



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

**08-07 – COLORADO SPRINGS
CLAIMS RESERVE FUND**

PUBLIC REPORT

JULY 23, 2008

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Office of the City Auditor

Public Report

Date: July 23, 2008

To: Honorable Mayor and Members of City Council

Re: 08-07 – Colorado Springs Claims Reserve Fund

We performed an audit of the Colorado Springs Claims Reserve Fund for the period January 1, 2005 through December 31, 2006.

The purpose of our audit was 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 Claims Reserve Fund. We reviewed the claim processing procedures and policies, fund balance, internal controls, and the City Code where it applied to the fund. Our fieldwork covered the period from January 1, 2005 to December 31, 2006.

Based on the test work performed, we conclude proper underwriting techniques, sound funding procedures, loss reserves, claims procedures, and accounting practices were being followed in the management and operation of the Claims Reserve Fund. We did identify areas where internal controls could be strengthened and have presented those findings and our recommendations.

Finding four addresses the adequacy of the balance in the Claims Reserve Fund. Since December 31, 2007 data was available and we did believe it reliable, we incorporated it into our Finding. We believe the recommendation for Finding four needs to be implemented before the end of 2008.

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

Sincerely,

A handwritten signature in purple ink that reads "Jeff Litchfield".

Jeff Litchfield
City Auditor

cc: Penelope Culbreth-Graft, DPA, City Manager
Michael Anderson, Assistant City Manager
Pat Kelly, City Attorney
Ann Crossey, Human Resources Director

CITY AUDITOR JEFF LITCHFIELD, CPA CIA CFE

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Abbreviations and Acronyms used in this Report

Fund	Claims Reserve Fund
RMIS	Risk Management Information System
SA	System Administrator

Introduction

AUTHORIZATION

We performed an audit of the Colorado Springs Claims Reserve Fund for the period January 1, 2005 through December 31, 2006. We conducted this audit under the authority of Chapter 1, Article 5, Part 502(H) of the City Code which states:

1.5.502(H): CLAIMS 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 claims reserve fund or any other funds being used to cover deductible amounts when there is insurance coverage. 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 Risk Management, which is under the reporting structure of the City Manager. The City Manager is a City Council Appointee.

SCOPE AND METHODOLOGY

The purpose of our audit was 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 Claims Reserve Fund. We reviewed the claim processing procedures and policies, fund balance, internal controls, and the City Code where it applied to the fund. Our fieldwork covered the period from January 1, 2005 to December 31, 2006.

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 such test of records and other supporting documentation as was deemed necessary in the circumstances. We reviewed the internal control structure and performed compliance tests. Sufficient competent evidential matter was gathered to support our conclusions.

BACKGROUND

The City has self-insured its operations and those of several of its enterprises since 1986. The Risk Management Division was established to manage and administer the operation of the Claims Reserve Fund. Along with administering the liability claims for the City, Risk Management also administers Springs Utilities liability claims.

Introduction

OVERALL OPINION

Based on the test work performed, we conclude proper underwriting techniques, sound funding procedures, loss reserves, claims procedures, and accounting practices were being followed in the management and operation of the Claims Reserve Fund. We did identify areas where internal controls could be strengthened and have presented those findings and our recommendations.

Finding four addresses the adequacy of the balance in the Claims Reserve Fund. Since December 31, 2007 data was available and we did believe it reliable, we incorporated it into our Finding. We believe the recommendation for Finding four needs to be implemented before the end of 2008.

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

Findings, Recommendations, and Responses

1. An inappropriate transfer was made from the Claims Reserve Fund.

Chapter 1, Article 5, Part 5, Sections (A), (C), and (D) of the City Code state:

(A) "At the end of any fiscal year, all unexpended and unencumbered monies in the claims reserve fund shall remain in the fund and **shall not** be credited or transferred to any other funds.

(C) Expenditures made out of the claims reserve fund in accord with this subsection **shall be made only** for the following purposes: 1) To pay general liability claims and automobile liability claims and related expenses brought against the City.... 2) To pay the costs of defense....

(D) Monies in the claims reserve fund **shall not** be used to pay any of the following: 3) Any other claim or expense not set forth in subsection C of this section." Emphasis added.

Page 16-1 of the 2005 budget that was presented to and approved by the City Council included a transfer of \$322,612 from the Claims Reserve Fund to the Capital Improvements Fund. The funds were transferred during the 2005 budget year.

In our reading of the City Code, even though Section (A) states "at the end of any fiscal year," we believe the intent of Section (A), when coupled with Sections (B) and (C), prohibit transfers of this type and therefore conclude the transfer was in violation of the City Code references mentioned above.

Auditor's Recommendation:

We recommend the City Code be followed and future transfers from the Claims Reserve Fund to other funds be disallowed. However, the City Auditor believes the net effect of this transfer could have been accomplished by reducing the revenues into the Claims Reserve Fund and transferring the amount of the reduction to the CIP funds. Therefore, we are not recommending the transfer be reversed. If, in the future, the City desires to transfer funds from the Claims Reserve Fund to other funds, we recommend the City Code be amended to allow the transfer (see Finding four for a discussion on why a future transfer may be necessary).

Risk Management's Response:

We agree; the City Code speaks to the issue of preserving the Claims Reserve Fund. We believe the intent is to prohibit the transfer of funds that could influence the integrity of the Fund and ability to pay claims required in any given year.

Findings, Recommendations, and Responses

2. A daily backup of the Risk Management Information System did not exist.

The City contract with the provider of the RMIS stated the City was responsible for creating and maintaining original backup of Risk Management's claim files. However, according to Risk Management, the consultant was responsible for and was currently creating and maintaining backup files for the RMIS. This system was a web-based system and the data resided on a server at the consultant's facility. Risk Management did not have its own server and did not perform a backup procedure.

Section 4.12 of the contract stated the City "has optional Disaster Recovery services," which required the City to send a full backup copy of the City's RMIS data to the Consultant.

If the consultant did perform a backup procedure, it was not documented in the contract. Furthermore, Risk Management had not tested the backup data by performing a recovery procedure. Risk Management was at risk of losing the claims data if the consultant loses the database on its server.

Auditor's Recommendation:

We recommend that Risk Management adhere to the terms of the contract by taking steps to create, maintain, and periodically test backups of their data. However, if Risk Management and the Consultant have agreed the Consultant will provide backup, maintenance, and testing services, we recommend this process be formally documented. The documentation might be as simple as a letter of understanding between the City and the Consultant or it might require an amendment to the original contract.

Regardless of who is responsible for the backup, we recommend Risk Management perform, or cause to be performed, routine testing of the backup procedures ensuring that recovery of data is viable and timely.

Risk Management's Response:

We agree with the recommendation. We are working with our Purchasing Division to have an 'audit clause' as recommended by the audit, to be added to our contract. Since our system is ASP hosted by Mountain View our data is stored on its servers for the life of the contract in accordance with retention policies. We will be exploring ways to ensure our data is periodically backed-up and the back-up tested.

Findings, Recommendations, and Responses

3. Internal controls over the claim payment process and establishing reserves need to be improved.

Internal Controls over setting of the reserve level were inadequate –

- The reserve level served as an estimate of liability. It served as a low-level control. The total payments of the claim should not be above the reserve level. Risk Management had a verbal policy that required the Office Specialist to have written authority before the reserves were increased. During testing, there were four instances when the reserves were increased over the authorized amount. In these instances, it appeared that a review of the current reserve level was not performed prior to increasing the reserve on the claims.
- The reserve level on one claim was increased in excess of the settlement authority level approved by the Claims Review Board.
- All adjusters were allowed to increase reserves. In addition, administrative staff also had the capability of increasing reserves, when directed and provided with written authorization.

Internal Controls regarding claims payments were weak –

- The Supervisor authorized and reviewed claim payments while having the ability to enter payments and create claims without upper management review. The performance of multiple tasks eliminated segregation of duties as an internal control.
- The Supervisor had the ability to add and edit vendor information without a review process. Accounts Payable did not verify vendor information or receive invoices with the Voucher Payment Reports.
- Adjusters had the ability to add and edit vendor (contact) information in the RMIS, initiate and approve payments, and add/increase reserve levels.
- Several staff members, including all adjusters, had the ability to receive checks from the Accounts Payable Department in order to hand-deliver payments to claimants.
- The System Administrator (SA) had unlimited access to the RMIS with no review by upper management. The SA performed other functions in the system including creation of claims, approval of payments, addition of vendors, and deletion of records.

Auditor's Recommendation:

We recommend internal controls over the setting of reserve levels be strengthened. Current procedures should be reviewed. Additional procedures should be established that would require the level of the reserve to be reviewed before a reserve level could be edited.

We recommend internal controls over the payment of claims be strengthened. Management should strive to eliminate inappropriate segregation of duties. If duties cannot be adequately segregated due to the size of the Risk Management Office, compensating controls should be developed. These compensating controls could include system access limitations via user profiles or exception reports to be reviewed by the Risk Manager. RMIS may be able to provide exception reports, audit trails, user access reports, or similar compensating controls.

Findings, Recommendations, and Responses

Risk Management's Response:

We agree with the recommendations in concept and understand and support the importance of establishing adequate checks and balances. Adjusters no longer have the ability to increase reserves and any reserve change must be supported by a written request processed by an office specialist. There is a rotation of duties when personnel are absent from the office. The Liability supervisor can no longer enter claim payments. Currently a claim adjuster processes a payment request for the settlement of a claim. We send payments to Accounts Payable weekly with some exception for rush payments. Prior to sending the request a supervisor reviews a paper payment schedule and signs off on the payment requests. It is the supervisor's responsibility to verify all payments are owed and large payments are verified and reviewed for settlement authority. A supervisor will review all new claims after they are created and before a payment can be processed. An adjusters' settlement authority cannot be exceeded without supervisor approval. Our principal analyst reconciles and balances the liability self-insurance fund monthly. A reserve can be posted in an amount greater than settlement authority however a claim payment cannot exceed the settlement authority granted on the claim. We also rely on the internal controls established by the Accounts Payable Division of Finance Department. We will continue to work on establishing greater internal controls subject to the limitations of our RMIS software and budget restrictions.

Findings, Recommendations, and Responses

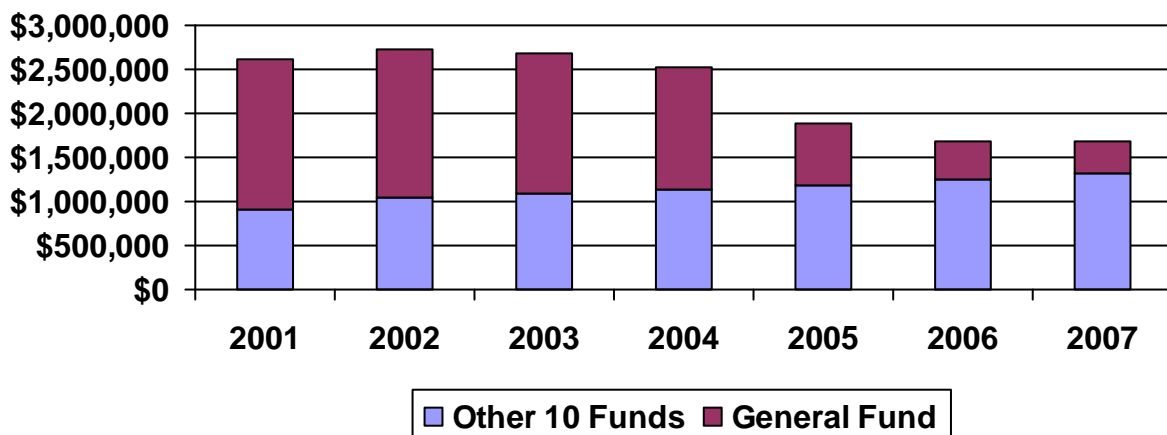
4. The balance in the Claims Reserve Fund has reached a point where it could be interpreted as being inadequate.

City Code 1.5.502 (B) stated, “The claims reserve fund shall maintain reserves to provide for the contingency that in any year the contribution to the claims reserve fund from other funds is not adequate to cover the actual expenses realized in that year.” We interpret this section of the Code to address the importance of protecting the City by providing reasonable assurance that funds will be made available to pay current and outstanding claims.

The same City Code section also stated, “The Risk Manager, after consultation with the Director of Finance and the City Attorney, shall recommend the amount of money that is required to maintain adequate reserves. Adequate reserves shall be maintained in the claims reserve fund subject to available appropriations made by the City Council at its discretion.” The Risk Manager, after meeting with the Director of Finance and the City Attorney, recommended that \$500,000 be contributed to the Claims Reserve Fund in 2005 and \$500,000 in 2006. The 2005 contribution was \$500,000; however the 2006 contribution, as recommended by the Budget Office and approved by the City Council was \$223,126.

The Code requires the City Controller to account for independent fund categories with the Claims Reserve Fund. We have found the City to be in compliance in this area and currently reports activity in 11 different fund categories. The chart shown below contains the balance in the Claims Reserve Fund for each of the last seven years. The years 2001 through 2006 are from this and our preceding two audits. The 2007 numbers are for the most recent year and, while they are unaudited, do represent the most current figures.

Claims Reserve Fund - Composition of End of Fiscal Year Balances



The above chart shows that the balance of the fund has steadily declined over the last six years, and while the total decline is 35.8%, the General Fund portion of the fund has declined 78.8% and the balance for the other funds has increased by 43.2%.

Findings, Recommendations, and Responses

The following table breaks out the 2007 End of Year Balance by Fund. It is sorted by each Fund's share of the total balance. We have also included a column which represents the Average Annual Sources by Fund and a column for Average Annual Uses by Fund. The Sources by Fund is comprised of transfers from those funds as well as investment income and changes in investment balances. For the General Fund, the Uses by Fund do not include the \$322,612 transfer mentioned in Funding 1.

Fund	2007 End of Year Balance	Average Annual Sources	Average Annual Uses
Cemetery	\$ 3,999	\$ 867	\$ 163
Development Review	15,418	3,245	675
Pikes Peak Highway	45,988	8,677	13,470
Human Services	51,515	7,256	1,757
Patty Jewett*	87,407	2,991	1,501
Valley Hi*	110,528	3,554	49
Parking System*	136,478	4,382	0
Regional Building*	226,359	7,916	5,735
Airport*	230,960	32,772	1,100
General Fund	356,907	535,797	663,984
Housing Authority*	<u>408,709</u>	<u>14,507</u>	<u>1,028</u>
Total	\$1,674,268	\$ 621,963	\$ 689,462

* These six Funds did not make a contribution to the Claims Reserve Fund in 2007. The Airport is the only one of these Funds to make a contribution in the last five years.

In looking at the 2007 End of Year Balance and the sum of the Average Annual Sources and Uses, it provides an impression that the overall Claims Reserve Fund has Adequate Reserves to cover the Average Annual Uses. However, if you look at the General Fund portion of the fund, you reach the conclusion the General Fund Balance will continue to be depleted and will soon (within four years) reach a zero balance, which translates to no reserves being available.

In looking at the above table, you also get the impression that some funds have Reserves that will probably never be used. For example, the Housing Authority has a balance of \$408,709 with average annual uses of \$1,028. The Housing Authority has not made a contribution to the Claims Reserve Fund since 2002, yet, because of investment earnings, their balance has risen by \$56,373 during that time period. The current City Code does not allow these funds to be transferred back to the Housing Authority. There are currently six Funds that are not making contributions to the Claims Reserve Funds, yet, because of investment earnings, their balances are increasing each year.

Findings, Recommendations, and Responses

Auditor's Recommendation:

We recommend the City develop a definition of what is "Adequate Reserves," and using that definition, develop a plan to have each fund brought to their targeted level. As recommended in Finding 1, if the City desires to transfer funds from the Claims Reserve Fund to other funds, including the Fund that made the initial deposit, we recommend the City Code be amended to allow the transfer.

Risk Management's Response:

We agree with the audit recommendations. This discussion began at the Claims Reserve Fund committee meeting on May 6, 2008. The Claims Reserve Fund committee agreed to take on the responsibilities to establish a governance policy to include a definition of 'adequate funding'. Funding recommendations for 2009 were increased to prevent any further erosion of the fund balance.