



City of Colorado Springs



Office of the City Auditor

Date: August 17, 2006
To: Honorable Mayor and Members of City Council
Re: 06-117 – Workers' Compensation Claims Reserve Fund

AUTHORIZATION

We have performed an examination of the Workers' Compensation Claim Reserve Fund. We conducted this examination under the authority of Chapter 1, Article 2, Part 706 and Article 5, Part 602(I) of the City Code, which state:

1.2.706: EXAMINE BOOKS, RECORDS:

The City Auditor shall examine and inspect all books, records, files, papers, documents and information stored on computer records or in other files or records relating to all financial affairs of every office, department, group, enterprise, political subdivision and organization which receives funds from the City or under the direct or indirect control of the City Council. The Auditor may require any person to appear at any time upon proper notice and to produce any accounts, books, records, files and other papers pertaining to the receipt or expenditure of City funds, whether general or special. If that person fails to produce the papers, then the Auditor may request Council approval to search for and take any book, paper or record in the custody of that person or public official. (1968 Code §1-10.3; Ord. 76-54; Ord. 01-42)

1.5.602(I): WORKERS' COMPENSATION CLAIM RESERVE FUND:

The City Auditor or any person authorized by the City Auditor shall conduct an examination at least once every two (2) years to determine that proper underwriting techniques, sound funding procedures, loss reserves, claims procedures and accounting practices are being followed in the management and operation of the Workers' Compensation Claim Reserve Fund. The City Auditor shall present a report of findings to the City Council. (Ord. 90-58; Ord. 93-190; Ord. 01-42)

Both the City of Colorado Springs (City) and Colorado Springs Utilities (Utilities) pay their workers' compensation claims from the Fund. The Fund is also used by both organizations to set aside reserves for anticipated claims. See Table 1 for comparative workers' compensation statistics related to the organizations.

CITY AUDITOR JEFF LITCHFIELD, CPA CIA CFE

TEL 719-385-5991 • FAX 719-385-5699 • FRAUD HOTLINE 719-385-2387
30 South Nevada Avenue, Suite 604 • P.O. Box 1575, Mail Code 640 • Colorado Springs, CO 80901-1575

BACKGROUND

Our prior audit was performed in 2004 and covered the period of January 1, 2002 through December 31, 2003. We identified a few issues such as missing documentation in claims files, miscalculations on the reserve worksheets, and compensation premium calculation errors in PeopleSoft. We also reported reserve deficiencies in the Fund. During 2004, the Claim Reserve Fund Committee put the Fund on a “watch basis” stating that should all of the City’s portion of claims outstanding materialize, the City would have to rely on the General Fund to cover these costs.

OUR AUDIT

We conducted the audit of Worker’s Compensation Claims Reserve Fund (the Fund) for the two year period of January 1, 2004 to December 31, 2005, as directed by the City Code to determine the following:

- proper underwriting techniques were used,
- sound funding procedures existed,
- adequate loss reserves existed,
- claims procedures were being followed, and
- accounting was in accordance with generally accepted accounting standards (GAAP).

The audit was conducted in a manner that met or exceeded the Standards of the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. The audit included such tests of records and other supporting documentation as we deemed necessary in the circumstance. We reviewed the internal control structure and performed compliance tests using statistical sampling techniques.

Based upon our audit, we noted the following:

1. The City did not have adequate loss reserves for workers’ compensation in the Fund.

The City Auditor’s Office is charged with determining whether the Fund has adequate reserves per City Code 1.5.602(I).

We have determined that the City’s portion of the Fund as of December 31, 2005, was underfunded for future liabilities by approximately \$2.7 million. Unfunded liabilities in this Fund ultimately become a liability to the General Fund.

Utilities funding for future liabilities appeared to be adequate.

The City Code 1.5.602(B) states, “Adequate reserves shall be maintained in the Workers’ Compensation Claim Reserve Fund subject to available appropriations made by the City Council at its discretion.” The Code then continues to state, “Each fund balance shall include sufficient funds to cover and discharge all known and potential workers’ compensation liability.” These two statements appear to be in conflict. The first statement allows maintaining adequate reserves to be at the discretion of City Council. The second statement requires the Fund to have sufficient funds.

Auditor's Recommendation:

We recommend that this section of the Code be reviewed and modified to reflect the intended funding policy. Fund reserves should be set according to the intended funding policy with the understanding that any unfunded liability in the Fund becomes a liability to the General Fund.

City's Response:

Risk Management agrees with the auditor's recommendations. The past practice of the Claim Reserve Funding Committee was to provide adequate funding to assure the payment of the workers' compensation benefits liability in any given year. We will work with the City Attorney to review an acceptable change to the City Code.

2. The City's portion of administrative and insurance expenses were not recovered by the Fund.

The City Code 1.5.602(B) states, "Each fund balance shall include sufficient funds to cover and discharge all known and potential workers' compensation liability and allow for administrative cost in discharging the liability."

We noted that funding recommendations for contributions to the Fund did not include any of the administration and insurance costs since 2001. The administrative and insurance expenses have significantly eroded the fund balance by approximately \$3.1 million since 2001.

Auditor's Recommendation:

We recommend the costs for administration and insurance be included when determining funding recommendations.

City's Response:

We agree with the auditor's recommendation. Risk Management currently provides our budget office with an estimate of insurance costs and the administrative costs for the fund. We are required to pay for an excess insurance policy, self-insurance surcharge taxes and a self-insurance permit fee. The costs will be presented at the Claim Reserve Fund committee meeting each year.

3. There were not adequate segregation of duties for the claims payment process.

Adequate segregation of duties reduces the likelihood that an error will occur and remain undetected. Due to the small office staff, the Senior Office Specialist duties have not been properly segregated. The Senior Office Specialist has the ability to enter approved invoices and then electronically transfer this information to Accounts Payable for processing. Once processed, this information is electronically transferred back to Risk Management and any discrepancies are investigated and reviewed by the Senior Office Specialist. The risk exists

that the Office Specialist could process a payment that does not agree with the approved invoice and this would not be detected.

Auditor's Recommendation:

We recommend that a process be implemented that requires a separate review of the actual invoice to the electronic data before it is transferred to Accounts Payable. This review should make sure that the approval by the Claims Adjuster was documented on the actual invoice. They should also compare the approved invoice to the electronic payment file to ensure that the amount and the vendor's name and address are in agreement. Furthermore, the individual who performs the independent review should then transfer the electronic file so that no changes can be made. This review process should be documented to provide evidence that this review occurred.

City's Response:

Risk Management agrees with the auditor's recommendation in concept, and understand and support the importance of establishing adequate checks and balances. Currently, a provider's bill is reviewed by the claim adjuster and fee scheduled before it is delivered to claim processing for payment of the bill. We send payment requests to accounts payable weekly. Prior to sending the request a supervisor reviews a paper payment schedule and signs off on the payment request. Any large payment request is questioned. The workers' compensation supervisor reviews a listing of new claims each month to provide assurance that all claims are actually claims. Our administrative technician reconciles and balances the workers' compensation self-insurance fund monthly. Risk Management's budget currently does not have the staff time needed to perform the auditor's recommendation.

4. There is an informal policy to allow approximately 21 days for an employee to report an incident before a penalty applies.

Per the Colorado Department of Labor, 2005 Colorado Workers' Compensation Act, Section 8-43-102, an employee who sustains an injury from an accident shall notify the employer in writing within four days of the occurrence of the injury. For each day of late reporting, the employee may lose up to one day's compensation for time lost due to injury. The written policy in the City's Workers' Compensation Claims Manual stated that the claim must be reported in writing within four days.

In the sample we tested, there were several instances where individuals reported injuries after four days and were fully paid for time lost due to injury.

After a discussion with Risk Management, we learned that there was an informal policy within the organization to allow employees to report injuries up to 21 days before they were considered late.

The workers' compensation documentation for new employees stated that injuries had to be reported no later than 48 hours or benefits could be suspended. This language is in conflict with the State regulations and City Policy which allow four days to report an injury before an adjustment to benefits can occur.

Auditor's Recommendation:

We recommend that the policy to report injuries be reviewed to determine the allowable time an employee has to report injuries before a penalty applies. This policy should be in compliance with State regulations and be documented. Reference material in the Claim's Manual and on the new employee form should be updated appropriately.

City's Response:

Senate bill 90-26 was signed into law on June 8, 1990. The statute required written notice of a claim within four working days. Our claim program was designed to establish personal contact with our employees. We received authority from the Division of Workers' Compensation to waive the written requirement if an employee contacts the claims office, reports the claim by telephone or files a minor injury report. Case law interpretation of the statutory filing requirements requires the employer to show neglect in providing notice of a claim. In our investigations, if an employee reports an injury to a supervisor or in some instances to another employee, it is considered notice to the employer. The second prong to the penalty test for late reporting is for the employer to prove it was prejudiced by the conduct. We have but rarely imposed a penalty against an employee for a merited claim for benefits.

5. Worker's Compensation premiums were not calculated correctly.

We recalculated the workers' compensation premiums charged to the various City departments by job code. The majority of the premiums did not recalculate correctly. For 2005, the material differences by job code ranged from \$1,500 to \$26,800. The total variance of the amount reported and the amount recalculated was approximately \$53,900.

We detected an error in the system generated report that Payroll relied upon to charge premiums to the various departments. This error caused premiums to be calculated incorrectly. Although the overall Fund contributions collected were sufficient to pay current claims, this was only coincidental due to fluctuations in staffing throughout the year.

Auditor's Recommendation:

We recommend the report used by Payroll to charge workers' compensation premiums be corrected. Procedures should be implemented to review this report to ensure premiums are calculating correctly. Any discrepancies should be investigated and corrected immediately.

City's Response:

We agree with this recommendation and will ask our Finance Payroll section to help us resolve this issue.

6. The information provided to the Claim Reserve Fund Committee (Committee) could be improved.

Each year Risk Management prepares a set of reports detailing the history of the Fund along with recommendations for the following year's funding. The information is presented separately for the City and Utilities.

The City and Utilities have two different committees that determine the amount needed to adequately fund their portions of the Fund. For each of these committees, a memo from Risk Management is prepared recommending funding. Attached to the memo are some supporting documents. One of these documents is called the Claim Reserve Fund Report (Report). The Report displays five independent columns that provide current and historical financial information regarding the Fund. See Table 2. This information is then used by the Committee to set contribution requirements.

The Report column titles are misnomers and could be misleading without further explanation. This Report could be improved to provide better information to the Committee in which to base funding decisions.

Specifically, the second column is headed "Balance" but does not include outstanding claims. A more appropriate title would be "Balance before Outstanding Claims." A footnote would also suffice.

The third column is headed "Outstanding Reserves." The data presented is actually the amount of claims incurred but not yet paid. However, the title appears to indicate that this is the amount of reserves in the Fund. A more descriptive title would be "Outstanding Liabilities".

The fourth column is headed "Contributions." However, the data presented here is the amount requested, not the amount actually contributed. We recommend the data under that heading show the actual contributions for the year.

In addition, the Report should include other inflows such as interest and other outflows so that the beginning balance plus contributions and other inflows less paid claims and other outflows equals the ending balance.

Auditor's Recommendation:

We recommend that the headings in this document be modified to properly reflect the actual data presented. We also recommend additional columns be added in order to reflect all activity affecting the balance of the Fund in a given year. This would improve the information relied upon by the Committee for funding decisions.

City's Response:

We agree with the Auditor's recommendation and are preparing a report to support the recommendation. A corrected report will be sent to the Claim Reserve Funding committee this year.

CONCLUSION

Based on the testwork performed, proper underwriting techniques were used, claim procedures were properly followed, and accounting was in accordance with GAAP. However, as of December 31, 2005, the Workers' Compensation Fund for the City was underfunded by \$2,685,152. Utilities funding appeared to be adequate. Increased contributions are necessary to provide for adequate reserves for the City in the Fund.

We thank Risk Management for their excellent cooperation during this review. Their attitude regarding our audit was exceptional as they desire to continually improve their operations.

Please contact me if you have any questions regarding this report.

Sincerely,



Jeff Litchfield
City Auditor

cc: Lorne Kramer, City Manager
Mike Anderson, Asst. City Manager
Terri Velasquez, City Finance Director
Vicki Phillips, City Accounting/Payroll Manager
Mark Anderson, City Risk Manager
Victoria McColm, City Sr. Claims Adjuster
Ann Crossey, City Human Resources Director
Kimberly Bingman, City Payroll Supervisor
Jerry Forte, Utilities Executive Director
Edward Easterlin, Chief Planning & Finance Officer
Jeanne Brown, Utilities Continuous Improvement Manager
Sandi Yukman, Integrated Resources Division Officer
Sonya Thieme, Accounting Manager

Table 1 Comparative Statistics – City of Colorado Springs and Colorado Springs Utilities

	2004		2005	
	<u>Utilities</u>	<u>City</u>	<u>Utilities</u>	<u>City</u>
Number of Employees	2,045	2,935	2,082	2,995
Number of Claims	133	362	147	451
Claims Per 100 Employees	6.50	12.33	7.06	15.06
Total Contributions	\$3,009,865	\$2,898,926	\$2,042,751	\$3,205,154
Total Claims Paid	\$928,811	\$2,802,079	\$1,574,617	\$2,973,098
Average Claim Paid	\$6,984	\$7,741	\$10,712	\$6,592
Total Outstanding Claims	\$1,939,832	\$3,151,615	\$2,242,416	\$2,879,898
Fund Balance	\$1,668,062	\$(2,324,360)	\$1,078,907	\$(2,685,152)

Table 2 City's Workers' Compensation Claims Reserve Fund Report

YEAR	BALANCE	O/S RESERVES	CONTRIBUTIONS	PAID CLAIMS
1996	\$2,813,858	\$3,797,992	\$2,550,000	\$2,016,086
1997	\$3,618,735	\$3,057,877	\$2,550,000	\$2,402,864
1998	\$3,498,877	\$2,752,688	\$2,200,000	\$2,541,781
1999	\$3,564,503	\$3,087,807	\$1,950,000	\$2,367,513
2000	\$3,312,485	\$3,455,286	\$1,750,000	\$2,755,657
2001	\$3,251,548	\$2,353,070	\$1,750,000	\$2,175,917
2002	\$2,927,191	\$2,483,372	\$1,600,000	\$2,828,213
2003	\$1,537,570	\$2,777,137	\$1,510,000	\$3,410,439
2004	\$ 827,255	\$3,151,615	\$1,470,000	\$2,802,079
2005	\$ 217,643	\$2,879,898	\$1,970,000	\$2,973,098

Data provided by Risk Management