts. A procedure should be developed to ensure that only one contract is in-force for each group to avoid litigation issues. | As of June 2008, the Group Program at State Fund provided copies of the in-force group contracts to the State Fund Legal and Internal Audit Departments. Updated files will be provided to the Legal and Internal Audit Departments quarterly.<br><br>In March 2008, new procedures and contract signoff sheets were created to verify that no duplicate contracts exist. A new procedure was developed to ensure that the new Group contract supersedes all other contracts. | ***This finding has been partially remediated.*** New Group contract templates state that the newly signed contract supersedes all previous contracts. The State Fund Legal Department received copies of the first quarter Group contracts and is in the process of transitioning the retention and review of Group contracts. State Fund needs to clearly communicate with the Legal Department about the retention of contracts on a quarterly basis and |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | document this process in formal State Fund policies and procedures. |
| 37. Group Association Program | Group Association Payment Approval Based on Incomplete Support | State Fund should not approve groups for payment until all applicable information is obtained from the groups and analyzed. | State Fund developed procedure 20-00-502, which identifies controls to avoid recurrence. As of June 2008, this matter was rectified. | ***This finding has been remediated.*** |
| 38. Group Association Program | Lack of Verification of Group Membership at District Office | An underwriting policy should be put in place that requires verification with the group administrator if the policyholder is a member of the group before or shortly after the discount is applied. The verification of the discount should take place within 60 days after the quote is provided by State Fund. On September 12, 2007, State Fund management informed us that they are reviewing broad aspects of the group program for improvements. | In August 2008, policies were developed to resolve this matter. Procedure 20-00-813 – Non-Casual Cancellation, Policy Conversion identifies a letter that is being sent to brokers to notify them of the change and impact on their commission with the removal of the account from the group. | ***This finding has been remediated.*** |
| 39. Group Association Program | Underwriting Guidelines for Groups Need Enhancement | Underwriting guidelines need to be clear regarding the eligibility of policyholders for groups. Guidelines should be strengthened regarding the placement of ineligible members into group policies. | As of June 2008, State Fund Underwriting has re-reviewed the eligibility screens and has determined that they are clear and appropriately in place. The eligibility requirements are programmed into the quoting system. All group expectations will be processed through Home Office Underwriting Rating and Field Underwriting Unit. Procedure 20-00-511 (Group Exceptions) documents the process. | ***This finding has been remediated.*** |
| 40. Group Association | Group Estimated Contract | Policies and procedures should be developed and followed for all contracts. | As of April 2008, new procedures were developed to address this finding. An email was | ***This finding has been partially remediated.*** The |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| Program | Premium (ECP) and Administrative Fees – Lack of Adherence to Controls and Contract Requirements | Any exceptions made to newly established policies and procedures should be documented and approved by the State Fund President and the Board. The Legal Department should be actively involved in the contract review process and should approve any changes made to the standard contract. Any old contracts, should be terminated before any new contracts are issued with individual groups, to guarantee there are no overlapping contracts. | sent to all district offices advising them of the new procedures. Procedure 20-00-502 addresses these changes.<br><br>Contract changes are all reviewed by Legal, and are generally documented in Underwriting files. Ongoing reviews are made to assure all files are properly documented. The process is to be memorialized in procedures. | new contract template no longer utilizes ECP and is based upon actual amounts, as opposed to estimated amounts. The Legal Department is in the process of transitioning the retention and review of Group Association Agreements from outside counsel to State Fund Home Office Legal personnel. At the time of our review, the Legal Department's review of contracts had not yet been memorialized in procedures. Procedure 20-00-502, Group Association Contract Review, should be updated to clearly detail the Legal Department's role in Group Contract review and evidence of the Legal Department's review should be documented and maintained. Additionally, Group Approval Forms should be completed in their entirety prior to Manager/Executive signatures, and Legal personnel should be required to sign as well. Procedure 20-00-502 does not address the recommendation that the State Fund President and |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | Board approve exceptions to newly developed policies and procedures. |
| 41. Group Association Program | Lack of Contract Review Procedures | Procedures should be established that clearly define the group association contract review process. The Legal Department should be actively involved to monitor compliance. State Fund executives are currently making changes to the contract review process with assistance from outside counsel. As the procedures evolve, all departments should be informed of the new policies and these procedures should be strictly enforced. | As of June 2008, procedures 20-00-502 (Group Association Contract Development) and 20-00-506 (Association Fee Payment Process) document the process for changes made to address this finding.<br><br>Compliance resides with Underwriting and Group Executive and is documented in Underwriting files. If changes to the form contract occur, they are reviewed and approved in advance by the Legal Department. | ***This finding has been remediated.*** |
| 42. Group Association Program | Communication of Advertising Responsibility to Groups Inconsistent | State Fund Group Program communication regarding advertising should be consistent. Advertising requirements should also be listed and adhered to in the group contracts. A formal memo should be created by the Marketing Department and then be sent to all groups communicating any change in the allowance of advertising of the State Fund group insurance program. | As of June 30, 2008, new contract templates were developed. Procedure 45-00-60 (Group Marketing Fee) addresses this matter. | ***This finding has been remediated.*** |
| 43. Group Association Program | Eliminate Conflicts of Interest for Group Association Administration | State Fund must develop policies to address the administration of associations by former State Fund employees in order to avoid potential conflicts of interest. Conflict of interest statements should be reviewed by the Legal Department to ensure that all potential conflicts are addressed. The state appointment process should assure that conflict of interests do | State Fund agrees with the recommendation but concludes that no further action is needed at this time. Reasoning and justification are based on the following:<br>1. The Policy Reference and Operating Procedure manual was updated in March 2008 to address many concerns about group and association handling. Included are 20-00-501 through 20-00-508, 20-00-508, 20-00-510, and | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | not exist for future Board appointments. | 20-00-511.<br>2. Conflict of Interest issues relating to current employees are addressed in the Incompatible and Unethical Activities Policy and Code of Conduct.<br>3. SB 1145 imposes post-employment restrictions under the Milton Marks Post government Employment Restrictions Act.<br>4. AB 1874 prohibits the board of directors from financial conflicts of interest with State Fund.<br>5. In the Supreme Court ruling of Edwards v. Arthur Andersen LLP the court states "we conclude that section 16600 prohibits employee noncompetition agreements unless the agreement falls within a statutory exception.<br>6. B&P Code section 16600 states "...every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." It favors employee mobility and insures "that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice." It also protects "the important legal right of persons to engage in businesses and occupations of their choosing."<br>7. State Fund legal opinion. | |
| 44. Group Association Program | Group Administrative Fees Paid to Individuals | All checks to group associations should be made out to the group association, not to the administrator of the group association. | As of June 2008, procedure 20-00-506 (Association Payment Process) memorializes the process. | ***This finding has been remediated.*** |
| 45. Group Association Program | Group Administrative Fees Classified Incorrectly | State Fund should develop guidelines for the correct classification of group administrative fee payments. We recommend that these fees be classified in total as a write in for miscellaneous | As of June 2008, Group Administration Fees have been reclassified as miscellaneous write-ins in State Fund's annual underwriting and investment expense exhibit for the 2007 Annual Statement. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | expense on the NAIC Annual Statement. This will promote transparency. | | |
| 46. IT | Lack of Permanent IT Program Manager | State Fund should engage an outside consultant to assist with the oversight of the IT Department until a permanent Chief Information Officer position is established. As there are significant IT matters to address prospectively, State Fund should look for more effective leadership in this department. | State Fund has engaged an outside consultant to oversee the IT Department. | ***This finding has been remediated.*** |
| 47. IT | Prior Report Findings Remain Open | Internal and external audit IT exceptions should be prioritized by management in a timely manner to address remediation issues. These action steps should be memorialized in the IT files for reference. | In December 2007, the Audit Compliance Oversight Team prioritized remediation issues of internal and external audit IT exceptions. The Audit Compliance Oversight Team is memorializing the action steps in the IT files for reference. | ***This finding has been remediated.*** |
| 48. IT | IT Procedures Not Formalized or Approved | All IT related policies and procedures should be updated and submitted for senior management approval. Once approved, these procedures should be implemented and monitored. Additionally, communication policies between the district and home office should be formalized so that all parties are aware of the protocol. COBIT control objectives should be used by State Fund to assure that policies and procedures adequately identify and address the risks. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** The IT Security Policies were approved by the IT Vice President and Executive Vice President as of June 2, 2008. However, analysis and identification of IT General Controls should be performed for all offices. |
| 49. IT | Vacaville Project Budget Incomplete | The contracts and expense budgets for the Vacaville Data Center should be reviewed by the Board and/or financial experts to assess the accuracy of | As of June 2008, the State Fund Board reviewed and approved the budgets for the Vacaville Data Center. The budgets for the Vacaville Data Center migration costs have been documented. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | assumptions in the budget for each phase. The budgets for the data center migration costs should be documented in more detail to ensure that expense calculations like project supervision, decommissioning of old data centers and engagement of consultants can be analyzed. | | |
| 50. IT | Enterprise Security Group Lacks Authority | The role of State Fund's Enterprise Security Group should be evaluated in order to permit the Security Group to act as an enforcer of State Fund's IT policies. Security best practices should also be integrated into the IT policies on an enterprise-wide basis. | As of June 2008, the role of State Fund's Enterprise Security Group has been evaluated and changed to a separate section of IT that reports to the IT Program Manager. Security best practices are integrated into the IT policies on an enterprise-wide basis. As of June 2, 2008, the Corporate Guidelines and Security Policies were approved by the IT VP. | ***This finding has been remediated.*** |
| 51. IT | Segregation of Duties Issues | State Fund should make enhancements to the Oracle system. The Oracle segregation of duties should be reviewed and revised. User criteria in Oracle, including the functions of preparing, approving and receiving should be assigned separately to provide for segregation of duties. The Oracle software has extensive exception reports available to State Fund. These reports should be enabled. Oracle audit trails from critical systems must be reviewed on a periodic basis with exceptions followed up by the Enterprise Security staff. | As of June 2008, State Fund responded that a comprehensive review was completed in November 2007. Financial users were reassigned modified Oracle responsibilities and Oracle GL Super User responsibility was removed. Segregation of duties for requisition preparers, approvers, and receivers are in place and verified through Oracle setups or exception reports.<br><br>As of September 2008, the Oracle Financials/HR User Group, which includes the IT-Enterprise Security Unit, will conduct quarterly reviews of all Oracle Financials/HR reports. | ***This finding has been remediated.*** |
| 52. IT | Business Recovery Plans Outdated | State Fund should perform a review of its computer operations functions to ensure that Business Continuity and Disaster | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** State Fund has implemented new |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | Recovery plans are updated, tested and standardized throughout the organization. Data center physical and logical security in all offices should be enhanced to protect equipment from damage and to safeguard the center from unauthorized access. | | procedures for data center access and review. State Fund is currently moving its central data center to Vacaville. The new facility currently supports approximately 750 users and a limited number of production servers are in place. Review of this facility will be necessary to determine if the proper safeguards are in place. Full migration of production systems from the regional offices to Vacaville is estimated to be complete by July 1, 2009.<br><br>State Fund has created standard templates for the Business Continuity and Disaster Recovery plans. Estimated completion of the plans based on the current operating architecture is December 31, 2008. The plans will then be updated when the migration to Vacaville is complete. The plans in development should include specific duties for the systems staff in offices and be tested. |
| 53. IT | Standardize Change Management and | The Change Management documentation process should be standardized. Instead of utilizing a paper form for certain changes, | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | Formalize Procedures | the automated tool (People Soft Change Management module) should be used for all types of changes.<br><br>The Enterprise Security Group should have a more active role in the supervision and approval of critical systems changes as the inherent risks of the Change Management/System Development Life Cycle (SDLC) process are closely related to this discipline. | | |
| 54. IT | User Administration Procedures Not Formalized | Policies and procedures related to user account management should be documented to describe in detail a standard authorization and set up process for the State Fund systems. A standardized user access report should be produced for all the critical systems. The report should be reviewed and approved by the data and systems owners on a regular periodic basis.<br><br>Policies and procedures related to user account creation should be documented to describe in detail a standard authorization and set-up process on the systems. IT and HR should both play a role in this process.<br><br>User termination on the State Fund systems should follow established procedures. The termination process should be consistent throughout the organization, including the district offices. This process would commonly be initiated by HR communicating to the Enterprise Security Group regarding the | As of June, 2008, the IT Corporate Guidelines and Security Policies were updated in December 2007 and approved in June 2008, which addressed user account management. Additionally, in December 2007, the User Administration Operation Manual was completed, which documents the standard authorization and set up process for systems using Action Request Form. In January 2008, HR updated and published the Employee Separation Checklist to monitor the Action Request Forms on a daily basis, follow-up with the system liaison and compile the information on a monthly basis for the Enterprise Security Manager.<br><br>On September 12, 2008, a standardized user access report was produced and provided quarterly to programs and data owners for review, approval, and certification. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | employee termination. Enterprise Security would then be responsible for terminating all user system access rights. | | |
| 55. IT | Non-Authorized Software and Applications on Workstations | A strict policy should be enforced over non-authorized software and application installation by employees. The policy should consider the monitoring of installed software and the removal process. Also, sanctions for the violation of this policy should be communicated to employees. All staff should acknowledge their awareness of the policy. | As of June 2008, State Fund responded that IT completes a quarterly scan of software and notifies Program Managers of software not removed. IT has tested the procedure and corresponding controls. The quarterly scan is ongoing and IT performs random scans for verification. | ***This finding has been remediated.*** |
| 56. IT | Oracle Procurement System Approval Limits Not Reviewed | Approval limits should be reviewed and criteria for limits should be defined.<br><br>In September 2007, State Fund Executives stated that new range limits were implemented for each functional position. However, user access criteria and appropriate range limit criteria were still in development. | As of June 2008, State Fund responded that the standard approval limits were adjusted in September and October 2007 to $5,000 for Assistant Program Managers responsible for Real Estate Management, Information Technology, Claims/Rehabilitation, Safety & Health, and Human Resources Programs. Segregation of duties for requisition preparers, approvers, and receivers are verified through Oracle setups or exception reports. | ***This finding has been remediated.*** |
| 57. IT | Procurement Settings Not Reviewed | A review should be performed of the settings and configuration of the Procurement system. Formalized requisition procedures should be established to include:<br><br>▪ An audit trail of preparer/approver<br>▪ Monetary restrictions<br>▪ Preventative controls to eliminate the re-use of cancelled requisitions | As of June 2008, the procurement system settings and configuration were reviewed and modified. Notice of the changes was distributed to State Fund managers and executives. | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 58. IT | Oracle Audit Logs Not Consistently Reviewed | Audit trails from critical systems should be reviewed on a periodic basis. Furthermore, identified exceptions should be documented and followed up by the Enterprise Security Group. | As of September 2008, the Oracle Financials/HR User Group, which includes the IT-Enterprise Security Unit, will conduct quarterly reviews of all Oracle Financials/HR reports. | ***This finding has been remediated.*** |
| 59. IT | Password Settings Not Standardized | All password settings for critical applications and systems should be reviewed and established in a way that complies with the recommended security settings established by best practices. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** State Fund has formalized a Password Policy that has been approved by the IT Vice President. However, the Executive Committee needs to sign off on the policies before they become effective. The Audit Compliance Team is currently reviewing password settings for critical applications and systems. State Fund indicated that the planned remediation date is December 31, 2008. |
| 60. IT | User Recertification Process Deficient | A user access review and approval recertification process should be performed at least every six months. Data owners should be required to sign a user access review document, which should detail the name of the staff and the authorized functions for each employee based on a “least privilege” criteria. | As of September 2008, IT provides quarterly user access reports to programs and data owners for review, approval and certification. | ***This finding has been partially remediated.*** The first round of user access reports have been provided to program and data owners for review. Documentation of the reviews in process was provided. Certification of users is required to be completed by January 1, 2009. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 61. IT | Internet Access Monitoring Not Performed | Formalized internet monitoring should be enabled to track unauthorized access attempts. | As of June 2008, Enterprise Security and HR have developed a formalized internet monitoring process. Enterprise Security will provide HR with report of top sites based on hits, browse time, and report of users accessing blocked sites. Enterprise Security, HR and Internal Audit will meet quarterly to discuss internet monitoring. | ***This finding has been remediated.*** |
| 62. IT | Security Management Access Not Restricted | User access procedures should be created to ensure authorized access is restricted for the following:<br><br>▪ BT Global Workstation Administration security<br>▪ PC Desktop Data<br>▪ Applications<br><br>Active directory user access procedures should be established to make certain that current IDs belong to active employees and any unauthorized access is revoked in a timely manner. | As of June 2008, State Fund responded that HR updated and published the Employee Separation Checklist in January of 2008. The Enterprise Security Supervisor monitors the Action Request Forms (ARFs) on a daily basis, follows up with the system liaison and compiles the information on a monthly basis for the Executive Systems Enterprise Compliance (ESEC) manager. A status of outstanding ARFs is sent to the ESEC twice a day to ensure that employee access to systems has been terminated or revised timely. IT Client Support and Data Center conducted a clean-up of Active Directory in September 2007 to ensure access to workstations is restricted. | ***This finding has been remediated.*** |
| 63. IT | State Fund Anti-Virus Policy Not Formally Approved | State Fund should prepare, approve and implement a written anti-virus policy to ensure that all workstations on the State Fund network are protected from viruses. | As of June 2008, IT has prepared and approved a written Anti-Malware policy. The Anti-Malware policy was approved in June 2008. | ***This finding has been remediated.*** |
| 64. IT | Data Tape Encryption Not Performed | The initiative to encrypt all data tapes should be completed within a set timeline. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** Encryption has been enabled on back-up tapes for State Fund offices, with the exception of Home |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | Office and Fairfield. There is a current project to centralize the data centers to Vacaville, and included in this project is an initiative to enable encryption on back-up tapes. The State Fund anticipated remediation date is December 31, 2008. |
| 65. IT | Performance and Capacity Monitoring Not Performed | State Fund should assess upper management reporting needs. Per the Data Center Manager, there is a corporate initiative to utilize a more robust monitoring for performance and capacity, to be installed with the new data center. This initiative should be completed within a set timeline. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been partially remediated.*** The HP Openview system has been upgraded and upper management has provided input into the monitoring metrics to be provided. State Fund has upgraded HP Openview and is in the process of finalizing reports to be provided to management. However, reports to upper management have not yet been provided. |
| 66. IT | Data Center Physical Access Activity Not Reviewed | Physical and logical access restrictions should be enhanced to include logging and monitoring of access, and prevention of unauthorized access. | As of June 2008, Real Estate Management (REM) provided IT with a list of all individuals with access to Home Office Data Center. Enterprise Security receives and reviews quarterly Home Office Data Center access reports. | ***This finding has been remediated.*** |
| 67. IT | Data Center Physical Security Not Monitored | State Fund should strengthen the physical security at the data center. The Data Center Manager should sign a user access | As of June 2008, State Fund installed a camera in Fresno. Cameras scheduled to be installed at the other data centers in April 2008. | ***This finding has been partially remediated.*** State Fund has installed cameras |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | review document which should detail the name of the staff and the authorized functions for each employee based on a "least privilege" criteria. Access cards should be reviewed regularly to determine if the deactivation date is appropriate. | REM provides for signoff access reports to IT quarterly for IT management to review and re-validate access to data centers. Enterprise Security handles the distribution. | to monitor access at the Fresno Claims Processing Center data center, Home Office data center and the Fairfield computer room. However, during site visits of the Sacramento, Glendale, Redding, Monterey Park and San Diego District Offices, no cameras were observed within the data center or covering the data center entrances. In addition, there were no intrusion alarms for the Monterey Park building, or for critical areas within the leased space, particularly the computer rooms. Documented procedures for security badge issuance and transference does not exist at the San Diego District Office.<br><br>Access to the Sacramento and San Diego data centers are not limited to those who need access for business reasons only. Although the Glendale data center has raised floors, no water detection sensors or alarms exist to protect against water leakage from higher floors. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | Enterprise Security is receiving monthly access reports from Real Estate Management of those who have attempted to access the data centers. In addition, on a quarterly basis access is recertified by the managers of those with access to ensure proper approval and continued need for access. |
| 68. IT | Home Office Help Desk and Support Not Monitored | Help desk tickets should be monitored and closed in a timely fashion. The help desk ticket monitoring should be performed centrally where problems occurring throughout State Fund can be identified and addressed. | As of June 2008, State Fund responded that help desk tickets are monitored and closed in a timely fashion. State Fund established a Mailbox Monitoring Procedure. | ***This finding has been partially remediated.*** State Fund has implemented a help desk incident management ticket monitoring procedure to ensure that tickets are cleared in a reasonable timeframe.<br><br>State Fund is currently reviewing procedures for monitoring help desk tickets at the various State Fund sites and will be implementing consistent standards for tracking and monitoring of problems for locations. The anticipated remediation date is December 31, 2008. |
| 69. IT | Physical Security Access Cards Not | State Fund should review and update the access cards on a periodic basis. | As of June 2008, REM drafted a Corporate Guideline and formal procedures on security | ***This finding has been partially remediated.*** State |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | Reviewed | | access. The procedures will require all Programs to review and revalidate access to their work areas on a quarterly basis.<br><br>The Corporate Guideline has been staffed out by Business Services with responses back by end of April. | Fund implemented a new Corporate Guideline regarding physical access in 2008. State Fund performed a review on access to the Home Office to ensure compliance with the new guideline; however, limited evidence of this review was available. Real Estate Management intends to revalidate access on a semi-annual basis, with the first revalidation to be completed in January 2009. Audit evidence should be kept for this review, including the reports with the beginning access and documentation of changes made. |
| 70. All District Offices | Lack of Formalized Claim Review | Management should sign-off on the case reserve balances to indicate that the reviews, performed at least annually, and the case reserves were properly recorded. Establishment of a quality review function would enhance State Fund's ability to evaluate individual performance, identify training opportunities, and establish and monitor metrics across the organization. Additionally, procedures should be developed to ensure that all known medical costs are considered when case reserves are established and that actuaries are made aware of medical bill processing delays when determining reserves. | As of June 30, State Fund responded that the CPCs will transmit a Quarterly Aging Report to the Executive Vice President for Actuarial Services, within ten days of each quarter end. The report will provide a breakdown by aging category (0-15 days, 16-30 days, 31-60 days and bills in overdue status) and average days to resolution. As of April 2008, the first report was issued. | ***This finding has been partially remediated.*** Claims testing performed in the district office visits revealed that, in general, case reserves are reviewed by a supervisor or manager at least once every six months. However, ECF lacks the functionality to provide evidence that a review has been performed unless the reviewer makes a change to a reserve or a reserve requires supervisory approval. ECF should be |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | configured to capture reserve estimate reviews performed even if no changes to the estimates are made or the approval is not required.<br><br>In addition, we noted a trend of adjusters' first reserve estimates occurring over 20 days past the expected reserve establishment date. |
| 71. All District Offices | Claim Reserve Revisions | Consistent methods should be followed to monitor timely completion of case reserve estimates. | As of June 30, 2008, State Fund responded that Claims/Rehabilitation met with the Claims Managers (CM) and the Assistant Claims Manager (ACM) in March and April 2008. The CMs and ACMs were asked to review Claims Reference Manual (CRM) section 10-20-201A, which provides direction as to when an estimate must be reviewed with staff. Managers were advised that this CRM section will be amended to include an annual ACM review. | ***This finding has been remediated.*** |
| 72. All District Offices | Budget Cuts Not Aligned with Strategic Business Plans for Training and Development | Additional training should be provided so that new or reassigned claims personnel are proficient with the ECF software and enter consistent and accurate claims data. Also, Internal Audit should conduct reviews of the district offices' implementation of this software on a rotational basis. | As of June 2008, State Fund responded that the 2006 and 2007 Audit Plans included ECF implementation audits. | ***This finding has not yet been remediated.*** State Fund personnel have had an additional year of ECF exposure. Therefore, the necessity for significant training on ECF has been minimized.<br><br>Many of the dates found in the claim reserve histories do not reconcile from DB2 to |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | ECF. These dates ranged from differing by one day to exceeding 30 days. Examiners also noted instances where the reserve estimate amount in DB2 did not reconcile to the amount reported in ECF. DB2 should be timely interfacing with ECF to contain the most current information contained in ECF. Once DB2 and ECF interface, a reconciliation report should highlight any differences noted in the two systems.<br><br>ECF is in need of additional functionality. Specifically, ECF should be regularly interfacing with DB2. ECF should also have the capability to process types of payments (i.e. compensation and medical) and the capability to capture fields necessary for payment processing. State Fund appears to be aware of these additional necessities. Given the strain on State Fund IT resources, the additional functionalities have not been implemented. State Fund should devote adequate IT resources to the development and implementation of additional functionality to |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | ECF in order to maximize the business objectives and streamline claims processing. As of November 1, 2008 ownership of ECF is maintained by the IT Department. |
| 73. All District Offices | Notification of Quotes for Review Needed | PowerComp should be automated to provide supervisors with notification of pending quotes requiring review. | As of June 2008, State Fund responded that Underwriting has reviewed this recommendation and determined no further programming is required to create an automated notification system. | ***This finding has been remediated.*** |
| 74. Bay Area District Office | Inappropriate Authority to Approve Claims and Process Medical Bills | Medical bill payment capability should be limited to the claims processing centers. | As of June 2008, district office resources were used as a stop gap measure to address backlogged medical bills. Bills remained subject to automatic bill review system edits or were reviewed by trained CPC bill reviewers. | ***This finding has been remediated.*** |
| 75. San Diego District Office | Inadequate Staffing in Claims Area | We recommend that State Fund assess the staffing level in the claims area and take appropriate action. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |
| 76. San Diego District Office | Need for Accurate Record Keeping Process | A protocol should be established to ensure a consistent record keeping process. Additionally, a suspense account for undelivered e-mail should be established and monitored to determine that no claim correspondence is lost. | As of June 2008, State Fund responded that procedure 20-00-473 – Maintaining and Centralizing Master Policy File was updated. | ***This finding has been remediated.*** |
| 77. San Diego District Office | Need for Consistent Processes for Policy Renewals | A consistent process for policy renewals should be established and followed. | As of June 2008, State Fund Home Office Underwriting met with the Customer Service Center to review renewal processing and queried the districts on their processes. | ***This finding has been remediated.*** |
| 78. San | Lack of | All payment plan payments should be | State Fund did not provide a response to this | ***This finding has not yet been*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| Diego District Office | Segregation of Duties for Posting of Credits and Custody of Cash | sent to a customer service center to strengthen segregation of duties. This will ensure that payments are not being received by the same personnel who are responsible for issuing credit. | finding and recommendation. | ***remediated.*** Testing completed during the San Diego and Sacramento District Office visits conducted revealed that this process has not been changed per the 2007 Operational Review Report recommendations. Corporate Guidelines and processes should be updated to require these payments be sent directly to the Home Office. Subsequent to our review, a memorandum from Credit and Collections, dated November 19, 2008, was issued requiring payments to be sent directly to the Credit and Collections Department.<br><br>There are no documented polices and procedures established to process and print claims payment checks at the Redding District Office. In addition, clerical staff in Redding has the ability to create new payees in WISP, initialize a claim payment and take physical custody of the claim payment checks. |
| 79. Orange County District Office | Incomplete Documentation in State Fund Online (SFO) | Within the existing underwriting procedure, a process should be established that ensures all underwriting documents are scanned and archived. | As of June, 2008, State Fund responded that the Imaging hardware used to scan and index documents was upgraded as part of the Insurance Services Department's move to | ***This finding has been partially remediated.*** Testing completed during the district office visits |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | System | Additionally, a process should be implemented to verify that the payment of commission agrees to the actual calculation provided by home office. | Pleasanton in June 2007. Insurance Services is developing a report for district use to identify policies that are on the mainframe which do not have documents scanned and imaged within the time period specified in State Fund procedures. Underwriting researched the policies where errors were noted by the Department and found all but four of the documents. Two policy numbers were incomplete and a summary report containing exhibits was produced. Marketing and Fiscal Services reviewed both policies referenced by examiners and could find no discrepancies between the Home Office commission calculations and the commissions posted within State Fund Online. As of December 2007, the unit responsible for the Broker Commission calculation was moved from Marketing to Fiscal and Investment Services. A formal reconciliation process has been developed. | conducted did not reveal significant instances of missing scanned policy documentation. There was one instance in the Monterey Park District Office where a policyholder was given a merit-rated premium quote even though the base premium used to calculate the quote did not meet the $75,000 merit-rating threshold. This appeared to be an isolated instance. |
| 80. Orange County District Office | Standardized Tracking and Monitoring Method Needed for Case Documents | A process should be implemented that provides a consistent methodology in tracking and monitoring case documents to allow management or quality review teams to effectively detect errors or detect untimely decisions. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |
| 81. Orange County District Office | Stricter Controls Needed for Recurring Payments | The reconciliation between the recurring payments schedule and the adjuster's accounts should be reviewed by the adjuster's supervisor to guarantee that there are no inaccurate payments. The WISP system should consider the cumulative total of all recurring payments in accordance with the adjustors authority limits. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** Testing completed during the district office visits did not reveal any changes implemented to address this finding. |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| 82. Bakersfield District Office | Review of District Office Procedures Needed to Conform With Established Protocol | The Claims Rehabilitation Manager should independently evaluate the district office claims processing procedures to ensure they are consistent with the State Fund Home Office claims manuals and guidelines. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |
| 83. All Claims Processing Centers | Late Payment Penalties Increase | State Fund should ensure that the problems at the claims processing centers resulting in significant late payment penalties are addressed. In August 2007, State Fund hired a consultant to assist with this matter and hired temporary staff to address the processing backlog. | As of June 2008, State Fund employed the measures to address this matter. | ***This finding has been remediated.*** |
| 84. All Claims Processing Centers | Need for Proper Establishment of Reserves for Known Claims | A process should be established to ensure all known medical payments, at a minimum, are considered when case reserves are established. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** Existing procedures established for creating reserves for known claims are being reviewed. The procedures will also be revised to stress the importance of reviewing all medical reports on file as well as outstanding bills that have been received on a claim. Currently, there is a planned and systematic analysis of those medical claims that were under-reserved. A focused training program will be established to address the issue. The State Fund |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | estimated time to complete the analysis and implement changes is December 15, 2008. |
| 85. All Claims Processing Centers | Identify and Prioritize High-Dollar Bills | An aging report for management should be developed to identify all old and high-dollar value unpaid and un-reviewed bills so they can be processed in a timely manner. Subsequent to testing, State Fund added a document type, such as hospital, doctor, etc., to the index of scanned medical bills. This allows State Fund the ability to sort by document type and potentially identify high-dollar bills. The high-dollar medical bills can then be manually assigned to a bill reviewer for processing.<br><br>Additionally, a report currently exists to identify unpaid bills under review of over $5,000 and 45 days or more from receipt ("BDM Management Report – Unpaid Bills over $5,000, 45 or more from receipt"). At a minimum, management should leverage this query to age and monitor unpaid bills currently under review that are nearing the 45 day mark. | In December 2007 system implementation and reports to identify high cost bills in production were completed. A report to monitor bills over $5,000 and older than 45 days was decommissioned and replaced with the High Cost Bill Report by Location and High Cost Summary Report – All Locations. New monitoring procedures were developed. | ***This finding has been partially remediated.*** In December 2007 changes were made to the Scan/Index System to allow identification of the billed amount of an invoice. The State Fund supervisor can now query bills over $50,000, pull them out of the normal processing sequence and assign to staff for quick processing.<br><br>Based upon testing of the 25 high-dollar bills (greater than $5,000), there was an instance where a bill that was input incorrectly as a new claim in the ECF system, was paid after the payment due date. The error was not detected because the error report was not functioning correctly. There are other procedures in place to safeguard that such errors are manually detected by bill reviewers; however, these procedures were not followed. |
| 86. Fairfield Claims | Call Center Training Needed | Appropriate district office staff and the manager should be provided training to | As of March 2008, State Fund responded that all CPC call group staff completed a training | ***This finding has been remediated.*** |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| Processing Center | | handle ABR related calls. | program. | |
| 87. Fairfield Claims Processing Center | Limited Understanding of the Functions of the CPC | The CPC Claims Managers should receive additional training on the functions of the Claims Processing Center. Certain CPC Claims Managers should be paired with a mentor in another CPC location and be encouraged to ask questions and participate in open discussions with this mentor. | In March 2008 functional training of CPC managers was completed. The newest CPC manager met with other experienced CPC managers on four occasions subsequent to her appointment for mentoring purposes. Senior CPC manager designated as a formal mentor going forward. | ***This finding has been remediated.*** |
| 88. Fresno Claims Processing Center | Quality Assurance Reviews Should be Re-established | The reviews performed by the ABR supervisors should be reinstated in order to ensure issues are identified on a timely basis. | As of July 2008 an ABR quality assurance process has been implemented at the CPC locations. | ***This finding has been remediated.*** |
| 89. Fresno Claims Processing Center | Automated Control over the E-fax System | The e-fax system problem needs to be resolved in order to avoid a similar large number of bills being recorded into the ECF system and to make certain duplicate payments are not made. Management should be provided with the status of the resolution and review of any duplicate payments. | As of June 2008, State Fund responded that defect #14362 noting issue and correction was closed and a new code was effective April 2007. A duplicate payment checking occurs automatically on all bills processed in the bill review application. If a possible duplicate payment situation is encountered, it is identified for the bill reviewer to prevent payment and potential duplicate payments are resolved as they occur. | ***This finding has been remediated.*** |
| 90. Burbank Claims Processing Center | Ensure Access Controls to Archive Room is Restricted | Access to the archive room should be restricted to authorized employees only. | As of June 2008, State Fund responded that a lock was installed to restrict access to the Manager and Building Services Supervisor only. | ***This finding has been remediated.*** |
| 91. Business Services | Internal Audit of Fleet Management Needed | An internal audit of the fleet car pool should be performed as fleet management is an area where a large amount of funds are expended. An analysis of the need for | As of July 2008, State Fund completed an analysis of the fleet car inventory in February 2008. Based on this analysis of the fleet car inventory, 175-180 vehicles were identified to | ***This finding has been partially remediated.*** State Fund did decrease the size of its fleet car inventory by |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | fleet vehicles should be considered to determine whether all of the vehicles owned or leased by State Fund are necessary. On a periodic basis, the fleet manager should also perform an audit of the State Fund Monthly Travel Logs for compliance with State Fund policy. | be sold. | approximately 200 vehicles. However, the removal of these vehicles was based on age, mileage and condition of the vehicle as opposed to the associated employee's business purpose for being awarded a fleet vehicle. An audit of the fleet management has not been performed by the State Fund Internal Audit since 2003. However, Internal Audit has included an audit of fleet management in its 2009 Audit Plan.<br><br>Additionally, updated policies and procedures pertaining to Business Services Operations are yet to be complete or implemented. The estimated adoption date for updated policies and procedures is January 2009. |
| 92. Business Services | Reasonableness Tests to Compare Miles Versus Expenses Not Performed | Reasonableness tests of gasoline expense on a random sample of fleet vehicles should be performed by Business Services on a periodic basis to ensure cards are not used for unauthorized purchases. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** State Fund has developed a spreadsheet to monitor the monthly mileage activity and gasoline expenses, and to verify vehicle maintenance. This spreadsheet will serve as a tool to facilitate the internal monitoring of mileage, gasoline expenses incurred and required maintenance. However, a monthly audit of |

| Functional Area | Summary of Finding | 2007 Recommendation | State Fund Response | RSM Response |
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| | | | | the reasonableness of the miles traveled and corresponding gasoline expenses will not be performed until January 2009. Additionally, the process of completing these audits has not been documented or implemented as the updated policies and procedures for Business Services Operations remain incomplete. The State Fund estimated adoption date for updated policies and procedures is January 2009. |
| 93. Business Services | Vehicle Mileage Audit Not Completed Periodically | On a periodic basis, the fleet manager should perform an audit of the State Fund Monthly Travel Logs for compliance with State Fund policy. Testing should include verification of the recorded mileage and any miles not related to State Fund business should be identified. In addition, substantiation of required maintenance should be performed. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** A monthly audit of the reasonableness of the miles traveled was not performed by the close of the review.<br>Subsequent to the close of the review, State Fund did perform its first audit for the reasonableness of miles traveled in November 2008. |
| 94. Business Services | Some Inequalities Exist Among Employee Benefits Regarding Fleet Vehicles | For all employees with assigned vehicles, an audit of the time spent in the field versus time spent at their job site should be performed. For all employees not meeting the 50% requirement, the assignment of a State Fund owned vehicle should be discontinued. Consideration should also be given to allow employees the option of using their own vehicles for | State Fund employees may use personal vehicles with supervisory approval and proof of required insurance. | ***This finding has not yet been remediated.*** The current fleet management policy does briefly discuss the use of private vehicles. However, State Fund does not have a robust process for tracking personal vehicle use or encouraging personal vehicle |

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| | | the occasional off-site travel requirements. | | use. Additionally, no audit of fleet management has been performed to assess compliance with the 50% travel requirement for fleet vehicle usage contained in State Fund policies.<br>An audit of fleet operations to assess compliance with the 50% travel requirement is to be performed by June 2009.<br>The policies and procedures pertaining to Business Services Operations are expected by State Fund to be finalized in January 2009. |
| 95. Business Services | Large Backlog of Claims Files Not Filmed | Given the magnitude of backlog (over 100,000 files) and the newer scanning and indexing processes available, consideration should be given to scanning/indexing these old claim files in lieu of microfilming. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** State Fund engaged a consultant group to compile a Closed Claim Study detailing the options for file retention and storage. The results and recommendations from the Closed Claim Study were submitted to the Executive Committee for review on July 31, 2008. However, no decision has been made and no actions have been implemented to address this finding. |
| 96. Business Services | Significant Contracts Signed | To maintain the proper level of internal controls, a manager who is also | The Accounts Payable function has been transferred to the Fiscal & Business Services | ***This finding has been remediated.*** |

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| | by Inappropriate Personnel | responsible for the accounts payable function should not perform the purchasing function, even on a limited basis. Also, State Fund's policy states that no other department should be permitted to agree to any agreement or contract, for other than real property. | Department. | |
| 97. Business Services | Contracts Entered into with Zero Cost | State Fund stated that beginning in June 2007, the zero cost contract practice was discontinued and all contracts are now given a dollar value based on estimated hours and the contracted hourly rates. However, our testing samples did not reflect the new procedures implemented in June so we cannot verify this change.<br><br>Management should continue the practice of requiring a valid estimated cost be included on all SOW and in all contracts. By doing so, the contracts will be signed and approved by an individual with the appropriate authority levels. | As of July 2008, Business Services is continuing the practice of requiring a valid estimated cost on all contracts and SOW. | ***This finding has been remediated.*** |
| 98. Business Services | Accounts Payable Supervisor has Inappropriate Access within Oracle | Authority levels for all Oracle users should be reviewed to determine whether the permissions given are appropriate. Please see IT Findings for further details on user permission recommendations. | State Fund performed a comprehensive review in November 2007. As a result of this comprehensive review, financial users were reassigned modified Oracle responsibilities and Oracle GL Super User responsibilities were removed. | ***This finding has been remediated.*** |
| 99. Business Services | Improperly Prepared Reconciliations of Funds Received | All reconciliations and reimbursements for the President's Award for Corporate Excellence (PACE) program should be thoroughly reviewed for accuracy before processing payments to State Fund employees. | As of July 2008, the PACE Employee Recognition Program procedure was enhanced to include a second thorough review by another analyst. | ***This finding has been remediated.*** |

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| 100. Business Services | Invoices Paid With No Purchase Order or Contract | All payments should be evidenced by an approved purchase order or a fully executed contract. | As of July 2008, new stringent procedures and controls have been established to help insure invoices are properly approved and expenses are legitimate and adhere to Business Services Guidelines. | ***This finding has been remediated.*** |
| 101. Business Services | Need for Consistent Invoice Processing Forms | Internal controls should be designed and implemented to ensure that expenditures are properly supported by an original invoice and approved prior to the release of funds. State Fund should consider additional testing in this area. | As of July 2008, a log has been established for transactions that are not supported by the original invoices. This log identifies all payment types where supplier invoices are not provided and an "Invoice Substitute" form is required. This log is submitted to the Executive Committee for their review and concurrence on a quarterly basis. New transactions or payment types requiring an "Invoice Substitute" form but not listed on the log require approval form a member of the Executive Committee prior to their consideration for payment.<br><br>Fiscal & Business Services completed a retroactive test of invoice transactions previously supported by "Invoice Substitute" forms. Forms were reviewed and found to be approved and submitted for payment within approved guidelines. | ***This finding has not yet been remediated.*** State Fund has established a listing of vendors that are approved for payment without an invoice. This listing is submitted to members of the Executive Committee on a quarterly basis.<br><br>The design of this control is not adequate. The listing is very limited and general. Additionally, there is no evidence of the Executive Committee's review and approval of this listing.<br><br>Accounts Payable Unit should compile and maintain a log of actual payments processed without invoices as opposed to a general listing of vendors that are approved for payment without an invoice. A transactional log should be submitted to the Executive Committee for |

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| | | | | their review and concurrence on at least a quarterly basis. |
| 102. Business Services | Employee Reimbursements Not Processed in Compliance with State Fund Policy | A formal policy covering employee expense reimbursements should be established and followed at all times. These transactions should also be subjected to the audit and approval process in all instances. | As of July 2008, a formal expense reimbursement policy has been implemented. When an exception or "rush" payment is requested, it is subject to the same audit and approval processes as other payments and must comply with corporate guidelines. | ***This finding has been remediated.*** |
| 103. Business Services | Record Retention Policy Lacking | The Business Services Department should make certain that retention schedules are developed and maintained for each business area, as well as maintain a central repository with all State Fund record retention schedules. The Records and Information Management policy should be updated to include the retention schedules for all business areas, as well as the length of time records should be stored, procedures for sending records offsite, off-site storage facilities utilized by State Fund, procedures for sending items offsite, and the tracking of destruction dates. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** State Fund has taken steps to establish a new program solely dedicated to the records management function. However, the full implementation and operation of the new program is expected by State Fund to take 18-24 months. No changes to policies and/or procedures have taken place in the interim to address this finding. |
| 104. Business Services | IT Vendor Contract Guidelines Vague | IT vendor contract guidelines should be updated to provide specific policies and procedures for the following areas: 1) review and approval of IT vendor contract service, 2) preparation and approval of IT vendor service requisitions, 3) solicitation and evaluation of quotations such as price, vendor reliability and vendor quality, 4) review and approval of contracts by managers in the IT and Legal | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** Updated policies and procedures pertaining to Contracts and Purchasing are yet to be complete and implemented.<br><br>A draft of the Contracts and Purchasing Guidelines was provided with an effective |

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| | | Department, 5) preparation and approval of purchase orders, 6) required procedures for a vendor background check, and 7) accounting for IT vendor services such as capitalization and expenditures. Additionally, retention of contracts should be centralized at State Fund to ensure that original contracts, amendments and any other pertinent information are available. State Fund is working with outside counsel to enhance the IT vendor contract process. | | date of November 1, 2008. However, the draft provided did not include guidelines specifically relevant to IT contracts. |
| 105. Business Services | Methods for IT Contracting Should be Realigned | The method in which IT consultants are employed should follow State Fund prescribed policies and procedures. IT consultants used for operational purposes should be utilized for short-term needs only. For long term needs, IT needs to work with the HR Department to develop an annual budget for utilization requirements. IT consultants used for project development purposes should be contracted by project through the use of a fixed fee bidding process that requires key objectives and deliverables be met by the vendor. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** Updated policies and procedures pertaining to Contracts and Purchasing are yet to be complete and implemented.<br><br>A draft of the Contracts and Purchasing Guidelines was provided with an effective date of November 1, 2008. However, the draft provided did not include Contract and Purchasing Guidelines specifically relevant to IT contracts.<br><br>IT consultants' contracts are entered based on a six-month term based upon State Fund policy. In many cases, the IT consultants' contracts undergo subsequent extensions without defining key |

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| | | | | objectives or final completion date.<br><br>Transition plans discussing the usage of IT consultants were reviewed. However, these plans do not appear to provide specific metrics detailing when usage of IT consultants will be terminated. |
| 106. Business Services | IT Vendor Guidelines Should Address the Legal Department's Review | The State Fund Legal Department should establish written guidelines outlining the process for legal review of IT vendor contracts. These guidelines should include a definition of what modifications require legal oversight and define the criteria to be considered by the purchasing agents. Additionally, supervisory control should be established over the purchasing agents. This review should be conducted by a supervising Program Manager. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** Updated policies and procedures pertaining to Contracts and Purchasing are yet to be complete and implemented.<br><br>A draft of the Contracts and Purchasing Guidelines was provided with an effective date of November 1, 2008. However, the draft provided appeared to be incomplete.<br><br>New Contracts and Purchasing Guidelines did not appear to contain a reference to the criteria that would warrant a legal review. The new Contracts and Purchasing Guidelines should include specific reference to the criteria that would prompt a legal review. |

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| 107. Business Services | Lack of Adequate Vendor Background Check | State Fund should refine background checks for vendors and implement controls in Business Services to ensure compliance with all contract provisions. | State Fund did not provide a response to this finding and recommendation. | ***This finding has not yet been remediated.*** State Fund has drafted new Supplier Identification and Qualification Guidelines. However, the new guidelines have not been finalized or implemented. The State Fund estimated adoption date for the guidelines is December 10, 2008.<br><br>Contract testing revealed that background checks are not being performed on vendors as recommended by examiners. |
| 108. Business Services | IT Vendor Contract Documentation Not Available for Review | Retention of contracts should be centralized at State Fund to ensure that original contracts, amendments and any other pertinent information are available for review.<br><br>As a result of the Internal Audit IT Consultant Contract Review recommendation, dated November 8, 2006, Business Services now retains all original contracts and is the custodian of such contracts. However, contract information prior to November 2006 may not have been retained by Business Services. | State Fund did not provide a response to this finding and recommendation. | ***This finding has been remediated.*** |
| 109. Business | Vendor Payment | If payments deviate from contract terms, | In March of 2008, appropriate controls were | ***This finding has not yet been*** |

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| Services | History Did Not Conform to Contract | State Fund should keep a record of the reasons for payment inconsistencies in the files. Additionally, all contract revisions should be on file and kept with the master vendor contract. These contracts should be filed with the Legal Department. | implemented and are being enforced by Purchasing and Accounts Payable Unit. All contract documentation is maintained in Oracle. All supporting documents are scanned and made a part of the Oracle contract file. Contracts pre-dating Oracle have been scanned and are kept as a separate file for reference.<br><br>Business Services coordinates with Legal on the storage and retrieval of contract information. All IT vendor contracts involving litigation are filed with the Legal Department. | ***remediated.*** It appears State Fund does not formally track deviations in actual payments compared to contract terms. State Fund's Accounts Payable Unit personnel have made efforts to implement a manual control. However, this control is inadequate in design and operating effectiveness. |
| 110. Business Services | Circumvention of State Fund Procurement/ Budget Process | All employees should receive ethics training including information regarding how to report unethical practices. The practice of using encumbrances has been part of the corporate culture at State Fund for some time. Employees require proper training on accruals verses encumbrances in addition to training on proper budget techniques. The Board of Directors and State Fund executives should set the proper tone regarding corporate ethics and take the necessary steps to make certain the organization is in compliance with its ethics policies. Additionally, consideration should be given to requiring retroactive conflict of interest statements or disclosures for all procurement personnel and vendors. | As of July 2008, the Accounts Payable function has been transferred to the Fiscal and Investment Services Department. Beginning in the Fall of 2007, the Fiscal and Investment Services Department is responsible for the accrual of all group administrative fees and the review of business functions for proper accruals. The business practice of allowing unused encumbrances to be transferred to other budget accounts has been stopped.<br><br>A Code of Ethics has been drafted and Corporate Guidelines on Incompatible Activities and Business Ethics have been revised. | ***The finding has been partially remediated.*** State Fund has refined its Code of Conduct and related Unethical and Incompatible Activities Guidelines. The Code of Conduct will provide for reporting of unethical and incompatible activities through the Integrity in Action and Whistleblower Programs. However, the updated Code of Conduct has not been implemented. The State Fund estimated implementation date is January 2009.<br><br>A review of the filed Statements of Economic Interest revealed that a number of high-level State Fund personnel are not required to file the Statements of Economic Interest. |