



**CITY OF COLORADO SPRINGS  
OFFICE OF THE CITY AUDITOR**

**08-06 – MEMORIAL HEALTH SYSTEM WORKERS'  
COMPENSATION SELF INSURANCE FUND**

**PUBLIC REPORT**

**APRIL 30, 2008**

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City of Colorado Springs



## Office of the City Auditor Public Report

Date: April 30, 2008

To: Honorable Mayor and Members of City Council  
Members of Memorial Health System Audit Committee  
Members of the Memorial Health System Board of Trustees

Re: 08-06 – Memorial Health System Workers' Compensation Self Insurance Fund

We performed an audit of Memorial Health System's (MHS) Workers' Compensation Self Insurance Fund. The audit period was May 2005 through December 2006.

The purpose of the audit was to review the Workers' Compensation Self Insurance Fund to determine that proper underwriting techniques, sound funding procedures, loss reserves, claims procedures, and accounting practices were being followed in the management and operation of the Workers' Compensation Claim Reserve Fund.

Based on the test work performed, we conclude proper underwriting techniques were used and claim procedures were properly followed. We did identify nine findings and recommendations for areas where we believe internal controls could be strengthened.

As always, feel free to contact me if you have any questions.

Sincerely,

Jeff Litchfield  
City Auditor

cc: Larry McEvoy, Interim Chief Executive Officer  
Gary Flansburg, Chief Financial Office/Senior Vice President  
Bonnie Angotti, Vice President of Ambulatory Services  
Carlene Crall, Vice President/Chief Human Resources Officer  
Colleen Jones Henry, Director Employee/Occupational Health & Workers' Compensation  
Will Mercado, Workers' Compensation Administrator  
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# 08-06 – MEMORIAL HEALTH SYSTEM WORKERS’ COMPENSATION SELF INSURANCE FUND

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### Abbreviations and Acronyms used in this Report

The Act	2006 Colorado Workers' Compensation Act
Division	State of Colorado Department of Labor and Employment Division of Workers' Compensation
OWC	Memorial Health System's Office of Workers' Compensation
MHS	Memorial Health System
Annual Review	Self-Insured Permit Holder's Annual Review
Finance	Memorial Health System's Finance Department
The City	City of Colorado Springs
RTO	Recovery Time Objective
RPO	Recovery Point Objective

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## Introduction

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### AUTHORIZATION

We performed an audit of Memorial Health System's (MHS) Workers' Compensation Self Insurance Fund for the period beginning May 1, 2005 and ending December 31, 2006. We conducted this audit under the authority of Chapter 1, Article 5, Part 602(I) which states:

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.

### ORGANIZATIONAL PLACEMENT

The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council. The audited entity in this audit was Memorial Health System (MHS), which is an enterprise fund of the City of Colorado Springs under the direction of its Chief Executive Officer. The Chief Executive Officer reports to the Memorial Health System Board of Trustees, who are appointed by the City Council.

### SCOPE AND METHODOLOGY

The purpose of this audit was to comply with Section 1.5.602 (I) of the City Code that requires the City Auditor to conduct an examination at least every two years to determine if:

- proper underwriting techniques were used,
- sound funding procedures existed,
- adequate loss reserves existed, and
- claims procedures were being followed.

The audit also included a review and evaluation of internal controls related to the documentation and payment of Workers' Compensation claims.

The audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. The audit included interviews with appropriate personnel and included such tests of records and other supporting documentation as deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests were performed. Sufficient competent evidential matter was gathered to support our conclusions.

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## Introduction

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### BACKGROUND

MHS has been a self-insured, self-administered employer with regard to Workers' Compensation since August of 1994 governed by the 2006 Colorado Workers' Compensation Act (the Act). The Office of Workers' Compensation (OWC) was staffed by a claims analyst and a support specialist. The OWC has experienced significant changes in management over the last two years. As of December 31, 2006, MHS had approximately \$4.6 million reserved for Workers' Compensation claims.

### COMMENDABLE PRACTICES

In the course of our audit, we did note one item we consider a Commendable Practice. During August of 2006, the current claims analyst began managing the operations of the OWC. Current management adopted a philosophy of active claim management. In addition, the claims administration software was utilized extensively by the OWC staff to ensure compliance with the Act.

### OVERALL OPINION

Based on the test work performed, we conclude proper underwriting techniques were used and claim procedures were properly followed. We did identify nine findings and recommendations for areas where we believe internal controls could be strengthened.

***We have made no determination as to which findings are more important than others.  
Therefore, the findings are not necessarily listed in order of importance***

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## Findings, Recommendations and Responses

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1. **There were no policies or procedures governing the preparation of the Self-Insured Permit Holder's Annual Review Data which resulted in inadequate supporting documentation and untimely filing.**

As a self-insured permit holder, MHS was required by the *Rules Governing the Issuance of Self Insurance Permits Under the Workers' Compensation Act* to file a *Self-Insured Permit Holder's Annual Review Data* (Annual Review) worksheet with the State of Colorado Department of Labor and Employment Division of Workers' Compensation (the Division). The Annual Review worksheet and required supplementary information was to be filed with the Division within 60 days following the anniversary date of the permit. MHS's permit anniversary was August first.

We reviewed the Annual Review worksheets as filed by MHS for 2006 and 2005. There was no documentation maintained to support the claims history data provided on the 2006 and 2005 Annual Reviews. MHS's claims administration software was used to gather the data, but those reports were not printed and maintained for support. The 2006 Annual Review was not filed within 60 days of the permit anniversary date. MHS did not incur a penalty for the untimely filing of the 2006 Annual Review.

***Auditor's Recommendation:***

We recommend that the OWC develop policy documentation to ensure the Annual Review is adequately supported and timely filed. The policy should document the procedures to be followed for compilation of the claims history data, include details regarding supporting documentation to be maintained, and steps to ensure timely filing.

***MHS's Response:***

We agree with the recommendation. The following corrections have been implemented. The 2007 report was filed on August 20, 2007—well within 60 days of the self-insurance permit anniversary date. Moreover, internal instructions on the preparation of these reports are now in place. Along with instructions issued by the Division of Workers' Compensation in its annual tasking letter, there is sufficient guidance to facilitate the accurate and timely submission of Annual Review reports.

***Projected Implementation Date:*** Completed August 2007.

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## Findings, Recommendations and Responses

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### 2. The quarterly analysis of the Workers' Compensation Reserve was insufficient.

A quarterly analysis of the Workers' Compensation Reserve was prepared by MHS's Finance Department (Finance). The December 2006 analysis that we examined did not contain evidence of timely preparation or review. Although claim payments were processed through this account, there was no reconciliation between claims paid per the claims administration software and the general ledger. The adequacy of the reserve was evaluated by an independent actuarial study conducted on a biennial basis, but the reserve was not evaluated for adequacy during the quarterly analysis process. There was no communication between the OWC and Finance regarding the actuarial study or claim reserves.

Best practices for internal controls over financial reporting require that analysis impacting the general ledger be reviewed and approved by a knowledgeable person, independent of the preparer, in a timely manner.

#### ***Auditor's Recommendation:***

We recommend that the general ledger reconciliation process as it relates to the Workers' Compensation Reserve be strengthened by:

- increasing communication between the OWC and Finance regarding claims reserves,
- reconciling claims paid per the claims administration software and the general ledger,
- evaluating the adequacy of claims reserve through the analysis of claims history, reserves against open claims and the biennial actuarial study, and
- requiring an independent timely internal review.

#### ***MHS's Response:***

We agree with the recommendation. The OWC will provide a monthly report from the claim management software to the Finance Department to be used for the general ledger reconciliation process. In addition, the following steps have been taken to improve communications and enhance collaboration between the OWC and Finance:

- The OWC gave Finance a management book with copies of the most recent reports for payment of surcharge taxes and annual renewal of our self-insurance permit. The book also has a copy of the policy summary page showing policy limits and a copy of the most recent surety bond, obtained to protect unpaid losses.
- A new cost center was created to consolidate all the budget line items for the Workers' Compensation program. This provides a better instrument to track program losses and expenses as well as to conduct trend analysis.
- The Finance Department will produce a quarterly report for the new cost center with reconciliation statements to conduct trend analysis and review the adequacy of reserves.

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## Findings, Recommendations and Responses

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- The independent internal review will be overseen by the Controller/Associate Administrator.
- The most recent independent actuarial study, estimated our unpaid losses at \$2.6 million, a reduction from \$3.9 million 2 years ago. Further validation of the adequacy of our reserves was provided by the Division of Workers' Compensation. They estimated our unpaid losses at \$2.8 million as a result of their annual review in conjunction with the renewal of the self-insured permit. Our current reserves stand at \$2.8 million.
- These procedures will be added to the Workers' Compensation Procedures Manual.

***Projected Implementation Date:*** Completed January 2008.

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## Findings, Recommendations and Responses

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### 3. The policies and procedures were not reflective of current practices.

MHS adopted the City of Colorado Springs' (the City) Workers' Compensation policies and procedures manual but did not fully update them to reflect the actual practices of the OWC. Certain appendices that are utilized by the City are not utilized by the OWC, but have not been removed from the policies and procedures manual. The policies and procedures contained references to City employees. The policies and procedures referred to Article 54 of the Act that was no longer applicable.

***Auditor's Recommendation:***

We recommend that the OWC thoroughly review and make needed updates to the policies and procedures manual. The policies and procedures manual should be reflective of MHS's current practices.

***MHS's Response:***

We agree with the recommendation. A new procedures manual was approved effective February 6, 2008 and is posted on Memorial's M-Net or intranet. The procedures manual provides internal guidance for the MHS Workers' Compensation Program. It does not duplicate information already in the Colorado Workers' Compensation Act and Rules of Procedure or information that is otherwise available in the website of the Division of Workers' Compensation.

***Projected Implementation Date:*** Completed February 2008.

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## Findings, Recommendations and Responses

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### 4. The Workers' Compensation payment process was not adequately segregated.

The claims analyst and support specialist of the OWC had the ability to create a new claim in claims administration software, enter medical bills into the claims administration software, and create check requests. The check requests were approved by the Director of Workers' Compensation. Processed payments received from Accounts Payable are returned to the OWC for distribution to claimants and medical providers.

A fictitious claim could be created in claims administration software and illegitimate medical bills could be paid without detection.

#### ***Auditor's Recommendation:***

We recommend that the payment process be segregated by:

- restricting access to enter bills into the claims administration software from the staff of the OWC, and
- requiring that one member of the OWC staff prepare the check request while the other member of the OWC staff receive the payments from Accounts Payable, compare to the original check request, and distribute payments.

In addition, as detailed in Finding 2 above, we recommend a reconciliation of the claims paid per the claims administration software and the general ledger. This practice would increase controls regarding OWC related payments.

#### ***MHS's Response:***

We respectfully disagree with the finding and support the goal of implementing strong financial controls. We believe our financial controls have sufficient checks and balances to prevent the fraudulent issuance of payments. The controls are found in our procedures manual. They are as follows:

- OWC staff do not enter most medical bills into the claims administration software. That task is performed by staff at the Medical Network Department.
- This is done after the bills are returned by Corvel, the company that reviews and re-prices bills according to the Colorado Fee Guidelines.
- OWC staff request the checks, but the payments are issued by Accounts Payable in Finance.
- The medical payments are generally issued back to Memorial Health System as most medical treatment is provided in house. Other payments go to referral doctors and other health care providers in the community in the event employees are referred outside Memorial Health System. Payments for medical bills do not go to individual claimants.
- Settlement payments will be approved by a member of the executive team in addition to the OWC department management.
- Every check request includes supporting documentation and is reviewed and approved by the Director prior to being forwarded to Accounts Payable. Each check is reviewed and approved by the Accounting Manager.

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## Findings, Recommendations and Responses

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- After the check is received back at the OWC, payment is recorded in the claim management software and evidence of the transaction, with supporting documentation, is filed in the file folder where it is available for audit.
- Moreover, should a member of the OWC staff become injured on the job, Potential Conflict of Interest provisions in the Procedures Manual require MHS to contract with a third party administrator to manage that particular claim.

### ***City Auditor's Response:***

We acknowledge that MHS has implemented some compensating controls around payments. However, the OWC staff still have the ability to start a claim, enter bills into the system, and distribute payments. We recognize that there is significant risk associated with the current situation. We did not determine whether the current software used by the OWC could restrict access to achieve a more appropriate segregation of duties. We recommend that segregation of duties be considered when selecting new claims software as addressed in Finding 9.

### ***Management's Acceptance of Risk:***

We acknowledge and accept the risks associated with our current environment.

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## Findings, Recommendations and Responses

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**5. The 2006 Payroll Statement Forms were not adequately supported and the process to compile the data was not documented.**

The Act required MHS to file a Payroll Statement Form with the Division on a semiannual basis. The data was compiled by Finance and provided to the OWC, which fills out the Payroll Statement Form. During the course of this audit, MHS Finance was unable to reproduce or reconcile the amounts reported on the 2006 Payroll Statement Forms filed with the Division.

***Auditor's Recommendation:***

We recommend that MHS document the process to be followed by Finance to compile the Payroll Statement Form data. Adequate documentation should be provided by Finance to the OWC supporting the Payroll Statement Form data.

***MHS's Response:***

We agree with the recommendation and have implemented the following process:

- Budget/Decision Support will generate payroll information for the requested time period utilizing the decision support system.
- Payroll information will cover all Memorial Health System employees.
- Payroll expense will include the appropriate payroll pay codes to reflect the paid wages, excluding bonuses and paid time off payouts.

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## Findings, Recommendations and Responses

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### 6. The claims handling and processing procedures were not adequate.

We observed an overall lack of controls and maintenance of claimant files. Based on our test work of 32 files, we noted the following:

- 6, or 19% had late filings to claimant and/or Division,
- 8, or 25% did not contain adequate documentation to support medical and/or indemnity payments,
- 7, or 22% were missing documentation, and
- 4, or 13% were not updated as required or on a regular basis.

Our tests included activity from May 2005 through December 2006. We want to acknowledge that the current OWC manager was not in place until August 2006. Most of our audit period was under prior management. We did not test 2007 claim handling, but recognize a general attention to detail and quality of work ethic on the part of the current staff.

#### ***Auditor's Recommendation:***

We recommend that MHS develop and document claims handling and processing procedures. The development and documentation of an internal control system for claims handling and processing will help to ensure that claims are appropriately handled. Such a system will also improve the efficiency and effectiveness of the claim handling procedures.

#### ***MHS's Response:***

We agree with the recommendation. Since August 2006, OWC staff have systematically implemented a number of measures to improve the efficiency and effectiveness of claims handling procedures. Among them are:

- Extensive use of the claims administration software to include consistent use of the electronic diary to suspense claim management actions.
- Revamped the filing process to include dividing file folders in categories for ease of use.
- Indemnity payments are managed in an ongoing basis (as changes occur) through the use of a worksheet. The worksheet is submitted to Payroll along with check requests to document the rationale for each payment.
- All files are under active management and progressing towards final resolution.

***Projected Implementation Date:*** Complete and subject to continuous improvement.

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## Findings, Recommendations and Responses

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**7. The system recovery plan for claims administration software has not been developed or tested.**

MHS has not developed or tested a system recovery plan for the OWC's claims administration software. Per the Business Impact Analysis provided by MHS, the claims administration software Recovery Time Objective (RTO) was two hours and the Recovery Point Objective (RPO) was no more than 24 hours. The RTO was used as a basis for developing the recovery strategies and was a determinant as to whether or not to implement the recovery strategies during an outage. The RPO was the point in time to which critical process must be recovered after an outage. While the claims administration software was not as critical as other MHS applications, a RPO of no more than 24 hours does indicate the importance of the system to MHS's operations.

***Auditor's Recommendation:***

We recommend that MHS develop and test a system recovery plan for its claims administration software.

***MHS's Response:***

We agree with the recommendation. We are currently in the process of creating a system recovery plan for each of the two classes of servers we utilize: virtual and physical. Once the plan is implemented, we will test it to ensure it meets our disaster recovery requirement.

***Projected Implementation Date:*** April 2008

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## Findings, Recommendations and Responses

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### 8. The claims administration software backup data was not encrypted.

The backup data of the claims administration software was not encrypted.

Confidential claimant data contained on the backup tapes could be compromised if the backup tapes were misused.

***Auditor's Recommendation:***

We recommend that the claims administration software backup tapes be encrypted.

***MHS's Response:***

Management has reviewed the current configuration for tape backup systems and processes and believes that the information is adequately protected. We will evaluate the auditor's recommendations for encryption of the tapes and determine if the added expense warrants any benefits of encryption.

***City Auditor's Response:***

We acknowledge and understand MHS's position on this issue. However, we believe every reasonable method to protect employee personal and medical information should be pursued.

***Management's Acceptance of Risk:***

We are willing to accept the risk associated with our current practice if we decide not to make any additional changes.

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## Findings, Recommendations and Responses

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### 9. The claims administration software should be upgraded.

MHS, at the time of our audit, used an older version of its claims administration software. This version did not allow system users, prior employee user access in this case, to be deactivated. If a system user was deactivated, certain history would be lost from the system.

In addition, the operating version in use during our review did not allow integration with MHS's third-party medical re-pricing vendor. Integration with the medical re-pricing vendor would eliminate certain administrative tasks associated with Workers' Compensation claims processes.

***Auditor's Recommendation:***

We recommend the claims administration software be upgraded to enhance internal controls such as being able to deactivate a terminated employee. The upgrade will also allow for increased efficiencies.

***MHS's Response:***

We agree with the recommendation. Rather than upgrade to a newer version of the current software, we have decided to conduct an open competition for award of a replacement. The current vendor, RiskEnvision, will be invited to participate. Development of award criteria is under way. Any changes are subject to the availability of capital funds.