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Date: October 1, 2015

To: Audit, Finance and Enterprise Committee

From: Jennifer Ruttman, City Auditor

Subject: Audit of Workers' Compensation Program

cc: Mayor and Council
John Pombier, Assistant City Manager
Gary Manning, Human Resources Director
Nitra Hawkins, Safety Services Administrator

Pursuant to the Council-approved Audit Plan, the City Auditor's office has completed an audit of the City's Workers' Compensation Program. The report is attached. Please feel free to contact me with any questions or concerns.

AUDIT REPORT

CITY AUDITOR

Report Date:	September 3, 2015
Department:	Human Resources, Safety Services Division
Subject:	Workers' Compensation Claims Management
Lead Auditor:	Kate Witek

OBJECTIVE

This audit was conducted to determine whether internal controls related to Workers' Compensation claims management are adequate to provide reasonable assurance that:

- The program is operating in accordance with applicable policies, laws and best practices.
- Claim payments are accurate and authorized.
- The risk of loss due to errors or fraud is minimized and/or effectively mitigated.

SCOPE & METHODOLOGY

To accomplish our objective, we:

- Reviewed and tested compliance with applicable Arizona Revised Statutes, Industrial Commission regulations, Arizona Administrative Code, records retention requirements, Management Policy 346-*Industrial Insurance Program*, and other policies & procedures.
- Interviewed responsible staff and management in the Human Resources, City Attorney, and Financial Services departments.
- Reviewed and tested Workers' Compensation medical and lost wages claims managed between 7/1/2013 and 12/31/2014.
- Reviewed the claims payment oversight process established in response to the FY 2014 Single Audit finding #2014-004, "Internal Controls over Workers Compensation Claims".

BACKGROUND

Workers' Compensation is a "no fault" insurance program which provides constitutionally mandated medical benefits and wage replacement to employees injured in the course of their employment. All AZ Workers' Compensation insurance carriers, including self-insured entities, are monitored by the Industrial Commission of Arizona (ICA). The City of Mesa has been self-insured for Workers' Compensation since 1982, and the program is administered by staff in the Safety Services Division of the Human Resources Department. Additional oversight is provided by a Self-Insurance Trust Fund Board appointed by the City Council.

Process Overview

According to City policy, an employee injured on the job must visit a Banner Occupational Health Clinic (Banner) for an initial medical examination as soon as the injury occurs, or when the employee becomes aware of the injury. Banner sends the employee's injury information to the City's Workers' Compensation office and to the ICA. After reviewing the information, the ICA notifies both the employee and the Workers' Compensation office that a claim has been officially filed. The Workers' Compensation office, as the insurance carrier, then has 21 days to approve or deny the claim. According to state law, Workers' Compensation claims must be filed within 1 year of the employee becoming aware of the injury.

Types of Claims

There are 2 types of Workers' Compensation claims:

- 1) Medical Only - All medical expenses associated with the injury are paid and the employee does not require time off from work.
- 2) Time Loss - All medical expenses associated with the injury are paid and a doctor concludes an employee is unable to work due to the injury.

If a doctor determines an employee is unable to work, and the employee is off work more than 7 days, the employee is entitled to compensation for lost wages. This compensation is paid at $66\frac{2}{3}$ percent of an employee's Average Monthly Wage (AMW), up to a statutory maximum (\$4,337.82 for 2015). If an employee meets eligibility requirements, the City's Industrial Insurance Program (IIP) will pay a portion of the lost wages that are not paid by Workers' Compensation.

Permanent (Perpetual) Awards

If a doctor determines an employee's medical condition is stationary and the employee has sustained a permanent impairment, the doctor will assess the percentage of impairment according to standards set by the American Medical Association. The employee will receive a permanent compensation award based on the determination. There are two types of permanent compensation awards. A *scheduled* award is conferred pursuant to state statute for a particular injury, and the rate is calculated as a specified percentage of the employee's AMW. An *unscheduled* award is determined by the ICA, and the rate is calculated at 55% of the difference between the employee's AMW and the reduction or loss of earning capacity (LEC) resulting from the injury. A total loss of earning award is calculated at $66\frac{2}{3}$ percent of the employee's AMW.

Fiscal Impact

The table below shows the actual program costs, along with the actuarially calculated unpaid claim balance* for the past 4 fiscal years.

	FY 2011	FY 2012	FY 2013	FY 2014
Administration	923,772	895,090	926,435	930,000
Claims Paid	3,127,828	3,568,076	3,686,440	3,086,000
Premiums to Insurance Carrier	235,825	266,104	300,290	314,582
Total Program Costs	4,289,436	4,731,282	4,915,178	4,332,596
Unpaid claim balance*	\$11,469,618	\$18,718,196	\$21,706,500	\$22,807,000

* The City of Mesa is required by statute to assure the unpaid claim balance with a security bond and monitor long-term actuarial claim liabilities for adequacy.

CONCLUSION

In our opinion, internal controls related to Workers' Compensation claims management are adequate to provide reasonable assurance that the program is operating in accordance with applicable policies, laws, and regulations. However, although we did not find that losses had occurred, improved controls are needed to ensure that claim payments are accurate and authorized; and to minimize or effectively mitigate the risk of loss due to errors or fraud.

Our observations and recommendations are summarized below. For additional details and responses from management, please see the attached Corrective Action Plans (CAPs).

[Note: Additional findings and recommendations involving aspects of the Workers' Compensation program that are closely related to payroll processing may be forthcoming in a separate report on our citywide payroll audit (in process, as of this writing).]

OBSERVATIONS AND RECOMMENDATIONS

1. Policies and procedures for managing claims and payments are not in writing. To ensure consistent handling of claims, as well as continuity of operations upon staff turnover, we are recommending that detailed written policies and procedures for all essential processes be developed and formally adopted by management. These documents should be reviewed periodically and updated as necessary to mitigate the risks associated with this complex, highly regulated activity.
2. Checks received in the mail were not being processed in accordance with City policies. We are recommending stronger internal controls to ensure checks are safeguarded from loss, deposited in a timely manner, and properly recorded in the City's financial system. These include segregation of duties, immediate restrictive endorsement of checks, improved physical security/chain of custody processes, and full compliance with the City's cash handling policies.
3. Claim records have been deleted from the RiskMaster claims management database. We are recommending improvements to application security controls, in order to help ensure the

accuracy and completeness of claims data, preserve an effective audit trail, and reduce the risk of fraudulent activity.

4. In our opinion, the claims payment review process implemented by management in response to a 2014 Single Audit finding (#2014-004) should be strengthened to increase its effectiveness as an internal control. We are recommending that the number of transactions tested be increased as necessary to provide a more statistically reliable result.

CAP#1: Policies and procedures are not in writing.

Observation: There are no formal written policies and procedures for the Workers' Compensation program.

Criteria: An effective system of internal controls requires that all critical and complex processes be clearly documented in written policies and procedures, to formally establish management's expectations, to ensure compliance with complex regulations and policies, to ensure consistent outcomes, and to help mitigate many common operational risks.

Comments: Claims adjusters work with considerable autonomy and rely primarily on professional judgment when making claims management decisions. With no formal guidelines established by management, similar claims may be treated differently depending on the individual adjuster.

Without written standard operating procedures, training of employees may be inconsistent, and there is an increased risk of disruption of operations upon staff turnover.

Recommendation: 1-1. Management objectives should be clearly communicated in written program policies, and all essential processes in the Workers' Compensation program should be documented in detailed written procedures formally adopted by management. These documents should be regularly reviewed and updated to ensure they remain current.

Management Response: 1-1. Agree.

Implementation Plan:

Create and document all essential processes for the City of Mesa's workers' compensation program.

One hour brainstorming sessions will be held each week with the Workers' Compensation Representatives and Administrative Staff to:
1) identify processes and/or protocols specific to how the City's Workers' Compensation program is administered; and 2) create written procedures.

Sessions will begin the week of September 14, 2015.

Individual or Position Responsible:

Safety Administrator, Management Assistant and Workers' Compensation Staff.

Estimated Completion Date: 8/31/2016

CAP#2: Cash handling processes need improvement.

Observation: Checks received through the mail by the Workers' Compensation office have not been handled in accordance with the City's cash handling policy and have not been adequately safeguarded from loss.

Criteria: Management Policy 210, *Cash Handling* requires, in part, that:

- Employees know where cash (and cash equivalents) are at all times.
- Employees know what has occurred from the beginning of a cash handling process to the end of the process.
- Individual accountability (i.e. chain of custody) be maintained throughout all cash handling operations.
- Checks shall be restrictively endorsed upon receipt and stored in a secure location.
- Administrators not directly involved with the cash receipt process should periodically evaluate overall internal controls to ensure that reasonable controls exist to safeguard cash and that employees understand and follow them.

Comments: We found that checks received in the mail were being given to a claims adjuster to document in the corresponding case file, and then sent via inner-office to "Customer Service" (the Revenue Collections Business Office). In addition, no follow up procedures were in place to ensure these checks were received by Customer Service or properly recorded in the accounting system.

In many instances, such as with Pharmacy refunds, these checks are unanticipated, which further increases their vulnerability.

Recommendation: Management should ensure that all checks received are handled in compliance with Management Policy 210, including but not limited to the following:

- 2-1. Checks received in the mail should be immediately restrictively endorsed.
- 2-2. Checks should never be transmitted via interoffice mail.

- 2-3. Checks should be logged upon receipt, *preferably* by an employee in a position unrelated to the Workers' Compensation payment process. *(Note: If current resources do not allow these duties to be segregated, the overall system of controls will need to effectively compensate for the associated risk.)*
- 2-4. All funds received in connection with a claim should be documented in the associated claim file, along with evidence (such as the revenue receipt from Customer Service) showing that the funds were properly recorded in the Workers' Compensation Fund in the City's financial system.

**Management
Response:**

2-1. Agree.

Implementation Plan:

Established a chain of custody process that includes the restrictive endorsement of checks and cash items immediately upon receipt.

See the Safety Service Cash Handling process document for specific details on entire process.

Individual or Position Responsible:

Senior Program Assistants

Estimated Completion Date: 8/11/2015

2-2. Agree.

Implementation Plan:

Established a chain of custody process that includes the delivery of the checks directly to Customer Service for deposit.

Safety Services purchased a lock box that has been secured in the Worker's Compensation vault. If for some reason staff is unable to walk the check(s) to Customer Service for deposit immediately upon receipt, the checks will be secured in the lock box until the deposit can be made.

See the Safety Service Cash Handling process document for specific details on entire process.

Individual or Position Responsible:

Senior Program Assistants

Estimated Completion Date: 8/5/2015 Immediate

2-3. Agree.

Implementation Plan:

Established a chain of custody process that includes checks (cash items) being logged immediately upon receipt in Safety Services.

See the Safety Service Cash Handling process document for specific details on entire process.

Individual or Position Responsible:

Senior Program Assistants

Estimated Completion Date: 10/5/2015

2-4. Agree.

Implementation Plan:

Established a chain of custody process that includes scanning and attaching the revenue receipt from Customer Service to the applicable workers' compensation claim.

See the Safety Service Cash Handling process document for specific details on entire process.

Individual or Position Responsible:

Senior Program Assistants

Estimated Completion Date: 8/5/2015 Immediate

CAP#3 – System security settings should prevent deletion of claim records.

Observation: RiskMaster system security settings have been configured to allow 2 Safety Services employees the ability to delete claim records.

Criteria: Internal controls should be designed to help ensure the accuracy and completeness of data during processing. Allowing an employee to delete a claim prevents an effective audit trail and is therefore a significant deficiency in internal control.

Comments: Workers' Compensation claims (managed by Safety Services) and Property & Public Liability claims (managed by the City Attorney's office) share a single database system (RiskMaster). However, 2 employees in Safety Services have administrative access and are therefore able to configure security settings for all users, including themselves. These are the only employees (outside of ITD) with the ability to delete claims and perform other system administrator-level tasks.

Although only a small number of claims (13 of 1804) have actually been deleted, the ability to delete a claim is a significant deficiency in internal control, because it provides a means to effectively and permanently conceal fraudulent activity.

Safety Services staff were able to provide supporting documentation for 5 of the 13 deleted claims, but had no explanation for the remaining 8 claims. A manual "edit log" is supposed to be used to track certain actions, including deletions, but the RiskMaster system activity/audit log has not been turned on. Therefore, we were unable to determine who deleted the rest of the claims; and we were unable to track changes which may have been made to any user's access permissions during the audit period.

Recommendation: 3-1. A thorough review of all RiskMaster system user roles and permissions should be performed, and the system should be reconfigured to ensure adequate controls are in place.

3-2. If the System Administrator role is to remain in the operating department(s), protocols should be established

to ensure effective internal controls are maintained and compliance is monitored. No end users of the RiskMaster system should have the ability to delete a claim record.

3-3. The RiskMaster system's activity/audit log functionality should be activated and configured to provide an adequate audit trail and to allow for monitoring of compliance with established security protocols.

**Management
Response:**

3-1. Agree.

Implementation Plan:

Review the RiskMaster user roles with all essential stakeholder groups.

Individual or Position Responsible:

Safety Administrator

Estimated Completion Date: 6/30/2016

3-2. Agree.

Implementation Plan:

The ability to delete RiskMaster claims and events was temporarily removed from system user roles and permissions for all employees outside of the IT Department on 08/05/2015.

Interim procedures have been implemented to include a workflow that requires the approval of the HR Department Director to approve the deletion of any claims and/or events with supporting justification documentation.

All RiskMaster claim and/or event deletion requests must go through the following steps in Safety Services:

1) Any requests for deletions will be routed via email directly to the Safety Administrator for review and authorization. 2) Once approved by the Safety Administrator, the deletion request will be submitted via email to the HR Director for review and final approval. 3) Once the deletion request is authorized by the HR Director, an email confirmation will be sent to the Safety Administrator authorizing the deletion. 4) The deletion of the claim or event will be completed by the Management Assistant. 5) The Management Assistant will send a deletion confirmation email to the Safety Administrator. 6) The deletion authorization request (email chain) will then be filed in File Net.

A more formal delete request and approval process will need to be created and finalized based on discussions with all stakeholders, to include the City Attorney's Office and the IT Department.

Individual or Position Responsible:

Safety Administrator

Estimated Completion Date: 6/30/2016

3-3. Agree.

Implementation Plan:

Meet with appropriate IT personnel and RiskMaster vendor to have the system wide history tracking function turned on.

Individual or Position Responsible:

Management Assistant

Estimated Completion Date: 12/31/2015

CAP#4: Management oversight of claim payments needs improvement.

Observations: In response to a finding in the City's FY2014 Single Audit, management implemented a process in which claim payments are reviewed and approved, on a sample basis, after the payments are processed. However, the number of payments being selected for review each month does not provide a statistically reliable result.

Criteria: A secure internal control environment includes appropriate separation of duties. For example, the individual authorizing a transaction should be different than the person preparing source documents and recording the transaction. Since Safety Services does not have the resources to completely segregate these duties, the review and approval process described above was implemented as a compensating control.

Comments: The City's external auditors cited a lack of internal control over Workers' Compensation claims as a finding in the City's FY2014 Single Audit, stating that there was "...a lack of proper review and approval," for claims. As a corrective action, management established a monthly process in which a sample of payments made during the prior month are reviewed and approved.

The Workers' Compensation program employs two claims adjusters who manage hundreds of cases at any given time. Among their many duties, adjusters retain service providers as needed (attorneys, medical reviewers, investigators, etc.), process claimant paperwork to and from the Industrial Commission, and process payment requests for service providers, claimant awards, and pharmacy charges. The department does not have additional resources available to enable the segregation of these duties.

According to our statistical analysis, the number of payments being tested by management provides only a 60% confidence level (the probability that a sample represents the true value of the population). As a general rule, for attribute testing, auditors prefer to use a sample size that provides a confidence level of 90% or above.

Recommendation: 4-1. Management should increase the number of transactions tested, to raise the confidence level of the post-payment review process to provide a more reliable and effective internal control. Using a test sample that provides a confidence level of 90% or above is recommended. *[Note: As an example, for the month of July 2014, this would have required that 15 payments be tested, rather than 4.]*

**Management
Response:**

4-1. Agree.

Implementation Plan:

Incorporate the use of a sample size calculator to identify the number of post- payment workers' compensation transactions that will be audited each month.

The sample size calculator will be provided by the City Auditor's Office.

Individual or Position Responsible:

Safety Administrator

Estimated Completion Date: 1/1/2016